FRANKLY FINANCIAL.COM

119 Cedar Street
East Hanover, NJ 07936

973-515-5184 • Fax: 973-515-5190
FranklyFinancial@nationwideplanning.com

Frank McKinley
Financial Wellness Coach

JUNE 2023

financial $UCCESS

Practical Implications of Investment Theory

Many investment principles used to develop investment portfolios derive from one investment theory — the capital asset pricing model. What exactly is this theory and how does it apply to your investments?

The capital asset pricing model was developed over 50 years ago by Harry Markowitz, who won a Nobel Prize for his work. His theory centers on the concept that adding an asset to a portfolio that is not highly correlated with other assets in the portfolio can reduce the portfolio's variation risk. Before his theory, it was common practice to look for undervalued assets to add to a portfolio. His approach evaluated how a particular asset would impact the portfolio's risk and return. Whether it makes sense to add that investment to the portfolio depends as much on how the asset's return will vary with returns of other portfolio assets as it does on its own return prospects.

This theory provides the underlying rationale for asset allocation. The key is that the returns of different assets do not behave in the same manner during different economic times, so adding different assets can reduce the volatility in that portfolio. While the return of a diversified portfolio may be lower than that of investing solely in the best performing asset, this is typically viewed as an acceptable tradeoff for the reduced risk. Many people have also realized it is difficult to identify the best performing asset in any given year, so a diversified portfolio provides more consistent returns.

Some investment implications that have been drawn from this theory include:

- ✔ A properly diversified portfolio will combine assets that do not have highly correlated returns. Thus, when one asset is declining, other portfolio assets may be increasing or not decreasing as much.
- ✔ Rather than focusing on each investment's risk, investors should consider their portfolio's overall risk.
- ✔ Including a small percentage of a volatile investment may

Continued on page 2

Frankly Speaking

Has Spring Really Sprung?

Apple and Microsoft alone now account for 13.3% of the S&P 500, the highest level on record. Not since IBM and AT&T in 1978 have two stocks made up a greater share of the benchmark. -Seeking Alpha, April 5, 2023

Yes, things change. Consider the parallels of Apple & Microsoft to IBM and AT&T. All good companies then, and still good companies today. Which did you own then, but wish you owned today?

The U.S. spends more on its military than the next 10 nations combined. Last year, the U.S. spent $877 billion on defense, more than 10 times the amount spent by Russia, which came in third at $86 billion. China, at #2, spent $292 billion. -Axios, April 24, 2023

Leona Helmsley, widely dubbed the "Queen of Mean," said, "We don't pay taxes. Only the little people pay taxes." In a fitting bit of chronology, the judge ordered her prison sentence to start on April 15. -Time & The History Channel

"I am not worried about the deficit. It is big enough to take care of itself." -Ronald Reagan. ❍❍❍

FR2022-1212-0037

Practical Implications

Continued from page 1

not increase a portfolio's overall risk, provided that investment's returns do not vary closely with other assets' returns in the portfolio.

✔ When small portions of stocks are added to an all bond portfolio, risk initially decreases, even though stocks are more volatile than bonds. Thus, an all bond portfolio is not the lowest risk portfolio.

✔ Investors should consider how varying percentages of different asset classes will affect their portfolio's risk and return before deciding on an asset allocation.

Managing Your Portfolio

Consider this investment process to incorporate this theory:

✔ **Determine your risk/return preferences.** You should assess the potential downsides as well as upsides for various investments to get a feel for how much risk you can tolerate.

✔ **Decide on an asset allocation mix.** Your asset allocation strategy represents your personal decisions about how much of your portfolio should be allocated to various investment categories. After considering your risk tolerance, time horizon for investing, and return needs, you can form a target asset allocation mix. Within broad investment categories, make allocation decisions for each category. Not only will each individual's allocation strategy differ, but your strategy will vary over time.

✔ **Select individual investments.** Investigate a wide range of options, but make sure you understand the basics of each, examining the types of risk they are subject to as well as their historical rates of return. Your selections should fit in with your overall asset allocation.

✔ **Rebalance periodically.** Over time, your asset allocation will stray from your desired allocation due to varying rates of return on your investments. See the article "A Portfolio Tune Up" for more details.

Please call to discuss your investment portfolio. ❍❍❍

A Portfolio Tune Up

Over time, the weighting of asset classes in your portfolio can change. After spending a great deal of time to develop an asset allocation strategy, it can be frustrating to see these changes. However, a simple rebalancing of your portfolio may be all that is needed to get your portfolio back in line.

The need for rebalancing is part of the nature of investing. Since different investments earn different rates of return, their values grow at different rates, changing the weightings in your portfolio. These changes can cause your portfolio risk to increase or decrease, making rebalancing a necessary part of portfolio maintenance.

When should you rebalance?

While you should definitely rebalance when your financial objectives or life circumstances change, you also want to rebalance on a regular basis. There are three basic methods to consider:

✔ **Rebalance annually.** Choose a date to rebalance, perhaps at the beginning of the year, when you receive your annual statements, or at the end of a quarter. On that date every year, compare your current allocation to your target allocation. Any allocations off by more than 5-10% would require rebalancing. Once you have rebalanced, don't be tempted to make other rebalancing changes during the year. Wait for your next rebalancing date.

✔ **Rebalance when your allocation differs from your target allocation by a designated percentage.** With this type of rebalancing, you monitor your portfolio more frequently, perhaps monthly. Once your allocation moves from your target allocation by a predetermined percentage, perhaps 5-10%, rebalance your portfolio.

✔ **Rebalance based on current market conditions.** With this approach, rather than one specific percentage for each asset class, you might have a target range. For instance, you might allocate anywhere from 30% to 50% of your portfolio to large-capitalization stocks. Depending on your views of the market, you might want to allocate near the low or high end of that range. Thus, your allocation will change as your views about the market change.

How do you rebalance?

There are many ways to change your allocation among investments. You can purchase additional amounts of the investment that is underrepresented in your portfolio. You can sell investments in overrepresented portions and invest the proceeds in underrepresented portions. Any withdrawals can be taken from overweighted investments. Income from your portfolio, such as dividends and interest, can be invested in underweighted investments. Ultimately, you need to consider tax ramifications and your own individual investment preferences. Please call if you'd like help rebalancing your portfolio. ❍❍❍

How to Talk Finances with Your Parents

There comes a time when even the most independent of parents will need to start relying on their children, especially when it comes to money. Here are a few signs that you may need to get involved in your parents' financial dealings, even if it's uncomfortable to do so:

✔ If they can no longer handle day-to-day details of balancing their budget or paying bills.

✔ If they have begun making very large purchases or withdrawing large sums of cash.

✔ If they express grandiose thoughts of spending money.

✔ If they are reluctant to spend money, even to meet their bare necessities.

✔ If they begin writing more checks than usual.

✔ If they begin to open and close multiple accounts.

✔ If they stop meeting long-term financial obligations or neglect bill payments.

If your parents are exhibiting more than one of these behaviors, it is important for their financial security for you to step in.

How to Approach Your Parents

Control is a big deal — no one likes to give it up, especially those who have been taking care of themselves for decades. In fact, the feeling of losing control over their finances can cause people to lash out and respond with anger. One strategy to avoid this is by appealing to their desire to help and protect you. You can ask them for tips and guidance on your own financial planning, opening a discussion about how they have set things up in their own lives. Touch on long-term care and ask if they've set money aside in savings for this or if they have a long-term care insurance policy instead.

Sometimes the best route to take is involving a third party. Parents can have a difficult time opening up to their children about sensitive matters, especially if things have not gone according to plan financially. Using a financial planner, tax advisor, or elder law attorney can remove their feelings of damaged pride or worries that you might think less of them. It will probably also help that your parents don't have memories of that outside professional making the kind of money mistakes you may have made in your youth.

Organizing Your Parents' Finances

When the time comes to get everything in order for them, you will need a lot of paperwork. This includes:

✔ **Sources of retirement income**. If they don't have the records readily available, you may need to check the mail or their online bank accounts to determine what income they have coming in through investments, retirement plans, social security, etc.

✔ **Residential preference**. Your parents may want to live in the family house forever, but it is unlikely they will not be able to remain independent indefinitely. If one or both of them becomes ill, they may need 24-hour care that you will not be able to provide. This means you will need to know what they can afford and where they would prefer to stay.

✔ **Last will and testament**. Make sure your parents have an updated will so their surviving loved ones do not end up in a legal battle upon their passing. The best way to make sure their wishes are followed is to have them record in their will, not rely on spoken agreements.

✔ **Durable power of attorney**. The legal authorization to take over your parents' finances and make decisions on their behalf is an important matter to have settled. You will also need to determine who will have durable power of attorney for healthcare to make healthcare-related decisions for them.

✔ **Living will.** This is similar to a durable power of attorney for healthcare, but is also a reflection of the direct wishes of the incapacitated person, such as if they would prefer to not be resuscitated or what life-saving measures they want.

✔ **Funeral arrangements**. Your parents may have already sorted out some of these issues, such as where they would prefer to be buried or have their ashes spread, but seniors often forget to tell their children about this. It may seem morbid, but it is important to know their wishes beforehand.

✔ **Update beneficiary forms**. Your parents will need up-to-date beneficiaries for everything from insurance policies to insurance payouts.

✔ **Plan for estate taxes.** The larger the estate, the more prudent it may be to seek advice from an estate attorney or financial advisor. ❍❍❍

Understanding Stock Market Risk

Investing in stocks involves risk, but that doesn't mean they should be avoided. In exchange for being willing to accept the possibility of loss, you receive the potential of earning significant returns.

Risk and stock investing go hand in hand. When you are buying a stock, you are purchasing a small piece of a company. The value of that stock is not fixed. Because you can't know for sure what will happen to the stock's price in the future, the investment comes with a risk.

Stock values rise and fall for a variety of reasons. Once you understand the various factors that might affect a stock's price, you'll be better able to understand the risk associated with any particular investment and get a sense of whether it is a good addition to your portfolio. Risks associated with stocks fall into two broad categories:

Systematic risk or market risk: This is the type of risk that affects an entire market. It is typically unpredictable and unavoidable.

Unsystematic risk: This is the opposite of systematic risk. Unsystematic risks affect only certain companies or sectors of the market. For example, changes in energy prices might affect the price of energy stocks, while a political crisis in a certain country might affect stock prices in that region. Or a company might suffer a leadership shakeup that causes the stock to drop. It's easier to identify unsystematic risks than to anticipate systematic risks.

If you want to invest in stocks, you need to come to terms with risk. The key is to remember that risk or volatility in the stock market is natural. Rather than worrying too much about what the market is doing in the short term, you can insulate yourself by developing a clear investment strategy. Select stock investments based on your long-term goals. Then, keep your hands off your investments because one other major risk that stock market investors face is themselves. Letting emotions drive your investing decisions will almost always lead to less impressive returns.

You can also cope with stock market risk by diversifying your portfolio into asset classes other than stocks. By including bonds, cash, and other investments in your portfolio, you'll be better able to cope with the ups and downs of the market. ❍❍❍

Watching Your Stocks

Here are five things to review as you monitor your stocks' performances:

✔ **Earnings** — Pay attention to the company's quarterly and annual earnings statements, which include comparisons with the recent past and often reviews of what management expects.

✔ **Price and dividends** — Follow the stock's price compared to its 52-week highs and lows. Examine its trailing total returns.

✔ **P/E and PEG ratios** — Price to earnings (P/E) and price/earnings growth (PEG) ratios are often better indicators than the stock price as to how relatively expensive or cheap a stock is.

✔ **Insider transactions and stock buybacks** — A company buying back its own stock or whose senior executives and directors are accumulating more shares is a bullish sign. When insiders are selling off major holdings of their own stock, it's quite often an indication of a stock price peak.

✔ **Sudden and large price changes on high volume** — When a stock makes a sudden, high-volume move it can be the start of a new, long-term trend. ❍❍❍

Financial Thoughts

In 2022, the S&P 500 index experienced one of its most volatile years since the financial crisis of 2007-–2009. Through mid-October, the index had risen or fallen by 2% or more on 38 trading days. The post-financial crisis average is 14 days. Only 2020 saw more days with a daily change over 2% with 44 days. Though often thought of in terms of downside moves, volatility refers to both positive and negative fluctuations in price. There were nearly an equal number of days with big upward moves as downward moves. The volatility in 2022 is attributed to inflation, tightening monetary policy, the war in Ukraine, ongoing supply chain issues, and reactive investors (Source: *AAII Journal*, November 2022).

Two-thirds of people in the United States were not optimistic about their personal finances in 2022, with 87% of Americans stressed about personal finance. Approximately 61% of Americans live paycheck to paycheck (Source: moneytransfers.com, 2022).

A recent gallup poll found that about 32% of Americans maintain a household budget and 30% have a long term financial plan that includes savings and investment goals (Source: Gallup, 2022). ❍❍❍