



Stephen Molyneaux

ASSET ALLOCATION AND MARKET VOLATILITY

PORTFOLIO BALANCE AND MANAGEMENT CAN TAME MARKET VOLATILITY SWINGS

Generally speaking, the term “market volatility” refers to the ups and downs in the prices of securities. For example, if the price of a stock goes up and down rapidly over a short time period, it is said to have high volatility. The inverse, low volatility is when the price of the stock remains fairly stable and seldom fluctuates greatly. ***Volatility is at the heart of investing – without it there would be nothing to invest in except cash or cash-equivalent instruments.*** If volatility and the higher risk associated with it didn’t exist, there wouldn’t be the opportunity to earn higher returns. Accepting this maxim is easier said than done when you see markets spiraling downward as they have been recently. Smart investors, those who have determined their risk level, and with a long-term strategy in hand, accept the intrinsic volatility of certain investments and learn to cope with the anxiety-ridden drops in the market.

While you can never totally eliminate volatility in your portfolio, short of keeping all your money in cash, there are certain defensive and opportunistic strategies which may limit your risk. Asset allocation – spreading investments across a variety of asset classes (U.S. stocks and bonds, non-U.S. stocks and bonds, commodities, short-term debt, cash equivalents, etc.) and re-balancing the portfolio periodically is one of the best strategies for minimizing risk and maximizing profits. The advantage of adding a diverse range of assets, with little or no correlation to each other, is that when some assets fall in value others may move higher and offset the losses. For example, under certain economic conditions, adding bonds and commodities to a portfolio may provide a counterweight or hedge to a potential stock selloff. Often, asset allocation is even subdivided further within the asset class itself. With U.S. stocks for instance, large cap stocks are considered less volatile than small caps, and dividend paying stocks

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Frank Johnson, CFP

A RORSCHACH TEST FOR YOUR PORTFOLIO

IS IRRATIONAL BEHAVIOR AFFECTING YOUR INVESTMENT DECISION MAKING?

Scientists, who study such matters, inform us that modern man is neurologically wired exactly the same as our prehistoric relatives. When a contemporary investor experiences the fear and anxiety of markets plummeting, his net worth shrinking or his retirement plans fading, the physiological response is much the same as our ancient relatives would experience when unexpectedly coming face to face with a saber-toothed tiger or woolly mammoth – the fear center in the brain will respond involuntarily and unconsciously by flooding stress hormones into the bloodstream. In a matter of milliseconds, these stress hormones will elevate the blood pressure, increase the pulse, stimulate the eyes to widen, and increase muscle tension in preparation for a “fight or flight” response to that which we perceive as a threat to our well being. In so many words, when facing a frightening situation, humans are hard-wired to surrender much of what makes us rational creatures and instead respond in a nearly pure, biologically driven emotional response. Behavioral finance researchers have uncovered a great deal of evidence in academic studies which demonstrate much of our financial decision making judgment is irrational, inconsistent, and incompetent. We are not the overly logical, rational minded species we think we are. Often, our decision making is biased and influenced by a myriad of psychological factors. With so much fear and anxiety dominating today’s financial markets, it may be an appropriate time to take a quick glimpse at how irrational emotional factors could be influencing our financial decision making.

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Laurence Burnette, CFP

THE 4 PERCENT SOLUTION GAUGING YOUR ANNUAL EXPENSES IN RETIREMENT CAN BE TRICKY



Rules of thumb and guidelines abound in every investment arena – you will always hear about specific percentages you should save, spend or invest based on where you are in life. They are made to draw attention to specific investment needs everyone has, and for that reason, it is good to have them. A popular one is that no one should spend more than 4 percent annually of the value of their retirement nest egg in any given year. Another is that retirees only need 70-80 percent of their last working year's income to maintain their standard of living. The reality is that everyone's retirement goals are different and should be planned based on specific needs, not general rules of thumb. This is why retirement plans should be made with the aid of experts in tax, estate and investment issues. A good starting point would be a meeting with your CFP professional advisor who could go over your personal situation and define particular percentages that can be withdrawn from your overall retirement savings while you continue to work or relax. A downside of not planning your retirement withdrawal is that you may outlive your retirement savings. Wachovia's recent fourth annual Retirement Survey showed that many retirees enter their post-working years with no idea – or limitations – on how much of their retirement savings they will spend on an annual basis. The financial firm reported that 28 percent of surveyed retirees with average total savings of \$375,000 withdraw 10 percent or more of their retirement savings annually to pay for expenses. Further, only one-third (38 percent) pegged their withdrawal rate at 5 percent or less. Only about half (47 percent) said they had a written withdrawal strategy, and only 28 percent said they have a written budget for spending their savings.

Here are some suggestions to assist in determining an appropriate amount to withdraw each year in retirement:

Define a vision of retirement and revisit it every year: Anyone who has worked with a good investment manager or financial planner has addressed the kind of retirement they envision. Incorporating part-time work into the retirement picture might make other financial goals more affordable. A person who manages his or her finances or works with an expert needs to revisit those goals annually to assess the feasibility of affording a particular lifestyle in retirement.

Track working-life expenses for 3-6 months: This is where that vision of retirement becomes real. Understanding what an individual spends on lifestyle choices may motivate an investor to shift his behavior from spending to saving.

Create a worst-case health scenario: For many retirees, increasing healthcare expenses and the cost of end-of-life-care account for significant spending. As a result, many retirees may pay for expensive experimental treatments to fight disease or long-term assisted living or nursing home care. According to AARP, annual nursing home costs will be at more than \$100,000 a year in the next two decades compared to their current annual range of \$45,000-\$80,000+. While public aid picks up medical expenses for those who exhaust their assets in most states, most of us desire more than minimal standards of care.

Shift into a retirement investment strategy in stages: It goes without saying that the younger you are when you start saving for retirement the better. With a clear majority of investors having inadequate retirement funds in place near or at retirement age, it may seem silly to talk about investing post-retirement, but it is important. Good advisers can help build more balanced portfolios that fit the exact needs of the investor, both before and during retirement.

See how long you can put off taking Social Security: The Wachovia study also reported that the majority of respondents planned to start taking Social Security benefits at age 62, the earliest point possible. Another 17 percent reported taking Social Security benefits at age 65. Only 9 percent reported delaying Social Security benefits past age 65. Even though no one will get rich off of Social Security, delaying taking those payments will result in larger payments later, but get advice to see if that decision is right for you.

This column is provided by Laurence C. Burnette, CFP, a member of the Financial Planning Association.

**“IRRATIONALLY HELD TRUTHS MAY BE MORE HARMFUL
THAN REASONED ERRORS.”**

Thomas Henry Huxley



The following are some of the most common cognitive errors identified by behavioral finance experts:

Follow the Crowd – or the Lemming Syndrome. Jumping on the bandwagon is a near universal trait in the human species. Researchers tell us that investors follow both the crowd and conventional wisdom to avoid feeling regret in the event that their personal decision proves to be incorrect. It is much safer to buy a hot stock, or dump a stock everyone says is a loser, because in the event your own investment decision proves to be wrong, you can always rationalize that everyone else made the exact same mistake. There is safety in numbers, and no one likes to stand out from the crowd as the lone dissenting voice, or as Warren Buffet so aptly put it, “It’s only when the tide goes out that you learn who’s been swimming naked.” Many economists identify the lemming syndrome as being the central contributing factor in the undervalued and overvalued extremes of markets - the lemming falls victim to following other lemmings in great monolithic waves of greed and fear which sway markets to extremes.

Endowment – or the Benefactor Syndrome. When securities are given to an heir, the heir tends to feel obligated to keep the securities. Psychologists tell us many people suffer a sense of guilt or betrayal when they sell securities that were willed to them upon the death of a loved one because the asset represents much more than just a stock certificate or bond, it represents an entire range of emotional ties to the deceased. Behavioral finance experts advise benefactors to attempt to focus on the monetary value of the inherited asset and not the particular security itself

Overconfidence – or the Mr. Smarty-Pants Syndrome. Researchers theorize that ego plays a large role in peoples’ tendency to speculate. Overconfident investors suffer from an illusion of superior knowledge and skills which they think other investors lack. Overconfident types remember all their successes, but have an uncanny ability to filter out all their past failed investment decisions. Those suffering the syndrome have a tendency to trade too much and assume too much risk. Psychologists report men, as a general rule, have much larger egos than women; hence, probably why the term is Mr. Smarty-Pants and not Mrs. Smarty-Pants. The overconfident investor should keep in mind that in every speculative trade there is an opposite, well-informed participant who is assuming a contrary position- and that other trader is betting you aren’t as smart as you think you are.

Attachment – or the Touchy-Feely Syndrome. This bias can lead investors to become overly loyal to some of the securities they have held in their portfolio over an extended period of time. It is almost as if the investor forms an emotional bond with the asset. Many people suffering this inclination have a deep and wide knowledge of a particular favorite stock - they can recite the history of the stock, its ups and downs, managerial leadership, etc. Often, local stocks become the favorite of those with an attachment soft spot. The close proximity allows the investor to follow their “pet” investment in his/her local media and therefore nurture an even deeper association with the stock. Attachment bias is one of the central traits of the lackadaisical “buy and hold” investor. Shareholders with an attachment predisposition tend to focus on a security’s good traits and gloss over much of the bad news regarding the security. In the face of objective, analytical criticism of their pet stock, the typical retort is that it is “their” stock and they are sticking with it no matter what!

While this short list of investment prejudices is in no way comprehensive, every investor owes it to themselves to have their portfolio examined from a psychological angle to determine if irrational emotions are influencing their investment decisions. The best way to identify most emotionally driven investment errors is to have a financial expert make a purely objective assessment of your portfolio. You may be surprised how irrational and human you are.



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offer a different value in comparison to stocks that don't distribute some of their cash flow. So even within the same asset class, diversity can help to limit the volatility or risk. A wide spectrum of diverse investments that are continuously being re-balanced helps to stabilize the portfolio and reduce the overall volatility. Investors want to be able to enjoy the gains of volatile markets without exposing themselves to unnecessary levels of risk. As we said earlier, the only way to completely eliminate risk in your portfolio would be to invest solely in cash or cash equivalents such as CDs - but if you followed such a strategy you would lose greatly on the reward side. Historically, stocks have far outperformed stable value investments. Perhaps the worst advice an investor could follow, especially in times when markets are highly volatile, is in the theory that you can limit risk by buying and selling investments at just the right time. Chasing performance, or trying to time markets by jumping in and out of investments is almost always a losing proposition. Selling poorly performing investments when markets turn south will often do nothing more than turn a short-term loss into a permanent loss. Market gains and losses tend to come in short, compacted time frames, and if an investor misses out on even a small part of a market's rebound, the long-term loss on return is dramatic. The following data demonstrates the advantage of taking a long-term view and staying invested in a market:

An investment of \$10,000 in the S&P 500 Index in 1982 would have grown to an account balance of \$93,075 by the end of the twenty year period in 2001. Now, consider the results if the investor had left the market for even a short period of time and missed some of the best-performing days during this twenty year period.

- *An investor who missed just the 10 best-performing days in the market resulted in an account balance of \$56,044. A loss of \$37,031 compared to investors who had remained in the market.*
- *An investor who missed just the 30 best-performing days in the market resulted in an account balance of \$28,144. A loss of \$64,931 compared to investors who had remained in the market.*
- *An investor who missed just the 50 best-performing days in the market resulted in an account balance of \$15,781. A loss of \$77,294 compared to investors who had remained in the market.*

Source: "The Best Advice of All Time," *Money Magazine*, Sept. 2007

Changing economic events, mixed with a client's risk tolerance and investment time horizon are all factored into repositioning assets within a well-allocated portfolio. Achieving superior returns with low volatility requires constantly reconfiguring assets dependent upon a nearly endless laundry list of facts and events - capital market expectations fluctuate daily, weekly, and yearly. With the proper portfolio construction and management, volatility can be limited and that should make it easier for an investor to ride out any downside market moves. Investors should remember market returns are not always positive over the short term. Volatility and price movements are a fact of life in any market. Old sailors claim that during severe storms, seamen should stay focused on the distant horizon and never look at any approaching menacing swells. They contend it will help you to stay relaxed and make the ride seem more tranquil. The old sailor's advice may be very appropriate for today's investors.

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