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Should You Consider International Investing?

During the 1990s, the U.S. stock market significantly outperformed international stock markets. International investments drew little attention during that time. But now the situation has reversed, with international investments outperforming U.S. stock investments over the past few years. Is now the time to take another look at international investments? Before deciding, consider these points:

Do international investments really add diversification benefits to a portfolio? The primary objective of diversification is to reduce the volatility in your portfolio. For instance, when the U.S. stock market is declining, investments in other parts of the world may be increasing. Over the short term, especially during periods of crisis, stock markets throughout the world tend to move in the same direction. Many believe that the world economy has become more entwined, making world markets more correlated with each other, possibly reducing the benefits of global diversification. Yet, how closely a country's stock market is correlated to the U.S. stock market will depend on how heavily that country depends on exports to the U.S.

One way to determine the diversification benefits of adding an asset class to your portfolio is to review the correlation between the two assets. Correlation is a statistical measure of the extent to which one asset class moves in relation to another asset class, ranging from +1 to -1. A correlation of +1 means the two assets are highly correlated and move very closely together in the same direction. Combining assets with a high positive correlation will not provide much risk reduction. A correlation of -1 indicates the assets move in opposite directions, a rare event in the investment world. A correlation close to 0 means

there is no relationship in the price movements of the two assets. Combining assets that aren't highly correlated can help reduce a portfolio's volatility.

A recent study comparing the correlation of returns between the U.S. stock market and major foreign stock markets for the period from 1988 to 2007 found the following correlations with the U.S. stock market:

Japan	.35
Pacific region	.42
Australia	.50
Hong Kong	.51
Switzerland	.54
Singapore	.55
Germany	.60
France	.62
United Kingdom	.65
Netherlands	.67
Europe	.71
Canada	.73

(Sources: T. Rowe Price Associates, Inc., Standard & Poor's, 2008)

While some of the correlations are relatively high, others are fairly low. Since these correlations relate only to major foreign markets, there is potentially less correlation with developing countries' stock markets. In general, the correlations with foreign markets are still low enough to provide diversification benefits.

Do returns in foreign markets offer greater potential than U.S. stock market returns? No one can predict the future performance of any stock market. However, reviewing past performance can help develop realistic expectations. International investments outperformed the U.S. stock market for five-year rolling periods from 1974 to 1982 and from 1985 to 1990. From 1990 to 2003, international markets lagged the U.S. stock market. Since 2004, international markets have outperformed the U.S. stock market (Sources: *The Case for Global Investing*, 2005; *Diversifying Overseas*, 2007).

These returns, however, compare overall international returns to U.S. returns. From 1987 through 2006, the U.S. stock market never had the highest returns out of 10 major foreign markets. In 2002, the U.S. stock market ranked 9th out of 10 markets, 10th in 2003 and 2004, 8th in 2005, and 10th in 2006 (Source: *Diversifying Overseas*, 2007).

Even though international markets have had higher returns than the U.S. for the past few years, international investments lagged behind U.S. investments for such a long time that there may be opportunities to find investments in other parts of the world that are more attractively priced than those in the U.S.

Does international investing offer other advantages? The U.S. stock market now represents only 45% of total market capitalization in the world, down from 66% in 1970 (Source: *Diversifying Overseas*, 2007). Limiting yourself to U.S. investments means eliminating over half of the world's investments from consideration. In a number of industries, the world's leading companies are not U.S.-based. Of the top 10 industry leaders in terms of market capitalization, the following were located outside the U.S.:

- 9 in metals and mining companies
- 8 in electronic equipment and instruments companies
- 7 in automobile companies
- 7 in household durables companies
- 7 in telecommunications companies

(Source: *Diversifying Overseas*, 2007)

Also, since different countries are at different developmental stages or at different stages in the economic cycle, you may find opportunities to invest in trends in other parts of the world that you missed in the U.S.

What percentage of your portfolio should be invested in international investments? It is usually recommended that you allocate at least 10% of your portfolio to international investments, since less than that will typically have little effect on your portfolio's total return. It is common to see recommendations of a 20% to 30% allocation to international investments. Inflows to international mutual funds have increased 89.6% from 2004 to 2007, with investments in international mutual funds comprising 20% of all equity mutual funds in 2008 compared to 18% in 2006 (Source: *Bank Investment Consultant*, July 2008).

However, what percentage you allocate will depend on personal factors, such as your risk tolerance, time horizon for investing, and comfort level with foreign investments.

International investing may not be suitable for everyone. In addition to the risks associated with domestic investing, foreign investing has unique risks, such as currency fluctuations, political and social changes, and greater share price volatility. Diversification does not ensure against loss.

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The Basics of Currency Fluctuations

An international investment's return is based on two factors - the investment's return in its local currency plus currency fluctuations. For example, suppose you purchase a British stock whose price increases 10% in one year in terms of British pounds. If, during that same year, the British pound increased in value by 5% compared to the U.S. dollar, your total return would be 15% - 10% from the investment's return and 5% from currency fluctuations. However, if the British pound decreased by 5%, your total return would be 5%.

When the U.S. dollar declines in value compared to the other currency, your investment increases in value since more dollars are required to purchase the investment. An increase in the U.S. dollar compared to the other currency means your investment decreases in value. Over the past couple of years, the falling U.S. dollar has caused increased returns for international investments. One study indicates that for the 2 1/2 years ended May 31, 2008, two-thirds of the gains in the EAFE index were a result of the dollar's decline against currencies in that index (Source: *On Wall Street*, August 2008).

Most countries use a system of managed floating exchange rates. Supply and demand factors set the exchange rate most of the time, as international banks, investors, tourists, consumers, and multinational companies buy and sell foreign currencies and goods. Governments typically only intervene to prevent massive fluctuations in exchange rates.

Demand for a particular currency is determined by many factors, including a country's inflation rate, interest rates, political and economic outlook, monetary policies, and speculation. The U.S. dollar does not move uniformly against all currencies - it can be rising against one currency while it is declining against another one.

In general, a rising dollar makes it less expensive for Americans to travel abroad, to import foreign goods, and to purchase foreign investments. However, U.S. companies may suffer since cheaper imported goods hurt sales of domestic products. When the dollar is declining, it becomes more expensive for Americans to travel abroad and to import foreign goods, but U.S. goods become more competitive in international markets.

When looking at international investments, consider these tips about currency fluctuations:

- Foreign bonds are subject to more currency risk than foreign equities.
- Currency fluctuations tend to be more moderate in parts of the world where political and economic factors are stable and the local currency is strong. Avoid areas where inflation rates are extremely high.
- Diversifying your investments by country and region can help reduce the overall effects of currency risk.

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Don't Underestimate Inflation

Inflation has been tame for so long that it's easy to ignore when planning for retirement. However, even inflation of 2% or 3% per year, over a period of many years, can seriously erode the purchasing power of your funds. At 2.5% inflation, \$1 today will be worth 78 cents in 10 years, 61 cents in 20 years, and 48 cents in 30 years. That can have a major impact on those entering retirement for several reasons:

- New retirees are less likely to have defined-benefit pensions. Thus, they must rely more on Social Security benefits and personal savings, including defined-contribution plans such as 401(k) plans.
- Cost of living adjustments for Social Security benefits are less generous. While Social Security benefits are still adjusted for inflation based on the consumer price index (CPI), the methodology for calculating the CPI changed dramatically in 1999, reducing increases in the CPI.
- Retirees are living longer. As life expectancies increase, retirees are spending more years in retirement, so their retirement savings are subject to the impact of inflation over a longer time period.
- Health-care costs are becoming more of a burden to retirees. More and more companies are reducing benefits or eliminating health care insurance for retirees, and health-care costs tend to increase faster than overall inflation. For instance, in 2006, the overall CPI increased 3.2%, while medical care costs increased 4.0% and hospital and related services increased 6.4% (Source: Bureau of Labor Statistics, 2007).

To combat the effects of inflation on your retirement income, consider these tips:

- **Use a conservative inflation rate for planning purposes.** Since your retirement is likely to span decades, consider inflation over long time periods. For instance, while inflation has averaged 2.54% over the past 10 years, it has averaged 4.31% over the past 30 years (Source: Bureau of Labor Statistics, 2007).

- **Consider investment alternatives likely to stay ahead of inflation.** Thus, a significant portion of your portfolio will probably be invested in stocks, which have typically earned returns in excess of inflation.
- **Invest in tax-advantaged investment vehicles.** Look into 401(k) plans, individual retirement accounts, and other retirement vehicles. While each has different rules for taxing contributions and earnings, all provide some tax-free or tax-deferred benefits. Since you aren't paying income taxes on earnings throughout the years, that typically means you'll have a larger balance at retirement than if you were paying taxes throughout the years. Thus, you'll start out with a larger retirement base to help combat inflation's effects.
- **Keep fixed expenses as low as possible.** Try to enter retirement with as few debts as possible. If you aren't using a significant portion of your income to pay a mortgage, car payment, or credit card debts, you'll have more flexibility to deal with higher prices.
- **Decide how you will deal with health-care costs.** While Medicare will help once you turn age 65, it still does not cover many health-care costs. Look into Medigap policies and prescription coverage to help with those noncovered expenditures, especially if your employer does not provide health insurance after retirement.
- **Minimize withdrawals from your retirement assets, especially during the early years of retirement.** To counter inflation, you need to withdraw larger and larger sums just to maintain the same purchasing power. To make sure you don't run out of funds late in life, keep withdrawals during the early years to a minimum.
- **Be prepared for change.** After retirement, keep a close eye on your investments. If inflation increases and you are concerned that increasing withdrawals may deplete your investments, you may want to look for ways to reduce your living expenses or go back to work at least part-time.

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Make Saving a Habit

Habits are all about the principle of human inertia: we tend to keep doing what we've always done and shy away from doing something new. That principle may work against you at first. If you're not used to saving money, it can be hard to get started. But once you gain some inertia in your new saving habits, it'll be relatively easy to keep it up.

We all need to save money to meet our financial goals. If you haven't started saving or aren't saving enough, here are some tips:

- 1. Take full advantage of payroll saving plans.** Payroll deduction is, without doubt, one of the greatest financial innovations. With just a few strokes of a pen on an authorization form, you hook yourself up to a savings program that works for you without any more effort. It doesn't matter what type of plan it is or how much you put in. Just get started, and you have a new habit.
- 2. Aim to max out on company matches.** When a company offers you a matching contribution, it's like they're saying, "Here's some free money. Want it?" What sane argument can anyone make to turn it down? The only conceivable one is that you need all the money you make to pay bills.
- 3. Treat saving like a bill.** The old adage for saving is, "Pay yourself first." It makes perfect sense, and the trick is to treat saving like any other bill. Name an amount and a date to pay it, and make the payment when it comes due. Instead of driving to the bank, you can mail your deposit in, or better yet, transfer the money online or over the phone.
- 4. Set up automatic checking debits.** Many financial institutions offer automatic withdrawals from your checking account into your savings account, money market, or other investment account. Known as Automated Clearing House (ACH) debits, these automatic withdrawals are nearly as good as payroll deductions to make saving easy.
- 5. Set annual goals for account balances.** You can never reach a goal if you don't have one. Specific annual targets for your account balances become incentives to save, and by dividing the difference between your current balance and your target, you can easily derive the periodic amount you need to contribute.
- 6. Devote your raises to saving.** When you get a raise, don't forget to increase your savings. If you can afford to, bank the entire raise. If not, at a minimum increase your savings proportionally.
- 7. Save your loose change.** Keep a savings jar, and at the end of the week put your loose change in it. This can mean more than coins. It can be bills below any denomination you choose, like anything less than a 10- or 20-dollar bill. At the end of the month, take it to the bank.

Saving is all about discipline - denying yourself immediate gratification in favor of securing your future. For some people, this is instinctively difficult, but at some level it's a challenge for everyone. Following the seven steps above can take some of the pain out of creating a new habit or adjusting an existing one to help you pursue your goals.

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The Changing Dynamics of Home-Equity Loans

When home prices were increasing, home-equity loans were a convenient way to finance numerous types of expenditures. While the loan is secured by the home's equity, the proceeds can be used for anything, including expenditures that have nothing to do with the home. In addition, home-equity loans have a significant advantage over other forms of consumer credit - interest paid on up to \$100,000 of home-equity loan proceeds can be deducted on your tax return if you itemize deductions. Home-equity loans typically offer competitive interest rates, usually no more than the prime rate or 1% or 2% over prime. Competitive interest rates combined with tax deductibility can add up to very attractive after-tax rates.

With all those advantages, it's no wonder home-equity debt became popular with homeowners. Until recently, lenders were often willing to offer home-equity loans on up to 100% of your home's value, with a simple application process and a quick check of home prices in your area.

But with declining home values and increasing numbers of foreclosures, lenders are not as anxious to approve home-equity loans. While the loan is secured by the home, it is a second lien that is subordinate to the mortgage. Thus, following a sale, the home-equity loan won't be paid until the mortgage is paid in full.

Many homeowners are being notified by lenders that their home-equity line of credit is reduced or frozen. Most contracts contain a provision allowing the lender to reduce or suspend the line if home values fall significantly or the homeowner's ability to repay the loan decreases. Signs to the lender of a decreased ability to repay include a poor credit rating, a small down payment with no private mortgage insurance, or late payments noted on your credit report. If you receive such a notice but still need the line, call and discuss the situation with your lender.

If you are trying to obtain a home-equity loan, be aware of possible changes:

- **The loan-to-value ratio will probably be lower.** In the past, it was not uncommon for a mortgage and home-equity loan to total 100% or more of the home's market value. Nowadays, anything over 90% is rare, and that

- percentage may be much lower in markets with declining home values. Some areas have limits as low as 65% of the home's value.
- **Your credit score is more important.** In the past, it was fairly easy to obtain a home-equity loan. Now, lenders are more concerned about your credit rating. If your credit score is less than 680, it will be difficult to find a lender willing to approve the loan. The higher your score, the more options available.
 - **You'll need a full appraisal of your home.** In the past, a simple review of home values in your area was often enough for a home-equity loan. Now, you'll probably need a full appraisal, including a walk-through of your home.

Please call if you'd like to discuss home-equity loans in more detail.