REINVENTING Retirement
YOUR RETIREMENT PLANNING NEWSLETTER
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Back to School

Renew Your Investment Knowledge

As fall brings students back into the classroom, it's also a good time for investors to regroup, review and build on their investment basics. To celebrate the season of renewed knowledge, we offer the following core curriculum:

- **Asset Allocation 101: An introduction**
- **Asset Allocation 201: Delving deeper**
- **History Lessons: Learning from your mistakes**
- **Psychology: Understanding investor behavior**

Asset Allocation 101: The Most Important Investment Lesson

One of the critical lessons of investing is asset allocation. It's an organized strategy of dividing your investments among different asset classes, such as stocks, bonds and cash equivalents.

Diversification is sometimes described as "not putting all your eggs in a single basket." Also, be sure that your investment baskets are different from each other. For example, if you invest in a few U.S. stock funds, typically they should hold distinctly different stocks. Otherwise, your investments would tend to be duplicated, rather than diversified.

One of the strengths of asset allocation is that it can be customized for each individual. Begin by determining your time horizon, risk tolerance, financial situation, and level of investment understanding. These factors will lead to your ideal investment mix.

To illustrate, Paul is 35 years old. He expects to retire in about 30 years. He's comfortable with a relatively high level of investment risk and allocates 75% to stock funds and 25% to bond funds, with nothing in cash-equivalent funds. In contrast, Joan is close to retirement and puts 40% of her investments in stock funds, 40% in bond funds, and the remaining 20% in cash-equivalent funds.

Because investments with higher potential returns often have elevated risks, it may be prudent for you to diversify while taking on as much risk as you feel comfortable with. That will enable you to seek the highest potential return while remaining within your risk comfort zone.

The final step in the initial asset allocation process is to select and invest in funds that reflect your asset allocation. Then monitor your investments over time.

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Asset Allocation 201: Taking Diversification to Another Level

This course explains how to make your asset allocation more effective. We'll learn some basics on the following:

- **What makes asset allocation work**
- **How to avoid fund overlap**
- **How to broaden your asset allocation**
- **Reviewing and rebalancing**

Prerequisite course: Asset Allocation 101

Here are some key concepts:

Correlation: This describes how similarly any two investments perform. High correlation means two investments have similar performance patterns. Low, neutral or negative correlation indicates that two investments—individual stocks, for instance, or mutual funds—tend to perform independently of one another or differently. Investing in funds that have low correlation with each other tends to lead to more effective asset allocation because it's more likely that when one does poorly, the other will counterbalance that with better results.

Avoid Overlap: To make sure that your funds are as diversified as you would like them to be, examine your fund's prospectus and annual and semi-annual shareholder reports. These documents describe the fund's investment strategy, its risks, performance, top holdings, and sector and industry allocations.

Extend Your Asset Allocation: This is a good way to avoid overlapping holdings. After selecting the right mix of stocks, bonds and cash, drill down further and explore the different segments within the stock and bond markets. U.S. stock funds can focus on large-cap, mid-cap and small-cap stocks. "Cap" is short for capitalization. It refers to a company's total value— its number of shares multiplied by the price per share. Large-cap stocks tend to be steadier performers while smaller-cap stocks often have better growth potential.

"Value" and "growth" are two distinct styles that fund managers may pursue. Growth and value investment styles tend to take turns outperforming one another over periods. Investing in a variety of funds can lessen the likelihood of overlap, improve your portfolio's diversification, and help you lower your risk.

Similarly, you may wish to diversify further by combining international and U.S. stock funds or by investing in government and corporate bond funds or in short-term and long-term bond funds.

Review and Rebalance: Each year, review your portfolio's performance and asset allocation. The mix of assets may shift over time because a fund that has performed very well will have grown within your mix relative to one that has not performed as well. To rebalance to your original asset allocation, you could transfer some money from the faster-growing fund to the slower-growing one. In addition to helping you keep on track towards your goals, it enforces the "buy low/sell high" approach, which is never a bad thing.

History: Learning From Our Mistakes

"Those who do not learn from the past are condemned to repeat it."
– George Santayana

As humans, we all make mistakes. Fortunately, we can learn from our mistakes and from those of other investors. Here are five lessons to be learned from common mistakes:

Beware of bubbles. As investors, if we could collectively learn one major lesson, it would be to not believe that "it's different this time." If an investment or commodity appears to be defying the laws of gravity—shooting straight up—we should know that this can't continue forever. We should have learned this in the great technology/Internet investment bubble of the late 1990s, and we had another learning opportunity as the great real estate bubble burst in the last year or two. Unfortunately, many people are paying a hefty price today for their latest expensive mistake—extending their budgets too far on real estate.

Don't chase performance. The disclaimer "past performance is no guarantee of future results" should be etched into our brains by now, but somehow many of us still think that last year's hot stock or fund will repeat as #1. History tells us otherwise. Rather than focus on recent hot performers, consider other factors, such as asset allocation, or longer track records—perhaps a fund's performance over five or 10 years, rather than just a year.

Buy-and-hold beats frequent trading. One reason that many experienced investors take a buy-and-hold approach is that trading in and out of stocks frequently

incurs additional costs and taxes. And those expenses cut into your net returns.

Market timing simply doesn't work. Like frequent trading, trying to time the market—selling stocks and then buying back into the market at what you think are the ideal times—just doesn't work. You have to make the right call not just once, but twice. That's just too hard for people to do with consistency.

Don't procrastinate. If you keep putting off investing in your retirement, you will lose an enormous opportunity because of the power of compound returns.

Probing the Psychology of Investor Behavior

What triggers the investment decisions that we make? Why do we buy, sell or hold onto certain investments? How do our emotions affect our behavior as investors?

The answers to these questions are found in behavioral finance, a field that combines psychology and finance to explain the biases that affect our behavior as investors. These common and sometimes irrational investor behaviors include:

Loss aversion: We are often less willing to sell investments that have lost value than those on which we have made money. That may seem odd, but sometimes we don't want to admit that we have lost money or made a bad investment decision. Unfortunately, ignoring or denying a mistake can't undo it, and could make things worse. For example, by refusing to cut our losses on a bad investment, we might continue to incur additional financial loss.

Herd mentality: The feeling of not wanting to be left out or to miss out on a good thing partly explains how investment bubbles and crashes occur. Rather than think for ourselves, too often, many investors follow the crowd. This can be quite dangerous, especially in cases where everyone is being irrational, and when emotions such as greed and fear are involved.

Selective thinking: This is a built-in bias. We rely on information sources that confirm our beliefs, interpret information in a way that justifies our actions, or remember only certain successes, and not failures. Regardless of what shape this takes, selective thinking distorts our views and behavior as investors.

Overconfidence: This bias is a form of selective thinking, and can be dangerous. It may lead to heightened risk if it involves reckless thinking and behavior. Ironically, if you believe you can't lose, you may be more likely to lose or to lose more when investing.

Other very different forms of irrational investor behavior include:

- Second-guessing: thinking that whatever you decided was wrong—the investment itself, or the timing, for instance.
- Inertia: If fear of failure causes inaction, it can stand in the way of success. For example, people who don't take full advantage of an employer's matching contribution in a retirement plan pass up a great benefit.
- Panic or fear: Overreacting to any market event can be costly.

Do you experience any of these investor emotions or biases? The first step is to be aware of them. Then, try to overcome – or work with – your emotions so that you can become a better investor.

- Try to be objective.
- Consciously try to remain independent of the prevailing crowd mentality.
- Limit your risks. You can do this by investing in index funds rather than actively managed funds, eliminating the chance you'll do worse than the market; diversifying through mutual funds rather than buying individual stocks; and holding on to your investments over the long term, rather than trading frequently.

Retirement in Motion

TIPS AND RESOURCES THAT EVERYONE CAN USE

Boomers on the Brink

Issues facing participants approaching retirement

A recent survey of baby boomers revealed that most 44 to 62-year-olds are not following the financial discipline of their retired parents, who attribute their financial success to avoiding credit card debt, creating an emergency fund, and saving enough for retirement. Only two in 10 baby boomers say they've done an excellent job saving for retirement. Fewer than half say they have done a good job at saving. Just one in three say they've done an excellent job creating an emergency fund. However, boomers generally do have better money management skills and are more open to trying new financial products and investing in stocks, which have produced better long-term returns historically. The survey was conducted by NAVA, the Association of Insured Retirement Solutions.

Q & A

Common questions asked by retirement plan participants

What is "rebalancing?"

It's important to monitor your investment mix regularly. If your allocation to stocks and bonds should shift over time, or if your goals or risk tolerance should change, you may need to review and rebalance your portfolio to bring it back into line. Let's say you'd like to rebalance from stocks to bonds. You could sell some stocks and, with those proceeds, buy some bonds. Or, if you are contributing regularly to a retirement account, you could allocate more of your new contributions to bonds to even things out. Many investment professionals recommend that you review and rebalance your investments each year.

Tools & Techniques

Resources and ideas to guide you in your retirement planning efforts

Dollar Cost Averaging

Contributing regularly and systematically to a retirement plan isn't just a vitally important way to meet your long-term savings goals. It's also a form of dollar-cost averaging. That means you invest the same dollar amount regularly. When the market is down, you can buy more shares at a lower cost, and when the market rises, the same dollar amount purchases fewer shares. This enforces investing discipline and tends to lower the average price per share.

Quarterly Reminders

- **Think ahead:** With the New Year still a few months away, think about what financial improvements you'd like to make in your life next year. Rather than waiting until January 1, why not think about financial resolutions for 2009 now and develop a plan? Would you like to save more? Get out of debt? Start an emergency cash fund? Plan the change now and put it in place by January 1.
- **Act now:** While there's still time left this year, have you accomplished all that you wanted to? Could you start a college savings plan for a child? Have you reviewed your asset allocation? If you itemize your taxes, consider prepaying your state taxes or property taxes and making tax-deductible charitable contributions now.

Corner on the Market

Basic financial terms to know

Bulls and Bears

Investment markets that rise for an extended period are known as bull markets. When they decline by 20% or more, they are called bear markets. Why 'bulls' and 'bears'? One theory is that bears strike downward with their paws while bulls swing their horns upward to strike a victim. Bull and bear markets may create a bumpy or volatile investment ride, but they are a natural part of investment cycles and long-term investors learn to live with them.

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