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INVESTMENT GROUP

Offering Complete Wealth Management Services

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The Nature of Financial Risk and How to Manage It

Life is full of risks. Every time you drive to the market you take a risk. Will someone rear end you? Will someone ding your car in the parking lot? Somehow you manage these risks, pick up a pizza for dinner, and drive home safely.

Today I would like to talk about risk, specifically financial risk, and how you can manage it.

Most people think that financial risk is simply the risk that the hot stock you buy will go down, not up. Or that your 401K will turn into a 201K.

At Hornstein Investment Group we have a more inclusive concept of risk. Risk is the uncertainty that you might not meet your financial goals, both long-term and short-term, for whatever the reason.

There are a variety of risks that can derail your plans, not just that your favorite stock is a dud, and different kinds of risks require different ways to manage them.

We can't eliminate risk, but there are ways to manage it.

The typical investment model measures risk with the statistical tool of Standard Deviation. Sounds impressive, doesn't it? But Standard Deviation is no more than a measure of how much your investment is likely to deviate, up or down, from its average annual returns in any given year. It also is called volatility.

But Standard Deviation does not tell you how likely such a deviation is to occur. Nor does it tell you how much it will hurt when your stock goes down, or how you will react.

There is no way to know what will occur in the future. We cannot say for sure how bad something could or would be and the likelihood something will go wrong.

So when looking at risk, you need to look at how likely is it that something will go wrong, how bad would or could it be, how would it affect your life and the life of your family, and how would you react.

We at Hornstein Investment Group look at your investments in a similar way. If something went wrong, how bad would it be?

Investments

Anytime you invest in something there is a risk that you might not get your money back. To compensate you for this risk, people pay you, either interest, dividends or capital gain. But these are not guaranteed.

In theory, the more risk you take the higher your return should be. But it also can be that the higher the risk, the more you lose. Risky investments do not necessarily mean that they have higher return potential.

Conversely, less risky investments, like money market accounts or CDs, pay you less, but give you more assurance of getting back your money. But these safer investments carry another risk. Will your potential return be enough for you to meet your goals?

Working with a knowledgeably financial advisor, you need to ask:

- How much risk is enough to potentially meet your goal?
- How much is too much?
  - Maybe you do not need to take so much risk to potentially meet your goal. If your goal is to have a $50K down payment on a house in 2 years and you have $48K, you do not need to take very much risk to meet your goal. And you shouldn't.
- Everyone has a different risk tolerance.
  - It should be part of your entire financial profile, not just your investments.
  - How many people depend on you and your income?
  - You need to talk with your advisor (and spouse) to identify and understand your risk tolerance.
  - How secure is your job or business?
  - Will you be inheriting money? If so, when?
- When do you need the money?
  - With a longer time horizon, you have more time to recoup any possible losses.
  - The less likely you are to have to sell when a stock is down.
- What would happen if you did not meet your goal?
  - Is this retirement money or saving for a vacation cabin?
  - How much can you afford to lose?
  - This may not be an optimistic view, but it certainly is more realistic.

How do you know what is the "right" amount of investment risk?

There is no correct amount of risk.

This is a personal decision and there may not be a "right" answer for you. But, there probably are more and less appropriate amounts of risk for each one of us. A professional financial consultant can help you determine your risk tolerance.

We use a questionnaire that helps us determine your risk tolerance. But we also discuss with you when do you need the money, your other sources of income, your current job situation, your family situation and anything else that might be relevant.

The key is to match the amount of risk in your investment portfolio with your risk tolerance.

What are some other financial risks you face?

You could miscalculate how much you need in retirement.

- You cannot go by a rule of thumb.
    - Need 65% or 85% of pre-retirement income?
    - Everyone's situation is different.
    - Family of 7 or family of 2?
    - Pension?
    - Plans to travel?
    - Will your house be paid off?

Not saving enough for retirement or procrastinating.

Here is where a professional financial consultant can really help. He or she can help you calculate how much you need to save, and develop a realistic plan. And can help with the discipline needed to put your plan into effect.

- You need to calculate how much to save to meet your goal. You can't just wing it.
- If your goal is 20 years in the future, how much will costs go up?
- If you save a little extra will it make a difference?
- Can you wait a few years?

    - For example, if you start to save $100 a month at age 35 and earn a hypothetical 5% a year, you will have over $83,000 when you turn 65. If you wait until you are 45 and earn an equal 5%, you will have just over $41,000. You would need to save $200 a month to come close -- $82,000+
    - This is a hypothetical example, but it does convey the message that starting to save earlier could produce more at the end.

Longevity

- What if you live to be 95, will you have enough money?

- For men, what if your wife outlives you by 10 or 15 years. Will she have enough to make it?

- One of the biggest risks to your retirement plan is just plain living longer than you expect and running out of money.

Can you save too much for retirement?

- Yes, you can. Then you may have missed out on some great adventures.
- But this is a good problem that we can help you resolve.
- Maybe you are close to your goal and you can reduce the amount of risk you are taking with your investments.
- A professional financial advisor can give you a better estimate of how much you will need when you retire, where you stand now, and how much more to save to increase your chances of reaching that goal.

Taking Social Security too early or too late

- May represent 1/3 to ½ of your monthly income. Can't just pull a number out of a hat or decide on emotions.

- A financial advisor can help you calculate when you reach the breakeven point if you decide to take Social Security early or late. At best, this is an estimate. But it should be an educated estimate.

- And it should include how it will affect the benefits your spouse may receive.

- Need to consider and calculate:

    - Normal Retirement Age, which Social Security now defines as 65 or 66, depending on when you were born. How much do you lose by taking benefits early or how much do you gain by taking benefits later? Include extra you put in by working longer, earnings going up?

    - Will you be working? According to the Social Security Administration, between the ages of 62 and your NRA, you lose $1 for $2 earned over $14,160 (2009), then $1 for $3 over $37,680 in year of NRA

- How is your health?

- Do people in your family live long lives?
- Or do they die earlier?
- What if one spouse might outlive the other by 10 or 15 years?

Taking Social Security too soon or too late can cost you thousands of dollars. It is a mistake you should not make.

Not saving enough for college.

- What would you do if your child were admitted to Harvard?
- Again, a professional financial consultant can give you a better idea of how much college will cost when your children or grandchildren are ready.

What are the financial risks against which you need to take preventive action, that is, buy insurance?

Illness

- If you get sick and miss a week or two of work, do you have enough sick leave to cover the time? If not, do you have cash readily available to replace your lost salary?

- If you became really sick and could not work for 3 or 4 months, how would you pay your bills?

- Do you have health insurance? Have you reviewed it to know what it covers and what it doesn't? Is there a better plan available?

Accidents

- Accidents happen. Like getting sick, if you fell and broke your leg, do you have health insurance? Do you have the funds to get you through 2 weeks or even 2 months of missed work?

- And if someone had an accident on your property, do you have liability insurance? Is it enough?

    - If not, you could lose all your savings and your brilliant investment in Canadian oil shale stocks would only go to pay more to the person who fell.

- What if the car accident were your fault? Do you have adequate liability insurance if the car you hit was a Lamborghini? Or would you have to sell your house to pay the repair bill?

Insurance -- Never risk more than you can afford to lose (deductible and self insurance). At the same time, do not buy insurance that you don't need. So you need to review your coverage periodically.

- Life
- Property
- Umbrella
- LTC
- Car

You should consider the cost versus the benefit of insurance prior to purchase. Guarantees are subject to the claims paying ability of the insurer. Be sure to talk with your financial advisor or insurance professional about your personal situation prior to buying anything.

Another useful risk management tool is to have an **Emergency Fund t**o cover short-term expenses from accidents, illness, layoffs, and surprises. A good rule of thumb is to have 6 months of expenses in a savings account or money market account.

But a better approach is to look at your particular situation. For example, if you and your spouse work for the USG and have each accumulated 5-6 months of sick leave, you may only need 2-3 months of expenses in the bank. If you and your spouse are sole proprietors of a business that provides 100% of your income, you may want a year of expenses in the bank.

Likewise your insurance needs are specific to your situation. Again, if you are a federal employee with 6 months of sick leave accumulated, you may not need disability insurance. If you are the sole breadwinner in business for yourself, you most likely need disability insurance.

Estate Planning mistakes can cost a bundle.

- Current Estate Tax Rate is 45%, yes 45%.
- Will the Government or your children inherit your house?

Moreover, will your last wishes be honored?

- If you are part of a blended family, do you want your children to inherit your part and your spouse's children to inherit his or her part?

- If you are part of a same-sex relationship, will your partner inherit your assets? Or will it be a fight with your family?

Estate Planning

- Proper Estate Planning can save you a bundle and make sure that your last wishes are honored.
- Probating your Will can cost tens of thousands of dollars more than final administration of a Trust.
- Be sure the analyze the costs of probating your will versus the costs of administering a trust.

How much does Probate cost?

The State of California decides. California is a “statutory state,” which means that the State Legislature sets a fee schedule for the attorney and the executor of a probated will. Currently, the schedule provides that the fee is 4% of the first $100,000 in gross value of property, 3% of the next $100,000, 2% of the next $800,000, and a sliding scale starting at 1% of the amount over $1 million of gross value.

For example, if you leave your house valued at $400,000 to your children they will pay a total of $11,000 to the attorney and an additional $11,000 to the executor of your Will.

But wait, it gets worse. If you have an outstanding mortgage of $200,000 on the house, your children still pay fees based on the $400,000 value of the house, not the $200,000 equity you had in the house. If your house and investments are worth $800,000, the statutory fees alone are $38,000, that is, 19,000 to the attorney and $19,000 to the executor!

If some long lost former husband or wife or anyone else learns of the probate of the Will in the newspaper, he or she can show up at the hearing with an attorney to challenge the Will and try to claim a share. And then the real fun begins. So be sure to consult a knowledgeable Estate Attorney.

Finally, **Taxes**. Simply put, Taxes are going up. And not just on the wealthy. You are going to want a qualified professional on your side, unless you enjoy paying more than you must.

Nor do you want to take a risk with the IRS by trying to pay less than should. Having a CPA on your side can help you make some smart decisions that are both legal and reduce your taxes.

For example, which types of investments should go in an IRA and which in a taxable account? Making the right decision can reduce your taxes, legally.

In the end, managing financial risks is not about finding an investment guru who has a crystal ball to tell you the next Hot Stock to buy. Rather, it is a multidimensional approach to striving to improve your odds for success.

How do you do that? Buy more lottery tickets? Go to a fortune teller to get the right numbers?

No, I would argue that the best way is to find a good financial advisor who can look at your entire financial situation and work with you to develop a financial strategy that

- helps meet your goals,
- protects you against a catastrophic event, and
- that you can implement.

Having a plan that incorporates all aspects of your financial life can give you more control and increases your chances of meeting your financial goals.

At Hornstein Investment Group we believe that Planning and Discipline are the best ways to improve the odds of reaching your financial goals. There are no magic shortcuts to managing risk.

At Hornstein Investment Group:

- We take the time to know you, your values and your goals.

- We look at your total financial situation to make sure you have covered all the bases.

- We fit your individual investment plan into your total financial situation.

- We do not invest in the latest Hot Tips.

- It is what we call Plain Vanilla Investing. But we believe it is good Vanilla.

If this way of looking at financial risk makes sense to you, then Hornstein Investment Group may be right for you. Talk with me about setting up a free ½ hour consultation.

The use of a financial consultant does not ensure a profit or protect against loss. Any examples used were hypothetical. Hypothetical examples do not represent any specific situation. Your results will vary. Any hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

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