



HELPING CLIENTS BUILD AND MANAGE WEALTH™

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THE BACK BAY ADVISOR

Should You Favor Growth or Value Investing?

The two basic investing styles are growth and value. While one style tends to perform better at any given time, the dominant style varies over time. The basic elements of each style include:

Growth Investing

Growth investors look for stocks with above-average growth in sales and earnings, typically at a 15% or higher annual rate. Growth companies tend to have higher price/earnings (P/E) ratios with little or no dividends, since earnings are typically used to finance future growth. As growth stocks gain favor, investors tend to bid their prices up to lofty levels. Earnings projections largely drive the value of these companies, so earnings disappointments can dramatically impact their value.

When searching for appropriate growth stocks, you should be looking for a fast-growing company that you feel will be able to sustain that growth for an extended period of time. Characteristics of fast-growing companies include a strong franchise and management, dominant market share and industry position, high return on equity, consistently superior earnings growth, high stock price and P/E ratios, and some stock price volatility.

How likely is it for a company to sustain above-average growth for an extended period of time? One study looked at companies in the Standard & Poor's 500 (S&P 500) for

the period from 1991 to 2003, and identified how many were able to sustain a 10% growth rate for multiple successive years.* During that time, 145 companies had a 10% growth rate for one year, but that declined to 22 companies for five years, three for 10 years, and only one for the entire 13 years. For the same time period, 87 companies experienced a 25% growth rate for one year, but that declined to 12 for five years and by the ninth year, no companies had a 25% growth rate (Source: *Evading Mean Reversion*, 2005).

Value Investing

Value investors emphasize stocks with market values that are low based on earnings, dividends,

or assets. Companies in this category typically include those in out-of-favor industries, turnaround or troubled companies, or mature and stable companies with modest growth expectations. Dividend yield may be higher than average since the stock price is low. Signals that a company may be turning around include insider buying, improving profit margins, increasing earnings estimates, or higher trading volumes. Value investors must typically exhibit patience since it can take a while for the market to realize a particular stock's value.

When searching for value stocks, you should look for a company with depressed earnings and a

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When Should You Sell?

It's always difficult to determine the proper time to sell a stock. What if you sell and the stock price increases dramatically? Or what if you hold on to the stock and its price declines? To help you decide when to sell, consider these signals:

- **The price of a stock with a large loss isn't moving.** Investors hate selling a stock with a loss, often wanting to hold on until they at least break even. However, just because the stock's price was much higher in the past doesn't mean it will hit that price anytime soon. You may want to sell and reinvest in another stock

with better prospects. To help make that decision, forget what you paid for the stock. Instead, analyze it at its current price, deciding whether you would purchase it now at that price.

- **The stock has hit your target sell price.** When you purchase a stock, set both high and low target sales prices. While you don't have to sell when the stock hits those prices, you should at least review it at that time. You might want to set rigid rules for selling a stock when it declines by a certain percentage of your purchase

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Growth or Value?

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stock price that you feel will recover soon. Characteristics of good value companies include low stock price valuations, low price/earnings and price/book ratios, higher dividend yields, and short-term problems.

Which Style Performs Better?

Growth stocks typically do well when the economy is growing and the stock market is rising, while value stocks typically do well when the stock market is peaking or falling. Many investors are naturally drawn to a growth investing style since growth stocks usually have exciting news, capturing much press attention. Value companies often receive unfavorable press, requiring more resolve on the investor's part to continue holding them.

So which style will excel in the future? Just as you can't predict where the market is headed, it is difficult to determine when each style will dominate. Thus, it may make more sense to include both styles in your portfolio. That way, no matter what style dominates, it will be represented in your portfolio. One study reviewed the performance of a value portfolio, a growth portfolio, and a portfolio with 50% value stocks and 50% growth stocks during the period from 1981 to 2003. Over three-year rolling periods during that time, the combined portfolio outperformed the S&P 500 57% of the time, compared to 53% of the time with growth stocks and 52% of the time with value stocks. The combined portfolio outperformed the S&P 500 62% of the time over five-year rolling periods and 75% of the time over 10-year periods (Source: *Strategy and Tactics in Style Investing*, Autumn 2004).

Please call if you'd like to discuss investing styles and their impact on your portfolio. ■■■

* The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future results. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.

Reviewing a Company's Annual Report

Whether you're researching a stock to purchase or monitoring a stock you own, the company's annual report should be central to your analysis. Annual reports contain a wealth of financial information, which can provide significant insight into a company's operations and future prospects.

Annual reports generally contain three key sections — management's message to shareholders, a discussion of the company's operations, and the financial statements. Keep these points in mind when reviewing the annual report:

- **Read the independent auditor's report.** In most cases, you'll find an unqualified opinion stating the financial statements were audited in accordance with standards of the Public Accounting Oversight Board and present fairly, in all material respects, the financial position of the company for the last three years. You'll want further details if the report indicates problems, concerns about the company's ability to stay in business, or incidences where the financial statements do not follow generally accepted accounting principles. Many companies have changed auditors in recent years to reduce costs or for other factors. Make sure, however, that any auditor changes are not a result of disputes with the auditors.
- **Review management's discussion carefully.** You want to feel comfortable that management is candid and straightforward about the company's results and is not glossing over problems or concerns. You should get a feel for the company's future prospects, its competitive position, and any significant risks to business operations.
- **Look for important facts in the footnotes.** Information about outstanding litigation, class action suits, derivative exposure,

environmental problems, and unfunded pension liabilities can be found here, alerting you to potential problems. Changes in accounting policies will also be discussed, which may indicate that management is making changes to improve financial results. You can also find important information about the company's business, including whether any customer accounts for more than 5% to 10% of sales, how much is spent on advertising and research and development, what shareholders' rights plans are in effect, how many stock options are outstanding, information on acquisitions and divestitures, and details on business segments.

- **Analyze financial trends over at least a three-year period.** Review whether sales and profits are increasing or decreasing. Also, calculate the profit margin (net income divided by revenues) and the return on equity (profits divided by average shareholder equity), comparing these to prior years and to ratios for other companies in the same industry.
- **Review the company's financial solvency.** Calculate the current ratio (total current assets divided by total current liabilities) to track the company's ability to pay creditors over the short term. Longer-term solvency can be measured by dividing total liabilities (the total of current liabilities, long-term debt, other liabilities, and deferred income taxes) by total assets. Compare these numbers to the company's figures from prior years and to other companies in the same industry to see if there is cause for concern.

It takes time and careful analysis to get a complete picture from the information presented in an annual report. Please call if you'd like help with this process. ■■■

Should You Sell?

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price, to ensure you don't incur substantial losses. Many investors find it emotionally difficult to sell a stock at a loss, so this rule takes the emotion out of that decision. Keep in mind that capital losses can be offset against capital gains, and an excess of \$3,000 can be deducted against ordinary income. Any remaining capital losses can be carried forward indefinitely.

- **Your stock's performance is lagging the market or its industry.** Compare your stock's performance to that of other stocks in the same industry and to the overall market. Keep in mind that your stock's performance will vary over time, depending on the stage of the market cycle and how your stock's industry is performing in that cycle. Consider selling a stock that has lagged in performance for an extended period.
- **The stock's fundamentals have changed.** The world is constantly changing and the market leaders of today may not be the market leaders of tomorrow. Thus, watch your stocks so you can spot when fundamentals may be shifting.
- **The stock is subject to negative news stories.** You shouldn't sell a stock at the first sign of trouble, since it's not unusual for a stock to go through a difficult period. But if the news is continuing and involves significant events like management shakeups, major competitors stealing market share, unwelcome mergers and acquisitions, or top executives selling large blocks of stock, it's time to reevaluate the stock.
- **The stock's price has run up too much, too quickly.** While this is a good thing, the price could have risen so significantly that

Your Stock Allocation

Your asset allocation mix represents your personal decisions about how much of your portfolio to allocate to various investment categories, such as stocks, bonds, and cash. How much you allocate to each category depends on your financial objectives and personal circumstances. However, it is a percentage that is likely to change over time. As your needs for safety of principal and a steady income stream become more important, the percentage of stocks you own is likely to decrease. Some factors to consider when deciding how much to allocate to stocks include:

- **Your risk tolerance.** The advantage of including both stocks and bonds in your portfolio is that when one category is declining, the other category will hopefully offset this decline. For instance, in 2002, the Standard & Poor's 500 (S&P 500) returned -22.1%, while long-term government bonds returned 17.8% and intermediate-term bonds returned 12.9%.* One way to assess the percentage of stocks to include in your portfolio is to look at how holding varying percentages of stocks and bonds would have impacted your average return.
- **Your time horizon.** The longer your time horizon for investing, the more risk you can typically tolerate in your portfolio, since you have more time to overcome any significant downturns in your portfolio. Certainly, individuals with short time horizons, perhaps five years or less, should be very cautious about how much to allocate to stocks. But as your time horizon lengthens, you can theoretically add a higher stock mix to your asset allocation. However, in all situations, make sure you're comfortable with the percentage

allocated to each category.

- **Your return needs.** Your need to emphasize income or growth is likely to change over your life. When you are trying to accumulate significant assets for a goal far in the future, you may want to allocate more of your mix to stocks. However, when your needs for a predictable income stream become more important, such as when retirement approaches, you may want to allocate more to bonds.

Once you decide how much to allocate to stocks, you need to ensure that you diversify within the stock category. Consider large-capitalization stocks, small-capitalization stocks, value stocks, growth stocks, and international stocks. Each type of stock has different risks and return potential. If you'd like help assessing how much to allocate to stocks and how to diversify that allocation, please call. ■■■

* Source: *Stocks, Bonds, Bill, and Inflation 2006 Yearbook*, Ibbotson Associates. The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future results. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions. Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting methods. This may result in greater share price volatility.

you may not think it has the potential to increase much more in the future. At that point, you may want to sell and purchase another stock with better prospects.

If you have difficulty imple-

menting your sell strategies, call for a second opinion. Often, discussing your thoughts with someone else causes you to consider other factors or helps ensure your reasons for selling are valid. ■■■

News and Announcements

Back Bay Financial Group is 10 years old this fall! We are proud to achieve this milestone. Bob Siefert and John LeBlanc formed Back Bay Financial Group one decade ago, and we now manage more than \$295 million in assets. Some of our clients have been with us from the beginning and others have joined us along the way. We value the relationships we have with each of you and credit our clients with providing us a solid foundation for continued growth.

Coinciding with our 10-year anniversary milestone is the recognition of BBFG as one of the top wealth management firms in the country. Recently, we were named as a Top Wealth Manager by *Wealth Manager* magazine, formerly *Bloomberg Wealth Manager*. This is the fourth time we have been recognized in this publication. We are among 18 Massachusetts firms of 420 chosen nationwide.

We kicked off the summer with our semiannual, off-site strategic planning meeting focusing on infrastructure and client services. Leading our efforts were Becky Martz and Joyce Alper with the Worldox document management system software, which makes business information more accessible to all of our employees.

Other technology projects include Portfolio Center, for investment management, and GoToMeeting.com, which enables us to meet with clients virtually through the internet. As we incorporate these new technologies into our daily work, a BBFG committee has been formed to ensure streamlined and consistent processes. This committee of Phil Lee, David Young, John, and Joyce oversees quality control for the company.

Bob is leading our effort to offer investment advisory services to foundations and endowments with the help of Christina Aylward. You may have noticed an expanded Foundations and Endowments section on our web site (www.backbayfinancial.com). We have also added more details and articles about Dimensional Fund Advisors (DFA).

Throughout the year, BBFG offers opportunities to finance majors who help with many special projects. Rainey Lennon, a senior at Saint Anselm College in New Hampshire, provided BBFG with administrative support over the summer months. Meghan Sanders, a sophomore at Northeastern University, and Christina, a senior at Boston College, will be staying with us on a part-time basis over the coming year. Lindsay McDonald, a recent graduate of Salve Regina University in Rhode Island, rejoined us to assist with the document management system project. Mandy Magee and John devoted time in August to recruit interns for the upcoming school year.

Continuing professional education in all areas of financial planning and wealth management is an important aspect of BBFG services. Susan Brown attended the National Association of Personal Financial Advisors Study Group meeting in July, which focused on

Massachusetts estate tax issues. Becky attended Fidelity Investment's Technology in Practice event. Jeanne Gibson Sullivan is staying current on changes to 529 college savings plans in which tax-free withdrawal status was made permanent rather than expiring in 2010. Emily O'Hara, John, and Phil participated in a webinar on evaluating financial plans. They also attended a Financial Planning Association seminar on recent research on sustainable withdrawal rates from portfolios, the topic of a recent research paper written by Jeanne. Ed Childs and Phil attended a two-day DFA conference for financial advisors in Washington, D.C., where passive investment strategies and the academic theories developed by DFA were discussed. John and Rainey visited Francis Sellers for a business meeting at his home office on Cape Cod. Involvement in the community is also important to BBFG. Bob has been named to the board of the Fast Break Club, a booster organization for the Boston College women's basketball team.

To reenergize, our staff found time to relax and enjoy the summer. Mandy and her husband, Joshh, went to Colonial Williamsburg and also Chicago, where they saw a Cubs-Cardinals game. Lindsay traveled to Europe for a month after graduation and ventured to the Czech Republic. Becky visited Las Vegas for the first time this summer for a friend's wedding. John spent time at his summer cabin in Maine in July and August, combining vacation time with client visits to Brunswick and Cape Porpoise. Meghan went to Virginia Beach and New York City. Phil hiked in New Hampshire and vacationed on Cape Cod with his family. Jeanne traveled to Kansas City to visit family and friends and participated in a regatta of small, remote-controlled boats. She and her family also went to Mexico, visited the Mayan ruins and floated down an underground river. David journeyed to the Pacific Northwest for his brother's wedding and saw the Blue Angels at the Seattle SeaFair. Susan specializes in small-town vacations, and this summer, she visited Kutztown, Allentown, and Cooperstown.

After moving into her new condo in South Boston, Emily took her brother, visiting from California, to Fenway Park for his first time. Loyal Red Sox fans Emily, Becky, Mandy, David, Bob, and Ed also attended a game together. Francis and his wife, Marianne, enjoyed visits from family this summer fishing and boating on the Bass River near their home in South Yarmouth.

To celebrate our anniversary, we invited retained clients to a special evening at the Colonnade Hotel for dinner with guest speaker Dr. Paul Schervish, Professor of Sociology and Director of the Center on Wealth and Philanthropy at Boston College. Mandy and Emily planned all the logistics and highlights to make the night memorable.

BBFG wishes you a wonderful fall season.