

January 2011 Issue

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Concentrate on the Basics

When faced with all the decisions that need to be made to ensure you select appropriate investments to help pursue your long-term investment goals, it's easy to become overwhelmed. How do you choose the right combination of investments to help you work toward a goal that may be decades away? The answer is to concentrate on the basics. Make sure you are getting these fundamentals right:

- **Don't wait - invest now.** To put the power of compounding to work for you, start investing now. It's easy to put off investing, thinking you'll have more money or more time at some point in the future. Typically, however, you'll be better off saving less now than waiting and saving more later. Consider the savings habits of a 20-year-old couple. The wife starts contributing \$2,000 per year to a tax-deferred investment, such as a 401(k) plan, when she is 20. After 10 years, she decides to stop investing and let her money grow until retirement. She has invested a total of \$20,000. Her husband starts investing when she stops, investing \$2,000 per year from the time he is 30 until he retires at age 65. Thus, he saves every year for 35 years, making a total contribution of \$70,000 - \$50,000 more than his wife. If they both earn 8% compounded annually, who will have the larger potential balance at age 65? Time and compounding of earnings favor the wife. Before paying any taxes, her balance would equal \$462,649, while her husband's balance would be \$372,204. (This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)
- **Live below your means so you can invest more.** It's a basic fact that most people have trouble coming to grips with - the amount of money you have left over for investing is a direct result of your lifestyle. Don't have any money left over for investing? Ruthlessly cut your living expenses and redirect all those reductions to investments.

- **Maintain reasonable return expectations.** When developing your financial goals, you'll typically decide how much you need, when you'll need the money, and how much you'll earn on those savings. Those factors will determine how much you'll need to save on an annual basis to reach your goals. The higher your expected return on your investments, the less you'll need to save every year. However, if your assumed rate of return is significantly higher than your actual rate of return, you won't reach your goals. Thus, it's important to come up with reasonable return expectations. While past returns aren't a guarantee of future returns, you'll want to start by reviewing historical rates of return for investments you're interested in. Assessing your progress every year will allow you to make adjustments along the way.
- **Understand that risk can't be totally avoided.** All investments are subject to different types of risk, which can affect the investment's return. Cash is primarily affected by purchasing-power risk, or the risk that its purchasing power will decrease due to inflation. Bonds are subject to interest-rate risk, or the risk that interest rates will rise and cause the bond's value to decrease, and default risk, or the risk that the issuer will not repay the bond. 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 stock will be affected by overall stock market movements. These risks make some investments more suitable for longer investment periods and others more suitable for shorter investment periods.
- **Diversify your portfolio.** Typically, you do not know which asset class will perform best on a year-to-year basis. Diversification is a defensive strategy - it helps protect your portfolio during market downturns and helps reduce your portfolio's volatility. Diversify your investment portfolio among and within a variety of investment categories.
- **Only invest in the stock market for the long term.** Stocks should only be considered by investors with an investment time frame of at least five years. Remaining in the market over the long term reduces the risk of receiving a lower return than you expected.
- **Don't try to time the market.** Timing the market is a difficult strategy to accomplish successfully, since so many factors affect the market. Remember that most people, including professionals, have difficulty timing the market with any degree of accuracy. Instead, concentrate on setting an investment program that works in all market environments and that you can stick with in good and bad times.
- **Pay attention to taxes.** Taxes are probably your portfolio's largest expense. Ordinary income taxes on short-term capital gains and losses can go as high as 35%, while long-term capital gains and dividend income are taxed at rates not exceeding 15% (5% if you are in the 10% or 15% tax brackets). Using strategies that defer income for as long as possible can make a substantial difference in the ultimate size of your portfolio. Some strategies to consider include utilizing tax-deferred investment vehicles (such as 401(k) plans and individual retirement accounts), minimizing portfolio turnover, selling investments with losses to offset

gains, and placing assets generating ordinary income or that you want to trade frequently in your tax-deferred accounts.

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Thinking Strategically about Risk

When it comes to risk, many investors claim to be either "risk averse" or "risk tolerant." Generally, the risk averse invest more in bonds, while the risk tolerant invest more in stocks. But is risk really that simple?

York University business school professor Moshe Milevsky recently wrote an article on risk that was featured in *The Wall Street Journal*. In it, he states that investors often don't look at risk as strategically as they should and don't consider the most important asset of all: themselves.

Milevsky believes investors should consider how a high or low day in the stock market directly impacts their take-home pay. The answer varies greatly by industry and job profession: a middle school librarian may have a zero impact, while an investment banker or portfolio manager may be highly impacted by the stock market's highs and lows.

After considering this relationship, investors should consider how this relates to their investment portfolio. Instead of assuming a position in one of the risk camps (averse or tolerant), look at how much risk your "personal balance sheet" can tolerate.

Your personal beta

Rather than looking at your assets as allocations of monies into stocks, bonds, real estate, and so on - consider your number one asset as *you*. Look at your future earnings and consider the amount of income that you will generate before retirement.

After looking at your income and - in generalities - how it is tied to the stock market, actually assign a number to it. Milevsky explains it this way, "If a stock has a beta of 1, it means that it's likely to move pretty much in tandem with the overall market. A beta above that means that if the market falls, the stock will likely fall by even more; a beta below 1 means the stock won't move as much as the market." (Source: *The Wall Street Journal*, 2010).

Most traditional professions have a beta of zero. This doesn't mean the incomes don't fluctuate, but that the volatility of the stock market has no impact on the incomes.

A question of balance. Once you know your personal beta, apply it to how your portfolio is allocated. If you have a high personal beta, if the returns on your human capital tend to fluctuate with the market, then your financial capital - your 401(k), IRA, brokerage account, etc. - should be invested more conservatively. It doesn't matter if you *feel* the market is due to rise. You should instead be considering that if markets decline over a prolonged period of time, there is a greater chance you might lose your job, be unemployed for a long time, own less valuable stock options, and so on.

Rethink your insurance. Human capital isn't influenced only by the stock market. It is vulnerable to plenty of other factors, such as death, disability, and extended illness. One way to reduce the risk level on your balance sheet is to ensure that you are properly insured. Insurance allows your family to treat your human capital a bit more like a bond and perhaps take more risk in their financial portfolio.

Start early. Assessing your personal beta, understanding your income and human capital worth, and allocating the right assets to your portfolio will help you think strategically about risk.

Milevsky claims that "knowing your personal beta will help you manage your total risk more effectively. And that is always a safe strategy."

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Should You Invest or Pay Off Debt?

It can be difficult to decide where to allocate your funds when you want to both increase your investment portfolio and reduce your outstanding debt. While there are many factors to consider, the decision typically depends on the potential return of the investment compared to the interest rate paid on the debt.

For instance, if you are considering purchasing a bond with a 5% interest rate, paying off a mortgage with a 6% interest rate, or reducing credit card debt with a 12% interest rate, you should probably pay off your credit card debt.

When analyzing the situation, look at after-tax, not pretax, rates. In this example, interest income from the corporate bond is subject to federal income taxes, the mortgage interest is tax deductible, and there is no tax deduction for the credit card

interest. If you're in the 25% tax bracket, the 5% rate on the corporate bond will net 3.75% after taxes, the 6% mortgage will cost 4.5% after taxes, and the 12% credit card debt costs 12% without an income tax deduction.

There are some situations, however, when you should consider other factors besides just the financial ones, including:

- **When your employer matches your 401(k) contributions** - Many employers match contributions to 401(k) plans, which is money you lose if you don't contribute. Those matching contributions can make a big difference when deciding whether to invest or pay off debt. For example, assume your employer matches 50% of contributions up to 6% of your salary. If you're earning \$50,000, a 6% contribution equals \$3,000, with a \$1,500 matching contribution from your employer. Thus, you should typically take advantage of all matching contributions before using money to pay down debt.
- **When you are paying down your mortgage rather than other debt** - Often, there is psychological satisfaction in paying down your mortgage to build equity in your home. However, mortgage debt is usually the last debt that should be paid off, since interest rates are typically lower than other forms of debt, and the interest payments are tax deductible. If you want to pay down debt, make a list of all your debts, the interest rates, and whether the interest is tax deductible. Start paying off the debt with the highest nondeductible interest rate. Once that debt is paid in full, move to the next highest interest rate, continuing down your list until all debt is paid in full.
- **When you're using money from your retirement savings to pay off debt** - Many 401(k) plans allow loans at relatively low interest rates. Thus, you may be tempted to take out a loan and use the proceeds to pay off your high-interest-rate credit card debt and auto loans. One of the dangers of this strategy is you'll start to regard your retirement savings as a piggy bank that can be dipped into whenever you need money. It's typically better to leave retirement savings alone so the money can compound for your retirement. Also, you don't want to take out a loan, pay off your credit cards, and then start running up balances on those cards again.

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Before Purchasing That Stock

If you've been investing for years without a defined strategy, it may be time to change that and align your portfolio accordingly. Or perhaps you have a strategy that needs some dusting off. Maybe it's simply time to sit down and realign your portfolio with your investment strategy. After all, the markets aren't static; your portfolio shouldn't be either.

Whether you're investing for the first time or buying new stocks to augment your current portfolio, there are five important questions to ask yourself:

What's your objective? Is your ideal stock one that pays a high dividend or one that has a high growth rate with no dividends? Is it a stock with relatively little price volatility but lower potential gains, or one with a lot of potential risk and higher potential rewards?

How you answer those questions - and the stocks you choose - depends on your objectives. If capital preservation is your goal, for example, a lower-risk stock is probably preferred. On the other hand, if you're young and growth is your target, a higher potential return stock may make more sense. Whatever your objective, defining that goal is the first step to selecting stocks for your portfolio.

Is your portfolio diversified? When considering which stock to purchase, determine whether you need to target your investment in certain areas to balance out your diversification. Make sure your portfolio isn't concentrated in just one industry, but spread out over at least four or five. And there are other dimensions to consider as well, such as cap weighting (large, mid, and small), style (growth or value), and geography (U.S.-based, developed foreign markets, and emerging markets).

The benefit of diversification is that the up and down movements of different asset subclasses are not completely correlated, so that over time, losses in one industry or subclass may be offset by gains or lesser losses in another.

What's your expected holding period? If you're looking to trade for quick gains, your expected holding period is short. In that case, you need to be sure you are timing your purchase so you're getting in near the beginning of an upswing, not the end of one.

If you are buying for the long term, on the other hand, the price you pay is less critical, as long as you don't purchase a stock in the early stages of a steep decline in value.

What's the prevailing market trend? In the 1990s, the market was so strong that almost any stock you bought was likely to go up in value. But in a trendless or declining market, it's a lot harder to find a winner, at least in the short and intermediate terms. That's because the majority of stocks move in the same direction as the market, no matter how fundamentally strong a stock may be.

At the current price, would you be paying too much? To answer this question, you'll have to consider some basic fundamentals.

First, look at the stock's price/earnings (P/E) ratio, which is its price per share divided by earnings per share. How does it compare to the stock's normal range, and how does it compare to its competitors? If the P/E ratio is high, maybe the stock is overpriced. On the other hand, if it's low, it could either be a bargain or an indication of a fundamental weakness.

In addition to the P/E ratio, you should examine the stock's past and future earnings growth rate. Then look at its price/earnings to growth ratio (PEG ratio). The PEG ratio compares the stock's P/E ratio to its five-year projected earnings growth rate. A PEG ratio of 1 to 1.5 is typically considered normal. A PEG of 2.0 or higher is often a sign that a stock is overpriced, while a PEG ratio below 1 may be an indication that the stock is a bargain.

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Clean Up Your Portfolio

As a new year begins, gather all your information together, thoroughly analyze it, and clean up your portfolio. Some points to consider during this review include:

- **Take another look at your asset allocation plan.** Do this before you review your actual investments so you aren't influenced by your current allocation. You may now realize that your risk tolerance is lower than you originally thought, so some changes to your allocation may be needed. Or you may realize you need to increase your allocation to one investment category or another to reach your financial goals.
- **Find your most recent statements.** List each investment and its current value. Total your investments by category - cash, bonds, and stocks. Then compare those percentages to your asset allocation plan. If you haven't done this review in a while, you're likely to find your current allocation is off.
- **Decide how to get your allocation back in line.** Look for ways to accomplish this as soon as possible.
- **Get rid of small accounts.** It's not unusual to find you have several small accounts. Perhaps you have a bank savings account with several hundred dollars in it that you don't use anymore. Or you may have a small investment account you received as a gift. The accounts may be so small that you haven't taken the time to cash them out. But you still have to look at the statements every month and make sure any income is included on your tax return. Consolidate the funds in one account.
- **Look for ways to simplify your investments.** Do you have a variety of individual retirement accounts (IRAs) that can be consolidated in one IRA? Do you own similar stocks or other investments that aren't adding much in the way of diversification? While you want to be properly diversified, minimize the number of accounts and investments you own so your investments are easier to monitor.

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For instance, if you are considering purchasing a bond with a 5% interest rate, paying off a mortgage with a 6% interest rate, or reducing credit card debt with a 12% interest rate, you should probably pay off your credit card debt.

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