Ask the Budget Guy submitted by Allen Gunter

Seven, Eight, Nine, Ten... We Are Finally At the End!

This is the fourth and last in a series of articles on investing (see the Budget Guy archives on the website for the others). I started this series because I feel that investing is one of the most important financial issues we face. Our long-term financial security depends on how much we save and how well we invest what we do save. And it seems to me that it's also important for our long term spiritual security (see Luke 16:11, for example: "If therefore you have not been faithful in the use of worldly wealth, who will entrust the true riches to you?")

Unfortunately, too many people save too little (the national savings rate is actually negative - most people are spending more than they're making). And many who are saving are confused about what to do with their savings, often feeling like investing is just too complex and they don't have the necessary knowledge or skills.

The truth is, it doesn't take that much to get decent investment returns over the long term. The key is to choose an asset allocation that you think will let you sleep at night and then buy mutual funds (index funds in particular) to satisfy your allocation.

See the past articles in this series for more "why's" and "how-to's." Read on for some final details.

Testing Your Allocation and Funds

The whole idea of asset allocation is to keep you from getting worried and selling out when the financial markets hit a rough patch. You won't know for sure what you can handle until it happens, but you can test your allocation and the funds you've chosen by seeing how they have behaved in the past.

You do this by getting the annual returns for each fund for as many years as you can (at least five; I recommend 10 or more). Apply your asset allocation to those returns and see how you feel about the results.

Suppose, for example, you've decided on a 60% stock/40% bond allocation using the Vanguard Total Stock Market Index Fund (symbol VTSMX) for the stock portion and the Vanguard Intermediate-Term Bond Index Fund (VBIIX) for the bonds. Here's how you would test how you would have fared in, say, 1999:

Fund	Fund Return	Portfolio Return
VTSMX (60%)	23.8%	60% of 23.8% = 14.3%
VBIIX (40%)	-3.0%	40% of -3.0% = -1.2%
		13.1%

Do that for every year of past data you can get and see how you feel about the results. For example, if we extended the testing on our hypothetical portfolio to include all the years from 1996 through 2005 we get:

1996	1997	1998	1999	2000
13.6%	22.4%	18.0%	13.1%	-1.2%
2001	**2002**	**2003**	**2004**	**2005**
-2.9%	-8.2%	21.1%	9.6%	4.3%

We would have earned the equivalent of 9.0% over the 10 years, but only if we had hung on in 2000, 2001 and 2002 when things were looking pretty bleak.

If you get results that are too uncomfortable, decrease your stock allocation, increase your bond allocation and see how that feels. For example, a 50% stock/50% bond allocation of those same funds over that same 10 years would still have returned 8.6%. But you would have had a gain of 1.1% in 2000, and the losses in 2001 and 2002 would have been reduced to -0.8% and -5.0%, respectively. A trade-off of a little return for some peace of mind.

The reverse also works. If you feel you can live through more losses in order to get more return, you can increase your stock allocation. A 100% stock allocation invested in VTSMX over those 10 years would have returned the equivalent of 10.6% per year. To get that, though, you would have had to accept losses of 11%, 11% and 21% in 2000, 2001 and 2002. If you're in your thirties and saving for retirement,

continued, next page

that might be acceptable. If you're in your fifties and getting close to retirement, it probably wouldn't be.

Changing Your Allocation

So now you've done your reading, thinking, choosing and testing, and you've got an allocation and some mutual funds you think make sense for you. You're adding a little bit to your investments on a regular basis and you're feeling pretty good about things.

But then the markets start going down and so does the value of your investments. This is when "gut check" testing starts. You're likely to be at least a little nervous and worried, but that's normal. I always get a little nervous when the markets aren't working the way I want them to. When that happens, I reassure myself by confirming that the loss is still within what I can expect to happen from time to time, based on my allocation and funds.

But what if you are nervous enough that it's hanging over you, nagging you throughout the day? Maybe you get a sinking feeling every time you think about how much the value of your investments has fallen. Those probably are signs that you need to rethink your allocation (or perhaps your mutual funds, if you're not using index funds).

Just don't do anything drastic like selling everything and sticking it all in your money market account. Instead, shift your allocation to put more into bonds. One of the best ways to do this is to simply put all of your future investments into bonds until you've reached a new allocation that's more comfortable. If you really must do something right away, sell a small portion of your stocks and invest that money in your bonds.

You'll also want to change your allocation as your time horizon changes. You should have more in bonds (even putting some into money market funds) as you get closer to the time you will need the money. Just keep in mind that when you're saving for retirement, for example, you won't need all the money on the day you retire. Unless your health is bad, you will still be investing part of your money for 20 or 30 years or more.

Rebalancing

From time to time, such as when stocks have been doing particularly well, you will find that your assets are out of sync with your allocation. For example, you may have ended up with more in stocks than you wanted. That just means that it's time to rebalance. And you rebalance the same way you would change your allocation — put new investments into the asset that's too low and/or sell some of the asset that's too high and reinvest it in the other asset.

Investing at Work

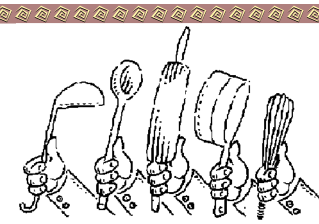
If you are investing in a 401(k) or 403(b) plan at work, your investment options are limited and there may not be clear choices. If there is no broad stock market index fund, use the stock option that seems to have the broadest mix of large and small companies. The bond fund should be easier — most plans have a short or intermediate term fund. Read the information on each and ask questions so that you choose the options that go best with your allocation.

\- - - - - - - - -

Questions? Want a little help getting started? Just give me a call or drop me an email.

Part of my job at SHPC is helping people get out of debt and manage their finances better. It's free and it's confidential. Just call the Budget Guy, Allen Gunter, at 292-4035 or send an email to BudgetGuy@shpc.org. And check out the Crown Financial Ministries Small Study Groups – call Margaret Fetty at 288-9034 for more info.

Recipe for a Clean Kitchen:



Gather one preschool director, one parent, one preschool teacher and an IHN representative. Combine in a well-used kitchen, mix well with cleansers and elbow grease. Stir around for a couple of hours. Product: one sparkling-clean kitchen! Many thanks to Terri Courtney, Karen Ayers, Susie Bridges and Wayne Crawley — and whoever else came by to lend a hand!