The REBALANCING Season

Whether you’re ready for it or not, seasons change. The daily differences are almost unnoticeable. But before you know it, the new season has arrived. Over time, incremental changes in the values of your retirement investments can also have a noticeable effect — on your account’s asset allocation. Unlike the changing seasons, however, there is something you can do about an asset allocation that’s shifted from your target percentages. You can rebalance your investments.

Shifting Values

When you initially set up your account, you decided on a certain mix of investments — your original asset allocation. However, the way your account is allocated at any point in time depends on the values of your various investments, which are always changing.

Over time, variations in investment performance can cause your asset allocation to shift. The investments that have been outperforming the others will grow to represent a greater portion of your account. So even though you haven’t changed investments, your account is no longer allocated according to your original strategy.

Risk and Reward

Growth is good. However, when your asset allocation shifts, the level of risk in your account may no longer match your original strategy. For example, when the portion of stock investments in your account grows, so does your exposure to risk, since stocks are inherently riskier than other asset classes.

Alternatively, when the portion of your account invested in stocks declines, the resulting asset allocation is more conservative than you originally planned. Your risk exposure is lower, but so is your potential for future gains.

Time to Rebalance

You can return to your original asset allocation and keep your investments in line with your risk tolerance by rebalancing. There are two options. Either change the way your new contributions are invested until your original asset allocation is restored, or sell some investments in the over-weighted asset class and buy investments in the underweighted asset classes.

An Annual Event

Although it’s best not to worry about day-to-day fluctuations in the investment markets, it is important to check your asset allocation at least once a year. If small changes have made a big difference, it could be time to rebalance.
Whether your plans are all sewn up or you’re just starting to put the pieces in place, your company’s retirement plan provides a convenient way to save money for your future. It also offers a variety of investment choices. But making sure your account is invested in a way that best suits your needs is up to you.

**Classic Patterns**
Deciding on an appropriate asset allocation — the way your account is divided up among stocks, bonds, and cash alternative investments — is a matter of balancing the potential for earnings and investment risk.

Historically, the long-term returns of stocks have beaten the returns of bonds and cash alternatives. In the short term, however, stock returns have been very volatile. So there’s a substantial risk of earning poor returns or losing money when you invest in stocks. Bond returns, by comparison, are less volatile, and cash alternatives are much less volatile than stocks.

Note that cash alternative investments may not be federally guaranteed or insured and that it is possible to lose money by investing in cash alternatives. Returns on cash alternative investments may not keep pace with inflation, so you could lose purchasing power.

**A Three-piece Strategy**
There is no single ideal asset allocation. The mix that’s right for you won’t be the same as the one that suits your cousin or your aunt or even your best friend. To find an asset allocation that’s right for you, look at three key things: your investing time horizon, your risk tolerance, and your overall goals.

**Measuring Time Horizon**
Determining your investing time horizon is straightforward — it’s the amount of time you have left to invest before you’ll need your money. If you’re putting money away so you can take a big vacation in five years, your time horizon is five years. Five years is considered a relatively short time frame, so you’d most likely put a sizeable portion of your money into conservative investments with a low risk of loss.

If you have lots of time before you intend to retire, you’ll want to make the most of those years by building up your savings. You may be comfortable investing a large portion of your account in stocks because you’ll likely have time for your investments to recover from any downturns.

As your time horizon shrinks, you become more vulnerable to a stock market downturn. As retirement gets closer, consider reducing your exposure to risk by shifting more of your account to less risky bond and cash alternative investments.

**Measuring Risk**
Deciding how much to allocate to the various asset classes also depends on your risk tolerance. One aspect of your risk tolerance is your attitude — how you feel about taking risk. For example, if you were asked to choose between going white-water rafting and canoeing on a lake, your answer would indicate how much risk you’re inclined to take. The same is true with investment risk. If the potential for higher returns far outweighs the risk of losing money, you may be inclined to invest heavily in stocks.

**A Well-tailored ASSET ALLOCATION**
But that’s only part of the picture. You may feel comfortable with a high level of investment risk, but there are other factors to consider. For instance, if your spouse’s job situation is tenuous, it may be wise to reduce your risk exposure until things are more settled financially. Ask yourself how much you’re willing to lose in a year. Any time investment losses would leave your financial situation in jeopardy, your capacity to take risk is reduced.

**Measuring Goals**

The final part of the asset allocation equation is figuring out how much you need to save. If you have big plans for retirement, you’ll need a substantial nest egg. So you may be willing to accept more risk in return for potentially higher returns. On the other hand, if you have other retirement income sources (additional savings or investment accounts, a pension from a former employer, or the like), you may be inclined to invest more conservatively.

**Key Alterations**

As these three factors change, revisit your asset allocation to see if it’s still appropriate. You may need to adjust the balance of risk and potential reward in your retirement portfolio. Keep in mind that most experts suggest holding at least some stock investments, even after retirement, to provide some measure of growth or, at a minimum, to help you stay ahead of inflation.

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**A Look at Performance**

Chart assumes $1,000 invested in different investment types on 01/01/1991 through 12/31/2010. Stocks are represented by the Standard & Poor’s 500 Index (an unmanaged index of the stocks of 500 major corporations). Bonds are represented by the Barclay’s Capital U.S. Aggregate Bond Index (an unmanaged index of U.S. government, corporate, and mortgage-backed securities). Cash alternatives are represented by 3-month Treasury bills. Indexes are unmanaged and do not include fees and expenses an investor would normally incur. Past performance does not guarantee future results. It is not possible to invest directly in an index.

Source: NPI
Be PREPARED


A Double Whammy

The cost of health care has been rising. According to data from the Bureau of Labor Statistics, U.S. consumers spent an average of $3,126 on health care in 2009, an increase of 5% from 2008. Spending on health care tends to increase as you get older, as the chart shows.

Reality Check

Surprised? Many people think their expenses will be significantly lower once they retire. And that may be true in some cases. But the amount you spend on health care will most likely go up. As a matter of fact, increases in health care costs could push your overall expenses higher during retirement.

If you currently have health insurance through your employer, that coverage may not be available after you retire. Even if your or your spouse’s employer does provide a subsidized retiree health plan, you’ll likely have to pay premiums, deductibles, and copayments, which could be significant.

What About Medicare?

The Employee Benefit Research Institute (EBRI) estimates that future retirees will need substantial savings to cover their health care expenses.* For example, the projections show that men retiring in 2020 at age 65 will need savings of $163,000 to have a 75% likelihood of covering retirement health care expenses. Under the same scenario, women will need $203,000.

These figures are based on individuals with “median” prescription drug needs throughout retirement who have health care coverage through Medicare, a Medigap policy, and Medicare Part D (which pays for non-hospital prescription drugs). Longevity, the need for health care services, and prescription drug usage will affect the actual level of savings needed.

The Bottom Line

The best way to prepare for retirement is to carefully estimate all your future expenses — and to keep saving.

* Issue Brief, December 2010, No. 351

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### Health Care Costs Increase with Age

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<th>Annual amount spent</th>
<th>% of total expenditures</th>
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