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Balancing Your Investment Choices with Asset Allocation

A chocolate cake. Pasta. A pancake. They're all very different, but they generally involve flour, eggs, and perhaps a liquid. Depending on how much of each ingredient you use, you can get very different outcomes. The same is true of your investments. Balancing a portfolio means combining various types of investments using a recipe that's right for you.

Getting the right mix

The combination of investments you choose can be as important as your specific investments. The mix of various asset classes, such as stocks, bonds, and cash equivalents, accounts for most of the ups and downs of a portfolio's returns.

There's another reason to think about the mix of investments in your portfolio. Each type of investment has specific strengths and weaknesses that enable it to play a specific role in your overall investing strategy. Some investments may be chosen for their growth potential. Others may provide regular income. Still others may offer safety or simply serve as a temporary place to park your money. And some investments even try to fill more than one role. Because you probably have multiple needs and desires, you need some combination of investment types.

Balancing how much of each you should include is one of your most important tasks as an investor. That balance between growth, income, and safety is called your asset allocation. It doesn't guarantee a profit or insure against a loss, but it does help you manage the level and type of risks you face.

Balancing risk and return

Ideally, you should strive for an overall combination of investments that minimizes the risk you take in trying to achieve a targeted rate of return. This often means balancing more conservative investments against others that are designed to provide a higher return but that also involve more risk. For example, let's say you want to get a 7.5% return on your money. Your financial professional tells you that in in the past, stock market returns have averaged about 10% annually, and bonds roughly 5%. One way to try to achieve your 7.5% return would be by choosing a 50-50 mix of stocks and bonds. It might not work out that way, of course.

Even if your asset allocation was right for you when you chose it, it may not be right for you now. It needs to change as your circumstances and priorities change.

This is only a hypothetical illustration, not a real portfolio, and there's no guarantee that either stocks or bonds will perform as they have in the past. But asset allocation gives you a place to start.

Someone living on a fixed income, whose priority is having a regular stream of money coming in, will probably need a very different asset allocation than a young, well-to-do working professional whose priority is saving for a retirement that's 30 years away. Many publications feature model investment portfolios that recommend generic asset allocations based on an investor's age. These can help jump-start your thinking about how to divide up your investments. However, because they're based on averages and hypothetical situations, they shouldn't be seen as definitive. Your asset allocation is—or should be—as unique as you are. Even if two people are the same age and have similar

About New Wealth Advisors.

New Wealth Advisors is an independent, fee-only, SEC-registered investment advisor, operating as a multi-family investment office. We work with newly wealthy individuals and families to protect, grow and manage assets.

incomes, they may have very different needs and goals. At New Wealth Advisors your asset allocation is highly tailored to your individual circumstances.

Many ways to diversify

When financial professionals refer to asset allocation, they're usually talking about overall classes: stocks, bonds, and cash or cash equivalents. However, there are others that also can be used to complement the major asset classes once you've got those basics covered. They include real estate and alternative investments such as hedge funds, private equity, metals, or collectibles. Because their returns don't necessarily correlate closely with returns from major asset classes, they can provide additional diversification and balance in a portfolio.

Even within an asset class, consider how your assets are allocated. For example, if you're investing in stocks, you could allocate a certain amount to large-cap stocks and a different percentage to stocks of smaller companies. Or you might allocate based on geography, putting some money in U.S. stocks and some in foreign companies. Bond investments might be allocated by various maturities, with some money in bonds that mature quickly and some in longer-term bonds. Or you might favor tax-free bonds over taxable ones, depending on your tax status and the type of account in which the bonds are held.

Asset allocation strategies

There are various approaches to calculating an asset allocation that makes the most sense for you.

The most popular approach is to look at what you're investing for and how long you have to reach each goal. Those goals get balanced against your need for money to live on. The more secure your immediate income and the longer you have to achieve your investing goals, the more aggressively you might be able to invest for them. Your asset allocation might have a greater percentage of stocks than either bonds or cash, for example. Or you might be in the opposite situation. If you're stretched financially and would have to tap your investments in an emergency, you'll need to balance that fact against your longer-term goals. In addition to establishing an emergency fund, you may need to invest more conservatively than you might otherwise want to.

Some investors believe in shifting their assets among asset classes based on which types of investments they expect will do well or poorly in the near term. However, this approach, called "market timing," is extremely difficult even for experienced investors. If you're determined to try this, you should probably get some expert advice—and recognize that no one really knows where markets are headed.

Some people try to match market returns with an overall "core" strategy for most of their portfolio. They then put a smaller portion in very targeted investments that may behave very differently from those in the core and provide greater overall diversification. These often are asset classes that an investor thinks could benefit from more active management.

Just as you allocate your assets in an overall portfolio, you can also allocate assets for a specific goal. For example, you might have one asset allocation for retirement savings and another for college tuition bills. A retired professional with a conservative overall portfolio might still be comfortable investing more aggressively with money intended to be a grandchild's inheritance. Someone who has taken the risk of starting a business might decide to be more conservative with his or her personal portfolio.

Things to think about with your planner

- Don't forget about the impact of inflation on your savings. As time goes by, your money will probably buy less and less unless your portfolio at least keeps pace with the inflation rate. Even if you think of yourself as a conservative investor, your asset allocation should take long-term inflation into account.

- Your asset allocation should balance your financial goals with your emotional needs. If the way your money is invested keeps you awake worrying at night, you may need to rethink your investing goals and whether the strategy you're pursuing is worth the lost sleep.

- Your tax status might affect your asset allocation, though your decisions shouldn't be based solely on tax concerns.

Even if your asset allocation was right for you when you chose it, it may not be right for you now. It should change as your circumstances do and as new ways to invest are introduced. A piece of clothing you wore 10 years ago may not fit now; you just might need to update your asset allocation, too.

Will the Estate Tax Stay Repealed for 2010?

In 2001, a law was passed that gradually phased out the federal estate tax through 2009, and repealed it altogether in 2010. That law, however, "sunsets" or expires in 2011 and reinstates pre-2001 tax law levels (with an exemption of $1 million and a top tax rate of 55%). Since 2001, the economic and political climate in the United States has changed significantly. The federal budget deficit has ballooned, the financial markets have been in turmoil, and most importantly, power has shifted to the Democrats. So, the question is: just how likely is it that 2010 will be an estate tax-free year?

Chance of repeal?...virtually zero

Of course, anything can happen, but President Obama has made it clear that he believes the estate tax should continue in some form or other. And in the Senate, Finance Committee Chairman Max Baucus has firmly stated "...repeal isn't going to happen." With increased Democratic majorities in both chambers of Congress, it seems highly likely that some action will be taken soon to head off the one-year sabbatical scheduled for 2010.

Future of the estate tax

Several bills have been introduced in Congress in the intervening years since 2001, some calling for full repeal, others for reform. Reforms that have been proposed include:

- Raising the exemption and/or lowering the tax rates
- Making the exemption "portable" between spouses (allowing surviving spouses to use any unused portion of the deceased spouse's exemption)
- Replacing the estate tax with an inheritance tax (transferring the transfer tax burden to heirs)
- Replacing the step-up in basis rule with a carryover basis rule (also transferring the tax burden to heirs in the form of capital gains tax)

President Obama has endorsed the following reforms:

- Freezing the estate tax at 2009 levels ($3.5 million exemption and 45% top rate)
- Indexing the exemption for inflation
- Disallowing or limiting valuation discounts

Planning for continued uncertainty

All indications point to the estate tax remaining for the foreseeable future. While the uncertainty that continues to surround the exact components of the estate tax may tempt some individuals to do nothing or wait and see, it may be wiser to review your plans now to ensure that they can withstand the winds of change.

Creating a flexible estate plan is the key to avoiding the pitfalls of future tax law changes, as well as changes that may occur in your personal life. A flexible estate plan uses language and provisions in wills and trusts that maximize the ability to pass estate assets free of estate taxes. And other tools, such as disclaimers and powers of appointment, can allow heirs or trustees to respond to circumstances existing at the time of your death.

Beyond tax

Remember that dealing with estate taxes, no matter what the future may hold, is just a piece of your estate plan. The experienced financial professionals at New Wealth Advisors can help you identify strategies that may help you achieve your overall estate planning goals.

The standards used by each ratings service differ, and the ratings ultimately reflect the service's opinion of the financial strength and claims-paying ability of the insurer—it is not a guarantee of future performance.

Is Your Insurance Company Safe?

The recent financial difficulties of some of the largest and oldest insurance companies may have you wondering about the financial strength of your insurer. Here are some sources of information that you can use to help you determine whether your insurance policy is safe.

It's in the ratings

There are several rating services that review, evaluate, and rank insurance companies based on their financial strength and claims-paying ability. The primary players in the ratings game are A.M. Best (www.ambest.com),Standard & Poor's (www.standardandpoors.com), Fitch (www.fitchratings.com), Moody's (www.moodys.com), and The Street.Com (formerly Weiss, www.thestreet.com).

The standards used by each ratings service differ, and the ratings ultimately reflect the service's opinion of the financial strength and claims-paying ability of the insurer—it is not a guarantee of future performance. So you should consider your insurer's ratings from at least two or more services to determine its financial strength.

State regulation

Insurance companies are heavily regulated by the states in which they are headquartered. Generally, each state requires that an insurer has sufficient reserves to pay all of its claims. In addition, states require that companies file updated financial reports that often are available to the public through the state's insurance department. Check with your state's department of insurance for information about the company maintaining your policy.

Important financial information

While financial ratings are important, there are other sources that provide financial information about your insurer. For instance, the National Association of Insurance Commissioners (NAIC) is an organization representing the insurance departments of all 50 states. You can access their information by going to www.naic.org. An important statistic contained in the NAIC's financial report of each company is the assets to liabilities ratio. This statistic compares the insurer's total assets to its total liabilities. For example, a favorable assets to liabilities ratio may be $108 of assets for each $100 of liabilities.

Comparing companies

Many insurers subscribe to the Standard Analytical Service, Inc., an independent organization that compares insurance companies based on financial statements filed with state departments of insurance. Many insurers publish the Standard's reports on their websites.

The reports compare insurers based on a few important statistics. One such statistic compares the ratio of an insurer's bonds, stocks, cash, and short-term investments to liabilities. A higher ratio of liquid assets to liabilities may indicate the company's ability to cover unforeseen emergency cash requirements if they arise.

Another statistic compares an insurer's surplus assets to life insurance in force. A high ratio of surplus to life insurance in force provides evidence of a company's ability to meet its claims obligations.

If you claim benefits from your policy during a period of extraordinary claims activity, will your insurer be able to satisfy your claim? The chances are better if the insurer has a high ratio of assets, including capital, to policy reserve liabilities. A high surplus ratio may indicate a company's ability to meet its claims obligations even during a period of high volume.

If the worst happens ...

If your company experiences severe financial difficulties, it might be taken over by the state's insurance department. Generally, claims continue to be honored as long as premiums are current. If the company lacks sufficient assets and reserves to pay all claims, the state's guaranty association will either pay claims directly or transfer the policies to a financially stable insurance company that will honor the claims. The National Organization of Life and Health Insurance Guaranty Association (NOLHGA) provides information on state guaranty associations and insurance companies that have failed or are in danger of failing (www.nolhga.com).

ASK THE EXPERTS

Can I convert my traditional IRA to a Roth in 2009?

With recent market declines, many investors are taking a new look at converting their traditional IRA to a Roth IRA. For many, the tax cost of converting has dropped significantly, making this a more attractive option.

You can convert your traditional IRA to a Roth IRA in 2009 if your modified adjusted gross income (MAGI) is $100,000 or less. If you file a joint federal tax return with your spouse, the $100,000 limit applies to your combined income. If you're married filing separately, you're not allowed to convert at all in 2009. You generally have to include the amount you convert in your gross income for the year of conversion, but any nondeductible contributions you've made to your traditional IRA won't be taxed.

If you're not eligible to convert in 2009, there's always next year—literally, in this case. Starting in 2010 anyone can convert, regardless of income level or marital status. Plus, if you convert in 2010, you're allowed to spread the income tax hit over two years: you report half the taxable income from the conversion in 2011, and half in 2012. So, even if you're eligible to convert in 2009, you should discuss with your financial professional whether it makes sense in your particular case to wait until 2010 to convert in order to take advantage of this special tax rule.

If you're eligible, converting is easy. Simply notify your IRA provider that you want to convert your existing IRA to a Roth IRA, and they'll provide you with the necessary paperwork to complete. You can also transfer or roll your assets over to a new IRA provider. The financial planners at New Wealth Advisors are happy to coordinate this process for you.

Remember that you can also convert SEP IRAs (and SIMPLE IRAs that are at least two years old) to Roth IRAs. And, if you're eligible for a distribution from your employer retirement plan (for example, a 401(k) or 403(b) plan), you may also be eligible to transfer or roll over those distributions to a Roth IRA, subject to these same conversion rules.

I converted my traditional IRA to a Roth in 2008—can I undo this?

In most cases, yes. If you converted your traditional IRA to a Roth IRA in 2008, before the recent market downturn, you may find that you now owe taxes on a conversion amount that's significantly higher than what your investments are now worth. If that's the case, you may find it advantageous to undo your conversion. The IRS refers to this process as a "recharacterization."

You may also want to recharacterize if you converted in 2008, and now find that you weren't eligible because your 2008 income is higher than you expected.

A recharacterization is essentially a do-over. You're treated as if you never converted your traditional IRA to the Roth IRA. You accomplish this by transferring the Roth IRA assets, and any earnings, back to a traditional IRA (in a trustee-to-trustee transfer if you're using a new traditional IRA provider).

To undo your 2008 conversion, you need to carefully follow these steps:

- Inform your IRA providers (the one holding the Roth IRA and the one providing the traditional IRA, if different) that you intend to recharacterize your Roth IRA to a traditional IRA. You must provide this notice on or before the date the assets are transferred back to the traditional IRA.
- Make sure the transfer is completed by the due date for filing your federal income tax return for 2008, including extensions. For most taxpayers, that can be as late as October 15, 2009. (If you've already filed a timely 2008 tax return, you can still recharacterize by making the transfer and filing an amended return by October 15, 2009. Be sure to write: "Filed pursuant to Section 301.9100-2" on your Form 1040-X.)
- Report the recharacterization to the IRS (see Form 8606 for more information).

If you undo your 2008 conversion in 2009, you generally won't be able to convert back to a Roth IRA until 31 days after the recharacterization. As always, our CFP's at New Wealth Advisors are happy to assist you with this if needed.

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