PERSONAL CAPITAL

Guide to a Better **Financial Life**

3 STEPS TO MANAGING YOUR MONEY

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Your ability to manage your finances is critical in determining what your future will look like.

Do you know how to set (and stick to) a budget? Are you making regular 401k contributions? Are you protected against risk without being so cautious that you miss opportunities? These are all pieces of your personal financial puzzle.

You don't need to be an expert to manage your money effectively, but you do have to put some effort into it.

This guide is designed to help you generate a realistic financial game plan you can follow and control. You may learn to avoid some basic mistakes, better understand your money, and take simple actions with real impact - creating a path to a better financial life.

Make a Plan

You are the CEO of your money – at the end of the day, managing your money is your job, and you've got important decisions to make. Like any other job, before you make important decisions with your finances, you need to have a plan in place in order to identify your goals and figure out a roadmap to achieving them.

GET ORGANIZED

For successful financial planning, it is critical to understand what you've got, how much you make, what you owe, how you spend, and how you are investing for the future.

If you have a solid foundation, then a thorough assessment of your position will make that abundantly clear. If you face serious challenges, clearly understanding them will empower you to make adjustments and significantly improve your situation and financial future. Not only will your finances improve, but you will feel better emotionally when you have a plan and are in control.

RETIREMENT SPENDING
"The Magic Number"

The odds of achieving greater wealth can increase if you define your goals and a plan to achieve them. Most people have a limited number of true financial goals. First and foremost is almost always "retirement."

So what is the critical number in retirement planning? Most folks want somewhere between 80% and 100% of their average spending level in the years leading up to retirement. Very few aspire to spend meaningfully more in retirement than they do in their later working years, and very few people want to cut back more than a "little bit." Either of these adjustments is fine if you plan for them.

Know Your Big Picture

Here's a good, basic checklist of things you should know about your financial life:

1. The value of all your assets
2. The value of all your liabilities and debts
3. Your net worth (assets minus liabilities)
4. How much you spend on a monthly and annual basis — and where you spend it
5. How much you earn after tax on a monthly and annual basis
6. Your asset allocation
7. How much you pay in fees

OTHER FINANCIAL GOALS TO CONSIDER

Retirement isn't the only long-term financial goal you should be planning for. Other considerations include:

Children's education

Legacy & estate planning wishes / charitable giving

Provisions for health care costs

Major discretionary expenses (wedding, boat, vacation, etc.)

Home purchase (or second home purchase)

While these are all important goals, it's also important to understand they are competing for the same resources as your desired retirement. Whether you spend money on your kid's college or a trip to Hawaii, the tradeoff is always less money for retirement spending and/or your estate. These types of costs are known as consumption desires.

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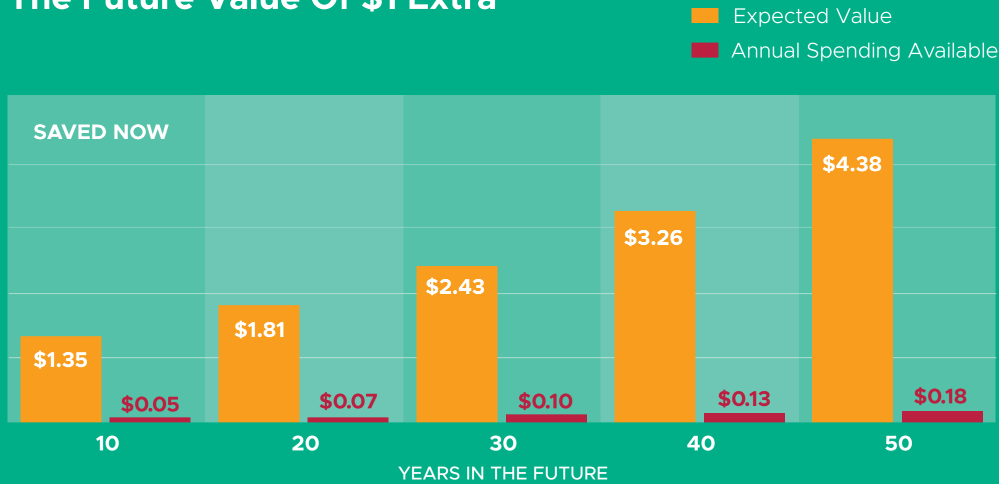
Embracing Technology

Embracing new technologies can give you a leg up. Our free financial software allows you to easily manage your entire financial life in one secure place so you can reach your goals faster. You can develop your long-term financial strategy – calculate your net worth, set a budget, and plan for retirement. Our technology provides tremendous insight into your unique situation, which means we know where you stand relative to your financial goals, and in most cases, can immediately identify changes that will make a major difference.

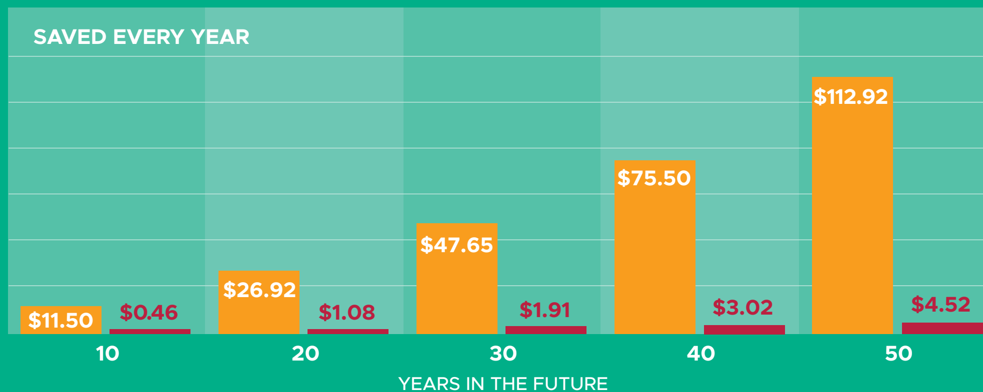
THE COST OF CONSUMPTION

Because any money you don't spend today would theoretically be invested and grow over time, current consumption actually ends up costing you an even bigger amount of future consumption. It is important to have a sense of how much.

The Future Value Of $1 Extra



Above is a rough approximation of what one dollar saved today may buy you in the future, in inflation-adjusted terms. We assume a real return of 3% (investment returns are of course extremely unpredictable, but 3% is a reasonable proxy after inflation, taxes, and fees). If you are 35 and plan to retire at 65, not spending a dollar now may provide you with an extra $2.43 of spending power. Or another way to look at it, assuming a 4% withdrawal rate, for each dollar saved, you will be able to spend an additional $.10 every year in retirement (Below).



**We assume a real return of 3% (investment returns are, of course, unpredictable, but 3% can be a reasonable proxy after inflation, taxes, and fees). It compounds either $1 at 3% or $1 added every year at 3%; therefore, we assume a 4% "safe withdrawal rate" for how much can be "spent" every year.*

BALANCING SAVING VS. SPENDING

Just because saving now means you could spend a bunch of money when you are 85 doesn't necessarily mean you always must save every dollar. The goal is to keep consumption fairly smooth over your lifetime, and to always think of it in the larger context of your overall goals.

It is tempting and convenient to categorize goals into "buckets," but doing so can lead you to shortchange your larger goals. Imagine you've created a bucket for saving toward buying an expensive car. You may think about that money differently from funds that you sock away in your 401k, but spending it still reduces your resources for retirement. That doesn't mean you shouldn't save for (and buy) the car, but the tradeoff must be made in the proper holistic context. Always think big picture.

SOCIAL SECURITY

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Social Security Planning

We believe it is safe to plan on receiving at least 75% of the Social Security benefit to which you are entitled under the current system. If you are already over 60, it is unlikely you will have any benefit reductions, though it is possible the Cost of Living Adjustment (COLA) may be reduced. It is important to understand what your projected benefits are. You can find out here: www.ssa.gov/estimator

Social Security is poorly understood and its importance is routinely underestimated. Today, an individual who earned more than $110,000 (inflation adjusted) for each of the last 20 years is entitled to about $30,000 per year in benefits if he or she starts taking Social Security at the "full retirement age" of 66.

Let's say you retire with $2 million. A "safe" annual withdrawal of 4% would provide $80,000 of income per year. With Social Security, that may become $110,000. There's a big lifestyle difference between $80,000 and $110,000 in annual spending. If you are entitled to benefits - unless you retire with well over $5 million - Social Security will play a big role in your retirement.

ESTIMATING HEALTH CARE COSTS

Unknown future health care costs are a major cause of financial anxiety. Research estimates that about half of Americans turning 65 today will require long-term care, and on average, will incur $138,000 in future long-term care costs – this includes custodial care, home care, or nursing home care, for periods longer than a year for those who have a chronic illness or medical disabilities. These costs are usually not covered by standard health insurance, Social Security or Medicare. The majority of retirement health care costs come in the last few years of life. The silver lining of the "highest costs at the end" scenario is that it allows more time for assets to grow before they are needed.

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Action Items

- [ ] Aggregate your financial accounts on Personal Capital
- [ ] FILL IN THE BLANK
  I/we would like to spend at least
  $__________ a year in retirement in today's dollars
- [ ] Take 30 minutes using the Retirement Planner to understand where you stand financially
- [ ] If you are between 35 and 62, go to www.ssa.gov/estimator to see how much Social Security you are likely to receive

STEP 2

Save & Spend

Unless you inherit or marry money (or win the lottery), there are only two ways to afford retirement: Get a job that offers a good pension, or save and invest. When it comes to saving, there are two main factors - how much and where.

HOW MUCH DO I NEED TO SAVE?

Because most people experience diminishing marginal returns on money that they spend, most will benefit from relatively smooth consumption over time. What does this mean?

You get massively more value from the first $50,000 per year that you spend than you do from the next $50,000. Anyone spending over a million dollars per year may not feel much incremental benefit at all from spending another $50,000. Ideally, you'd like your pre-retirement life to involve sufficient saving such that you can maintain a similar lifestyle in retirement. This is known as smoothing consumption — being consistent with the amount you spend each year throughout your lifetime.

It is impossible to smooth consumption precisely because life is unpredictable. Most people's earnings increase significantly over time, and unforeseen circumstances can arise at any time. Ideally, aiming to spend roughly the same amount every year over time allows you to maximize the utility of your money, and also allows you to predict your savings needs for retirement.

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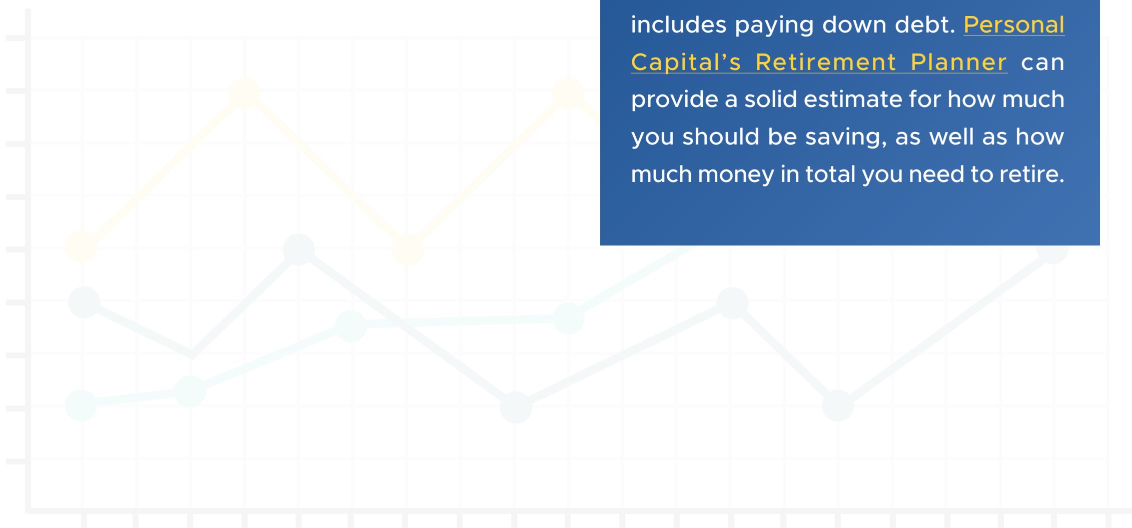
Smoothing Consumption

Calculating the saving rate to smooth consumption is mathematically straightforward. A simple and widely accepted approach is to save at least 15%-20% of your income. This figure includes paying down debt. Personal Capital's Retirement Planner can provide a solid estimate for how much you should be saving, as well as how much money in total you need to retire.



WHERE SHOULD I SAVE?

In which account or investment vehicle should you be saving? The primary choices include tax-advantaged retirement accounts, taxable brokerage accounts, bank accounts, physical property, or paying down debt. With so many potential variables, it's impossible to offer hard rules that will apply to everyone, but here are some useful guidelines:

High-Interest debt

> If you have high-interest debt, pay that off first

Employer-matched retirement account

> If your employer offers any kind of matching contribution to your 401k, always save at least up to the amount matched. This is the first priority. Employer matching is part of your compensation; failing to take advantage of it is the same as tearing up a few paychecks per year.

Tax-advantaged accounts

> Even if no employer match is available, try to maximize savings in tax-advantaged retirement accounts before saving in taxable accounts. The current tax deduction combined with the deferral of taxes on your investment earnings can mean anywhere from 10% to 50% more total spending power over your lifetime.

Roth IRA & Roth 401k accounts

Roth accounts can be a great way to save if your tax rate in retirement will be similar or higher than your current tax rate. You don't get a tax deduction when you contribute, but your withdrawals in retirement are tax free. There are income limits to how much you can contribute to a Roth.

Traditional IRA & 401k accounts

If you anticipate your tax rate in retirement will be much lower, traditional IRA and 401k accounts are usually better. When deciding between Roth and traditional, keep in mind that generally if you are already in the 24% or higher federal tax bracket, you probably can't (and shouldn't) contribute to a Roth.

529 Accounts

A 529 plan is a tax-advantaged savings plan designed to encourage saving for education costs. As of 2018, 529 plans are expanded to cover not only college-related expenses, but also those related to elementary and secondary schools. If you have kids, opening one or more 529 plan accounts usually makes sense, but only after other tax-advantaged retirement account contributions are maxed out.

Buy a Home

A primary home can be a wonderful investment, especially if you enjoy living in it. Keep in mind that real estate historically appreciates at about the rate of inflation, which is less than the historical appreciation of stocks. Even so, the leverage of a mortgage and the tax benefits of the interest deduction still make owning your primary home a good idea, as long as you can afford it and plan to live in it for at least six years.

Pay Off Your Mortgage

If you have a mortgage rate under 4.5%, it is generally not a good idea to pay it off early, unless you also have a large stock portfolio (i.e. one that is larger than the value of your home). Conversely, if you don't have the stomach to own stocks, maintaining a mortgage and simultaneously holding a significant amount of lower yielding cash or bonds is simply throwing money away. In this case, go ahead and pay off the mortgage.

Purchase Other Real Estate

Second homes and rental properties can be great investments, but they're not for everyone. As a general rule, a second property that is not rented out should be considered consumption, not an investment. (Read our free Personal Capital Vacation Home Buying Guide for more information).

HOW SHOULD I SPEND?

Once you're retired, adhering to the right spending level is one of your most important financial responsibilities. Spend too much and you risk running out of money. Spend too little and you will miss out on valuable life experiences.

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Spending Questions to Ask Yourself

A complicated whirl of variables and "what if?" scenarios have direct bearing on your spending level. Here are some of the questions you should ask yourself when it comes to spending in retirement:

When do I want to retire?

How long will I live?

What about my spouse?

How much will health care cost?

Will I move?

How much do I want to leave behind?

These are just a few of the questions you'll need to answer to project a solid, strategic spending rate that will support a reasonable lifestyle in retirement. Talk to a financial advisor who can guide you through answering these tough questions.

Withdrawal Rate

From an asset management perspective, the spending question is usually framed in terms of one's "withdrawal rate." This is the amount spent from your investment portfolio each year as a percentage of the total portfolio value. Typically, it is assumed the original withdrawal dollar amount remains constant, except for an annual inflation adjustment.

Required Minimum Distributions (RMDs) for retirement accounts do not count toward your withdrawal rate if you reinvest them in a taxable account. If they are spent, however, they do count as part of your withdrawals. The same goes for interest and dividends.

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Withdrawals in Retirement

If you have a mix of tax-advantaged retirement accounts, such as IRAs and 401ks, along with taxable brokerage or bank accounts, the order of how you withdraw and spend from these accounts makes a big difference. The goal is to minimize tax impact.

The general rule is to deplete taxable accounts first, traditional IRA or 401k tax deferred accounts next, and save tax exempt Roth assets for last (required minimum distributions [RMDs] for retirement accounts must be taken in a timely fashion in order to avoid stiff penalties). If you have large IRA balances and are between retirement and the RMD age of 70.5, it often makes sense to start some IRA withdrawals up to the 25% tax bracket, especially if you haven't started Social Security yet.

If you find yourself in a high tax bracket in retirement with Roth assets but little in regular taxable accounts to access, a combination of modest Roth withdrawals along with traditional IRA assets may be the best way to satisfy income needs. But generally, Roth accounts should be maintained as long as possible because they benefit most from deferred growth and tax-free withdrawal. In addition, if you pass money on to heirs, Roth money is the best kind to inherit because it will continue to grow tax free. Contact a financial advisor to learn more.

Living Off the Interest: An Illusion

Many people think successful retirement means building a nest egg big enough to generate interest and dividend payments sufficient to meet their spending needs. They envision themselves "living off the interest" while their principal remains untouched. There are some critical flaws with this mindset:

It ignores inflation: Inflation gradually diminishes the spending power of your fixed income, which means you won't be able to get by on just interest and dividends. If your portfolio doesn't grow right along with inflation, you'll end up withdrawing your principal at an uncomfortable pace to cover your expenses as your retirement progresses.

It ignores taxes: When it comes to generating income for retirement, after-tax total return is all that really matters. Uncle Sam is going to get his piece, leaving you with a smaller chunk than you might be thinking you'll have to spend.

It can result in poor choices: This mindset leads many people to stretch for high-yielding, potentially risky investments that "promise" high returns, rather than building a well-diversified portfolio that continues to generate value.

A Balanced Approach

Your goal should be to find a withdrawal rate that balances your lifestyle needs with a minimal (or at least acceptable) risk of running out of money. This is challenging for most people - we're wired to extrapolate trends; we get too excited in bull markets and too dour in bear markets. After a few years of good investment returns, many people get comfortable spending too much because they see their balances go up. It takes a lot of discipline to avoid this trap.

Like many things in life, luck and timing play a big role in your financial success in retirement. These factors may be beyond your control, but regardless of how they play out, it's up to you to exercise control where you can. Establishing and maintaining a disciplined withdrawal strategy for your retirement will substantially increase your odds of success.

The 4% Rule

An industry rule of thumb suggests that balanced portfolios will not run out of money if the withdrawal rate is limited to 4% annually. This is known as the 4% Rule. The 4% withdrawal figure is based on the original portfolio value and is adjusted upward for inflation annually. Withdrawals are not adjusted for market returns.

The 4% Rule has limitations, but it is a good starting point for most people. If you follow the rule consistently, year after year, you would neither increase spending in a bull market, nor decrease spending in a bear market. Of course this is not entirely realistic if the markets have major moves. It's usually okay to spend a little more if your portfolio goes up, and it makes sense to cut back a little if markets are down in the initial years.

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Estimating Your Retirement Planning Position

You can perform a rough estimate of your retirement planning position by using the "4% Rule". Generally, if you invest well, you can plan to safely spend about 4% of your starting nest egg each year in retirement. This means that at the start of retirement you will need about 25 times the amount you plan to withdraw on an annual basis. For example, to spend $80,000 per year, you'll need about $2 million at retirement. Factor in Social Security benefits and you will need less.

If your planned annual withdrawal after Social Security and pensions amounts to less than 3% of the total nest egg you expect to have on the day you retire, you are in good shape. Between 3% and 5% and you're in OK shape. Over 5% means your retirement spending goals are at high risk.

Health Care

The average couple retiring at 65 will spend about $275,000 on health care over the course of their retirement. These expenses can come in the form of long-term care. Medicaid laws ensure that you will not be thrown out on the street if your assets are depleted because of long-term care costs. In fact, it may be worth planning to make use of this government insurance policy if/when the need arises, rather than sacrificing too much consumption early in retirement to plan for expenses that may never occur.

Time Horizon

The period over which money will be invested and spent is referred to as its time horizon. Typically this represents the life expectancy of the owner(s), but could be longer if the assets are intended to be passed on to heirs or charity. Saving rates, spending rates, and asset allocation should all be designed around the time horizon.

Many people often underestimate how long they'll need their money to last. There is a good chance you – or your partner/spouse – will live well into your nineties. If you and your spouse are both 40, there is roughly a 25% chance one of you will live to 95. And if you are both still alive at 65, those odds go up to roughly 33%.

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Calculating Your Time Horizon

You probably have a better idea of your own expected longevity than any actuarial table. If your time horizon is less than 20 years, you can afford greater withdrawal rates and can move away from the 4% rule. The new rule of thumb becomes one divided by time horizon (1 / # of years); so if you expect to need your money to last 15 years, a withdrawal rate of 6.7% (1 / 15) may be appropriate. This assumes your assets keep up with inflation, but not much more — a realistic conservative assumption for shorter time horizons.

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Action Items

- [ ] If you are still working, go to the Retirement Planner and learn how much you need to save. If you should be saving more, consider setting up an automated investment plan to move money from your paycheck or checking account into investment accounts. Even small amounts make a big difference.

- [ ] If you are already retired, visit the Retirement Planner and learn how much you can afford to spend from your investment portfolio.

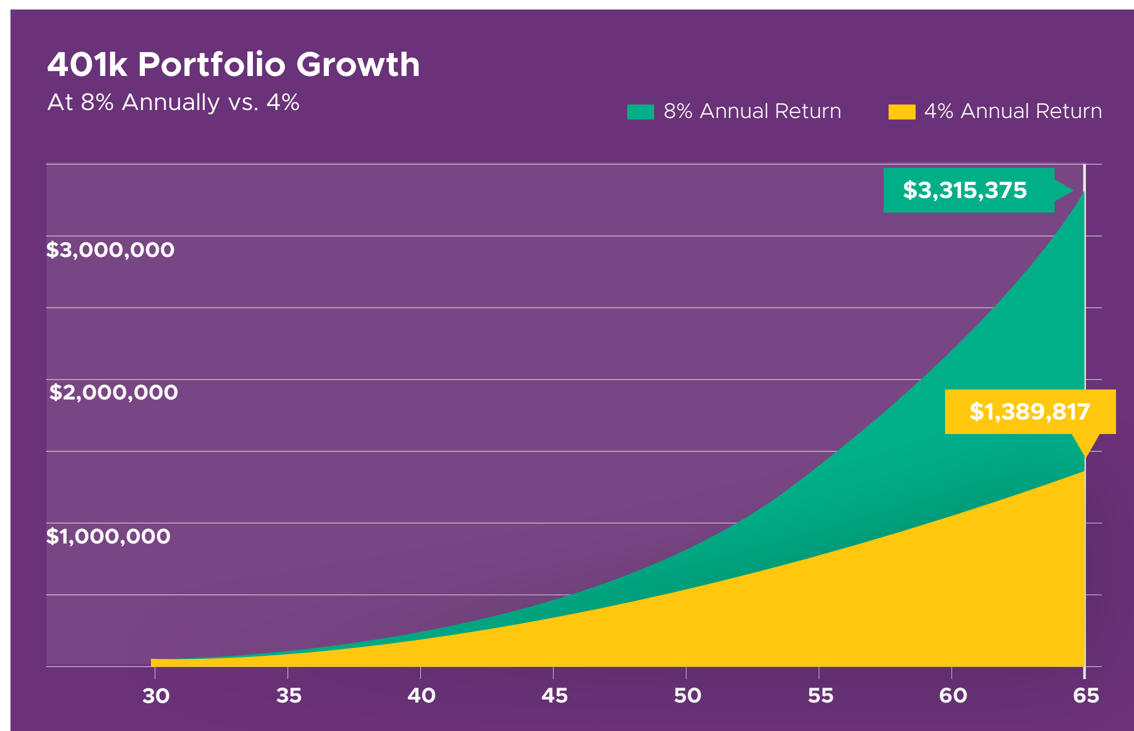
- [ ] Set a goal for how much you will save or spend in the next year.

Invest

How you invest your money can greatly impact your future. Fortunately, investing wisely doesn't need to be complicated. In fact, keeping it simple is the best way to avoid poor performance. But you must have a strategy - your money won't invest itself.

PERFORMANCE MATTERS

Imagine you start saving at age 30, make the maximum contribution (currently $18,500) to your 401k account every year, but don't save another dime until you retire at 65. If your 401k earns 8% annually, you will retire with more than $3.3 million and can expect to spend more than $11,000 per month in retirement (based on the 4% rule, but ignoring inflation, taxes and Social Security). But if your 401k earns only 4%, your investment income drops to about $4,600 – less than half of the first figure.



Unfortunately, the second outcome here is the reality for many people. The 2013 DALBAR Quantitative Analysis of Investor Behavior (QAIB) study, the average do-it-yourself equity mutual fund investor's 20-year annualized return lagged the S&P 500 by more than 4%. These results are costing millions of Americans the comfortable retirement for which they have worked so hard. And this is only referring to positive returns; wrong-way bets, leveraged losses, and outright fraud make matters even worse.

PASSIVE VS ACTIVE INVESTING

Passive investing involves using low-cost index funds to build a portfolio based on a pre-determined strategic asset allocation (how much in stocks, bonds, and cash). Funds are then either rebalanced periodically back to long-term target weights, or held indefinitely. No attempt is made to time allocations or to buy individual stocks or actively managed mutual funds. However, you will still need to determine how you want your assets allocated upfront and when to rebalance, so there is more work than what the term "passive" may indicate. Keep in mind, individual investors – even those who index – can have a tough time beating their benchmark.

The Myth of Beating the Market

Market timing and stock picking are like going to Las Vegas. You might win, but most likely you will lose. If you go every year, it is nearly guaranteed you will end up losing. The difference is you are betting big chunks of your net worth. (And you're not even getting free drinks.) The financial industry spends millions of dollars promoting active products that promise to outperform the market. Meanwhile, the financial media plays along and promotes an active mindset for two reasons. First, the industry spends a lot of advertising dollars; and second, passive is boring! Who wants to watch Jim Cramer recommend buying and holding an index fund?

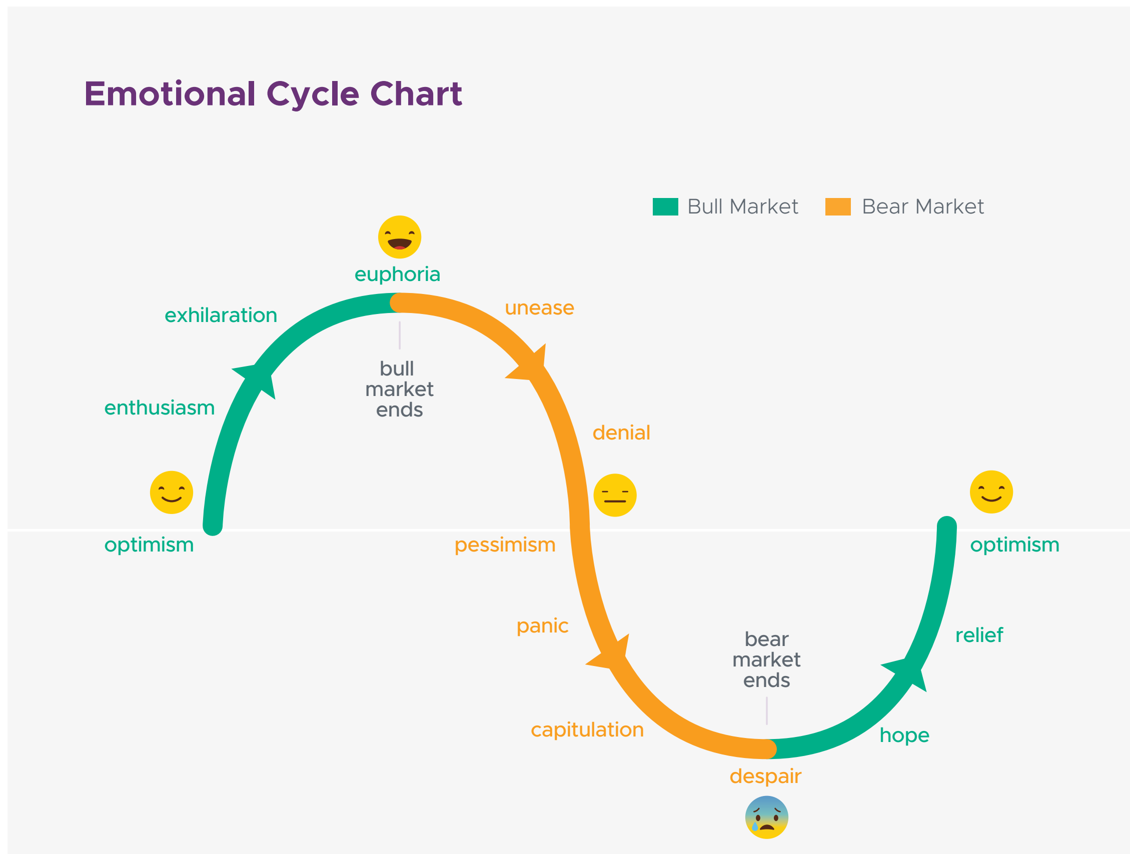
Active investing generally involves a manager making specific investments, usually with the goal to outperform a benchmark index. While many people believe that active investing is far more exciting – especially with its imagined potential for "beating the market" – the main problem with active management and stock picking is an astounding lack of success. Even professional managers rarely beat their benchmark.

Holding a diversified portfolio of several active funds is particularly hopeless. A small number of funds should outperform, but even if you're lucky enough to hold some of these, statistics dictate that their performance is highly unlikely to offset underperformance in the rest of your funds. This failure is largely attributable to high expense ratios and embedded trade costs within actively managed funds.

What about those mutual fund managers with the great track records? Unfortunately, past performance is not predictive of future performance. More than 10,000 mutual fund managers are out there today trying to beat the market. Statistically, some of them have to look good. The problem is that this is an "in-sample" analysis; there is no statistical evidence that any of them will be able to repeat good performance in the future.

DIY OR DELEGATE?

The most important thing an investment manager can do for you is increase your odds of implementing and maintaining a strategic asset allocation that is properly aligned with your future spending needs. It's true, advisors charge fees, and for an advisor to be worth using, the benefit must be worth the cost.



A common misperception is that using index funds makes it easy to successfully self-manage. While it's true that index funds can make it easier to implement a good strategy, the vast majority of people still make costly mistakes. The most expensive mistakes are made at the bottoms of bear markets and at the peaks of bull markets. Remember, investing is extremely emotional; you can make or lose a lot of money by reacting to market events. Watching others make more money at the end of a bull market causes all sorts of weird emotions, as does losing 5% of your wealth in one day. Fear and greed are very powerful. A good advisor can help you control emotions.

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What to Look for in an Advisor

If you decide to get professional help, it's imperative to find someone good. Unfortunately, this isn't always easy. Here are some things to look for in an advisor:

Is a fiduciary, which means they are obligated to act in their clients' best interest.

Uses technology to understand your whole financial picture and give you a sophisticated allocation in an efficient way

Will propose a personalized strategy before you hire them

Has deep, real-life experience managing money, and is more focused on that then finding more clients

Gives goal-oriented advice, not return-oriented advice

Is available to talk to you always and proactively communicates with you

Does not use mutual funds with load fees

Does not promise unrealistic returns; if it sounds too good to be true, it probably is

ASSET ALLOCATION

Asset allocation refers to your portfolio's relative exposure to the major types of liquid investments. In other words, how much of your money do you put in stocks, bonds, cash, and alternatives? Successful asset allocation strategy balances your need, ability, and willingness to take risk. It should be based on your expected cash flows and be designed to maximize the odds of achieving your retirement spending goals. It is widely accepted that asset allocation is probably the most important factor in successful investing. Here are four keys to successful asset allocation:

1. Consider the big picture

Most people are more aggressive when they are young, but often not to the extent they should be. During these early years, you should take advantage of your greater ability to bear risk. Should you enjoy strong market conditions, investment returns will compound over longer periods of time and significantly boost your overall wealth. As retirement draws closer, however, it is time to fine tune the level of risk you can afford while still meeting your growth and spending goals.

For many people, their home is a very important asset and their mortgage is a major liability. When you buy a home with a mortgage, you are increasing your allocation to real estate and decreasing your allocation to bonds. Always look at the whole pie. If you own a home, don't sink too much cash into it too soon. The idea is to keep funds that you might otherwise pour into the fixed asset of your home working for you in the stock market, where the returns can be expected to be greater over time. Avoid allowing your stock holdings to fall below 35% of your total net worth until you are within 10 to 15 years of retirement. Only as retirement draws close should paying off the mortgage become a priority.

2. Have a long-term plan

Most investors should seek minimum volatility for an expected level of return. Investment professionals refer to this as being on the "efficient frontier". Finding the right level of risk is equally important. The level of risk you take is a balance of three key elements:

> Your need for growth to finance your cash flow needs

> Your ability to withstand volatility and meet cash flow needs

> Your willingness to deal with volatility and risk.

Early or Mid-Career: Most people who will be working and saving for 10 or more years should maintain a high allocation to stocks, usually on the order of 70% or more. The primary exceptions are if you have a short- or mid-term cash need (like a home down payment) or already have more money than you need for retirement.

A high allocation to stocks requires faith that capitalism will continue to function and the world will allow it to do so. Assuming this to be true, global stocks are highly likely to provide desirable returns over periods of greater than 25 years. While stocks will likely do much better than bonds or cash over the next 25 years, inflation-adjusted returns may be lower than they have been over the last century.

Retired or Approaching Retirement: As you near or enter retirement, your investment approach should shift from pursuit of growth to fine-tuning your goals. You will need to determine how much you want to spend each year, and then find an asset allocation that maximizes your chances of hitting that target. Stocks should still play a meaningful role, but in most cases, it will be a reduced one. Most people approaching retirement can't afford to take as much risk as they might have in the past because they have less time to rebound from losses.

Determining the right strategic asset allocation in retirement is complex with many variables. Some of the big ones include:

> Expected time horizon(s)

> Desired spending (withdrawal rate)

> Market environment

> Interest rates

> Risk tolerance

> Legacy goals

> Non-liquid assets

3. Diversify, diversify, diversify

Diversification is achieved by owning multiple asset classes and securities with a positive expected return and low or negative correlations. Simply put: their values tend to move in opposite directions relative to one another in response to market events. It is also important to diversify at the sub-asset class level.

Asset Allocation

Your investment strategy should reflect an optimal blend of asset classes to achieve a given risk-adjusted return. In general, stocks provide great growth potential, but can be the most risky. Bonds tend to be more stable than stocks, but are subject to price swings as interest rates change. Alternatives, such as real estate, gold, and other commodities, provide additional diversification and can act as a hedge against inflation. Cash is the most stable asset class, but typically has low returns. Talk with a financial advisor to learn more about your target asset allocation to achieve your goals.

Size, style, sector, and industry are important factors. It's generally good to aim for a well-balanced mix within each. Diversification is also important within bond holdings; the issuer, duration, and credit quality are key factors. Inflation-protected bonds provide important diversification, helping shield returns against rising prices.

Once constructed, a properly diversified portfolio must be maintained. Periodic rebalancing ensures that the portfolio remains consistent with its original goals. It can also boost returns by reducing volatility from sector and style bubbles.

4. Tax Management

As a potential drain on your nest egg, taxes are important. Improper tax management can cost you more than a quarter of your long-term return, severely limiting spending power in retirement. The good news is that taxes can be managed. There are four key areas where investors can place their tax focus:

Tax Efficiency

Thousands of potential investment vehicles exist today, each with radically different tax implications. Choosing and using tax-efficient investments is a vital first step toward keeping more of your money.

> **MUTUAL FUNDS** are notoriously bad in terms of tax management.

> **EXCHANGE TRADED FUNDS (ETFs)** are generally more tax efficient than mutual funds.

> **INDIVIDUAL STOCKS** can be the most tax-efficient way to gain exposure to equities.

> **BOND ETFs** and passive bond mutual funds are generally more tax efficient than actively managed bond mutual funds, but the tax treatment of income generated from bonds differs from that of equities.

> **REAL ESTATE INVESTMENT TRUSTS (REITs)** dividends are generally taxed as ordinary income to shareholders.

Tax Location

Proper tax management also means placing the right securities in the right accounts. This is called tax location. Depending upon the underlying characteristics of the investment, strategically placing it in either a taxable, tax-deferred, or tax-exempt account may improve your annual return.

So what securities go where? One general rule is to place high-yield stocks in tax-deferred or -exempt accounts, like IRAs and Roth IRAs, and low-yield or no-yield stocks in taxable accounts. The reasoning is simple: the dividends in tax-deferred or -exempt accounts can be re- invested and grow tax-free. And even though you might eventually pay taxes (as when you withdraw money from a traditional IRA), the power of compounding can produce a higher annualized return over time.

Fixed income investments are a little trickier. While interest on bonds is taxed at a higher rate than stock dividends, the slower growth of low-yield bonds can actually make them better candidates for taxable accounts. Placing higher yielding bonds in tax-deferred accounts should result in higher aggregate returns over time.

Tax Loss Harvesting

Tax loss harvesting is the process of intentionally realizing losses to offset realized gains. It's slightly counterintuitive — after all, you're supposed to sell high, right? But the idea is not to eliminate exposure entirely; it's only a temporary sale to reduce your tax bill, after which you buy back the same stock.

The only caveat is that you must obey the 30-day Wash Sale rule, which states that to claim the loss, you cannot purchase the same security within 30 days before or after the sale. You also can't buy a new security that is essentially the same. Even if you don't have any gains to offset, you can deduct up to $3,000 in losses from your taxable income, resulting in a higher net after-tax return.

Roth Conversions

Roth retirement accounts differ from traditional IRAs and 401ks in that contributions are not tax deductible, but earnings and qualified distributions are tax free. Beginning in 2010, anyone with an existing traditional IRA account can convert it to a Roth IRA. The amount of the conversion counts as ordinary income in that year; after that, the assets are tax free for life. This can be very appealing, but criteria must be met before a Roth conversion makes sense. The most important factor to consider is if you expect your future tax rate in retirement to be lower (which it often is); then converting and paying taxes now as opposed to later probably does not make sense.

A Roth conversion can also generate a large tax bill, and it matters how you go about paying it. A Roth conversion only makes sense if you can pay the tax bill with funds from an outside non-retirement account.

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Action Items

- [ ] Determine your game plan: Do you want to try to beat the market with an active trading or stock-picking approach, or utilize a long-term, strategic, passive-based approach? Are you best served managing your own assets, or would you be better off with professional help?

- [ ] If you don't think your current broker or advisor is doing the best possible job for you, start looking for a new one.

- [ ] Use our Fee Analyzer to determine what hidden fees are costing you.

- [ ] Determine an appropriate long-term strategic asset allocation. It may change over time, but it should be designed to be appropriate for several years. You can use the Investment Checkup tool.

- [ ] Review your portfolio for tax efficiency. Avoid owning too many active mutual funds. If you have REITs or high-yield bonds in taxable accounts, consider moving them to tax-advantaged retirement accounts.

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ONE CIRCLE STAR WAY, FIRST FLOOR
SAN CARLOS, CALIFORNIA 94070

999 18TH STREET, SUITE 800
DENVER, COLORADO 80202

250 MONTGOMERY ST, SUITE 700
SAN FRANCISCO, CA 94104