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Coming to Terms with Stocks

With all of the volatility in the stock market over the past few years, it can be difficult to determine how to devise an investment strategy to help reach your financial goals. To help you determine a reasonable rate of return to expect on your stock investments, it might be instructive to review some "facts" about the stock market:

- **The stock market's historical return can change dramatically depending on the period considered.** For instance, from 1926 to 2008, the Standard & Poor's 500 (S&P 500) had an average annual return of 9.6%. From 1984 to 2008 (25 years), the average return was 9.2% and 6.4% from 1999 to 2008 (10 years).*
- **The market tends to revert to the mean.** There is a tendency for the stock market, when it has an extended period of above- or below-average returns, to revert back to the average return. Thus, following an extended period of above-average returns in the 1990s, the stock market experienced a significant downturn, bringing the averages back in line.
- **History may not be a good predictor of future returns.** The expected rate of return for your investment program is typically based on an analysis of past returns, since no one can predict future returns. However, realize that those returns may not be replicated in the future. During much of the stock market's history, the United States was in a substantial growth phase as it grew from a struggling nation to a superpower. Growth in the future may not approach those levels, which could dampen stock returns.
- **The pattern of actual returns affects your investment balance.** 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 high

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Encourage Estate Planning

Parenting is a never-ending job. Even when your children are grown, there will probably be lessons you'll want to teach them, such as the need for estate planning. Some items to include in that lesson are:

- **Explain why estate planning is important.** Your role is not to dictate what they should do with their estate, just to emphasize the need for estate planning. When your children encounter major life events, such as marriage, divorce, or a child's birth, remind them to review their estate plans.
- **Make sure all important estate-planning documents are in place.** At a minimum, every adult should have a will, a durable power of attorney, and a health care proxy. A durable power of attorney designates an individual to control their financial affairs if they become incapacitated, while a health care proxy delegates health care decisions to a third person when they are unable to make those decisions.
- **Coordinate estate planning across generations.** If you have a substantial estate, you may want to coordinate your estate planning efforts with those of your children. A coordinated effort can help minimize estate taxes. ❍❍❍

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Coming to Terms

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returns in the early years, your portfolio's value 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.

❍ **Historical returns do not include several items that investors must deal with.** Two of the most significant items not accounted for in historical returns are inflation and taxes. Over the long term, from 1926 to 2009, inflation averaged 3.0%.* Short-term capital gains are taxed at ordinary income tax rates of up to 35%, while long-term capital gains and dividend income are taxed at 15% (0% for taxpayers in the 10% and 15% tax brackets).

❍ **Investors have a difficult time earning historical returns.** Several studies have found that investors' returns tend to lag the overall market, since investors have a tendency to buy high and sell low. One study found that the average investor's return is at least 2% lower than the market return (Source: *Money*, January/February 2010).

What does all this mean to an investor? When designing an investment program, use a conservative estimated rate of return, since it may be difficult to earn the historical returns of the past. It's easier to start out with a lower expected rate of return and find out later that your actual return is higher, which means you just need to save less. However, if you use a higher estimated rate of return than you actually earn, it may be difficult to increase your savings to make up for that difference.

Consider these strategies when designing your investment program:

❍ **Take a fresh look at your financial goals.** Reevaluate your goals, how much you need to reach them, and how much you should be saving annually based on lower expected returns.

❍ **Save more of your income.** If you can't count on returns to provide growth in your portfolio, you should compensate by saving more of your income. That may mean you'll need to work overtime or take on a second job to provide additional income. Another strategy is to reduce your living expenses and save the reductions.

❍ **Invest in a tax-efficient manner.** Taxes are often a significant investment expense, so using strategies to defer the payment of taxes can make a substantial difference in your portfolio's ultimate size. Utilize tax-deferred investment vehicles, such as 401(k) plans and individual retirement accounts. Or emphasize investments generating capital gains or dividend income rather than ordinary income. Minimize turnover in your portfolio, so unrealized gains can grow for many years.

❍ **Adequately diversify your investment 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 a variety of investment categories, such as stocks, bonds, cash, and other alternatives. Also diversify within investment categories.

❍ **Evaluate your portfolio's performance annually.** That way, if returns are lower than you targeted, you can make adjustments to your strategy to compensate for these variations in return.

Please call if you'd like to review your investment program. ❍❍❍

* Source: *Stocks, Bonds, Bills, and Inflation 2010 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 returns.

Your Stock Allocation

Some factors to consider when deciding how much to allocate to stocks include:

❍ **Your risk tolerance** — The advantage of including both stocks and bonds in your portfolio is that when one category is declining, the other category will hopefully offset this decline. For instance, in 2008, the Standard & Poor's 500 (S&P 500) returned -37%, while long-term government bonds returned 25.9%.*

❍ **Your time horizon** — The longer your time horizon for investing, the more risk you can typically tolerate in your portfolio, since you have more time to overcome any significant downturns in your portfolio. Certainly, individuals with short time horizons, perhaps five years or less, should be very cautious about how much to allocate to stocks.

❍ **Your return needs** — Your need to emphasize income or growth is likely to change over your life. When you are trying to accumulate significant assets for a goal far in the future, you may want to allocate more of your mix to stocks. However, when your needs for a predictable income stream become more important, you may want to allocate more to bonds. ❍❍❍

* Source: *Stocks, Bonds, Bills, and Inflation 2010 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.

Watching Your Stocks

For some people, checking their stocks' performance only leads to anxiety and stress. For others, it's an enjoyable activity that leads them to soak up every piece of news about the companies they are invested in. Still others are content with a cursory review of their quarterly account statements and a more detailed annual review.

No matter how often you prefer to monitor your stocks' performance, there are certain items you should consider. Here are five things to review as you monitor your stocks' performance:

- **Earnings** — Pay attention to the company's quarterly and annual earnings statements, which include comparisons with the recent past and often reviews of what management expects for the next quarter and year. Review the stock's earnings trend and how the company performs compared to analysts' estimates. Watch out for earnings surprises, which can cause rapid price changes up or down, and may indicate the start of a new stock price trend.
- **Price and dividends** — Follow the stock's price compared to its 52-week highs and lows. Examine its trailing total returns year to date and over the last one-, three-, five-, and 10-year periods. Look for changes in the absolute dollar amount of dividends and the current yield (the annual dividend divided by the current price).
- **P/E and PEG ratios** — Price to earnings (P/E) and price/earnings growth (PEG) ratios are often better indicators than the stock price as to how relatively expensive or cheap a stock is. The P/E ratio is useful for comparing the stock to other stocks and to the market in general, while the PEG ratio is a strong indicator of whether the stock is overpriced or underpriced compared to its projected earnings growth rate over the next five years.
- **Insider transactions and stock buybacks** — A company buying back its own stock or whose senior executives and directors are accumulating more shares is a bullish sign. On the other hand, when insiders are selling off major holdings of their own stock, it's quite often an indication that the stock price has peaked.
- **Sudden and large price changes on high volume** — When a stock makes a sudden, high-volume move — particularly when it opens much higher or lower than the previous day's high or low — it can be the start of a new, long-term trend.

For help monitoring your stocks' performance, or if you need to make a change to your investment portfolio, please call. ❍❍❍

Evaluating P/E Ratios

Price/earnings (P/E) ratios are a common measure of stock value, both for individual stocks and the overall market. Calculating a P/E ratio is straightforward — it is simply the price of a single share of stock divided by the company's per-share earnings. However, P/E ratios can be calculated using different earnings numbers. Trailing P/E ratios, which are typically reported in newspapers, use earnings per share for the most recent four quarters, while forward P/E ratios use forecasts of future earnings per share.

The difficulty is deciding what a reasonable P/E ratio is for a particular company or for the overall stock market. For individual companies, investors' expectations about future earnings affect the P/E ratio. P/E ratios for the overall market change based on broad market conditions and investors' views about how desirable stocks are compared to other investments.

There is no absolute measure of what P/E ratio should be paid for a given company with a given growth rate. P/E ratios can fluctuate significantly over time and among companies and industries. It generally helps to follow the P/E ratios of stocks that interest you, along with companies in similar industries, to develop a feel for how the P/E ratios fluctuate.

One way to evaluate P/E ratios is to consider a company's current P/E ratio divided by its historical P/E ratio. If it is much lower than 1, you might want to investigate why. If the value is much higher than 1, carefully assess whether you want to invest at this time. You may want to wait until the P/E ratio returns to a more historical level.

You can also divide a company's current P/E ratio by the market's overall P/E ratio. If that figure is much higher than 1 (and thus higher than the overall market), you should evaluate whether the company's prospects justify that valuation. ❍❍❍

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Reevaluate Your Portfolio

The market changes. Companies change. Investments change. Your needs and goals change. That's why it's important to see — at least once a year — if your investment portfolio needs to change, too. Here is a step-by-step plan for reevaluating your portfolio.

Step 1. Review the value of your investment portfolio.

Have your investments lost value? Gained value? By how much? Answering these questions will give you the big-picture overview of your portfolio's status.

Step 2. Check how your portfolio is performing in comparison to benchmarks.

If you simply review the absolute performance of your investments, you may feel you've done very well or quite poorly. However, what really matters is how your investments have performed relative to their respective benchmark indexes. There are a number of indexes that can be used as benchmarks against which you can measure your investment's performance.

Step 3. Compare the individual investments in your portfolio against comparable investments in the same asset class.

Step 2 will give you an idea of how your particular investments performed against their relative indexes, while Step 3 will help you understand how individual investments similar to yours have performed. Compare your individual investments against comparable investments in the same asset class.

Ensuring that you're comparing similar investments can be difficult when you're looking at individual investments. Please call if you need help determining investments to use for comparison.

Step 4. Ensure that your investments remain consistent with your established goals.

As your life circumstances change, so should your investments. If your financial goals include sending children to college or saving for retirement, you'll want to transition your assets into more conservative investments as you get closer to your goal.

You'll also want to evaluate whether your asset allocations remain consistent with your financial goals. As investments gain and lose value, your asset allocations can change. You may need to adjust your investments if uneven gains and losses have disrupted your asset allocations.

Step 5. Make any necessary tweaks to your investment allocations.

Once you've gone through Steps 1 through 4, you should know what changes are needed in your portfolio. To make those changes, you can:

❍ Sell off investments from overweighted asset categories and use the proceeds to purchase investments for underweighted asset categories.

❍ Purchase new investments for underweighted asset categories.

❍ Alter your contributions (if you make regular contributions to your investment portfolio) so that more investments go to underweighted asset categories until your portfolio is back in balance.

You should reevalate your investment portfolio annually. Please call if you'd like help with this analysis. ❍❍❍

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