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Principles of Stock Diversification

What professional money managers know and private investors need to learn is how to avoid depending on chance to determine their investment results. One of the first principles is to reduce risk by diversifying — spreading risk over a number of different stocks. Since over the long term even the best stocks fluctuate in value, the goal is both to avoid catastrophic losses as well as smooth out the ups and downs of your total portfolio value by always having some stocks that are outperforming others.

Almost instinctively, everyone knows this. But in practice, that notion only takes you so far. What you really need to know is this: how many different baskets are there, and how many do you need to potentially achieve the best result?

In no particular order, here are the keys to effective risk control of a stock portfolio through diversification:

Number of stocks. There is no preferred number of stocks that provides just the right amount of diversification. But most money managers agree that it falls in the range of 10 to 30, while some say you're okay with just five and others say even 30 isn't enough. The underlying trade-off is safety versus performance. The more stock issues you own, the lower your risk; but at the same time, the lower your potential return, as the results of the best performers get diluted by the other stocks.

Weighting. To diversify properly means you have to pay attention not just to the number of issues you own, but how much money you have invested in each. If you have 10 issues, but 90% of your money in one; you're not properly diversified. The more evenly you spread your money among the stocks you own, the more diversified your

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Principles of Stock

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portfolio becomes.

Sectors and industries. Similarly, you're not very diversified if all of your stocks are in the same sector of the economy. While you may be hedged against the risk of severe mismanagement at any one company, in general, stocks in the same industry move in roughly the same direction at the same time, because they're all exposed to the same risks in their marketplace. You achieve more risk control by choosing stocks from at least five sectors and, within sectors, different industries.

Company size. When it comes to stock performance, size matters. Size is measured by the stock's price times the number of outstanding shares, for a figure called market capitalization, or market cap for short. In general, over the long run, small-cap stocks produce the best returns, followed by mid-sized stocks and then large-cap stocks. As you might expect, among these three categories, small-cap stocks are the riskiest and large-cap stocks less risky and more stable. Having all three in your portfolio offers another level of diversification.

Investment style. There are two classic investment styles: growth and value. Studies show that over the long run they generate roughly the same total return. One difference is a matter of volatility: growth stocks tend to have wider swings in value, both up and down, than value stocks. Another is timing. Normally, they take turns outperforming each other. By investing in both at the same time, you increase your diversification benefits.

Domestic and foreign. Finally, you can diversify by where your stocks operate, since foreign markets are often out of phase with the U.S. market. Among U.S.-traded stocks, you can obtain more diversification by investing both in companies that operate only in the U.S. as well as in multinationals. You can also invest in foreign-based companies whose stocks trade in the U.S.

Clearly, it takes careful research and analysis to create and maintain a properly diversified stock portfolio, and there are many ways to do it. Most important, however, is to build a portfolio that can meet your goals while suiting your tolerance for risk. It's possible both to over- and underdiversify. Please call your financial advisor if you'd like to discuss this in more detail. ❍❍❍

4 Reasons to Create an Estate Plan

From the clothes on your back to the roof over your head, the money in your checking account and your 401(k) plan, every asset you own (and most of your liabilities, too) is part of your estate. Your earthly possessions — financial and otherwise — will be left behind after your death. To whom? That is exactly the question an estate plan, when it's prepared correctly, will answer.

Chances are you won't like your state's plan for your estate — Every state has different laws for what happens to a person's estate if he/she has no plan in place. Generally speaking, if you don't have an estate plan in place, the state will allocate your estate as it sees fit, which may not coincide with your desires. Even if your estate ends up disbursed as you would have wanted, the process of sorting everything out (called probate) can take many months or even years and end up eroding a substantial chunk of your estate assets. If you want to ensure that you have control over what happens to your estate, you should have an estate plan.

To avoid disputes among family and friends — Mourning someone's passing is already difficult enough, but no estate plan will likely add even more stress for your loved ones in their time of grief. When a person passes without an estate plan, it's common for family disputes to erupt, as people argue over how money and possessions should be split. When you have an estate plan, even though people may not agree with the way you allocate your estate, you're making clear your wishes — not leaving it up to them to decide.

To take care of your loved ones — When you pass, you leave people behind. You may have a spouse, children, grandchildren, siblings, parents, pets. Number one, you want to ensure that your children or any other dependents (yes, including pets) will be taken care of by someone you love and trust — so that even though you can't care for those dependents, they are still being loved and cared for the way you would have wanted.

To take care of yourself — While planning what will become of your assets after you die is a significant component of estate planning, it's also about what happens to you. Do you want to be cremated or buried? What kind of funeral do you want to have? Do you want to donate your organs? Do you want to donate your body to science? If you pass without specifying your wishes to these questions, it's up to your family or the state to decide what to do. Or what if you become unable to care for yourself? With an estate plan, you can ensure that you are taken care of in life and in death.

Of course, these are not the only important reasons to create an estate plan (for large estates, tax planning is a very important reason to create a plan), but these are four of the most critical. No matter what you own or how old you are, having an estate plan will protect your family, you, and your estate when you pass. ❍❍❍

How Much Life Insurance Do You Need?

There are rules of thumb to determine how much life insurance to buy — like seven to 10 times your annual earnings. You don't hear this advice much anymore, but if you do, ignore it. How much life insurance you need is a question that can only be answered after a thorough analysis, which means there's no one answer that's right for everyone.

Let's start with an understanding of the primary purpose of life insurance: It's supposed to provide support for the people who depend on your income, like a spouse and/or children. No spouse or children? Then you may not need any life insurance at all — unless you have special estate planning needs.

Replacing Your Income

Another way of describing the basic purpose of life insurance is income replacement. Simply put, it means leaving your beneficiaries a lump sum of money that can generate an income equal to the amount of money you were making.

Let's say you earn $100,000 a year. And let's assume that the decision-maker you leave behind could invest a lump sum that would generate income of 4% a year. To determine how much that lump sum needs to be is simple math: divide $100,000 by 4%. The answer is $2.5 million, which is 25 times your annual income.

Easy? Sure, you if ignore inflation — which is a very serious challenge — and the fact that these days it's not easy to find safe investments that can be counted upon to generate 4% income every year.

As for inflation, the problem is that every year a dollar buys less. So if you want your heirs to keep up with inflation — to maintain the same level of real income each year — then the investment return on the proceeds of your insurance policy has to equal the total of the rate at which your heirs withdraw from them *plus* an amount equal to the rate of inflation.

Alternatively, your beneficiaries could withdraw whatever they need to keep up with inflation. So, when inflation proceeds at a steady rate of 3% per year, they withdraw $100,000 in the first year, $103,000 in the second year, $106,090 in the third, and so on to keep the same level of real income each year. But this means they're drawing down principal, and that means it will eventually disappear.

In the example above, with the invested life insurance proceeds earning 4% a year and the heirs withdrawing $100,000 in the first year and more in each subsequent year to cover 3% inflation, the entire principal would be gone after 29 years. Now, that may be fine if your surviving spouse is 60 years old when you die, since it would cover him/her for most if not all of his/her lifetime; but it wouldn't be so good if your spouse was considerably younger when policy benefits are paid, or if you're hoping to support children or grandchildren.

In addition, the simple income replacement method overlooks other kinds of contingencies, like providing a college education for your children. This brings us to the second method of determining how much life insurance you need: needs analysis.

Needs Analysis

While the income replacement calculation beats the old rules of thumb, it still represents only a very basic level of planning that can leave many important considerations unexamined. As an alternative, the needs analysis calculation looks at all of your survivors' relevant lifestyle needs to determine the appropriate amount of life insurance. This approach relies on many of the same considerations that a full-fledged financial plan addresses, such as:

✔ **Will your surviving spouse work?** The extent to which your spouse can earn income from employment will reduce the amount of insurance you need. If a paycheck is a possibility, though, to what extent will it be reduced by childcare expenses?

✔ **Should your spouse pay off debt?** If your spouse's income possibilities are limited, it might make sense to use some life insurance benefits to pay off a mortgage or other debts.

✔ **Funding a college education.** If you were planning on using a portion of your income to fund your children's educations, is the life insurance policy enough?

✔ **Financing your spouse's retirement.** If your contributions to an IRA or workplace retirement account are essential to meeting your retirement goals, you need to factor that into the calculation of your life insurance amount.

The bottom line: there's no one-size-fits-all approach to determining how much life insurance is right for you and your family. The best approach is to work from a plan that takes all aspects of your financial life and goals into account. If you're unsure whether you have the right coverage, please call your financial advisor. ❍❍❍

Investing in Your Golden Years

There are so many unknowns: Will Social Security be there when you retire? How long will you live? Will the stock market decline right as you need to make retirement withdrawals? How aggressive should you be with your retirement allocation as you near retirement?

As is often the case, the answer is, it depends. While we can't predict the future of Social Security or how long we'll live, we can take steps to allocate our investments so we have the right balance of stocks, bonds, and cash equivalents for our financial goals. Determining that mix as you near retirement involves both qualitative and quantitative factors. You'll need to consider:

- ✔ How much you've already accumulated for retirement
- ✔ How much you can save annually between now and when you retire
- ✔ How large a portfolio you're going to need, based on how much you want to withdraw annually during retirement

Each investor's needs are different, so the strategy that optimizes one person's allocation may not work for the next investor. However, there are some general guidelines to consider for your portfolio as you approach retirement:

- ✔ The younger you are, the higher your allocation to stocks can be. With time on your side, your portfolio will have time to recover from any market downturns.
- ✔ Even if you're young, you'll probably want to include some bonds in your portfolio, which will help reduce the overall volatility.

As a general rule, as you approach retirement age, you'll want to increase the percentage of your portfolio that's invested in bonds. If you have other stable retirement resources, such as pension benefits or Social Security, you may be able to allocate a larger percentage of your portfolio to stocks.

Likewise, if you have a large portfolio, more than you will deplete during your lifetime, you might be able to be more aggressive, since a short-term setback in the market won't seriously affect your ability to make withdrawals from your portfolio.

Whatever your unique situation, the optimal stock-bond-cash portfolio allocation is probably not 0% stocks and 100% bonds and cash. While you don't want to near retirement with a portfolio that's too aggressive, some stocks may help your portfolio continue to grow. ❍❍❍

Discussing Your Estate Plan

Talking about what will happen after a person dies can be a painful and scary discussion, but a necessary one. It's important to talk with your loved ones about what you want, what they want, and what is laid out in your will.

- ✔ **Keep it light —** Having this discussion can bring up a lot of emotions for your loved ones, so keep the conversation light but to the point.
- ✔ **Talk openly and honestly —** A decision you have made may hurt someone's feelings, or there may be things you don't want to tell people about; but it is crucial to be open and honest.
- ✔ **Discuss values, not just valuables —** When you die, how do you want people to remember you? What parts of you do you want to live on? This may include traditions, values, family names, rituals, religious beliefs, and so on.
- ✔ **Have a professional present —** In many cases, a professional has a better understanding of how estate planning works and can assist by answering any questions your loved ones may have. You might have a family-only conversation first and then a second conversation with the estate planning professional. ❍❍❍

Financial Thoughts

In a recent survey about whether individuals would have made different life choices, 46% of those between the ages of 50 and 64 said that they would have chosen different professions (compared to 29% of those age 65 and older), 25% said they would have delayed having children (compared to 17% of those age 65 and older), and 43% would have ended a bad relationship (compared to 25% of those age 65 and older). In the same survey, 11% of those between the ages of 50 and 64 said that their family was doing very well financially, compared to 22% of those age 65 and older (Source: *AARP Bulletin*, January–February 2014).

Approximately 28% of Americans would consider moving to another state or county to get better and/or cheaper health insurance. Of those between the ages of 18 and 29, 40% would be willing to move to another state (Source: Bankrate.com, 2014).

Almost 37% of investors believe that they can meet their financial goals without investing in stocks, while 22% believe that stocks are the best long-term investment (Source: *Money*, January 2014). ❍❍❍

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