CHRISTOPHER H. WEED CPA, INC.
REGISTERED INVESTMENT ADVISOR

Christopher H. Weed, CPA/PFS, CFP®, MBA (Tax)

1313 W. Robinhood Drive, Suite A-2 • Stockton, CA 95207
P.O. Box 7954 • Stockton, CA 95267-0954
(209) 957-5025 • Fax (209) 957-5027
Website: www.chrisweedcpa.com • e-mail: cweed@pacbell.net

FINANCIAL CONCEPTS

JULY 2012

How to Measure and Manage Investment Risk

Risk — the possibility of losing money — is one of the most feared words in investing. Despite most people's aversion to risk, the history of market manias shows that most people — even some of the most risk-averse — have the ability to abandon their fear of losses when asset prices soar for a long time.

So what gives some people the ability to control their emotions and make cool and calm decisions? Two main reasons are that they know how to measure risk and how to manage it. And, to the extent that individual investors learn both, they increase their chances for making smart decisions that keep their portfolios on track toward meeting their goals.

Two Ways of Measuring Risk

Beta — Professionals have two common ways to measure risk. The first is beta, which is how closely a portfolio's performance matches or varies from that of a benchmark index. The benchmark for large-company U.S.-traded stocks is the S&P 500 stock index, while a general benchmark for bonds of medium-range maturity is the Barclays Aggregate Bond index. The performance of indexes is normally expressed as a percentage and reflects their total return, which is a combination of any interest or dividend payments and their change in price.

Beta is expressed as a number on an open-ended scale, and it can be a positive number, a negative number, or zero. A beta of 1.0 means that a stock or portfolio's returns are identical in both size and direction to the benchmark, while a beta of -2.0 means that the portfolio's returns are twice as large in the *opposite* direction of the index. For example, when the S&P 500 index return is 12%, a portfolio with a beta of 1.0 should also return 12%, while a

Continued on page 2

News and Announcements

Do you know the way to Los Angeles through Madera? If not, get a map of the central valley. Go to Madera to ride the bullet train to Bakersfield, where you can catch an Amtrak bus to Los Angeles. It will only cost California taxpayers $68 billion for this luxury.

Maybe you like San Francisco better. Get in your car and drive through the Delta. It will be easy, as all the water is being sent to Southern California via some canals. This luxury is only costing California taxpayers $24 billion.

Maybe getting close to nature is more your style. That's fine; except the state was planning on closing 70 state parks. Please send money to the state to help keep them open for our use. Wait a minute, they just found $54 million in a slush fund that was not reported.

Now that we have toured the state, let's return to our state capital, Sacramento. Our politicians have, according to them, cut everything they can to balance the budget. But, they are still short $9 billion. That's why Prop 30 is on the ballet. It will increase state revenue by about $9 billion annually, for at least the next four years.

California has never had a problem with revenue. It has a problem with spending. Politicians failed to tell you that California has over $150 billion of unfunded pension liabilities with CALPERS and STRS. Their refusal to address the problem means it will just get larger. They also forgot to tell you that while they were cutting everything they could, they gave over 1,000 of their employees pay raises.

To summarize, our politicians have, in a period of decreasing revenues, done the following:

- ❍ Approved $68 billion for the bullet train
- ❍ Approved $24 billion for the Peripheral Canal
- ❍ Found $54 million in a state parks slush fund
- ❍ Refused to do anything about the $150 billion unfunded pension liabilities of CALPERS and STRS.
- ❍ Gave pay raises to over 1,000 of their employees.

They now say they need $9 billion more. What do you think? Do you agree? Please exercise your right to vote on November 6, 2012. ❍❍❍

How to Measure

Continued from page 1

stock with a beta of -2.0 should lose 24%. A beta of 0.0 means there is no patterned relationship between the two returns.

Standard deviation — A second way professionals measure investment risk is with standard deviation. Expressed as a percentage, it reflects a range of returns above and below an annual average rate of return for the stock or portfolio itself, without reference to a benchmark. It's standard deviation that measures the way many define risk: volatility.

In statistics, when applied to investment returns, one standard deviation covers about two-thirds of all returns. So a portfolio that has an average rate of return of 9% and a standard deviation of 12% means that in six to seven years out of 10, the portfolio's returns range between -3% and 21%. In general, a lower standard deviation is better, because it reflects less chance of a negative return.

Techniques to Manage Risk

Individual investors can use several methods to help reduce risk and volatility in their portfolios:

❍ **Diversification.** The fewer the number of securities you own in your portfolio, the greater the risk that one or more will produce losses that reduce your ability to generate positive compound returns. In a stock portfolio, that means owning stocks of at least 10 different companies from at least five different sectors (such as, but not limited to, technology, consumer staples, finance, energy, and basic materials).

❍ **Asset allocation.** This refers to spreading your investments over the three classic asset classes (stocks, bonds, and cash) according to a formula that potentially matches the rate of return you need to meet your goals. The formula determines what percentage of your holdings should be from each asset class. Because bonds and cash generate more steady (if smaller) average returns than stocks, the more of each included in your portfolio, the less volatile your overall returns should be.

❍ **Dollar cost averaging.** This is a technique that puts price declines to your advantage. It involves making periodic purchases in the same dollar amount of the same securities, in good markets and bad. When you continue to buy shares when their prices fall, you buy more shares than when the prices are higher. This gives you more shares, which increases your dollar gains when prices start going back up. However, it neither guarantees a profit nor protects against loss in a prolonged declining market. Because dollar cost averaging involves continuous investment regardless of fluctuating price levels, investors should carefully consider their financial ability to continue investment through periods of low prices.

❍ **Portfolio rebalancing.** This is a two-step process by which you restore your holdings to the proportions defined by your asset allocation strategy. The first step is to sell a portion of the investments in those asset classes where your holdings have grown to be larger than their prescribed percentage. The second step is to use the sale proceeds to buy more of the securities from those asset classes whose proportions have become too small. This provides a benefit similar dollar cost averaging.

Managing risk isn't about avoiding all losses, since they are an inevitable part of the investment process. Instead, it's about minimizing your losses while achieving the rate of return you need to reach your financial goals. ❍❍❍

Your Parents' Estate Plans

Estate planning can be a difficult subject to discuss with your parents. But to help ensure their estate is settled quickly according to their wishes, family members should have some basic information. You don't need to know the specifics, but you should find out:

❍ **Where important estate planning documents are located.** Don't ask for specifics, just make sure documents are in place so their wishes will be carried out. Find out if they have a durable power of attorney and a health care proxy. With a durable power of attorney, they designate someone to control their financial affairs if they become incapacitated. If your parents are concerned that this person may assume control prematurely, suggest leaving the document with their attorney, who can deliver it to the appropriate person when necessary. A health care proxy delegates health care decisions to a third person when your parent is unable to make those decisions. Usually, this document also outlines procedures to be used to prolong life.

❍ **How to contact their advisors.** Ask for a list of names, addresses, and phone numbers of lawyers, accountants, and financial advisors.

❍ **Their rationale for distributing their estate.** Often, when heirs understand why an estate is being distributed in a particular manner, it can prevent problems among those heirs. If your parents are reluctant to discuss these things now, suggest they leave a personal letter explaining their rationale for distributions.

❍ **Preferences for the future.** Find out where your parents would like to live if they're not physically able to live in their current home. Discuss in detail what procedures they want performed to prolong life in the event of a terminal illness. Determine their preferences for funeral arrangements. ❍❍❍

Taking Inflation into Account

Inflation is one the most insidious risks investors face for two reasons: 1) it's unavoidable and 2) it's easily overlooked. Since 1926, the U.S. has experienced an annual rate of inflation of 3%, which is deemed a healthy rate for economic growth.

The other way to look at that 3% hike in prices is that the dollar you owned last year is now worth just 97 cents. Again, that alone doesn't seem like a big deal, until you compound that rate over time. After 10 years, at that same rate of inflation, a dollar is worth 74 cents; after 15 years, it's worth just 64 cents; and after 25 years, it's worth only 48 cents.

Financial experts and economists make a distinction between "nominal" and "real" or inflation-adjusted growth. Nominal growth means that if the market value of your IRA rose from $100,000 to $103,000, it grew by $3,000, or 3%. But if the prices of all goods and services also rose 3%, your "real" return was 0%.

Think of inflation like an annual tax on your retirement account. On the last day of 2011, you withdraw $3,000 from your account to pay your "tax" bill, reducing the balance from $103,000 to $100,000. By December 31, 2012, your IRA is worth $103,000 again, but your "tax" bill is $3,090 — 3% higher. Now when you make your withdrawal, your account balance slips under $100,000 to $99,910. If your return and inflation remain at 3%, by the end of 2013 your account will be worth $102,908 and your tax bill will be $3,183.

Do this for 20 years and your annual "tax" bill climbs to $5,261 and your account balance has declined by about 25% to $75,401. *This example is presented for illustrative purposes only and does not project the performance of a specific investment.*

The direct implication for investors is the need to account for inflation in their financial plans. The way financial planners do this is to either 1) state your goals in present dollars and subtract an assumed rate of inflation from your expected return; ***or*** 2) state your goals in future dollars by compounding your current expenses by the assumed rate of inflation and use your nominal rates of return to project your future asset values.

To deal with inflation, investors and retirees may have to make some adjustments in how they invest or reduce their lifestyle in retirement. Since historically stocks have been the best way to keep your investment assets growing faster than inflation, even the most conservative investors may need to keep a healthy percentage of their portfolios invested in stocks.

Please call if you'd like to discuss this in more detail. ❍❍❍

Developing Your Financial Goals

Properly designed, your financial goals should provide motivation to help you control spending. Often, individuals develop vague goals such as paying for a child's college education, getting out of debt, or retiring comfortably. Since the goals aren't specific, they don't provide help in deciding how to accomplish them or in determining whether you are making sufficient progress toward reaching them. Keep these tips in mind when developing financial goals:

❍ **Set exciting goals.** Your goals should keep you motivated to reduce spending and save for the future. For instance, instead of "saving for retirement," a specific goal would be "retiring at age 60 with $1,000,000 in investments so I can travel and golf." Whenever you're tempted to abandon that goal, visualize what you're saving for.

❍ **Make your goals meaningful to you.** Everyone knows they should be saving for retirement, but if you think you're too young to think about it, set another goal that is relevant to you now. When you are getting started, setting goals you're motivated to achieve will help you realize the importance of the goal-setting process. Once you achieve some short-term goals, you may be more motivated to set longer-term goals.

❍ **State your goals in measurable terms.** Quantify your ultimate goals as well as interim goals so you can track your progress. If you need $500,000 in 20 years, how much should you have accumulated after one year, five years, or 10 years?

❍ **Prioritize your goals.** If you have more than one goal, you may not have the resources to pursue all of them at the same time. Prioritize your goals so you can work toward those most important to you.

❍ **Don't be afraid to set ambitious goals.** Just because a goal is difficult to achieve doesn't mean you should not strive to attain it. It does mean you'll need to develop appropriate strategies and stay disciplined.

❍ **Reward yourself when you make progress toward your goals.** To maintain your commitment to goals that can take years to achieve, reward yourself when you reach interim goals. ❍❍❍

Retirement and the 4% Rule

Wouldn't it be great if there was a nice, simple rule you could follow to know how much money you could safely withdraw from your retirement savings if you want it to last for 30 years or more? Well, it just so happens that there is.

It's called the "4% Rule," and it doesn't require much explanation. In retirement, take out no more than 4% of the combined value of all the financial assets you own and they'll last 30 years or more — more than the average length of time Americans spend in retirement.

Is there anything wrong with this rule? It's a crude solution, it may hurt a lot more than necessary, and success is not guaranteed. In other words, the 4% Rule may be much more valuable as a guide than a steadfast rule.

Origins: The Trinity Study

The rule originated in a 1998 study by three professors from Trinity University in San Antonio, Texas. They tested five different portfolio asset allocation strategies using historical market index performance for stocks and bonds for the 70-year period from 1926 through 1995 and annual withdrawal rates ranging from 3% to 12%. They found that regardless of the asset allocation — from all stocks to all bonds and several mixes in between — capital remained in the accounts after 30 years if withdrawals didn't exceed 4% a year.

In other words, if you're 65, have a retirement portfolio of $1 million, and don't want to run out of money until you're 95, then you can withdraw up to $40,000 a year.

On Further Reflection. . .

A few things seem awkward about the 4% Rule:

- ❍ What if you need more than $40,000 a year?
- ❍ What do you do if you live to be 100?
- ❍ What if you get really spectacular returns in your first few years so that by the time you're 95 you find you have a much bigger surplus than you expected? You realize, much to your dismay, that all along you could have afforded a more comfortable lifestyle.
- ❍ What if in the first few years of your retirement, the stock market drops by 45%?

Questions like these very quickly show the real value of the rule: it's a good place to start — nothing more. As a starting point, the rule can be especially sobering for people who think they can withdraw 8% to 10% a year or more for 30 years.

Four percent is a good number to use to guesstimate how much you need to accumulate in assets to retire. For example, if you want $100,000 a year, it's going to take a nest egg of $2.5 million in today's dollars. If you're far from that amount and you have less than five years before retirement, some revisions to your plans may be in order.

The Better Way to Optimize Your Withdrawal Rate

The truth is that choosing the "right" withdrawal rate year after year is a lot more complicated than applying a simple rule of thumb. You need to take into account your health, your family history for longevity, variable rates of return, your risk tolerance, and all of your goals, including what kind of legacy you may want to leave to your family or charities.

Ultimately, the only right way to determine how much you need in your retirement nest egg before you retire and how much you can withdraw annually once you're in retirement is to create a comprehensive financial plan and then update it at least once a year. Please call if you'd like to review in detail how much you can withdraw in retirement. ❍❍❍

FR2012-0221-0302

Did You Know?

Almost 80% of Americans did not focus on financial planning in their 2012 resolutions (Source: Allianz Life, 2012).

In 2012, Social Security payments increased 3.6%, the first increase since 2009. The typical retiree saw an increase of approximately $43 per month (Source: *U.S. News & World Report*, 2012).

Approximately 20% of Americans over 65 have fallen victim to a financial scam, a loss of more than $2.6 billion a year (Source: Investor Protection Trust, 2012).

Approximately 54.3% of young adults between the ages of 18 and 24 are employed, the lowest level since the government began tracking this data in 1948 (Source: Pew Research Center, 2012).

Over 85% of Americans age 60 and over do not have long-term-term care insurance. Of those who do not have insurance, 37% will rely on family to pay expenses, 28% believe Medicare or Medicaid will pay for care, 22% don't know how they will pay for care, and 9% believe that health insurance will pay expenses (Source: *SmartMoney*, January 2012).

The average student loan debt burden for individuals between the ages of 38 and 41 totaled $12,000, up from $9,000 in 2009, as more people seek midcareer training (Source: *InvestmentNews*, January 2, 2012). ❍❍❍