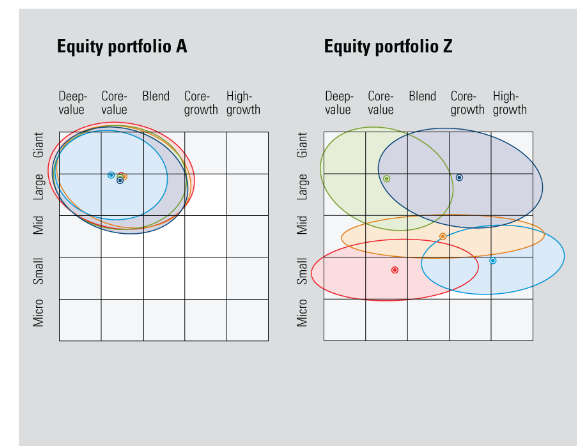
Investing With Integrity

August 2010 | Vol. No. 1 | Investment Updates

Exploration in Diversification

Investors seeking a well-rounded portfolio often wonder how many funds they need to reduce risk through diversification. The answer isn't a specific number of funds, but rather the holdings of each fund in the portfolio. If multiple funds in a portfolio have similar holdings, an investor can fail to achieve diversification benefits. Portfolio A and Portfolio Z in the image contain five mutual funds. Each oval represents the ownership zone, which accounts for 75% of the fund's holdings. The funds in Portfolio A overlap, indicating that each fund shares similar style characteristics. Too much overlap defeats the purpose of using multiple funds to create a diversified portfolio. Portfolio Z spans across many styles, so positive performance by some investments can neutralize the negative effect of others. As illustrated, it is important to be aware of the possibility of security overlap when constructing a diversified portfolio.

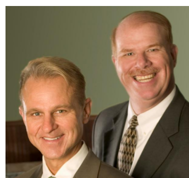
More Concentrated Portfolio Versus Diversified Portfolio



Diversification does not eliminate the risk of experiencing investment losses.

Source: Funds chosen from Morningstar's open-end database.

Advisor's Corner



Integrity Financial Planners
info@integrity-fp.com
541-469-4080

Charles Blozinski, CFP and Thomas Goodwin, CFP, EA offer their clients the advantage of over 35 years of combined experience in financial services. They work as an interactive team to provide independent, unbiased financial advice in a fee-only environment. Integrity Financial Planners is a registered investment advisor in the State of Oregon.

Achieving the Proper Balance of Risk and Return

Integrity:

- Understanding your risk tolerance is important when deciding on an appropriate asset allocation. It is the policy of Integrity Financial Planners to have our clients fill out a FinaMetrica risk profile before considering a moderate or aggressive asset allocation.

An important decision that every investor must make is determining the amount of investment risk to assume while maintaining a level of comfort. Risk is simply defined as the probability that the actual return for an investment will differ from that which was expected. It is possible that some or even all of an investor's original investment may be lost. In other words, there are no sure things in the investment world.

All investments contain some degree of risk; however, some investments are considered more volatile (riskier) than others. Low levels of uncertainty, or low risk, are usually linked to investments with low potential returns. On the other hand, investments with high levels of uncertainty, or high risk, are generally accompanied by high potential returns. The relationship between risk and return is such that one must be willing to accept greater risk if one wants to pursue greater returns.

A common misunderstanding among investors is that higher risk will lead to greater returns. According to the risk/return tradeoff, however, higher risk investments provide an investor with the possibility, not the certainty, of higher returns.

Consider the table below showing the periodic returns of three hypothetical investments. Investment A fluctuates very little from period to period. It has low volatility or a low amount of risk. However, this low risk is accompanied by low average returns. Conversely, Investment B has greater periodic fluctuations from one period to the other and has even lost money in one of the periods. On the flip side, Investment B's average return is higher than that of Investment A, corresponding to this higher level of risk. The riskiest investment of the three is Investment C, which has experienced a double-digit loss in one period. The returns for Investment C have also been periodically quite high, resulting in the highest average return of all three investments.

As the saying goes, "There is no free lunch"; in many cases, investments that generate high returns also come with high levels of volatility or risk. These high returns act as a compensation for investors, for assuming high risk. Further, it is very important to realize that taking on a high level of risk in hopes of attaining a high level of return is not for everyone.

An investor's risk tolerance varies according to age, income requirements, financial goals, and other considerations particular to each investor's unique situation. It is essential to determine your attitude toward—and your tolerance for—risk, while (all the time) keeping in mind that past performance is by no means a guarantee of future results.

Periodic Performance of Three Investments

	1	2	3	4	5	6	7	Average
Investment A	4%	7%	5%	7%	5%	2%	5%	5.0%
Investment B	2%	12%	–4%	21%	12%	1%	8%	7.4%
Investment C	5%	22%	–14%	32%	16%	–4%	13%	10.0%

The Future of Taxes

Integrity:

- Tax year 2010 is likely to have the lowest federal tax rates for the foreseeable future. This makes 2010 the best opportunity for Roth IRA conversions and many other tax strategies.

Now that our 2009 taxes have been filed and the lucky ones have received their refunds, nobody even wants to think about next year's returns. The Obama administration is pushing for major tax increases in 2011, which is causing many unhappy Americans to take to the streets in so-called tea-party rallies. It is important that you, as a taxpayer, be informed about these changes and consider which ones will affect you most.

Income Tax: The current tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are set to expire at the end of 2010. The proposed change for next year will eliminate the bottom bracket of 10% and change the remaining five to 15%, 28%, 31%, 36%, and 39.6%. The income thresholds that define these tax brackets will also change. It is highly likely that we will all pay more taxes next year.

Capital Gains Tax: Currently, long-term capital gains on investments are taxed at 0% for taxpayers in the two lowest brackets, and at 15% for everyone else. When these rates expire at the end of 2010, capital gains tax is projected to become 10% for taxpayers in the lowest tax bracket, and 20% for everyone else.

Dividend Tax: Whenever you receive dividends from your investments, you're supposed to pay tax on those dividends. In 2003, President George W. Bush signed a law under which qualified dividends were taxed at the same rate as long-term capital gains: 15%. This tax law is also set to expire in 2011; the current plan is to bring dividend taxes in line with ordinary income tax rates. So, if you're in the top tax bracket, you will pay 39.6% dividend tax, as opposed to only 15% last year.

Estate Tax: In 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001, a 10-year tax act that would expire in 2011. This act eliminated the federal estate tax for people dying in 2010. However, there is talk of maintaining the 2010 estate tax at its 2009 parameters. What will happen in 2011 is also uncertain. Unless changed beforehand, 2011 estate taxes will revert to pre-2001 rates, which could mean a marginal rate of up to 55%.

Other Taxes: For families with children, it may be good to know that the $1,000 child tax credit will revert to $500 after 2010.

After reading and understanding in detail which changes will apply to your situation, the next step is to decide how you want to reorganize your investments in order to minimize the impact of these tax increases. One option you might want to consider is municipal bonds, which are generally exempt from federal income taxes. These bonds can also be exempt from state and local taxes, but different states have different rules, so be sure to check before investing.

Another option would be relocating your investments, for example putting high-tax investments in your 401k (tax-deferred) account and low-tax investments in your taxable one. Since you will probably fall under a lower tax bracket in retirement, tax-deferred retirement plans can be a valuable investing tool.

Proposed Changes to Tax Rates

	2010	2011
Personal income tax	10% to 35%	15% to 39.6%
Long-term capital gains tax	Maximum of 15%	Maximum of 20%
Qualified dividends tax	15%	Ordinary income tax rate
Estate tax	Maximum of 45%	Maximum of 55%

This is for illustrative purposes only and should not be viewed as a recommendation to buy or sell a particular type of security. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The tax changes noted are proposed only and not guaranteed. Please consult with your financial professional regarding such services.

After the Storm

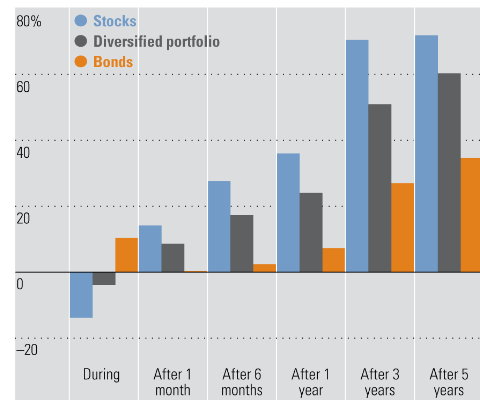
Integrity:

- This article is a good reminder that the purpose of a diversified portfolio is to generate long term returns higher than bonds with lower risk (volitility) than the overall stock marker.

Severe market declines can scare investors into selling at the worst possible time: when prices are at their lowest. Sticking with your investment strategy through tough times requires careful planning and discipline, but it is more likely to pay off in the long run.

The image illustrates the average performance of stocks, bonds, and a diversified portfolio during and after four U.S. recessions. During recessions, stocks performed the worst and bonds the best, while the diversified portfolio offered a middle ground. However, after the recessions and in the long run, stocks provided the highest returns, followed by the diversified portfolio; bonds did not measure up. There are two lessons here: 1) Since you cannot know for certain when the market will bottom out, if you are invested, stay invested, and 2) Diversify in order to reduce downside risk.

Performance During and After Recessions



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Recession data is from National Bureau of Economic Research (NBER). The average cumulative returns are calculated from the end of each of the longest four recessions in U.S. history (1929–2008). The four recession periods considered herein as defined by the NBER are as follows: Aug. '29 – Mar. '33; May '37 – June '38; Nov. '73 – Mar. '75; and July '81 – Nov. '82. The recession that began in December 2007 is still occurring and is not included in the analysis. The diversified portfolio consists of 60% stocks and 40% bonds, and is always rebalanced. Please keep in mind that diversification does not eliminate the risk of experiencing investment losses.

Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general, and bonds by the 20-year U.S. government bond. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs.

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Integrity Financial Planners
PO Box 4790
Brookings, Oregon 97415
info@integrity-fp.com
www.integrity-fp.com
Tel:541-469-4080