Wealth Management

INVESTMENTS, ADVICE & TRUST SERVICES

CEFCU Wealth Management

7900 N. University Street
Peoria, IL 61615
309.633.3836 or
1.800.633.7077, ext. 33836
Fax 309.633.2588

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The High Cost of Investor Error

Market volatility poses a substantial risk to your investments. But an even greater risk may be the mistakes investors make on their own. Although you can't control market performance, you can avoid missteps, such as the ones discussed below, that may derail your portfolio's performance.

Ignoring Inflation

For a long-term investor, even modest inflation is likely to have an impact on portfolio returns. While past performance is no guarantee of future performance, stocks typically offer the best chance for earning returns that keep pace with increases in the cost of living. Although equity investments involve risk, including them in a portfolio generally offers the best opportunity for potential growth.

Failing To Diversify

Inflation is not the only threat to a portfolio. Investing in only a few companies or in a single market sector exposes a portfolio to another kind of risk — the risk that those investments could lose value, without gains from other investments to help cushion the losses. Diversifying a portfolio with a mix of large-cap, small-cap, and other stocks, along with bonds and cash investments, can help manage risk. If one sector of the economy or one investment class is not performing well, other investments may help compensate.*

Focusing Only on Current Performance

Investors may be tempted to buy an investment that is performing well during a strong market. But just because an investment is thriving in a bull market doesn't mean it has long-term potential. Comparing several years of returns with the returns of similar investments and a benchmark index provides historical perspective. An investment that has held steady in a down market or performed relatively consistently under a variety of market conditions can be a good portfolio choice.

** Diversification does not ensure a profit or protect against loss in a declining market.*

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European QE

Earlier this year, the European Central Bank (ECB) announced that it will engage in its own version of quantitative easing (QE) to head off the consequences of potential deflation. The ECB is committing at least $1.1 trillion euros to this bond buying campaign. Mario Draghi, the ECB president, felt that this program was necessary to address the stagnant European economy.

Since the announcement of the European QE, the euro has continued its slide against the U.S. dollar. The euro was worth $1.20 in early January and stands at $1.06 as of the date this article was written.

The weakening of the euro should be a boon to European exports but has dampened European stock returns for U.S. investors due to the euro's declining value. The weaker euro could also be a drag on net income, at least over the short haul, for U.S. companies that do significant business in Europe and do not have adequate currency hedging strategies in place.

By Sheldon Reynolds, CFA

Are You Adequately Insured?

To protect your wealth, your family, your business, and your legacy, it's critical to have adequate insurance coverage. Consider the following situations.

Liability Coverage

You may have already purchased the maximum amount of coverage on your vehicles and your home(s). But you can further protect your assets by purchasing an umbrella or excess liability policy. You might consider adding directors and officers liability coverage if you serve on a charity's board or employment practices liability insurance if you have household staff.

Life Insurance

Life insurance can serve many financial needs beyond providing income after the death of a breadwinner. For example, you might use life insurance to replace an asset in your estate that you plan to leave to a specific individual. Or you might create a life insurance trust to transfer assets to younger heirs who may not be ready to manage a large inheritance. You could also arrange for insurance proceeds to benefit a charity or fund a buy-sell agreement for your business.

An Insurance Checklist

Reduce insurance premium costs and ensure you're adequately protected by conducting an insurance review.

Pay attention to deductibles. Consider how much you could pay out of pocket for a loss, and estimate how much you could save with a higher deductible.

Bundle your policies. Besides affording multiple policy discounts, insuring with a single carrier can prevent coverage gaps.

Understand your risks. Risks could include inexperienced drivers, entertaining in your home, hiring contractors, owning animals, serving on nonprofit boards, posting/blogging on social media, operating a home-based business, traveling out of the country, and chartering/leasing an aircraft as a pilot.

Combine and Simplify

Maintaining your finances can be time consuming enough without having to keep track of multiple accounts. You can simplify the task by consolidating assets to make them more manageable.

Unintended Consequences

For most individuals, the proliferation of accounts may be inadvertent. Throughout your career, you may have accumulated money in more than one employer-sponsored retirement plan or individual retirement account (IRA). In addition, you may have personal savings and investments in banks, credit unions, and brokerage accounts. Having multiple accounts makes investments harder to monitor. And once you begin taking required minimum distributions (RMDs) from your tax-deferred retirement accounts, having several accounts can complicate matters for you.

Making It Easier

You can consolidate retirement accounts by rolling over balances from former employers' plans into your current employer's plan (if it accepts rollovers) or an individual retirement account. A trustee-to-trustee transfer avoids taxes and penalties on the funds you roll over.

When It's Just the Two of You

Estate planning can be challenging when there are no children to inherit a couple's assets. Deciding how property should be distributed and appointing someone to make medical and financial decisions in an emergency are important steps in the estate planning process.

The Basic Plan

A will that leaves all assets to the surviving spouse may be the foundation of each spouse's estate plan. But what will happen to the assets if there are no children to inherit them after both spouses die? If no provisions are made for the future disposition of the couple's property, loved ones may be disinherited or a favorite charity may be denied support.

Strategies To Consider

One option is for the spouses to specify in their respective wills the individuals or organizations that should receive their property if the other spouse is no longer living. This strategy allows the surviving spouse to benefit from the predeceased spouse's assets but leaves open the possibility that the surviving spouse could change his or her will to name different beneficiaries.

Alternatively, each spouse could create an irrevocable trust either in the will or in a separate trust document. Upon the death of the first spouse, the surviving spouse benefits from the trust assets. The trust document names the beneficiaries who will receive the assets when the second spouse dies.

Other Matters

Couples without children should think about whom they want to make financial and medical decisions for them if they become incapacitated. Spouses may appoint each other but, as a precaution, should also consider naming someone else they trust to serve simultaneously or in succession.

The "Other" Stock

When individuals talk about investing in "stock," they typically are referring to common stock. But there is another type of stock that may interest investors seeking current income. *Preferred* stock has characteristics of both common stock and fixed income securities.

Preferred shares typically pay dividends, often at a fixed rate. Like corporate bonds, preferred stocks are rated by the major credit agencies, and share prices are sensitive to interest rate changes. Some preferred stocks are "callable," meaning the issuing company has the right to redeem shares at a certain price after a specified date.

> ". . . share prices are sensitive to interest rate changes."

Preferred stockholders are paid dividends before common stockholders. So, if a company's profits are down, dividends on common stock would be suspended before dividends on preferred stock. And if the company declares bankruptcy or is liquidated, holders of preferred stock have a stronger claim on any dividend payments and corporation assets than common stockholders.

Preferred stock can be a valuable addition to an income portfolio. However, investors seeking potential growth might find common stock a better option.

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Not Defining Goals

Different goals require different types of investments. Income-generating investments can help investors save for short-term goals, such as buying a car or taking a special vacation. Equity investments with the potential to appreciate over time are appropriate for long-term goals, such as retirement. Identifying objectives in advance of choosing investments will help focus the selection process.

Overreacting to a Downturn

Although there should be criteria in place for selling an investment when it's not performing as expected, it's also important to avoid overreacting when the market declines. Taking money out of the stock market — even for a short period — may prevent investors from benefiting from a market rally. By not being invested when the market begins a recovery, investors could lose out on potentially significant gains.

Trading Too Frequently

Buying and selling investments too often can result in lower returns. For one thing, trading costs can eat into profits. For another, selling an investment before meeting the tax law's long-term holding period (more than one year) generally means the gain will be taxed at the investor's regular income-tax rate rather than at the more favorable capital gains tax rate.

Disregarding an Employer's Retirement Plan

Money grows tax deferred in an employer's qualified plan, so it's important to contribute the maximum amount possible — or at least enough to take advantage of any employer match. And rolling over the account balance to an individual retirement account or a new employer's plan when changing jobs helps avoid taxes and penalties and keeps retirement plan money tax deferred.

This publication involves sophisticated tax and financial planning concepts. Before applying anything you read to your situation, you should consult with your professional advisor.