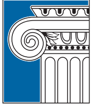

Back Bay Financial Group, Inc.
*Helping Clients Build and Manage Wealth™*

Spring 2009

# The Back Bay Advisor

535 Boylston Street, Suite 300 • Boston, MA 02116 • (617) 247-0518 • www.backbayfinancial.com

## 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, 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

Continued on page 2

## Taxes and Your Investments

Ordinary income taxes on short-term capital gains and interest income can go as high as 35%, while long-term capital gains and qualified dividend income are taxed at rates not exceeding 15% (0% if you are in the 10% or 15% tax bracket). One way to help maintain your portfolio's growth potential is to invest in a tax-efficient manner. Some suggestions include:

- **Contribute to your 401(k) plan.** Contributions are made on a pre-tax basis, so you don't pay income taxes currently (Social Security and Medicare taxes are paid) and earnings grow on a tax-deferred basis until withdrawn. In 2009, you can contribute a maximum of $16,500 to a 401(k) plan, although plans typically limit your contributions to a certain percentage of your pay to ensure the plan complies with nondiscrimination rules. Individuals over age 50 may be able to make an additional catch-up contribution of $5,500 in 2009. Many employers also match your contribution.
- **Make contributions to an individual retirement account (IRA).** In 2009, you can contribute a maximum of $5,000, plus those over age 50 can make an additional $1,000 catch-up contribution. Investigate whether you're eligible to contribute to a traditional deductible IRA or a Roth IRA and then decide which option is best for you.
- **Carefully decide which investments to hold in tax-advantaged and taxable accounts.** Gains from investments held in retirement accounts, such as 401(k) plans and traditional IRAs, are taxed at ordinary income tax rates when withdrawn, rather than the lower capital gains tax rates. While it may make sense to hold investments that produce ordinary income or that you want to trade frequently in retirement accounts and investments that generate capital gains in taxable accounts, factors such as your investment period should also be considered.
- **Analyze the tax consequences before rebalancing your portfolio.** Portfolio rebalancing is a taxable event that may result in a taxable gain or loss. In general, avoid selling investments from your taxable portfolio for reasons other than poor performance.

Continued on page 3

# What's a Reasonable Rate of Return?

How do you know if you're saving enough for a future goal? You must get three factors right — how much you need, when you need the money, and how much you'll earn on your investments. You can then calculate how much you should save on an annual basis.

The typical approach to estimating a rate of return is to look at average annual returns for some historical period. For instance, from 1926 to 2007 (82 years), the average return for the stock market as measured by the Standard & Poor's 500 (S&P 500) was 10.4%. Change the period to 1958 to 2007 (50 years) and the return changes to 11.0%, 12.7% from 1983 to 2007 (25 years), and 5.9% from 1998 to 2007 (10 years).* Assume you want to save $1,000,000 in 30 years. To reach that goal, you need to save $5,635 annually at 10.4%, $5,025 at 11.0%, $3,616 at 12.7%, and $12,873 at 5.9%.**

It's tempting to use the highest return possible, since that results in the lowest savings amount. But consider using a conservative estimate. If you save too much, you can always reduce savings in later years or spend more in retirement. The alternatives are far less attractive if you don't save enough. Consider the following points:

- **Your investing time frame will probably encompass decades.** Thus, consider using a historical rate of return that covers a very long time frame, making adjustments from there.
- **Factor in inflation.** When estimating inflation, factor in a long time period. For instance, inflation, as measured by the consumer price index, averaged 3.1% since 1926 (Source: Bureau of Labor Statistics, 2008).
- **Watch your pattern of returns.** 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 higher returns in the early years, your portfolio 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. Assess your portfolio's progress on a regular basis, but at least annually, so you can make adjustments along the way.

What is a reasonable long-term rate of return to use for stock investments? Starting with the average return from 1926 to 2007 of 10.4% and subtracting 3.1% inflation would result in a return of 7.3%. You may even want to use a more conservative return if you feel the stock market may encounter an extended period of below-average returns. Sure, that means you'll need to save more every year, but learning to live within your means and saving significant portions of your income aren't bad things. Please call to discuss this in more detail.

* Source: *2008 Ibbotson Stocks, Bonds, Bills, and Inflation Classic Yearbook.* 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 results. ** Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.

## Risk and Return

Continued from page 1

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.

## Taxes and Investments

Continued from page 1

Bring your asset allocation in line through other methods.

- **Consider municipal bonds or stocks generating dividend income if you are in a high tax bracket.** Since municipal bond interest is exempt from federal, and sometimes state and local, income taxes, your marginal tax bracket is a major factor when deciding whether to include municipal bonds in your portfolio. Thus, you should determine how a muni bond's yield compares to the after-tax yield of a comparable taxable bond. Since qualified dividend income is taxed at rates not exceeding 15%, stocks that generate significant dividend income may be a good choice for high tax bracket investors.
- **Look into tax-advantaged ways to save for college.** If you are saving for college, look at education savings accounts (ESAs) and Section 529 plans. The annual contribution limit to ESAs is $2,000. While you can't deduct the contribution on your tax return, earnings grow tax free as long as funds are used for qualified education expenses. With Section 529 plans, you can contribute up to $65,000 to a qualified plan ($130,000 if the gift is split with your spouse) in one year and count it as your annual $13,000 tax-free gift for five years. Distributions from 529 plans to pay qualified higher-education expenses are excluded from income.
- **Consider owning a home.** Despite declining home values over the past couple of years, owning a home has significant tax advantages. Mortgage interest and property taxes can be deducted on your tax return, reducing the cost of owning a home. Mortgage interest is deductible on up to $1,000,000 of original debt incurred to purchase a principal residence. Additionally, interest paid on up to $100,000 of home-equity debt is deductible on your tax return. When you sell your home, significant capital gains can be excluded from income. You can exclude up to $250,000 of gain if you are a single taxpayer and up to $500,000 of gain if you are married filing jointly, provided the home was your primary residence for at least two of the preceding five years.

These are only a few suggestions for investing in a tax-efficient manner. If you'd like to review other options, please call.

# Does Buy and Hold Still Make Sense?

We all know the basics — design an asset allocation plan, ignore market fluctuations, and stick with the plan for the long term. In other words, become a buy-and-hold investor. But in an era where everything seems to change overnight, is it realistic to expect to find investments you'll be comfortable owning for years or even decades?

Before you answer that question, you need to consider whether it's possible to reliably time the market. Unfortunately, it's a difficult strategy to implement for a couple of reasons:

- **No one has been able to consistently predict where the stock market is headed.** Many try, but so many factors affect the market that even professionals watching the market full-time find it difficult to time the market with any degree of accuracy. In retrospect, everything seems crystal clear. Are you still upset you didn't get out of technology stocks in 2000? While we now know that was the market top for technology stocks, very few recognized that in 2000. Also, significant market gains can occur in a matter of days, making it risky to be out of the market for any length of time.
- **Frequent trading seems to reduce, rather than increase, returns.** Several studies of investor trading found that investors who trade more frequently have lower portfolio returns than those who trade less frequently. A recent study found that for the 20 years ending in 2007, the average equity fund investor earned an annualized return of 4.5%, compared to an annualized return of 11.8% for the Standard & Poor's 500 (Source: *Fortune*, November 10, 2008).* Why? Investors tend to buy hot sectors and sell underperforming investments — the opposite of a buy-low-and-sell-high strategy. Also, trading results in a taxable event. Even with capital gains rates at 15% and the highest ordinary income tax rate at 35%, taxes significantly reduce your portfolio's return.

Rather than trying to time the market, devise an asset allocation strategy you'll be comfortable with for years and then purchase investments for that strategy. (Asset allocation does not assure a profit or protect against loss in declining financial markets.) That doesn't mean you'll never sell an investment, but selling should be an infrequent part of your investment strategy. If you'd like help implementing this strategy, please call.

* 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 results. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.

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## In the News

**George Padula** discussed his thoughts on the AIG executive bonus controversy in a televised interview with WBZ-TV. He was also featured in a *Financial Planning* article on alternative asset classes.

**Jeanne Gibson Sullivan** teamed up with the *Boston Globe* Money Makeover feature to advise a freelance graphic designer/musician on saving for retirement.

*Financial Advisor* magazine quoted **John LeBlanc** on Back Bay Financial Group's plans to cost effectively increase productivity. **Susan Brown** appeared in a *Kiplinger's Retirement Report* article on how to approach a portfolio when looking to sell stocks.

## Client Services

**Becky Martz** continued to implement Assemblage software to streamline the distribution of quarterly reports. She also began researching new technology for client online access.

A new system contributed to more efficient payroll processing for **Mandy Magee**, leaving her with more time to attend to client services-related tasks.

## Technology

The firm is making a great effort to improve electronic communication with clients. Thank you to all who participated in the recent survey. A new e-newsletter will be available soon!

## All Work and No Play…

The staff celebrated the holidays together at their annual party in January. This year, **Jeanne Gibson Sullivan** hosted the party at her home in Reading.

In an effort to escape the cold, New England winter **John LeBlanc** spent a week on the east coast of Florida. **Rainey Lennon** traveled to the west coast of Florida for a long weekend to see her family, while **Emily O'Hara** visited her family in California. **Ed Childs** celebrated his birthday with a trip to New Orleans.

**Bob Siefert** enjoyed time in California where he was asked to give a presentation on behalf of a client. Bob was also able to escape to Aruba for a week.

**Kevin Sweeney** headed up north to ski. He also attended the Boston Wine Expo with his wife. Attempting to recruit new fans for women's basketball, Bob brought Kevin to see University of Connecticut play University of Louisville.

Bob and his wife Maureen joined **Susan Brown** and her husband Rick for the annual WERS A Capella Festival.

Ed joined his partner Charles Tersolo to exhibit paintings at an art fair.

## Continuing Education

**Ed Childs**, **Susan Brown, John LeBlanc** and **Jeanne Gibson Sullivan** attended a Massachusetts Financial Planning Association Meeting. *Financial Advisor* columnist Bob Veres, among others, discussed a variety of financial topics including ethics and Wall Street.

Jeanne also attended the Schwab Investment Outlook Symposium in Boston with John, Susan and **Erik Gudim**. The event featured leading economists, fund managers and industry executives, including Schwab Chief Investment Strategist Liz Ann Sonders, as well as CNBC Senior Economic Reporter Steve Liesman.

Erik later participated in a "Smart Tax Strategies for Clients in 2009" Webcast. He also attended an industry event focused on exchange-traded funds strategies as well as an event discussing the current macro-economic environment.

**Mary Evans** and **Bob Siefert** attended a seminar on charitable and estate planning sponsored by the Boston Foundation.

**Phil Lee** participated in a "Six Things You Can Do With an Old Insurance Policy" workshop, as well as a symposium on alternative investments. Susan Brown attended an industry sponsored investment seminar.

## Giving Back

**Jeanne Gibson Sullivan** participated in a career panel at Tufts University and in March she gave a presentation to graduating seniors at Mount Holyoke College focusing on basic financial planning issues.

**George Padula** also offered his expertise by teaching a 12-week investment planning course at Boston University for students enrolled in the Certified Financial Planning program.

The Donor Advised Funds (DAF) Committee — **Erik Gudim**, **Mandy Magee** and George Padula — was busy reviewing possible candidates to receive donations from the firm. **Bob Siefert** and **Phil Lee** recently enjoyed the annual Martin Luther King Concert preformed by the Boston Children's Chorus — a recipient of donations made by BBFG for the past two years.

Winthrop resident **John LeBlanc** participated in "Financial Focus" — an hour long panel discussion presented by Winthrop Community Access Television.

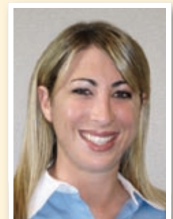
George and John attended a Back Bay Association (BBA) event featuring Boston City Councilor Michael Ross as a guest speaker. The BBA is a community organization that initiates programs to improve, promote, and protect the quality of life in the Back Bay.

## Company News

To kick-off the new year, the firm met to discuss 2009 goals and objectives at an off-site meeting. The group met at **John LeBlanc**'s house and dined at the Winthrop Arms Hotel.

**Rainey Lennon** was a key figure in planning two seminars — one for professional colleagues and another for clients. Both events focused on financial planning strategies in today's economy. **Kevin Sweeney** and **Phil Lee** were among those who participated at the event.

Congratulations to **Emily O'Hara**, who recently received her Certified Financial Planner™ designation.



Emily O'Hara, MSFP, CFP®

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