

FINANCIAL PORTFOLIO PLANNING:

DESIGNING YOUR FISCAL HOUSE

TO WEATHER THE ELEMENTS

Prepared for:



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DESIGNING YOUR FISCAL HOUSE TO WEATHER THE ELEMENTS

Designing a home is more than just planning out the interior floor plan. There is also the challenge of building a home that can withstand the external elements. The same can be said for a financial portfolio. Over time, our financial assets must weather a multitude of uncertain conditions, including market swings, economic downturns, fluctuating interest rates, rising inflation and changes in our own lives.

Building a strong, flexible, renewable and sustainable financial portfolio is a lot like building a weather-resistant home. The overall strength of a house is dependent on how well its components — the walls, floors, roof and foundation — work together as a singular unit.

FISCAL HOUSE DESIGN: START WITH A STRATEGY

To build a home, you start with a full set of construction drawings. This is the blueprint that details not only what your house will look like, but all of the individual components that will integrate to create the home. Obviously, you don't just start with one room and then add on later. You design the whole house at one time. To do so, you must first consider all of your objectives for the house, including the specific components and features that you want in the house — and those you don't. With these objectives in mind, you and a professional designer would work together to draw a plan that includes every room and every detail of each room until you have a full set of construction plans, plus a list of materials and resources needed to build the house.

Likewise, a financial portfolio comprises a foundation, walls, roof and even fencing. When designing your fiscal house, you must begin with the foundation, because without a strong foundation, the house may crumble.



Foundation

The foundational elements of a financial portfolio are typically the most protected assets — money you can't afford to lose. This is the money you need to pay your bills, to eat and to keep a roof over your head — now and in the future. In your fiscal house, the walls and roof are the elements that could be rebuilt over time, but the foundation is the element needed to provide stability for the rest of the house.

Generally, the financial products that make up the foundation include:

- Checking, savings, CD accounts — protected by the Federal Deposit Insurance Corporation
- Government bonds — protected by the U.S. Treasury Department
- Traditional fixed and fixed index annuities — protected by the financial strength and claims-paying ability of the issuing insurance company

Widely regarded as the leading sage on investing, Warren Buffett sets this primary rule of investing: Don't lose money. The foundation of your fiscal house is what provides the protection that will help you adhere to this rule and contains the products commonly used to generate a steady and reliable income.

Walls

The walls of a financial portfolio represent the first level of risk in a portfolio. They are composed of investments that can provide various benefits, like income, cash flow and inflation protection, but unlike the assets in the foundation, they are subject to risk including the loss of principal. It's important that the walls are coordinated with assets in both the foundation and the roof because frequently they represent hard-working elements that may contribute significantly to your goals with a moderate level of risk. Some of the investments that may compose the walls of a portfolio include:

- Corporate bonds
- Municipal bonds
- Hard assets, such as oil, natural gas, gold, silver, farmland and commercial real estate (some oil and gas, gold and silver as a commodity do not provide income)
- Private real estate investment trusts (REITs)

Roof

The roof of your fiscal house is represented by the highest level of risk your portfolio can tolerate. These investments provide growth opportunities, but your principal and any capital appreciation can be lost during periods of declining values due to market forces beyond your control — similar to the way a thunderstorm or hail storm could damage the roof of your home. This is why it's so important to incorporate into your financial portfolio design a sound foundation and strong walls. If the roof is ever damaged due to market volatility, it should not cause the entire fiscal house to crumble. Assets that make up the roof may include:

- Stocks
- Mutual funds
- Exchange-traded funds
- Options
- Commodities

Fencing

Finally, as a means to help protect your loved ones after your death, you may want to consider building a fence around your fiscal house, represented by life insurance. The death benefit provided by life insurance can help replace your lost income, help your family cover the various taxes that may be due on your assets and, of course, help with the funeral and other final expenses. Annuities can also be an option by providing steady and reliable income for the rest of your life — and that of your spouse.

OPPORTUNITY COST

It may be tempting when constructing your fiscal house to simply steer clear of any risk, but that would open you up to opportunity costs. Also known as shortfall risk, opportunity cost is when a portfolio does not contain financial vehicles that provide the opportunity for a higher total return. In other words, while investing in stocks will subject your portfolio to risk, if your primary objective is growth (to help an investor work towards their long-term objectives) not including stocks runs the risk of lower total returns.

BUILDING STRATEGIES

An experienced builder has at his or her disposal the knowledge and necessary tools to build a strong, weather-resistant home. Likewise, a knowledgeable financial professional can help you select the appropriate financial tools and allocation strategies to design a financial portfolio that seeks to weather the ups and downs of the market.

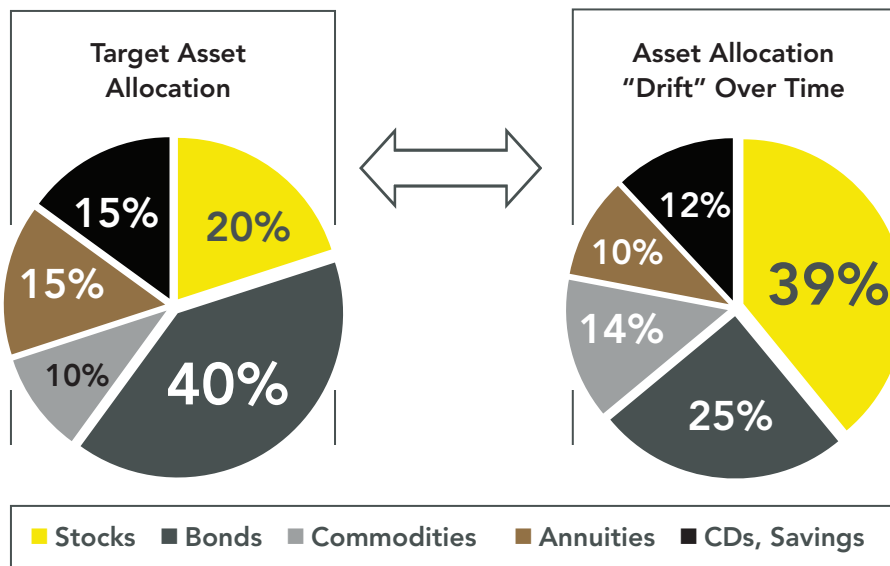
Asset Allocation

While the fundamental tools, materials and plans for two different houses may be similar, every home is unique. To work toward meeting your unique needs, you may want to allocate your assets among various financial vehicles, including stocks, bonds, commodities, annuities and CDs. This is called asset allocation.

The key to effective asset allocation is to determine what combination of assets is appropriately suited to help you pursue your financial goals within your time frame, and then periodically rebalance your portfolio to maintain these allocation percentages. Failing to do so may cause your portfolio to “drift” outside your desired allocations based on performance differences, as illustrated in the accompanying pie charts.

RULE OF 100

The Rule of 100 is an often-cited rule of thumb that recommends you subtract your current age from 100 to arrive at the maximum percentage you should invest in risk-based assets. For example, if you are 65, the Rule of 100 would recommend investing no more than 35% ($100 - 65 = 35$) of your portfolio in stocks.



This hypothetical example is provided for illustrative purposes only and does not represent a real life scenario.

When you periodically rebalance your portfolio, be sure to keep these points in mind:

- Recent interest rate movements and their impact on bonds
- Buying low, selling high
- Tax ramifications of capital gains and/or dividend income
- Selling losses to offset gains
- Your age and changing objectives

Diversification

Within each asset class, you have a wide range of financial vehicles from which to choose. To help protect your portfolio against the risk of any one poorly performing

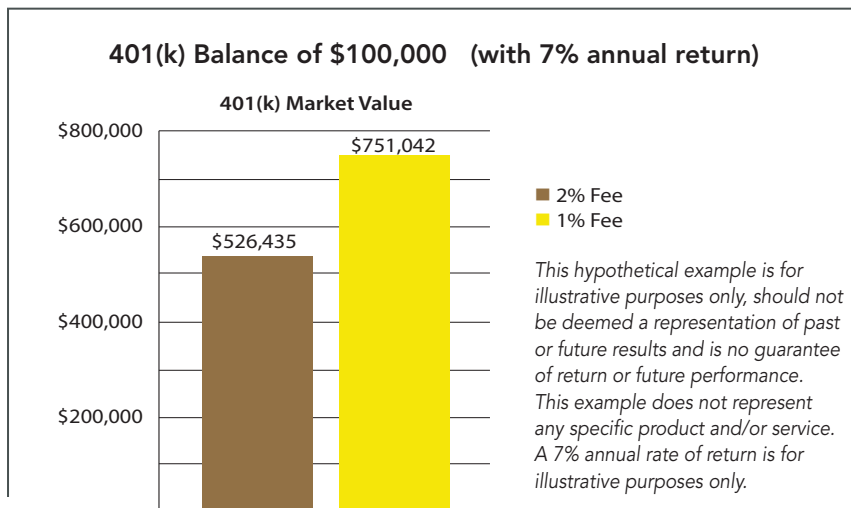
vehicle, it is generally a good idea to select a variety of different financial vehicles in each asset category. While you may have different asset classes within your portfolio (stocks, bonds, cash, insurance), recognize that your financial vehicles are not well-diversified if, for instance, you only hold one stock, one bond and one money market instrument. Diversification is the strategy of spreading your dollars across a spectrum of different holdings in each asset class.

Diversification can apply to various portfolio strategies, such as:

- Global diversification (domestic and international securities)
- Tax diversification (taxable and tax-deferred accounts)
- Location diversification (individual retirement accounts, or IRAs, 401(k) and brokerage accounts)
- Management diversification (i.e., Bernie Madoff risk)
- Timing diversification (ladder bonds, CDs)
- Product diversification (securities and insurance contracts)

Cost Management

An investor may become so focused on diversifying across a number of financial vehicles that he ignores how much this wide variety is costing him. If you go over budget when building a house, you may have to cut back in some areas — such as less expensive doors, appliances or landscaping. When it comes to your financial assets, management and holding fees can impact your return and possibly the chances of meeting your goals within your anticipated time frame.



For example, assume you have a 401(k) balance of \$100,000 with a 7% average annual return. If the fees to manage and administer this plan total 2%, after 35 years the balance would be \$526,435. However, if fees were 1% less for a total of 1%, the investment would be worth \$751,042 in the same time frame — an increase of 42.7%.

Be sure to ask about the “construction and maintenance” costs related to each financial vehicle you consider for your portfolio.

INDEXING One strategy that can help a portion of your fiscal house be low maintenance is to purchase index-linked vehicles. Indexing is a strategy that attempts to track the performance of a specific market index. For example, a fixed index annuity combines tax deferral and the potential for interest based on positive changes of an external index. The insurance company issuing the annuity uses a crediting method to track the performance of the chosen index or indexes during a specific period. At the end of each time period, the company calculates the indexed interest. If the result is positive, the annuity is credited interest up to a predetermined amount. If the result is negative, nothing happens — the annuity’s value doesn’t decline.

With a fixed index annuity, the interest credited on your contract may be affected by the performance of an external index. However, your contract does not directly participate in the index or any equity or fixed interest investments. You are not buying shares in an index. The index value does not include the dividends paid on any equity investments underlying any equity index or any interest paid on any fixed income investments underlying any bond index. These dividends and interest are not reflected in the interest credited to your contract.

Just as you wouldn't give a builder carte blanche to build your home whenever he gets around to it, **it's important to consider your timeline** in order to select appropriate financial vehicles.

Timeline

When building your fiscal house, prepare a time frame in which you want to meet certain objectives. Just as you wouldn't give a builder carte blanche to build your home whenever he gets around to it, it's important to consider your timeline in order to select appropriate financial vehicles. For example, stocks offer the opportunity for higher returns but are best deployed over a longer time frame to offset short-term risk of loss. When establishing your retirement timeline, take into consideration your current age, the age at which you would like to retire and the amount of income you'll need at that time to meet your lifestyle goals.

Risk Management

Risk management in a fiscal house is like installing insulation to protect your walls, floors and ceilings from the elements such as market losses or inflation. Risk management strategies and insurance products that can play a role in those strategies may include:

- Diversification
- Growth components to help keep pace with inflation
- Liquidity for access to your money if necessary
- Guaranteed income contracts

Remodeling

In the same way you take on home remodeling projects to keep your home updated and working for you, your fiscal house strategies should be reviewed at minimum on an annual basis to help ensure your portfolio stays on track to meet your needs. You wouldn't take on a remodeling project without considering what goals you want to achieve — such as updating, a more convenient layout, cost efficiency and market value — so be sure you know what your goals are before making

any changes to your asset allocations. And while doing it yourself is all the rage in home remodeling, it may not be your best call when it comes to your fiscal house. An experienced advisor can help you determine what changes make sense based on the objectives you hope to achieve.

Sustainability

How long do you need to maintain your fiscal house? In other words, how long do you expect to live and need your portfolio to provide retirement income? Your fiscal strategy should include elements of sustainability to help ensure that you do not spend down your retirement assets too soon. The following are a few sustainability strategies to consider:

- Coordinating your distribution plan with your Social Security benefits
- Repositioning wealth with an IRA rollover
- Whether to draw income from taxable or tax-deferred accounts first
- The decision to take a lump sum in lieu of pension benefits
- Tax implications related to job income, required minimum distributions and Roth IRA conversions
- Utilizing products that provide a steady and reliable stream of income
- The sustainability of lifetime income for the surviving spouse
- Leaving a legacy to loved ones or charitable organizations

Remember, these strategies can impact more than your retirement income. They can have tax and legal consequences as well, which is why it is important to consult with a team of professionals, including a financial advisor, insurance professional, tax professional and attorney.



THE BIG PICTURE

One of the most important aspects of building your fiscal house is to include every element of your financial picture. It is common for consumers to have their portfolio spread out among many different financial vehicles with no centralized strategy or management. For example, you may have a financial advisor who manages your investment portfolio, an IRA you manage yourself, a 401(k) at work managed by individual fund managers and insurance policies you've purchased over time that have not been reviewed in years.

To get your fiscal house in order, all of these components should be reviewed regularly as part of an overall strategy. After all, your personal financial strategy is not truly complete if it does not take into account assets you hold in your IRA or 401(k) plan. The details of each component of your financial strategy are important, but only inasmuch as they work within the big picture.

Much as you would build a house to suit the needs of your family, your fiscal house requires at least that much time and attention — and more. After all, fiscal house upkeep is similar to maintaining a home; it's not something you build and never think about again. There are constant tweaks, upgrades and even occasional repairs that must be made, and the ever-constant vigilance to protect and enhance the value it provides you.

This same philosophy applies to your fiscal house.



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