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A 3-Step Asset Allocation Plan

Perhaps the most important move you can make for your investments is to properly diversify your portfolio. By investing in a mix of stocks, bonds, and cash, you'll reduce the risk of a significant loss.

How you combine your diverse mix of investments is called your asset allocation. Asset allocation is a highly individual determination that's based on your risk tolerance, financial goals, and age. Asset allocation will spread out your investments among a mix of three types:

- ✔ **Stocks** — Stocks tend to be the riskiest investment. However, while they have the highest potential for loss, they also offer the greatest potential for gain.
- ✔ **Bonds** — Bonds tend to be less risky than stocks but more risky than cash equivalents.
- ✔ **Cash** — Cash equivalents, such as savings account, certificates of deposit, and money market accounts, typically offer the lowest risk and the lowest potential returns.

The benefits of allocating your assets across the three types of investments include:

- ✔ Proper asset allocation diversifies your portfolio among the three types of investments, reducing your risk.
- ✔ Allocating your assets between the three types allows you to tailor your portfolio to your specific goals.
- ✔ You can help manage the level of risk and volatility of your returns.

Considerations

To properly allocate your investments across stocks, bonds, and cash, consider this three-step approach to asset allocation:

Step 1: Be honest about your level of risk tolerance.

Some people think that investing in a relatively unknown start-up company with a great idea is a sound investment, while others prefer to stick with stable companies with household names. In other words, risk tolerance varies.

If you don't mind the more dramatic ups and downs associated

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3-Step Asset

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with higher-risk investments, you may see higher return potential. But if you can't stand the thought of putting your hard-earned money in an untested company, you're probably better off sticking with relatively low-risk allocations, even though you may see more modest returns.

Step 2: Write down your financial goals.

What are your investments' purposes? Are you saving to buy your first home? Planning to send your children to college? Looking to retire early? Whatever your financial goals are, knowing them will help you determine how to allocate your assets to help you meet them.

Step 3: Consider your time horizon for meeting goals.

How much time do you have before you need your money for your goals? Is retirement a long-term goal, with 30 years to go? Or is it a short-term goal, with only five years to go? If you're just starting a career, do you have short-term goals, like buying a house, as well as intermediate-term goals, like sending your children to college?

There's no consensus on exactly how much of your portfolio should be in any of the three investment categories at any time. However, broadly speaking, the farther away in time you are from your financial goals, the more aggressively you can be invested.

If your financial goal is retirement, for example, and you're just starting out, you'll want to have a higher percentage of your assets invested in stocks and the lowest percentage in cash. As you near retirement, though, you'll want to reallocate your assets more conservatively, so that a larger percentage is in bonds and cash than in stocks.

Keep in mind that diversification does not guarantee investment returns and does not eliminate the risk of loss. Please call so we can help you allocate your assets given your unique situation. ❍❍❍

10 Common Investor Mistakes

Here are 10 of the most common mistakes that individual investors make while trying to do the best they can:

✔ **Falling in love with a stock.** There are a host of reasons for this, among them that we or a relative worked for the company, we inherited it, we like being associated with the company's prestige, or simply that it's been a steady performer. The problem is, however, that the stock won't fall in love with us and won't think twice about losing half or more of its value.

✔ **Catching a falling knife.** When a high-flying stock goes bad, it drops fast and hard. But when this happens, there are thousands of investors who think it's a steal and buy shares when they see it bounce. What they often learn is that the stock price has a lot farther to fall before finally coming to rest.

✔ **Investing on tips.** The problem with tips is that the average investor hears them after just about everyone else already has. As a result, we buy the stock at its highest price.

✔ **Chasing performance**. For many people, stocks only become attractive after they've gone so high and so long that they've reached the end of their run.

✔ **Failing to diversify**. The best way to get rich in the stock market is to put all your money into one stock. But it only works if the stock goes to the moon. If it goes in the opposite direction, this is also the best way to become poor. It's smartest to spread out your risk as well as your chances of success by diversifying.

✔ **Thinking only short term.** This is actually the opposite of investing. It's speculating. There are few part-timers who succeed at this game. The danger is that, just like changing lanes too many times in a traffic jam, you're just as likely to fall behind where you might have been had you just stayed where you were.

✔ **Playing penny stocks.** Inflation hit true penny stocks years ago. The strict definition is stocks priced less than $5 a share, that have daily trading volume of less than 100,000 shares. Usually, the companies have net tangible assets of only a few million dollars and a short operating history. The odds of hitting it big with these are about the same as winning the lottery, if not worse. Owned mostly by individual investors and the founders of the company, penny stocks are notoriously volatile and risky.

✔ **Waiting to break even.** It's been said that more money has been lost by investors waiting to recoup their initial investment than for any other reason. Successful investors know when it's time to cut their losses and look for a better opportunity.

✔ **Being too conservative.** This syndrome is the opposite of most of the previous mistakes. In this case, investors are so afraid of losing money that they fail to put enough money in growth vehicles to stay ahead of inflation. As a result, the buying power of their portfolio declines year by year, courting the risk they'll have a lower standard of living the older they get.

✔ **Investing without a plan.** This is another way of saying all of the above. Sound financial plans match your income, resources, and risk tolerance with an investment strategy that provides the discipline that can take emotions out of the equation. Please call if you'd like help developing an investment strategy.

Measuring an Investment's Risk

How has your portfolio performed compared to the major indexes? Has it experienced sharper or milder fluctuations? The answers to these questions will help you determine your portfolio's risk. Different measures of risk exist for stocks and bonds.

Stocks

Basically, stocks are subject to two types of risk — market risk and nonmarket risk. Nonmarket risk, also called specific risk, is the risk that events specific to a company or its industry will adversely affect the stock's price. For instance, an increase in the cost of oil would be expected to adversely affect the stock prices of the entire oil industry, while a major management change would only affect that company. Market risk, on the other hand, is the risk that a particular stock's price will be affected by overall stock market movements.

Nonmarket risk can be reduced through diversification. By owning several different stocks in different industries whose stock prices have shown little correlation to each other, you reduce the risk that nonmarket factors will adversely affect your total portfolio.

No matter how many stocks you own, you can't totally eliminate market risk. However, you can measure a stock's historical response to market movements and select those with a level of volatility you are comfortable with. Beta and standard deviation are two tools commonly used to measure stock risk.

Beta

Beta, which can be found in a number of published services, is a statistical measure of the impact stock market movements have historically had on a stock's price. By comparing the returns of the Standard & Poor's 500 (S&P 500) to a particular stock's returns, a pattern develops that indicates the stock's exposure to stock market risk.

The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market and has a beta of 1. A stock with a beta of 1 means that, on average, it moves parallel with the S&P 500 — the stock should rise 10% when the S&P 500 rises 10% and decline 10% when the S&P 500 declines 10%. A beta greater than 1 indicates the stock should rise or fall to a greater extent than stock market movements, while a beta less than 1 means the stock should rise or fall to a lesser extent than the S&P 500. Since beta measures movements on average, you cannot expect an exact correlation with each market movement.

Calculating your portfolio's beta will give you a measure of its overall market risk. To do so, find the betas for all your stocks. Each beta is then multiplied by the percentage of your total portfolio that stocks represents (i.e., a stock with a beta of 1.2 that comprises 10% of your portfolio would have a weighted beta of 1.2 times 10% or .12). Add all the weighted betas together to arrive at your portfolio's overall beta.

Standard Deviation

Standard deviation, which can also be found in a number of published services, measures a stock's volatility, regardless of the cause. It basically tells you how much a stock's short-term returns have moved around its long-term average return. The most common way to calculate standard deviation is to figure the deviation from an average monthly return over a three-, five-, or 10-year period and then annualize that number. Higher standard deviations represent more volatility. In statistical terms, 68% of the time, the stock's range of returns will fall within one standard deviation of the average return; 95% of the time, the stock's range of returns will fall within two standard deviations.

Consider this example. Assume you own a stock with an average return of 10.2% and a standard deviation of 15%. 68% of the time, you can expect your return to fall within a range of –4.8% to 25.2%; 95% of the time, you can expect your return to fall within a range of –19.8% to 40.2%. (This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)

Bonds

Interest rates and bond prices move in opposite directions, which can significantly affect a bond's market value. However, it is often difficult to determine what impact a given interest rate change will have on a specific bond, since maturity date, credit ratings, coupon rate, and current interest rates all affect the result. Duration can be a helpful tool in estimating the expected impact of interest rate changes on your bond portfolio. Duration calculates how much a bond's price will move for every 1% change in interest rates. For instance, a bond with a duration of six years will experience a 6% decrease in value for every 1% increase in interest rates. A bond's duration is typically shorter than its maturity. You can set a overall target duration for your portfolio, so you'll have a reasonable estimate of how your bond portfolio will fluctuate with interest rate changes. ❍❍❍

Your Parents' Estate Plans

Estate planning can be a difficult subject to discuss with your parents. You don't want to seem concerned about how much money they may eventually leave you, while they may fear you are interfering with their finances. But to help ensure their estate is settled quickly according to their wishes, family members should have some basic information. You don't need to know the specifics about who will receive what, but you should find out:

✔ **Where important estate planning documents are located.** Don't ask for specifics, just make sure documents are in place so their wishes will be carried out. Find out if they have a durable power of attorney and a 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 them. Usually, this document also outlines procedures to be used to prolong life.

✔ **How to contact their advisors.** Ask for a list of names, addresses, and phone numbers of lawyers, accountants, and financial advisors.

✔ **Their rationale for distributing their estate.** Often, when heirs understand why an estate is being distributed in a particular manner, it can prevent problems among those heirs. If your parents are reluctant to discuss now, suggest they leave a personal letter with their estate planning documents explaining their rationale for distributions.

✔ **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.

While these topics are sometimes not easy to discuss, they are important to know to ensure that your parents' estate is properly handled. ❍❍❍

Tax Planning Tips

Plan Ahead. Strategic tax planning should really commence at the beginning of each year — not at the beginning of tax season. That is the best time to save for goals that can benefit you during tax season and beyond.

Make a List. To serve as an ongoing reminder, make a list of applicable tax deductions and consider keeping it in plain sight.

Stay Organized. Keep track of deductible expenses, donations, and cash gifts in a designated tax deduction folder.

Do a Mid-Year Financial Review. Change is inevitable, though unfortunately, it's not always easy to anticipate while you're trying to plan ahead for tax season. For this reason, incorporate tax planning as part of your mid-year financial review; accounting for income changes, unanticipated quarterly bonuses, investment gains and losses, or changes in family status can substantially modify your owed taxes or refund.

Don't Go It Alone. Go to a professional who knows all the complex technicalities of tax planning; they can spot oversights, helping to maximize your refund and reduce your risk of audit. ❍❍❍

Periodically Review Beneficiaries

Many assets have beneficiary designations that dictate who receives the asset after your death. These selections typically override any provisions in your estate planning documents. Consider these points:

✔ **Select the most appropriate person as beneficiary for each asset.** First, list all your assets with beneficiaries, noting the owner, primary beneficiary, and contingent beneficiary. Then determine whether you have selected the appropriate person as beneficiary for each asset.

✔ **Indicate what percentage of the asset each beneficiary should receive.** Also, in the event a beneficiary dies before you, decide whether each beneficiary's share should be distributed to that person's heirs or divided among the remaining beneficiaries.

✔ **Assess whether beneficiaries are capable of managing the asset.** If not, you may want to set up a trust to control distribution.

✔ **Periodically review your beneficiaries to see whether changes are warranted.** A divorce, remarriage, spouse's death, or child's birth are all events that may require changes. You should also review your beneficiary choice if you make changes to your will. ❍❍❍