Our Two Cents

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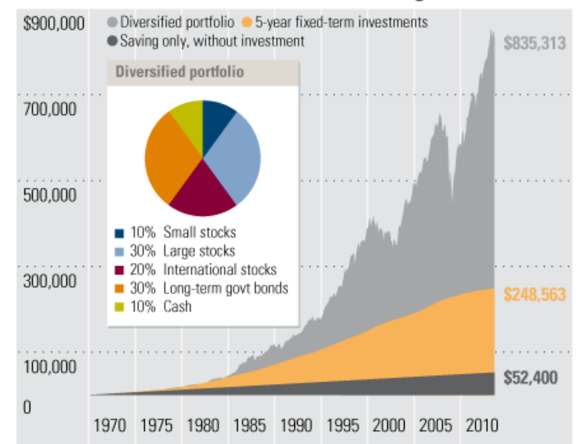
Saving Is Not Enough

After two financial crises occurring almost back to back during the "lost decade," investors have every right to be risk-averse, hesitant, angry, or distrustful. The problem with not investing at all, however, is that you may not have sufficient money to achieve your financial goals. An individual saving $100 per month, without investing, would have put away only $52,400 since 1970. By placing that money in five-year fixed-term investments, the investor would have been able to end up with almost five times that amount. And if invested in a diversified portfolio, our investor's savings would have grown to $835,313. It's true that any investment involves varying levels of risk. But, as the image illustrates, even if you have low risk tolerance, you can find a suitable investment for your needs that may still be much better than no investment at all.

Two Types of Investments Versus Saving Without Investment, Jan 1970–Aug 2013



Past performance is no guarantee of future results. This hypothetical example is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. The diversified portfolio was created for illustrative purposes only; it is neither a recommendation, nor an actual portfolio. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Diversification does not eliminate the risk of experiencing investment losses. The data assumes reinvestment of income and does not account for taxes or transaction costs.

Source: Small stocks—Ibbotson® Small Company Stock Index. Large stocks—Standard & Poor's 500®, an unmanaged group of securities considered to be representative of the U.S. stock market. International stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) index. Long-term government bonds—20-year U.S. government bond. 5-year fixed-term investments—yield on a 5-year U.S. government bond. Cash—30-day U.S. Treasury bill.

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Sifting thru the numbers

The market headlines tout the double digit returns from the stock market this year. You may look at your portfolio and see something less. Be careful that you are comparing apples to apples. While the stock market is having an above average year, the bond/fixed income market is not. In fact, the typical conservative investments such as municipal bonds and inflation protected assets are well in the red this year.

You need to look at your asset mix and compute the mixed return you are getting versus the blended return (stocks and bonds) of the markets. Then you are in a position to judge how you are doing.

Most importantly is that you maintain your risk tolerance during these times and be careful not to get into a situation that if the markets retreat that you are not able to withstand the reversal and impact on your net worth.

Do You Have a Job-Loss Safety Net?

“What are the chances that I'll lose my job?” Unless you're a retiree, a tenured college professor, or the owner of a business, that question has probably passed through your mind at least a few times over the recent years. Even if you're confident about the security of your current position, it never hurts to put in place a good safety net. Some of the primary steps are outlined below.

1) Build Up Your Emergency Fund

Having an emergency fund in place can help if you suddenly find yourself unemployed. Moreover, an emergency fund can also be helpful for unexpected and unreimbursed medical expenses, big-ticket auto and home repairs, etc. Conventional financial-planning wisdom has long held that you should keep three to six months' worth of living expenses in highly liquid accounts like checking or savings accounts, certificates of deposit (CDs), money market accounts or money-market mutual funds, but the recent financial crisis illustrates that figure is probably too low. Wouldn't you like to have more than three months to find a new job if you lost yours?

2) Consider a Roth IRA for Retirement Savings

You can't put your life—and your long-term financial goals—on hold just because you're worried about job loss. But you can be strategic about what you sink your money into, and that means focusing on those investments with the fewest strings attached in case you need to make a withdrawal. Rather than saving within the confines of your company retirement plan or a traditional IRA, where you'll pay taxes and penalties if you need to withdraw your assets prematurely, consider deploying fresh retirement dollars into a Roth IRA instead. With a Roth IRA you can withdraw your contributions tax-free at any time (the early withdrawal penalty, however, may still apply). And because you're contributing aftertax dollars, you won't have to pay taxes on your earnings from year to year or upon withdrawal during retirement. Please keep in mind that income limits do apply—talk to your financial advisor to see if you're eligible.

3) Pay Down Costly Forms of Debt

If you already have expensive types of debt such as credit cards and are concerned about job security, the first thing to do is to reduce that burden as soon as you possibly can. Credit card companies are the last folks you want to mess around with if you find yourself in a financial bind, as they're able to raise your rates if you're late on a payment.

4) Be a Commitment-Phobe

While service providers—particularly purveyors of cable TV, Internet, and telephone service—will offer you a lower rate if you sign a contract of a year or more, be sure to weigh those lower rates against the risk that you'll lose your job. If you're concerned about job security, read the fine print on any contracts to see what it would cost you to get out of the agreement in a pinch.

5) Contemplate Refinancing

If you haven't refinanced your primary mortgage to take advantage of currently low rates, it's time to have someone run the numbers. As with any type of financing, it's better to shop for a mortgage while you're employed than when you are not.

6) Take Advantage of the Perks You Have

Have you had a physical lately? Do you need new glasses or contacts? Are you overdue for a visit to the dentist? If so, it's time to make some appointments. Chances are you're paying decent-sized premiums for the insurance you have through your employer, so it pays to take advantage of all your perks while you still have them.

Benefits of Staying Invested Through Market Volatility

The recent market volatility has investors questioning, “Are stocks still a good investment?” It’s a good question, and one way to address this issue is to look at the recent 2007–2009 market crash. Investors who bailed out of the stock market following the significant decline and moved their money to the safety of cash would be quite disappointed to learn that the stock market, in fact, recovered significantly.

The top image illustrates the value of a $100,000 investment in the stock market at the end of October 2007 (when the downturn began). Over the next several quarters, this $100,000 investment declined significantly, and by February 2009 (the trough date) was down to $49,051, a 51% decline. If an investor panicked and exited the stock market to invest the remainder ($49,051) in Treasury bills (proxy for cash), here’s what would have happened. The bottom graph illustrates the growth of the $49,051 investment in both the stock market and Treasury bills since March 2009. The difference in the ending wealth values of the two investments is considerable. If an investor remained invested in the stock market, the ending value of the investment would be $103,333. If the same investor exited the market at the bottom to invest in Treasury bills, the ending value of the investment would be only $49,201. While exiting the market during a downward spiral may mean avoiding down days, it also means missing days when the market bounces back. While all recoveries may not yield the same results, investors may be well advised to stick with a long-term approach to investing.

The beginning investment time period of October 2007 was chosen to illustrate two concepts: (1) investing right before a significant market downturn and (2) the contrast between exiting the stock market and staying invested during a recovery. The exact timeline of the downturn-recovery is as follows: October 2007 (peak before the downturn), February 2009 (trough), March 2012 (recovery).

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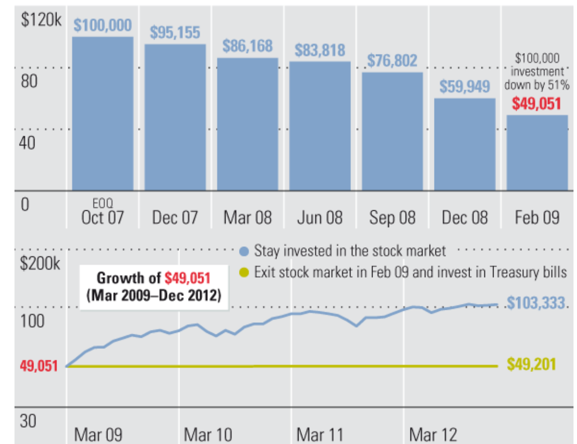
Ending Wealth Values After a Market Decline and Recovery



The Risks of Over-Allocated Funds

Exposure to concentrated investments may increase the overall risk of a portfolio. As a rule of thumb, if a fund holds more than 30% of assets in one sector, you may be putting all those eggs in one basket. Take, for example, the dot-com bubble. Investors who loaded up on rapidly growing Internet investments probably lost a considerable amount of money when the bubble burst.

It is also important to consider the extent a fund is vested in its top investments. For example, if 25% of its assets are in the top three holdings, or a fund consists of 40 or fewer holdings, the fund could be a higher risk. Funds with investments concentrated in one country can be a risky proposition as well. A fund manager not only must pick good investments but also runs the risk of a souring economy. Country-specific risks become even more prominent when a fund involves investments in emerging markets. These economies are generally subject to a variety of risks that can drive holdings southbound.

Concentrated investing is not for the casual or risk-averse. You can be exposed to substantially greater losses than those in the overall market, so be sure to evaluate a fund’s holdings to determine the level of risk inherent when investing.

Keep in mind that diversification does not eliminate the risk of experiencing investment losses. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Keep in mind that concentrated investments are narrowly focused investments that typically exhibit higher volatility than the market in general. These investments will fluctuate with current market conditions and may be worth more or less than the original cost upon liquidation.

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