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Retirees: Inflation Protection for Retirement Portfolios

Retirees and pre-retirees have been challenged by the investing environment during the past few years. As it becomes harder to generate a livable income stream from retirement portfolios given the low bond yields, retirees have to choose between tapping their principal and venturing into high-yielding, but also riskier, securities. Inventors are concerned about what could happen to their bond portfolios if interest rates were to rise. While inflation currently appears to be in line with historical norms, retirees remain concerned about the potential for rising inflation and its effect on their portfolios. Inflation-linked securities like Treasury Inflation-Protected Securities (TIPS) are the most direct way to hedge against inflation. But even investors who are convinced that TIPS are a good place to be still have questions about implementation.

Here is why inflation protection is important for retirement portfolios. Retirees miss out on some of the inflation protection that working people normally enjoy. Paychecks will generally trend upward to keep pace with rising prices but retirees don't have that safety net. Social Security payments are adjusted upward in an effort to keep pace with rising prices. But to the extent that a retiree is living off a portfolio anchored in fixed-rate investments, the payout from that sleeve of the portfolio will be fixed. If prices go up, the purchasing power portfolio of that portfolio, and in turn the retiree's standard of living, goes down. This is why inflation-indexed securities like TIPS, whose principal values adjust upward to keep pace with inflation, are an important part of a retiree's fixed-income portfolio.

TIPS are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. TIPS are subject to unique risks, most notably liquidity risk and inflation risk.

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Advisor Corner

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WHAT A MONTH!
2012 Market Performance
01-01-12 to 2-29-12
DJIA ^DJI Up 6.01%
S&P 500 ^GSPC Up 8.59%
NASDAQ ^IXIC Up 13.89%
Russell 2000 ^ RUT Up 9.45%

Source: http://finance.yahoo.com

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Making the Most of Your 401(k)

Focus on Your Goal: It is very important to have a time frame for your retirement. Whether or not this comes to fruition, you'll want to plan for it. If your retirement is still more than 20 years away, you can probably afford to keep most of your plan in investments with a higher level of risk, such as stocks. While you will undoubtedly experience the ups and downs of the stock market, time is on your side. Just don't panic when the inevitable downs come your way.

On the other hand, if your retirement goal is right around the corner, you will most likely want to work on preserving your portfolio. In this case, it might be in your best interest to take on less risk. If you find yourself in a position to preserve your wealth, don't be afraid to shift more of your portfolio to less risky investments, such as bonds, or even cash.

Contribute Money NOW: Most people, at one time or another, have found themselves saying they just don't have the extra cash to contribute to their retirement. While this may be the case for some, contributing just 1% of your pay is a good place to start. Try your hardest to increase this rate every year, until you max out. Furthermore, if your employer provides any type of match to your contribution, saving becomes even more important. And contributions are made on a pre-tax basis, providing you with a very nice tax benefit by shaving money off your tax bill.

Choose Investment Options Wisely: When it comes to picking which investments will make up your 401(k), this can be quite a challenging task. You absolutely must understand your investment options and choose those that are right for you. Don't swing for the next home-run investment. When it comes to saving for retirement, consistent, positive growth wins. Asset allocation is one of the most important factors in determining both return and risk of an investment portfolio, so you may want to consult a financial advisor for guidance.

Be Careful when Changing Jobs: Most people only change jobs about every four or five years. But if you do switch, don't forget about the 401(k) from your previous employer. More importantly, do not take a cash distribution of your plan's balance. If you do this, you'll be starting from scratch and will have to pay early withdrawal penalties and income tax. You do have options, though. You may be able to keep the money in your prior employer's plan. You can roll the money over into the new plan. Or you can roll the money into an IRA. The important thing is that your savings will continue to grow and you will not have to incur any penalties or pay any taxes.

Resist Borrowing from Your Plan: Borrowing from your retirement account, except for extreme circumstances, is generally a very bad idea. As with taking a cash distribution, you are derailing your savings plan. If you are paying back your loan, it's going to be a lot harder to maintain your current contribution rate. And once again there are tax implications. If you have to borrow, try other alternatives, and preserve your retirement account if at all possible.

Keep Beneficiary Information Up to Date: Call your human resources representative and ask about your current beneficiary designations. Don't waste all that hard work saving money only to have it go to someone who's no longer a part of your life.

Assessing Risk

Investing and poker have been compared on many levels. For starters, poker is a zero-sum game—what the winner wins has to be equal to what the losers lose. But investing is not a zero-sum game because over time stocks tend to have positive returns, making it possible for investors to be overall winners.

Both, however, are games of incomplete information with unknown variables and conditions that cannot be controlled. To offset these uncertainties, it is important for players of both groups to assess and understand their appetite for risk. Doing so develops discipline, a strategy, and may help reduce unexpected setbacks.

The questions below are designed to help shed light on your risk tolerance. The questions are hypothetical in nature and are not meant to represent investment advice. Answers are symbolic of different risk levels: "a" conservative, "b" moderate, and "c" aggressive.

1. I am comfortable with investments that may often experience large declines in value if there is a potential for higher return.

a. Disagree b. Uncertain c. Agree

2. Suppose you owned a well-diversified portfolio that fell by 20% over a short period of time. Assuming you have 10 years until you begin withdrawals from your account, how would you react?

a. I would immediately change to a more conservative portfolio. b. I would wait at least 6 months to one year before changing to more conservative options. c. I would not change my portfolio.

3. Which statement best describes your investment goals?

a. Protect the value of my account by minimizing loss and accepting lower long-term returns. b. Balance moderate levels of risk with moderate levels of returns. c. Maximize long term returns and accept large or dramatic swings in the value of my investments.

4. Portfolios with the highest average returns also tend to have the highest chance of short-term losses. The data below represents five hypothetical investments of $100,000 over a one-year time frame. Which range would you feel most comfortable with?

a. Portfolio A: $139,000 – $88,800 b. Portfolio B: $179,000 – $75,700 c. Portfolio C: $215,000 – $59,500

Now, keep in mind that these are only guidelines meant to give you insight into how you think and behave as an investor. Once you have discovered that you are, let's say, aggressive, this certainly doesn't mean that you now have to invest in high-risk stocks and emerging markets for the rest of your life. On the contrary, your risk tolerance may change over time, and revisiting these questions periodically may let you know if it's time to change your investment strategy.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original price of $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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