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A Registered Investment Advisor

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What Is a Reasonable Rate of Return?

The assumed rate of return used in your investment program will determine how much you need to save to reach your financial goals and how much you can withdraw annually from your portfolio after retirement. Use a rate that is too high and you may not accumulate the amount you need or be able to withdraw enough during retirement. But what is a reasonable long-term rate of return?

Typically, the assumed rate of return for an investment program is the average annual return for some historical period. Data is readily available going back as far as 1926. But does looking at history still make sense in the current market environment? Consider the following points when deciding on an assumed long-term rate of return:

✔ When selecting what historical period to consider, keep in mind that returns can vary substantially over different time periods. As a starting point, you may want to consider average returns for the period from 1926 to present, making adjustments from there.

✔ Understand the difference between arithmetic and geometric returns. For the period from 1926 to 2012, the arithmetic average annual return for the Standard & Poor's 500 (S&P 500) was 11.8%, while the geometric average return was 9.8%.* The arithmetic average is a simple average of the sum of each annual return divided by the number of years used. The geometric return calculates the return earned over the years, calculating the change in value over a specified period. Basically, you calculate how $1 would grow over the years based on actual year-by-year returns, determining what rate of return would produce the ending value. Typically, the geometric return will be equal to or lower than the arithmetic return.

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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.

✔ **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, such as when retirement approaches, you may want to allocate more to bonds. ❍❍❍

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What Is a Reasonable?

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✔ Don't forget to factor in inflation. When determining how much you want to have saved by a future date, your figure is stated in terms of today's dollars. Due to inflation over the years, that amount will not have the same purchasing power as it has today. You will need a higher amount at that future date for the same purchasing power. Thus, you should factor inflation into your assumed rate of return. From 1926 to 2012, inflation has averaged 3% annually.*

✔ Returns tend to regress to the mean. There is a tendency for the stock market, when it has had above- or below-average returns for an extended period, to revert back to the average. So, following an extended period of above-average returns, it is possible that the market may go through a period of below-average returns. Thus, you may want to lower your expected annual return.

✔ Use conservative estimates. When deciding between a lower or higher expected return, it is usually more prudent to use the lower return. While a higher return means that you will need to save less annually, you run the risk of not meeting your savings goals if actual returns are lower. Which is better — to have too much money saved when you are ready to retire or not enough? If you save too much, you can always reduce your savings in later years or spend more in retirement. The alternatives are far less attractive if you don't have enough money saved.

So what is a reasonable long-term rate of return to use in investment programs? Starting out with the average geometric return (since this is more conservative than the arithmetic return) from 1926 to 2012 of 9.8% and subtracting the long-term inflation rate of 3% would result in a return of 6.8%. You may even want to use a more conservative return than that if you feel the stock market may go through an extended period of below-average returns. If you'd like to discuss this in more detail, including how various rates of return would affect your long-term portfolio, please call. ❍❍❍

* 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. Returns presented are for illustrative purposes only and are not intended to project the performance of any specific investment vehicle. Source: *Stocks, Bonds, Bills, and Inflation 2013 Yearbook*.

When Can You Retire?

When can you retire? It depends — on how old you are; how much you have saved; the extent to which you'll rely on Social Security, a pension, or tax-advantaged retirement accounts; how your investments perform; the kind of lifestyle you want in retirement; and how long you'll live.

Factors to Consider When Setting a Target Retirement Age

1. What kind of lifestyle do you want in retirement? Given the same monthly savings rate, there is a tradeoff between when you can retire and the kind of lifestyle you can have once you do. For example, if you're currently 50 years old, earn $50,000 per year, and plan to live to age 90, for about the same monthly savings amount, you can retire at age 65 with 50% of your preretirement income or at age 70 with 100% of your preretirement income (Source: Kiplinger Retirement Savings Calculator). There's no right or wrong answer here, it's simply a tradeoff.

2. What does Social Security consider to be your full retirement age? The government will allow you to start receiving Social Security benefits at age 62, but those benefits will be less than what you'd receive if you waited until your full retirement age. For example, for an individual born in 1960 or later who retires at age 62 instead of age 67 (his full retirement age), his monthly benefits will be reduced by 30%. For individuals born before 1960, full retirement age ranges from 65 to 66 and 10 months, and the reduction in benefits for retiring at age 62 ranges from 20% to 29.17%.

Of course, if you're not counting on Social Security for retirement income, then you can retire whenever you want and wait until your full retirement age to start taking Social Security benefits.

3. What do your pension plan and other retirement plans consider to be full retirement age? Like Social Security, most pension plans have a certain minimum age at which they will begin paying benefits (at a reduced rate), and a certain age at which you become eligible to start receiving full benefits. Similarly, tax-advantaged retirement plans, like 401(k) plans and IRAs, penalize distributions (except in certain circumstances) before age 59½. ***Important to note:*** While most people focus on the earliest age at which they can retire, it's also important to understand when you may be *required* to start taking retirement benefits or distributions from retirement accounts. 401(k)s and 403(b)s require minimum distributions beginning at age 70½ (unless you're still working in most cases), as do traditional IRAs.

If you would like to retire at age 62 but the math just isn't working out, you might consider partial retirement. By continuing to generate income even after you've left the workplace, you can retire earlier than if you're not generating any income at all. ❍❍❍

How the Fed Impacts the Market

What moves the stock market? There is no easy answer to that question. Ultimately, many factors influence the stock market indices that are often referred to generally as the market.

At the most micro level, the price of individual stocks is influenced by company performance — or, more accurately, investors' perception of future company performance. At the most macro level, the prices of stocks are influenced by the economy — or, more accurately, investors' perception of the economy's future performance.

From micro to macro, the key factor is this: investor perception. Whether investors are irrationally exuberant or irrationally despondent or anywhere in between, investor perception can and does move markets. One factor that strongly influences investors' outlook of future economic performance is the Federal Reserve.

The Fed: How It Works in the Economy

The Federal Reserve has a dual mandate: to pursue the economic goals of price stability and maximum employment. The Fed affects those goals through management of the nation's supply of money and credit (in other words, by conducting monetary policy).

People sometimes talk about the Fed setting interest rates, which it does not actually do. The Fed sets a target for the federal funds rate, which is the rate banks charge each other for overnight loans, which influences other interest rates. Typically, when the federal funds rate rises or falls, so do the prime rate, mortgage rates, auto loan rates, and other rates.

So how does the Fed help the economy reach its target fed funds rate if it doesn't set the rate directly? Through what's called open market operations, essentially buying or selling government securities. When the Fed wants to lower the fed funds rate, it engages in expansionary monetary policy. It buys government securities, which means that it's sending more cash into the economy — specifically to banks. Banks want to loan that money, so they lower interest rates to entice more borrowers.

How Fed Actions Affect the Market

Since the financial crisis, the Fed has been engaged in a series of stimulus programs known as quantitative easing. The current program entails $85 billion in monthly bond purchases. As a result of these programs, interest rates have remained near historic lows.

But the Fed can't keep interest rates low forever, because low interest rates put upward pressure on inflation. So the Fed's job is a balancing act, trying to keep unemployment low and inflation at a target level of about 2%.

In recent months, as the economy has continued to show signs of improvement and employment levels have continued to rise (even as the unemployment *rate* has not fallen dramatically), market watchers have all assumed that the Fed would soon announce it would

scale back its economic stimulus programs.

The Fed did just that on June 19 when Fed Chairman Ben Bernanke announced after the Federal Open Market Committee meeting that the Fed intended to begin gradually reducing monthly bond buying this year, depending on continued economic strength. When the stock market reacted strongly, he later backtracked, indicating it would be some time before the Fed would reduce bond buying.

How Should You React?

As an investor, what does the Fed's influence on markets mean for you? It's not wise for individual investors to buy or sell investments based on what the Fed has said it might or might not do at some uncertain point in the future.

What individual investors should do is review investment portfolios annually. From changes in Fed policy to changes in asset value in different classes, an annual review of your portfolio — and tweaks to your investments to ensure that your portfolio remains in line with your financial strategy — is the right way to ensure that you are maximizing performance given market fluctuations that are out of your control. Please call if you'd like to discuss this in more detail. ❍❍❍

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Handling the Financial Aspects of Death

The emotional trauma of dealing with a loved one's death can be devastating. If you also have to handle the financial aspects, it can seem overwhelming to deal with all the details. Following is a checklist of items to consider:

✔ Your most immediate concern will be to notify family and friends of the death and make funeral arrangements. If you aren't sure of the deceased's burial wishes, look for a letter of instruction or a will that details preferences. You'll probably need to contact a funeral home as well as your loved one's religious organization. An obituary will need to be prepared, a burial site may need to be purchased, and death certificates must be obtained. Be sure to keep track of all payments for funeral and other expenses.

✔ If a surviving spouse and/or minor children are involved, evaluate their means of support and determine whether care for the dependents needs to be obtained. In terms of the loved one's home, you may need to deal with security at the residence, provide for the care of pets, send mail to another location, and arrange for the care or disposal of perishable property, such as plants and food.

✔ Locate any safe deposit boxes and follow necessary procedures to have them opened.

✔ If the deceased was employed, contact his/her employer to start the process of collecting any outstanding pay, life insurance proceeds, or other benefits. If the deceased was retired, notify Social Security and any pension plans.

✔ Locate important documents, including wills, trusts, deeds, investment records, insurance policies, business and partnership arrangements, and other evidence of assets and liabilities.

✔ Meet with an attorney to discuss the deceased's estate matters. Depending on the estate's complexity, you may need to retain an attorney, accountant, and/or financial advisor. While you may be hesitant to spend the deceased's funds on professional services, these professionals have experience dealing with the financial matters of estates and can help significantly with the process. ❍❍❍

Asset Allocation Tips

✔ By owning different types of assets, it is hoped that when one asset suffers a major decline, other assets will be increasing.

✔ Not only should you diversify across broad investment categories, such a stocks, bonds, and cash, you should also diversify within those categories.

✔ Assessing your risk tolerance is one of the most important, yet most subjective, parts of determining your asset allocation.

✔ Your portfolio can become more aggressive as your time horizon lengthens.

✔ Make sure you have reasonable return expectations for various investment categories.

✔ Time diversification is also important. By staying in the market through different market cycles, you reduce the risk of receiving a lower return than expected.

✔ Rebalance your portfolio at least annually. Over time, your actual asset allocation will stray from your desired allocation due to varying rates of return on your different investments. Changes may be needed to bring your allocation back in line. ❍❍❍

Financial Thoughts

In a recent survey of affluent investors in North America, Europe, Asia, and Australia, investors said gaps exist between the rates of return they desire and the rates of return they are actually receiving. U.S. investors ranked sixth, with a 2.6% gap. Low yields and uncertainty over tax law changes were listed as the biggest challenges for U.S. investors. U.S. investors led all countries in terms of holding equities (with a 39% allocation) and had the largest precentage of their equity allocations in mutual funds (49%). U.S. investors were more likely to invest domestically than any other country, with just 11% investing internationally for income (Source: Legg Mason Global Income Survey, March 2013).

According to a study by Britain's Institute of Economic Affairs that covered individuals ages 50 to 70 years old, retirement adversely affects health. The study found that being retired led to a 39% reduction in the likelihood of describing one's health as "very good" or "excellent," a 41% increase in the probability of suffering from clinical depression, and a 63% increase in the probability of having at least one diagnosed physical condition (Source: Institute of Economic Affairs, May 2013). ❍❍❍