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Financial Briefs

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Finding a Balance between Risk and Return

One of the most basic investment principles is that returns reward you for the risks that you take. While investors are often uncomfortable with the concept of risk, it is this uncertainty that makes higher rates of return possible. Some basic investment principles related to risk and return include:

- Returns on specific investments are not known in advance. Investors can review historical rates of return, but there is no guarantee that past returns will be indicative of future returns.
- With most investments, there is the possibility that the investment will not meet your return expectations.
- The uncertainty regarding your actual return creates risk. Greater uncertainties typically lead to greater risk.
- Investments are subject to many different types of risk. Cash is primarily subject to purchasing power risk, or the risk that its purchasing power will decrease due to inflation. In addition to purchasing power risk, bonds are subject to interest rate risk, or the risk that interest rates will increase and cause the bond's value to decrease; and default risk, or the risk that the issuer will not repay the principal or interest on the bonds. Stocks are primarily subject to nonmarket risk, or the risk that events specific to a company or its industry will adversely affect a stock's price; and market risk, or the risk that a particular stock will be affected by overall stock market movements.
- There is generally a trade-off between risk and return. Low levels of risk are the most desirable and typically have lower return potential, while higher levels of risk are typically undesirable so must offer higher return potential to encourage investors to invest. Be cautious of claims of high returns with low risk.

There are strategies that can be used to reduce the total risk in your investment portfolio:

- **Diversify your portfolio.** You should diversify among several different investment categories, including cash, bonds, and stocks, as well as within investment categories, such as owning

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Why Strategy Is Important

How do you go about development an investment strategy? Here are four steps:

Step 1: Determine your goals. As in any aspect of life, your financial goals will drive your investment strategy. Whether you are planning for retirement, a child's college education, or a vacation, you have to know what you are working toward.

If your goal is retirement, for example, what does that look like? A five-star luxury tour of Europe and around-the-world cruise? Or visiting the grandchildren down the street? For your strategy to be successful, it has to be founded on a concrete, detailed articulation of what it's designed to achieve.

Step 2: Examine your financial profile. This is a great opportunity to get a detailed view of your finances — your income, your debts, your assets, your budget, and your existing investments. It will help you learn where you are relative to where you want to be and allow you to develop a strategy to get there. If you have mounds of debt, your first priority may be to pay those off. If your finances are in order but you don't have an emergency fund saved, that may be your first priority.

Once you know what you have to work with, you can better achieve your goals.

Step 3: Analyze your

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Finding a Balance

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several types of stocks. A properly diversified portfolio should contain a mix of asset types whose values have historically moved in different directions or in the same direction with different magnitudes. By owning several investments rather than just one, a downturn in any one should not have a significant impact on your total return. Of course, the opposite is also true — if you have one investment with exceptional returns, your total return will be lower than if that was your only investment.

- **Stay in the market through different market cycles.** Remaining in the market over the long term helps to reduce the risk of receiving a lower return than expected, especially for more volatile investments, such as stocks.
- **Use dollar cost averaging to invest.** Rather than accumulating cash so you have a large sum to invest, invest small amounts regularly. Dollar cost averaging involves investing a certain sum of money in set amounts at regular intervals. This spreads your purchases over a period of time, preventing you from making one major purchase at high prices. Since you are investing a set amount, you purchase more shares when prices are lower and fewer shares when prices are higher.

While a valuable investment strategy, dollar cost averaging does not ensure a profit or protect against losses in declining markets. Before starting a program, consider your ability to continue purchases during periods of low price levels. This strategy requires the discipline to invest consistently regardless of market prices and can help develop a habit of regular investing.

If you'd like to discuss how to balance risk and return in your portfolio, please call.

5 Investment Tips for Novice Investors

If you're just making your foray into investing, you are likely to get investment advice from just about everyone you meet. At the end of the day, however, you're the one who has to live with the consequences of your investment decisions. Here are a few tips to get you started:

1. Start as soon as possible. The sooner you start investing, the more time you are allowing the market to grow your money. For example, John wants to retire at age 65 and starts investing at age 20. He contributes a portion of his income to his employer-matched 401(k) plan — for a total of $130,500 in contributions. With an 8% average rate of return, at the end of the 45 years, John will have about $1.2 million.

If John waits until he is age 30 to begin investing, even if he puts in the same total amount under the exact same circumstances, he will have 43% less — just $694,000 at age 65. The extra decade *alone* (remember, he contributed the same amount) almost doubles the value of John's investments at age 65. In addition, the earlier you start, the better insulated you'll be against the market's ups and downs. As Warren Buffett said, "By starting early, your investing dollars have a better chance of surviving your mistakes and the market's gyrations."

2. Get smart. It's very easy to just follow someone's advice or do what everyone else is doing, but it's so important to conduct your own research of the market and different types of investments. You certainly don't have to become an expert. Much like you might do before a doctor visit, learning about the marketplace and the players will arm you with questions for your financial advisor. Whether you search the Internet, read books, watch financial news, listen to talk radio, or read financial articles like this one, make sure the information comes from reliable, unbiased sources.

3. Seek professional help. While having an understanding of the market overall and your investments more specifically, you don't have to become a professional investor to find success. After all, investing is a full-time job. Get advice and investment management help from a trusted financial advisor.

4. Diversify. Diversification — allocating your investments across different asset classes and asset class categories — is a crucial component in reaching your investment goals. If you have all of your money in one investment and it declines substantially, your entire strategy is compromised; that can be especially damaging the closer you are to your financial goals. As professor and investment expert Joel Greenblatt advises, "You must be diversified enough to survive bad times or bad luck so that skill and good process can have the chance to pay off over the long term."

5. Rebalance. It's important to update your strategy and rebalance your investments on an annual basis. When you develop an investment strategy, you allocate your funds in a way that fits your financial profile and goals at the time. However, at the end of the year, you may realize that the weighting of your asset classes has changed as certain assets have grown and others have shrunk. Rebalancing will bring your investments back into alignment with your strategy. If your financial profile or goals have changed, you'll need to revisit your strategy.

When you first get started, investing can be confusing and overwhelming, but following these five tips should make for an easier start. Please call if you'd like to discuss this in more detail.

Why a Strategy

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investment appetite. Are you a conservative or aggressive investor? Aggressive investors are willing to accept the potential of substantial financial loss for the potential of substantial financial gain.

Conservative investors are willing to accept smaller financial gain for lower risk of financial loss. Whether it's more appropriate to be an aggressive investor or a conservative investor depends in part on where you are relative to your goals.

For example, if your goal is retirement, it is generally more appropriate to invest aggressively when you are younger and further away from that goal. It is generally more appropriate to invest more conservatively as you get closer to retirement, pulling your money out of higher-risk investments to avoid losses that your investments don't have time to recover from. Are you striking the right balance?

Step 4: Be advised. Seeking counsel from a credible financial advisor will help you make the best investment decisions based on your goals, your financial profile, and your risk appetite. A financial advisor will ensure that you are getting the most from your investments and that your money is allocated properly, helping you rebalance your profile every year.

In addition to having expertise in the different types of investments and a deep understanding of what's going on in the market, advisors are also not emotionally attached. This can be invaluable in keeping you aligned with your strategy, especially when the market is fluctuating.

Like a good map, an investment strategy will help get you from point A to point Z on the road to achieving your financial goals. To develop a strategy, revisit an existing one, or for help getting back on the road, please call.

Have You Assessed Your Risk Tolerance?

While investors want the highest returns possible, returns compensate you for the risks you take — higher risks are generally rewarded with higher returns. Thus, you need to assess how much risk you are willing to take to obtain potentially higher returns.

However, this can be a difficult task. It is one thing to theoretically answer questions about how you would react in different circumstances and quite another to actually watch your investments decrease significantly in value. What you are trying to assess is your emotional tolerance for risk, or how much price volatility you are comfortable with.

Some questions that can help you gauge that risk tolerance include:

- **What long-term annual rate of return do you expect to earn on your investments?** Your answer will help determine the types of investments you need to choose to meet that target. Review historical rates of return as well as variations in those returns over a long time period to see if your estimates are reasonable.

  Expecting a high rate of return may mean you'll have to invest in asset classes you aren't comfortable with or that you may be tempted to sell frequently. A better alternative may be to lower your expectations and invest in assets you are comfortable owning.
- **What length of time are you investing for?** Some investments, such as stocks, should only be purchased for long time horizons. Using them for short-term purposes may increase the risk in your portfolio, since you may be forced to sell during a market downturn.
- **How long are you willing to sustain a loss before selling?** The market volatility of the past several years will give you some indication of how comfortable you are holding investments with losses.
- **What types of investments do you own now and how comfortable are you with them?** Make sure you understand the basics of any investments you own, including the historical rate of return, the largest one-year loss, and the risks the investment is subject to.

  If you don't understand an investment or are not comfortable owning it, you may be tempted to sell at an inopportune time. Over time, your comfort level with risk should increase as your understanding of how risk impacts different investments increases.
- **Have you reassessed your financial goals recently?** Due to the significant market volatility of the past few years, your financial plan may need to be revamped. Otherwise, you may find you won't have sufficient resources in the future to meet your goals.

  Based on your current investment values, determine what needs to be done to meet your financial goals. You may need to save more, change or eliminate some goals, or delay your retirement date.
- **Do you understand ways to reduce the risk in your portfolio?** While all investments are subject to risk, there are some risk reduction strategies you should consider for your portfolio. These strategies include diversifying your portfolio, staying in the market through difference market cycles, and using dollar cost averaging to invest. (See the article "Finding a Balance between Risk and Return" for more details.)

Ensuring your investments are compatible with your risk tolerance is an important component of your investment strategy. Please call if you'd like help assessing your risk tolerance.

Business Data

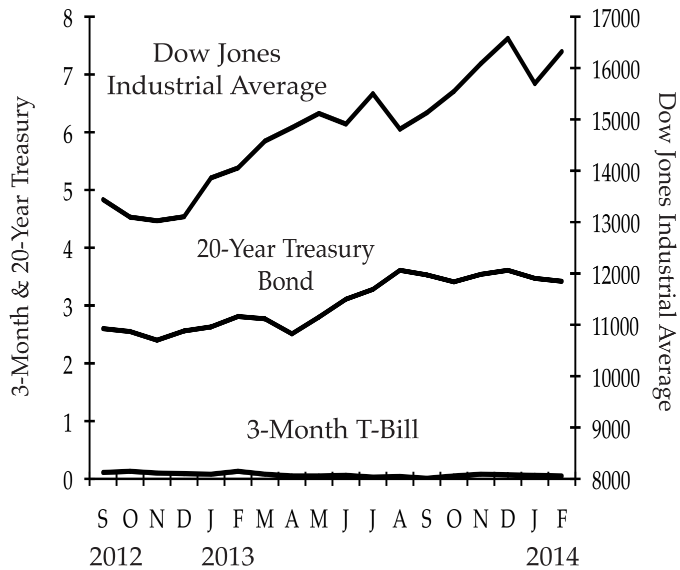
Indicator	Month-end Dec-13	Jan-14	Feb-14	Dec-12	Feb-13
Prime rate	3.25	3.25	3.25	3.25	3.25
3-month T-bill yield	0.07	0.06	0.05	0.09	0.13
10-year T-note yield	2.89	2.82	2.73	1.80	2.01
20-year T-bond yield	3.61	3.47	3.42	2.56	2.81
Dow Jones Corp.	3.11	2.96	2.83	2.70	2.61
GDP (adj. annual rate)#	+2.50	+4.10	+2.40	+0.40	+0.40

Indicator	Month-end Dec-13	Jan-14	Feb-14	% Change YTD	12-Mon
Dow Jones Industrials	16576.66	15698.85	16321.71	-1.5%	16.1%
Standard & Poor's 500	1848.36	1782.59	1859.45	0.6%	22.8%
Nasdaq Composite	4176.59	4103.88	4308.12	3.1%	36.3%
Gold	1201.50	1251.00	1326.50	10.4%	-16.5%
Unemployment rate@	7.00	6.70	6.60	-5.7%	-16.5%
Consumer price index@	233.10	233.00	233.90	0.3%	1.6%
Index of leading ind.@	99.30	99.20	99.50	1.2%	5.5%

— 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan Sources: *Barron's*, *Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

September 2012 to February 2014



News and Announcements

The Benefits of Low-Correlated Assets

By combining assets with low correlation, you can potentially improve portfolio returns while reducing risk. Correlation is a statistical measure of how one asset class performs in relation to another asset class. Correlations can range from +1 to –1. A correlation of +1 means the two assets move very closely together in the same direction. Combining assets with a high positive correlation will not provide much risk reduction. A correlation of –1 indicates the assets move in opposite directions, a rare event in the investment world. A correlation close to 0 means no relationship exists in the price movements of the two assets.

Combining assets with consistently high correlations to each other does little to reduce risk. The greatest combination benefit to a portfolio seems to be achieved by combining assets with low correlations, which results in reduced risk.

When selecting investments for your portfolio, don't just look at their risk and return characteristics. Also consider the diversification aspects for your overall portfolio. While correlations change over time, general observations include:

- Stocks tend to have a low positive correlation with corporate and government bonds.
- Short-term bonds tend to have a low correlation with long-term bonds.
- Stock markets around the world are all positively correlated to some degree. In general, European stock markets are more closely correlated to each other and the U.S. than to markets in Japan or Asia. Correlations between developed countries tend to be higher than correlations between developed and emerging countries.
- Real estate tends to have a low correlation with stocks and bonds.

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