Finding a Balance between Risk and Return

One of the most basic investment principles is that returns reward you for the risks that you take. While investors are often uncomfortable with the concept of risk, it is this uncertainty that makes higher rates of return possible. Some basic investment principles related to risk and return include:

✔ Returns on specific investments are not known in advance. Investors can review historical rates of return, but there is no guarantee that past returns will be indicative of future returns.

✔ With most investments, there is the possibility that the investment will not meet your return expectations.

✔ The uncertainty regarding your actual return creates risk. Greater uncertainties typically lead to greater risk.

✔ Investments are subject to many different types of risk. Cash is primarily subject to purchasing power risk, or the risk that its purchasing power will decrease due to inflation. In addition to purchasing power risk, bonds are subject to interest rate risk, or the risk that interest rates will increase and cause the bond’s value to decrease, and default risk, or the risk that the issuer will not repay the principal or interest on the bonds. Stocks are primarily subject to nonmarket risk,

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Hanover Group at Morgan Stanley Smith Barney News

We’ve Moved

As of August 30, 2010, we are located at 203 Heater Road, Lebanon, New Hampshire, just off Route 89. We are consolidating office space with our new colleagues at Morgan Stanley Smith Barney. Please note the new address and phone numbers above.

Congratulations

Congratulations to John and Maribel on the birth of Francisco William on July 6. Mom, Dad, “Paco,” and big brother, Jackson, are doing well. Sleep is a more precious commodity now, but all are enjoying the expanded family.

Mailbox Overload?

Is the amount of statements and paperwork becoming too large to store and securely destroy once they are no longer necessary? You can reduce the amount of mail we send you by enrolling for E-Delivery of statements and other mailings. (We recommend paper copies of 1099s.) Once enrolled, you receive an e-mail informing you of a digital copy of mailings available through our online account access website. For more information, go to http://www.fa.smithbarney.com/hanovergroup, and click on “Go Paperless” on the right side of the screen. Please contact Mairi with any questions.

Morgan Stanley Smith Barney

MARK B. SEVERS, CFP®
Senior Vice President – Wealth Management
Senior Investment Management Consultant

JOHN T. SOUTHER, CFA
Financial Advisor

MAIRI A. BRAYTON
Client Service Associate

203 Heater Rd.
Lebanon, NH 03766
603-442-7900  800-829-5232
603-442-7988 Fax
TheHanoverGroup@mssb.com
www.fa.smithbarney.com/hanovergroup

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or the risk that events specific to a company or its industry will adversely affect a stock’s price, and market risk, or the risk that a particular stock will be affected by overall stock market movements.

✔ There is generally a tradeoff between risk and return. Low levels of risk are the most desirable and typically have lower return potential, while higher levels of risk are typically undesirable, so they must offer higher return potential to encourage investors to invest. Be cautious of claims of high returns with low risk.

There are strategies that can be used to reduce the total risk in your investment portfolio:

✔ Diversify your portfolio. You should diversify among several different investment categories, including cash, bonds, and stocks, as well as within investment categories, such as owning several types of stocks. A properly diversified portfolio should contain a mix of asset types whose values have historically moved in different directions or in the same direction with different magnitudes. By owning several investments rather than just one, a downturn in any one should not have a significant impact on your total return. However, diversification does not assure a profit or protect against loss in declining financial markets.

✔ Stay in the market through different market cycles. Remaining in the market over the long term helps to reduce the risk of receiving a lower return than expected, especially for more volatile investments, such as stocks.

✔ Use dollar cost averaging to invest. Rather than accumulating cash so you have a large sum to invest, invest small amounts regularly. Dollar cost averaging involves investing a certain sum of money in set amounts at regular intervals. This spreads your purchases over a period of time, preventing you from making one major purchase at high prices. Since you are investing a set amount, you purchase more shares when prices are lower and fewer shares when prices are higher. While a valuable investment strategy, dollar cost averaging does not ensure a profit or protect against losses in declining markets. Before starting a program, consider your ability to continue purchases during periods of low price levels.

If you’d like to discuss how to balance risk and return in your portfolio, please call.

Protecting Your Family

Without an up-to-date estate plan, you could end up bequeathing part of your estate to an ex-spouse, disinheriting your own children, leaving less than you intended to your current spouse, or paying too much in estate taxes. Fortunately, there are a number of estate planning tools that can help avoid these unintended consequences.

✔ Disinherit your ex-spouse — To avoid accidentally bequeathing part of your estate to your ex-spouse, review how all assets are titled and check beneficiaries on all life insurance policies and retirement accounts. Update estate planning documents, removing your ex-spouse.

✔ Protect your own children — Consider a trust for the benefit of your children. Even if one or more of your children predecease your ex-spouse, their inheritance can go to their children or be split up among the trust’s other beneficiaries.

✔ Provide for your current spouse — If you leave your estate to your current spouse without explicitly providing for your own children, your estate could end up in the hands of your spouse’s children when he/she dies, leaving your children out of the picture. A qualified terminable interest property (QTIP) trust can help prevent that from happening. A QTIP trust can pay income and part of the principal to your current spouse for the remainder of his/her life, and then transfer the remaining assets to your children when your spouse dies.

✔ Minimize estate taxes — If an insurance policy is set up properly, the proceeds are distributed free of both income and estate taxes. Another benefit is that the life insurance policy can be used to pay proceeds to specific beneficiaries you designate.

✔ Protect your individual assets — If you’re heading into marriage, a prenuptial agreement can detail what will happen to your individual assets in the event of divorce or death. Think carefully about holding property jointly. No matter what your estate planning documents state, property held in joint tenancy with rights of survivorship passes to the other owner.

Blending families is not an easy task. Making estate-planning decisions in a blended family environment can be complex, but it is a subject that should not be ignored. Please call if you’d like to discuss this topic in more detail.
A common rule of thumb when planning for retirement is to save 10% of your gross income during your working years. Since this rule of thumb has been around for a long time, it’s logical to question whether it’s still an appropriate guideline. Several trends suggest that it is probably on the low side:

✔ Fewer individuals are covered by defined-benefit plans. The 10% guideline anticipated that a retiree would receive a defined-benefit pension as well as Social Security benefits. But a substantial portion of the work force is no longer covered by a defined-benefit pension.

✔ The Social Security system will face increasing pressure in the future. Due to the unprecedented number of baby boomers that will be retiring in the near future, there will be fewer workers to pay the benefits for each retiree. By 2037, unless changes are made to the system, benefits will need to be reduced by approximately 25% to equal revenues collected (Source: Social Security Administration, 2009).

✔ Life expectancies are continuing to increase. Average retirement ages have been decreasing while life expectancies have been increasing. Currently, at age 65, the average life expectancy is 82 years for a man and 85 years for a woman, compared to 78 years for a man and 81 years for a woman in 1950 (Source: Journal of Financial Planning, August 2008). Thus, the average retiree has fewer years to accumulate savings, but those savings must last for a longer period of time.

Is 10% Enough?

✔ Plans for retirement have changed. Another common retirement planning rule of thumb is that you’ll need 70% of preretirement income during retirement. (Source: Money, January 2009). However, that guideline assumed a relatively inactive retirement lifestyle. Increasingly, retirees view retirement as a time to travel extensively or engage in expensive new hobbies. Thus, more and more retirees are finding little change in their income needs after retirement.

All these trends point to the fact that future retirees will be responsible for providing more of their income for a longer period of time. Thus, you should consider higher, not lower, savings rates. While 10% of income may sound like a lot of money, consider how many years you expect to work compared to how many years will be spent in retirement. Assume you start working at age 22, work until age 62, and then die at age 82. Thus, you work 40 years and are retired for 20 years — for every two years you work, you need to support yourself for one year in retirement. If your retirement expenses don’t go down and you don’t have a defined-benefit pension, you’ll most likely need to save significant sums to support yourself for that length of time.

Contrast the current situation with a typical scenario in 1950. At that time, the average retiree worked 47 years before retiring for nine years. Thus, that person worked over five years to support one year of retirement.

For many people, then, the answer may be to extend their working years. In the above example, if you wait until age 70 instead of age 62 to retire, you will work for 48 years and be retired for 12 years. Thus, you will work four years for every year of retirement. While preretirees may not have the mathematics down, many realize that working longer, rather than retiring earlier, may be the only way to ensure that they don’t run out of retirement funds. Almost all recent surveys of baby boomers indicate that the majority expect to work at least part-time during retirement.

These stark realities don’t mean that you can’t retire, just that you need to plan carefully. Thus, you should start saving as much as possible, as soon as possible, for your retirement. Waiting even a few years to start saving can substantially increase the annual amount you need to save.

Trying to gauge whether your retirement savings are on track? While there’s nothing like going through a thorough analysis, you can take a quick look by adding up all your retirement assets and multiplying that balance by 3% or 4%. This withdrawal percentage should ensure that your retirement assets last for several decades. If you’d like to discuss retirement planning, please call.
The subject of income taxes is one that most people prefer to ignore. However, since income taxes are a significant expense for most taxpayers, you should come to grips with some basics about taxes:

Realize you can exert some degree of control over how much you pay in income taxes. While you do have to file and pay taxes every year, how much you pay depends on the tax strategies used. Discuss your tax situation with a tax professional, reviewing ways to help reduce your income tax bill.

Understand basic tax concepts. You don’t have to become a tax expert, but you should have a basic understanding of the tax laws so you recognize when you need assistance. Before any major financial transaction, such as selling a home or investments, review the tax ramifications.

Don’t make decisions solely for tax reasons. While you want to minimize the payment of income taxes, that is only one factor in most financial decisions. You should first make sure the transaction is economically beneficial and then decide how to minimize the potential tax effects.

Keep good tax records. During the year, file any records with possible tax ramifications. That way, when it comes time to file your income tax return, all your tax records will be located in one place and you won’t forget a deduction.

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