financial focus

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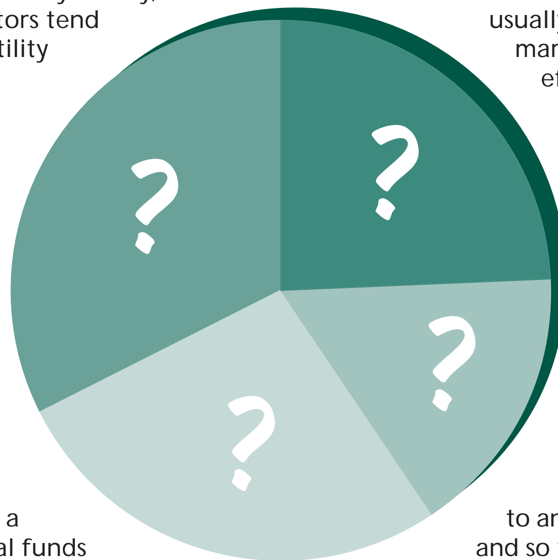
FUNCTIONAL ASSET ALLOCATION: EQUITY ASSETS

by Robert Reed, PhD, CFP®

Owning a share of a company – being an equity holder – allows you to participate in the U.S. and world economy. While bondholders are loaners, shareholders are owners. The equity portion of your portfolio is important because that is where your money grows . . . eventually. But this long-term advantage is easily obscured by equities' short-term volatility.

Watching fund prices bounce around day-to-day, week-to-week is scary. Average investors tend to buy high and sell low because volatility makes them anxious. The popular financial press abets this dysfunction by encouraging people to "play the market." And, of course, there are always hucksters around who have figured it out and will tell you how to beat the market – for the price of their book, newsletter, or seminar. (If they know where the gold is buried, why are they selling maps?)



In order to invest in equities (as opposed to speculate in stocks) you must think in the long-term. And what will keep you on an even keel over this extended time period is a basic knowledge of how equity mutual funds divide stocks into classes and how these classes interact. From the perspective of Functional Asset Allocation equities have four classes: U.S. Large Cap, U.S. Small Cap, International, and Employer stock.

U.S. Large Cap includes the largest 1000-1500 US companies. Owning this class allows you to diversify among companies that comprise 80 percent of the economic activity in our country and over 50 percent worldwide. The market is unrelentingly efficient for these large well-researched firms, so we recommend index funds (funds that track the class average) to achieve broad diversification at low cost. While finer divisions of U.S. large caps are popular (e.g., growth, value), these make little difference for people with modest portfolios.

U.S. Small Cap includes all the other U.S. companies traded on the stock exchange (including those usually referred to as "mid cap"). The market for small caps is much less efficient than that for large caps and this gives professional money managers a reasonable chance to add value by stock analysis. Market inefficiencies also create higher volatility and thus small caps are given a smaller allocation in our portfolios (10 percent - 30 percent).

International are foreign companies bought on foreign markets. Since these companies tend to rise as the dollar falls, this class functions to hedge the dollar. It is impractical for everyday people to analyze and invest in foreign companies , and so these assets are usually represented in mutual funds. Due to relatively inefficient foreign markets, an astute money manager can add value through stock selection. Mutual funds in this class outperform international indices over 60 percent of the time.

Employer Stock is treated as a distinct asset class in Functional Asset Allocation because such stock functions as extended compensation. This is a complex asset class and demands special attention. Diversification is critical when your employment, pension, and a substantial portion of your portfolio are dependent on a single company. If the value of employer stock exceeds 20 percent of your portfolio, you need to diversify out of this asset class. Until that threshold, Functional Asset Allocation calls for a more conservative allocation in other asset classes.

This simple division of mutual funds captures equities' growth potential while limiting the temptation to speculate on particular market segments. Since you fully invest in all equity classes, you are prepared to grow with the market regardless of which particular segment is "hot."

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GETTING YOUR KIDS OFF ON THE RIGHT FINANCIAL FOOT

by Maura Murphy, CFP®

Many of us did not have the opportunity to learn about appropriate financial behavior while growing up. As a result, we have had to learn financial lessons the hard way. Make this the year that you make sure your children are learning some of these key lessons and developing basic healthy financial habits.

- Give them the opportunity to manage money.
- Teach them to be savers
- Teach them to be givers.
- Teach them to set achievable financial goals.

Manage Money

All kids need to have access to money to begin learning how to manage money. You can either give allowances or encourage children to work for money. This allows them to learn how to make financial decisions, make mistakes and enjoy success on a small scale.

Create Savers

Encourage your kids to save money and to learn first hand how accumulated savings can generate its own income. Getting the kids to open savings accounts and make monthly deposits is a nice way to start them out, but I found an even better motivator. Be your own bank, paying a very high rate of interest. A few years ago, I read about a father who opened "The Bank of Mom & Dad." This bank existed only on his computer. There were only two account holders – his two elementary school-age children. This bank had an interesting feature: it paid 5 percent interest PER MONTH. That comes to a whopping 60 percent annual interest. Talk about getting your kids excited about saving! I followed his example, and my kids were hooked. I kept track of the balances on Quicken, paid interest monthly and printed monthly statements. Once their balances exceeded $125, we transferred their balances to accounts at the local credit union where they can now deposit and withdraw money as they wish.

Teach them to be givers

We encourage our kids to donate 10 percent of their annual savings to charity. In December, we sit down with them and talk about what issues the kids really care about or who the kids really want to help. Give your children the opportunity to give locally as often as possible, where they can get lots of great feedback face-to-face from the recipient organization. My kids have given money to the local animal shelter, an international organization that fights child slavery, our local Habitat for Humanity chapter, and a local organization that offers immediate shelter and assistance to individuals and families. The feedback they get is tremendous and these kids feel terrific about their ability to make a difference.

Establish the "Jar System" for small goals

Elementary school kids often ask for things that can be saved for in a short period of time. When your child asks for a reasonably priced item in a store, tell them they can get it and you will help them get started in saving for it. As soon as possible, get a jar and attach a label that tells what they are saving for and how much they are trying to save. When my kids were younger, I would draw a little picture of the item. Start with goals that require saving $15 or less, and give them opportunities to earn some money so that they can achieve their goal in a reasonable amount of time . . . say four to six weeks for early elementary school. As soon as they have enough money, make the time to take them to make the purchase to reward meeting their goal. By the time the kids are in third grade you can increase the goal amounts to $30 to $50. My fifth grader just succeeded in saving enough money to purchase a large aquarium, all equipment, and stocked it with fish and plants – a goal that cost significantly more than $50.

Another great use of the jar system is to establish family goals to which all members of the family contribute. We used this system to make our first family visit to Disneyland (not a large financial outlay, as we had free airfare and stayed with friends). We saved $600. It took a year, and the kids stayed very motivated. They returned cans, did small jobs for neighbors and even contributed part of their birthday & Christmas money. Set your first family goal low enough and make it exciting enough that everyone stays motivated until it's achieved.

Make the parent contribution high enough that you make progress, but low enough so that the kids are really contributing in a meaningful way. Announce progress regularly. Bring home brochures, books or visit web sites to keep interest in the goal as high as possible. Once you've reached one goal like this, your kids will be motivated to meet higher goals.

You can also eventually open an auxiliary savings account when the goals get large enough. We are currently saving for a trip to the Yucatan Peninsula. When our jar accumulates $100, we deposit it in our Yucatan account. We currently have $900 saved of the $4,000 or so needed. We have guide books, a map of Mexico on the hallway wall, and we are learning Spanish from a set of language CDs.

If you consistently reinforce earning and savings habits, allow your kids the opportunity to manage their money, make mistakes and have success, the rewards reaped when they are adults will be tremendous, and they *will* thank you for it.

HOW THE FALLING DOLLAR MAY FALL ON YOUR FINANCES

by Karen Folk, Urbana, IL, adapted from an April 2004 Financial Planning Association Article

You may have recently read or heard numerous references about the "falling dollar," but not paid them much attention. Perhaps you should. If you travel overseas, invest, or buy any imported products, the falling U.S. dollar will have an impact on your personal and family finances.

The falling dollar refers to the exchange value of the American dollar. It has declined sharply against several major world currencies. The American dollar, for example, lost 20 percent in buying power in 2003 against the euro,10 percent against the yen and 34 percent against the Australian dollar, according to numbers from the *Wall Street Journal*, and it hit an 11-year low against the British pound and a 6-year low against the Canadian dollar. In short, the buck buys less abroad than it once did. This decline is both good and bad for American consumers. Here are the major impacts, and what changes you might make in your finances to minimize or take advantage of the falling dollar.

More expensive consumer goods. Many consumer goods Americans buy, from cars to electronics to apparel, are imported. The prices of those products inevitably rise as the value of the U.S. dollar declines. However, some "foreign" products, such as many Asian cars, are actually manufactured in the United States. Still, numerous imported products have risen in price. The obvious counter strategy, of course, is to buy American, or carefully comparison shop, especially for big ticket items such as autos and major appliances.

Travel costs more. With a falling dollar, it's a cold fact that hotels, meals and tourist sights are going to cost more for American travelers to Europe, Japan, Canada, Australia and other nations. Your hard-earned vacation savings in U.S. dollars won't buy as much of the local currency as they did before. You can either delay travel until the dollar strengthens, or "buy American" by traveling within the United States. U.S. historical sites and/or national parks can provide a less expensive family vacation option. Or, travel abroad where the exchange rate is more favorable. The dollar, for example, has risen against the currencies of Mexico and several Latin American nations, making them cheaper travel destinations.

Investing. While you may not want to travel overseas soon because of the cost, you may want to send your money there. U.S. based mutual funds that invest internationally have benefited from the drop in the dollar. This also holds true for foreign stocks and bonds. On the domestic investment side, a weak American dollar is good for those American companies – small as well as the huge multinational corporations – that sell a lot of their product abroad. Exported American products are cheaper, and thus more competitive, and those increased international sales revenues are converted to U.S. dollars.

Ultimately, most investors should look long term. For one thing, currency fluctuations generally even out over time. Second, the primary benefits of devoting a portion of your portfolio to overseas investments (perhaps 10 to 20 percent) is not to ride the winds of currency fluctuations but to diversify and actually reduce overall investment risk, and to buy into good companies abroad.

*(**Rising Rates**, continued from page 4)*

Q. What happens to my bond mutual fund if interest rates rise?

A. Since a bond fund doesn't have a specific maturity date, the chances are the fund's total return will go down. Total return encompasses both change in prices and interest rate payments. If interest rates rise, the values of bonds held by the fund would fall, negatively affecting total return. However, the fund will continue to receive interest payments from the bonds it holds and will pass them along to investors regularly, maintaining current yield. Bond fund investors also enjoy professional management and asset diversification.

Q. Besides rising interest rates, are there any other risks I should consider?

A. Yes, virtually all investments carry some degree of risk that you might lose some or all of your investment. When investing in bonds other than government-guaranteed securities, it's important to remember that an investment's return is linked to its credit as well as market changes. The higher the return, the higher the risk. Conversely, relatively safe investments offer relatively lower returns. Bond choices range from U.S. Treasury securities, which are backed by the full faith and credit of the U.S. government and are free from credit risk, to bonds that are below investment grade and considered speculative.

From a Functional Asset Allocation™ standpoint, bonds and interest earning investments serve to preserve capital and protect against deflation and provide liquidity. Regardless of what happens in the financial markets, we want to make sure that our clients have adequate cash flow and are able to maintain their standard of living. Interest earning investments protect you during deflation while keeping this portion of your investment portfolio stable.

We work with clients to help assess their tolerance for risk and determine how much and what type of bonds and interest earning investments are appropriate based on their overall investment plan.

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? ? ASK an Advisor ? ?

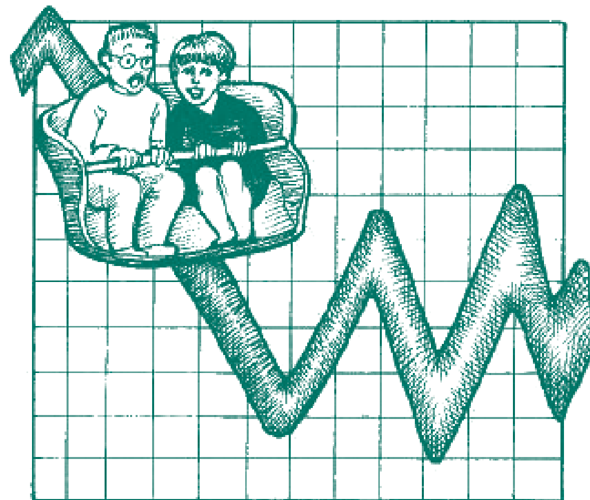
HOW WILL RISING INTEREST RATES AFFECT MY INVESTMENTS?

by Barry J. Swaim, CFP®

With the U.S. economic recovery gaining steam, everyone should be aware that interest rates won't stay at their current low levels much longer. Several Federal Reserve Bank officials, including Chairman Alan Greenspan, have noted in recent speeches that they do not plan to leave their target for a key overnight interest rate, the Federal funds rate, at a 46-year low of 1 percent forever.

Q. What causes interest rates to change?

A. Interest rates change on a regular basis. The rates that you pay on a mortgage or other type of loan will vary from day-to-day and week-to-week based on many variables, including inflation, unemployment rates, growth rates, tax laws, and the Fed's policies and outlook. The Fed affects interest rates by setting two key rates, the discount rate and the federal funds rate. The discount rate is the rate which the Federal Reserve Bank charges its member banks for overnight loans. The Fed actually controls this rate directly, but it tends to have little impact on the activities of banks because these funds are also available elsewhere. The federal funds rate is the interest rate at which banks loan excess reserves to each other. While the Fed can't directly affect this rate, it effectively controls it in the way it buys and sells Treasuries to banks. This is the rate that reaches individual investors, though the changes usually aren't felt for a period of time.



Q. So, why should the average investor care about interest rates?

A. Of course, interest rates affect things such as loans and mortgages, but they also have an effect on the markets as well. As rates change, the demand for different types of investments will change as well.
Currently, rising interest rates and expectations for economic recovery are impacting bond prices. As interest rates change, so do the values of all bonds in the marketplace. If you are thinking about buying bonds, or have recently bought some, you need to be aware of the effect of rising rates on your holdings. Here are some questions you should consider.

Q. Now that interest rates have started to rise, how will that affect bonds?

A. Just as bond prices go up when yields go down, the prices of bonds you own now will generally drop as yields – interest rates – go up.

Q. When rates go up, do all bonds lose the same value?

A. No, changes in interest rates don't affect all bonds equally. Generally, the longer the bond's maturity, for example a bond that matures in ten years versus another that matures in two years, the more it's affected by changing interest rates. A ten year bond will usually lose more of its value if rates go up than the two year note. Also, the lower a bond's "coupon" rate, the more sensitive the bond's price is to changes in interest rates. Other features can have an effect as well. For example, a variable rate bond probably won't lose as much value as a fixed rate security.

Q. What should I do as interest rates rise? Should I hold onto my bonds or sell them?

A. If you buy a bond and hold onto it until it matures, which many investors do, rising rates won't have any effect on the income you receive. You simply redeem your maturing bond andget back the face value of the bond. In the meantime, you will continue to earn or accrue interest at the rate you expected when you bought the bond.

Q. What happens if rates go up and I need to sell my bonds?

A. If interest rates go up and you need to sell your bonds before they mature, you need to be aware their value may have gone down and you may have to sell at a loss. Remember bond prices move in the opposition direction as yield. At some point, though, rates will go down.

Q. What will happen if I sell then?

A. If interest rates have gone down since you bought your bonds, the value of your bonds will have actually gone up, giving you what's known as a "capital gain." That's because your bond is worth more.

*(continued on page 3, **Rising Rates**)*