TIME TO SAVE WITH CHRIS & DAVE

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Chris G. Volk, CFP

David J. Lutz Jr.

Inside this issue:

"Take calculated risks. That is quite different from being rash."
~ General George S. Patton

Imagine it is a hot, autumn day. The forecast calls for severe thunderstorms and intense lightning. Not wanting to miss the recently announced $350 million dollar Powerball Lottery drawing, you jump in your car and head to the local store to buy a ticket. In this short amount of time, how many risks did you just undertake?

Well, first of all, there is the risk of getting struck by lightning in which the odds are 576,000 to 1. The second would be possibly dying in a car accident in which the odds are 18,565 to1. And last but not least, the chances of actually winning the Powerball are 195,249,054 to 1. (Just in case you missed that, you are three hundred times more likely to get struck by lightning than win the lottery.) I'm sure most of us don't analyze every decision we make in life to this extent. If we did, we just might decide to lock ourselves in our home. But, then again, the odds of drowning in our own bathtub are 685,000 to 1.

The truth is avoiding every risk in life is practically impossible. Minimizing or lessening your chance of loss seems to be a more reasonable solution. For example, just wearing a seatbelt significantly lowers your risk of dying in a car accident. Seeking shelter before a storm should lesson the chances of getting struck by lightning. And not buying that lottery ticket will guarantee that you don't lose any money gambling.

Gambling is a word I often hear people associate with the stock market. I can understand how some people may feel this way. But, in reading a book by John Bogle, the 81 year old founder of the Vanguard Group, he stated that "if you remained invested in the stock market for fifteen consecutive years, there has never been a period where you didn't make money".* Simply put, according to John Bogle, the odds of

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* Taylor Larimore, Mel Lindauer, Michael LeBoeuf, John C. (FRW) Bogle, "The Boglehead Guide to Investing", page 215

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making money if you remain invested for fifteen consecutive years is 1 to 1. Please keep in mind that past performance does not guarantee future results. But, don't those odds seem a lot better than playing the lottery?

With such a high probability of success one might assume there is absolutely no risk to invest in the stock market. But that is unequivocally not true. There are many risks to consider and I would like to discuss a few of them here today. It is my hope that afterwards you will have a better understanding of these risks and will feel more comfortable knowing that Chris and I try to minimize or eliminate as many of these risks as possible.

One way to protect yourself from rising inflation is to invest in bonds.

To begin with, most people hate to lose money. This is probably due to the fact that it takes most of us such a long time to earn it. One way to prevent a loss from happening is to save in guaranteed accounts such as U.S. savings bonds, certificates of deposit, or money market accounts. Anyone who has had a C.D. mature or visited a bank recently has seen the low interest rates being offered on these types of investments right now. And that brings us to our first risk; inflation. If inflation rises faster than the rate of return on your savings bond or C.D., you run the risk of running out of money early. This is also referred to as purchasing power risk because we all know that the cost of a loaf of bread today is a lot more than it was twenty years ago. Having your money keep pace with inflation is a very important risk to manage. I honestly don't know of anyone who wants to go back to work when they are old because they depleted their savings and can't survive on social security only. As such, we should all focus on investing our money in assets that protect us from rising inflation.

One way to protect oneself from rising inflation is to invest in bonds. A bond is basically an I.O.U. In return for your investment, the issuer of the bond will provide you with regular interest payments. At the end of the term you will receive your original investment back. Bonds are issued by many different organizations such as the U.S. government, government agencies, corporations, municipalities, and foreign governments. Considering that an investor may not be repaid their full principal or interest by the entity issuing the bond, this has a bearing on the bond's interest rate. For example, the current yield on a 10 year U.S. Government T-Bond is 2.72% whereas a 10 year Ford Motor Bond is yielding 6.25%. The reason for this large discrepancy is there is the possibility that Ford will not have enough cash to make the interest or principal payment obligations. The U.S Government on the other hand prints our nation's currency so there is never any risk that holders of government debt won't get repaid. This notion of not being able to repay bond buyers is known as default risk. Bonds also have several more risks. One of the more important ones to manage is called interest rate risk. To explain this concept in more detail I would like to use the following example.

Imagine that five years ago you purchased a bond yielding 5%. Today, the economy is doing much better. As such, the Federal Reserve has increased interest rates to 6%. At this time you need some money for an upcoming trip, so you decide to sell your 5% bond. I, on the other hand, am looking to purchase bonds. Am I going to want to buy your bond yielding 5% or a new bond being issued at 6%? Most likely I am going to want to buy a new one yielding 6%. As such the demand for your bond is less, which makes the value less. Vice versa, if interest rates go down, your bond would be worth more because new bonds are being issued at lower rates. As you can see there is an inverse relationship between the price of a bond and the interest rate. Depending on which direction interest rates go will determine the value of the bonds in your portfolio.

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A third factor that needs to be considered when investing in bonds is a bond's maturity date. Bonds are issued with many different maturity dates such as one year, ten years, and thirty years. Since we know that interest rates are going to rise and fall thereby affecting the price of bonds, the length of the bond maturity plays an important role as well. In fact, bonds that mature in one year or less are not as risky as longer-term maturity bonds. The reason for that is because (1) you stand to get your principal back sooner in a shorter term bond and (2) you aren't locked into a low yielding bond if interest rates go up. This is otherwise known as reinvestment rate risk.

Finally, some bond issuers include a call feature so that if interest rates go down, they can retire the existing bonds and issue new ones at lower rates. If that happens, the purchaser of the original bond runs the risk of not receiving as much in income as they had originally anticipated. This type of risk is referred to as call risk.

One way to avoid the risks associated with bonds is to purchase stocks instead. Although stocks have historically returned more than bonds, that is only because they involve even more risk. Some of those risks include political, exchange rate, business, financial, marketability, and liquidity risk. Let me take a brief moment to explain these risks in a little more detail.

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- ***Political Risk***

Political risk can occur when you buy an investment from an overseas country like Nigeria. While Nigeria is very rich in oil and gas reserves, its energy infrastructure regularly comes under attack by anti-government rebels. Sometimes, these rebels cause significant damage thereby lessoning oil company's profits. As such, political factors need to be thought about before deciding to invest in certain unstable countries.

- ***Exchange Rate Risk***

Like political risk, exchange rate risk also occurs when you purchase foreign companies. For example, if I buy 100 shares of Toyota stock in Japanese Yen, my investment will fluctuate based upon the currency exchange rate between Yen and U.S. dollars. For those who have ever visited Canada and had to exchange their dollars for Canadian dollars you understand a little of what I am talking about.

- ***Business Risk***

Business risk can happen if you own both J.C. Penney's and Macy's stock. If J.C Penney's reports bad earnings, Macy's stock price may fall in tandem since they are both in the department store business.

- ***Financial Risk***

Financial risk refers to the amount of debt that a company has on their balance sheet. In the fall of 2008, Bear Sterns and Lehman Brothers, two longstanding Wall Street investment banks, failed because they had significantly more debt on their balance sheet than assets. When this occurred, remaining financial institutions ceased lending capital, even if they could afford to, out of fear that they would be next. As the banking system started to freeze up, the U.S Treasury had little choice but to intervene to keep credit flowing. If the government did not get involved, many companies may have had to declare bankruptcy thus causing the stock to become worthless.

- ***Marketability Risk***

Marketability risk is seen with smaller companies whose stock doesn't trade as much as larger companies. For those looking to sell their small company shares at a certain price, there may not be any buyers at that price, thus decreasing

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the value.

- ***Liquidity Risk***

And, finally, liquidity risk is how quickly one can turn an investment into cash. A stock or bond is an example of a very liquid investment, whereas a business or home may take months to sell.

As you can see there are a lot of risks to consider before making any investment. Now that we are aware of some of them, what are some ways to manage those risks? In particular, there are four, namely avoidance, retention, transfer, or reduction. Let's take a look at these.

1. Risk Avoidance

Risk avoidance simply means not investing in any risky assets like stocks or bonds. Instead one should invest in only guaranteed return investments like U.S. Savings bonds, certificates of deposit, and money market accounts. However, as mentioned previously, inflation risk is still present and will need to be carefully managed. As such, just as one can lock themselves in their house to avoid certain external risks, avoiding all risks when investing is practically impossible as there is no riskless investment.

2. Risk Retention

The second option would be risk retention. Risk retention basically means that whatever consequences occur, I will accept them. An example of this would be deciding not to save or plan for retirement. If that choice is made, that person is choosing to live on social security only. If you are currently living on social security or have seen your social security estimate that the government mails you, you are painfully aware of what you will be receiving from the government for all those years of paying into the system. In fact, assuming that you earned $106,800 or more per year during your working lifetime, the maximum that you can expect to receive from social security in 2010 is $2,346 a month. For those who made less than $106,800 per year, your social security benefit will be even less than that.

3. Risk Transfer

The third risk management technique is risk transfer. An example of risk transfer is purchasing a life insurance policy or annuity. A life insurance policy pays out a benefit when someone dies whereas an annuity pays a benefit when someone lives. In either case, you are effectively giving your money to an insurance company and having them manage the risks in return for a certain payout.

4. Risk Reduction

Lastly, risk reduction is taking calculated risks or diversifying. Diversifying is also known as "not putting all your eggs in one basket." For example, to mitigate inflation risk we can invest some of our savings in stocks which have historically beaten inflation. To mitigate the many risks of investing in stocks, we can invest some of our savings in bonds. Although bonds have historically returned less than stocks, they do so with less volatility and risk. By diversifying your investments and spreading your money around, you can effectively reduce your total risk and hopefully minimize losses too. Please keep in mind that when you allocate some of your assets to these markets, you assume market risk which cannot be diversified away. With market risk there is always the possibility that at some point in time you will experience a loss.

In summary, in this quarter's newsletter we reviewed many of the various types of risks. The one risk that probably

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poses the greatest threat to many Americans future is risk retention or doing absolutely no planning at all. Sure, some people may be lucky enough to go their whole life without doing any financial planning. But, why take the risk? One of the advantages to working with a financial advisor is we take the time to educate ourselves on current laws, listen to your concerns, analyze the risks you may be susceptible to, and then work together to come up with a plan to manage them. Sure we may not be able to prevent you from every risk there is in life, but our advice will always be based upon what is best for you and to reduce or eliminate as many risks as possible in your life.

Product Update

I know it's only October 1st, but pretty soon stores will be gearing up for the Christmas shopping season. If you find yourself having a hard time coming up with a gift idea for that child that seemingly has enough clothes and every toy, may we suggest the wonderful gift of an education this year? Studies have shown that the more education you have, the greater your potential income. But the cost of post secondary school does not come cheaply. If this type of gift may be of interest to you, please check with the child's parents to see if they have already established a 529 College Savings Plan or Education Savings Account. You may be able to contribute directly to it. If not, then please give Chris or myself a call and we would be more than happy to set up an account for you. Likewise, if you live in the state of Pennsylvania, your contribution may qualify for a state tax deduction as well. I understand how much fun it is to watch a child unwrap their gifts on Christmas day. But that child's joy typically only lasts for a short while before they become bored and move on to the next toy. On the other hand, the gift of an education is one that you can look back upon fervently and say that you played a small role in that person's life.

Heathcare Reform Update

The Patient Protection and Affordable Care Act of 2010 was signed into law earlier this year and is making important changes to the administration of medical benefit plans. Some of those changes take place immediately whereas others will be phased in over the next few years.

One of the changes taking place immediately is the treatment of dependents. Previously the law was written where a dependent child would be removed from their parent's coverage at age 19, unless they provided documentation that they were a full-time student at which point they would be covered to age 25.

Under the new law, dependents will now be allowed to be covered under their parent's coverage up to age 26, no matter whether they are a full-time student or not and as long as the plan covered dependents. For those of who may be affected by this new law, please contact your insurance carrier or Human Resources Department at your work to see what needs to be done to get your dependent covered. In the meantime, Chris and I will do our best to inform you of additional changes in health care reform as they become effective.

Important Dates

Tuesday, November 2, 2010 - Election Day

Sunday, November 7, 2010 - Daylight Savings Time Ends - Remember to turn your clocks back one hour

Thursday, November 11, 2010 - Veteran's Day - Please remember all who served.

Thursday & Friday, November 25-26, 2010 - Thanksgiving - Office Closed

Friday, December 24, 2010 - Christmas Eve - Office Closed

Friday, December 31, 2010 - New Year's Eve - Office Closed

Website of the Quarter

Want to learn more about inflation risk? Have you forgotten what the cost of goods and services were in the past? Then please visit www.thepeoplehistory.com.This fun website gives you news, events, prices, and pop culture facts from 1920 to modern day!

** A Final Word From Dave **

Two and a half years ago I began the long and arduous process of studying for the CERTIFIED FINANCIAL PLANNER™ exam. Well, I am proud to announce that this past July I took the exam and passed it. It is my hope that what I have learned from this experience, along with my 11 years in the business, will allow me to better serve all of you going forward.

In next quarter's issue I'm going to look at some issues that have been in the news recently like health care reform and the possible reinstatement of the estate tax in 2011. Stay tuned….

David J. Lutz Jr.
The Advisors Group of Pittsburgh
790 Holiday Drive, Foster Plaza 11
Pittsburgh, PA 15220
412-539-0055 x235
fax 412-539-0056
lutz@advisorsgroup-pgh.com

Chris G. Volk
The Advisors Group of Pittsburgh
790 Holiday Drive, Foster Plaza 11
Pittsburgh, PA 15220
412-539-0055 x230
Fax 412-539-0056
volk@advisorsgroup-pgh.com