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Understanding Risk Tolerance and Risk Capacity

When determining an appropriate asset allocation mix, it is important to consider not only one's risk tolerance, but also one's risk capacity.

An investor's risk tolerance refers to his or her aversion to risk, while an investor's risk capacity relates to his or her ability to assume risk. Sometimes, an investor's risk capacity and risk tolerance do not match up. If an investor's capacity to take risk is low but the risk tolerance is high, then the portfolio should be reallocated more conservatively to prevent taking unnecessary risk. On the other hand, if an investor's risk capacity is high but the risk tolerance is low, reallocating the portfolio more aggressively may be necessary to meet future return goals. In either case, speaking with a financial advisor may help to determine if your risk tolerance and risk capacity are in sync.

Risk Strategy Matrix

		Risk Capacity	
		High	**Low**
Risk Tolerance	**High**	No action required	Consider reallocating more conservatively
	Low	Consider reallocating more aggressively	No action required

There is no guarantee that diversification or asset allocation will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. It is highly recommended that you consult with a financial professional for advice specific to your situation.

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Advisor Corner

We are off to a fast start in 2013. Equity markets have been steadily moving higher, and the DOW and the S&P 500 has now topped their all time highs. While headwinds still threaten the success in 2013, valuations are still showing equities are resonably priced, even with this recent run up.

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Thank you for your continued business and trust that you have placed with us. We look forward to the continued success in 2013!

What You Need to Know about Health Savings Accounts

Health Savings Accounts (HSAs) are growing in popularity, and more companies are offering them to their employees. Many people, however, are confused about what these plans are and when it is appropriate to take advantage of them.

What Is an HSA? Health Savings Accounts were created by a provision in the Medicare Prescription Drug Improvement and Modernization Act of 2003 and signed into law in December of that year. The purpose of creating the accounts was to provide a way for Americans to prepare for future medical costs and lower their health insurance premiums by switching to higher-deductible medical plans. Employers can establish plans for employees, and HSAs are also offered by banks, credit unions, insurance companies, and other approved companies.

In 2013, an individual can contribute up to $3,250 to an HSA, while families can contribute $6,450. People over 55 can also make a catch-up contribution of $1,000.

What Type of Tax Benefits Does an HSA Offer? Personal contributions offer participants an “above-the-line” deduction, which allows them to reduce their taxable income by the amount they contribute to their HSA. Participants aren't required to itemize their deductions to realize this benefit.

If your employer offers a “salary reduction” plan (also known as a “Section 125 plan” or “cafeteria plan”), you can make contributions to your HSA on a pre-tax basis. However, the “above-the-line” deduction is off limits for those who elect to contribute on a pre-tax basis.

If you are self employed, you cannot contribute to an HSA on a pre-tax basis. However, you can contribute with after-tax dollars and take the above-the-line deduction.

Who’s Eligible? In order to be eligible to contribute to an HSA you have to be covered by a high-deductible health insurance plan. "High-deductible" is defined as a deductible (where you pay the first dollars for medical service out of your own pocket) of $1,250 or higher for singles and $2,500 or higher for families.

In order to be eligible to contribute to an HSA, you cannot be 65 years of age or older. People 65 and older can maintain an HSA established prior to age 65, but they can no longer make contributions into it.

An HSA cannot be established for those eligible to be claimed as a dependent on another person's tax return. Also, if you are covered by another health insurance plan (such as a spouse's), you are not eligible for an HSA.

If you die and have money in an HSA, your spouse can use the account as if it were his or her own. If you are not married, the account can pass to a beneficiary but will no longer be considered an HSA and will be taxable to the beneficiary. If your estate is the beneficiary, the value of the HSA will be included on your final income tax return.

Making Withdrawals from Your HSA: Withdrawals made from your HSA are tax-free if used for qualified medical expenses. The same things you can deduct on Schedule A are considered medical expenses for HSAs. For more information on exactly what qualifies, see IRS Publication 502: Medical and Dental Expenses.

If you don't need to withdraw the funds from your HSA, you can let your contributions grow over time tax-free (similar to IRA accounts). HSA contributions grow on a tax-deferred basis. Moreover, unlike flexible spending accounts you may have used in the past, HSA contributions are not “use it or lose it.”

What Is a Bond Ladder?

Laddering a bond portfolio means that you buy bonds with varying maturity dates, for example: one bond maturing in a year, another in three years, and two others maturing five and 10 years from now, respectively. When the bonds mature, the investor can either spend the proceeds, which would necessitate matching the maturity dates of the bonds in the ladder to spending needs (for example, when college tuition comes due each year) or reinvest in another bond that matures at a later date.

Laddering is, above all, a diversification strategy, enabling you to spread your assets across multiple credits with different characteristics, thereby mitigating the risk of sinking a lot of your assets into a single bond that defaults. And if you're reinvesting your proceeds when a bond matures, laddering helps you further diversify across multiple interest-rate environments.

For example, let's say you wanted to move money into the bond market right now. If you were willing to sink your money into a bond maturing in 10 years, you'd likely have to settle for a yield of 2% on a Treasury bond and less than 4% for an investment-grade corporate bond, quite low by historical standards. If bond yields went up before your bond matured, meaning that new bonds with higher yields became available, you'd have two choices, neither of them appealing. You could hold your bond until it matured in 10 years, thereby forgoing the ability to generate a higher income stream between now and then. Alternatively, you could sell your old bond and buy the new, higher-yielding one, but you wouldn't be able to sell it at face value.

A laddered strategy, by contrast, could help you combat that risk. You could invest a slice of your bond portfolio in a bond that won't mature for 10 more years, but put the rest of your money into bonds with shorter terms like six months, two years, three years, and five years. If interest rates trended up during the next decade, as in the example above, you'd come out ahead of the person who bought and held the 10-year bond because you'd be able to reinvest the proceeds from your shorter-term bonds into the newly available higher-yielding bonds.

The downside is that, if interest rates decline during the time you hold a laddered bond portfolio as they have during the past few decades, you'd have to reinvest maturing bonds at ever-lower interest rates, thereby reducing your portfolio's aggregate yield over the time that you held it. Your return would have been higher if you had simply purchased a higher-yielding, long-maturity bond at the outset of your holding period and sat tight until maturity.

Incredible shrinking yields are the key reason why many folks who had been employing laddered strategies have abandoned them in recent years. At the same time, some believe that yields can't go down much further from here and feel that the benefits of building a bond ladder today may outweigh the risks. However, because laddered bondholders are investing smaller sums into more bonds on a regular basis, their trading costs are apt to be higher than those of bond investors who take a concentrated, buy-and-hold approach.

Diversification does not eliminate the risk of experiencing investment losses. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes. Treasury bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while corporate bonds are not guaranteed. With corporate bonds an investor is a creditor of the corporation and the bond is subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade.

The Flavors of Investing

It is tempting to jump on the investment bandwagon when certain parts of the market soar based on a trend or analyst report. While great potential exists, sector investing can also come with great risk.

As seen in the image, what is hot one year isn't always hot the next. Interested investors should be willing to follow a sector's ups and downs, as timing the market is difficult. Investing in specific sectors can add volatility to a portfolio, but exposure to the right sectors can contribute to improved financial performance. Keep in mind that while sector investing can fill a gap or serve as a speculative play, a balanced asset allocation should be the core of any portfolio.

10-Year Sector Winners and Losers

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Highest return	50.3	38.1	40.8	39.4	32.9	–16.1	61.9	30.5	18.5	32.5
	41.0	32.1	14.8	36.2	27.5	–23.3	53.6	27.4	13.4	29.1
	37.6	23.3	12.2	21.8	17.2	–28.1	50.2	24.9	11.9	24.6
	37.3	19.2	8.1	19.7	16.6	–38.2	35.6	24.2	6.9	19.3
	34.8	17.9	6.0	17.6	12.6	–38.4	34.0	23.4	5.1	18.6
	32.1	15.4	6.0	15.4	12.0	–39.4	29.3	23.2	4.1	16.5
	26.1	14.4	5.2	15.1	8.0	–39.8	24.0	14.5	0.6	15.3
	24.7	12.5	3.7	15.0	0.2	–41.2	21.0	13.4	–0.4	13.3
	19.8	10.1	3.0	11.9	–8.7	–42.0	15.6	11.8	–0.7	10.1
	18.9	3.5	–1.4	10.9	–17.9	–48.1	14.5	7.3	–14.1	4.3
Lowest return	17.4	0.8	–6.0	6.7	–18.3	–51.3	11.8	5.1	–16.5	2.2

Legend: Basic Mat., Comm. Ser., Cons. Cyclical, Cons. Def., Energy, Financial, Health Care, Industrials, Real Estate, Technology, Utilities

This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Sector investments are narrowly-focused investments that typically exhibit higher volatility than the market in general. Sector investments will fluctuate with current market conditions and may be worth more or less than the original cost upon liquidation. Returns and principal invested in stocks are not guaranteed.

Source: Sectors in this example are represented by the Morningstar Sector Indexes.

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