MSM FINANCIAL STRATEGIES
Creating Customized Strategies For Achieving Your Financial Goals

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Coming to Terms with Stocks

With all of the volatility in the stock market over the past few years, it can be difficult to determine how to devise an investment strategy to help reach your financial goals. To help you determine a reasonable rate of return to expect on your stock investments, it might be instructive to review some facts about the stock market:

✔ **The stock market's historical return can change dramatically depending on the period considered.** For instance, from 1926 to 2022, the Standard & Poor's 500 (S&P 500) had an average annual return of 10.1%. From 1998 to 2022 (25 years), the average return was 7.7% and 12.4% from 2013 to 2022 (10 years).*

✔ **The market tends to revert to the mean.** There is a tendency for the stock market to revert back to the average return when it has an extended period of above- or below-average returns.

✔ **History may not be a good predictor of future returns.** The expected rate of return for your investment program is typically based on an analysis of past returns, since no one can predict future returns. However, realize those returns may not be replicated in the future. During much of the stock market's history, the United States was in a substantial growth phase as it evolved from a struggling nation to a superpower. Growth in the future may not approach those levels.

✔ **The pattern of actual returns affects your investment balance.** Even if you get the average rate of return exactly right, your portfolio's balance will depend on the pattern of actual returns during that period. Some years will experience higher-than-average returns, while other years will have lower or even negative returns. If you experience high returns in the early years, your portfolio's value will be lower than if those returns occurred in the later years. If you encounter negative returns in the early years, you will have a higher balance than if those negative returns came in the later years.

✔ **Historical returns do not include several factors that investors must deal with.** Two of

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The Need for an IRA

In addition to a 401(k) plan or defined-benefit plan from an employer, you may also want to contribute to an individual retirement account (IRA) for some or all of the following reasons:

✔ **You'll probably need the additional funds for retirement.** There are a variety of ways to save, but an IRA can be a good alternative.

✔ **You'll lower your taxes.** You can lower your taxes currently by contributing to a traditional deductible IRA or in the future by contributing to a Roth IRA.

✔ **You're more likely to use the funds for retirement.** The government discourages the use of IRA funds for other purposes by assessing a 10% federal income tax penalty when funds are withdrawn before age 59½ (except in certain limited circumstances). That makes it more difficult to withdraw the funds and more likely they'll stay in the IRA.

✔ **You have a wide variety of investing options.** With a 401(k) plan, you typically have a limited number of investment options. However, with an IRA, you can invest in a wide variety of investments. ❍❍❍

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Coming to Terms

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the most significant factors are inflation and taxes, which can significantly impact the value of your portfolio.

✔ **Investors have a difficult time earning historical returns.** Several studies have found that investors' returns tend to lag the overall market, since investors have a tendency to buy high and sell low.

What does all this mean to an investor? When designing an investment program, use a conservative estimated rate of return, since it may be difficult to earn the historical returns of the past. It's easier to start with a lower expected rate of return and find out later that your actual return is higher, which means you just need to save less. However, if you use a higher estimated rate of return than you actually earn, it may be difficult to increase your savings to make up for that difference.

Consider these strategies when designing your investment program:

✔ **Take a fresh look at your financial goals.** Reevaluate your goals, how much you need to reach them, and how much you should be saving annually based on lower expected returns.

✔ **Save more of your income.** If you can't count on returns to provide growth in your portfolio, you should compensate by saving more of your income. That may mean you'll need to work overtime or take on a second job to provide additional income. Another strategy is to reduce your living expenses and save the reductions.

✔ **Invest in a tax-efficient manner.** Taxes are often a significant investment expense, so using strategies to defer the payment of taxes can make a substantial difference in your portfolio's ultimate size. Utilize tax-deferred investment vehicles, such as 401(k) plans and individual retirement accounts. Or emphasize investments generating capital gains or dividend income rather than ordinary income. Minimize turnover in your portfolio so unrealized gains can grow for many years.

✔ **Adequately diversify your investment portfolio.** Typically, you do not know which asset class will perform best on a year-to-year basis. Diversification is a defensive strategy — it may help protect your portfolio during market downturns and help reduce your portfolio's volatility. Diversify your investment portfolio among a variety of investment categories such as stocks, bonds, cash, and other alternatives. Also diversify within investment categories.

✔ **Evaluate your portfolio's performance annually.** If returns are lower than you targeted, you can make adjustments to your strategy in the coming year to compensate for these variations in return.

Please call if you'd like to review your investment program. ❍❍❍

* Source: dqydj.com. The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future returns.

Principles of Stock Diversification

The best way to reduce risk in stock portfolios is to diversify. To make wise investment decisions, investors must be aware of the two types of risk they face: **undiversifiable risk,** or market /systematic risk, like inflation, interest rates, exchange rates, political instability; and **diversifiable risk**, which is the unsystematic risk specific to a company, industry, market, or country. Undiversifiable risk is assumed by all investors and nothing can be done to mitigate it, but diversifiable risk can be managed with a diversified portfolio.

To reach your long-term financial goals and avoid taking risks that threaten those goals, most experts agree that diversification is key. A properly diversified equity portfolio should contain stocks from different industries, valuations, growth rates, countries, and even company sizes to reduce volatility and your exposure to loss of capital. The more unrelated the stocks in your portfolio, the less likely they will be subject to the same risk.

Like most things, there is no definitive number of stocks that applies to all situations, but most experts agree that 15 to 20 stocks across different industries is optimal. And while diversification is a crucial part of a good portfolio, overdiversification leads to its own complications.

Overdiversification occurs when the investor holds a large number of stocks, which makes it very difficult to know the individual companies well. When there are too many companies to keep track of, the investor is at greater risk of making irrational decisions that could negatively impact the return on their portfolio. If your portfolio contains 100 stocks, there may be less overall risk that one stock loss harms your return, but there will also be less benefit from a great investment. Striking an appropriate balance that keeps you knowledgeable about and engaged with your investments across a varied amount of industries is essential to reaching your long-term goals.

Diversifying your stock portfolio will help you manage the risk of the price movements of your assets, but it can't completely eliminate risk and volatility. ❍❍❍

Should You Borrow from Your 401(k) Plan?

For many people, their 401(k) account represents one of their largest financial assets. While designed to provide a source of income in retirement, the Internal Revenue Service (IRS) allows plan sponsors to permit participants to borrow from their accounts before they retire.

But tapping into your 401(k) may jeopardize the lifestyle you're hoping for once you retire. So is it ever okay to borrow from your 401(k) plan?

The general consensus is that spending today what you've put away for tomorrow is a bad idea, especially if you're planning to spend on discretionary purchases. If you're using your account as an alternative to a credit card, it's most likely a sign that you're living beyond your means and probably should look for ways to cut back your spending. However, under certain circumstances, borrowing from your 401(k) plan may make financial sense. Before you take out a plan loan, though, it's important to weigh the pros and cons.

The Advantages of 401(k) Loans

If your family is suffering financial distress and your credit is poor, a 401(k) loan might be your only option for a loan. The terms can also be quite generous: you're allowed to borrow half of your account value, to a maximum of $50,000, and the rate is generally very competitive with rates on unsecured consumer loans — typically 1% above the prime rate, although this will vary by plan. Finally, application fees, if your plan charges them, are generally much lower than bank fees.

Plans must also allow hardship withdrawals, but specific requirements must be met to qualify. In addition, the withdrawal is subject to income taxes and early withdrawal penalties.

Because a 401(k) loan isn't subject to income tax or penalties, it's likely a better alternative. In addition, because you're paying yourself back with interest, your loan retains some value as an asset that provides a positive return.

The Disadvantages

The first thing to realize is that you have to pay the balance with interest within five years, unless the proceeds are being used to purchase a principal residence (then you can repay over a longer time period). Next, consider how secure your job is, because if you no longer work for your plan sponsor, you may have to repay the entire loan balance within 90 days. Otherwise, that amount is considered a withdrawal; and if you're not yet at least 59½ years old, you'll owe a 10% penalty in addition to income taxes.

A plan loan also presents some other possible disadvantages:

Opportunity Cost. Money taken out of your plan can't take advantage of bull markets. So even though your interest payments are providing some return, having your money out of the stock market could significantly reduce how much you'll have when you're ready to retire.

Suspended Contributions. Make sure you won't have to reduce or stop new 401(k) contributions, because you are struggling to make your loan payments.

Taxation. Loan payments are made from after-tax income, and interest paid on the loan is not tax deductible. Thus, other types of loans, such as home-equity loans, may be cheaper on an after-tax basis.

If you're seriously thinking about taking out a loan from your qualified retirement plan, it's important to assess its short- and long-term consequences and consider alternatives. Please call if you'd like to discuss this in more detail.
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A Strategy for College Costs

If you haven't looked at college costs recently, be prepared. For the 2022-23 school year, the average annual cost of a public university is $23,250, while a private university costs $53,430 (Source: *Trends in College Pricing*, 2022). To help ensure you'll be prepared to provide your children with a college education, start planning now. Consider the following tips to help with the process:

✔ **Start investing now.** Determine how much you need to save to reach your goals. Many people will have difficulty saving the amount needed to fully fund a college education. However, there are other sources to help fund those costs, such as loans or financial aid. Thus, your goal may be to accumulate 30%, 50%, or some other percentage of the total cost of college. The important thing is to start an investment program now and invest as much as you can.

✔ **Determine if you can pay some costs from current income.** Paying down your debts before your child enters college may free up current income for college costs. One strategy is to make extra principal payments with your mortgage payment, attempting to pay off your mortgage by the time your child enters college. Then, funds used for your mortgage payment will be available for college costs.

✔ **Encourage your child to participate in the process.** Maintaining good grades and participating in extracurricular activities may make your child a more desirable candidate for college. He/she may then be eligible for a larger range of grants or scholarships. The most attractive loan programs are offered only to students. While you may not want to burden your child with large loans, it may make sense for your child to obtain the loan and you can then gift funds at a later date for him/her to repay the loan.

✔ **Expect your child to work to pay part of the cost.** Although a child will have difficulty saving all the costs for college, you may expect him/her to fund a certain percentage of those costs. You can make him/her responsible for tuition, out-of-pocket expenses, transportation costs, or room and board. This may also help ensure your child is committed to his/her education.

If you'd like help developing a strategy for financing your child's college education, please call. ❍❍❍

Pay Yourself First

If you're looking for ways to start paying yourself first, consider the following:

✔ **Reduce spending, diverting those reductions to savings.** One way to accomplish this is to cut back on your spending. But for many people, this feels too much like sacrifice. Another alternative is to find ways to spend less for the same items. For instance, get quotes for your car and home insurance from several companies. Or find ways to reduce your borrowing costs.

✔ **Save all unexpected income.** Immediately save any money from tax refunds, bonuses, cash gifts, and inheritances. Before you get used to any salary increases, put that raise into savings.

✔ **Make saving automatic.** Resolve to immediately set up an investment account that automatically deducts money from your bank account every month. Start out with small amounts that aren't even noticeable. As you get used to saving on a regular basis, increase the amount periodically. Another good alternative is to sign up for your company's 401(k) plan.

Please call to discuss additional ways to help pay yourself first. ❍❍❍

Financial Thoughts

About 13% of families owned a privately held small business in 2019. Business ownership increases with income, with nearly 40% of families in the top income decile owning a small, mid, or large business (Source: Federal Reserve, 2022).

Approximately 18% of people making over $100,000 annually live paycheck to paycheck (Source: Willis Towers Watson, 2022).

Married people feel more financially stable than unmarried individuals. In 2020, 82% of married people considered themselves doing at least okay financially. Only 67% of single people had the same response (Source: Federal Reserve, 2022).

Excluding mortgages, 30% of American adults' income goes toward paying off debt. After mortgages, the top source of debt is credit card debt at 19% of income, car loans at 8% of income, and student debt at 7% of income (Source: Northwestern Mutual, 2022).

First-generation college students are about three times more likely to be behind on student loan payments than students with a parent who earned a bachelor's degree (Source: Federal Reserve, 2022). ❍❍❍