

Identifying Investment Risk And Coping With It

Are you a risk-taker? To realize rewards, you usually have to take some risks, especially when it comes to finances. But beyond understanding that investment risk and reward go hand in hand, it's important to know how they relate. What is the nature of risk, and how can you handle the different kinds of risk that could affect the performance of your investments?

What is the nature of risk?

For many investors, risk is associated with the inherent volatility of the equities markets. You run the risk that your investments will perform worse this year than last year, worse than you anticipated, or worse than the markets as a whole.

Risk means you have something to lose—the money you've put into a particular investment or the money you might have made if you had made different choices. You could also run the risk of throwing good money after bad, of buying more of something when the price is low only to see the value fall further.

Although risk and reward are related, there's no direct, predictable connection between the two. You could decide to take fewer risks and still lose money, or you might ratchet up your investment risk without cashing in on higher returns. Nevertheless, it's important to try to keep risk and reward in a balance that fits your situation.

What are the main types of risks? Financial experts often debate

this question, but the pros generally agree that two significant risks investors face are inflation and emotion.

1. Inflation risk. Essentially, this is the risk that money you earn will lose some of its purchasing power over time. For example, if you buy a five-year certificate of deposit (CD) from a reputable bank, there's relatively little risk that the bank won't live up to the terms of the CD. But there's a much bigger risk that the dollars you receive in five years won't buy as much as they would now.

If you're old enough to have experienced the 1980s, you might recall the days when money market funds paid interest at double-digit percentage rates. However, with double-digit inflation occurring at the same time, most savers barely stayed even.

Inflation risk can present problems to all investors, and especially to retirees. Someone who left work in 1978 might have felt pretty comfortable with a pension paying \$40,000 a year. But that \$40,000 was worth only about \$12,200 in 2013, according to the Bureau of Labor Statistics. This represents a loss of almost three-quarters of the money's buying power.

One way to protect against inflation risk is to include an appropriate ratio of stocks and stock funds in your portfolio. (Or, if you're more conservative, you might consider



Of Course It's Rigged...

Michael Lewis' latest novel, *Flash Boys*, has reignited the discussion around high-frequency trading. From office water coolers to Senate hearings, everyone wants to know if the market is efficient, transparent, and, most importantly, safe.

High-frequency (HF) traders use powerful computers to enter hundreds of thousands of orders per second. These orders are designed to exploit tiny inefficiencies in stock prices and take advantage of slower traders. Is it fair? Of course not. But regulators let these transgressions slide, since the high-frequency trades help maintain liquidity in the market (so buyers always can find sellers and vice-versa), and the advantage usually can be measured only in hundredths of a cent.

For most investors, the cost created by HF trading is estimated to be less than 0.001% per year. Does that make it acceptable? No.

Technology scandals are nothing new on Wall Street. The ticker-tape, the telephone, and the computer have all been accused, in their time, of giving an unfair advantage to those with the audacity (and the resources) to use them first.

But don't expect any real change until regulators prohibit the stock exchanges from profiting from the rigging, which they do by charging the HF traders hefty fees. And until the HF traders are brought to heel, don't expect investors to believe that the markets are truly fair, or particularly safe.

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Count On The Portability Provision

Though it's still true that you can't take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a "portability" provision that's now part of the law, any unused portion of the individual exemption from federal estate tax that isn't used by the estate of the first spouse to die may be claimed by the surviving spouse's estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous \$5 million that is increased annually to account for inflation. (The exemption for 2014 is \$5.34 million.) As a result, a couple in 2014 can transfer up to \$10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns \$4 million on his own, his wife has \$3.5 million, and they hold

\$2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse's will leaves his or her entire estate to the other spouse and, upon the death of that spouse, to the couple's children.



Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn't use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple's assets, worth a total of \$10 million. When she dies, that \$10 million in assets goes to the

couple's children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on \$4.66 million (the \$10 million in assets minus her \$5.34 million exemption). At

the current 40% estate tax rate, the estate would owe more than \$1.8 million—money that wouldn't go to the children. With portability, however, the combined exemption of \$10.68 million more than covers the \$10 million in the estate, and the heirs pay no federal estate tax.

As beneficial as the portability provision can be, it won't necessarily solve every potential estate-planning problem. For example, it still might be a good idea to establish

a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust could still be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

Planning Ideas For The Next Generation

Have you ever wished you could do it all over again?

Experience can be a great teacher, and it's natural to imagine that with the benefit of hindsight you would have made better decisions about everything from raising your children to managing your financial affairs. While that may or may not be true, what is certain is that you can offer younger family members some of the insight you've acquired along the way.

Here are some thoughts you might pass along:

1. When you get a pay raise or a new higher-paying job, consider earmarking at least part of the

additional money for retirement savings. You'll be amazed by what tax-deferred compounding can do to even relatively small sums over the course of several decades. Using raises to increase your contribution to a 401(k) can be relatively painless. Ratchet up your saving rate by a percentage point or two each year and you'll soon reach the maximum for annual pre-tax contributions to 401(k)s and similar employer-sponsored plans—\$17,500 in 2014 if you're younger than age 50. Beginning at 50, you'll be eligible to contribute an extra \$5,500 a year.

2. Try to resist the siren song of early retirement. Leaving your job in

your 50s may be tempting, but it runs counter to several financial realities. Most people have not saved enough to retire comfortably even at the traditional age of 65, and quitting early can mortgage your future in two ways—reducing the amount you can save while extending the time that your savings must support you. By the same token, however, every year you keep working improves your situation. Moreover, as life expectancies increase, more and more people find they want to stay on the job at least part-time, and not only for financial reasons. Working can help keep you engaged and healthy,

Five Financial Ideas For Grandparents

Spoiling your grandchildren with extravagant gifts may be fun, but you're not really doing them—or yourself—any favors. Instead, it may be wise to look for ways that help your grandchildren but that also make financial sense for you and your children.

Your experience handling money matters is one invaluable gift you can pass along. Sharing your savvy not only helps grandchildren develop healthy financial habits but also to understand family and cultural values. Tell them about your first job, how you started a business, and financial goofs you've made, such as overspending or making bad investments. "There's a big legacy gap," says Nathan Dungan, author of *Prodigal Sons and Material Girls: How Not to Be Your Child's ATM*.

"Grandparents aren't having these conversations with the grandchildren."

But don't leave your own children out of the loop. Make sure your advice and giving strategies don't conflict with their plans or guidance for your grandchildren. Here are several ways you might help:

Leverage your gifts. A grandparent can now give as much as \$14,000 a year tax-free to each child and grandchild. But rather than simply putting cash in the grandchildren's pockets, consider creative alternatives. You might open a custodial savings account for a grandson and match what he saves. Or you could establish a brokerage account and use your

particularly if you find something you really like to do.

3. You can begin receiving social security benefits as early as age 62, but your benefit is reduced if you start

receiving payments before your full retirement age. In addition, if you start social security early AND you are still working, your benefits may be significantly penalized. Each year

you delay will increase the amount of your monthly benefit, and if you wait until age 70, you'll get 76% more than if you had started drawing benefits at 62. However, waiting too long could



contributions to help your grand-daughter learn about investing. But stick to broad mutual funds rather than individual stocks. Choosing the wrong stock could lead to deep losses and discourage your would-be Warren Buffett.

Encourage philanthropy. There are several options for helping your grandchildren learn the value of charitable giving, and many of these vehicles also offer estate tax advantages. For example, you could transfer assets from your estate into your own family foundation; though to be effective, a family foundation needs a large initial commitment. Your grandkids could help screen grant applications or serve on the board. A less expensive alternative is a donor-advised fund, which also lets grandparents and grandchildren confer about what charities to support. "This is like having your own foundation to support causes you believe in, but without the hassles and paperwork that go along with operating one," Dungan says.

Take care of college. There are various methods of funding your grandchild's education, with different advantages and disadvantages. A 529 college savings plan offers tax deferred growth and tax free withdrawals for college expenses, but the investment options may be limited. Another alternative is to use a custodial account; though you lose the tax benefits from the 529, you would have a greater variety of

mean you receive a smaller total payout, if you die earlier than anticipated.

4. Don't feel like you have to go it alone in making financial decisions.

Working with an advisor could help you make sense of complex financial markets and chart a comfortable path toward your goals. The right advisor can assist you in deciding how much to save, how to

allocate your investments, how to weigh the pros and cons of buying a home and other major financial choices, and, when the time comes, how to deploy your retirement nest egg. ●

investment choices. However, your grandchild would gain access to the funds at age 21. For those grandparents who are concerned about the access to principal at age 21, a "crummey" trust, frequently used for life insurance, could be drafted to provide greater flexibility with the age of distribution, but may come with higher administrative costs. In addition, it may be treated as an asset belonging to the grandchild for financial aid purposes. Another option for grandparents interested in delaying a grandchild's access to the funds is a 2503(b) trust; any income must be distributed annually, but you can set the age of distribution upon drafting the agreement. For current school expenses, consider sending a tuition check directly to your grandchild's college. It won't count against your \$14,000 annual gift-tax exemption.

Put a roof over their heads. First-time homebuyers often qualify for a mortgage but lack cash for a down payment and closing costs. Your gift could make up the shortfall.

Alternatively, you could make a low-interest or interest-free loan, though that may raise tax issues. If qualifying for a home loan is a problem for your grandchildren, you could co-sign a mortgage. Some financial companies even allow grandparents to pledge securities as collateral for a grandchild's mortgage, so you can contribute without liquidating personal holdings.

Guide with your gifts. One alternative to direct giving is funding a trust, which can be customized to fit your goals. An incentive trust, for example, could be instructed to distribute funds to your grandchildren in installments at specified points in their lives and may tie payouts to your grandchild's accomplishments—reaching a certain income level, for example, or getting a college or graduate degree. But tread carefully, warns Dungan. "You need to help a grandchild develop healthy financial habits before trust distributions start," he says. Be careful about the kinds of hurdles you set up. "You want your grandchildren to be connected to their life passions, not yours, so don't strive for too much control," he suggests. ●

Financial Plans Are Meant To Be Revised

One great benefit of a financial plan is that it gives you a feeling of certainty. Designed to take into account wide-ranging scenarios, it seemingly should be able to shrug off an uptick in inflation, a bear-market stretch for stocks, or a spike in interest rates. Yet there are some circumstances—such as the recent once-in-several-decades plunge of the economy and financial markets—that even the most carefully constructed plan can't fully anticipate. Such events, as well as possible changes in your own situation, mean that every financial plan, sooner or later, will have to be revised. Preparing a financial plan is a process, not a one-time event, and making smart, timely alterations is crucial.

Consider how that process works. A financial advisor takes stock of an investor's overall financial situation and asks questions about goals, comfort level with investment risks, and the timetable for using investment proceeds. Then, the advisor establishes a comprehensive plan designed to help achieve those objectives.

That requires several assumptions

about how markets and the economy will behave. For example, an advisor might base a plan on a projected inflation rate of 3%, an 8% average annual return for stocks, and 4% yearly gains for bonds.

Though some or all of those assumptions might miss the mark, the idea is that, taken together, they should be close enough to be useful. Yet even small inaccuracies, left uncorrected for 20 or 30 years, will leave a plan seriously out of whack.

Think of a ship setting out from New York for, say, Lisbon. The captain charts a course that should take the ship across the Atlantic to Portugal. But what if he makes a small miscalculation? Even if he's off only 1%, that could be a problem, and unexpected changes in winds and currents along the way are likely to make things worse. If he sticks to his original bearings, he could end up in Africa—or Ireland.

But that won't happen, because

every good sailor understands the need for minor but constant course corrections. And a financial plan requires similar adjustments. Look at the predictions of economists, market forecasters, or the government, and you'll see that no estimate extending more than a year or two into the future will be even close.

So a financial plan written to predict the feasibility of a retirement 30 years away won't—and can't—be accurate. But it can establish a starting point. Reaching your goals requires frequent adjustments to compensate for the winds and currents you meet along the way.

Once you understand that basic certainty, you can prepare by discussing how, and under what circumstances, your plan will need to be altered. As part of our financial planning relationship, we regularly review our clients' plans to make sure they continue to move toward their long term goals. ●



Identifying Investment Risk

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inflation-protection bonds.) History has shown, however, that holding even a modest equity stake may increase returns without undue risk when compared to a pure fixed-income portfolio.

2. Emotional risk. It's easy to let emotions rule decision-making. Almost everyone is subject to bouts of fear and greed, and investors have an innate tendency to be overconfident about their ability to choose winning positions. But simply doing what feels right—or avoiding what feels wrong—can lead to adverse results.

Consider an investor who sits on the sidelines during a bull market, nervous about following the crowd—a

tendency that indeed can be counterproductive. But finally the investor gets tired of losing out and jumps in, buying at the top of the market and without carefully considering the fundamentals of particular investments. Others get into trouble when the market is falling and they sell solid holdings in a panic, losing out on the chance to benefit when they rebound.

The best protection against emotion is to have a carefully considered investment plan and to try to stick with it even when markets are highly volatile. Having a balance of stocks for growth and bonds for stability and income can help smooth out inevitable market bumps.

How do you manage risk?

Everybody has a different risk

tolerance. A good approach for managing yours is to stick to investment fundamentals. That may be as simple as refocusing on the key principles of diversification and asset allocation.

Diversification spreads your investments over a broad mix of asset classes, an approach that has the potential to reduce risk. Asset allocation is the process of assigning percentages to those asset classes based on your particular needs and risk tolerance, and then rebalancing your holdings regularly to keep them close to their assigned allotments.

There's no way to avoid risk completely, but you still can generate earnings while staying within your comfort zone. We're here to provide guidance. ●