August 2008 Issue

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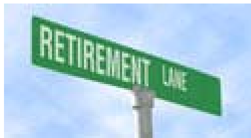

Maintaining Your Retirement Income

Saving enough by age 65 to ensure that you can maintain your standard of living through a long retirement has become increasingly difficult. Consider just this one fact. Current retirees receive close to 70% of their retirement income from Social Security and defined-benefit pension plans, while today's workers will probably only receive one-third of their retirement income from those sources (Source: Ibbotson Associates, 2007).

While that means you'll be responsible for a significant portion of your retirement income, Social Security and defined-benefit plans are a valuable component of that income. For years, we've heard that Social Security benefits are modest at best and should not be counted on as our only source of retirement income. Sometimes, it's even suggested to completely forget about Social Security benefits when planning for retirement, because changes in the system will probably be necessary when the huge number of baby boomers start retiring. But the fact is that Social Security benefits are a very valuable benefit, especially since benefits are adjusted for inflation annually.

For instance, the maximum Social Security benefit in 2008 for workers retiring at full retirement age is $2,185 monthly. While that might not seem like that much money, consider how much you'd need to accumulate to generate that monthly income. A 66-year-old male would have to pay approximately $377,000 for an annuity that would pay $2,165 monthly for life with annual inflation adjustments, while a 66-year-old woman would pay approximately $421,000 (Source: Vanguard, 2008).

While only 21% of the work force is currently covered by a defined-benefit plan, it is a valuable benefit if you are covered by one. Defined-benefit plans typically don't adjust your benefits for inflation, but they will pay a benefit for your life or the joint lives of you and your spouse, depending on the option you choose.

But despite the value of Social Security and defined-benefit plans, you will probably be responsible for the majority of your retirement income, whether you obtain that income from 401(k) plans, individual retirement accounts (IRAs), or taxable investments. Before retiring,

you'll want to ensure that you have sufficient savings to support yourself for 20, 30, or even 40 years, depending on your age when you retire.

Deciding how much you need to accumulate by retirement age is difficult, since so many of the variables that go into that calculation are uncertain. To come up with an estimate, you need to make assumptions about your life expectancy, how much income you'll need during retirement, how much you'll receive from other retirement sources, when you will retire, your long-term rate of return on investments, future inflation, and future income tax rates. If your estimates are inaccurate, you could end up with little in the way of income in the later years of your life.

Because of all the uncertainty, it is typically recommended that you only withdraw modest amounts from your retirement savings, especially in the early years of your retirement. A common rule of thumb is to withdraw no more than 4% annually from your retirement funds. So if you want to withdraw $75,000 annually from your retirement assets, you'll need to accumulate $1,875,000 by retirement age.

But that 4% figure is based on the value of your investments when you are ready to make the withdrawal and is not a static number based on your savings when you retire. During periods of market volatility, your asset balances can fluctuate significantly, causing major changes in the recommended withdrawal amounts. Market fluctuations are especially dangerous during the early years of your retirement, when it can be difficult to make up for market declines while you are withdrawing money from those reduced balances. If you aren't able to overcome market declines, you could be forced to drastically change your retirement plans.

How can you ensure that your retirement savings will last a lifetime? Consider these points:

- **Annuitize a portion of your retirement assets.** This will provide you with a definite monthly income for the rest of your life. Annuities can be purchased with or without inflation protection. Since an annuity is paid for the rest of your life, it protects you from outliving your savings and from the risk that lower-than-expected investment returns will reduce your portfolio. Typically, the benefits will end once you (and your spouse if you elect joint benefits) die, although some annuities will pay a lump sum or periodic benefit to beneficiaries. Thus, it is important to understand that if you (and your spouse if you elect joint benefits) die at a relatively young age, your benefits may not equal the purchase price of the annuity. While you probably do not want to use all of your retirement assets to purchase an annuity, you may want to use enough to purchase an annuity that will cover your regular monthly expenses.
- **Withdraw conservative amounts from your retirement assets.** If you limit your withdrawals to 3% or 4% of your balance, the assets should last for decades. At least annually, reassess your retirement assets and make sure that your withdrawals are reasonable based on your current balances. Market fluctuations can cause your asset allocation to get out of line, so you should rebalance at least annually. Even during retirement, you should allocate your assets among a variety of investment types, ensuring that your allocation is appropriate for your specific situation.
- **Maximize other sources of income.** While Social Security benefits and defined-benefit plan benefits will likely only provide moderate income, don't totally discount these income sources. Delay Social Security benefits as long as possible, until age 70, to maximize the benefits you'll receive. These benefits are also adjusted annually for inflation. While defined-benefit plans are becoming increasingly rare, make sure you apply for benefits if

you are covered.

- **Look for other ways to remove risk from your retirement investments.** There are a variety of portfolio strategies that can help cushion the impact of market fluctuations. If your portfolio is properly diversified, downturns in one asset class can be offset to at least some extent by the performance of other assets in your portfolio.
- **Reach retirement with minimal expenses.** Cut back on your living expenses before retirement, and try to enter retirement with as few debts as possible. Mortgage and consumer debt payments consume a significant portion of most people's income. Pay off those debts by retirement, and you can significantly reduce your cost of living. This can have a two-fold impact on your retirement. First, it frees up money to set aside for retirement. Second, you get used to a lower standard of living, which should also reduce the cost of your retirement lifestyle.
- **Work as long as possible.** While there is something very alluring about totally retiring from the work force, the reality is that a long retirement is very costly. Working a few more years can go a long way in helping fund your retirement. Those years are typically your highest earning years, so hopefully you'll save significant sums during that period. Also, every year you work is one year you don't have to support yourself with your retirement savings. Once you are ready to retire, try to work at least part-time during the early years of your retirement. That doesn't mean you have to stay at your current job. You can find a totally different job or start a business. Even modest earnings can help significantly with retirement expenses.

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Ensuring You Have Enough Life Insurance

For some people, the prospect of buying a life insurance policy that pays out upon their death is too close a look at their own mortality. Yet, at the same time, none of us want to leave our families financially insecure when we die. That's why it's critical to have sufficient life insurance.

The most typical reason for purchasing life insurance is to ensure your spouse and dependents have sufficient funds to maintain their lifestyle. To determine how much is needed to do that, consider these questions:

1. What lifestyle do you want to provide to your spouse and dependents when you die? Review their needs in detail, taking a look at things like:

- What standard of living do you want to provide? Will your spouse and children live in the same house?
- Will the family have to make different child-care arrangements?
- How many and what kinds of automobiles will be needed?

- If your spouse works, will he/she decide to stay home with the children?
- If your spouse stays at home, will he/she return to the work force?
- Do you want to pay for your children's college educations?
- What other financial help do you want to provide to your children?
- Do you want to pay off a mortgage or other debt with insurance proceeds?
- What are your spouse's retirement plans? Is he/she counting on you for retirement income?
- Do you need to consider the support of elderly parents or other relatives?

2. How much will that lifestyle cost? Come up with an estimate of how much this lifestyle will cost. Include all of your current expenses that would remain the same as well as any new expenses you have identified, such as for child care. Remember to factor in hidden costs, such as providing for health insurance that was paid for by your employer. For large debts, such as a mortgage, determine if it makes sense to pay the loan off in full or to continue making monthly payments.

3. How much life insurance do you need? First, consider what other income sources your spouse and/or dependents will have. This could include your spouse's earnings, retirement plans, Social Security benefits, savings, and investments. Life insurance proceeds will be needed to provide the difference.

Your life insurance needs will change over time, so you should periodically go through this analysis.

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Lessons Learned from the Stock Market

The stock market volatility of the past few years has taught some valuable lessons about the stock market:

- **The market tends to revert to the mean.** There is a tendency for the stock market, when it has an extended period of above or below average returns, to revert back to the average return. Thus, following an extended period of above-average returns in the 1990s, the stock market experienced a significant downturn, helping to bring the averages back in line.
- **Don't chase performance.** Investors often move out of sectors that are not performing well, investing that money in investments that are currently high performers. But the market is cyclical, and often those high performers are poised to underperform, while the sectors just sold are ready to outperform. Rather than trying to guess which sector is going to outperform, make sure your portfolio is broadly diversified across a range of investment sectors.
- **Avoid strategies designed to "get rich quick" in the stock market.** The stock market is a place for investment, not speculation. When your expectations are too high, you

have a tendency to chase after high-risk investments. Your goal should be to earn reasonable returns over the long term, investing in high-quality stocks.

- **Don't avoid selling a stock because you have a loss.** When selling a stock with a loss, an investor has to admit that he/she made a mistake, which is psychologically difficult to do. When evaluating your stock investments, objectively review the prospects of each one, making decisions to hold or sell on that basis rather than on whether the stock has a gain or loss.
- **Make sure an investment will add diversification benefits to your portfolio.** Diversification helps reduce the volatility in your portfolio, since various investments will respond differently to economic events and market factors. Yet it's common for investors to keep adding investments that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor.
- **Check your portfolio's performance periodically.** While everyone likes to think their portfolio is beating the market averages, many investors simply don't know for sure. So thoroughly analyze your portfolio's performance periodically.
- **No one knows where the market is headed.** No one has shown a consistent ability to predict where the market is headed in the future. So don't pay attention to either gloomy or optimistic predictions. Instead, approach investing with a formal plan so you can make informed decisions with confidence.

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Monitoring Your Stocks

There are five factors to look for as you monitor your stocks' performance:

1. Earnings. Pay attention to the company's quarterly and annual earnings statements, which include comparisons with the recent past, and quite often, reviews of what management expects for the next quarter and year. Look for the stock's earnings trend and how the company performs compared to analysts' estimates. Watch out for earnings "surprises," which can cause rapid price changes.

2. Price and dividends. Follow the stock's price compared to its 52-week highs and lows. Examine its trailing total returns year to date and over the last one-, three-, five-, and 10-year periods. Look for changes in the absolute dollar amount of dividends and the current yield (the annual dividend divided by the current price).

3. P/E and PEG ratios. Price to earnings (P/E) and price/earning growth (PEG) ratios are often better indications than the price of the stock as to how relatively expensive or cheap a stock is. The P/E ratio is useful for comparing the stock to other stocks and to the market in general; the PEG ratio is a strong indicator of whether the stock is overpriced or underpriced compared to its projected earnings growth rate over the next five years.

4. Insider transactions and stock buybacks. A company buying back its own stock or whose senior executives and directors are accumulating more shares is a bullish sign. On the other hand, when insiders are selling off major holdings of their own stock, it's quite often an

indication that the stock price has already peaked.

5. Sudden and large price changes on high volume. When a stock makes a sudden, high-volume move - particularly when it opens much higher or lower than the previous day's high or low - it can be the start of a new, long-term trend in the direction of that move.

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The Benefits of Low-Correlated Assets

At first glance, asset correlation may seem like a complex topic. However, it is important to understand the concept and how it affects your portfolio. 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 consistently low correlations, which results in consistently reduced risk.

When selecting investments for your portfolio, 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.
  Past performance does not indicate future results.

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FR2008-0421-0041