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401(k) UPDATE

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# Practical Implications of Investment Theory

Many investment principles used to develop investment portfolios are derived from one investment theory — the Capital Asset Pricing Model (CAPM). What exactly is this theory and how does it apply to your investments?

The CAPM was developed over 50 years ago by Harry Markowitz, who won a Nobel Prize for his work. His theory centers on the concept that adding an asset to a portfolio that is not highly correlated with other assets in the portfolio can reduce variation risk. Before his theory, it was common practice to look for undervalued assets to add to a portfolio. His approach evaluated how a particular asset would impact a portfolio's risk and return. Whether it makes sense to add that investment to the portfolio depends as much on how the asset's return will vary with returns of other portfolio assets as on its own return prospects.

This theory provides the underlying rationale for asset allocation. The key is that the returns of different assets do not behave in the same manner during different economic times, so adding different assets can reduce the volatility in that portfolio. While the return of a diversified portfolio may be lower than that of investing solely in the best performing asset, it is typically viewed as an acceptable trade-off for reduced risk. Many people have also realized that it is difficult to identify the best performing asset in any given year, so a diversified portfolio provides more consistent returns.

Some of the investment implications that have been drawn from this theory include:

✔ A properly diversified portfolio will combine assets that do not have highly correlated returns. Thus, when one asset is declining, other assets may be increasing or not decreasing as much.

*Continued on page 2*

## Asset Correlation

Asset correlation is the measure of how assets move in correlation to one another. Highly correlated assets move in the same direction at the same time, while negatively correlated assets move in opposite directions — one moves up as the other moves down.

The theory of asset correlation is that you can reduce risk and increase returns by investing in asset combinations that are not correlated. The basic rule has been that equities go up when economies do well, and bonds do better when economies go down. Their low correlation to one another is why this has been effective over the years.

However, recently, bond markets have become more highly correlated to equities. This change in correlation has become a new risk factor investors need to think about when developing their asset allocation. It's not just about the percentage of bonds in your portfolio anymore, but the types of bonds as well. The new thinking is that you have to plan your investment strategy around volatility because of the change in bond behavior. ❍❍❍

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# Investment Theory

*Continued from page 1*

✔ Rather than focusing on each investment's risk, investors should consider their portfolio's overall risk.

✔ Including a small percentage of a volatile investment may not increase a portfolio's overall risk, provided that investment's returns do not vary closely with other assets' returns in the portfolio.

✔ When small portions of stocks are added to an all-bond portfolio, risk initially decreases, even though stocks are more volatile than bonds. Thus, an all-bond portfolio is not the lowest risk portfolio.

✔ Investors should consider how varying percentages of different asset classes will affect their portfolio's risk and return before deciding on an asset allocation.

### Managing Your Portfolio

Consider this investment process to incorporate this theory:

✔ **Determine your risk/return preferences.** You should assess the potential downside as well as upside for various investments to get a feel for how much risk you can tolerate.

✔ **Decide on an asset allocation mix.** Your asset allocation strategy represents your personal decisions about how much of your portfolio should be allocated to various investment categories. After considering your risk tolerance, time horizon for investing, and return needs, you can form a target asset allocation mix. Within broad investment categories, make allocation decisions for each category. Not only will each individual's allocation strategy differ, but your strategy will vary over time.

✔ **Select individual investments.** Investigate a wide range of options, but make sure you understand the basics of each, examining the risk types as well as their historical rates of return. Your selections should fit in with your overall asset allocation.

✔ **Rebalance periodically.** Over time, your asset allocation will stray from your desired allocation due to varying rates of return on your investments. See the article "Rebalance Your Portfolio" for more details. ❍❍❍

# Rebalance Your Portfolio

There is a relatively underused and simple technique to raise your long-term portfolio performance and reduce your risk at the same time. It's called rebalancing, and it's something every investor can and should do.

First, to rebalance you need to have more than one investment in your portfolio. Second, you need to determine the right mix of those investments for your objectives.

For example, an aggressive investor with a long time horizon might invest 80% of his/her portfolio in stocks, 15% in bonds, and 5% in cash. On the other hand, a conservative investor might hold 30% in stocks, 60% in bonds, and 10% in cash.

The purpose of rebalancing is to restore an investor's portfolio to the structure that fits his/her objectives. Here's how you do it: you sell off a portion of any asset class that has increased beyond its target percentage and reinvest the sale proceeds in more of the asset classes that have shrunk below their target percentage. The calculation is simple: multiply the new market value of your portfolio by your target mix percentages and compare them to the values in your account.

Aside from maintaining the level of investment risk that's right for you, rebalancing has two additional benefits. First, it forces you to lock in your gains, which many investors fail to do. Second, rebalancing can add as much as one-half percent or more to your long-term investment returns. That may not sound like much; but over 20 years, it could mean thousands of dollars more in your portfolio.

A good rule of thumb for rebalancing is once a year. But depending on market performance, it could be more or less often than that. The best advice is to check your portfolio several times a year and rebalance whenever there have been significant changes in the weighting of its constituent parts.

This is just an overview of rebalancing. It can apply not only to asset classes, but to sub-asset classes as well. For example, your asset allocation strategy may call for specific exposure to large- and small-cap stocks, or U.S. and foreign stocks, while your bond portfolio may include Treasury, investment-grade corporate, and/or high-yield bonds. Changes in their weighting may suggest you rebalance among these, too. There's also the question of which particular stocks or bonds you sell or buy.

Finally, there's always the chance that changes in your portfolio may coincide with changes in your objectives — you may actually need to be taking more or less risk than in the past. Whether and when to rebalance is just one of many considerations that are important to maintaining your investment portfolio. ❍❍❍

## Taking the Plunge: When Should You Retire?

Most people know instinctively that deciding when to retire is one of the most important life decisions they'll ever make. What most people don't know, however, is how to actually make that decision.

The traditional retirement age is 65. But some people want to retire early, say at age 55. Others look at how much they'll get from Social Security — benefits begin at age 62, but the longer you delay, the more it pays out. Then there's the matter of your retirement portfolio — with many retirement portfolios lower than they were a few years ago, many people are wondering if they might have to put off retiring far longer than they had expected.

The most important question to answer is: how many years can you afford the lifestyle you want in retirement? The worst thing that can happen is that you run out of money in retirement. The best idea is to work with a qualified financial advisor to answer this question. But to give you an idea of what's involved in making that decision, here's a summary of the main considerations:

**What is your lifestyle going to cost in retirement?** This is the most basic parameter to determine. Is your house paid off? Are you going to travel and entertain frequently? Do you want to own two homes, one in a warmer climate for the winter and a cooler one in the summer? What will the cost of living be in each of those places? What kind of uncovered medical expenses do you expect? Start by putting together an annual household budget for all of your expenses.

**What sources of income will you have?** Will it be only Social Security, or will it include other regular payments from a pension, consulting or self-employment, rental income, royalties, etc.?

**How much do you have accumulated and what annual income can you generate from it?** Sources of retirement savings often include IRAs, 401(k) plans, and taxable accounts.

**Will your income cover your expenses?** If so, you *might* be able to retire at the age you project. However, if the rate at which you withdraw money from your retirement portfolio is too high, you run the risk of depleting those resources before you die, which will likely result in making some very uncomfortable adjustments to your lifestyle.

If you determine that your income won't cover your expenses, there are three solutions:

✔ Delay retiring while you add to your personal savings and increase the amount you can collect from Social Security.

✔ Change the investment mix in your portfolio to potentially increase your rate of return.

✔ Aim for a less-expensive retirement lifestyle.

A thorough financial plan runs through all of these calculations and aims at a realistic answer to the question of when you should retire, based on all the details of your finances and the level of risk that's appropriate for you. ❍❍❍

## Catch-Up Options for Those 50 and Older

Once you hit your 50th birthday, most people are well on their way to retirement. They've saved. They've invested. They've made smart choices.

What happens, though, when you've done all those things, yet retiring in the near future still seems like an impossibility? Don't worry, you're not alone. In fact, there are special provisions in place that are dedicated just for individuals like you who are trying to play catch-up.

Here are a couple of scenarios in which you can contribute in excess of the limits that apply to others younger than you.

First, let's look at IRAs. Most people can contribute $5,500 or 100% of compensation; but if you're playing catch-up and are over 50 (by the end of the year), you can put in an additional $1,000 dollars. Not a huge additional amount, but it does make a difference.

If you're over 50 (or will be by the end of the year) and are enrolled in an employer-sponsored plan, you can also put your retirement savings into overdrive in excess of your younger coworkers. If you have a 401(k), 403(b), or a 457 plan where you're able to defer $18,000, you can bump that up another $6,000, which can make a huge difference.

So, being over 50 does have its advantages. If you're still playing catch-up at this age with your retirement, there is still plenty of time to get back on track. ❍❍❍

## Why Do Interest Rates Fluctuate?

While it is difficult to predict how much and in which direction interest rates will move, the factors causing those fluctuations include:

✔ **Economic conditions** — The volume of business activity affects interest rates. In periods of economic growth, businesses require large amounts of debt to finance increases in working capital and fixed assets. This increase in demand coupled with increased consumer borrowing puts pressure on interest rates to rise. As the economy contracts, businesses and consumers cut back on their borrowing, and interest rates start to fall.

✔ **Monetary policy** — The Federal Reserve attempts to assist the economy in growing at a stable rate with low inflation. Their actions, including buying or selling Treasury securities in the open market, raising or lowering the discount rate, and changing reserve requirements, impact the level of interest rates.

✔ **Expected inflation** — The market interest rate on a risk-free security has two components — the real rate of return plus an inflation premium. Investors' expectations about the future rate of inflation impact the level of interest rates.

✔ **Federal deficit** — Since the federal government is such a large borrower in our economy, significant changes in the amount being borrowed can impact overall interest rates.

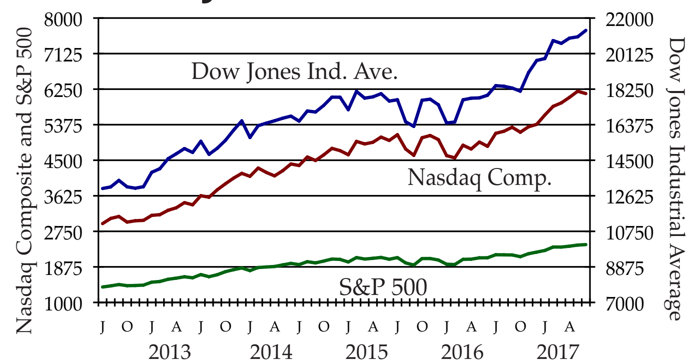
Other factors can also impact interest rates, such as the rate of saving by individuals and corporations, international capital flows, and the premium required by investors to assume interest rate risk. Even though the factors affecting overall interest rates are known, the interplay of all of these factors makes it difficult to precisely predict the future direction of interest rates. ❍❍❍

## Market Data

| | Month End | | | % Change | |
|---|---|---|---|---|---|
| | Jun 17 | May 17 | Apr 17 | YTD | 12-Mon. |
| Dow Jones Ind. | 21349.63 | 21008.65 | 20940.51 | 8.0% | 19.1% |
| S&P 500 | 2423.41 | 2411.80 | 2384.20 | 8.2 | 15.5 |
| Nasdaq Comp. | 6140.42 | 6198.52 | 6047.61 | 14.1 | 26.8 |
| Wilshire 5000 | 25124.96 | 24933.08 | 24737.28 | 7.9 | 16.2 |
| Gold | 1242.25 | 1266.20 | 1266.45 | 7.2 | -5.9 |
| | | | | Dec 16 | Jun 16 |
| Prime rate | 4.25 | 4.00 | 4.00 | 3.75 | 3.50 |
| Money market rate | 0.33 | 0.33 | 0.30 | 0.29 | 0.27 |
| 3-month T-bill rate | 1.02 | 0.96 | 0.82 | 0.56 | 0.26 |
| 20-yr. T-bond rate | 2.49 | 2.68 | 2.60 | 2.86 | 1.99 |
| Dow Jones Corp. | 2.99 | 3.04 | 3.09 | 3.17 | 2.78 |
| Bond Buyer Muni | 4.08 | 4.10 | 4.20 | 4.26 | 3.82 |

Sources: *Barron's, Wall Street Journal*

### Stock Indices
### July 2012 to June 2017




Past performance does not guarantee future results.

## Thoughts about Retirement Planning

When asked how retirees spend their time, 67% of men connect with family, 52% socialize with friends, 42% volunteer, 38% participate in sports and outdoor activities, 28% work full- or part-time, and 15% take classes. For women, on the other hand, 80% connect with family, 75% socialize with friends, 58% volunteer, 18% participate in sports and outdoor activities, 19% work full- or part-time, and 30% take classes (Source: *Money*, November 2016).

Of the 62 million women working in the United States, only 45% participate in a retirement plan (Source: *asecurelife.com*, 2016).

The average American expects to retire at age 65, up from age 63 in 2002. However, 26% of baby boomers expect to retire at age 70 or older (Source: *Journal of Financial Planning*, October 2016).

The average amount of Social Security benefits paid to those over age 65 in retirement was $12,232 in 2014 (Source: MarketWatch, 2016).

Approximately 30% of adults born in the 1940s and 1950s have a traditional pension plan, compared to 11% of those born in the 1980s (Source: Urban Institute, 2016).

Medicare, by itself, covers approximately 60% of medical expenses (Source: *The New York Times*, 2016). ❍❍❍