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S U C C E S S

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## How to Measure and Manage Investment Risk

**R**isk — 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 and everybody else seems to have made a lot of money.

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

*Continued on page 2*

### Overdiversification

**D**iversify. Diversify. Diversify. But keep in mind that it is possible to overdiversify, which can lead to lackluster returns. Thus, you should know the difference between healthy diversification and excess diversification.

The primary benefit of diversification for your portfolio is to spread market risk over different investments in a way that will decrease the impact any one investment will have on your total return. With an appropriate level of diversification, your overall return will not be significantly impacted if one investment does not perform as expected.

Thus, it is not just the number of investments you hold that impacts your return, but how those investments interact with one another. If you keep adding investments that react to the market in the same way, you are not really diversifying. You are just adding similar investments to your portfolio. Adding too many investments to your portfolio also makes it more difficult to monitor your investments. With too many investments to keep track of, it is more likely that you will miss important information about investments. ○○○

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## How to Measure

Continued from page 1

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 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 the risk and volatility in their portfolios. These include:

✓ **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

## Taking Inflation into Account

**I**nflation is one of 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. 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.

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 (i.e., don't adjust them for the effects of inflation) 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.

The investor who thinks he/she is avoiding risk by staying out of the stock market is ignoring inflation risk. Without some offset for the eroding effect of inflation, such ultraconservative investors virtually guarantee that the longer they live, the less purchasing power they will have. ○○○

(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 (e.g., 70% stocks, 25% bonds, and 5% cash). 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.

Please call if you need help aligning your investment strategy with your goals while adapting to changing market trends. ○○○

# Start Longevity Planning Now

**J**ust because we are living longer doesn't mean we're going to remain healthy throughout our longer lives. In the past, seniors who lived long lives tended to be healthier in their senior years, which meant they had lower medical bills. But while some credit goes to more active, health-conscious, smoke-free lifestyles, it's safe to say that today's seniors owe more to prescription drugs and medical advances for lengthening their lifespan.

And as we all know, health care costs money — lots of it. In fact, Fidelity Investments found in its 2011 *Retiree Health Care Costs Estimate* study that a 65-year-old couple retiring this year with Medicare coverage will still need \$230,000 to pay for medical expenses throughout retirement, excluding nursing-home care.

Speaking of which, with a longer life comes the greater likelihood of needing assisted living or long-term care. According to the Genworth 2011 *Cost of Care Survey*, assisted living averages \$39,000 a year and nursing homes average more than \$70,000 a year — per person. For a couple, this kind of care could cost far more than their annual household income during their highest earning years.



## Plan Now for a Long Life

Some of the things you can do to plan for a long life come down to repositioning your assets — as well as your approach toward life.

For example, lifestyle factors can contribute significantly to both how long you live and the quality of life you lead. Areas where most of us could easily pay more attention include lower caloric intake, higher vegetable and fruit consumption, a higher fiber diet, lower body fat, and regular exercise.

Furthermore, research has revealed that as you age, learning new skills can help protect the brain against age-related memory decline and dementia. This is particularly important during retirement when you no longer have the day-to-day cognitive challenges that kept your mind active. Effective brain-stimulating activities include doing crossword puzzles, playing video games, learning a new skill such as cooking or ballroom dancing, or learning a foreign language.

Studies have also found that people who feel the most socially connected are four times less likely to develop serious illnesses. A Brigham Young University study reports that social connections — friends, family, neighbors, or colleagues — improve our odds of survival by 50%. In fact, the study asserts that low social interaction is the equivalent to smoking 15 cigarettes a day or being an alcoholic (Source: *Social Relationships and Mortality Risk*, July 2010).

## Finances

This is a good time to think about your priorities and align your assets to support your personal goals (not just your financial aspirations). In fact, you may need to reposition your assets to accommodate a longer life with fewer assets than you previously thought.

When we talk about reevaluating and establishing financial goals, it shouldn't just be about seeking a 10% average annual return on your investments over the next five years. You should consider what you actually want to do with your money. What is the purpose of it — to live out your life comfortably and secure, or to live in luxury, entertain, and travel extensively? The latter lifestyle may no longer be your priority, so before you determine what changes to make in your finances, it's important to establish what you want from your life.

Even in retirement, your portfolio may need to be positioned for both growth and security. Growth to meet the challenges of a long life and the impact of long-term inflation and health care, but also sources of secure income to ensure that your daily essential living expenses will be met.

## Insurance

During this continuing era of slow economic recovery, remember that one of the key components to managing wealth is managing risk. In addition to the traditional sources of retirement and estate planning, consider today's popular insurance options, such as annuities, long-term care, and life insurance policies.

## A Lifelong Plan

Life is long, and it's getting longer with each generation. They say that life gets in the way of even the best-laid plans, and it's true. Every plan — even a financial plan — requires tweaking and adjusting periodically to account for current events. However, your personal goals may well remain the same for the rest of your life. So if you establish the purpose of your money — what it is that you want out of life — then you can reposition your assets to help you reach those goals. ○○○

## Market Timing vs. Buy and Hold

**M**arket timing involves making financial market buy and sell decisions based on your prediction of the future performance of the market. A buy-and-hold investment strategy, in contrast, involves buying in to the market on a regular basis and holding your investments over time.

The fact is that the market is an incredibly complex system. Investment returns depend on a wide range of factors — from who the company's chief executive officer is to inflation in China. Economists suggest that stock prices exhibit what they call random walk behavior, meaning that future performance cannot be predicted based on past performance.

Market timers retort that they have built complex models that analyze all factors affecting a stock's price. Sometimes, these models do accurately predict the movement of a stock price. But too often, unforeseen factors can send a stock's price quickly up or down.

Also, market timing is a more time-intensive strategy. You need to

monitor your investment closely to stay on top of all the factors that can affect it.

For the average investor, a buy-and-hold strategy is much more practical. While buy-and-hold investors will suffer in market downturns, by staying invested in the market, your investments will recover when the market recovers. While there is no guarantee that will happen, historically, the general direction of the market has been upward.

The benefits of a buy-and-hold strategy over a market timing strategy include:

- ✓ It doesn't require constant monitoring of the market or the news.
- ✓ It's less complex. You'll typically make far fewer trades with a buy-and-hold strategy.
- ✓ There are fewer tax consequences. Since you have fewer trades, you'll have fewer taxable transactions.

Please call if you would like to discuss this in more detail. ○○○



## Know When to Exit

**E**veryone purchases investments with the expectation that the price will go up, earning profits on that investment. Unfortunately, that doesn't always happen, making it necessary to develop an exit strategy.

When purchasing an investment, write down your reasons for purchasing the investment and when you will sell. That could include both upside and downside sell criteria. As an investment is declining, it is common to come up with excuses to delay selling — it's a temporary setback, wait until next week, wait until earnings are reported, etc. Then, the further the investment declines, the more likely you will want to wait for the investment to turn around before selling. That is how large losses are incurred.

Instead, set a firm sell guideline, which will ensure that you don't incur substantial losses. For instance, you might sell an investment when it declines by 5% of your purchase price. While it will probably still be painful to sell the investment at a loss, this will ensure that you don't incur major losses in your portfolio. You have effectively put a cap on your losses. ○○○

## Financial Thoughts

**T**he average amount that U.S. families paid for college during the 2010–2011 school year declined by 9% compared with the prior year. On average, families spent \$21,889 on college costs. One likely reason for the spending reduction is an increase in the percentage of costs covered by scholarships and grants, which rose from 25% to 33% of college costs during the same period. For the average family in the survey,

parental assets financed 30% of college costs, student borrowing financed 15%, and student assets were responsible for 11% (Source: Sallie Mae, 2011).

In a recent survey, 49% of middle-income baby boomers had not tried to determine how much money they should need to live comfortably during retirement (Source: Insured Retirement Institute, 2011).

In a recent survey, 83% of the respondents believed their finances will either remain the same or improve during the next 12 months. Only one-quarter of the respondents indicated that they had experienced no financial hardship due to the recent stock market volatility and recession (Source: Certified Financial Planner website, 2011). ○○○