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Finding a Balance between Risk and Return

One of the most basic investment principles is that returns reward you for the risks that you take. While investors are often uncomfortable with the concept of risk, it is this uncertainty that makes higher rates of return possible. Some basic investment principles related to risk and return include:

- Returns on specific investments are not known in advance. Investors can review historical rates of return, but there is no guarantee that past returns will be indicative of future returns.
- With most investments, there is the possibility that the investment will not meet your return expectations.
- The uncertainty regarding your actual return creates risk. Greater uncertainties typically lead to greater risk.
- Investments are subject to many different types of risk. Cash is primarily subject to purchasing power risk, or the risk that its purchasing power will decrease due to inflation. In addition to purchasing power risk, bonds are subject to interest rate risk, or the risk that interest rates will increase and cause the bond's value to decrease, and default risk, or the risk that the issuer will not repay the principal or interest on the bonds. Stocks are primarily subject to nonmarket risk, or the risk that events specific to a company or its industry will adversely affect a stock's price, and market risk, or the risk that a particular stock will be affected by overall stock market movements.
- There is generally a tradeoff between risk and return. Low levels of risk are the most desirable and typically have lower return potential; while higher levels of risk are typically undesirable, so they must offer higher

return potential to encourage investors to invest. Be cautious of claims of high returns with low risk.

There are strategies that can be used to reduce the total risk in your investment portfolio:

- **Diversify your portfolio.** You should diversify among several different investment categories, including cash, bonds, and stocks, as well as within investment categories, such as owning several types of stocks. A properly diversified portfolio should contain a mix of asset types whose values have historically moved in different directions or in the same direction with different magnitudes. By owning several investments rather than just one, a downturn in any one should not have a significant impact on your total return.
- **Stay in the market through different market cycles.** Remaining in the market over the long term helps to reduce the risk of receiving a lower return than expected, especially for more volatile investments, such as stocks.
- **Use dollar cost averaging to invest.** Rather than accumulating cash so you have a large sum to invest, invest small amounts regularly. Dollar cost averaging involves investing a certain sum of money in set amounts at regular intervals. This spreads your purchases over a period of time, preventing you from making one major purchase at high prices. Since you are investing a set amount, you purchase more shares when prices are lower and fewer shares when prices are higher. While a valuable investment strategy, dollar cost averaging does not ensure a profit or protect against losses in declining markets. Before starting a program, consider your ability to continue purchases during periods of low price levels.

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What's a Reasonable Rate of Return?

How do you know if you're saving enough for a future goal? You must get three factors right - how much you need, when you need the money, and how much you'll earn on your investments. You can then calculate how much you should save on an annual basis.

The typical approach to estimating a rate of return is to look at average annual returns for some historical period. For instance, from 1926 to 2007 (82 years), the average return for the stock market as measured by the Standard & Poor's 500 (S&P 500) was 10.4%. Change the period to 1958 to 2007 (50 years) and the return changes to 11.0%, 12.7% from 1983 to 2007 (25 years), and 5.9% from 1998 to 2007 (10 years). * Assume you want to save \$1,000,000 in 30 years. To reach that goal, you need to save \$5,635 annually at 10.4%, \$5,025 at 11.0%, \$3,616 at 12.7%, and \$12,873 at 5.9%.

It's tempting to use the highest return possible, since that results in the lowest savings amount. But consider using a conservative estimate. If you save too much, you can always reduce savings in later years or spend more in retirement. The alternatives are far less attractive if you don't save enough. Consider the following points:

- **Your investing time frame will probably encompass decades.** Thus, consider using an historical rate of return that covers a very long time frame, making adjustments from there.
- **Factor in inflation.** When estimating inflation, factor in a long time period. For instance, inflation, as measured by the consumer price index, averaged 3.1% since 1926 (Source: Bureau of Labor Statistics, 2008).
- **Watch your pattern of returns.** Even if you get the average rate of return exactly right, your portfolio's balance will depend on the pattern of actual returns during that period. Some years will experience higher-than-average returns, while other years will have lower or even negative returns. If you experience higher returns in the early years, your portfolio balance will be lower than if those returns occurred in the later years. If you encounter negative returns in the early years, you will have a higher balance than if those negative returns came in the later years. Assess your portfolio's progress every year so you can make adjustments along the way.

What is a reasonable long-term rate of return to use for stock investments? Starting with the average return from 1926 to 2007 of 10.4% and subtracting 3.1% inflation would result in a return of 7.3%. You may even want to use a more conservative return if you feel the stock market may encounter an extended period of below-average returns. Sure, that means you'll need to save more every year, but learning to live within your means and saving significant portions of your income aren't bad things.

* Source: *2008 Ibbotson Stocks, Bonds, Bills, and Inflation Classic Yearbook*. 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.

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Make Pension Decisions Carefully

In the past, a retiree typically received a monthly pension check and Social Security benefits. Now, it's not uncommon for a retiree to have a pension plan, a couple of 401(k) plans, some individual retirement accounts (IRAs), personal savings, possibly some deferred compensation, and maybe an annuity. Deciding how to handle all of those different income sources in the most advantageous manner is a daunting task. In many cases, decisions regarding pension plans are irrevocable, so proper choices are imperative. Before making those decisions, consider the following:

Prepare a list of all of your retirement assets, by type of plan. Indicate the expected monthly income as well as the earliest and latest date you can start taking benefits. Review the payment options available to see if some assets should be used before others. For instance, defined-benefit plans and deferred compensation plans generally require you to take benefits when you retire, whether you want the money or not. Other plans, such as 401(k)s and IRAs, allow you to start withdrawals between the ages of 59 1/2 and 70 1/2, providing flexibility regarding the amount withdrawn. Thus, if you can, it is typically advantageous to leave that money in the plan to grow tax deferred until a later date. You must begin taking minimum distributions from traditional IRAs (not Roth IRAs), 401(k) plans (unless you are still working), and other qualified plans by the time you are 70 1/2.

Decide whether you want to take a lump-sum distribution or receive an annuity. This option is generally offered with 401(k) plans, profit-sharing plans, and some defined-contribution plans. Your decision should be based on the income tax ramifications of the different options, your personal needs, and your financial ability to handle the money.

If you opt for an annuity, you must decide among various payment options, including life only, which pays you a certain amount until your death; joint and survivor, which will also pay a certain amount to your spouse after your death; and life and period certain, which pays a certain amount for your life or a specific time period, whichever is longer. Your payments are generally taxed as ordinary income when received.

You may like the peace of mind that comes with annuities, since you are assured of a monthly income without having to worry about investment decisions. However, annuity amounts are typically fixed, so inflation can seriously erode the purchasing power of this income over the years.

A lump-sum distribution gives you the opportunity to invest your retirement funds. Thus, you receive the rewards of smart investment decisions, but you can also suffer from poor decisions. Since you own the funds, proceeds can be left to your heirs after death.

The tax treatment of a lump-sum distribution depends on how you handle the distribution. The least favorable alternative is to include all the proceeds in your taxable income in the current year, subjecting the proceeds to your top tax rate, and possibly the 10% tax penalty if you are under age 59 1/2.

As an alternative, any portion of your account balance in a qualified plan can be rolled over into an IRA within 60 days. This rollover defers the tax on the distribution and allows it to grow tax deferred until withdrawn. Keep in mind that if you take possession of the funds, your employer must withhold 20% of the proceeds, even if you plan to roll over the entire balance. You can avoid this provision by having your employer directly transfer the distribution to your IRA. If you are between the ages of 59 1/2 and 70 1/2, you can access the funds as you need them, penalty free, paying ordinary income taxes only as you withdraw funds.

Determine how to withdraw money from your plans. After going through this analysis, you can decide when to start taking distributions. These decisions will take into account your life expectancy, your tax situation, your current income needs, the expected inflation rate, and your expected rate of return on retirement assets. The calculations can quickly become very complex if you need to evaluate several different plans under several different payment scenarios. Since the calculations are so important for your retirement, please call if you'd like help with these decisions.

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Does Buy and Hold Still Make Sense?

We all know the basics - design an asset allocation plan, ignore market fluctuations, and stick with the plan for the long term. In other words, become a

buy-and-hold investor. But in an era where everything seems to change overnight, is it realistic to expect to find investments you'll be comfortable owning for years or even decades?

Before you answer that question, you need to consider whether it's possible to reliably time the market. Unfortunately, it's a difficult strategy to implement for a couple of reasons:

- **No one has been able to consistently predict where the stock market is headed.** Many try, but so many factors affect the market that even professionals watching the market full-time find it difficult to time the market with any degree of accuracy. In retrospect, everything seems crystal clear. Are you still upset you didn't get out of technology stocks in 2000? While we now know that was the market top for technology stocks, very few recognized that in 2000. Also, significant market gains can occur in a matter of days, making it risky to be out of the market for any length of time.
- **Frequent trading seems to reduce, rather than increase, returns.** Several studies of investor trading found that investors who trade more frequently have lower portfolio returns than those who trade less frequently. A recent study found that for the 20 years ending in 2007, the average equity fund investor earned an annualized return of 4.5%, compared to an annualized return of 11.8% for the Standard & Poor's 500 (Source: *Fortune*, November 10, 2008).* Why? Investors tend to buy hot sectors and sell underperforming investments - the opposite of a buy-low-and-sell-high strategy. Also, trading results in a taxable event. Even with capital gains rates at 15% and the highest ordinary income tax rate at 35%, taxes significantly reduce your portfolio's return.

Rather than trying to time the market, devise an asset allocation strategy you'll be comfortable with for years and then purchase investments for that strategy. That doesn't mean you'll never sell an investment, but selling should be an infrequent part of your investment strategy.

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Assisting Your Parents with Their Finances

Discussing financial matters with your parents can be difficult. You don't want to seem concerned about how much money they may eventually leave you, while they may fear you are interfering in their lives. Yet, without discussing these matters beforehand, you may have trouble finding financial records or determining their wishes if you need to take over their finances.

Consider discussing financial matters with your parents when they are in their early 60s. Include all immediate family members to prevent future misunderstandings, making sure to cover the following:

- **Where are personal records kept?** You don't need to know specifics, but you should find out where important records are located. Determine where details about insurance policies, investments, deeds, birth and marriage certificates, pension information, bank statements, estate planning documents, credit card information, and outstanding debts are kept.
- **Who are their advisers?** Ask for a list with names, addresses, and phone numbers of all advisers and physicians. Get details about medical conditions and medications being taken.
- **What are their monthly income and expenses?** This will help you determine whether they have sufficient income to pay bills. If they don't, you may be able to help them change investment selections or find ways to increase income.
- **Do they have adequate insurance?** Make sure your parents have adequate insurance coverage and have made provisions for long-term-care needs. Have them investigate long-term-care insurance when they are still healthy and young enough to qualify for reasonable premiums. If they aren't interested in coverage but you fear the burden of long-term care will fall on you, you may want to obtain the insurance for them.
- **Do they have up-to-date estate planning documents?** Don't ask for specifics, just make sure documents are in place so their wishes can be carried out. Find out if they have a durable power of attorney and health-care proxy. With a durable power of attorney, they designate someone to control their financial affairs if they become incapacitated. If your parents are concerned that this person may assume control prematurely, suggest leaving the document with their attorney, who can deliver it to the appropriate person when necessary. A health-care proxy delegates health-care decisions to a third person when your parent is unable to

make those decisions. Usually, this document also outlines procedures to be used to prolong life.

- **What are their preferences for the future?** Find out where your parents would like to live if they're not physically able to live in their current home. Do they want to move in with relatives or live in an assisted-living facility? Discuss in detail what procedures they want performed to prolong life in the event of a terminal illness. Determine their preferences for funeral arrangements.

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