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Just How Risky Is Your Portfolio?

If you're like most people, you probably evaluate your portfolio in terms of its return. However, return isn't the only factor you should consider; also important is the amount of risk you take in pursuing those returns. The term "risk" is often understood to mean the risk of loss. However, a portfolio is generally a means to an end, such as paying for retirement or a child's college tuition. In that context, "risk" also means the risk of not meeting your financial needs.

Risk-adjusted return

Let's say that Don's portfolio earns an average of 7% a year for 10 years. However, his annual returns have been very uneven; one year his return might be 11%, another year it might be down 10%. Meanwhile, Betty's portfolio also has averaged a 7% annual return in the same time, but her returns have been more even; she hasn't had spectacular years, but she has avoided any negative annual returns.

You might think both would end up with the same amount of money after 10 years, but that's not necessarily the case. It depends in part on the timing and size of the declines in Don's portfolio. A big loss in the first year or two means he'll spend valuable time recovering rather than being able to make the most of compounding; that can affect future growth. That's why it's important to consider an investment's risk-adjusted return.

Volatility measures

One of the most common measures of volatility is standard deviation, which gauges the degree of an investment's up-and-down moves over a period of time. It shows how much the investment's returns have deviated from time to time from its own average. The higher the standard deviation of an investment or portfolio, the bumpier the road to those returns has been.

Another way to assess a portfolio's volatility is to determine its beta. This compares a portfolio's ups and downs to those of a benchmark index, such as the S&P 500, and indicates how sensitive the portfolio might be to overall market movements. An investment or portfolio with a beta of 1 would have exactly as much market risk as its benchmark. The higher the beta, the more volatile the portfolio. (However, remember that investments also have unique risks that are not related to market behavior. Those risks can create volatility patterns that are different from the underlying benchmark.)

The risk of not achieving your goals

Another way to evaluate risk is to estimate the chances of your portfolio failing to meet a desired financial goal. A computer modeling technique known as Monte Carlo simulation generates multiple scenarios for how a portfolio might perform based on the past returns of the asset classes included in it. Though past performance is no guarantee of future results, such a projection can estimate how close your plan might come to reaching a target amount.

Let's look at a hypothetical example. Bob wants to retire in 15 years. A Monte Carlo simulation might suggest that, given his current level of saving and his portfolio's asset allocation, Bob has a 90% chance of achieving his retirement target. If he chose to save more, he might increase his odds of success to 95%. Or Bob might decide that he's comfortable with an 85% chance of success if that also means his portfolio might be less volatile. (Be aware that a Monte Carlo simulation is a projection, not a guarantee.)

Are you getting paid enough to take risk?

Another approach to thinking about portfolio risk involves the reward side of the risk-reward tradeoff. You can compare a portfolio's return to that of a relatively risk-free investment, such as the inflation-adjusted return on a short-term U.S. Treasury bill. Modern portfolio theory is based on the assumption that you should receive greater compensation for taking more risk (though there's no guarantee it will work out that way, of course). A stock should offer a potentially higher return than a Treasury bond; the difference between the two returns is the equity's risk premium. While understanding risk premium doesn't necessarily minimize risk, it can help you evaluate whether the return you're getting is worth the risk you're taking.

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Coordinating Social Security Benefits with Other Retirement Assets

Special rules for government pensions

If your pension is from a job where you did not pay Social Security taxes (such as certain government jobs), two special provisions may apply. If you're entitled to receive a government pension as well as Social Security spousal retirement or survivor's benefits based on your spouse's (or former spouse's) earnings, the government pension offset (GPO) may apply. Under this provision, your spousal or survivor's benefit may be reduced by two-thirds of your government pension (some exceptions apply).

The windfall elimination provision (WEP) affects how your Social Security retirement or disability benefit is figured if you receive a pension from work not covered by Social Security. The formula used to figure your benefit is modified, resulting in a lower Social Security benefit.

Social Security provides retirement income you can't outlive. And, in addition to your own benefit, your spouse may be eligible to receive benefits based on your earnings record in the form of spousal benefits and survivor's benefits. So, it's easy to see why, with all of these potential benefit options, Social Security is an important source of retirement income. But, according to the Social Security Administration, only about 40% of an average worker's preretirement income is replaced by Social Security (Source: SSA Publication No. 05-10035, July 2012). When trying to figure out how you'll meet your retirement income needs, you'll probably have to coordinate your Social Security benefits with other retirement income sources such as pensions, qualified retirement accounts (e.g., 401(k), IRA), and other personal savings.

Factors to consider

How you incorporate Social Security benefits into your total retirement income plan may depend on a number of factors, including whether you're married, your health and life expectancy, whether you (or your spouse) will work during retirement, the amount of your Social Security benefit (and that of your spouse, if applicable), other sources of retirement income (e.g., pension), how much retirement savings you have, and, of course, your retirement income needs of you and your spouse, including the income need of your spouse after your death.

A factor to consider is that Social Security has a "built-in" protection against longevity risk. Benefits increase each year you delay starting benefits through age 69 (benefits do not increase past age 70), so the later you start receiving benefits, the greater the benefit amount. In addition, Social Security benefits are inflation-protected, and may increase with annual cost-of-living adjustments based on increases in the Consumer Price Index.

How much you may pay in income tax may also factor into your retirement income plan. For example, distributions from tax-qualified accounts (e.g., 401(k)s, IRAs, but not including Roth IRAs) are generally taxed as ordinary income. Up to 85% of your Social Security benefits may also be taxed, depending on your modified adjusted gross income and tax filing status. Tax issues are complex, so you should talk to a tax advisor to understand your options and the tax consequences.

Pensions

If you're lucky enough to have a traditional employer pension available, that's another reliable source of income. You'll want to be sure that you effectively coordinate your Social Security benefit with pension income. Your pension may increase in value based on your age and years of employment, but it may not include cost-of-living adjustments (COLAs). As mentioned earlier, Social Security not only increases the longer you delay taking benefits, but it may increase with COLAs.

If your pension benefit increases past the age at which you retire, you might consider waiting to take your pension (either single or joint and survivor with your spouse) in order to maximize your pension benefit amount. Depending on your income needs, you could start Social Security benefits earlier to provide income. Or, if you've already reached your maximum pension benefit, you could start your pension first, and defer Social Security in order to receive an increased monthly benefit later. Your decision depends on your individual situation, including your pension benefit amount and whether it increases in value after you retire, and the pension options that are available to you (e.g., single life, qualified joint and survivor). You can get an explanation of your pension options prior to retirement from your pension plan, including the relative values of any optional forms of benefit available to you.

Personal savings

Prior to retirement, when it came to personal savings, your focus was probably on accumulation--building as large a nest egg as possible. As you transition into retirement, that focus changes. Rather than concentrating on accumulation, you're going to need to look at your personal savings in terms of distribution and income potential. Your savings potentially can provide a source of income to help you bridge any gap between the time you begin retirement (if you've stopped working) and the time you wait to begin taking Social Security benefits.

One option you might consider, depending on the amount of retirement savings you have and your income needs, is taking some of your savings and purchasing an immediate annuity, which will provide a guaranteed (based on the claims-paying ability of the annuity issuer) income stream. In this way, your remaining savings may have a chance to increase in value, while delaying Social Security benefits increases your annual benefit as well.

Incorporating Social Security into your retirement income plan involves several other important factors. Talk to your financial professional for help in developing the best plan for you.

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Happy Healthday! HSAs Turn 10

HSAs celebrate their 10th anniversary in 2013. If you are eligible to save money in an HSA but don't currently take advantage of it, you may want to consider whether its many potential benefits may be right for you.

Created 10 years ago as part of the Medicare Prescription Drug and Modernization Act of 2003, health savings accounts (HSAs) have gained in popularity over the past decade. According to the Employee Benefit Research Institute (EBRI), more employers and employees have been contributing to HSAs in recent years, and the amount contributed to HSAs has generally been on the rise. For example, the percentage of individuals in employee-only HSAs contributing $1,500 or more rose from 21% in 2006 to 42% in 2012, while the percentage of employees contributing nothing decreased from 28% to 15% over that same period. (Sources: "HRA/HSA Health Plan Contributions Continue to Grow," EBRI, February 20, 2013, and *EBRI Notes,* February 2013.) If you are eligible to contribute to an HSA, you may want to take another look at these savings plans, which could benefit your financial situation both now and in the future.

HSAs explained

Health savings accounts help individuals and families set aside money on a tax-advantaged basis to pay for health-care costs. HSAs are typically offered by employers along with what's known as "high-deductible health plans," or HDHPs--health insurance plans that generally offer lower premium payments in exchange for high annual deductibles (at least $1,250 for individuals and $2,500 for families in 2013).* You must be enrolled in an HDHP in order to participate in an HSA. If your employer provides an HDHP but does not offer an HSA, you may be able to establish an account on your own through a financial institution. Self-employed individuals can also use HSAs.

Here's how an HSA works:

- You can contribute up to $3,250 for individual coverage or $6,450 for family coverage to an HSA in 2013. If you are age 55 or older, you may also make "catch-up" contributions of up to $1,000.
- Your employer may also make contributions on your behalf.
- You can contribute in one lump sum or in periodic (e.g., monthly) amounts.
- You can make contributions for the current year up until your tax-filing deadline (generally, April 15 of the year following the year of coverage).

One of the key advantages of an HSA is that your contributions are tax deductible. If your plan is offered through your employer, you may be able to make automatic contributions on a pretax basis (similar to a work-based retirement savings plan) and any employer contributions are generally excluded from your gross taxable income as well. Moreover, you can typically select from a variety of savings and investment vehicles for your contribution dollars, and the earnings grow tax deferred until you withdraw them. Withdrawals then used for qualified medical expenses are tax free.

Permitted expenses

You can withdraw money from your HSA to pay for qualified expenses for yourself, your spouse, or your dependents. Permitted expenses include:

- Health insurance deductibles and co-payments
- Prescription drugs
- Vision care and eyeglasses
- Dental care
- Laboratory fees
- Hearing aids and more

For a complete list of eligible expenses, please see IRS Publication 502.

On the other hand, HSA distributions that you use for nonqualified expenses are subject to income taxes and a 20% penalty tax.

Eligibility rules

In order to be eligible for an HSA, you must have qualifying HDHP coverage. You won't be eligible if you're covered by another health plan (e.g., your spouse's nonqualified health plan), if you're 65 and enrolled in Medicare, or if someone else can claim you as a dependent. In addition, you may be ineligible if you're covered under a flexible spending account or health reimbursement arrangement that offers coverage similar to the HSA's.

Plans that won't affect your eligibility include dental and vision care insurance, long-term care insurance, and disability and accident insurance.

Rollovers

Unlike flexible spending accounts, where you have to use up all the funds you set aside for a plan year by a certain date or forfeit the money, HSA funds are yours to keep. If you leave your current employer and would like to roll your HSA money into another HSA, you are typically permitted to do so. And provided you are still eligible, you can continue to save in your account on a tax-deferred basis until you enroll in Medicare.

**Total out-of-pocket costs for HDHPs cannot exceed $6,250 for individuals and $12,500 for families.*

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What is a payable on death (POD) account?

A bank account can be designated as payable on death to someone of your choice. The bank pays these funds to this person almost immediately at your death, and the funds will generally not be subject to probate.

The payable on death designation is very simple and flexible. You can change the designation until your death, and the individual you designate has no right to the money until your death. Indeed, the individual will not receive the account unless he or she outlives you. A POD designation can also be used with U.S. savings bonds.

A typical bank account would be subject to probate at your death. Property subject to probate generally incurs fees, such as attorney's fees, and the transfer of probate property may be subject to delays of one to several years. A POD account usually avoids probate, and the named beneficiary can generally access the funds immediately after your death, without significant delays.

The requirements for a POD account may vary somewhat under state law, and state laws determine what is subject to probate. Ask your bank, attorney, or financial advisor to make sure that the account won't be subject to probate. A POD designation used with appropriate U.S. savings bonds will not be subject to probate in any state.

You do not make a gift for gift tax purposes when you name the beneficiary of a POD account. You remain subject to any income tax on funds in a POD account while you are alive. And funds in a POD account are subject to estate tax at your death. Of course, if your spouse is the named beneficiary, the funds would qualify for the estate tax marital deduction. If the named beneficiary is two or more generations younger than you (e.g., a grandchild), the funds may also be subject to generation-skipping transfer (GST) tax at your death. Substantial exemptions ($5,250,000 in 2013) are available to protect property from estate tax or GST tax.

A similar provision, transfer on death (TOD), is available for the transfer of stocks, bonds, and mutual funds to a named beneficiary at your death.

What is a joint bank account?

A joint bank account lets you name a co-owner for your bank account. Funds in the account transfer to your co-owner automatically if you die. Your estate generally avoids the expenses and delays of probate.

Holding checking and deposit accounts as joint bank accounts can be a simple and inexpensive way to transfer funds immediately upon your death. It guarantees your spouse (or other co-owner) continuing access to the family checking account to pay monthly bills. You can change the designation until your death. However, the co-owner can withdraw funds from the account until revoked as co-owner.

A typical bank account would be subject to probate at your death. Property subject to probate generally incurs fees, such as attorney's fees, and the transfer of probate property may be subject to delays of one to several years. A joint bank account usually avoids probate, and the co-owner can generally continue to access the funds immediately after your death, without delays.

The requirements for a joint bank account may vary somewhat under state law. Ask your bank, attorney, or financial advisor to make sure that the account won't be subject to probate.

You do not make a gift for gift tax purposes when you name the co-owner of a joint bank account. However, you do make a gift when the co-owner withdraws funds you contributed to the account. You generally remain subject to income tax on funds you contributed to the joint bank account while you are alive. And funds in a joint bank account may be subject to estate tax at your death. In general, if co-owned with your spouse, one-half of the account is included in your gross estate; if co-owned with anyone else, the account is included in your gross estate except to the extent that you can prove contributions were made by the other co-owner.

Gifts qualify for a $14,000 annual exclusion in 2013. Of course, if your spouse is the co-owner, the funds would qualify for the gift or estate tax marital deduction. If the co-owner is two or more generations younger than you (e.g., a grandchild), the funds may also be subject to generation-skipping transfer (GST) tax. Substantial exemptions ($5,250,000 in 2013) are available to protect property from gift and estate tax or GST tax.

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