



## *Making Sense of Performance Benchmarks*

# buildingcapital

THE FINANCIAL NEWSLETTER OF FINARC, LLC

To gauge how well a stock portfolio is doing, you need to compare it to a benchmark. Being familiar with various stock indexes commonly used to benchmark performance can help prevent apples-to-oranges comparisons.

### *Standard & Poor's 500 Composite Index*

The S&P 500 is a market value-weighted index of 500 widely held large-cap U.S. common stocks. A committee decides which companies are represented in the index, based on each one's market cap (\$4 billion plus), liquidity, and financial viability. It also tries to maintain a representative weighting of industries. Because it represents about 75% of the total market, the S&P 500 is considered a broader representation of the U.S. equity markets than the Dow Jones Industrial Average.

### *Dow Jones Industrial Average*

The DJIA, also called simply the Dow, is a price-weighted average of 30 well-known, actively traded stocks such as AT&T, Boeing, Coca-Cola, Exxon, General Motors, IBM, and McDonald's. Though the Dow is the oldest and best-known stock index, it represents less than 25% of the market value of all stocks on the New York Stock Exchange. In addition to serving as a proxy for the performance of blue-chip industrial stocks, it has given rise to several investing strategies based on Dow stocks.

### *Nasdaq Composite Index*

The Nasdaq index includes all 3,000-plus foreign and domestic stocks traded on the

Nasdaq system, an electronic network of securities dealers. The market value-weighted index includes many high-tech companies whose stocks first began trading after the Nasdaq system was launched in 1971.

### *Wilshire 5000 Equity Index*

The Wilshire 5000 includes not only common stocks but also real estate investment trusts (REITs) and master limited partnerships. Because almost all actively traded U.S. securities are included in it, it is considered the broadest U.S. equity index. However, because it is weighted by market capitalization, the Wilshire's largest stocks account for the bulk of its total market cap and greatly affect its performance.

### *Russell 2000 Index*

The Russell 2000 is a market cap-weighted index of approximately 2,000 stocks with market caps of less than \$3 billion. It includes the smallest stocks represented in the Russell 3000 Index, another large domestic-stock index, and is often used as a benchmark for small-cap stocks.

### *MSCI EAFE Index*

The EAFE (short for Europe/Australia/Far East), a market cap-weighted index of stocks in non-U.S. countries, focuses on stocks in large industrialized nations. It tends to be less volatile than indexes such as the S&P/IFCI, which focuses on securities in developing countries.

## *Money for Your Life: Determining Your Life Insurance Needs*

### *The thumb no longer rules*

Life is priceless. But if you're purchasing life insurance, a financial value needs to be assigned to it. How do you determine how much your life is worth in dollars to the family you'll leave behind?

There are several rules of thumb you might have heard about when it comes to calculating your basic life insurance coverage need. Figure six to eight times your annual gross income, and maybe throw in special funding needs (e.g., college for the kids) on top of

that. Or back into your answer by determining your premium expense as a percentage of your income--6%, plus an additional 1% for every dependent--and buy as much insurance as you can for that amount. These rules of thumb are simple enough to use. Trouble is, they don't take into consideration your individual circumstances. Consider them no more than a rough starting point.

#### *Are you what you earn?*

The human life value approach, often used in court cases involving wrongful death suits, attempts to measure your economic worth to those who would be affected by your death. Your human life value is defined as the present value of your future net earnings (adjusted for inflation) that would be used for your family's benefit, plus the value of other services you contribute (e.g., you mow the lawn rather than pay to have it done), through your planned retirement age. The resulting figure represents the amount of life insurance coverage you should have to adequately replace your economic value to your family should you die today.

While the human life value approach is more precise than any of the rules of thumb, it still has its weak points. In one sense, it tends to overstate your family's insurance need by failing to account for other assets and sources of income that can help support your family if you die. In another sense, it tends to understate your family's life insurance need by failing to account for certain large lump-sum expenses that will come up only after you die-- for example, final medical expenses, funeral costs, and estate settlement expenses. Finally, by focusing primarily on replacing your income, this approach may ignore the financial needs of your surviving family members.

#### *It's all in the family*

One of the more comprehensive methods of calculating your life insurance need is the family needs approach, which assumes that the purpose of life insurance is to cover the needs of your surviving family members. Accordingly, it focuses primarily on estimating what their immediate and ongoing financial needs would be upon your death.

Your family's immediate financial need will require cash to cover expenses incurred upon your death, such as final medical and funeral expenses. Their ongoing financial need will require an income stream to meet family expenses associated with dif-

ferent situations that will last until your surviving spouse's death (e.g., child dependency, college, spousal income needs until retirement, and spousal retirement). These needs will vary depending on your spouse's and children's ages, whether any family member has special needs, your spouse's capacity to earn income, your spouse's intended retirement age, and his or her life expectancy.

Under the family needs approach, the amount of life insurance you'll need will equal your family's immediate need plus the present value (after other expected sources of income are deducted) of your family's ongoing need, less the value of other assets that could meet some of these needs.

The general equation would look like this:

$$(\mathbf{Im} + \mathbf{P[On - Xi]}) - \mathbf{As} = \mathbf{LIN}$$

where **Im** equals the **I**mmEDIATE financial need at your death, **P[On - Xi]** equals the **P**resent value of your family's **O**ngoing financial need less other **eX**pected income, and **As** equals the value of existing **A**ssets available to defray some of these expenses. The result is your **L**ife **I**nsurance **N**eed.

By examining in detail your family's anticipated expenses during various periods after your death, the family needs approach provides a realistic estimate of your life insurance need. Not only does this approach offer more accurate estimates than the various rules of thumb, but it may also provide a clearer estimate of your family's needs than the human life value approach.

**For additional independent advice and help assessing your own situation, please consult us.**

### ***When will you retire?***

The average American can expect to live past age 77. (Source: National Center for Health Statistics) With future medical breakthroughs likely, it's not unreasonable to assume that life expectancy will continue to increase. Is your nest egg large enough to fund 20 or more years of retirement?

Here are some issues you should consider before making the important financial decision of when to retire. Is your nest egg adequate?

It's obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off of your retirement savings. For example, if you retire at age 65 instead of age 55, and save an addi-

## ***When will you retire? (cont)***

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tional \$20,000 per year at an 8% rate of return, you can potentially add \$312,909 to your retirement fund. (This is a hypothetical example and is not intended to reflect the actual performance of any specific investment.)

### **IRAs and employer retirement plans**

The longer you delay retirement, the longer you can build up tax-deferred funds in your IRAs or employer-sponsored retirement plans. If your employer has a traditional pension plan, leaving the company before normal retirement age may greatly reduce the final payout you receive from the plan.

You could also pay a price for retiring early if you participate in a 401(k) plan. You could end up forfeiting employer contributions in which you're not yet fully vested. You would also miss out on the opportunity to make additional contributions to the plan, and participate in future employer contributions

### **Health insurance**

Keep in mind that Medicare generally doesn't start until you're 65. Does your employer provide post-retirement medical benefits? Are you eligible for the coverage if you retire early? If not, you may have to look into COBRA or a private individual policy--which could be an expensive proposition.

### **Social Security benefits**

You can begin receiving your Social Security retirement benefit as early as age 62. However, your benefit may be 20% to 30% less than if you waited until full retirement age (65 to 67, depending on the year you were born). And if you continue to work past age 62, your benefit will generally be reduced \$1 for each \$2 you earn above the annual earnings limit (\$12,960 in 2007) until the year you reach full retirement age.

In some cases it may be to your advantage to delay receiving your Social Security retirement benefit even after you reach full retirement age. If you do so, your Social Security benefits may increase for two reasons.

First, each additional year that you work adds another year of earnings to your Social Security earnings record, resulting in potentially higher retire-

ment benefits. Second, under the Social Security Administration's delayed retirement credit, your benefit will increase by a certain percentage for each month that you delay retirement up to age 70. The percentage increase varies, depending on the year you were born.

### **Is phasing into retirement right for you?**

Retirement need not be an all-or-nothing affair. If you're not quite ready, financially or psychologically, for full retirement, consider downshifting from full-time to part-time employment. This will allow you to retain a source of income and remain active and productive.

Some employers are adopting "phased retirement" programs to help retain employees who might otherwise retire early, begin receiving their pension benefits, and then seek employment elsewhere, often with a competitor. Phased retirement usually refers to an arrangement that allows employees who've reached retirement age to begin receiving their pension benefit while continuing to work for the same employer with a reduced work schedule or workload.

You benefit from the opportunity to continue active employment at a level that allows you greater flexibility and time away from work, smoothing the transition from full-time employment to retirement. And your employer benefits by retaining the services of an experienced worker. Ask your plan administrator if phased retirement is an option under your employer's pension plan.

## ***Schwab Lowers Costs on Bond Trades, Makes Fixed Income Pricing More Transparent***

Effective July 1, 2007, Schwab reduced operating expense ratios on Schwab tax-free bond funds to a cap of 0.49% and lowered secondary bond-trade fees. In addition, the minimum initial investment for investor shares of these funds will be lower.

The new secondary trade cost is \$1 per corporate or municipal bond and there are no charges for Treasury trades. The trading costs will be displayed or communicated separately for secondary bond transactions so that the overall price of an order may be more easily understood. Please call us if you have any questions.

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### NEWS

We are pleased to announce that **Liam Timmons** has recently passed his Series 65, an exam for investment professionals. It covers retirement planning, fiduciary responsibility, and portfolio management strategies. Liam is performing client service and research assistant work. He will be attending the Carroll School of Business at Boston College part-time as he pursues his MBA.

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**Catherine Friend White** was selected by the readers of *Women's Business* as one of the top ten investment advisors in New England.

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Schwab Investor Checking now yields 4.25%. That's an exceptional rate for checking accounts.

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**W. David Malone** was interviewed by the Newton-Needham Chamber of Commerce on how FinArc assists business owners and other members of the local community with their investment needs.