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Item 1: Cover Page

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The brochure provides information about the qualifications and business practices of Lynch Financial Advisors. If you have any questions about the content of this brochure, please contact us at (916) 772-3103. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about Lynch Financial Advisors is also available on the SEC's website at www.adviserinfo.sec.gov

Lynch Financial Advisors is a Registered Investment Advisor (RIA). The ONLY written qualifications for becoming an RIA, is passing the series 65 exam. This exam requirement is lower than both NAPFA's requirements as well as the CFP's requirements and should not be taken as statement of skill or training. It is merely the written baseline level that FINRA requires for an RIA to pass.

Item 2: Material Changes

This section discusses only material changes since the last annual update of the brochure on February 28, 2019. We are no longer having every client go through a first year "full retainer" before they move to the "limited retainer". Also, the "limited retainer" has been changed to being "Early Accumulation Phase" and is no longer limited in the amount of time spent with the advisor.

Item 3: Table of Contents

a. Table of Contents

Item 4: Advisory Business

1. Statement of Information
   i. Lynch Financial Advisors has been a Registered Investment Advisory firm since 2002. The firm is comprised of one owner, Michael Lynch, who is 100% owner of the business.
   ii. Lynch Financial Advisors is a comprehensive financial planning firm that offers the following services: Financial Review, Financial Planning, and Wealth Management retainers. These services are offered to individuals and couples. In addition to services for individuals and couples, Lynch Financial Advisors also does business consulting. The nature of the consulting for businesses is always tailored to the specific needs of the client, with an emphasis on helping the owners of a company to build their business balance with growing their overall lifestyle. Almost all business retainers are complemented with one of the above retainers. Definitions of each follow:

1. Financial Review: This is a review of a clients "financial picture". The review is 2 hours and is open to an array of topics. The only items NOT offered in this meeting are: 1. Detailed portfolio design (current portfolio analysis is done, we just do not build a portfolio for a client then give it to them to implement. The reason is that at different times certain funds that we use would not be appropriate for a client. Put another way, a portfolios allocation and fund selection will change over the lifetime of each individual/client, and therefore a "static" or "fixed" portfolio should not be given to a client ("set it and forget it" does not apply to a portfolio). 2. Tax preparation. Questions that we regularly discuss with Financial Review clients are: "Will I reach retirement?", "What is the best way to save for retirement?", "What is the best way to save for my kids school?", "What do you think about my current portfolio?", "Do you think I missed any deductions on my tax return?", "How much money should we be putting away every year to reach our retirement goals?", and "How can we spend on a car/house?" (Just to name a few).
2. Financial Planning (first year, if needed):
   a. Financial Planning clients are those with less than $250,000 in investable assets. During the first year of our engagement we will cover these areas:
      i. Taxes (planning upcoming year, how much you may owe, ways to reduce your taxes, etc.),
      ii. Goal Setting (we take a comprehensive approach to goal setting, learning about your early memories of money, to how you spend it now. And finally, we look at the areas that are most important in your life and how to help you spend more time and achieve more balance in those areas),
      iii. Insurance (we work with your insurance agent to make sure that you are properly covered on life, disability, home, auto, etc. We review your deductibles for how much you should "self insure" (self insure is the deductible portion. It merely is an indication of how much you can afford to pay out of your own pocket),
      iv. Budgeting/Spending (call it what you want there are two sides to the finance equation, saving money for investments and saving money through spending. Our goal here is to identify any "leaks" in your "financial bucket" and to find any hidden tax deductions,
      v. Taxes (we perform an analysis of what your estimated taxes will be for the year, how much you need to

withhold and then give you some scenarios for how to save more in taxes (often by increasing your retirement contributions),

   vi. Preparation for will/trust meeting (we have found that we can drastically cut down on the time you will spend with an attorney, if we help you both understand what the options are (will/trust), put all of the information that your attorney will be looking for together, and lastly identify some of the key areas that tend to slow the process down (usually identifying who is going to watch your kids if something happens to you), and
   vii. Investment and portfolio planning (We separate out the *investment* and the *portfolio* portion, because we believe it is important to put of ALL of your assets(and liabilities) first: Your house, car, business partnerships, money in banks, credit card debt, and traditional investments (mutual funds, stocks, bonds etc). This gives us the "big" picture of what you have. In retirement, we can always adjust any of these items, e.g. buy a smaller house, drive your car longer, etc. Each one of these areas are a "lever" (something we can push or pull on) to get more out of your goal of financial independence. Once we have a good idea of your complete financial position (all of your investments), then we look at your portfolio (see more information on how we build/believe in our portfolio construction).

3. Wealth Management:
   a. Wealth Management clients are those with more than $250,000 in investable assets. During the first year of our engagement we will cover these areas:
      i. Taxes (planning upcoming year, how much you may owe, ways to reduce your taxes, etc.),
      ii. Goal Setting (we take a comprehensive approach to goal setting, learning about your early memories of money, to how you spend it now. And finally, we look at the areas that are most important in your life and how to help you spend more time and achieve more balance in those areas),
      iii. Insurance (we work with your insurance agent to make sure that you are properly covered on life, disability, home, auto, etc. We review your deductibles for how

much you should “self-insure” (self-insure is the deductible portion. It merely is an indication of how much you can afford to pay out of your own pocket),

iv. Budgeting/Spending (call it what you want there are two sides to the finance equation, saving money for investments and saving money through spending. Our goal here is to identify any “leaks” in your “financial bucket” and to find any hidden tax deductions,

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4. Early Accumulation Phase Retainer:

I. This is similar to the Full Retainer except that not all above mentioned items under the Full Retainer category may apply during this stage, such as preparation for Trust meeting. This is geared more towards clients just beginning to build their net worth and may not require as much time needed as those that fall under the Full Retainer.

II. Clients can have unlimited face-to-face meetings each year. They have full access to Lynch Financial Advisors via email, text or phone. And we perform their tax preparation.

2. Other Disclosures
    1. Lynch Financial Advisors does not participate in a wrap fee program.
    2. Lynch Financial Advisors does not charge performance-based fees.
    3. We manage approximately $32 million in AUM through our custodian along with approximately $25-$30 million in held-away workplace retirement accounts, and these are managed on a non-discretionary basis.
    4. Asset Management fees are calculated as of 12/31 for the upcoming year.

Item 5: Fees and Compensation

(*Clients are NEVER obligated to pay for the full retainer. They can give a 30-day notice and end service at any time during the engagement**).

iii. Financial Reviews are $500 (2 hours of guidance plus 2 hours of prep/post-meeting work) – this applies for first, second, third year, etc.

iv. Financial Planning Clients are billed based on the below matrix:

Totally Assets Managed	$0-75,000	$75,000-150,000	$150,000-250,000	$250k +
Single	$100	$125	$150	Wealth Management Client
Married	$150	$175	$200	Wealth Management Client

v. Wealth Management Clients are priced based on a number of factors:
   a. Married or single
   b. Salaried or business
   c. Financial/Tax complexity: Options (NQ's, ISO's, RS's etc), AMT (if you pay it you know the terms) dividends and capital gains
   d. Investable portfolio size (both in retirement accounts and held in brokerage accounts)
   e. Overall Net worth (we value residences at $0 when under water, and discount the value when "above water" to better reflect true assets that could be "worked" with)
   f. Overall complexity of client's situation

2. Fees start at $2,400 and can go north of $20,000

vi. Payment Methods:
   1. Client pay one of three ways: Monthly via a credit card (which stops at the end of every year), via sending us a check every month/quarter), paying in full with the option of a prorated refund at any point during the year. Investment management fees can be directly deducted from the client's brokerage account as well.
   2. Discounts and pro bono:
      a. On a very limited basis Lynch Financial Advisors will engage in "pro bono" work. This work is limited to 5% of clients and is geared towards helping those in serious financial problems. Additionally, no client can stay as a full pro bono client for longer than 2 years.
   3. Refunds
      a. Refunds are given to one of two types of clients:
         i. Financial Review: If a financial review client believes that the work we completed for their $500 was not worth what they paid us.
         ii. Retainer (Full and Early Accumulation Phase). If at any point in the engagement, the client becomes dissatisfied with our work, they can ask for a refund from 30 days from the point they send us a letter or email (e.g. if they send a letter in June 30th, then July 30th ends their engagement.)
            1. Proration determination only applies to quarterly and yearly paid clients (monthly clients will be considered paid in full and no additional charges will apply). To calculated the charge for clients that we have provided tax services, we will multiply the amount we paid the CPA to review and file the return by 3 (e.g. we paid $100, then 3 X $100= $300. We take this number and minus it from their full year fee, $2000 (we use the fee amount BEFORE any discount) - $300= $1700. We take this amount and divide it by 12, 1700/12 = 141.66 (we round down). So for the client that sent in a letter on the 30th and paid in full, we calculate the months the client owes us for (January 1 thru July 30th) or $141.66*7= $991.62. We take this number and subtract if from what the client

paid us (assuming a 5% discount to the $2000, they would have paid us $1,900), $1,900-991.62=$908.38 would be refunded to the client.

vii. Other possible fees
    1. Client will incur additional fees NOT paid to Lynch Financial Advisors, but may take place in conjunction with the financial planning:
        a. Mutual fund fees:
            i. Brokers charge a fee for holding your assets at their facility. The charge comes in the form of a one of two payments
                1. Inside of what is called the "12-b1" fee. This fee is typically less than .25%.
                2. When the above fees are not sufficient to cover the cost of housing the funds, a broker may charge a "transaction" fee. At TD Ameritrade (the typical brokerage our clients use) they cost $24 per purchase. Approximately 25% of the funds we use have a "transaction" fee.
            ii. Mutual funds charge a fee to manage their fund. The fees are comprised of:
                1. Transaction costs: cost of trading the asset in the fund
                2. Administrative costs: their fixed costs for their business
                3. And some profit component for managing the asset
            iii. All funds are different in what they cost
                1. Managers of small funds tend to cost more than larger funds, simply because they have less assets to spread their costs over.
                2. Managers that perform more due diligence or research cost more as well.
                3. Typical fund expense for funds we recommend costs between .5% to 1.2% per year.
            iv. Stocks/bonds, etc.
                1. These will incur a "transaction" costs for both the purchase and the sale. The transaction costs will vary depending upon the units (and value sometimes) of what is being purchased). TD Ameritrade's costs tend to be some of the least expensive of all brokers.

viii. Other disclosures:
    1. Lynch Financial Advisors is a Fee-Only planning firm. We hold no licenses for selling insurance, stocks, bonds, or mutual funds. As such we cannot and will not collect any fees in regards to any advice we give.

Item 6: Performance-Based Fees and Side-by-Side-Management

Lynch Financial Advisors does not charge performance-based fees of any sort.

Item 7: Types of Clients

ix. Lynch Financial Advisors works with couples, individual, and trusts (when applicable for the client's assets).
x. We have no account minimums
xi. Our clients tend to be between 30 and 70. Most clients have had to "work" for a living and consider themselves average to above average in living and wage standards.

Item 8: Methods of Analysis, Investment Strategies and Risk of Loss

xii. Investment analysis:
    1. We believe that the number one reason most investors fail to obtain "market" returns is based upon their own inherit bias. Much research has shown that people will take risks based on positive outcomes, but when viewed as negative outcomes they become much more risk adverse. The research of both Daniel Kahneman and Amos Tversky challenged our assumption that human's behave similar when viewing positive and negative economic activities. Research from a number of "think groups" showing poor performance of investors relative to the market suggest that Mr. Tversky and Mr. Kahneman's theories are valid in today's investing space.
    2. As such, we seek to build "boring" portfolios. Our fundamental goal is to slowly build on assets. While we don't suggest that we can miss any down movement the market, our strategy is to minimize losses, help to elevate our client's desire to save, their ability to save, and lastly to take small "opportunistic" positions in the market and/or sectors when we believe the risk justifies the position.

xiii. Risk
    1. We DO NOT believe in risk in relationship to our clients. Put another way, we DO NOT do risk assessments (see appendix A for a full description of this). Our belief is that risk assessment tools only aid brokers to sell more products by "converting" clients from risky to less risky assets as they age. Furthermore, there is NO relationship between the return that a client gets and the "risk" they take. While this is

counter to industry standards, the evidence (as shown is appendix A) is hard to refute. If we think about this simply, if a client says they can take on more "risk" what are they saying, "I want more return"? The vast majority of clients do not understand that with the "risk" comes a HIGHER likelihood of loss… and thereby a higher likelihood they will NOT meet their financial goals. Clients have NO control over the markets, therefore should never think in terms of how much "risk" they should take as this gives them a false hope for their desired outcome. Lastly, in our and other advisors experiences. Those that are taking more risk are usually those that are taking more risk in other areas of their life, have their own job, don't save enough, etc. They typically are playing "lotto" with the market trying to make up for their inability to save properly for retirement. Again, please see the appendix for a full explanation of this.

Item 9: Disciplinary Information

xiv. None

Item 10: Other Financial Industry Activities and Affiliations

xv. Lynch Financial Advisors has no compensation relationships with any entities, However, we do refer work:
  1. The CPAs we refer work to may, from time to time, refer clients back to us. They do not give us any discounts or compensation for the work we send to them. We have negotiated out a fixed hourly rate for tax returns, as opposed to their general practice of charging per tax return (based on complexity). The hourly fee reflects a reduced amount of time that the CPA takes and the volume of business we give them. While this is not a discount, the amount we pay per return is less than what a "person off the street" would pay.
  2. Real Estate, Mortgage people (brokers and bankers), Health Insurance, Auto Insurance, are from time to time our clients. We do not expect any client to use these people, but will recommend them based upon our experience with them. We do not receive any compensation, however, if our clients are more successful their fee typically goes up, (note:: there is an indirect level of compensation here).

xvi. Lynch Financial Advisors has no control personnel that are registered representatives of a broker-dealer, futures commission merchant, commodity pool operator, commodity trading advisor, or an associated person of the foregoing entities.

xvii. Lynch Financial Advisors does not recommend other investment advisors for our clients and thus we do not receive any compensation directly or indirectly from those advisors that creates a material conflict of interest.

XVV. Associations

xviii. Cambridge Advisors- Alliance of Comprehensive Planners

1. We are a member of this association. Cambridge Advisors is focused on helping advisors build successful practices. It does not receive any compensation for our services. They do receive a monthly or yearly fee for belonging to them, and in return for belonging to the association we do receive, from time to time, referrals from them.

xix. National Association of Personal Financial Advisors (NAPFA)

1. We are a member of this association. NAPFA is focused on helping advisors build successful practices. It does not receive any compensation for our services. They do receive a monthly or yearly fee for belonging to them, and in return for belonging to the association we do receive, from time to time, referrals from them.

Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading

i. Lynch Financial Advisors or a related person do not invest in the same securities that it or a related person recommends to clients; or recommends securities to clients, or buys or sells securities for client accounts at or about the same time that a related person or Lynch buys or sells the same securities for its own account.

Item 12: Brokerage Practices

ii. Lynch Financial Advisors does not receive soft-dollar benefits from a broker-dealer or a third party in connection with client securities transactions.

iii. We do aggregate the purchase or sale of securities for client accounts through block orders with pre-determined limit prices that are set whenever we re-allocate the investment model, which is usually on an annual basis.

iv. “Discount Brokers”

2. These are brokers that typically operate with MUCH lower costs than larger firms (Merrill Lynch, Morgan Stanley, etc).
3. All of our clients have their assets held at TD Ameritrade Institutional and Community National Bank. All clients are directed there as we know the availability of “no load” funds and transactions costs. No client, however, is forced to go to TD Ameritrade Institutional and Community National Bank.
4. Other discount brokers are: Schwab, Fidelity, and E-Trade.
5. If a client uses other brokers, we are not able to negotiate any pricing or produce oversight of their fees. It is important for the client to understand they will be paying for both Lynch Financial Advisors services as well as the brokers services, as we do not offset or reduce our fee for the amount at another broker/financial advisor

V. Review of accounts

xx. Seeing as clients have a mixture of the same 20 funds, we are continually monitoring those funds (based upon their return, objective, etc.) during the year.

xxi. We review client accounts a minimum of 2 times per year. One time in the spring and one time in the fall. From time to time, depending upon market fluctuations, we may perform some allocation at a different time in the market, (e.g. the market has retreated 10% or more, and we may take action to reallocate). Conversely, we may do the same based upon a 10% move or more up. We do not market time. We merely are looking at the cyclical nature of the market to see if there is an opportunity with a sector that is miss-priced.

Item 13: Review of Accounts

We periodically review client accounts throughout the year, usually quarterly. As mentioned in Item 12, we review the client accounts a minimum of 2 times per year and we may perform some allocation depending on the factors mentioned in Item 12 above. We provide our clients with a monthly report regarding their accounts.

Item 14: Client Referrals and Other Compensation

xxii. Referrals

1. For anyone that sends us a "lead" which is someone that we call on, we send the person a $15 Starbucks card
    a. For anyone that sends us a person/couple that sets a meeting, we send them a $50 thank you card.
    b. No other compensation is given. We like to thank people for thinking of us, but never want them to give a referral for the money.

xxiii. Compensation

1. From time to time we will have an event in the firm that causes us to believe we gave less than superior service (accidently missed a meeting, miss-communicated with the CPA about filing a return, etc.), at these times we will send an apology letter with a gift card ($50 for single and $100 for married).
2. No other compensation is given to clients or other people

Item 15: Custody

We do not custody assets here at Lynch Financial Advisors.

Item 16: Investment Decision

Since Lynch Financial Advisors does not have discretionary authority over client accounts we must receive approval from clients regarding any purchase or sale of a security, including the timing and amount to be purchase or sold. When we obtain certain authorities over client accounts, such as Limited Power of Attorney, we still receive approval from clients regarding any purchase or sale of a security, including the timing and amount to be purchased or sold.

Item 17: Voting Client Securities

We do not accept authority to vote client securities at Lynch Financial Advisors. Clients receive their proxies or other solicitations directly from their custodian. Clients can contact us by phone at 916-772-3103 should they have any questions about a solicitation.

Item 18: Financial Information

We do not require or solicit prepayment of more than $1200 in fees per client, six months or more in advance.

Item 19: Requirements for State-Registered Advisers

Principle executive officer is Michael Lynch. He received his B.S. in Business Administration (Finance and Economics) at California State University, Chico. He also holds a MBA from the University of Phoenix. Mike has spent his earlier career in sales and business development before transitioning into an advisor in 2000.

Other Businesses

xxiv. Lynch and Sons Pool Services
1. 100% owner of this business with Erin Lynch (She runs the business).
2. Spend 1 hours per week on average paying bills, developing marketing strategies and growth strategies
3. It is a pool service company

xxv. Lynch Business Center
1. 56% owner of this business
2. Spend about 1.5 hours a week with bills, prepping offices, and investor relations (2 clients (family and friend) invested in this project. We received NO compensation)

xxvi. Milbourn Lynch Partnership
1. 50% owner of this business
2. Spend no hours per week in this business. It is an oil and gas venture that is essentially worthless. Two clients share ownership in this business.

Item 20: Appendix A

Risk Assessment vs. Absolute Return

Does greater risk equal greater return? After many years in the market, ongoing research and comparative study, Lynch Financial Advisors concludes that taking risks with your investment dollars doesn't always add up.

Abstract

Risk Assessment tools – originally designed for wealthy investors in the bygone era that introduced mutual funds – are now outdated. Unfortunately, Risk Assessment tools are dangerously misused in today's market. You might be surprised to learn that even today's typical Diversified Portfolios – commonly regarded as stable and conservative investment strategies – carry unnecessary risk. Though investors often position themselves as prognosticators, the ups and downs of the market are simply impossible to predict. Rather than playing the Risk Assessment game, today's investors should carefully consider their personal financial goals and focus on the long-term gains fostered by a portfolio based not only on diversification, but also on a financial principle known as Absolute Return.

Glossary

Absolute Return is the actual financial return of an entire portfolio. In the world of asset management, an advisor that focuses on Absolute Return is continually evaluating Downside Risk and working to have positive returns, regardless of the state of the market.

Downside Risk is a measure of how much negative return an asset or portfolio has. Usually it implies that the portfolio involves higher-risk investments, because it has a higher probability of going backward.

Risk Assessment is a popular investment tool, usually based on a series of evaluation questions, which helps determine your ability to weather the Downside Risk of a portfolio.

Index Investing is a type of portfolio that concentrates on a set of indexes. Indexes, which are groupings of assets (large caps, mid caps, etc.), often provide the core for Diversified Portfolios.

Non-Correlated Assets are assets that are not tied to one another and don't necessarily move in sync with one another.

While managing today's financial portfolios, middle-income investors typically go through some type of risk-tolerance assessment. Risk Assessment tools are commonly used by financial advisors, investment counselors or brokers, and insurance agents. They are also a staple of retirement plans, such as 401(k)'s and 403b's. Similar tools can be found online that help you assess your ability to manage risk. Each tool offers a different perspective as to what your risk tolerance is, and they are built to help you allocate funds relative to the risk you are willing to take.

However, Risk Assessment tools are failing as a core investment strategy. Paladin, a reputable think tank, recently conducted a survey that revealed “Millions of investors fire financial planners and advisors every year because they did not receive the results and services they expected. Then more than 91% of the investors hired replacements, hoping the new advisors would be better than the ones they fired. “[1]

Since Risk Assessment is such a prevalent strategy, the study suggests a relationship between how much risk investors are taking on and their actual returns. It appears that in most cases, expectation exceeds the actual returns – or that returns were simply disappointing. After a while however, the cycle of taking risks associated with risk assessment tools, receiving low returns, and changing advisors recalls a dog chasing his tail.

Risk Tools Are Upside Down

The Paladin study makes it apparent that financial advisors managing middle-income portfolios must create financial solutions that can weather the ups and downs of the market. Bert Whitehead, ranked by *Worth* magazine as one of the top 100 financial advisors in the country, has maintained for years that traditional Risk Assessment tools are upside down.

Whitehead’s philosophy is simple and straightforward. Investors with a high tolerance for risk are typically entrepreneurs. Entrepreneurs typically own businesses. Business owners typically have a large amount of their net worth tied up in their business. For example, their retirement is often based largely on how well their business does. Tying up a large percentage of assets in one investment is by definition very risky. However, Risk Assessment tools will place this investor in an aggressive portfolio, when they should in fact maintain a very conservative port.

On the other hand, investors with moderate-income jobs, such as teachers, social workers and other government employees, typically test as conservative and are less willing to take risks, according to Whitehead. Although they crave stability, these investors can handle more volatility in their portfolios, because they often have the safety net of a pension plan. Even if their portfolio doesn’t do well, the impact on their retirement is limited. Unfortunately, because of Risk Assessment, a large population of investors will be placed in the wrong risk category.

Why is this happening? According to Whitehead, Risk Assessment tools started with the advent of mutual funds. Historically, a broker would be able to garner new commissions by selling stocks and buying new stocks. But when mutual funds came along, the large basket of stocks in the client’s portfolio was replaced by mutual funds. The idea of risk tolerance was linked to the idea that as clients progressed through different stages of life they needed to reallocate their portfolio. Reallocating meant selling current mutual funds and buying new mutual funds – a new way for the broker to make commissions.

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[1] Why do Millions of Investors Fire Their Financial Advisors Every Year? June 27, 2006, Palidin Registry, LLC

This was the case until experts, including Whitehead, began to question how Risk Assessment tools worked. Whitehead concluded that they are upside-down – that there is actually a dangerous *inverse* relationship between these tools and how portfolios should be allocated. With Risk Assessment tools, investors that shouldn't take risks were; and those that could take risks were not.

Doing the Math

Before you start investing, is important to understand the common ideology of traditional Risk Assessment tools:

- You *can* get a higher rate of return by taking on more risk. Financial advisors will often tell you that they can give you a greater return albeit with increased exposure to downside risk. To express this as a mathematical equation: To get a 6% return, you may have a downside of negative 2% to your overall portfolio. However, to get to 8%, it's common to have a downside risk of minus 10-20% – which means that your portfolio could go down that much in any given year. The problem with the down years is that you have to get close to a 12-30% return to offset the larger downside. As you can imagine, these numbers will strain the relationship between advisor and investor. Remember, 91% of financial advisors are replaced. The dog is not merely chasing his tail. To get an idea of the day-to-day and year-to-year fluctuations of the market, imagine the dog watching a yo-yo go up and down.

- With Risk Assessment tools, your advisor is analyzing historical returns – and betting that history will continue to repeat itself the exact same way. The risk management analysis for which you are paying your advisor is completely based on historical trends. So, your outcome is only as good as the future relates to the past.

Based on this, it is fairly apparent that, as Whitehead surmises, the commonly used risk tolerances used are inadequate. To take it a step further, Risk Assessment tools are simply not useful. It's easy to make the argument that it really doesn't matter whether you conduct a Risk Assessment at all.

We have already concluded that entrepreneurs need to have a stable portfolio, because of all their risk involved in their business. And although teachers and government employees might be able to take more volatility, it's safe to say they need overall stability in their portfolio. But there is another reason that stable portfolios are important: Because with jobs, relationships, children and travel, there is so much instability in the *rest* of our lives. Your portfolio shouldn't be adding to your stress; it should be part of your stability. We've seen that in bear markets, it can even be scary to hold bonds. But there is a big mental difference between a portfolio that drops 10% during a downturn and one that goes down 20%.

So perhaps the whole idea of risk tolerance doesn't make any sense. Is there any evidence to support this? In a landmark 20-year study, the Dalbar Company, an independent financial research firm, came to this conclusion: "Examining the flows into and out of mutual funds for the last 20 years, the Dalbar study of investor behavior found that market timers in stock mutual funds lost 3.29% per year on average. Over a period when the S&P grew by 12.98%, the average investor earned only 3.51%."[2]

To fully comprehend these numbers, let's compare the three groups that Dalbar is talking about here:

1. Market timers – a group that focuses on buying and selling mutual funds based on market conditions –lost 3.29%).

2. The average investor – assumed to be the sum-total of all mutual fund investors – gained 3.51%.

3. Standard & Poor's 500 index – a basket of 500 large cap stocks – gained 12.98%.

In short, whether you were a market timer or an average investor, you lost significantly compared to the S&P 500. Ironically, the S&P is a basket of U.S. brand-name stocks – with little diversification and a lot of volatility.

Aiming Toward 6%

The S&P is volatile and it had great returns, which is why it is considered more risky. Indeed, most analysts would agree that the non-diversified nature of just using a basket of U.S. stocks is risky. So, doesn't that mean that higher returns were generated by taking more risk? Absolutely – but that's only half of the picture.

While the S&P (and probably the overall market itself) produced good returns, neither the market timer nor the average investor did well. And more than likely, all of those investors that fired their advisor didn't do well either. Why is this?

There are many possible reasons, but one likely theory is that because of diversification, their returns were lower. This would make sense, because just investing in equities alone would likely yield a higher rate of return. When investors put bonds and other assets into their portfolio, the overall return typically goes down.

Significantly, there are numerous studies that suggest that the majority (approximately 80%) of fund managers don't beat the market over a 5 to 10-year window. Over a 20-year timeframe, the number drops even more. So, if we look at the average equity fund, for example, we may see only an 8% rate of return, compared to the market's 12.98% return over the same time period. And, averaging in bond funds and other types of mutual funds, the average portfolio likely would creep down to around 6%.

Of course, 6% is a much better number than the average investor's return (3.51%) and the market timer's loss (minus 3.29%) per year. With hundreds of thousands of financial advisors in the United States, you would think that the average investor would do much better. Even worse is that a huge percentage of advisors for those average investors work for large institutional firms, such as Merrill Lynch, AG Edwards, Northwestern Mutual, etc. We aren't suggesting that these firms are responsible

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[2] Dalbarinc.com

for the underperformance of the average investor. However, this data clearly suggests that the large brain trust of these firms appears to be not nearly as smart as the market.

Despite all the tools to help investors determine their risk tolerance – and all the financial advisors out there – the average investor continues to make big mistakes in terms of market timing and overall investing.

Your Definition of Risk

So, if Risk Assessment tools aren't working, how should you invest? Despite all our above reasoning, intuitively it still seems logical that greater risk would equal greater return. But risk depends on your perspective.

Think about your definition of risk. Most people think that they are doing a good job by not touching their volatile portfolio when it goes up and down. After all, those that are taking more risk will invariably have portfolios with larger swings in returns. They do understand that they have a higher risk of downside in any given year – but they are willing to take that risk because they have a long-time horizon. And when discussing risk, time may be the most important variable.

Best-selling author Suzy Orman says an investor needs a minimum of 10 years in the market. But to wait out market volatility, you often need to have a 30-year horizon. And even after 30 years, you must time your exit to make sure you get out at the right point. There are many studies that suggest that most investors – let alone financial advisors – frequently fail to coordinate this timing.

Let's take the example of a 20-year-old investor. He is not planning to retire for 45 years. He goes into the market for 15 years, but then decides he must lower his risk – so he gets prepared to move out of the market. This is basically what we all have been advised to do -- adjust our portfolios as we get older.

But what happens if he is in a down year when he tries to get out? It's not unlikely – since 1926 we have had 23 years in which large caps retracted and 25 years in which small caps retracted. Further, we had 13 years in which the large caps retracted more than 10%, and five times that the market retracted more than 20%. That's a retraction of 20% every 16 years on average.

Again, the unfortunate conclusion is that the market fares better than the majority of the investors. Most investors tend to move depending upon the market news. To determine why risk does not always equal return, let's look a little deeper. Assume two options for your portfolio:

<u>Option A</u>

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10

36%	-25%	-17%	17%	4%	-31%	-20%	53%	57%	25%

Option B

6% return every year.

Which one do you take?

Option A shows small cap market returns over a 10-year period. At which point would you have changed your advisor? What type of return would you have had if you didn't put in any additional money? 10%? 8%? How about 5.5%? (This example represents returns from 1968-1977)

Meanwhile, Option B would have given you an 8% better return.

Now the above scenario does have more down years than the average 10-year span. The point is, you don't know which 10-year period you will be working in when you are moving from one risk tolerance to the next. The standard investment model is to graduate from aggressive investments to moderate investments to conservative investments. But what if Year 2 was the year that you were supposed to move from aggressive to moderate? You would have lost 25% of your portfolio. If it had been Year 6 or 7, you would have cut your portfolio in half. Perhaps even worse, you would have missed the huge upswings in Years 8 and 9.

Next, what type of return would you have with Option C?

Option C

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
29%	21%	-9%	-12%	-22%	29%	11%	5%	16%	5%

10%? 8%? 6%? Yes, 6%.

Option C shows the returns of large cap stocks in the U.S. from 1998-2007. The problem with this scenario is that the big down years deplete the capital to invest the following year. In fact, by the end of Year 5, all the gains are depleted.

This highlights the fundamental problem with the standard 10-year time horizon: Most people don't have the patience to stand pat through the down years. And maybe they shouldn't. After all, why would you go through the drama of watching your portfolio drop by 22% – only to end up with a 6% return after 10 years? Compare that risk to the investors who returned 12.98% by investing in the S&P 500 for 20 years.

Minimize the Down Years

Most advisors believe they solve the problem by diversifying their clients' portfolios – spreading the risk across a number of different funds. But as the Dalbar study proves, diversity apparently doesn't reduce risk because the average investor is getting a worse return than the market.

So, what is the answer? Minimize the down years.

This sounds simple, but it is often missed as a key to helping investors get to their objective of long-term gain and financial independence. The best way to minimize the down years is to construct a portfolio of investments that minimize the draw down in a given period. And here's another thought – hire a financial advisor that thinks differently.

Here are some suggestions:

1. Use multiple money managers to distribute your investments.

2. Make sure that none of them approach the market the same way.

3. Make sure that they each are managing different types of investments.

There is more and more data that suggests that the chance of more stable returns is increased by the ability of the financial advisor or money manager to freely move where they see value. This is called Style Drift. Whether you believe those studies or not, there is also compelling evidence that suggests a broad base of non-correlated assets can actually give an investor a higher rate of return than the market – while taking on less risk.[3] [4]

The Behavioral Side of Investing

There is more to minimizing the down years than just the math. Think about the behavioral side of investing. If you looked at your portfolio and saw that in years when the market was going down your portfolio went down only half as much as the market, you would be more likely to stay invested.

This is the benefit to using a portfolio that has less Downside Risk. It leaves the investor calmer than the other investors going through the same rough sea. And these benefits snowball – investors are willing to invest even more money when they see their investments are stable. People are more apt to save if they feel that their hard-earned money isn't going to be lost.

Astonishingly, minimizing the down years is not a new theory. Back in 1979, a Princeton University professor named Daniel Kahneman studied how people behave regarding their money. What he found was that the fundamental notions that markets are efficient and people act rationally were not true. Today, Kahneman's Prospect Theory is one of the most widely cited in economics:

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[3] Style Boxes: Outside the Box By Craig T. Callahan, DBA and C. Thomas Howard, Ph.D.,May 2006 Issue of *Investment Advisor* Magazine

[4] Don't Panic If Your Mutual Fund Is Drifting by Michael Weiss, CFA, http://www.investopedia.com

> "Prospect theory argued that people's degree of pleasure depends more on their subjective experience than objective reality, as the rational model of economics held. A shopper, for example, might drive across town to buy a $10 calculator instead of a $15 one, but forgo the same trip to purchase a $125 jacket for $5 less, illogically believing the greater percentage saved on the calculator makes the trip more worthwhile. Prospect theory led to "loss aversion," which explained why investors clung to losing stocks rather than selling. Investors were more likely to sell stock they purchased at $50 a share if it rose to $70 and seemed overvalued; but if they bought the same stock at $90 and it fell to $70, they were disinclined to sell, even if shares still seemed overvalued. "[5]

Kahneman's research led to his winning the Nobel Prize in Economics, an award he shared with Vernon Smith of George Mason University.

The Advent of Absolute Return

The concept of Absolute Return is one of today's leading financial principles to emerge in the wake of Kahneman's research. Absolute Return is the actual financial return of a given asset, or of an entire portfolio – as opposed to the average or "arrhythmic return" of an asset or portfolio. In the world of asset management, a manager that focuses on Absolute Return is continually evaluating Downside Risk and working to have positive returns, regardless of the state of the market. The Absolute Return portfolio is clearly distinguished from Risk Assessment portfolios and typical Diversified Portfolios. Lynch Financial Advisors is a strong proponent of the Absolute Return method.

An Absolute Return portfolio is designed to minimize your Downside Risk. By contrast, a Diversified Portfolio strives to have different assets, but its main intention is simply diversification, not Downside Risk. That's because the concern of the typical Diversified Portfolio is performance on an average return over time – note that this is *not* equal to how your money grows inside of your portfolio. An Absolute Return portfolio reassesses how the portfolio is performing every quarter to ensure a low draw-down in any given quarter.

Absolute Return minimizes Downside Risk by implementing non-correlated assets. Non-correlated assets go well beyond diversifying away from typical large cap and international investments. An Absolute Return manager will often hedge the market and use alternative assets and commodities.

Diversification doesn't necessarily mean that a portfolio will work in any economic environment. In fact, most diversified portfolios work well only in strong markets. The typical diversification model includes large caps, international, small and mid caps. Non-correlated portfolios should have assets that work well in a down market. And all assets in the portfolio should have a different downside than the leading market indexes (i.e., Dow Jones or Standard & Poor's). In addition, all Absolute Return portfolios have a strict method for minimizing risk.

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[5] Hopeyen of the Associated Press on Jan. 2, 2002.

Tellingly, Absolute Return portfolios have more characteristics of the Yale Endowment than to a traditional financial advisor's portfolio. The Yale Endowment is one of the most successful endowments in the world. The managers of the Yale Endowment have long-term vision but they also must plan every year for money to come out of the endowment. As a result, this portfolio has many assets that most managers would never put in their portfolio, such as tree farms, oil and gas, international bonds, etc.

Absolute Return managers can employ many different strategies. They can hedge exposure in either direction of the market, to insure against frequent undervaluations and overvaluations of the market. They can use commodities and can either passively or actively invest in assets. Some Absolute Return managers will manage assets to look like bond returns. That may seem odd, but it makes sense: Bonds don't always produce steady returns. So, if you can use equities and get a bond-type return, you would likely beat a bond fund. Since the bond fund will still go up and down, based on its net asset value.

Often people think of Absolute Return in the negative light of hedge funds, but this is not always the case. For example, a mutual fund can be managed with an Absolute Return ideology. And your financial advisor can manage with an Absolute Return ideology as well.

Your Biggest Risks

We need to think differently and move ourselves into a new world where homework and research and a strong understanding of the cyclical nature of markets help us minimize downside. There is obviously little correlation in the real world to the Risk Assessment that people implement and the returns they receive. In fact, in today's world the biggest risks for the investor are:

1. Not saving enough.
2. Not minimizing a portfolio's down years.
3. Bailing out of the market too early.

Other than a government secured bond, there is nothing that is 100% guaranteed. Taking more risk for five, ten or even 15 years or more, doesn't guarantee higher returns. As we have seen, most people actually get less return than the market. As an investor, you can't stick your head in the sand. As advisors, we can't be in the business of prognosticating or guaranteeing that history will repeat itself. But statistics show that this is happening every day, over and over again.

Conclusion

It is evident that by removing Risk Assessment tools from the equation, we can at least eliminate the notion that the advisor has any control over the market. Investors need to understand what they can and can't control. They can't control the market, but they can attempt to control their downside risk. Other than buying U.S. treasuries, investors can't control market volatility, but they can minimize the risk of volatility by utilizing non-correlated assets and investment styles.

Finally – and most importantly, for the average investor – if they are using their portfolio as a means to retire, they need to make sure that their portfolio is not being managed to compensate for their overspending, or for their inability to save. The portfolio should be the bedrock of their future; a source of security and safety. If their portfolio is designed with this ideology, they will be able to enjoy the more important areas of their life: their family, their friends and their career. And they will be more relaxed and more successful in the financial endeavors that are within their control.

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