Just How Risky Is Your Portfolio?

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When summer comes, we usually think - vacation time. This is our time to get away, relax and try to forget about day to day worries. If we aren't intentional about doing this, before we know it, the summer is over and we wonder "What happened? This month's newsletter addresses a few items that, if we aren't intentional about planning, we will wake up one day and wonder, "What happened?"

Newsletter articles for this month are: 1) suggestions on how to know if your investments are too risky; 2) understanding the fees you pay in your 401(k) plan; 3) how to plan financially when you have a chronic illness; and 4) understanding what a "joint bank account" and a "payable on death bank account" mean.

As your ***CPA Firm*** & ***Trusted Advisor*** , we welcome your comments and encourage you to let us know if there are other topics you would like to hear about. Please visit our Website , Like Us on Facebook , or follow us on Twitter and LinkedIn to get updates and access a wealth of important information.

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If you're like most people, you probably evaluate your portfolio in terms of its return. However, return isn't the only factor you should consider; also important is the amount of risk you take in pursuing those returns. The term "risk" is often understood to mean the risk of loss. However, a portfolio is generally a means to an end, such as paying for retirement or a child's college tuition. In that context, "risk" also means the risk of not meeting your financial needs.

Risk-adjusted return

Let's say that Don's portfolio earns an average of 7% a year for 10 years. However, his annual returns have been very uneven; one year his return might be 11%, another year it might be down 10%. Meanwhile, Betty's portfolio also has averaged a 7% annual return in the same time, but her returns have been more even; she hasn't had spectacular years, but she has avoided any negative annual returns.

You might think both would end up with the same amount of money after 10 years, but that's not necessarily the case. It depends in part on the timing and size of the declines in Don's portfolio. A big loss in the first year or two means he'll spend valuable time recovering rather than being able to make the most of compounding; that can affect future growth. That's why it's important to consider an investment's risk-adjusted return.

Volatility measures

One of the most common measures of volatility is standard deviation, which gauges the degree of an investment's up-and-down moves over a period of time. It shows how much the investment's returns have deviated from time to time from its own average. The higher the standard deviation of an investment or portfolio, the bumpier the road to those returns has been.

Another way to assess a portfolio's volatility is to determine its beta. This compares a portfolio's ups and downs to those of a benchmark index, such as the S&P 500, and indicates how sensitive the portfolio might be to overall market movements. An investment or portfolio with a beta of 1 would have exactly as much market risk as its benchmark. The higher the beta, the more volatile the portfolio. (However, remember that investments also have unique risks that are not related to market behavior. Those risks can create volatility patterns that are different from the underlying benchmark.)

The risk of not achieving your goals

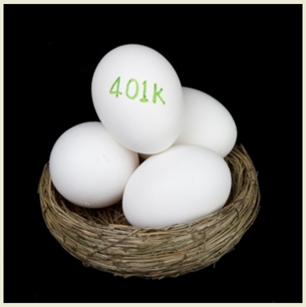
Another way to evaluate risk is to estimate the chances of your portfolio failing to meet a desired financial goal. A computer modeling technique known as Monte Carlo simulation generates multiple scenarios for how a portfolio might perform based on the past returns of the asset classes included in it. Though past performance is no guarantee of future results, such a projection can estimate how close your plan might come to reaching a target amount.

Let's look at a hypothetical example. Bob wants to retire in 15 years. A Monte Carlo simulation might suggest that, given his current level of saving and his portfolio's asset allocation, Bob has a 90% chance of achieving his retirement target. If he chose to save more, he might increase his odds of success to 95%. Or Bob might decide that he's comfortable with an 85% chance of success if that also means his portfolio might be less volatile. (Be aware that a Monte Carlo simulation is a projection, not a guarantee.)

Are you getting paid enough to take risk?

Another approach to thinking about portfolio risk involves the reward side of the risk-reward tradeoff. You can compare a portfolio's return to that of a relatively risk-free investment, such as the inflation-adjusted return on a short-term U.S. Treasury bill. Modern portfolio theory is based on the assumption that you should receive greater compensation for taking more risk (though there's no guarantee it will work out that way, of course). A stock should offer a potentially higher return than a Treasury bond; the difference between the two returns is the equity's risk premium. While understanding risk premium doesn't necessarily minimize risk, it can help you evaluate whether the return you're getting is worth the risk you're taking.

Understanding 401(k) Plan Fees and Expenses



Fees and expenses are factors that may affect your investment returns, and therefore impact your retirement income.

**These are hypothetical examples and are not intended to reflect the actual performance of any specific investment, nor are they an estimate or guarantee of future value.*

If you direct your own 401(k) plan investments you'll need to consider the investment objectives, the risk and return characteristics, and the performance over time of each investment option offered by your plan in order to make sound investment decisions. Fees and expenses are factors that may affect your investment returns, and therefore impact your retirement income.

Why should I care about plan fees?

In a 401(k) plan, your account balance will determine the amount of retirement income you will receive from the plan. While contributions to your account and the earnings on your investments will increase your retirement income, fees and expenses paid by your plan may substantially reduce the balance of your account.

Assume that you're an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7% and fees and expenses reduce your average returns by 0.5%, your account balance will grow to $226,556 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5%, however, your account balance will grow to only $162,846. The 1% difference in fees and expenses would reduce your account balance at retirement by 28%.*

The following table demonstrates how varying levels of fees and expenses can impact the growth of a hypothetical 401(k) plan account after 35 years, assuming a $25,000 starting balance, 7% annual return before expenses and fees, and no additional contributions.

Average Annual Fees and Expenses	Ending Balance After 35 Years*
0.0%	$266,915
0.5%	$226,556
1.0%	$192,152
1.5%	$162,846

How do I learn about my plan's fees?

The first step is to become informed about the different types of fees and expenses charged by your plan, and the way they are allocated to plan participants. The best way to do this is to study the fee disclosure information that your 401(k) plan provides to you.

Investment fees

By far the largest component of 401(k) plan fees and expenses is associated with managing plan investments. Your disclosure statement should clearly indicate the total annual operating expenses of each investment option. For example, in the case of a mutual fund, these operating expenses may include investment management fees and 12b-1 fees. These fees are charged against the assets of the fund and reduce the fund's total return. The annual operating expenses will be shown both as a percentage of assets (expense ratio) and as a dollar amount for each $1,000 invested. For example, a fund may have an expense ratio of.15%, or $1.50 for each $1,000 invested. In this case, $10,000 invested in the fund would cost $15.00 annually (10 times $1.50).

Your plan's disclosure material will also describe any shareholder-type (transaction) fees that apply to each investment option--things like sales charges and loads, withdrawal fees and surrender charges, and fees to transfer between investment options.

Your plan must also provide a chart that lets you easily compare information about each investment option. For example, if your plan allows you to choose among different mutual funds (or from different families of mutual funds), the difference in fees and expenses may help you choose between two or more funds that are otherwise similar in performance and investment strategy.

Administrative fees

The day-to-day operation of a 401(k) plan also involves expenses for basic services--plan record keeping, accounting, legal and trustee services--that are necessary for administering the plan as a whole. Sometimes employers pay these expenses. Sometimes they're paid by the plan, and either allocated to all participants in proportion to account balances (that is, participants with larger accounts pay more of the allocated expenses) or charged as a flat fee to each participant's account. Your fee disclosure should contain an explanation of any fees and expenses that may be charged to participants' accounts. You'll also receive an explanation of any fees and expenses that may be charged to your individual account--for example, fees for taking out a loan or processing a qualified domestic relations order.

Remember that fees and expenses are just one factor to consider when choosing an investment for your 401(k) plan account. You'll also need to consider a fund's investment performance in relation to the fees charged. However, all things being equal, minimizing the fees and expenses you pay to your 401(k) plan may help you increase your retirement nest egg--so be informed and review all your options carefully.

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Financial Planning When You Have a Chronic Illness

There's no such thing as a one-size-fits-all financial plan for someone with a chronic illness. Every condition is different, so your plan must be tailored to your needs and challenges, and reviewed periodically.

When you live with a chronic illness, you need to confront both the day-to-day and long-term financial implications of that illness. Talking openly about your health can be hard, but sharing your questions and challenges with those who can help you is extremely important, because recommendations can be better tailored to your needs. Every person with a chronic illness has unique issues, but here's a look at some topics you might need help with as you're putting together your financial plan.

Money management

A budget is a useful tool for anyone, but it's especially valuable when you have a chronic illness, because it will serve as a foundation when planning for the future. Both your income and expenses may change if you're unable to work or if your medical costs rise, and you may have unique expenses related to your condition that you'll need to account for. Clearly seeing your overall financial picture can also help you feel more in control.

Keeping good records is also important. For example, you may want to set up a system to help you track medical expenses and insurance claims. You may also want to prepare a list of instructions for others that includes where to find important household and financial information that a trusted friend or relative can access in an emergency.

Another step you might want to take is simplifying your finances. For example, if you have numerous financial accounts, you might want to consolidate them to make it easier and quicker for you or a trusted advisor to manage. Setting up automatic bill payments or online banking can also help you keep your budget on track and ensure that you pay all bills on time.

Insurance

Reviewing your insurance coverage is essential. Read your health insurance policy, and make sure you understand your co-payments, deductibles, and the nuts and bolts of your coverage. In addition, find out if you have any disability coverage, and what terms and conditions apply.

You may assume that you can't purchase additional life insurance, but this isn't necessarily the case. It may depend on your condition, or the type of life insurance you're seeking--some policies will not require a medical exam or will offer guaranteed coverage. If you already have life insurance, find out if your policy includes accelerated (living) benefits. You'll also want to review your beneficiary designations. If you're married, you'll want to make sure that your spouse has adequate insurance coverage, too.

Investing

Having a chronic illness can affect your investment strategy. Your income, cash flow requirements, and tolerance for risk may change, and your investment plan may need to be adjusted to account for both your short-term and long-term needs. You may need to keep more funds in a liquid account now (for example, to help you meet day-to-day living expenses or to use for home modifications, if necessary) but you'll want to thoroughly evaluate your long-term needs before making investment decisions. The course of your illness may be unpredictable, so your investment plan should remain flexible and be reviewed periodically.

Estate planning

You might think of estate planning as something you do to get your affairs in order in the event of your death, but estate planning tools can also help you manage your finances right now.

For example, you may want to have a durable power of attorney to help protect your property in the event you become unable to handle financial matters. A durable power of attorney allows you to authorize someone else to act on your behalf, so he or she can do things like pay everyday expenses, collect benefits, watch over your investments, and file taxes.

A living trust (also known as a revocable or inter vivos trust) is a separate legal entity you create to own property, such as your home or investments. The trust is called a living trust because it's meant to function while you're alive. You control the property in the trust, and, whenever you wish, you can change the trust terms, transfer property in and out of the trust, or end the trust altogether. You name a co-trustee such as a financial institution or a loved one who can manage the assets if you're unable to do so.

You may also want to have advanced medical directives in place to let others know what medical treatment you would want, or that allow someone to make medical decisions for you, in the event you can't express your wishes yourself. Depending on what's allowed by your state, these may include a living will, a durable power of attorney for health care, and a Do Not Resuscitate order.

Review your plan regularly

As your health changes, your needs will change too. Make sure to regularly review and update your financial plan.

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What is a payable on death (POD) account?

A bank account can be designated as payable on death to someone of your choice. The bank pays these funds to this person almost immediately at your death, and the funds will generally not be subject to probate.

The payable on death designation is very simple and flexible. You can change the designation until your death, and the individual you designate has no right to the money until your death. Indeed, the individual will not receive the account unless he or she outlives you. A POD designation can also be used with U.S. savings bonds.

A typical bank account would be subject to probate at your death. Property subject to probate generally incurs fees, such as attorney's fees, and the transfer of probate property may be subject to delays of one to several years. A POD account usually avoids probate, and the named beneficiary can generally access the funds immediately after your death, without significant delays.

The requirements for a POD account may vary somewhat under state law, and state laws determine what is subject to probate. Ask your bank, attorney, or financial advisor to make sure that the account won't be subject to probate. A POD designation used with appropriate U.S. savings bonds will not be subject to probate in any state.

You do not make a gift for gift tax purposes when you name the beneficiary of a POD account. You remain subject to any income tax on funds in a POD account while you are alive. And funds in a POD account are subject to estate tax at your death. Of course, if your spouse is the named beneficiary, the funds would qualify for the estate tax marital deduction. If the named beneficiary is two or more generations younger than you (e.g., a grandchild), the funds may also be subject to generation-skipping transfer (GST) tax at your death. Substantial exemptions ($5,250,000 in 2013) are available to protect property from estate tax or GST tax.

A similar provision, transfer on death (TOD), is available for the transfer of stocks, bonds, and mutual funds to a named beneficiary at your death.

What is a joint bank account?

A joint bank account lets you name a co-owner for your bank account. Funds in the account transfer to your co-owner automatically if you die. Your estate generally avoids the expenses and delays of probate.

Holding checking and deposit accounts as joint bank accounts can be a simple and inexpensive way to transfer funds immediately upon your death. It guarantees your spouse (or other co-owner) continuing access to the family checking account to pay monthly bills. You can change the designation until your death. However, the co-owner can withdraw funds from the account until revoked as co-owner.

A typical bank account would be subject to probate at your death. Property subject to probate generally incurs fees, such as attorney's fees, and the transfer of probate property may be subject to delays of one to several years. A joint bank account usually avoids probate, and the co-owner can generally continue to access the funds immediately after your death, without delays.

The requirements for a joint bank account may vary somewhat under state law. Ask your bank, attorney, or financial advisor to make sure that the account won't be subject to probate.

You do not make a gift for gift tax purposes when you name the co-owner of a joint bank account. However, you do make a gift when the co-owner withdraws funds you contributed to the account. You generally remain subject to income tax on funds you contributed to the joint bank account while you are alive. And funds in a joint bank account may be subject to estate tax at your death. In general, if co-owned with your spouse, one-half of the account is included in your gross estate; if co-owned with anyone else, the account is included in your gross estate except to the extent that you can prove contributions were made by the other co-owner.

Gifts qualify for a $14,000 annual exclusion in 2013. Of course, if your spouse is the co-owner, the funds would qualify for the gift or estate tax marital deduction. If the co-owner is two or more generations younger than you (e.g., a grandchild), the funds may also be subject to generation-skipping transfer (GST) tax. Substantial exemptions ($5,250,000 in 2013) are available to protect property from gift and estate tax or GST tax.

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