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What's 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 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 2016, the arithmetic average annual return for the Standard & Poor's 500 (S&P 500) was 12%, while the geometric average return was 10%.* 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, including 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.

✔ Don't forget to factor in inflation. When determining how

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Borrow Wisely

✔ Use debt only for items that have the potential to increase in value, such as a home, college education, or home remodeling. Avoid incurring debt on items like clothing, vacations, or other luxuries.

✔ Consider a shorter term when applying for loans. Even though your monthly payment will be higher, you will incur much less interest.

✔ Make as large a down payment as you can afford. If you can make prepayments without incurring a penalty, this can also significantly reduce the total interest paid.

✔ Consolidate high-interest-rate debts with lower-rate options. It is typically fairly easy to transfer balances from higher-rate to lower-rate credit cards. Another option is to obtain a home-equity loan to pay off consumer debt.

✔ Compare loan terms with several lenders, since interest rates can vary significantly. Negotiate with the lender. Review all your debt periodically to find less-expensive options.

✔ Review your credit report before applying for a loan, so you have an opportunity to correct any errors. ❍❍❍

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What's a Reasonable?

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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 2016, inflation has averaged 2.9% annually.*

✔ Returns tend to regress to the mean. There is a tendency for the stock market to revert back to the average when it has had above- or below- average returns for an extended period. 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 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 2016 of 10% and subtracting the long-term inflation rate of 2.9% would result in a return of 7.1%. You may even want to use a more conservative return 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 2017 Yearbook*.

Avoid Credit Card Dependence

As of the end of 2016, the total average household debt was over $132,000, which has significantly increased from 2002, when it was just over $88,000. Over the past 13 years, income has grown by 28%, while the cost of living has increased by 30% in that same time period (Source: *CNBC*, 2016).

The discrepancy between the cost of living and income has led Americans to rely more on credit cards. Approximately 70% of Americans have at least one credit card, with an average credit card balance of over $16,000. With the average credit card interest rate at 18.76%, the average household is paying almost $1,300 in interest each year (Source: *CNBC*, 2016).

Ask these questions to evaluate your credit card dependence:

✔ Do you rely on credit cards to make it until your next paycheck?

✔ Does it seem you always have to put unexpected expenses on your credit card?

✔ Do you spend more than you would with cash because your card has rewards?

✔ Do the holidays leave you with a mountain of debt?

If you answered yes to these questions, you are probably relying too much on your credit cards. If you are concerned that you are too dependent on your credit cards, there are steps you can take to become credit card independent.

✔ Put your credit cards somewhere for safekeeping to reduce the temptation to use them as your regular form of payment.

✔ Become more disciplined with spending by enacting a cash-only policy. While many people use debit cards as a convenient way to pay cash; be careful, because many financial institutions allow you to overdraft your account when you use a debit card and may charge a large fee for this overdraft privilege.

✔ Consolidate your balances to fewer cards that have the lowest interest rates and close the rest of your credit card accounts to reduce the amount of available credit and, thus, the potential amount of debt you could incur. While closing credit cards can have a negative impact on your credit score, it's still better to have a temporary credit score setback than to go deeper into debt if you can't control your spending. To reduce the impact to your score, you should also consider keeping your oldest credit card in addition to a lower interest-rate card.

✔ Shock yourself into reality by looking at a few important things on your credit card statement including: how much you are paying in interest on an annual basis, how long it will take you to pay off the balance and how much you will pay in interest if you are only making the monthly minimum payment. ❍❍❍

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Which Is Better? Saving or Paying Down Debt?

Debt can be dangerous to your financial health. Thus, is it better to save or pay down your debt first?

The answer depends on a lot of things that are unique to each individual, such as your age, how much you've already saved, what rate of interest you're paying, and more. A review of the basics of financial planning is a good way to approach the subject. Here we outline how you should use income not dedicated to day-to-day expenses, in order of priority.

First Priority: Insurance

One of the best routes to financial ruin is to not have adequate insurance, so your first priority should be to have the correct kinds of policies in the right amounts that protect you and your family.

If you're young and unmarried, this means having basic health insurance. Beyond that, if you have a family, you need life insurance as well as short- and long-term disability insurance.

In each case, you're looking to provide yourself or your survivors with a replacement for income you and they count on. The bottom line: if you have debt, make the minimum payments until you're properly insured and you have the next two priorities covered as well.

Second Priority: An Emergency Fund

Even if you don't have a family, you need to protect yourself against a job loss or major unexpected expense. The rule of thumb is to create an emergency savings fund equal to three to six months of your income. Not only does this give you breathing room from hardships, it also affords you the flexibility to move in connection with a job change you might want to make.

You should make creating an emergency savings fund a priority. If you can't take care of priorities one and two at the same time you pay for basic necessities, like groceries and gasoline, you're living beyond your means and need to cut back on your spending.

Third Priority: Retirement Savings

Finally, before you even think about making more than the minimum payments toward your debts, it's imperative that you start saving for retirement as soon as possible. Time is both the best ally and worst enemy of the saver.

Start saving too late, and it's possible that you'll need a rate of return you can only achieve in your dreams to accumulate enough for a worry-free retirement. On the other hand, even small amounts — as little as $25 a month — put away early enough can grow to sizable amounts by the time you're ready to retire.

With these three priorities covered, it's time to consider making extra payments to tackle your debt.

Guidelines for Debt Reduction

There are a number of factors to consider when you're ready to start accelerating the pace at which you pay down debt:

✔ **Start with the highest-interest-rate debt.** Instead of paying more on every one of your debts, concentrate on the one that charges the highest interest rate. In general, these will be store credit cards, followed by bank credit cards like Visa and MasterCard. Use all your spare cash flow to pay down one at a time.

✔ **Is it tax deductible?** Debt that you can write off against your taxes is generally considered good debt. In effect, the tax deduction reduces the interest rate by your marginal tax rate. In most cases, this means home mortgage interest.

✔ **What rate of return can you expect?** The most important consideration is whether you can earn more by investing your money than the interest rate you're being charged on your debt. If you can earn more in the financial markets than your interest rate, you should invest your money instead of paying off debt. If not, it's worth it to pay off debt.

✔ **How long until you retire?** This is a key consideration when you're thinking of paying off your mortgage, especially if it's near the end of its term. At that point, the tax benefits are minimal because most of your payments consist of principal, not interest. In addition, if you're 50 or older, the monthly cash flow you'd free up could be devoted to the extra $5,000 a year you can contribute pretax to an IRA or 401(k) plan. On the other hand, if you have 10 years or more to go on your mortgage, it could be smarter to keep making the minimum payments to retain the tax advantages. As an alternative, consider the advantages of refinancing the remaining balance. At a reduced principal amount and with mortgage interest rates near historic lows, you may be able to reduce your monthly payments.

Smart debt management is often overlooked as a way to improve your finances. Please call if you'd like to discuss this in more detail. ❍❍❍

Raising Financially Responsible Children

Raising children who are financially smart can be a real challenge. Here are some key strategies to help with these valuable lessons:

Money isn't free, it has to be earned. While some may disagree, paying your child an allowance for chores teaches that money is earned for hard work and also begins the process of teaching money management. The key here is to be consistent. Don't be tempted to give them extra money for something they want, because waiting until they have the money saved is one of the most important lessons.

Help them save when they receive or earn money. You should help them understand it is normal behavior to save a portion of what they earn or money they receive as gifts.

Help them establish goals. Help them determine both short- and long-term goals for their money. A short-term goal may be a toy they want to purchase, while a long-term goal may be to establish a specific dollar amount for ongoing savings.

Teenagers need a hands-on approach. They need to understand the day-to-day of how adult finances actually work, such as working for income, paying bills, budgeting, saving for retirement, and so on.

A good place to start is to show them your financial plan, including your goals and budget. If you are not comfortable with letting them see the dollar amounts, just save a copy of your budget with fictitious dollar amounts. Go through the line items on your budget to explain all the bills you pay monthly, as well as what is set aside for short- and long-term savings. And even simple things we take for granted need to be taught, such as how to pay bills online or even how to fill out a check.

Don't stop there. Another major issue to discuss is how loans work. Understanding debt is equally as important as understanding savings. They need to know that borrowing money costs money and how long it may take to pay that money back.

These aren't lessons taught in a day, but introduced over time. There are also some good interactive online tools that teach about both saving and borrowing. Please call if you'd like to discuss this in more detail. ❍❍❍

Set Your Own Debt Limits

The ready availability of credit makes it easy to incur more debt than you can comfortably repay. Rather than allowing lenders to set credit limits for you, determine your own limits.

To find out where you stand with consumer debt, make a list of your debts and monthly payments. Then calculate your debt-to-income ratio by dividing your monthly debt payments by your monthly net income. The general guideline is that your debt-to-income ratio should not exceed 10% to 15% of your net income, with 20% usually considered the absolute maximum. However, you should consider your own circumstances and decide how much debt you are comfortable with.

Before purchasing something on credit, carefully evaluate whether it makes financial sense to do so. Some questions to ask include: Should I wait and save the money so I can pay cash? Will the cost of the item increase or decrease in the future? Is it really worth paying interest on the item so I can use it now? Will I still be within my designated debt limits if I add this new debt payment? Will the item still have value after I finish paying for it? ❍❍❍

Financial Thoughts

Individuals in their 60s are the only age group in America that has seen solid employment growth in the past decade, with 5.9 million more working in 2016 than in 2006 (Source: Bureau of Labor Statistics, 2017).

Nearly three out of five retirees move into new jobs. And 80% said they continued to work past age 65 because they wanted to. Most said the new jobs were more flexible, fun, and fulfilling than their past jobs — and much less boring and stressful (Source: *AARP Magazine*, June/July 2017).

About 41% of individuals in their 60s own their home free and clear, compared with 24% of those in their 50s (Source: *AARP Magazine*, June/July 2017).

Recent research shows that better-paying jobs, which generally correlate with higher education levels, are less likely to face displacement by automation. Those earning less than $20 per hour have an 83% likelihood of having their jobs displaced by 2036, compared to 31% of those earning between $20 and $40 per hour and 4% of those earning over $40 per hour (Source: *Fortune*, July 1, 2017).

Two in seven people in their 60s admit they are not confident they have enough money to last through retirement (Source: National Council on Aging, 2015). ❍❍❍