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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 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 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 tradeoff 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 they 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:

Continued on page 2

Choosing a Beneficiary for Your 401(k) Plan

When you sign up for your 401(k) plan, you'll typically be asked to fill out a beneficiary designation form listing who should receive your 401(k) plan assets if you die. Make these selections carefully, since they typically override any provisions in your will.

If you are married, federal law dictates that your spouse is automatically your 401(k) plan's beneficiary. Even if you list another person as the primary beneficiary, your spouse will receive the proceeds unless he/she signs a written waiver.

When your beneficiaries are minor children, keep in mind that most 401(k) plans will not transfer money directly to minor children. Thus, you may want to set up a trust, so the trustee can take immediate control of the funds. Otherwise, a court-appointed trustee or guardian may need to be named.

Periodically review your beneficiaries to determine if changes are needed. A divorce, remarriage, spouse's death, or child's birth are all events that may require changes to beneficiaries. ❍❍❍

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Finding a Balance

Continued from page 1

✔ **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 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. However, diversification does not assure a profit or protect against loss in declining financial markets.

✔ **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.

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

Review Your Estate Plan

Between the fluctuating stock market and declining home values, the value of your assets probably changed dramatically over the past couple of years. Thus, it is probably a good time to take a look at your estate plan, considering the following:

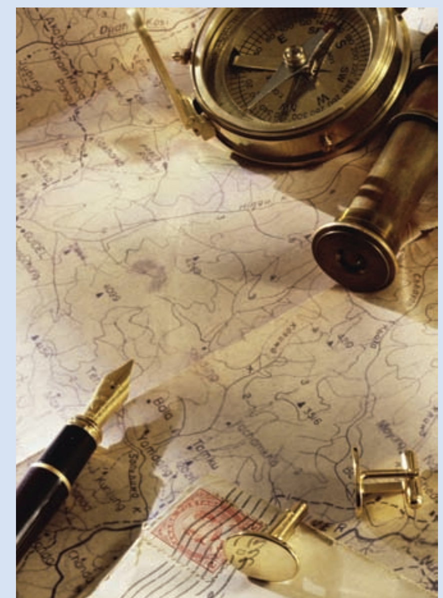
✔ **Take another look at your plans for distributing your estate.** Your estate plan may distribute specific assets to specific heirs, such as a business to one child and investments to another child. While those assets may have been equal in value in the past, that may have changed. You may want to place provisions in your estate plan to equalize distributions.

✔ **Review amounts being placed in different trusts.** Many estate planning documents indicate that trusts should be funded with assets equal to the exemption amount or the generation-skipping transfer tax exemption amount. Lower asset values coupled with significantly larger exemption amounts could result in placing too large a percentage of your estate into trusts. You may want to change how the amounts to go in trust are calculated.

✔ **Use lower asset values to leverage your lifetime gifting strategies.** In 2009 and 2010, you can gift up to $13,000 ($26,000 if the gift is split with your spouse) to any individual free of gift taxes. This amount is adjusted annually for inflation, in $1,000 increments. You can also gift up to $1,000,000 during your lifetime without paying gift taxes. When asset values are low, you might want to gift some of those assets to your heirs. There are other strategies to leverage gifts, such as setting up trusts that discount the value of the gift and using family limited partnerships or limited liability companies.

✔ **Consider converting traditional individual retirement accounts (IRAs) to Roth IRAs.** While your adjusted gross income could not exceed $100,000 in 2009 to convert, anyone can convert starting in 2010. Amounts rolled over from a qualified pension plan, such as a 401(k) plan, to a traditional IRA can also be converted to a Roth IRA. Transferred amounts must be included in income if they would be taxable when withdrawn (e.g., contributions and earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal tax penalty. While there are many factors to consider before converting, a major factor is the ability to pay the income taxes with funds outside the IRA. With lower investment values, your tax bill should also be lower. Once the IRA is converted to a Roth IRA, qualified distributions, whether taken by you or your heirs, will be received on a tax-free basis.

Please call if you'd like to review your estate plan in light of current conditions. ❍❍❍



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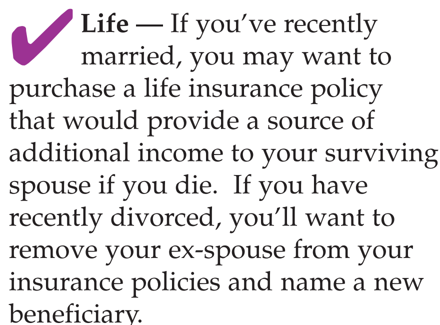
Do You Need to Change Your Insurance?

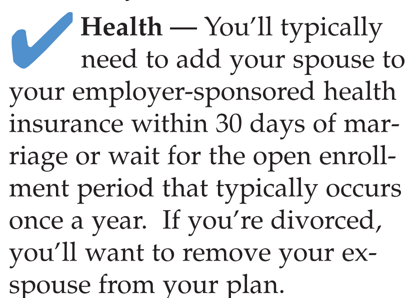
A recently conducted survey found that at least 32 million U.S. households own insurance policies that don't adequately meet their needs (Source: Trusted Choice, 2008). If yours is among those households, you could be paying too much for insurance, or you could find you have inadequate coverage.

Of course, the policies that were just right for you five years ago — or even one year ago — may not be right today. Thus, you should review your insurance every year or after a major life event, such as marriage, divorce, the birth of a child, a new job, or the death of a spouse or dependent. During that review, consider these seven questions:

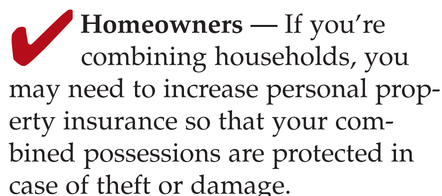
Have you recently married or divorced? A marriage or divorce may affect several different types of insurance needs, including:



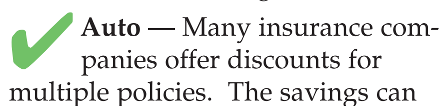
Life — If you've recently married, you may want to purchase a life insurance policy that would provide a source of additional income to your surviving spouse if you die. If you have recently divorced, you'll want to remove your ex-spouse from your insurance policies and name a new beneficiary.



Health — You'll typically need to add your spouse to your employer-sponsored health insurance within 30 days of marriage or wait for the open enrollment period that typically occurs once a year. If you're divorced, you'll want to remove your ex-spouse from your plan.



Homeowners — If you're combining households, you may need to increase personal property insurance so that your combined possessions are protected in case of theft or damage.



Auto — Many insurance companies offer discounts for multiple policies. The savings can be significant if both you and your new spouse have autos insured by the same company. Insurance companies that offer both auto and homeowners insurance may provide even larger discounts for those who purchase both types of policies.

Has your spouse died or become disabled? These types of changes warrant a reassessment of all your insurance needs. If your spouse has died, you'll want to rename beneficiaries on your life insurance policies.

Have you had a baby? According to the Insurance Information Institute, five million households with new babies have not updated their life insurance protection. You should ensure that your life insurance coverage is sufficient to provide for the child's needs until adulthood, perhaps including education expenses in addition to day-to-day expenses.

Also review your disability insurance coverage, since you now have another dependent relying on your income. Look into both short-term and long-term disability coverage. Many employers offer some level of disability insurance coverage. However, don't just assume that coverage is sufficient. You may need to purchase additional insurance to supplement that offered by your employer.

Keep in mind that you typically have 30 days after birth to add your child to your employer-sponsored health plan.

Are there any new drivers in your household? If you have a teenager who has just started driving, be prepared for significant increases in your auto insurance. Insurance companies often give premium discounts when the new driver has taken a certified driver's training course or is a good student, so make sure to check with your insurance company. Once your child goes away to college, inform your insurance company if your child did not take a car to college.

Have you switched jobs and/or dramatically increased or decreased your earned income? Have you retired? If you have a significant increase or decrease in your income that has caused changes in your lifestyle, you may want to adjust your life insurance policy.

Once you retire, reevaluate your life insurance to see if any changes are warranted. And, if you're no longer commuting every day, you may qualify for lower auto insurance premiums. Also make sure to review your long-term-care needs.

Have you acquired any new valuables? Have you purchased or sold a home? Your homeowners insurance policy, which also covers personal property up to specified limits, typically covers new purchases automatically. However, make sure that any new purchases don't exceed the limits of your policy, or the item may not be covered. Periodically review your inventory of personal property and compare it to your homeowners insurance.

Have you made extensive renovations on your home? The Insurance Information Institute indicates that nearly 40% of homeowners who have "significantly remodeled their homes" have not updated their homeowners insurance. Make sure to review your policy limits when you add significant value to your home. It's actually a good idea to review your limits periodically to make sure your policy will replace your home if it is totally destroyed. Changes in the cost of rebuilding a home can outpace the limits of your policy, and you don't want to be left unprotected.

It's a good idea to reassess your insurance needs at least once a year. ❍❍❍

FR2009-0720-0162

Using P/E Ratios to Evaluate Stocks

The price to earnings ratio — or P/E ratio — is the most widely used yardstick for evaluating stocks. A stock's P/E ratio is its current price per share divided by its annual earnings per share. You'll find it represented as a "trailing" P/E, which conveys the stock's price relative to its total earnings over the previous four quarters, or as a "forward" P/E, which looks at the stock's combined estimated earnings over the next four quarters.

One way of looking at the P/E ratio is as a representation of how much investors are willing to pay for a company's earnings stream. For a stock with a P/E ratio of 10, the market is saying it's willing to pay $10 for each $1 of the company's earnings.

By itself, the P/E ratio doesn't mean much; its significance comes from comparing it to other P/E ratios, including the stock's prior or historic P/E ratio; the P/E ratios of other stocks, particularly those in the same industry; and the P/E ratio for the stock market as a whole.

Comparing P/E ratios, you can start to evaluate whether a stock is underpriced (a good buy) or overpriced (time to sell if you own it, or avoid it if you don't).

A "good" P/E ratio is a relative term — dependent in large part on the industry that the company is in. Companies in fast-growing industries, like technology, biotech, and pharmaceuticals, often justify high P/E ratios over 20; while companies in low-profit margin, slow growth, or cyclical industries — food retailers, coal, and financial services — command lower P/E ratios, often in the teens or lower.

More recently, a related ratio has become increasingly popular among stock analysts: the price/earnings growth ratio, or PEG ratio. The PEG ratio is calculated by dividing a stock's P/E value by its projected average annual earnings growth rate over the next five years. Many experts believe the PEG ratio to be a more reliable measure of a stock's price and value than the P/E ratio.

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

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Insurance Basics

Review all of your policies every couple of years. You want to make sure you have adequate coverage in all major areas, while also evaluating whether revisions are needed due to changes in your personal circumstances.

Purchase insurance wisely. The primary purpose of insurance is to protect you from financially devastating losses, not from every minor loss you might incur. Thus, review all the riders and options in your policies, only retaining those that are important to you. Check if you qualify for discounts offered by your insurance companies. Consider increasing your deductible periodically.

Avoid insurance you don't need. Don't purchase insurance for minor items you can easily cover yourself, such as extended warranties on small household appliances. When reviewing your policies, make sure you're not paying for duplicate coverage. For instance, you may have disability income insurance at work and through a personal policy. Review the policy limits on both to ensure you aren't paying for benefits that can't be collected because you've exceeded the policy limits. ❍❍❍

Financial Thoughts

A recent study found that employees have been fairly consistent in their 401(k) investing habits despite the economic downturn. Despite losing an average of 28.3% in their 401(k) values in 2008, 74% of employees contributed to these plans, consistent with 2007 percentages. The amount of pay contributed only decreased from 7.7% in 2007 to 7.4% in 2008. Only 4.8% of employees ceased contributions to their 401(k) plans in 2008 (Source: Hewitt Associates, 2009).

While 90% of parents believe that sending their children to college is important, 55% of families with children between the ages of 15 and 18 have saved less than $10,000 for college, and 13% have saved nothing (Source: Oppenheimer Funds Survey, 2009).

Approximately 33% of high-net-worth families own businesses (Source: *Journal of Financial Planning*, July 2009).

To increase their chances of having enough money for a comfortable retirement, 81% of workers indicated in a recent survey that they are reducing expenses, 43% are changing the way they invest, 38% are working more, 25% are saving more, and 25% are seeking advice from a financial professional (Source: Employee Benefit Research Institute, 2009). ❍❍❍