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Investing for the Long Run

Strategies and Solutions to Help You Shape Up Your Personal Finances

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It seems we're always saving for something. As a kid, I saved my allowance for candy and toys. Later my attention turned to a car, college, engagement ring, wedding, honeymoon, and more recently, a condo. The items I'm saving for have gotten progressively more expensive and take greater diligence to acquire.

Lately, credit cards and eased loans have put many of the items for which I used to save for months within immediate reach. A trip to the store can end with a new tablet or television, easily purchased through credit. The average credit card debt for households has gone well into the thousands. These changing attitudes toward credit threaten to undermine our efforts to save toward—and enjoy—our retirement.

There's no better time than right now to shake bad habits. We've pulled together a collection of articles from Morningstar Investment Research Center and Morningstar.com to help you shape up your personal finances. You'll find worksheets and links to online tools that will help you get out of debt and back on track. We'll give you tips to weather life's emergencies, and we'll describe how to start investing and save for retirement.

Investing for the long run means saving for what really matters. You're already on the right path by picking up this book; simply read on. And pass it on, either by sharing this book or telling friends and family to get it free through Morningstar Investment Research Center at their local library.

Thank you,

Darrin Thomas

Darrin Thomas, Ph.D.
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01

Investing for the Long Run

Strategies and Solutions to Help You Shape Up Your Personal Finances

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Getting Your Finances in Order

How to Create a Budget You Can Live With

By Christine Benz
Director of
Personal Finance

We all need a budget, regardless of age, life stage, or whether we think we've "made it" or not. Get your spending and saving on track with our budget worksheet

A few years ago, I received an email from a couple seeking a portfolio makeover. They were in their mid-50s, and their portfolio had been taken on a wild ride during the financial crisis from 2007 through early 2009. That, in turn, had scuttled their hopes for retirement in less than a decade, and they were wondering how they could make up the lost ground.

This couple's investment portfolio, with more than 80% in stocks, was clearly too aggressive, given their life stage. In talking with them about their finances, however, I discovered that their investments weren't their main problem. Their spending was.

The couple had scrimped and saved to buy a carpet-cleaning business in the early 1990s and went through some lean years while they were building up their clientele. Thanks to their sacrifices and hard work, the business was generating more than $200,000 in take-home income per year.

As is so often the case, however, this couple's spending went up right along with their pay, and their savings slowed to a trickle. They bought a bigger home, took regular trips to Las Vegas, and were in the habit of spending money on nearly anything they wanted, from flat-screen TVs to catered family parties.

When I asked them if they had a budget, they said that they once had. While they were buying and building up their business, they lived in a two-bedroom apartment with their two children. But after their income had increased to a more comfortable level, they didn't see as much need for budgeting and eventually stopped tracking their expenses altogether. When they tried to look back on what they had spent over the past month, more than $1,500 was unaccounted for. I pointed out that if they were to save that amount each month rather than spend it on stuff that they couldn't remember, that would do far more to get their portfolio back on track than selecting the right investments ever could.

Because we all have a natural tendency to spend what we have, everyone needs a budget, regardless of age, life stage, or whether we think we've "made it" or not. The key point about a budget is that it helps to ensure that your spending syncs up with your priorities. This couple wanted to balance their here-and-now goals of travel and fun with their long-term goals of funding a comfortable retirement and perhaps leaving a legacy for their children.

Here's a quick overview of how to create a budget you can live within.

More Resources

Morningstar Budget Worksheet
► *morningstar.com/goto/budget*

Or turn to page 09 for an example of this worksheet

Evaluate Current Income and Expenses

Enter your current fixed and variable expenses, as well as information about your sources of income, on the Budget Worksheet. For expenses and income sources that don't fit neatly into the categories provided, use the "other" lines. If you have several expenses of a given type, make a note alongside the line item—for example, "DVD Rentals" or "Toiletries/Makeup." Also record any savings that you're typically able to set aside each month.

Scrutinize Your Variable Expenses

Start the budgeting process by scrutinizing your variable (or discretionary) expenses over the past month(s). Because you have the most control over this set of costs, making adjustments here is the fastest way to improve your household's financial picture.

Be forward-looking as you evaluate your variable expenses. The data you've supplied about your income and spending provides a snapshot of the money you have coming in and going out. But your budget gives you a chance to shape your spending to fit with your goals, both personal and financial. For example, you may have spent a lot on carryout and restaurant meals over the past month. But if getting in shape is on your list of personal priorities, you can tweak your budget to reduce your spending on restaurant meals and increase the dollars that you're allocating toward food from the grocery store so you can prepare healthy meals at home.

As you go through the process of evaluating your variable expenses, it's also essential to be realistic. Just as dieters can't stick with the plan if it doesn't allow for the occasional piece of birthday cake or glass of wine, it's also unrealistic to plot out a budget with no room for the occasional movie or lunch with friends. Using your real past expenses as a template for your budget helps to anchor you in reality, not a pipe dream.

If you anticipate expenses that are predictable but not necessarily monthly—such as holiday and birthday gifts—it's a good idea to distribute those costs throughout the year. Look back on the past year's worth of gift giving, estimate your expenditures, and adjust downward or upward as you see fit. Then divide by 12 to arrive at your monthly budgeted amount. Record your target expenditures for each line item in the Budget column on the Budget Worksheet.

Evaluate Your Fixed Expenses

Next, turn your attention to your fixed expenses on the Budget Worksheet. Although household necessities are usually referred to as fixed costs, that's a bit of a misnomer. Yes, these items are necessities, but you may be able to adjust them somewhat. Some areas in which it's possible to reduce your fixed costs:

- *Food:* Prepare meals at home
- *Clothing:* Try shopping the sale rack
- *Credit Card Interest Rates:* Sometimes negotiable

► *Mortgage Payments:* Refinancing may be an option
► *Telecom Services:* Change providers or negotiate a lower rate with your current provider

Take note of the areas where you may be able to reduce your fixed costs and plan to follow up on them. If you are able to obtain reductions in these areas, adjust your budget accordingly.

Watch the Bottom Line

As you tweak your target expenditures, pay attention to how the changes affect your bottom line. Your goal should be not only to balance your household budget but also increase the amount you have earmarked for saving and investing each month.

Re-Evaluate Each Month

Finally, put in place a plan to check your real-life spending versus your budget on an ongoing basis. One of the key mistakes that people make when budgeting is that they create a budget and then put it in the drawer.

Start by finding a place to record your household's expenses. Software like Quicken can help you track your expenses, but you can also track them with a pen and paper. Be sure to ask your spouse to do the same.

Next, block out time on your calendar each month (ideally, one hour per month over the next three to six months) to check up on your actual expenses versus your budget. If your first budget assumptions were unrealistic or if something material has changed in your household's financial picture, adjust your budget accordingly.

Excerpted from 30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances, *with permission from the publisher, John Wiley & Sons, Inc.. Copyright (c) MMX by Morningstar Inc.*

Download worksheet

► *morningstar.com/goto/budget*

Sample Monthly Budget Worksheet

Income	Earned
Salary (net: after taxes and benefits)	
Spouse's salary (net: after taxes and benefits)	
Pension income	
Interest/investment income	
Other income (specify)	
Total Income	

Fixed Expenses	Spent	Budget
Mortgage/rent		
Other real estate payments		
Auto loan		
Student loan		
Credit card payment		
Utilities		
Tuition		
Child care		
Food		
Clothing		
Insurance		
Other expenses		

Variable Expenses	Spent	Budget
Personal care		
Entertainment		
IRA contributions		
Dining out		
Other expenses		
Other expenses		
Other expenses		
Other expenses		
Other expenses		
Total Expenses Fixed + Variable		

Total Income		
	(-) Total Spent	(=) Current Savings
	(-) Total Budget	(=) Target Savings

Fifty Ways to Cut Expenses

By Christine Benz
Director of
Personal Finance

Follow these personal spending tips and watch the savings pile up

We often discuss ways to invest money for various goals like college funding, big-ticket purchases, and retirement. But before investors can tackle where to put the money, they need to tackle where to find the money.

Proper budgeting and cost-cutting can help you free up funds for investment, emergency accounts, or debt-paydown. Here are 50 ideas to help you stretch your dollars to the max. If you follow through on them, you'll make significant progress in cutting costs in your day-to-day life.

01
Watch out for shipping costs when buying via the Internet. Look for free shipping or buy locally.

02
Use the public library to check out movies or books for free.

03
When traveling, look online before you leave for ideas or coupons. Once on site, ask the locals for low-cost favorite spots.

04
Try a vacation at home (staycation). See and do the things you've always meant to do and save on hotel costs.

05
Compare rates for cable and satellite. Go with the less expensive option. Only sign up for the channels you know you'll watch.

06
Send free e-cards and save on postage.

07
Consider buying a certified preowned car instead of a new one.

08
Cut back trips to Starbucks or other premium coffee shops.

09
Stop buying clothes that are "dry clean only." Learn to iron.

10
Don't renew subscriptions to publications you don't have time to read.

11
Make IRA contributions early in the year to take advantage of additional months of tax deferral.

12
Lock in a fixed mortgage rate so your interest rate can't increase to a point you can no longer make your house payments.

13
Only use ATMs where you won't be charged service fees.

14
Give up expensive health club memberships. Learn to exercise outdoors, at home, or through the park district. Or join the YMCA.

15
Consider a small hybrid car over a similarly priced midsize non-hybrid to save you unnecessary pain at the pump.

16
Wait a little longer between manicures (try doing one yourself!), massages, or highlights (try a local training school).

17
Pay off your credit cards monthly and avoid paying interest.

18
If you must charge, switch to a no-fee or low-fee credit card. Go to bankrate.com to compare rates.

19
Wash your car at home and skip the car wash.

20
Pay your mortgage payment biweekly instead of monthly—you'll save on interest costs and pay off your mortgage sooner.

21
Check your credit history. Go to annualcreditreport.com and make sure everything is accurate. Good credit may mean lower interest charges.

22
Set up one checking account for regular recurring expenses and another for bigger-ticket items.

23
Take advantage of your employer match in your 401(k) or other retirement plan.

24
Don't take a loan from your 401(k) plan—you'll save on double taxation of that repaid interest.

25
Consider using exchange-traded funds (ETFs).

26
Talk to financial planners at no cost. Look for newspaper money shows or local events where this service may be offered.

27
If considering moving or retirement, look into places where the cost of living and/or state tax rates are cheaper.

28
Keep track of your cost basis on investments to save money on taxes when you sell an investment.

29
Put investments that generate ordinary income in tax-deferred accounts.

30
Put investments that generate capital gains or dividends (both generally taxed at lower rates than ordinary income) in taxable accounts.

31
Cook in bulk and freeze.

32
Pay attention to mutual fund brokerage fees and expense ratios on mutual funds you buy.

33
Quit smoking and take note of any other expensive habits.

34
Go to matinee movies instead of movies at night.

35
Turn down your home thermostat a couple degrees in the winter.

36
Only do full loads of laundry and fill the dishwasher before running it.

37
Plan parties where everyone brings something.

38
Bring your lunch to work or scout out the inexpensive places to buy lunch.

39
Sell stuff you don't need or use anymore on eBay.

40
Get a roommate and share expenses.

41
Be a smart grocery shopper—cut coupons, shop at discount stores, and stock up on sale items.

42
Buy energy-efficient appliances. They're cheaper in the long run.

43
Fill prescriptions with the generic form of the drug.

44
Plan your purchases—avoid impulse buying.

45
Keep up maintenance on cars. It may prevent costly future problems.

46
Get annual physicals to prevent costly future problems.

47
Track your spending. If you write it all down, you'll probably spend less. And you'll know exactly where your money goes.

48
Skip paying cab fare now and then. Walk or use public transportation.

49
Don't buy mutual funds just before capital gains distributions.

50
Do your own home improvements. Home Depot and Lowe's employees can walk you through what you need to know.

Five Steps to an Organized Financial Life

By Christine Benz
Director of
Personal Finance

Advice for keeping your financial documents in order

I come from a long line of neatniks, so getting and staying organized is essential to feeling like I have my life under control. When I'm completely overwhelmed with work, the very act of straightening the piles of papers on my desk or moving mail from the countertop to its rightful spot in my home office is enough to calm me down and clear my head.

If you don't have a similar emotional attachment to organization, more power to you. (If I had my druthers, I'd rather not be tyrannized by my label-maker and The Container Store catalog, either!) But there are concrete reasons to keep your financial documents in order, no matter what your personality type. For starters, it's a cinch that you'll have to put your hands on some of these papers in the future—to file your taxes or an insurance claim, for example—so it makes good sense to keep them in a logical and readily accessible location. It's also essential that your heirs be able to locate your important financial documents. Finally, keeping your financial paperwork organized will tend to keep you in touch with your personal balance sheet. If you're filing your financial documents as you receive them, you'll be forced to reckon—whether you like it or not—with how much you have in assets and how much you owe. You will thus have a better sense of where any potential trouble spots might lurk.

Of course, when it comes to any self-improvement project, the chasm separating reason and action can seem as wide as the Grand Canyon. There are ample reasons for many of us to lose a few pounds and watch less TV, to name a few. Yet there we are, curled up on the couch with a pint of our favorite ice cream and a guilty pleasure reality show on the tube. When it comes to getting your financial house in order, however, there are a few easy steps you can take that will get you well on your way to becoming truly organized. I've ticked them off below.

01

Learn What to Stash and What to Trash

There's a reason many of us put off organizing our financial paperwork and tend to hang on to too many documents: Throwing out a financial statement that we might need for insurance or tax purposes has more serious repercussions than pitching a sweater that just might come back into style. But few of us have the space, let alone the discipline, to squirrel away every last receipt and statement. (For an excellent overview of which financial documents you should save and which you can safely trash, check out the next article, *Can I Throw This Paperwork Out?* by Sue Stevens.)

To help protect against identity theft, a piece of advice bears repeating: Buy a shredder and use it to destroy the myriad documents that include your name or other personal information. Sue also notes that scanning documents that you might otherwise save in paper form can be helpful as you try to reduce clutter.

02

Know Where to Put What You Keep

Once you've determined which financial documents you can stash in your circular file and which you should be retaining, you'll have to develop a system for storing the items you're keeping.

If you have a filing system that works for you, great—proceed to Step 3. If you don't, I'd recommend a three-tier scheme: one for documents that relate to the current year; one for papers that you need to hang on to but have no immediate need for; and a safety deposit box for irreplaceable documents.

Reserve the current-year tier for any items that you might need to put your hands on in the near future, including banking and investment statements, documents relating to the current tax year (such as receipts for charitable donations), and utility and credit-card bills for the current year.

Each year or so, preferably after tax time, weed your current-year records, moving the previous year's documents to the second, or longer-term, storage tier. In these longer-term files, store the previous years' banking and investment statements (keep only those canceled checks you might need in the future, such as those relating to a major purchase), copies of your completed tax returns, insurance-related documents, and any other financial records you can anticipate needing down the road.

Reserve your safety deposit box for those few documents that would be particularly tough to replace if they were destroyed. Marriage and birth certificates, divorce decrees, passports, and original insurance policies all fall into this camp. It's also a good idea to take a video inventory of your major possessions and store that in the safety-deposit box as well.

03

Create a Master Directory

Even if you're fit as a fiddle, it doesn't hurt to plan for the unexpected. That's why I'd urge everyone to create a financial directory in case something should happen to you. On it, you should list all of your financial accounts, from banking to insurance policies to investment accounts, along with your passwords and the names and phone numbers of any advisors that you use. Give this document to a close relative or trusted friend, or create an electronic document (in a very secure location on your computer!) and provide that friend or relative with specific instructions for gaining access to it if need be.

04

Stay on Top of Incoming Mail

With the exception of the occasional greeting card, magazine, or catalog, most of our mailboxes are stuffed with nothing more than credit-card solicitations and bills. It's important to have a strategy for tackling each category and to integrate these strategies into your daily routine.

Because credit card solicitations and other printed statements often include your name, birth date, account number, and/or Social Security number, don't discard them without shredding first.

If you don't use an electronic bill-paying system, I'd also recommend logging any incoming bills on to a calendar as soon as you receive them. Note the date on which the bill should be mailed, who you owe, and how much. When you sit down to pay your bills for the coming week or month, this approach will help to ensure that nothing falls through the cracks.

05

Take Advantage of Technology

I've devoted most of this article to taming physical paperwork, but technological advances enable you to greatly reduce the amount of financial paperwork you have to contend with. For example, scanning important documents and storing them on a disc will enable you to reduce the amount of paperwork for which you need to find a physical home. And electronic bill-paying systems and automatic debit programs can also help simplify your financial life. Not only can they greatly reduce the time you spend on financial paperwork, but they also ensure that your bills get paid on time. (On the flip side, using an automatic debit program makes it essential that you stay on top of whether you have enough money in your account to cover outgoing bills.)

When it comes to aggregating and monitoring your investment accounts, I recommend using Morningstar Investment Research Center's Portfolio X-Ray tool. Use it to quickly size up your overall stock/bond/cash mix, identify your biggest bets, and determine whether a new fund would add diversification. When looking at your statements in isolation, it can be tough to tell how well you're doing. Portfolio X-Ray helps you see if you're on track to meet your goals.

More Resources

Morningstar
Portfolio X-Ray
► *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

Can I Throw This Paperwork Out?

By Sue Stevens
CFA, CFP, CPA

Get organized by consulting these tips

Most of us get inundated with financially related mail—bank statements, brokerage statements, annual reports, credit card statements, proxy voting, and more. One of the best ways of keeping down the clutter is to deal with each piece of mail as it arrives—decide if you need to keep it or if you can toss it.

There are two purchases you may want to make, if you haven't already: a shredder and a scanner. When you throw away financial documents, it's best to shred them. By doing this, you help prevent identity theft.

You may also find it helpful to scan documents you want to save instead of storing the paper files. For example, if you get monthly brokerage statements, you may want to scan in past statements and keep only paper copies of confirms and year-end statements (some of you may want to keep digital copies of everything). You can save your electronic documents to a CD and really cut back on physical storage space.

Continue reading for guidelines in answering, "can I throw this paperwork out?"

Keep it

- When you get your bank statement, you should go through the process of balancing your checkbook. Once that's done, file each monthly statement. If you get cancelled checks with your statement, keep them for one year in case you have some type of payment dispute.
- Tax returns for the past seven years (three years is the rule for most returns, but seven years covers a few other situations).
- Birth certificates, death certificates, marriage certificates
- Deeds
- Car titles
- Insurance policies
- Estate documents: wills, trusts, powers of attorney
- Contracts
- Medical records
- Prospectuses
- Investment confirmation statements for purchases and sales
- Year-end brokerage statements
- Monthly credit card statements (especially if they list items you deduct on your income tax return)
- Property tax bills

Toss it

- Once a year, go through the previous year's cancelled checks and only keep the ones that you may need in the future, such as checks written for home improvements (may become part of your home's cost basis), major purchases (may need for insurance purposes), or tax-deductible items. You can throw away cancelled checks for other routine purchases such as groceries, gasoline, clothing, utility bills (unless you deduct them).
- Your bank and brokerage statements may come with "stuffers"—typically some marketing material about other services. Read it once when it arrives and if you don't plan to use that service, throw it out.
- If you're going to vote your proxies, do it right away. If you choose not to vote your proxies, toss them.
- Read your annual reports when you get them. Then you can throw them out.
- Credit card receipts—after you verify them on your monthly statements.

Deciding to Invest Together

Starting a Life Together? Let's Talk Finances

By Rachel Haig
Assistant Site Editor for Morningstar.com

Get started in the right direction—and make sure you're heading the same way

If you are considering marriage or are recently married, there's probably a lot on your mind. Sitting down to discuss money issues may not be at the top of your list, but it's one of the most important tasks to tackle if you're starting a life with someone.

These days, couples are inundated with cautionary tales and divorce statistics warning of financial disputes—not exactly what you want to hear. It's true that money matters are complicated and have long been one of the top reasons why couples fight and split up. But discussing issues up front and getting your finances in order from the outset can help keep money from putting a damper on your relationship.

Tackling your finances as a couple begins with assessing your situation. Do you share financial attitudes, habits, and goals? Day-to-day questions such as whether you will share accounts, who will pay the bills, and how you will budget money together are important to discuss, and a candid conversation is the essential starting point.

Start the Dialogue

Regularly discussing your financial goals and current standing is a good habit to start now, if you haven't already. What shared and unshared goals do you have? What type of lifestyle do you want? Do either of you have student loans or outstanding credit card debt? How do you each feel about it? Get any financial anxieties in the open sooner rather than later.

Discuss upcoming financial plans, such as whether you will buy a house or if one of you is considering returning to school. Do you expect any major financial changes?

Ideally, these conversations should begin before you tie the knot. If you are already married, though, there's no better time to start than now.

Take Inventory

Once the two of you are on the same page, the next step is to map out your combined earnings, assets, and debts. Include your income, investments, credit card debt, and student loans. Also include any mortgages, car loans, and any other amounts you own or owe. Make a master list of each of your checking, savings, and investment accounts so you both know where everything is. The Net Worth Worksheet can help you get started.

Listing all of your assets and liabilities together will highlight any problem areas and help you see the big picture. Do you have two cars when you could get by with one? Do you have more combined debt than you realized? Once you know what you're dealing with, you can discuss how you will approach and prioritize complex issues—such as paying off credit cards and student loans—together.

More Resources

Morningstar Net Worth Worksheet
▸ *morningstar.com/goto/networth*

Or turn to page 20 for an example of this worksheet

Compare Employer Benefits

If you are already married, one of your first tasks to take on together is a side-by-side comparison of your options for health-care coverage. If you are not married, some companies also offer coverage for domestic partnerships—check with your human resources department for details. If you are both employed, you have the benefit of choosing from either plan. If one of you is in school or self-employed, the best option may be clearer cut.

Ask yourselves if it makes sense to keep separate coverage, or if one of your plans is better. Look at each policy's premiums, coverage, deductibles, prescription costs, and doctors covered to see if there is a clear winner. Also compare your vision and dental plans and life and disability insurance policies. Check with your employer(s) about rates to add coverage for your spouse.

Check Up on Other Insurance Needs

Even unmarried couples can frequently save money by streamlining insurance policies—especially if you already live together. Change your car insurance and homeowner's or renter's insurance so that you are both on the same policy. Usually, you receive a discount for using the same provider for multiple types of insurance. Also check in with your insurance agent about insuring personal articles, such as your ring or other jewelry, which may not be covered under your homeowner's or renter's insurance.

More important than precisely outlining your combined net worth and optimizing your insurance policies, however, is making sure you understand each other's financial attitudes and goals. Openly discussing your combined financial situation together from the outset will enable you to deal with the array of financial tasks and challenges you will inevitably face in your lives as a team.

Download worksheet

▸ *morningstar.com/goto/networth*

Sample Net Worth Worksheet

Net Worth / Assets

Taxable Accounts	You	Spouse	Joint	Total
Checking				
Savings				
Credit Union				
Money Markets				
Mutual Funds				
Stocks				
Bonds				
Stock Options (Vested)				
Other				
Retirement Accounts	You	Spouse	Joint	Total
Annuities				
Traditional IRAs				
Roth IRAs				
401(k), 403(b), 457				
Personal Property	You	Spouse	Joint	Total
Primary Residence				
Secondary Residence				
Cars				
Jewelry, Furs, Art				
Home Furnishings				
Other				
Life Insurance Cash Value				
Total Assets				

Sample Net Worth Worksheet Continued

Net Worth / Debt

Personal Property	You	Spouse	Joint	Total
Mortgage				
Home Equity Loan				
Car loan				
Credit Card Debt				
Student Loans				
Other				
Total Debt				

Total Assets	**(-) Total Debt**	**(=)Total Net Worth**

Should You Merge Your Finances?

By Rachel Haig
Assistant Site Editor for Morningstar.com

Deciding whether to share accounts

Newly joined couples have a lot of decisions to make: whether to register at Bloomingdale's or Target, whether to hire a sedate string quartet or a rockin' Rockabilly band to play at the reception, and whether to honeymoon somewhere exotic or stay closer to home.

Alongside those pressing decisions, it might be tempting to backburner the choice about whether to merge your financial accounts, keep them separate, or do a combination of both. But this decision will have a far bigger impact on your financial life, so it pays to give it due attention before you actually tie the knot.

Ultimately, your determination depends in large part on your individual financial views and habits, so an initial, candid discussion is essential before you delve into the specifics of how you will handle accounts.

Deciding the appropriate degree of account sharing also depends on a number of factors, including your spending habits and your living arrangement. If both of you work and have similar incomes, the decision is much different than if one of you brings in most of the money.

The primary decision is how to handle your bank accounts, including checking and savings accounts. (In those cases when one or both of you has your own business or children from a prior marriage, you're best off seeking legal advice to help you assess your options.)

You have three basic options:

Share Everything
This is the "traditional" approach. You can either add each other as co-owners to your existing accounts, or you can open a new account together. Joint accounts are typically set up so that spouses are "joint

tenants with rights of survivorship." You each have full access to the account, and assets automatically pass to the surviving spouse if one partner dies. There are also other legal arrangements for joint accounts that do not include survivorship rights, such as "tenants in common."

Sharing all of your accounts can be the most convenient approach, but it works best for people who share similar financial habits and generally agree on spending. Sharing everything also makes sense when one person is the primary earner.

This option doesn't allow for spending without the other person's knowledge, which, from my perspective, reinforces financial openness that should exist already. You should be communicating about spending regularly, especially for big purchases, so starting to share accounts shouldn't be too much of a shock. If one person is very uneasy about the idea of shared accounts, it's important to make sure he or she has aired any underlying anxieties. (Sharing accounts also creates challenges for surprising each other with gifts!)

Share Some

Many couples find sharing a portion of their finances to be the most comfortable option, either for the long term or as a way to transition. There are several variations, but a common approach is to create "Yours, Mine, and Ours" accounts. Create one combined bank account for shared expenses like rent and utility bills, and keep separate individual accounts for discretionary spending.

This approach enables each of you to have money to spend on your own purchases, without as much anxiety over whether the purchase is something you both want (you could also accomplish this with a simple budget, however).

Not surprisingly, keeping some accounts separate while combining other finances can make things more complicated. You would need to figure out how much each of you would contribute to the shared account each month and which expenses it would cover. Many couples base the amount each contributes on a proportionate percentage of their incomes.

Share None

There are some situations when it makes sense to keep your accounts completely separate. If you've already been living together without sharing accounts and haven't hit any rough patches, you have the option of simply continuing your current arrangement. Keeping accounts separate is also the way to go if you and your spouse want to keep a clear delineation between assets you each brought into the marriage (more on this below).

If you and your spouse keep your accounts separate, you will need to decide who will pay for which expenses. Some couples divide up bills so that each person is responsible for a certain set of payments each month.

Other Assets

You will also need to determine whether to add both your names to other assets, such as real estate, vehicles, and investment accounts. Adding your spouse to the deed of your house or condo is more complicated than setting up a joint bank account. Check with your mortgage lender, because changing the name on a mortgaged asset can lead to unintended consequences, and your lender may also require additional documents and fees. If you're already considering refinancing, though, it's an opportune time to consider adding your spouse to the mortgage and deed. Similarly, check with your lender before adding your spouse to your vehicle title.

For your taxable investment accounts, discuss your investment philosophies and determine if it makes sense to share an account. If one of you has a higher risk tolerance, for instance, it may make sense to keep things separate. Although your retirement accounts remain separate, you should develop a retirement plan together. How much is each of you contributing to your company retirement plan and/or IRA, and what does your combined retirement portfolio's asset allocation look like? (Use Morningstar Investment Research Center's Portfolio X-Ray tool to help sort this out.) While you're at it, remember to update your beneficiary designations.

Legal Considerations and Divorce

Few couples go into marriage expecting that they may eventually split up. But given high divorce rates in this country, it's worthwhile to give at least passing consideration to how your assets would be divvied up in the event of a divorce. That, in turn, could affect how you title your financial assets.

Laws governing asset ownership are intricate and vary by state, but it's worth considering general principles when deciding how you will handle your accounts. Family law recognizes a distinction between assets held individually before marriage and those acquired after marriage, and classifies assets as either marital or nonmarital property. Determining exactly what falls into each category can be tricky and can come down to whose name is on each account.

The American Bar Association's Family Legal Guide offers two tips for individuals worried about protecting certain assets in a divorce: 1. keep the account in your name only; and 2. do not comingle money from the account with joint accounts.

Couples who want to hammer out exactly how assets would be divided in a divorce should meet with an attorney. Prenuptial agreements before marriage are well-known, but postnuptial agreements are also an option.

Of course, these considerations can hit an emotional nerve, and there is heated debate over whether couples should plan for possible divorce.

Stay Flexible and Communicate

There isn't one solution that works best for everyone—it's a matter of figuring out what works for you. Regardless of your choice, make sure each person's responsibilities are clearly defined and both parties know where money is coming from and where it's going. Make a list of your monthly financial obligations, including your rent or mortgage, cell phone, cable, and utility bills, and determine who is responsible for making sure payments are made. Remember to include savings—both for retirement and other goals—as something the two of you must contribute to monthly. It will probably take some experimenting to find a system that suits you, and what works now might not be the best approach later. Remaining flexible and checking in with each other regularly is more important than nailing down a system right away.

More Resources

Morningstar Portfolio X-Ray
► *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

Budget for a Life Together

By Rachel Haig
Assistant Site Editor for Morningstar.com

Creating a joint budget is one of the first steps to a happy financial union

Setting up a budget with your spouse-to-be probably ranks right up there with cleaning the toilet or pulling a hangnail. Although it's likely one of the last things on your to-do list, setting up a joint budget is one of the first steps to getting your finances in order as a couple. It frequently makes sense to make a budget even before you get married, especially if you're already living together. While you may dread the idea of setting up a budget, the process can actually reduce anxiety.

If you are barely making ends meet, the consequences of not having a clear roadmap for how you'll spend your money each month could result in bad debt problems that expand into bankruptcy or foreclosure. Even couples who are in good financial shape can benefit from a budget, however. Without a budget, money-wary couples often focus on simply "spending less." That's a fine goal in the abstract, but in reality, that approach can cause unnecessary feelings of guilt for occasional indulgences. Instead of taking the "just spend less" route, use a budget to prioritize where you spend your money.

Setting up a budget as a couple isn't too different from setting one up individually, but there are added complexities—after all, there are two of you, and you probably don't spend your money in exactly the same way.

Just as when you set up a budget for yourself, what's arguably most important when setting up a budget as a couple is being reasonable. A budget is meant to help you see the big picture and plan how your money will be used. It isn't simply about helping you stay within spending boundaries. A joint budget is also a tool to ensure you agree on spending guidelines and to carve out money that's OK to spend on items that may not be absolute necessities.

Discuss Priorities

The first step is to figure out what each of you views as the most important uses of your money, and identify "must spend" items that cannot be cut. Outline short-, medium-, and long-term goals, and determine how much you want to save. Think about what each of you values. Would you rather live in a nicer home or be able to take more vacations? Would you rather buy premium foods or designer clothing? Start general—you'll hammer out specifics later, but it will be easier if you both have a broad sense of what you're trying to accomplish.

Track Your Spending

Before you start the actual budget, take some time to get a handle on where the two of you spend your money. (This may take a couple of months if you haven't been keeping track of your spending). There are several great Internet tools to help with this, such as Mint.com which automatically tracks and categorizes your transactions.

Or, you can track your spending the old-fashioned way—save all of your receipts, and make a list of your purchases in different categories at the end of each week (receipts can get out of hand if you wait until the end of the month).

If you put most of your charges on a credit card, taking a look at the statement can also give you a sense of where your money goes. Some credit-card companies also provide cardholders with a year-end statement summarizing charges by category—for example, "Groceries," "Dining," and so on.

List Fixed Spending

Once you have your spending history to work with, lay out all of your financial obligations that are the same or similar each month, such as your rent or mortgage, utilities, phone bills, student loans, and any other regular payments. Also include any money you set aside for savings each month, either in a company retirement plan or individual account.

Listing your fixed monthly costs will give you a general sense of what you have left to spend each month, after the amounts you know you have to pay. Seeing all of your forced monthly payouts can also raise budgeting questions. Do you really want to tie up so much of your money on a premium cable package? Could you save money by switching your cell phones to a family plan? Calling these "fixed" costs may be a misnomer because you actually have quite a bit of wiggle room with how much you spend.

Map Out Discretionary Spending

Finally, it's time to get into the nitty-gritty. There is some room to reduce your standard monthly expenses, but discretionary purchases are where you have the most room for cost-cutting.

Working with your spouse, divide your monthly spending into categories and determine approximately how much money to allocate each month. Categories should be fairly broad: restaurants, bars, entertainment (music, movies, theater, etc.), shopping (clothing, electronics), and travel are good examples. You and your spouse probably each spend money on things the other person doesn't understand. A budget helps you keep disagreements in check—as long as you each stay within agreed-upon amounts, there's no need to scrutinize individual purchases.

You should also decide how much of your paycheck(s) to sock away each month, both for retirement and other goals. Remember to save for an emergency fund, if you haven't already.

More Resources

Morningstar Budget Worksheet
► *morningstar.com/goto/budget*

Or turn to page 09 for an example of this worksheet

Consider your category spending limits to be general guidelines, but treat your savings as a fixed cost. It's OK if some months you spend more in one category and less in another, but you'll have much more success meeting your goals if you refuse to shortchange your savings.

The Morningstar Budget Worksheet is a good place to start your budget planning. Of course, staying on budget also requires continuing to track your spending on a monthly basis.

What Your Spouse Must Know About Investing

By Christine Benz
Director of Personal Finance

Could your partner handle these six issues without you?

Within every household, most couples divide and conquer. Maybe you do the laundry and your spouse handles the trash. Or perhaps he's in control of all things yard-related, but you always do the grocery shopping.

Handling a household's financial affairs is another one of those tasks that usually falls to one spouse or the other. Of course, there are some couples who are equally engaged in the process of budgeting, bill-paying, saving, and investing. But in most families, those jobs are the exclusive domain of just one partner.

If you're trolling around Morningstar Investment Research Center for information, there's a good chance that you're that person in your household. Perhaps you had hands-on work or educational experience with financial matters, or maybe you simply have a greater interest in financial affairs than does your spouse.

The key risk you run in single-handedly managing your family's financial affairs, however, is that you could leave your spouse out of the loop. If something were to happen to you, would he or she know how to manage the family nest egg? And even if you expect that your spouse will have to turn to a financial advisor for help when you're gone, would he or she even know where to look for advice?

Even if you're fit as a fiddle, make sure that your spouse would know how to handle the following issues if something were to happen to you.

Whom to Contact

Your first step in leaving your spouse well prepared is to draw up a list of your important financial contacts: financial planners, insurance agents, accountants, and attorneys. Include their names, phone numbers, and email addresses, and also provide a brief overview of what they've helped you with.

Where to Find Everything

After that, your next step is to delineate what assets you have and where to find them. You may hold a number of different accounts scattered across several different financial-service providers. You may have it all straight in your head, but it could seem like a confusing mess to your spouse. Try to streamline your investment accounts as much as you possibly can. Your partner will have a far easier time managing the family nest egg if something should happen to you. Maintaining a relatively short list of investments has another positive side effect: You'll have fewer moving parts to monitor. It also lessens the chance that you'll wind up with a portfolio that behaves a lot like an index fund but costs a good deal more.

In addition to streamlining your portfolio, it also makes sense to develop a filing system that makes sense to both of you. Start by creating a folder—either paper or electronic—for each separate account, and be judicious about what papers you store in each. (Stash: Brokerage and mutual fund statements, along with trade confirmations. Trash: Annual reports, prospectuses, and marketing literature.) Once you've done that, create a master directory, listing all of your accounts and account numbers (don't forget life-insurance policies), the names and phone numbers of any individuals you deal with at various financial institutions, and any URLs and passwords you need to gain access to your accounts. Store this information in an ultrasafe place, such as a safety-deposit box.

How You're Doing

Even if you don't inform your spouse of every investment decision you make, you should take time periodically to give him or her the big-picture view of where your finances stand. How much do you have overall, and how much of that is liquid (i.e., in securities that you could easily convert to cash)? Are you on track to meet your shared goals or do you need to increase your savings rate? Deciding how much to spend each month and how much to save and invest is a basic decision for every household, and both partners should be involved.

Which Assets to Tap First

Some of your assets can be tapped at any time, while others may carry penalties and tax costs if your spouse withdraws the money prematurely. To prevent your spouse from making a serious and costly mistake, it pays to clearly delineate which of your assets are liquid and which are not. As a general rule of thumb, you'll want to keep at least six months' worth of living expenses in highly liquid securities, such as money market funds, CDs, or money market alternatives.

Where to Go for Help

If you've been an investment do-it-yourselfer but expect that your spouse will have to seek outside help in managing your financial affairs after you've gone, it can't hurt to lay the groundwork for that possibility. Scout around for financial planners who share your investing philosophy and have served clients with needs similar to yours.

How to Learn More

Even if you expect that your spouse will use the services of a financial planner or advisor after you're gone, he or she will still need a basic grounding in money and investing. No, a financial book isn't beach reading, but a handful of commonsense investment books impart a lot of information in an easy-to-digest format.

Can You Afford to Live on One Salary?

By Christine Benz
Director of Personal Finance

In addition to making ends meet, be sure you don't give short shrift to your long-term goals

Many couples are presented with the difficult decision of cutting back to only one salary for their family, particularly if there is a new baby on the way and one parent would like to stay home and raise their child. What are all of the financial implications that couples should think through?

As with any budget question, the decision to go down to a single salary might look eminently doable on paper, but making ends meet on one paycheck could be more difficult in practice. You also need to assess how this decision will affect your long-term goals: If just one spouse is earning a paycheck, will that impede your ability to sock money away for retirement and college? How about your spouse's prospects for re-entering the workforce at a later time?

Here are some of the key things to think about as you conduct this analysis.

Be Realistic About Budgeting

Running a basic budget is a great first step when determining whether living on one salary is financially feasible. A good follow-up to that exercise, however, is to do a trial run during the next few months to make sure that a budget that looks good on paper is manageable in real life.

It's also essential that you pad your anticipated expenses to make room for the extra costs of taking care of a new baby, such as health-care expenses, diapers, and clothes, as well as furniture and other gear. The Web is full of calculators, such as babycenter.com, that can help you get your arms around the true costs of parenthood.

Make Sure You Have a Safety Net

Two-earner couples have more financial safeguards than do couples living on a single salary: If one spouse should lose his job or become disabled, there's still another income coming in the door. Because they're usually more financially fragile, single-income couples need to take additional steps to build a financial safety net. Key components include the following.

A Comfortable Emergency Fund
Although conventional wisdom holds that you should have three to six months' worth of living expenses in cash to tide you through unanticipated expenses or job loss, single-income couples will want to nudge that figure closer to a year's worth of living expenses. (Rather than holding so much in cash that's earning next to nil, such couples might consider employing a two-part emergency fund.)

Disability Insurance
Fully one third of people entering the workforce today will become disabled within their lifetimes, according to the Social Security Administration. That statistic accentuates the importance of purchasing disability coverage for the spouse who's employed outside the home. Many employers offer cost-effective coverage, but be sure to factor this expense into your after-baby-arrives budget. Sign up to pay for the coverage using aftertax dollars.

Life Insurance for Both Partners
It might seem obvious that you'd want to purchase a life insurance policy for the spouse who's earning a salary. But don't stop there. Should the nonearning spouse die, hiring an outside provider to pick up child-care responsibilities would be costly indeed. This is another set of costs to factor.

More Resources

Morningstar Retirement & College Savings Calculators
► *Visit Morningstar Investment Research Center and click the Portfolio tab to use these calculators*

Gauge the Impact on Long-Term Financial Goals

In addition to testing the short-term viability of your budget with a single income and troubleshooting unexpected events, it's also crucial that you consider the impact on long-term financial goals, especially retirement and college savings. A recent T. Rowe Price study found that younger savers who stop retirement-plan contributions for even a short period of time can face a serious financial impact because of lost compounding potential, though ratcheting up their future contribution rates can help make up for the lost savings.

If you haven't run the numbers recently on whether, how, and when you might able to retire, use a retirement calculator, such as the one on Morningstar Investment Research Center, to see how a reduced retirement-plan contribution rate affects your ability to reach your long-term goals. Many such calculators use a static contribution rate; a financial advisor can help you customize your contribution assumptions based on your own expectations about salary increases and if/when your spouse plans to return to the workforce.

Secondly, consider the impact that a smaller discretionary income stream will have for your child's college savings. Use a college calculator such as the one on Morningstar Investment Research Center to see how much you'll need to pay for school. The alarming cost of paying for college might look like a clear vote for your spouse to stay in the workforce. Bear in mind, however, that if your family has a lower income and smaller college-savings kitty when it comes time to matriculate, that can actually work in your favor when applying for financial aid or loans.

Think Through the Career Impact

More difficult to quantify, but equally worth thinking about, is the long-term career impact your spouse could face by pressing pause on her job. Consider staying on the job—or at least working part-time—in fields that may be difficult to re-enter later on.

Credit Score and Debt Reduction

Keep Your Credit Score High

By Esther Pak
Assistant Site Editor for
Morningstar.com

These tips serve as protective hedges to maintain your credit score

Your credit score serves as a key determinant of the costs of some of the most important and substantial purchases you'll make—like buying a home or car—as well as the interest rates that accompany your credit cards. Damaged credit can affect how much you pay for services such as insurance, and some employers even look to credit histories before extending job offers. What goes into calculating the score and how can you get yours up? Let's take a closer look.

FICO scores (named after Fair Isaac Corporation—the company that developed the methods for calculating the scores) are the most commonly used scores by lenders as they attempt to gauge a borrower's risk and reliability.

Your FICO score actually comprises three scores—one from each of the credit bureaus—TransUnion, Equifax, and Experian. Each score from the individual agencies runs from 300 to 850 points—the higher your score, the lower the risk.

What exactly goes into FICO scores isn't exactly transparent: The bureaus take into account your payment history, of course, but they also factor in how much you owe, length of credit history, and any new credit inquiries. Moreover, different lenders take different approaches to using FICO scores. Mortgage lenders, for example, will most likely look at all three FICO scores when evaluating your creditworthiness, but some automobile lenders will only use one of the three to qualify you for an auto loan. For more information about the ins and outs of FICO scores, go to myfico.com and visit their Education section.

Conducting a Checkup

Whether you're actively in the market for credit or not, it's helpful to know your current credit situation. For starters, every year you can obtain a free credit report from the three major credit bureaus at annualcreditreport.com—the only authorized source for consumers to obtain free credit reports. But keep in mind that this site doesn't provide actual FICO scores—you'll have to pay to see those. At myfico.com, you can buy two (TransUnion and Equifax) of your three FICO scores for $19.95 each. Note that other sites may provide generic credit scores but those are not the scores that lenders typically use.

As you evaluate your scores, keep in mind that lenders have varying standards when it comes to what constitutes a good credit score. The general rule of thumb is that a credit score above 720 is considered excellent, which puts you in a very good place when securing loans and other types of credit. On the other hand, a score below 620 is considered subpar and will tend to translate to higher interest rates on loans.

More Resources

- *annualcreditreport.com*
- *myfico.com*

Tips for Boosting Your Score

It might seem obvious that the best way to maintain a high credit score is to pay your bills on time. But some aspects of credit scoring are counterintuitive. Here are five tips for raising your score.

Stick With the Majors

Having at least one major credit card, such as Visa or MasterCard, and paying your bills promptly will have a bigger impact than will good behavior with department store and gas cards. At the same time, having too many credit cards can work against you. You might be tempted to overextend your credit, and new credit inquiries, which are typically initiated when you apply for a new card can lower your credit score. Too many inquiries can mean that you're taking on too much debt or are in some financial trouble and need additional credit to get above water.

Limit High Balances

The best way to improve your credit score is to pay down your revolving (or credit card) debt, because having a high balance/credit limit ratio doesn't bode well for your credit score. If you have a card that is close to being maxed out, consider transferring part of the balance to other cards. That's because it's generally better to have smaller balances on a few cards than a big balance just on one. Also keep your charges to 30% or less of a card's limit; 10% is ideal. If you're having trouble sticking to the limits, set up email or text alerts with credit card companies to let you know when you're approaching a limit you've set.

Comb Through Your Credit Report

When you receive your credit report, scrutinize it for any erroneous information, such as improperly reported late payments or accounts that don't belong to you. Also bear in mind that identity theft can swiftly hack away at your credit score. For example, identity thieves can use your card to make purchases and then redirect your bill so that you do not receive your bill in time, or they can deplete bank accounts leaving you with no means of paying the bills. If you do spot something like this, cancel all credit cards and alert your card issuer if you notice any fraudulent activity related to your credit cards. Then, file a police report in the community and a complaint with the Federal Trade Commission. Also call the toll-free fraud number at any one of the three major credit reporting agencies to place a fraud alert on all three of your reports. Doing so will ensure that all potential lenders speak with you directly and require you to answer a series of security questions before authorizing a new line of credit.

Keep Up Good Habits

If a history of making late payments with a credit card company has adversely affected your credit score, make it a priority to keep paying your bills on time going forward. Delinquencies on payments remain on your credit report for seven years, though some bankruptcies and unpaid tax liens can remain on your record for 15 years. So even though rebuilding your credit history might not be fun, it's possible to undo black marks on your record.

Maintain Old Relationships

Although those in credit-improvement mode might reflexively embark on an account-closing spree, it's usually wise to hang on to your oldest credit card accounts. That's because the length of your credit history is an important factor in your credit score, so closing old accounts can actually hurt your credit rating by making you look like a much newer borrower than you are. Moreover, closing an unused account without paying down your debt increases your utilization ratio, which is the amount of your total debt divided by your total available credit, and that too can be a negative for your credit rating.

Five Steps to Debt Reduction

By Staff
Morningstar.com

Live simpler and enjoy what you already own

A colleague recently mentioned that she spent the first half of her 20s racking up debt and the second half paying off that debt. She's not alone. An over-dependence on credit cards and hefty student loans can contribute to a lifestyle that starts out with debt and only gets worse as time goes on and spending pressures increase. And although consumers have been paying down their credit cards in the wake of the 2008 market crisis, they still have over $6,000 of credit card debt on average, according to a recent report by Credit Karma.

While some of us don't use credit cards or do pay our balances in full each month, debt can be a serious problem for those of us who rack it up. So, how do you get out of debt? Here are five steps to help you eliminate your debt and set yourself up to avoid problems in the future:

01

Know What You Owe

Figure out exactly whom you owe and how much you owe them. Make a list of all your debts, minimum monthly payments, due dates, and interest rates. Rank your debts in order from those with the highest interest rates to those with the lowest. Determine which debt (if any) is worth keeping. For example, it may make sense to keep mortgages and some loans for college. The interest on most mortgages is tax deductible—that's a major reason many people keep their mortgages even though they could pay it off. (To learn more about prioritizing debt repayment, read *Should You Pay Down Debt or Invest?* located on page 43.) And while some college loans may feature low rates, terms may not be as generous as they were in the past, so you'll need to review the details carefully.

When you know what you owe, you should also understand how others view your relationship to debt. Visit annualcreditreport.com for a free copy of your credit report. You should review your report at least annually and correct any errors. (You can also purchase a credit score when you order your free annual report.)

02

Set Up a Budget and Pay Down Your Debt

If you don't already have a budget, now is as good a time as any to start one. A budget will help you determine how much debt you can pay off as well as where you can trim expenses to end up with more cash to pay down debt. Read *How to Create a Budget You Can Live With* on page 06 for tips on creating a budget and a printable Budget worksheet.

Of course, it helps if you can "free up" money to pay down your debt faster. Some places to look to cut your costs include housing, travel and leisure, financial-services, and day-to-day costs.

Once your budget is in place, try to carve out as much as you can to pay down your debt—ideally more than just the minimum payments. You can use a debt calculator—such as the one found through CNN Money—to help you determine how much to pay on each credit card and how long it will take you to be debt-free.

While it might make the most financial sense to pay off the highest-interest-rate debt first, a technique called "debt-snowballing" could have appealing psychological benefits. Debt-snowballing involves carving out an amount to pay toward debt each month and applying the "snowball" amount (plus the minimum monthly payment) to the smallest debt until it is paid off. You then snowball the next smallest debt, and then the next, and so on, until all debts are paid off. In addition to your regular debt-reduction plan, you can also speed up the process by committing to put a percentage of any "windfall" money—such as bonuses, gifts, and tax refunds—toward your debt-reduction plan.

03

Lower Your Borrowing Costs

Get more bang for your debt-reduction buck. Review the recent credit card offers you've received in the mail or compare credit card rates online at sites such as bankrate.com. Once you know what's available, you can try to get your current debt holders to match it. Call your credit card companies and negotiate for lower interest rates. Consider transferring or consolidating higher interest-rate balances—but make sure you know how long the lower rate will last and what the regular ongoing rate will be. Be sure to check if there are balance-transfer fees and then decide if they're worth it.

04

Set Up an Emergency Fund

To keep yourself from falling back into the same credit card trap, you need to set yourself up for future success. An emergency fund is your financial cushion to help protect you from unexpected expenses (like car repairs) or changes in your income (such as losing your job). You should keep this fund in a money market or savings account for emergencies only. How much should you keep in an emergency fund? Start by saving three months' worth of expenses and work your way up to six months'. For more on how to do this, read *Five Tips for Your Emergency Fund* on page 61.

More Resources

Morningstar Budget Worksheet
▸ *morningstar.com/goto/budget*

Or turn to page 09 for an example of this worksheet

05

Live Within Your Means

This is a hard but necessary truth. Stick to cash whenever possible for future purchases. Find one good low-rate card for situations that require a credit card (such as Internet purchases). Pay it off every month and pay it off on time! You can even look into voluntarily simplifying and downsizing your lifestyle. Seek support and community if it helps you. There are hundreds of websites and blogs out there written by people looking to take control of their debt and financial lives. Check out zenhabits.net for debt elimination tips and tips on frugal living at about.com for starters.

More Resources

- *annualcreditreport.com*
- *money.cnn.com*
- *bankrate.com*
- *zenhabits.net*
- *about.com*

Safeguard Against Identity Theft

By Esther Pak
Assistant Site Editor for
Morningstar.com

Weigh the costs of these services against the benefits

Unfortunately, cases of credit card fraud and, more broadly, identity theft, are on the rise: Between 2001 and 2010, recorded complaints of identity theft nearly tripled, from 86,250 to 250,854. Many people are concerned about identity theft and want to understand how to protect themselves against it. Is this something individuals can do on their own, or is it better to use a paid service?

Sizing Up the Options

Consumers have a few options to ward against identity theft, ranging from free fraud alerts to paid credit-monitoring and identity-protection services. Choosing the right level of protection for you depends on your risk of identity theft and how much time you have.

Fraud Alerts

To help mitigate rampant identity theft, Congress passed the Fair and Accurate Credit Transaction Act of 2003 (FACT Act). In addition to allowing consumers to request and obtain free annual credit reports from each of the three nationwide consumer credit reporting companies (through annualcreditreport.com), the act also allows individuals to place free fraud alerts on their files if they have a good-faith suspicion that they have or are about to become a victim of fraud or identity theft.

To place a fraud alert, just call one of the three major credit bureaus. Once a fraud alert is placed in your credit file, a financial institution is then required to take reasonable measures to ensure your protection before approving any credit in your name, usually by asking you a series of questions about your other financial dealings (who your mortgage lender is, recent transactions, and so forth). Fraud alerts expire after 90 days, but can be renewed if you have continued reason to believe you're in danger of identity theft. Moreover, if you can show evidence that you were an identity theft victim (a valid police report showing that you have been a victim of identity theft, for example), you can request an extended fraud alert that stays in your file for a seven-year period.

On the plus side, fraud alerts are completely free and are a good first step if you have been, or are in danger of becoming, a victim of identity theft. However, they're not entirely foolproof. Keep in mind that fraud alerts are finite. They're also limited to protecting you from "new account" fraud, and they won't necessarily protect your existing accounts or credit cards.

Credit Freezes

An even more effective protection against identity theft is freezing your credit report, which will prevent anyone—including you—from taking additional credit in your name unless you decide to unfreeze your account. That means that new lenders cannot gain access to your credit report. And because lenders typically don't issue new credit without assessing a borrower's history first, a freeze effectively prevents identity thieves from opening an account in your name. But as long as the credit freeze is in place, you can't have access to your account, either, unless you pay an additional fee to temporarily unfreeze your account or completely remove the credit freeze from your file.

Consumer credit is regulated at the state and federal level; the fee structure for adding, temporarily lifting, or removing a credit freeze will vary state by state. For example, if you are a nonvictim Illinois resident, it will cost $10 per agency to place a credit freeze, an additional $10 dollars to temporarily lift it, and nothing to remove it altogether. Almost all states will waive all fees for identity-theft victims and for those who are over 65 years of age.

Credit freezes can make sense for those who have been victimized by identity theft and anticipate that they won't be applying for any additional credit in the near future. On the flip side, freezing and unfreezing credit might not only be costly, but also time-consuming (depending on the state you live in, it could take anywhere from 15 minutes to three days to lift or remove a credit freeze). If you anticipate that you'll be shopping for a mortgage or adding a new credit card in the future, it might be worth waiting before initiating a credit freeze on your account.

Credit Monitoring Services

Although fraud alerts and freezes help stave off identity thieves by making credit more difficult to obtain, credit-monitoring services attempt to keep you abreast of red flags in your credit picture. Each of the major credit bureaus offers this type of service.

At Experian, for example, a monthly fee of $14.99 will get you unlimited access to your Experian credit report and score, daily monitoring of your credit reports at all three agencies, and a monthly statement that notifies you of any suspicious activity. (Some signs of possible identity theft include inexplicable charges on your account or inaccurate personal information on your credit report—for example, an incorrect name, address, or Social Security number). Experian also offers telephone help with fraud resolution and reimburses some out-of-pocket expenses incurred while trying to resolve identity theft or other fraud.

Even though the additional protection might be worthwhile for those who are pressed for time, credit-monitoring services might not be necessary if you analyze your free credit reports each year and are vigilant about scouring your credit card bills and banking statements for unusual activity.

More Resources

► *annualcreditreport.com*

Identity-Theft Protection Services

Identity-theft protection services such as Identity Guard offer not just credit monitoring but also a comprehensive array of other services, including identity theft insurance of up to $1 million, a yearly three-bureau credit report, and a scan of black-market Internet and database sites that sell your information such as credit card and Social Security numbers. Such services also provide fraud detection using sophisticated technology to analyze customers' private information for signs of identity theft. You can expect the most comprehensive of services to cost anywhere from $15 to $20 dollars per month.

As with credit-monitoring services, it's possible to obtain some of the safeguards of identity-theft protection services on your own. Consumers can request free credit reports from the three major bureaus at annualcreditreport.com, and closely watch the activity on their bank and credit card accounts. For added protection, you can place a 90-day fraud alert on your credit files or even freeze your credit (as stated above); this way, you won't be paying monthly fees which can really rack up over time.

It's also worth noting that many of identity-theft protection services won't cover theft that occurred before you signed up for the service. So if an identity thief opened a fraudulent account in your name a year ago, you bought the service six months ago, and you don't discover the new account until next year when a collection agency notifies you, your insurance protection might not cover those losses.

Finally, before springing for extra protection, bear in mind that consumers automatically have protection from fraudulent activity. As a result of the Fair Credit Reporting Act, consumers cannot be held liable for more than $50 for fraudulent purchases made on their credit cards as long as they inform the credit card company within 60 days of when they receive their credit card statements.

Should You Pay Down Debt or Invest?

By Christine Benz
Director of
Personal Finance

Add precision to your household's capital allocation decisions

"If I have a mortgage, am I better off paying it down as soon as I possibly can, or should I use that money to invest in the market instead?"

One of my neighbors asked me that question, and I instantly knew that the topic would strike a chord with Morningstar users.

The shelves of your local bookstore are full of tomes that coach consumers on how to get credit card monkeys off their backs, and there's universal agreement that if you're carrying a balance on your credit card, the best thing that you can possibly do is get rid of it as soon as possible. The mortgage crisis also provided countless examples that taking on more mortgage-related debt than you can afford is a ticket to financial ruin.

But other types of debt, such as a manageable mortgage and low-interest student loans, occupy an underanalyzed middle ground. Interest rates on these types of debt are often substantially lower than credit card rates, and that interest may, in some cases, be tax-deductible. For those reasons, it's worth analyzing whether the aggressive paydown of that debt is the best use of your money or whether you should invest in the market.

Ultimately, it's a truly personal decision that's affected as much by your own personality as it is by math. I know several financially savvy individuals, including some of my Morningstar colleagues, who prioritized paying down their mortgages (or even paid them off altogether) over putting even more money into their investments. They wanted to reduce their households' fixed costs, and they've told me that step helped buy them peace of mind and gave them greater flexibility. Other people, particularly those who are just starting out and want to take maximum advantage of the compounding that long-term investing affords, may choose to invest in the market rather than prepaying their mortgages on an aggressive schedule. Here are some of the key factors that affect the decision about whether to pay off debt or to invest. Some of these variables, as you'll see, are difficult to quantify with precision.

Anticipated Return on Investment

You might think you can easily out-earn your mortgage interest rate, particularly given how low interest rates have gone over the past few years. However, bear in mind that paying off your mortgage offers a knowable rate of return (assuming it's a fixed-rate loan), whereas investing in almost anything else does not. Even if you're investing in a CD that pays you a fixed rate of interest, you may have to settle for a different, lower rate in the future. (And in any case, CD rates are currently below mortgage rates.)

Your time horizon for your investments will also likely have a significant impact on the combination of investments you choose and that, in turn, will affect the rate of return that you're able to earn. If you're a younger investor with a long anticipated time in the market and a high percentage of your portfolio in stocks, which have historically garnered better returns than bonds and cash, you could make a stronger case for paying less on your mortgage while putting more money into the stock market. Because of compounding, a dollar saved today is worth substantially more than one saved 20 years from now. Moreover, the larger your portfolio's equity stake, the more likely you are to be able to earn back your borrowing costs. (There are no guarantees, though. While stocks have returned more than bonds over very long periods, there's no telling whether that will be the case in the future.)

If, on the other hand, you have a big percentage of your portfolio in bonds because you hope to retire within the next 15 years, you have a smaller chance of recouping your borrowing costs and should think about paying down your mortgage on a more aggressive schedule.

Interest Rate to Service Your Debt

This factor seems straightforward, right? Yes, if you have a fixed-rate loan. But if you have an adjustable-rate loan, calculating your borrowing costs is more complicated. Adjustable-rate mortgages typically fluctuate in line with prevailing market interest rates, which makes it tricky to forecast long-term borrowing costs. While interest rates are currently quite low relative to historic norms, which in turn benefits borrowers with variable-rate loans, that may not always be the case.

Number of Years Until Retirement

One of the best things pre-retirees can do is to reduce their fixed costs going into retirement. Doing so buys them more flexibility and reduces the income they'll need to take from their portfolios once they retire. That, in turn, improves the odds that their portfolios will last throughout their lives. So if you're getting close to retirement, reducing or eliminating debt should top your list of priorities.

Tax Benefits Associated With Your Debt

Credit card debt has been rightly demonized as having no redeeming qualities whatsoever-—unless you're the credit card issuer, that is. But other types of debt may receive tax breaks that can help reduce your overall borrowing costs. For example, you're typically able to deduct any mortgage interest, as well as the interest on some types of home equity loans, on your tax return. This can be a particularly big advantage early in the life of your mortgage, when most of your payments go toward interest expenses. Say that your annual mortgage interest outlay is $20,000. If you're deducting that interest, your real mortgage cost is substantially lower.

You can also deduct student loan interest payments, up to a certain amount, provided your income falls below a certain threshold and you meet other requirements.

However, it's worth noting that taxpayers have a choice of either itemizing deductions or claiming a standard deduction on their income tax forms; in 2011 the standard deduction for single filers is $5,800, and $11,600 for married couples filing jointly. If your itemized deductions aren't substantially higher than your standard deduction, your tax savings from interest-payment deductions may not amount to much.

More Resources

Morningstar Expected Return Worksheet
► *morningstar.com/goto/return*

Or turn to page 47 for an example of this worksheet

Tax Advantages Associated With Investing

Just as certain types of debt are tax-deductible, you're also able to take advantage of tax breaks when you sock away money for retirement and college in certain types of vehicles. Those tax breaks can add to the return that you're able to pocket from those investments. Savers in 401(k)s and traditional IRAs enjoy tax-deferred compounding, while investors in Roth IRAs and 529 plans enjoy tax-free withdrawals when they use the money to pay for retirement and college, respectively. Therefore, the actual returns that you earn by saving in these types of vehicles are higher than what you earn on taxable investments.

Matching Contributions

Some employers match a portion of employees' contributions to their company retirement plans. That obviously enhances the attractiveness of investing at least enough to earn any matching funds that your employer has promised.

Private Mortgage Insurance

Private mortgage insurance is another factor to consider when deciding whether to invest in the market or to pay down your mortgage. Lenders typically require you to pay for this insurance if you have less than 20% equity in your home. Thus, if you're on the hook for PMI, you have a strong incentive to get rid of it as soon as you possibly can, either by paying down your principal value aggressively (and thereby building up your equity in the home) or by having your home reappraised if you've made substantial improvements to it.

Those are the general guidelines to bear in mind when you make your household's capital allocations. If you'd like to take a closer look at which financial payouts will give you a greater bang for your buck, take the following steps.

Step 1

Using the Expected Return Worksheet, write down any debts you have outstanding, including mortgages, home equity loans or lines of credit (if you currently have a balance), student loans, or credit cards. Fill in the Interest Rate % column; indicate if your rate is variable.

Note whether any part of that interest is tax-deductible. Also take note of whether you're paying private mortgage insurance on your home loan.

Step 2

Write down your current investment accounts. Indicate whether you're receiving any tax benefits by investing in that type of account, as well as whether you're earning any matching contributions. Leave the Expected Return % column blank.

Step 3
Use Morningstar Investment Research Center's Portfolio X-Ray Tool to identify the stock/bond/cash mix for each of your investment accounts: 401(k)s, IRAs, and any taxable accounts. Start by entering each of your holdings into the tool, then click "View your Portfolio X-Ray" to see the stock/bond/cash mix (also called an asset allocation) for that account.

Step 4
After you've found a stock/bond/cash breakdown for each of your accounts, calculate an expected return for each one. Of course, you can't be certain about the expected returns of any asset class, but a reasonable starting point is 1% for cash, 3% for bonds, and 6% for stock holdings.

If your account consists of some combination of stocks, bonds, and cash, you'll need to come up with a combined expected return. For example, if Portfolio X-Ray says that your account consists of 10% cash, 50% bonds, and 40% stock, you'd calculate the expected return as follows: a 2.4% return from the stock portion of your portfolio (6% times 0.40), a 1.5% return from the bond portion of your portfolio (3% times 0.50), and 0.1% contribution from the cash portion of your portfolio (1% times 0.10). The aggregate expected return for such a portfolio would be 4.0%. (2.4% + 1.5% + 0.1%)

Step 5
Compare the potential rates of return for your investment assets with the interest that you're paying to service your debt. Prioritize your spending in the following sequence:

- First priority (tie): Debt with high interest rate relative to what your investments are apt to earn, where interest is not deductible and/or you're paying private mortgage insurance
- First priority (tie): Company retirement-plan contributions that your employer is matching
- Second priority: Debt with high interest rates relative to what your investments are apt to earn, where interest is tax-deductible—or, debt with reasonable interest rates (4% to 5%), where interest is not tax-deductible
- Third priority (tie): Investments with reasonable expected rates of return (4% to 5%) that also enjoy tax-favored status—IRAs and 401(k)s
- Third priority (tie): Debt with reasonable interest rates (4% to 5%) and tax-deductible interest
- Fourth priority: Investments whose expected rates of return are in line with interest on debt and that enjoy no tax benefits.

As you go through this exercise, you're almost certain to encounter one or two toss-ups. When you do, the tie should go to the investment that offers you the most certain return. For example, say your mortgage interest is 5% and you're forecasting a similar return on your IRA. Because the return on your mortgage paydown is certain, whereas your investment's return is not, it makes sense to prepay at least some of your mortgage each month before putting cash to work in the IRA.

More Resources

Morningstar Portfolio X-Ray
▸ *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

Download worksheet

► *morningstar.com/goto/return*

Sample Expected Return Worksheet

Current Debts

Debts	Variable Rate		Deductible Interest		PMI		Interest Rate (%)	Priority
Home loan	*Yes*	*No*	*Yes*	*No*	*Yes*	*No*		
Home equity loan/line of credit	*Yes*	*No*	*Yes*	*No*				
Student loan	*Yes*	*No*	*Yes*	*No*				
Auto loan								
Credit card balance								
Credit card balance								
Credit card balance								
Other debt	*Yes*	*No*	*Yes*	*No*	*Yes*	*No*		

Current Investments

Investments	Tax Benefits (check)		Matching Contributions		Expected Return (%)	Priority
Company retirement plan	*Yes*	*No*	*Yes*	*No*		
Variable Rate						
IRA	*Yes*	*No*				
IRA	*Yes*	*No*				
College savings	*Yes*	*No*				
Taxable account						
Checking/savings						
Other savings/investments						

Home Ownership Decisions

Avoid These Home Buying Blunders

By Rachel Haig
Assistant Site Editor for Morningstar.com

How to become a homeowner without the headache

Buying a home is probably the largest purchase you will make. There are many important factors to consider when choosing to rent or buy a home. If you have decided to buy, though, you have a complex path ahead of you. Between picking the right agent, home, neighborhood, and mortgage, there are many opportunities for things to go awry. While by no means all-inclusive, avoiding these slip-ups will help ensure a smooth journey through the home-buying process.

Not Doing Your Homework

Educate yourself as much as possible before you even begin working with an agent. Start searching online to get a sense of the areas you are interested in and familiarize yourself with their price points. There are many free real estate search engines online, such as Trulia, Roost, and Zillow.

Also consider what type of loan suits you. The standard, "safe" choice is a 30-year fixed-rate mortgage. If you know you will be in the home for the long haul, a 30-year fixed mortgage ensures stable payments for the life of your loan. Be vigilant about adjustable-rate mortgages, or ARMs. These have dominated housing crisis headlines for their extremely low "teaser" rates that can balloon after a few years, massively increasing payments. There are different types of ARMs, some of which are sneakier than others. The initial period of low interest rates varies, but is usually five or seven years. Some have a set schedule of rate increases. Even with all that has ensued since the end of 2007, many lenders are still pushing ARMs. ARMs can make sense if you're planning to move within five years and you are sure you can cover higher interest rates in a worst-case scenario (such as not being able to sell). You should not use ARMs to stretch for a bigger loan, however. If you can't afford the house without an ARM, you can't afford the house. Stay on guard and do not let your lender or agent talk you into an adjustable rate mortgage if it's not really right for you.

Using the Seller's Agent

It is the job of the seller's agent to fetch the highest possible price while making few concessions. They are directly compensated for bringing in higher prices, as they are typically paid a percentage of the selling price, usually 5%-7%. Get your own agent. Interview several before picking one. Buyers' agents usually still get paid a percentage of the purchase price (keep that in mind if they suggest you can afford a more expensive home), so they will still have an interest in you paying more, but they also have a stake in making you happy, as their future business depends on referrals. Another option is to find an exclusive buyer agent who charges a flat rate, but then you would be responsible for an up-front payment, rather than your agent's pay coming out of the purchase price.

More Resources

- *trulia.com*
- *roost.com*
- *zillow.com*

Visiting Open Houses Before You Choose an Agent

Surprisingly, the agent at the open house may have a claim to you (and the commission if you buy that property) because he or she was the first agent who showed you the home. If you find the property of your dreams at an open house before you find an agent, you risk being locked into working with someone who does not have your interests at heart. Most agents probably wouldn't go through with trying to claim your commission if you found an agent afterward, but don't open yourself up to the possibility. Similarly, don't have agents you are interviewing show you a slew of houses—if you decide not to go with that agent, you may face complications if you make an offer on one of those properties with another agent.

Relying too Much on Your Agent

If you have concerns, speak up. Do not assume your agent will catch everything. Stay involved each step of the way and make sure you understand the ramifications of each decision.

Becoming Emotionally Attached to a Particular Property

It's difficult to separate yourself from a property, but you'll maintain your composure and leverage for negotiations if you try not to think of it as your new home (yet).

Allowing Surface Issues to Sway Your Opinion

Ignore bad decorating, such as paint color, and try to look past the current owner's furniture and aesthetic. Similarly, don't allow stylish upgrades such as stainless appliances and granite counters to trick you into thinking a property is structurally sound.

Leaving Important Contingencies Out of The Contract

Make sure you include stipulations for finding financing and passing an inspection. Also demand a final walk-through 24 hours before closing.

Making Inopportune Extra Mortgage Payments

Don't pre-pay your mortgage before maximizing your 401(k) match or paying off credit card debt—both typically offer a higher return. The urge to pay off your home as quickly as possible is understandable, but contribute at least enough to your 401(k) to take advantage of your company's full match first. Paying off credit card debt should also come before paying extra on your mortgage, as credit card interest rates are typically much higher than interest on your loan.

Is It Time to Refinance Your Mortgage?

By Esther Pak
Assistant Site Editor for
Morningstar.com

Dos and don'ts for home-owners who are eyeing those rock bottom rates

If you are a homeowner, the record-low interest rates on home mortgages have probably caught your attention, and the idea of refinancing your own mortgage may be on your radar. In August of 2010, bankrate.com reported an average of 4.59% for 30-year fixed mortgages. In fact, interest rates for 30-year fixed mortgages are at their lowest level since 1970, according to Freddie Mac (FMCC). These rock-bottom rates have led to the highest demand for home refinancing in 15 months.

Although the declining rates do appear singularly attractive, be sure to have a thorough understanding of what you're committing to before refinancing your mortgage. A good-looking rate should not be your only basis for refinancing, especially because the whens and whys of refinancing your home mortgage are neither straightforward nor cookie-cutter.

Ultimately, a mortgage refinance will make sense for some, but even then, the process will require additional legwork. For others, it will be more sensible to forgo a ride on the refinancing bandwagon and stick to their current mortgages.

Below, we've listed some dos and don'ts.

Do Know Where You Stand

A starting point to help determine whether refinancing makes sense for you is to see where you are now: Know your current loan's terms, including your remaining principal level and the interest rate of your current mortgage as well as whether your current loan has a prepayment penalty. Also get a feel for your current credit standing. Although the lender or mortgage broker will pull your credit report, you can check up on your credit history by using an online service from the government such as annualcreditreport.com, which allows you to request a free credit file from the three major credit agencies. That way you can get a feel for whether you'll qualify for the most favorable interest rate and terms.

Also give some consideration to what your home is worth right now, using the purchase price of homes that have recently sold in your area. It's worth mentioning from the get-go that it may not be a good idea to refinance if your property has depreciated. If your equity in the home has dropped below 20% or has totally evaporated, most lenders simply do not have an incentive to refinance a home that is valued lower than the original price. Government programs, such as the Making Home Affordable plan, may offer help to underwater borrowers, however.

More Resources

- ▸ *annualcreditreport.com*
- ▸ *bankrate.com*

Do Have Your Documents in Order

With the bursting of the housing bubble not too far in the rearview mirror, you may be requested to provide unexpected forms of documentation during the refinancing process. J.P. Morgan Chase (JPM) offers a list of documentation that you should have with you. Keep in mind that the amount of paperwork needed to process your refinance will vary by lender and your credit score (the worse the credit, the more documentation that will be required).

Do Crunch the Numbers

Sinking rates are obviously a motivator and for good reason: You can save money by refinancing to a lower interest expense. Conventional wisdom applies the "2-2-2 rule" to refinancing: Refinancing makes sense if you have been living in your house for two years, are planning on staying there for another two years, and the new rate is two points lower than your current mortgage rate.

However, rules of thumb like this one are often misleading because they do not apply to all scenarios. For example, interest rates will vary dramatically depending on your credit history, current loan terms, and how much you've already paid on your existing mortgage. Using a calculator to input conditions that are specific to you will be a more helpful guide than following any one rule of thumb. Use bankrate.com's calculator to input the loan term and interest rate of your intended refinancing. Compare the projected monthly payment with your current monthly payment to determine your savings.

If you can swing it, you might consider shortening the term of your loan to obtain an even lower rate; a mortgage calculator can help you compare your current loan payment with the payment on a shorter-term loan. On the flip side, be careful about lowering your rate by switching to a longer term—for example, opting for a 30-year loan rather than sticking with your current 20-year term. While lengthening the term of your mortgage can result in a lower payment, extending the mortgage term is likely to cost you more in interest over the life of the loan. That may be a worthwhile trade-off if you're in a serious cash crunch, but proceed with caution.

Do Shop Around for Lowest Rates

Don't assume that bigger institutions always offer the lowest rates. Regional lenders and independent mortgage brokers can help you find rates that are lower than the ones that the top three lenders are offering: Chase, Wells Fargo, or Bank of America. Investigate whether a lender in your area offers a better interest rate. Even if you are planning on hiring a broker, doing your own research and being well-informed of the rates that are currently out there puts you in a favorable position to spot discrepancies in the rates that brokers offer.

Do Refinance If You Are Planning to Keep Your Property Long Term

Refinancing multiple times can bring down your interest rate, but it also leaves hefty closing costs in its wake. According to LendingTree, a homeowner should project about 3%-6% of the total price of the home in settlement costs including taxes. This figure does not include any prepayment penalties, and the costs of any second mortgages that may exist. Ask yourself how long you plan to keep your property. Then, consider how many months of lower payments it will take to recover the closing costs of the new mortgage in comparison with how much your monthly payments decrease.

A note about closing costs: Federal law requires lenders to provide borrowers with a good faith estimate of settlement charges three days after they apply for a loan. However, lenders can charge fees that vary up to 10% from levels quoted in the GFE and still comply with the law, so it is important to stay on the offensive as you compare closing costs among different lenders. Insist on an estimate of the closing cost even if lenders seem unwilling to disclose those numbers. Don't hesitate to question lenders about fishy line items marked by vague terms such as "underwriting" and "application" fees which may be alternative names for services for which you are already paying.

Do Refinance for Stability

Borrowers who seek stability are increasingly ditching their adjustable-rate mortgages for fixed loans. If the prospect of fluctuating mortgage payments gives you heartburn, the certainty of locking in a fixed rate might be what you need.

Do Refinance to Consolidate Your Mortgage and Debt

Although adding to your principal level is far from ideal, using home equity to pay down more costly forms of debt can be a prudent financial move. Not only will you be able to obtain a lower rate on your mortgage than with other types of consumer financing, but unlike other consumer debt, mortgage interest is tax-deductible. By using a cash-out refinance, the new loan balance will consist of the current loan balance plus the desired cash-out amount. Say that your home is currently valued at $400,000 and your loan balance is $300,000. This means that you have $100,000 in equity and own 25% of your home. If you want to add a $20,000 cash-out in addition to your original $300,000 balance, your new loan amount would be $320,000.

Such cash-out loans were at the epicenter of the crisis, so keep in mind that lenders will make you jump through some hoops to arrange this type of financing. For example, most lenders require you to have owned your property for a least a year before they permit you to take out additional cash. Also note that when you cash-out, you reset your mortgage by taking on more debt and lose the equity that you may have spent years building. Reserve this option for emergencies or when interest rates are too low to pass up. As always, be sure to understand the restrictions and any costs involved before executing a cash-out refinance.

Don't Refinance if You've Been Paying Off Your First Home Mortgage for a Long Time

If you are almost finished paying off a 30-year fixed mortgage, then refinancing is probably not a good idea. A new loan will most likely put you in deeper debt by extending your loan term just as you were about to become debt free.

Don't Refinance if You've Used Up Substantial Equity

Refinancing is not a good idea if you have already tapped into your equity aggressively. You would usually want to refinance when you have built up at least 10% equity in your home, though most lenders consider 20% a threshold for obtaining the best terms for refinancing.

Don't Refinance if There Is a Prepayment Penalty on Your Mortgage

Waiting out the period during which prepayment penalties apply leads to more cost-effective refinancing, though you are risking higher interest rates at the end of the penalty period.

Don't Refinance if Your Credit History Is Suffering

At the risk of stating the obvious, getting your credit history and credit score in the best possible shape will also land you a better mortgage rate. The best rates are only available to people with spotless credit profiles: high credit scores without any negligence on record. Most lenders prefer that you have no late payments in the last 12 months before you refinance.

Don't Be Afraid to Seek Help if You're in Real Trouble

In February 2009, the Obama administration introduced the aforementioned Making Home Affordable plan to stabilize the housing market and help struggling homeowners avoid foreclosure. The program helps responsible homeowners willing to make payments to stay in their homes by decreasing their monthly payments to as low as 2% and extending repayment periods for as long as 40 years. Despite its noble intentions, the program has had mixed success to date. More than one third of the 1.24 million participants who enrolled in the program have already dropped out largely because of their inability to provide proof of income or to keep up with the monthly payments. Check out the Making Home Affordable website for more information about the specific programs that are offered.

Don't Shun Professional Help

Although you can handle many parts of the refinancing process on your own, you may need a professional broker or financial advisor to untangle some of the more complicated issues that may arise—if you have multiple properties, for example, or an unfavorable credit history. Until then, take advantage of the many online resources that major banks and lenders offer to help facilitate the process of refinancing your mortgage. Also, check out the various refinance calculators available at BankRate and LendingTree to help you outline a plan that will best accomplish your goals.

More Resources

- *makinghomeaffordable.gov*
- *lendingtree.com*

Preparing Emergency Funds

Where to Turn for Emergency Cash

By Christine Benz
Director of
Personal Finance

We rank consumers' options, from best to worst

If you find yourself in a financial pinch—bills to pay but no available cash to do so—it's worth taking a moment to assess your options. Some are decidedly better than others.

Here's a discussion of some of the options available for those in need of emergency cash. Although individuals' own circumstances will affect the attractiveness of these sources of financing, I've ranked them from the ones that are generally the most palatable to the least attractive.

Your Own Emergency Fund/Short-Term Securities
I know, the premise of this article is that an individual doesn't have a rainy-day fund. But no article about financial emergencies would be complete without emphasizing the importance of amassing such a fund to cover unforeseen expenses. If you're aiming to get your financial house in order, putting your emergency fund in place is job one (after you pay off any debt, that is). And if you have an emergency fund, remember: This money is to be used only in true emergencies (when the only alternatives are to go into debt or tap your longer-term investments).

Your emergency fund should consist of highly liquid securities, such as CDs or a money market account or fund. (Beware of higher-yielding money market alternatives, some of which blew up in 2008.) As I discuss in *Five Tips for your Emergency Fund* on page 61, traditional financial-planning wisdom holds that your emergency fund should be large enough to cover three to six months' worth of expenses. However, I think current economic conditions warrant amassing an emergency fund consisting of a year's worth of living expenses, if you can swing it. (I don't know about you, but if I lost my job I'd rather have more than three to six months to find a new one.)

Longer-Term Assets in Taxable Accounts

If you've depleted your emergency fund (or never had one to begin with) and still need cash, your next step should be to turn to any taxable stocks, stock funds, bonds, or bond funds. Remember, though, if you're selling a mutual fund you have owned for a very short period of time, you may face a redemption fee when you sell.

Roth IRA

It's never a great idea to tap your retirement assets unless you absolutely need to, but the Roth IRA does offer more flexibility than a traditional IRA, and that flexibility can come in handy if you find yourself in a financial bind.

You can withdraw any Roth IRA contributions (the amount you put in, not investment earnings) at any time, without having to pay penalties or tax. (After all, you contribute aftertax dollars to a Roth, so you've already paid taxes on that money.)

Withdrawals from Roth earnings, by contrast, may be subject to taxes and penalties unless you're age 59 1/2 or meet certain other criteria.

401(k) Loan

Companies are making it pretty easy to borrow from their 401(k) plans—maybe too easy, in my opinion. Some have gone so far as to offer debit cards that allow those who have already applied for loans to tap their savings.

It's easy to see the appeal. You're required to pay the loan back—usually within five years—with interest, but the interest gets paid back into your a ccount, not to a bank. The interest rates can be reasonable, often a few percentage points above the prime rate.

On the downside, borrowing from your 401(k) plan short shrifts your retirement savings. Not only will you have less money working for you in the market, but having to pay the loan back with interest also means that you're less likely to be able to make new contributions to your account. Loans from your 401(k) are particularly perilous if you lose your job. If that happens, you'll be required to pay the loan back right away, usually in 90 days. If you've sunk that borrowed money into some other asset, you'll really be stuck.

Home Equity Line of Credit

Tapping your own assets is invariably a better way to scare up cash than borrowing from someone else. But if you find that you must take out a loan, using a home equity line of credit is one of the better ways to go about it. Essentially, you're borrowing against any equity you've built up in your house.

On the plus side, interest rates on HELOCs may be reasonable, particularly if you've got a good credit rating, a fair amount of equity in your home (which also makes it less likely that you'll default), and aren't taking out a huge loan. The biggest advantage to the HELOC versus other loans, however, is that all or part of your interest will be tax-deductible. For these reasons, I recommend that nearly all homeowners secure a home equity line of credit while they're employed and can negotiate terms that are favorable to them. Even if you never need to use it, it's a good safety net in case of emergencies.

On the downside, lenders are feeling quite risk-averse these days, so if you're not a perfect borrower, you could be asked to pay an unfavorably high interest rate. And while it's less likely today than it was a few years ago, there's also the possibility that you could end up borrowing more than you actually have equity in the house; should you need to sell in a hurry, you'd have to cough up the difference.

Traditional IRA

Traditional IRAs, as I noted above, offer less flexibility than Roth IRAs. Unless you fit certain criteria, you'll owe taxes and/or a 10% penalty if you need to take an early withdrawal from a traditional IRA if you've made deductible contributions. Unlike the Roth, you've not yet paid taxes on these contributions, so it only makes sense that you'd owe Uncle Sam when you pull the money out. If you've made nondeductible IRA contributions, you'll owe the 10% penalty and tax on any investment earnings if you take an early withdrawal, unless you fit certain criteria.

Reverse Mortgage

Reverse mortgages have become popular over the past decade, as many seniors have found themselves short of income but long on home equity. A reverse mortgage allows a homeowner (usually those over age 62) to receive a pool of assets that represents one's equity in the home. The homeowners don't have to repay the loan as long as they're in their homes, but when they do leave their homes, the borrowed amount, plus interest, is deducted from the home's value.

As reverse mortgages have gotten more popular, they've prompted greater scrutiny and many more reputable lenders have gotten into the business. Still, rates can vary widely, so if such a loan appeals to you, you'll need to shop around. Also, it pays to understand the various types of reverse mortgages.
For a good overview, visit the Federal Trade Commission's website.

Credit Cards

This option is pretty straightforward, and usually not a great idea for reasons that most consumers well understand. True, some consumers have been able to play credit cards like a fiddle, shifting balances among cards with ultralow teaser rates and incurring little in interest along the way. If that's you, more power to you. For the rest of the world, credit cards are the single easiest way to wreck your financial standing. Not only are rates high, but credit card companies have every incentive to keep you paying for as long as possible. Thus, the minimum payments they require don't make a dent in your loan's principal.

401(k) Withdrawal

Most companies will let employees under age 59 1/2 take a withdrawal from their 401(k) plan if they have exhausted all other sources of financing and have an extreme need—for example, to pay unreimbursed medical expenses or to keep their home from going into foreclosure. However, such a withdrawal comes with some major strings attached. Depending on your circumstances, you'll have to pay income tax on the withdrawal and you may also incur a 10% early distribution penalty. And while you don't have to pay that money back (unlike a 401(k) loan), by not doing so you heighten the risk of falling short in retirement. In short, think of this option as strictly a last resort.

More Resources

Federal Trade Commision
► *consumer.ftc.gov*

Five Tips for Your Emergency Fund

By Christine Benz
Director of
Personal Finance

How to navigate when fear is running high and yields are running low

The past few years have brought a negative convergence for emergency-fund investors. A still-shaky economy and uncertain job market have underscored the importance of building a cash cushion to cover your costs in case of job loss or big, scary, unanticipated expenses such as medical bills or home repairs. At the same time, available yields on emergency-fund-appropriate investments have shriveled to next to nothing.

What to do? Here are some tips:

01
Customize, Based on Your Own Situation

Three to six months' worth of living expenses is a reasonable starting point when setting your emergency fund amount. But think of it as just that: a starting point. From there, you'll want to customize your emergency-fund amount based on your own situation. The basic question is this: How much time would you want to replace your job if you lost yours? The key swing factors that should affect your decision are how flexible you are in terms of your career choices and lifestyle.

Consider holding a larger emergency fund (six months' to a year's worth of living expenses—or more) if you:

- Have a high-paying job
- Hold a position in a highly specialized field
- Are self-employed
- Work on a freelance/contract basis
- Have dependents
- Have a nonworking spouse
- Have high fixed expenses, such as a mortgage, auto loans, and tuition bills
- Have a pre-existing medical condition that could result in hefty health-care bills if you were forced to purchase private health insurance

On the flip side, you may be able to get by with a smaller emergency fund if you:

- Have a good degree of career flexibility because you are in a lower-paying position and/or haven't yet developed a specialized career path
- Have other sources of income that could help defray a large share of household expenses, such as a working spouse
- Have a great degree of lifestyle flexibility (for example, you would be willing to relocate or get a roommate)

02
Focus on the Essentials

Setting aside even three months' worth of living expenses might sound like a daunting sum, particularly if you look back on your real-life spending habits. But once you strip out discretionary expenses that you could easily live without if you needed to, your emergency-fund amount is going to look a lot more manageable. To help find the right emergency-fund target, look back on your fixed expenses during the past several months: mortgage or rent, taxes, utilities, insurance, car payments, and food bills.

Bear in mind, however, that one key expense category could spike up if you lost your job: health-care costs. Your company's human resources administrator should be able to provide you with a quote on what obtaining COBRA continuation health coverage would cost, and you can also go to ehealthinsurance.com to obtain a range of insurance quotes for a person/family in your age range.

03
Build a Two-Part Emergency Fund

If you've decided to be conservative and build a large emergency fund—and I think that's a good strategy for those of you with higher-paying jobs and high fixed costs—you might consider splitting it into two pieces. For example, you might park three months' worth of living expenses in a traditional emergency-fund parking place (or a combination of them): your checking and savings account, a CD, money market account, or money market mutual fund.

To help address the fact that those truly safe investments are yielding next to nothing, you could then put another nine months' worth of expenses (or more) in a vehicle that would deliver a slightly higher yield in exchange for modest fluctuations in principal value. A short-term bond fund such as T. Rowe Price Short-Term Bond (PRWBX) or Vanguard Short-Term Bond Index (VBISX) would be appropriate for this role. If you're in a higher tax bracket, consider a short-term municipal fund; Fidelity and Vanguard field Morningstar's favorites.

04
Multitask Through a Roth

What if you're trying to build an emergency fund while saving for retirement at the same time? If that's you, you can consider building at least part of your emergency in a Roth IRA. This can be a viable option because the Roth, unlike a traditional IRA or 401(k), enables you to withdraw your contributions at any time and for any reason prior to age 59 1/2. Under a best-case scenario, the assets in your Roth would increase until you began withdrawing them in retirement. But if you lost your job, you could withdraw your Roth contributions if you needed the money to cover living expenses.

The key drawback to this approach is that ideally, you'd hold any assets you have earmarked for your emergency fund in something safe, such as a money market

More Resources

- *ehealthinsurance.com*

fund or CD. But those safe investments have very low long-term return potential, making them inappropriate if your goal is long-term growth for retirement.

05
Set Up Additional Safety Nets

Finally, while emergency funding is on your mind, investigate additional safety nets that you could turn to if you've exhausted your emergency assets. For example, check to see whether your company's retirement plan allows for loans. Because you'll pay interest to yourself rather than a bank when you take a 401(k) loan, tapping these assets is preferable to turning to a bank loan or credit card if you find yourself in a financial bind. (The key downside, of course, is that you're short-shrifting your own retirement savings.)

Obtaining a home equity line of credit may also make sense for homeowners who have built up substantial equity in their properties. The key to making this strategy work is to use the HELOC only in case of a true financial emergency and after you've exhausted other types of funding, rather than to cover discretionary expenditures such as cars and vacations.

Are You Adequately Insured Against Risk?

By Christine Benz
Director of
Personal Finance

Preventing disasters is more than half of financial success

At Morningstar, we firmly believe that the best investors are at least as attuned to the risks they're taking as they are the money they're making. For that reason, we've long preached the importance of having an appropriate stock/bond mix given your time horizon, the value of having durable holdings at the core of your portfolio, and the folly of dabbling in overly narrow, risky investments. We've often gotten guff from our readers for our caution, particularly when the market is going up. But we believe that Warren Buffett had it right when he said that the first rule of investing is to not lose money, and that rule number two is not to forget the first rule.

In addition to managing the risks in your investment portfolio, it's also important to anticipate and troubleshoot other financial risks that might arise. Here's an overview of some of the key risk-management questions to consider. This is by no means an inclusive list, by the way; I welcome your reflection on other risks that you've identified and steps you have taken to protect yourself.

Do You Have an Emergency Fund?

One of the fastest ways to start down the path toward financial ruin is not having a cushion to protect yourself against unanticipated events, such as losing your job, or unanticipated expenses like home and auto repairs or medical bills. For that reason, conventional financial-planning wisdom is to put three to six months' worth of living expenses in a highly liquid account such as a savings account, CD, or money market fund. Given the current economic climate, however, I'd recommend building up a more generous savings cushion—six months' to a year's worth of living expenses, if you can swing it. This is particularly important if you are a higher-income earner, because it usually takes longer to find higher-paying jobs than it does those that pay less, or if you have any reason to believe that your job is in peril. You can explore more details on setting up an emergency fund in the previous article, Five Tips for Your Emergency Fund.

Are You Protected Against Identity Theft?

Consumers have, thankfully, become much more attuned to the issue of identity theft. However, given the trying economic climate, I think it's safe to assume that identity theft could pick up in the months ahead. You can't be too careful about security when conducting transactions online, and you should get in the habit of shredding documents that include identifying information. (I'm admittedly paranoid, but I shred anything that comes into my house with my name on it.) For more tips on how to safeguard yourself against the risk of identity theft, read *Safeguard Against Identity Theft* on page 40.

Do You Have Adequate Insurance?

When making insurance decisions, one of the best pieces of advice is to not insure yourself against risks you can afford to cover. For example, if you have ample savings, you're not going to be sunk if your computer goes kaput and you need to buy a new one. (Sorry, extended-warranty sellers at Best Buy.) On the flipside, you'll definitely want to insure against bigger, more costly risks. For that reason, you'll obviously want to have coverage for your home and autos, as well as good medical coverage. Also look into the following:

Life Insurance

If you're still working and have dependents, your largest asset is your own ability to produce income in the future. Thus, it's essential that you have adequate life-insurance coverage. And if your spouse stays at home and cares for the kids, you may also want to investigate life insurance for her/him. Life-insurance agents may disagree with me, but term insurance is often the most effective (and certainly the most cost-effective) solution for many individuals. If an insurance agent recommends a more permanent type of policy, make sure you thoroughly understand the reasons why he or she finds this type of coverage preferable to a term policy.

Disability Insurance

Fully one third of Americans between the age of 35 and 65 will become disabled for more than 90 days during their working careers. If you couldn't do without your income for an extended period of time, it's imperative that you purchase disability coverage. Your employer may offer cost-effective coverage; sign up to pay for it using aftertax dollars, meaning that your benefits will be tax-free.

Umbrella Policy

If you're a worrywart like I am, you'll find that personal liability insurance (an "umbrella" policy) is one of the most cost-effective ways to purchase peace of mind. These policies usually sit on top of your homeowners and auto policies, and cover you in case you're sued for an accident that occurs on your property. If you have contractors, housecleaners, babysitters, or dog-walkers on your property—and even if you don't—an umbrella policy is a must.

Long-Term Care Insurance

Not everyone needs long-term care insurance. Those with a lot of assets may be able to cover their own long-term care costs, and those with small portfolios may be covered by Medicaid. If you're over 45 and fall somewhere in the middle of that spectrum, however, you should investigate long-term care, because the costs of nursing home or in-home care can quickly gobble up your nest egg. I favor the policies that include inflation protection, though you may pay more.

Investing: Get Started

Five Investing Mistakes for Newbies to Avoid

By Hilary Fazzone
Analyst
Mutual Funds

Tips for investors just starting out

Investing when you're young is always a great idea, because it allows you to take full advantage of the benefits of compounding, and it's doubly advantageous to start investing when the market has good upside potential. But that doesn't mean that just any investing is good investing. What follows is a basic, though not exhaustive, road map to help you avoid some common mistakes many new investors make.

01

Playing It Too Safe

Young investors have a big advantage over those who are closer to retirement: time. Investors with a long investment horizon can accommodate greater risk, and thus greater return potential, because there is adequate time to make up losses. The risk, then, is investing in securities that are too conservative and that don't have the potential to substantially outpace inflation over time.

If you're looking at the investments that have performed the best over the past three years, you might be inclined to stick with good old U.S. Treasuries or even a CD. From a risk standpoint it may seem prudent to do so, but it's more advantageous to strike a balance between risk and return potential through measured access to more aggressive asset classes, such as equities. You don't want to be in the position of not having saved enough.

Top fund shops such as T. Rowe Price and Vanguard have built their target-date lineups with this in mind. Both firms start their target date funds' equity stakes at 90% for investors who are furthest from retirement. (Currently, that applies to the 2050 and 2055 portfolios.) This means that these firms' asset-allocation committees, groups of highly experienced and successful investors who put a great deal of thought into this issue, are favoring stocks for younger investors.

02
Disregarding Risk
The flip side of that coin is failing to pay enough attention to risk. It's easy to be tempted by investments that promise market-slaughtering returns, because in many cases and for short periods of time, those investments can deliver. People love to talk about outsized gains from niche investments like technology funds. (Remember those?) But stretches of explosive performance don't often last, and when these investments fall, they can fall hard.

Emerging-markets funds are a great recent example. This category's recent returns have been enticing, but the wide performance swings that characterize this asset class have been on display lately. From 2003 to 2007, the average emerging-markets fund gained more than 35%—a greater gain than that enjoyed by any other international-fund category, except for Latin America. Then, emerging-markets funds lost 54% in 2008 as the market indiscriminately shunned risk-prone investments. Now the category is up 60% through September 2009. Among international-fund categories, only Latin America funds are more volatile than emerging-markets funds, as measured by 15-year standard deviation. This isn't to say that emerging markets are not viable places to invest—quite the contrary, as their growth potential is considerable. Rather, newer investors are better off investing in such volatile asset classes at the margins of their portfolios, using either proven fund managers or broad-based index or exchange-traded funds.

03
Overpaying
One of the easiest ways to hinder your portfolio's return potential is to overpay for the investments that you make. Individual stocks, for example, can be a great way to learn the ropes in investing, but if you're trading small sums of money in stocks or exchange-traded funds, you're ceding a huge percentage of your investment to transaction costs. Another way to overpay is to invest in funds that charge too much. This is a pretty intuitive concept. A high annual fee is taken as a percentage of your total investment and detracts directly from your returns. High costs mean a fund manager has to clear a higher hurdle to produce competitive returns. In fact, Morningstar has found cost to be one of the only data points that is predictive of future returns. Of course, it's not hard to find high-cost funds that have outperformed. But why not stack the deck in your favor by sticking with low-cost investments?

04
Investing Based on Headlines
It's easy to get caught up in the hype of hot asset classes, sectors, industries, and individual stocks. In 2008, for example, soaring oil prices in the first half of the year had investors clamoring for energy funds, commodity exposure, and shares of ConocoPhillips. Similar to the risk discussion, concentrated exposure to narrow areas of the market may seem like a great idea when those areas are appreciating, but when the tide turns, those investors who are caught with too much in a falling niche are hit hard. The natural-resources fund category, where most energy funds reside, gained more than 13% in the first half of 2008 and then dropped more than 50% in the second half of the year.

Green energy has been another hot topic in recent years. Stocks such as First Solar are a great example. Until recently, rising energy prices and heightened environmental awareness had buoyed stocks of companies working to develop solar and wind energy technologies. As the credit markets tightened, however, and financing for such ventures practically disappeared, the stock markets punished these stocks severely, demonstrating the quick turns narrow investments can make. Rather than invest in securities devoted entirely to such themes, the better option is to put your money in the hands of diversified managers who can invest in hot areas opportunistically and get out when conditions deteriorate.

05

Cutting and Running

One of the easiest traps for new investors, and even seasoned investors, to fall into is buying and selling at the wrong times. Human nature would have us buying when market conditions seem favorable and selling when they deteriorate, and that behavior can seriously impede your overall return. Morningstar has captured this behavior in its Investor Return data point, which compares the return a fund generates over time with the average return its shareholders actually capture. Take large-growth Fund Favorite Brandywine Blue, for example. That fund's 10-year return through April 30, 2009, was just over 2%, but its Investor Return indicates that the typical investor in Brandywine Blue lost nearly 15% over that period. This shows that investors have a hard time tolerating the ups and downs of the returns generated by the fund's momentum-based strategy. When Investor Returns lag funds' total returns (and in many cases they do), it illustrates the importance of sticking with your investments over the long term, even when periods of rough performance have you looking for the exits. Those investors who have the discipline to stick with their long-term investment plans will reap the benefits that materialize over the course of complete market cycles.

This is far from a complete list of the hazards that can befall new investors. And I do not mean to discourage would-be investors by pointing out the abundance of potential pitfalls they may face. The key is for investors to arm themselves with the knowledge to make good decisions, and Morningstar's tools, commentary, and analyses can help equip you to do just that.

More Resources

Morningstar
Fund Favorites

► *Visit Morningstar Investment Research Center and click Fund Favorites on the Home tab*

Making Your Investment Policy Statement

By Christine Benz
Director of
Personal Finance

Take steps to keep your investment portfolio on course

One of my favorite segments on National Public Radio is "This I Believe," a series of spoken essays in which individuals articulate the beliefs that have helped shape their lives. The essays, based on a 1950s radio program hosted by Edward R. Murrow, include thoughts about birth and death, baseball, and driving. Big names like Muhammad Ali and John Updike have contributed essays to "This I Believe," as have schoolteachers and attorneys. The series consistently demonstrates the value of having an overarching set of beliefs that can help you navigate tumultuous times.

Think of your investment policy statement as your own, investment-related version of "This I Believe." In it, you'll articulate the key reasons why you're investing, what you're hoping to gain from your investments, whether you're on track to meet your goals, and whether any changes are in order. Once you've created one, you can use your investment policy statement as your compass, a check to keep your investment portfolio on course to meet its goals even when the market and your emotions are telling you to run for the hills. Referring to your investment policy statement before you make any investment decisions can help ensure that you're investing with your head, not your gut.

Corporations and big institutional investors like pension plans create elaborate, 20-page investment policy statements. However, you needn't hire a consultant to develop your investment policy statement, and you don't have to use consultant-ish terms like "Executive Summary" and "Reporting Requirements," even though they appear in a lot of investment policy statements prepared by the pros.

In fact, I think the best investment policy statements for individuals are fairly stripped down and written in plain English; that way, you'll be able to easily identify the things that you should be focusing on.

More Resources

Morningstar Investment Policy Statement
► *morningstar.com/goto/policy*

Or turn to page 75 for an example of this statement

If you have separate investment portfolios geared toward different investment goals—for example, you have your own retirement assets that you expect to tap in 20 years as well as a college savings plan for your 15-year-old—you may find it helpful to create separate investment policy statements for each sleeve of your portfolio. Don't get too carried away, though. By getting too complicated and creating too many sleeves of your portfolio, you risk getting bogged down in paperwork and missing the big picture about whether your investments are on track to get you to your goals.

Step 1

Using the Investment Policy Statement as your template, start by writing down your key investing goal and the year in which you hope to reach it. If it's a goal that you will pay for over a number of years, such as retirement or college, fill out the Duration field. Of course, when it comes to retirement, filling out this field means quantifying your own longevity. That's tricky, but the actuarial tables on the Social Security Administration's Web site can help you arrive at a reasonable estimate. From there, I think it's helpful to be optimistic and assume even greater longevity.

Step 2

To the extent that you can, quantify how much your goal will cost. The Retirement and Savings calculators on Morningstar Investment Research Center can help. If you have a financial goal that's more than a year or two away, it's important to adjust the cost upward to reflect what you'll actually pay once inflation is factored in. That gets even more complicated for goals you expect to fund over several years, such as retirement or college.

Step 3

Go online or refer to your most recent statements to arrive at the current value of the investment assets you have earmarked for that specific goal. Also indicate how much you plan to invest toward this goal on an ongoing basis.

Step 4

Next, document your asset allocation targets for these investments.

Because your portfolio's asset allocation will ebb and flow based on how stocks are performing versus bonds and cash, your investment policy statement should set a range for your asset allocation rather than targeting a static figure for each asset class. After all, you don't want to have to make changes to your portfolio just because stocks went up 5% over the past month; that kind of trading can be costly and time-consuming.

For the broad asset classes, a range of 10 percentage points (or even 15 or 20 percentage points if you'd like to be a hands-off investor) is reasonable. For example, say your asset allocation target for your retirement portfolio is 55% stock, 40% bonds, and 5% cash. In your investment policy statement, you'd set out the ranges as follows:

- Stocks: 50% to 60%
- Bonds: 35% to 45%
- Cash: 0% to 10%

Some investment policy statements include sub-asset-class breakdowns, setting parameters for large-, mid-, and small-cap stock exposure; you can also break out U.S. and foreign stock exposure. There's nothing wrong with that, but you don't need to get too fancy. Setting your exposure to the broad asset classes and keeping your portfolio in line with those parameters is most important.

More Resources

Morningstar Retirement & College Savings Calculators

▶ *Visit Morningstar Investment Research Center and click the Portfolio tab to use these calculators*

Step 5

Based on your asset allocation parameters, project a rate of return for your portfolio. That will require you to forecast rates of return for various asset classes, a task that's certainly more art than science. I like to be conservative and assume a 6% return for stocks, a 4% return for bonds, and a 2% rate of return for cash. If your account consists of some combination of stocks, bonds, and cash (and you assume the forecasted rates of return I just laid out), you'll need to come up with a combined expected return. For example, if your accounts consist of 10% cash, 50% bonds, and 40% stocks, you'd calculate the expected return as follows: 2.4% return from the stock portion of your portfolio (6% x .40), 2.0% return from the bond portion of your portfolio (4% x .50), and 0.2% return from the cash portion of your portfolio (2% x .10). The aggregate expected return for such a portfolio would be 4.6% (2.4% + 2.0% + 0.2%).

Step 6

Next, document what you're looking for in your individual investments: the criteria you used when you selected the securities in your portfolio and what you'll use to judge them on an ongoing basis.

Some worthwhile criteria for do-it-yourselfers include:

- No-load funds only
- Expense ratios of less than 1% for stock funds, less than 0.75% for bond funds
- Manager tenure of more than five years
- Holds up well in down markets
- Average credit quality of A or better (for bond funds)
- History of good tax efficiency (for investments you hold in your taxable account)
- Long-term (10-year or more) returns in top half of peer group or beating appropriate market benchmark

Step 7

Once you've set your asset allocation parameters and your criteria for individual security selection, your next step is to specify how often you'll check up on your portfolio and when you'll make changes. In my experience, less is usually more when it comes to checking up on your holdings and your portfolio's performance. Semiannual or quarterly (at most) portfolio checkups are more than adequate. When it comes to making changes, I'd recommend doing so when your checkups indicate that your portfolio's allocations to the broad asset classes have diverged from your target by 5 or 10 percentage points or more.

Step 8

The final step in creating an investment policy statement is to specify what your checkups will consist of and how you'll evaluate whether you're on track to meet your goals.

You can do so in a few separate ways:

- Monitor individual holdings versus the criteria you laid out in Step 6.
- Monitor portfolio's asset allocation versus target allocation. (This will be the main trigger for your rebalancing efforts.)
- Monitor individual holdings' performance versus a style-appropriate benchmark.
- Monitor aggregate performance of holdings within an asset class versus a benchmark geared toward that asset class (for example, all U.S. stock funds' performance versus a broad-market benchmark like the Dow Jones Wilshire 500 Index).
- Monitor entire portfolio's performance versus a blended benchmark. For example, say your portfolio's asset-allocation target is 55% stocks and 45% bonds. You can benchmark your portfolio versus a blended portfolio consisting of 55% in Vanguard Total Stock

Market Index (VTSMX) and 45% in Vanguard Total Bond Market Index (VBMFX).

- Monitor portfolio's rate of return versus the projected rate of return you articulated in Step 5.
- Monitor assets accumulated versus your goal.

Next Steps

If you're familiar with investment policy statements, you know that they often include a couple of features that I've omitted here. For starters, they often include an investor's assessment of his or her own risk tolerance. In reality, however, most investors are very poor judges of their own ability to tolerate risk; when stocks are going up they rate their risk tolerance as very high, but when everything's going down, they feel more conservative. Because it's not very vuseful, I didn't include risk tolerance here.

Many investment policy statements also focus on performance, setting out rigid parameters such as "fund must be in top half of peer group over trailing three-year period." I think that, too, is misguided, because most investments lag their peer groups from time to time, and short-term underperformance can have a big effect on a holding's longer-term numbers. To the extent that your investment policy statement mentions performance, it should be very long-term.

More Resources

Social Security Administration Actuarial Tables
► *ssa.gov/oact/STATS*

Download worksheet

▸ *morningstar.com/goto/policy*

Sample Investment Policy Statement

Identify Investing Goals

Investing Goals	*When*
Duration	*Estimated Cost*
Current Assets	*Additional Contributions/ Frequency*

Specify Asset-Allocation Ranges

Domestic Equity		*% to*	
Large Cap (optional)		*% to*	
Mid-Cap (optional)		*% to*	
Small Cap (optional)		*% to*	
Foreign Equity		*% to*	
Developed Markets (optional)		*% to*	
Developing Markets (optional)		*% to*	
Bond		*% to*	
Short Term (optional)		*% to*	
Intermediate Term (optional)		*% to*	
Long Term (optional)		*% to*	
Cash		*% to*	

Project Rate of Return

Equity	*%*	
Bond	*%*	
Cash	*%*	
Combined	*%*	

Sample Investment Policy Statement Continued

Determine Investment Criteria

Equity

Bond

Specify Monitoring/ Rebalancing Frequency

- *Annually*
- *Semiannually*
- *Quarterly*
- *Rebalance when allocations to asset classes are % points from target*

Identify Monitoring Criteria (Check all that apply)

Fundamental	Performance
Individual Investments vs Investment Criteria	*Individual Investment Return vs Style-Specific Benchmark Return*
Portfolio Asset Allocation vs Targets	*Aggregate Asset-Class Return vs Asset-Class Benchmark Return*
Other (specify)	*Portfolio Return vs Blended Benchmark Return*
Other (specify)	*Portfolio Return vs Portfolio's Projected Rate of Return*
Other (specify)	*Current Assets vs Goal Assets*
Other (specify)	*Other (specify)*

When it Pays to Hire a Financial Professional

By Christine Benz
Director of
Personal Finance

Four situations when do-it-yourselfers can be penny-wise and pound-foolish

Paying a financial planner an ongoing fee to handle every aspect of your financial plan can make sense if you're extremely time-pressed or if your finances are particularly complicated. Ditto if you're very rich. Paying for ongoing financial advice (and hand-holding) may also be worth it if you've had trouble sticking with your investment plan through the market's many ups and downs. The best advisors earn their keep many times over by saving investors from their own worst tendencies to buy high and sell low.

For most other investors, however, I'd argue that it's not that difficult to create a sensible investment plan on your own. At the same time, I'd also tell you that you're better off delegating certain financial tasks—some of them investment-related, some of them only tangentially so—to a professional. Paying for advice on an a la carte basis enables you to pick and choose the best professional for a given job. For example, you should turn to an attorney to draft your estate plan, whereas a well-versed accountant or advisor may help you manage your stock options.

I'm all for keeping your finance-related costs as low as they can be, but here are a few of the key tasks where paying for professional advice is apt to be money well spent. (Note: This is not an inclusive list.)

Setting Up an Estate Plan

A quick Google search turns up scores of websites geared toward helping you write your own will. Creating a will in this fashion may be better than doing nothing, and an estate-planning kit may suit your needs if your situation is particularly uncomplicated and "vanilla."

However, it's hard to know whether your situation is truly generic or out of the ordinary unless you have basic knowledge of estate-planning issues and terminology. For example, you may want to treat your free-spending son differently in your estate plan than you would your financially fit daughter. Having a high net worth, previous marriages, a special-needs beneficiary, or strong charitable interests—just to name a few situations—may also call for a more customized estate plan.

That's where a competent estate-planning attorney comes in. He or she will ask you scores of questions about your own situation and what you hope to achieve with your estate plan and then ensure that your estate-planning documents are a reflection of your wants and needs. A good estate-planning attorney can also help you with the aspects of estate-planning that extend beyond your will, including setting up trusts, appointing powers of attorney, and making sure that your beneficiary designations are simpatico with the rest of your estate plan. Finally, an estate-planning attorney can help you keep your plan up to date as your life changes.

Handling Stock Options

Because stock options can prompt knotty tax questions (and the exercise of incentive stock options may trigger the dreaded Alternative Minimum Tax), an accountant who has had plenty of experience with stock options should be your first resource if you're attempting to navigate the stock-option maze. You don't want to settle for an accountant who deals with stock options just once or twice a year—you want someone who has witnessed many different scenarios and can propose a range of solutions.

But stock options aren't just complicated because of taxes. In fact, most accountants would acknowledge that an assessment of your company's future stock performance trumps taxes when it comes to deciding how to manage your stock options. Thus, if your accountant isn't comfortable discussing investment issues, you may also want to turn to an investment advisor to decide how to manage your options. An advisor or accountant can also provide a much needed "fresh set of eyes" in this situation, thereby helping ensure that you're looking at your company's prospects in an objective light.

In a similar vein, you may also want to turn to an accountant and/or financial advisor for guidance if your portfolio includes company stock or restricted stock.

Creating a Retirement Plan If You're Self-Employed

In addition to being able to make their own hours and work in their slippers on occasion, self-employed individuals have another perk that the rest of us worker bees don't enjoy: They have the opportunity to save even more in their retirement plans. Whereas most individuals can put as much as $17,500 in their company retirement plans in 2013 ($23,000 if you're older than 50), the self-employed can receive tax breaks on as much as $49,000 in retirement savings. And if you're the one setting up the plan, you can select the plan that best suits your needs.

On the downside, entrepreneurs have a dizzying array of retirement plans from which to choose, ranging from SEP IRAs to 401(k)s to profit-sharing plans to defined-benefit plans. Selecting the right one for you depends on many different factors, including the size of your business, the number of employees you have, the administrative costs of getting it up and running, and the size and frequency of your expected contributions. Hiring a financial advisor, preferably one who specializes in setting up these plans, can help you navigate the many choices.

Getting Ready for Retirement

With inflation spiking, figuring out whether you'll have enough to retire is complicated enough. To further complicate matters, many individuals retire with multiple sources of retirement income—a company retirement plan, multiple IRAs, taxable assets, and of course Social Security. (If your spouse has retirement assets in his or her name, that adds an additional layer of complexity.) That raises the question of whether your current assets will generate an adequate income stream, as well as what sequence you should use when tapping those assets. Hiring a financial advisor at this juncture can be invaluable in helping you think through all of the key issues, project cash flows from your various sources of retirement income, and arrive at a retirement strategy that makes sense for you.

How to Pick a Financial Advisor

By Rachel Haig
Assistant Site Editor for Morningstar.com

A guide to designations and fee structures, plus eight questions to ask

While many investors take the tried and true do-it-yourself approach, there may come a time when you consider turning to a financial professional. Whether you no longer have the time to manage your own investments, face a complicated tax situation, or simply want a second opinion, there are occasions when it makes sense to hire a professional. A few of these scenarios are highlighted in the previous article, *When It Pays to Hire a Financial Professional*.

But choosing to work with a professional is only the first decision you must make. From there, the flurry of different certifications and fee structures can confuse even experienced investors. Here is a guide to help you navigate your options.

Types of Professionals

Financial planners can carry an array of designations. Which one you should choose depends on the services you need. Most people seek out a Certified Financial Planner, Certified Public Accountant-Personal Financial Specialist, or Chartered Financial Consultant. ChFCs tend to sell insurance as part of their services; the other two usually do not. The CFP designation requires passing a series of exams and having at least three years of experience. If you want someone who knows taxes, choose a Certified Public Accountant. If you are looking for someone to help you choose individual securities, you may want a Chartered Financial Analyst, the designation that signifies expertise in the investment field. Many advisors have multiple designations.

Fee Structures

Again, the one that is right for you will vary depending on the type of service you want—if you want someone to manage your investments or simply to meet with you a couple of times each year to guide you. There are three types of fee structures:

Fee Only

The advisor is compensated solely by the client. Fee-only advisors can charge in a variety of ways. The fee can be a percentage of assets or a flat or hourly rate. The advisor is not selling any investment product and is not getting directly compensated for recommending specific investments. If you want a one-time checkup, it makes sense to find someone who charges by session or by hour. If you want ongoing portfolio advice, it may be more cost effective to find someone who charges a percentage of your assets. When the compensation is a percentage of your assets, your advisor's financial interests are aligned with yours—when your portfolio's value increases, your advisor earns more money; when it decreases, your advisor earns less.

Commission

The advisor is compensated by selling you products, such as mutual funds or an insurance policy. The advisor's pay is not tied to the performance of your portfolio. This may be the cheapest option, but there are potential conflicts of interest since the advisor is paid based on which securities you purchase and not based on how well your portfolio performs.

A Combination of Fee and Commission

Advisors who are paid this way usually call it "fee-based" compensation. Do not confuse this term with fee only. Under this structure, advisors still receive compensation from selling you particular products.

The fee-only option offers two big benefits. First, the advisor's investment recommendations are not driven by a commission. Second, it is more transparent—you will receive a bill and know exactly how much you paid for the services. With a commission-based advisor, you do not know how much the advisor has earned from you and how commissions affected your investment recommendations.

What is a reasonable fee? Asset-based fees are typically around 1%, while hourly rates range from $150 to $300, according to Money Magazine. The amount you pay will vary based on your advisor's particular fee structure. Many advisors charge different asset-based fees depending on the value of your account, so you can expect to pay a lower percentage if you have a large amount under management.

More Resources

- *fpanet.org*
- *napfa.org*
- *aicpa.org*

Where to Find One

Several websites can help you locate a financial professional who matches your needs. The Financial Planning Association is a national organization for all types of planners. The National Association of Personal Financial Advisors represents fee-only planners. The American Institute of Certified Public Accountants has a credential called Personal Financial Specialist. People who have this credential are CPAs who also have passed a series of exams on financial planning.

Questions to Ask

- What are your certifications? How many years of experience do you have? Look for someone with at least five years in the industry.
- How are you compensated?
- Do you accept fiduciary responsibility? Meaning, are they required to act in the best interest of clients?
- What types of clients do you see most often? Choose someone who regularly deals with the issues you face. Ask if you can speak to a couple of clients as references. It's unlikely you will be referred to an unsatisfied client, but you can still get a sense of how the advisor operates.
- What is your investment philosophy? What criteria is used to select securities? What role do expenses play when deciding between funds? Look for evidence

that the advisor is considering quality of management rather than just past performance.

- How often do you trade? Do you tend to buy and hold or do you trade frequently?
- What kind of software do you use? See if the advisor is comfortable discussing how it works, and try to determine if there is too much reliance on a computer for calculations and recommendations.
- Ask to see the advisor's ADV form, which all Registered Investment Advisors must file with their state or the SEC. This will show you any past compliance or legal issues. Advisors who manage more than $25 million in assets must register with the SEC, and you can search for information about them on the SEC website.

The Error-Proof Portfolio: Find the Right Stock/Bond Mix

By Christine Benz
Director of
Personal Finance

Asset allocation is the biggest determinant of how your portfolio behaves

Helping you create a sturdy financial plan, 30 minutes at a time, is the focus of my recent book, *30-Minute Money Solutions*. How much you save is the biggest determinant of whether you meet your financial goals, but setting an appropriate asset allocation is easily the second-most important factor. The following chapter, on arriving at an appropriate stock/bond/cash mix, is an excerpt from the book.

Are You a Stock or a Bond?

You may not be accustomed to comparing yourself to a financial security, but it may be useful when you're trying to figure out your portfolio's optimal stock/bond mix.

The thinking goes like this: If your own earnings power—which Morningstar Ibbotson Associates calls human capital—is very stable and predictable, then you're like a bond. Think of a tenured college professor, whose income is secure for the rest of his life, or a senior who's drawing upon a pension from a financially stable company. Because such an individual has a predictable income, he could keep a larger share of his portfolio in stocks than someone with less stable human capital. He's a bond.

At the opposite end of the spectrum would be an investment broker whose income depends completely upon the stock market. When the market is going up and the broker's clients are clamoring to invest, her commissions are high and she may also earn a bonus. But when the market is down, so is her income, and her bonus may be nonexistent. She's a stock. She'd want to hold much more in bonds than stocks, because her earnings are so dependent on the stock market.

Just as our career paths affect how we view our own human capital, so do our ages. When you're young and in the accumulation phase, you're long on human capital and short on financial capital—meaning that you have many working years ahead of you but you haven't yet amassed much in financial assets. Because you can expect a steady income stream from work, you can afford to take more risk by holding equities. As you approach retirement, however, you need to find ways to supplant the income that you earned while working. As a result, you'll want to shift your financial assets away from equities and into income-producing assets such as bonds or annuities.

Of course, there are no guarantees that stocks will return more than bonds, even though they have done so during very long periods of time. In fact, in the 10 years from August 1999 through August 2009, stocks eked out a small gain per year, on average, whereas bondholders gained an average of 6% per year. Against that backdrop, it might be tempting to ignore stocks altogether.

At the same time, however, it stands to reason that during very long periods of time, various asset classes will generate returns that compensate investors for their risks. Because investors in stocks shoulder more risk than bondholders, and bondholders take on more risk than investors in ultrasafe investments such as certificates of deposit, you can reasonably expect stocks to beat bonds and bonds to beat CDs and other "cash"-type investments during very long periods of time. (Of course there are no guarantees that will be the case, as the past decade shows.) In turn, that suggests that younger investors with long time frames should have the majority of their investments in stocks, whereas those who are close to needing their money should have the bulk of their assets in safer investments such as bonds and CDs.

What I've discussed so far is called strategic asset allocation—meaning that you arrive at a sensible stock/bond/cash mix and then gradually shift more of your portfolio into bonds and cash as you get older. Of course, it would be ideal if we could all position our portfolios to capture stocks' returns when they're going up and then move into safe investments right before stocks go down. In reality, however, timing the market by, say, selling stocks today and then buying them back at a later date is impossible to pull off with any degree of accuracy—so much so that most professional investors don't try it.

Maintaining a fairly stable asset allocation has a couple of other big benefits: It keeps your portfolio diversified, thereby reducing its ups and downs, and it also keeps you from getting whipped around by the market's day-to-day gyrations. An asset-allocation plan provides your portfolio with its own true north. If your portfolio's allocations veer meaningfully from your targets, then and only then should you make big changes.

To find the right stock/bond mix, you'll need:

- A list of your current investments
- An estimate of the year in which you plan to retire
- Morningstar Investment Research Center's Portfolio X-Ray Tool

Start the Clock

Step 1
Before determining a target asset allocation, start by checking out where you are now. Log on to Morningstar Investment Research Center's Portfolio X-Ray Tool, located in the Portfolio section of the database. Enter each of your holdings, as well as the amount that you hold in each. (Don't include any assets you have earmarked for short-term needs, such as your emergency fund.) Then click View Your Portfolio. You'll be able to see your allocations to

More Resources

Morningstar Portfolio X-Ray
- *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

stocks (both domestic and international), bonds, cash, and "other" (usually securities such as convertibles and preferred stock), as well as your sector and investment-style positioning.

Step 2

The next step is to get some guidance on where you should be. Find the asset allocation in the How Does Your Stock/Bond Mix Stack Up? document included on the next page that corresponds to your anticipated retirement date. Remember, this allocation corresponds to your long-term goals (for example, retirement assets), not your emergency fund or any shorter-term savings that you've earmarked for purchases that are close at hand.

Step 3

The allocations in the document mentioned above are a good starting point, but you can further fine-tune your asset allocation by asking yourself the following questions:

- Are you expecting other sources of income during retirement, such as a pension?
  Yes: More equities
  No: Fewer equities

- Does longevity run in your family?
  Yes: More equities
  No: Fewer equities

- Are you expecting to need a fairly high level of income during retirement?
  Yes: More equities
  No: Fewer equities

- Have you already accumulated a large nest egg?
  Yes: Fewer equities
  No: More equities

- Is your savings rate high?
  Yes: Fewer equities
  No: More equities

- Is there a chance that you'll need to tap your assets for some other goal prior to retirement?
  Yes: Fewer equities
  No: More equities

- Do you want to leave assets behind for your children or other loved ones?
  Yes: More equities
  No: Fewer equities

- If still working, are you in a very stable career with little chance of income disruption?
  Yes: More equities
  No: Fewer equities

Next Step

The Internet is chock-full of worthwhile tools to help you arrive at an appropriate asset allocation. T. Rowe Price's Retirement Income Calculator provides another way to see whether you're on track to meet your retirement income goals.

More Resources

How Does Your Stock/ Bond Mix Stack Up?
▸ *morningstar.com/goto/sbmix*

Or turn to page 86 to view the worksheet

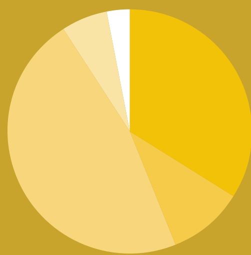
Download worksheet

► *morningstar.com/goto/sbmix*

How Does Your Stock/Bond Mix Stack Up?

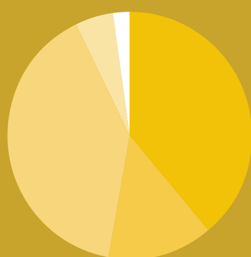
Retirement 2010

Asset Class Allocation	*(%)*
Stock US	34
Foreign Stock	10
Bond	47
Commodities	6
Cash	3



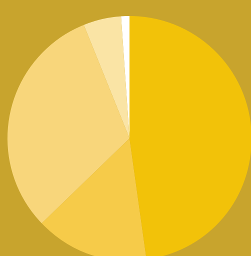
Retirement 2015

Asset Class Allocation	*(%)*
Stock US	39
Foreign Stock	14
Bond	40
Commodities	5
Cash	2



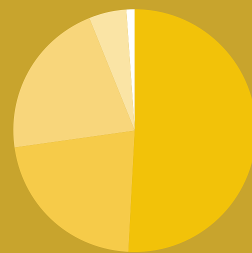
Retirement 2020

Asset Class Allocation	*(%)*
Stock US	48
Foreign Stock	15
Bond	31
Commodities	5
Cash	1



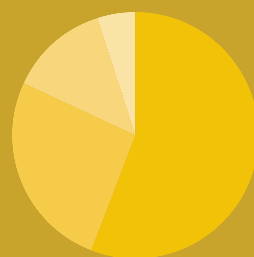
Retirement 2025

Asset Class Allocation	*(%)*
Stock US	51
Foreign Stock	22
Bond	21
Commodities	5
Cash	1



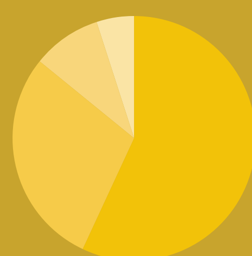
Retirement 2030

Asset Class Allocation	*(%)*
Stock US	56
Foreign Stock	26
Bond	13
Commodities	5
Cash	0



Retirement 2035

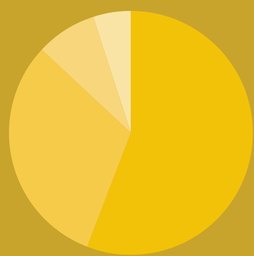
Asset Class Allocation	*(%)*
Stock US	57
Foreign Stock	29
Bond	9
Commodities	5
Cash	0



How Does Your Stock/Bond Mix Stack Up? Continued

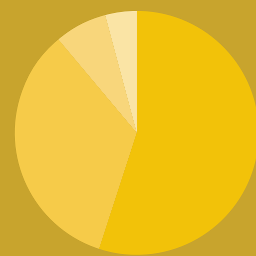
Retirement 2040

Asset Class Allocation	*(%)*
Stock US	56
Foreign Stock	31
Bond	8
Commodities	5
Cash	0



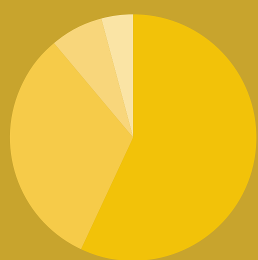
Retirement 2050

Asset Class Allocation	*(%)*
Stock US	55
Foreign Stock	34
Bond	7
Commodities	4
Cash	0



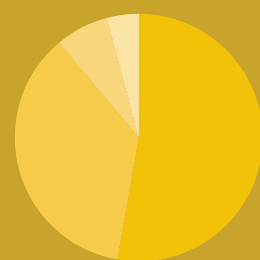
Retirement 2045

Asset Class Allocation	*(%)*
Stock US	57
Foreign Stock	32
Bond	7
Commodities	4
Cash	0



Retirement 2055

Asset Class Allocation	*(%)*
Stock US	53
Foreign Stock	36
Bond	7
Commodities	4
Cash	0



Allocations of Morningstar's Lifetime Allocation Indexes, developed in conjunction with asset allocation expert Ibbotson Associates. Note that even long-dated portfolios contain some bonds and near-dated portfolios include some stocks.

Preparing for Retirement

Roth IRA or 401(k): Which Should You Fund First?

By Christine Benz
Director of
Personal Finance

Plus six more strategic moves to a successful financial end game

I have heard from many Morningstar readers that they are strategizing about how best to allocate their financial resources. That's smart. Managing your personal finances is a lot like running a business, and the best businesspeople are those who make the best decisions about how to allocate their capital.

There are many decisions you have to make when determining how to allocate your personal financial resources. Grappling with whether to invest in the market or pay down your mortgage is one that we looked at earlier in *Should You Pay Down Debt or Invest?* on page 43. In order to make the most of your financial resources, you also have to pick and choose among the different investment-account types available to you. Should funding your 401(k) be your top priority, given that your money goes in on a pretax basis? How do Roth or traditional IRAs fit into the picture?

Because each of these decisions carries its own set of considerations, coming up with a one-size-fits-all financial priorities list can be tricky. For starters, we can't all avail ourselves of the same set of options; one person might have a pension plan, while another has a 401(k). Your tax bracket—both now and at the time you expect to retire—is also a big determinant of how you should prioritize the various tax-advantaged investment vehicles: Is it better to pay tax now or later? Your income level could also put certain investment options, such as the Roth IRA or a deductible IRA, off-limits. Liquidity is also important: If you think you might need the money sooner rather than later, you'll need to avoid vehicles that carry penalties for early withdrawal. Finally, if you're investing in an employee retirement plan with a limited menu of choices, you'll also have to weigh how good that lineup is.

Nonetheless, the following framework makes sense for individuals in a broad range of circumstances. Bear in mind that the following sequence will work better for some investors—for instance, those with a limited pool of money to put to work each year—than others. Thus, consider your own circumstances in deciding which sequence is the right one for you.

Pay Off Any Consumer Debt

I know. I know. Paying down your debt isn't an investment option per se. But if you think about it, avoiding high interest-rate payments—which are the unwelcome byproduct of consumer debt—is probably the safest investment of all. After all, you're reducing your costs without taking on additional risk.

I've heard some pundits say that it might be psychologically beneficial for investors to begin investing at the same time they're digging their way out of credit-card debt. While I can appreciate the sentiment, the math argues for paying off the debt before you begin investing. After all, most credit-card debt carries an interest rate in the double digits, while future returns on stocks and bonds aren't likely to be that high. (You'll also want to make sure that you've obtained the lowest credit-card interest rate.) Mortgage debt is in a slightly different category, as your interest is tax-deductible, but credit card debt has no redeeming features whatsoever.

Invest Enough in Your 401(k) to Take Advantage of Your Employer's Matching Contributions

If your employer is matching you on any part of your 401(k) contribution, you owe it to yourself to contribute at least enough to receive the full match. For example, if your employer is making a matching contribution of 3% of your salary and you make $50,000 a year, you'll need to contribute at least $1,500 of your own money to your 401(k) to be entitled to your employer's full matching contribution. Doing otherwise is like leaving free money on the table.

Invest in a Roth IRA

After you've stashed enough in your 401(k) to meet your employer's match, consider investing in a Roth IRA.

Why fund a Roth, to which you contribute after-tax dollars, before maxing out on your 401(k), to which you contribute on a pretax basis? In a word, flexibility. Whereas you must begin taking distributions from your 401(k) at age 70½, there are no such requirements governing Roth IRA withdrawals. You can let the money compound for as long as you like, and you can continue investing at any age. (With most other tax-sheltered vehicles, you can't make contributions once you hit age 70½.) In addition, withdrawals are tax-free, assuming you're age 59½ and you've held the account for at least five years. It's also worth noting that you can put a huge range of investments in a Roth IRA, whereas 401(k) plans typically require that you select funds from a limited menu.

True, in certain situations it might make sense for investors to contribute the maximum to their 401(k) plans and also avail themselves of traditional deductible IRAs (presuming they're eligible) before contributing to a Roth IRA. For example, if you expect to be in a lower tax bracket when you retire than when you were working, that's an argument for funding the 401(k) or deductible IRA before the Roth. That's because you'll pay taxes on your 401(k) and deductible IRA when you withdraw the money, whereas you contribute after-tax dollars to the Roth.

It may also turn out that you're simply not eligible to contribute to a Roth because your earnings are too high. If your income puts a Roth out of reach, move on to the next two suggestions.

Invest to the Max in Your 401(k) or Other Qualified Plan

Once you've met your employer's 401(k) matching contribution and set aside enough money to fully fund your Roth IRA in a given year ($5,500 in 2013; $6,500 for savers over 50 years of age), go back to your 401(k) and max out. Investors can contribute $17,500 to their 401(k)s in 2013; savers over 50 years of age can contribute an additional $5,500 this year. Because you're using pretax dollars, ratcheting up your 401(k) contribution to the limit might not be as painful as you think. If you're wondering how deeply an increased contribution will cut into your take-home pay, ask your company's human resources department to work up an estimate of your net pay assuming various contribution amounts.

Consider a Traditional Nondeductible IRA (or a Tax-Managed Mutual Fund)

If you earn too much to contribute to a Roth IRA (and therefore a deductible IRA is also out of reach), you might consider investing in a traditional nondeductible IRA. True, you won't be able to deduct your contribution from your taxable income—unlike a deductible IRA—and you'll also have to pay taxes on your account's investment earnings when you withdraw money. But you will enjoy the benefit of tax-deferred compounding.

Bear in mind, however, that a traditional nondeductible IRA carries all of the same restrictions that accompany a deductible IRA—in particular, you must begin taking distributions at age 70½, whether you're ready or not. Thus, I think you could make a good case for buying a tax-managed mutual fund rather than making a nondeductible IRA contribution. After all, tax-managed vehicles also promise tax-deferred compounding but carry no mandatory distributions.

If you do opt for a traditional nondeductible IRA, make sure you take maximum advantage of the fact that you won't have to pay taxes on any income or capital gains from the account as you go along. Thus, this is a good place to stash investments that are particularly tax-inefficient, including high-yield bond, Treasury Inflation-Protected Securities, real estate, and commodity funds.

Save for College

There are few things more important than saving for a child's future. And 529 plans and Coverdell Education Savings Accounts are also attractive from a tax standpoint, in that qualified withdrawals are tax-free. But you'll want to be sure not to short shrift your own retirement savings while you're socking it away for college. Loans and financial aid may be available to your college-bound child if he or she needs them, but retirees whose nest eggs fall short have fewer options available to them. Bear in mind that you can also withdraw money from your own IRA to pay for qualified college expenses if need be.

Fund Your Taxable Accounts/Pay Down Mortgage Debt

Once you've exhausted your key tax-advantaged options, turn your attention to saving money in your taxable accounts. From here on out, you'll want to stay hyperattuned to the tax efficiency of any investments you select.

At the same time, consider making bigger payments on your mortgage than your lender requires you to do. If returns on stocks and bonds are lower over the next decade than they have been in the recent past, it could be hard to call any debt "good debt," even if your interest rate is low and you earn a tax deduction on your interest.

Is Your Company Retirement Plan Up to Snuff?

By Christine Benz
Director of
Personal Finance

Ask these six key questions before maxing out your 401(k)

One of the most frequent questions that I get from Morningstar users is: Can you help me allocate my 401(k)? Through these questions, I've seen scores of company plans, ranging from thoughtfully constructed lineups chock-full of superb choices to plans that made me wonder, "What on Earth were they (the plan administrators) thinking?"

The broad disparity in quality among retirement plans argues for carefully scrutinizing your company plan before allocating valuable resources to it. True, it's hard to beat the tax-deferred compounding that a 401(k) plan affords. But if you have a fixed pool of investment dollars, it's probably wise to consider investing in an IRA (particularly a Roth IRA), over which you exert more control, before maxing out on a lousy company plan.

Here are some key considerations to bear in mind as you go about evaluating your own company plan.

Am I Earning a Match?

Many companies match their employees' contributions up to a certain percentage of their salaries. Firms' reasons for doing may not be entirely altruistic; for a plan to fall within government guidelines, contributions from the company's rank-and-file employees can't be substantially lower than contributions from the firm's top brass, so a company often has a strong incentive to get everyone to participate. But whatever the motive, employer matching contributions are an important perk that you should plan to take full advantage of. Even if further analysis indicates that your retirement plan is subpar, contribute at least the percentage your employer is matching you on. After all, a 100% match is like a 100% return on day one.

What Are the Costs?

In an ideal world, defined-contribution retirement plans would include only the lowest-cost investments around. After all, most companies, particularly larger ones, pool the assets of a number of employees, who together should be eligible for the low-cost, high-minimum "institutional" share class of a given mutual fund.

In the real world, however, many plans are chock-full of high-expense options. That's because some companies outsource the plan's administration to the investment firm managing the assets; that firm, in turn, extracts fees for the plan from the funds' expense ratio. In essence, the employees are paying for the administration of the plan out of their investment returns.

So how do you know if your plan is overly costly? Check out the expense ratio for each of your investment options. If the investment options in your 401(k) plan are mutual funds, check out their expense ratios on Morningstar Investment Research Center; be sure to match the share class you own with the one on the site. If you can't find the information about your 401(k) plan investments through Morningstar, ask your company for a prospectus for each of them.

In general, it's a mistake to pay more than 1.00% for a bond fund and 1.25% for a stock fund. You might consider a stock fund with an expense ratio above 1.25%—particularly if it's a small or specialized offering, such as an international small-cap fund—but you shouldn't go much higher.

How Good Are the Core Funds?

Because the assets in your company plan are apt to consume a big share of your retirement nest egg, it's essential that your plan feature worthwhile core stock and bond funds—anchor holdings to which you can devote 90% or more of your portfolio.

Start by assessing the quality of your plan's large-cap stock funds—those that land in Morningstar's large-value, -blend, or -growth categories. Your plan needn't feature top-flight funds from each of these three groups, but it should boast one or two sensible, well-diversified options. Index mutual funds, which mirror the holdings and returns of a given market benchmark, are showing up in more and more retirement plans, and can make superb anchor holdings provided their costs are reasonable. (Look for index funds with expenses of less—preferably much less—than 0.30% or so.) If your plan's core stock funds have active stock-pickers at the helm, check to see whether they have seasoned management teams and are well diversified across holdings and sectors. And for a bird's-eye view of how a stock fund is apt to behave in given market environments, review its calendar-year returns and rankings relative to its peers over the past five or so years.

You'll also want to assess the quality of the core bond funds in your plan, as such offerings are apt to take up a greater share of your portfolio as you grow closer to retirement. I'm encouraged to see more and more company retirement plans featuring funds run by "marquee-name" bond managers such as PIMCO, Western Asset, and BlackRock. Fidelity, Vanguard, and T. Rowe Price, all of which have a big presence in the 401(k) market, also run topnotch bond funds.

How Broad is the Lineup?

Once you've checked out your 401(k) lineup's entrees, turn your attention to the side dishes. Does your plan offer worthy options for diversifying? And if it does offer a varied menu, how good are the funds? Uneven quality is a particularly big consideration if all of the funds in your 401(k) plan hail from a single fund company. After all, few shops are good at everything. In this vein, it's particularly important to check up on whether your plan offers viable foreign-stock fund options. The typical investor's portfolio tends to be underweighted in foreign stocks, and for no good reason. (The U.S. market accounts for just 50% of the value of the global market, yet most U.S. investors devote far more than half their assets to U.S. stocks.)

Secondarily, check up on whether your plan features specialized stock funds, such as small-company offerings, as well as bond offerings to help add spice to your fixed-income portfolio, such as high-yield or inflation-protected funds. A lack of these niche offerings shouldn't keep you from investing in your company retirement plan, of course, but it will help you know what fund types you might emphasize in your other accounts.

Are There Any Simple Options?

As I've noted before, I'm a big fan of one-stop target-date funds that are designed to provide you with complete stock and bond exposure in one fell swoop. Such funds, which are increasingly appearing on 401(k) menus, can be a terrific choice for investors who don't have the time or the inclination to allocate their own assets. Some of these funds maintain fixed stock/bond allocations, while others actively "mature," or grow more conservative, as the investor reaches retirement. Here again, it's not a deal-breaker if your plan doesn't offer such an option, but the lack of a one-stop choice will mean that you'll have to pay more attention to allocating your assets across the various funds in the plan.

What Are My Alternatives?

So you've evaluated your 401(k) and found it lacking on some or all of the preceding criteria. What should your next steps be? First, determine whether your plan is seriously subpar or merely lacks a full array of attractive choices. If you discover that your 401(k) plan carries ultrahigh costs and subpar management, for example, you have strong motivation to investigate your other tax-sheltered options before shifting assets into the plan. (You should at least contribute enough to earn any matching contributions, however.) But if your plan features one or two solid picks, you should plan to invest in them and look to other tax-sheltered accounts—an IRA or your spouse's 401(k) plan, for example—to fill in areas where your company plan falls short.

A Note on Planning Questions

While Morningstar analysts and editors are happy to hear from readers, we cannot provide specific financial-planning advice or help you decide which funds to pick for your 401(k).

Should You Invest in a Subpar 401(k)?

By Christine Benz
Director of
Personal Finance

Assess your plan's worthiness with five key questions

All 401(k) plans offer tax-deferred compounding and the ability to make contributions on a regular schedule, both of which can be important benefits for long-term savers. But before you jump into a 401(k) with both feet, it's smart to consider whether your company retirement plan is the best receptacle for your money. If it's not up to snuff, you're better off contributing just enough to earn matching contributions, then move over to an IRA for additional retirement savings.

Here are the key questions to ask as you assess your 401(k) plan's worthiness.

Are You Earning a Match?

To see if your employer matches any portion of your contributions, get your mitts on your employee handbook or a document called a Summary Plan Description. If you're getting a match, you'll want to contribute at least that percentage of your salary to your plan.

How Costly Is the Plan Overall?

Before you invest more than the amount needed to maximize your matching contributions, check to see whether your plan is charging an extra layer of fees to cover administrative expenses. Employees at big companies may not have to pay this layer of expenses because their size has enabled them to negotiate good deals with investment providers. But employees of smaller firms may not be so lucky.

Again, look to the Summary Plan Description for a view of how much you're paying for the convenience of being in the 401(k) plan. (This number may also be found in your plan's annual report, often called Form 5500.) If administrative costs are higher than 0.5% per year, that's a red flag that your plan is costly.

How Good Are the Investment Options?

If you're earning a match and you're not paying an additional layer of administrative expenses, those are good signs that your plan is solid. But you also need to conduct some research on the quality of the investment options.

If your plan holds mutual funds, you can find detailed information about them by entering their tickers on Morningstar Investment Research Center (use the search bar in the upper right corner). Focus on the following data points:

Expense Ratio

Make sure you find an exact match for the fund share classes that are in your plan; for example, if your fund name is followed by an R1, look at data for an identical share class on Morningstar Investment Research Center. If your plan's investments are appreciably higher than the thresholds below, that's another red flag that your plan is pricey.

- U.S. stock funds: Less than 1.25%
- Bond funds: Less than 0.75%
- Foreign stock funds: Less than 1.5%

Manager Start Date

Also check how long the managers have been running the fund. When selecting mutual funds, there's rarely a good reason to settle for a newbie manager. Look for manager tenures of five years at a minimum.

Returns Relative to Category

Returns aren't the be-all and end-all of fund selection, but they are one of the only quantifiable measures of how a fund has delivered for its shareholders in the past. Check out a fund's five- and 10-year return ranking versus its category peers. (Lower numbers are better here.) Not every fund in your plan has to be at the top of the charts, but look for a good number of funds whose returns land in the category's top half or better.

Is There a Roth Feature?

If you're just starting out in your career, or even if you're not, the ability to make Roth 401(k) contributions can be an extremely desirable benefit. You'll pay taxes on Roth contributions, but you'll be able to take tax-free withdrawals--a key benefit if your future tax rate is higher than your current one. If a Roth makes sense for you and your plan doesn't have a Roth feature, you're better off funding a Roth IRA before putting money into a traditional 401(k).

Are You Maxing Out Your IRA Options?

Are you a high-income earner who is already maxing out other tax-sheltered options such as IRAs? If so, that argues for contributing the maximum to your 401(k), even if you don't particularly like the investment options and/or you're not earning a match. Contribution limits are much higher for 401(k)s than IRAs, allowing you to shelter more of your investment income from taxes. Those tax savings can be valuable if you're in a high tax bracket, even if the individual options in your plan are only so-so.

Five Tips to Make the Most of a Lousy 401(k)

By Christine Benz
Director of
Personal Finance

Maximize returns in a subpar retirement plan with these five tips

The issue of hidden fees in 401(k) plans has been getting attention, and not a moment too soon. Getting your arms around what you're truly paying is tricky work, and clearly some plan sponsors aren't doing their part to create topnotch company-retirement plans for employees.

If you find yourself in that boat, the next logical question to ask is whether you should even bother investing in a company plan that doesn't measure up. If your plan is extremely poor and you have a fairly small sum of money to invest each year, it makes sense to consider a Roth IRA or a traditional deductible IRA before steering funds to a company plan that's a stinker. (Be sure to contribute at least the amount your company is matching you on, however; doing otherwise is like turning away a guaranteed return of 100%.)

But if you do determine that the tax-deferred nature of the company-retirement plan offsets its weaknesses, how can you make the most of that subpar plan? Here are some tips for doing just that.

01
Go the Index Route

Okay, so maybe your plan doesn't feature mutual funds managed by topnotch stock-pickers. But if the plan's options include index funds—offerings that track a given market benchmark rather than attempting to beat it—you can obtain broad market exposure at a reasonable cost. Even if the index funds in your plan aren't the best—say, your plan offers an S&P 500 fund from Dreyfus rather than the ultracheap options from Vanguard and Fidelity—you're probably still better off going the index route than you are opting for a lackluster active fund. True, the active manager—even the one with a subpar past record—has a shot at beating his or benchmark, at least in theory. In practice, however, the active fund's expenses—as well as transaction costs that aren't reflected in its expense ratio—weigh heavily on that manager's ability to beat the benchmark.

02

Take the Best and Leave the Rest

It's natural to want to craft a 401(k) portfolio that's diversified across all of the major asset classes (bonds and U.S. and foreign stocks), but that might not be practical or prudent if your company plan doesn't offer viable options in all of these areas. If your plan features a few standout options and the rest are subpar, load up on the few decent funds and avoid the rest. You can use your IRA, your taxable accounts, or your spouse's retirement plan to delve into those asset classes and investment styles in which your own plan is lacking.

For example, say the stock funds in your company plan are poor but the lineup does offer a top-quality core bond fund. Even though your overall asset-allocation plan calls for just 30% in bonds, you could sink a big share of your 401(k) portfolio into the bond fund and then go light on bonds in your other accounts.

The key to making this strategy work is to look at all of the assets geared toward a particular goal or time horizon in aggregate. Morningstar Investment Research Center's Portfolio X-Ray can make easy work of this task. Just enter your retirement-related holdings into the tool, then click View your Portfolio X-Ray to see aggregate asset-class, investment style, and sector data for your holdings.

More Resources

Morningstar Portfolio X-Ray

► *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

03

Investigate the Brokerage Window, but Do So with Care

Increasingly, 401(k) plans—particularly those from large employers—are offering so-called "brokerage windows," also called self-directed accounts. If your plan offers such an option, you'll have the opportunity to delve into hundreds of other mutual funds, stocks, and even exchange-traded funds that aren't part of your 401(k) plan's preset menu.

Having the option to choose from such a wide array of securities can be a godsend if your plan consists of pricey funds that are past their prime. Using your plan's brokerage window, you can gain access to some of Morningstar's off-the-beaten-path Fund Favorites and you may also be able to venture into exchange-traded funds, some of which carry rock-bottom expense ratios.

But before you jump aboard, be sure to read the fine print. You may pay an extra fee (often levied annually) to participate in the brokerage window, and those extra costs can quickly erode the extra returns you might gain by venturing beyond your plan's preset menu. In addition, you may pay separate transaction costs to buy and sell securities that are part of the brokerage window. (That will almost certainly be the case when buying stocks and ETFs, so if you're going to go this route, it pays to do so by investing a single lump sum rather than making a lot of small purchases.) Finally, using the brokerage window may require additional work on your part. Whereas most 401(k) contributions are deducted directly from your paycheck, thereby adding valuable discipline to the investment process, you may have to actively make the trades into investments via your brokerage window.

And while the brokerage window might give you the opportunity to venture beyond the plain-vanilla offerings that are often mainstays of company retirement plans, beware of loading up on niche offerings with extreme risks. Even though the brokerage window might offer an array of sector funds, niche bond vehicles, and region-specific international offerings and ETFs, large-cap stock funds and intermediate-term bond funds should still serve as the linchpins of your 401(k) portfolio.

04
Talk to HR

If employees in your company are grumbling that the retirement plan is subpar, be sure to let your human resources department know how you feel. You may not be able to enact change overnight, because a lot of factors—not just the quality of investment options—figure into a company's decision to opt for one retirement-plan provider over another. (It's an unfortunate fact of life that some investment providers slash costs and offer employers other goodies to entice them to opt for substandard plans.) But your employer should still be aware that its benefits package isn't measuring up.

05
Check Out Other Options

If you've determined that your company plan is weak, that means you'll have to make the most of all of the investing options available to you, tax-sheltered and otherwise. Investigate whether you're eligible to contribute to a Roth or other IRA, and plan to max out your spouse's plan if it's better than yours. Also be savvy about investing in your taxable accounts; I'm a big fan of tax-managed funds, particularly those from Vanguard. Last but not least, recognize that your own savings rate is the most powerful lever you have in determining the size of your eventual nest egg.

More Resources

Morningstar
Fund Favorites
▶ *Visit Morningstar Investment Research Center and click Fund Favorites on the Home tab*

What Goes Where? The Art of Asset Allocation

By Christine Benz
Director of
Personal Finance

Taking care with asset placement can result in big tax savings

I'll confess: When it comes to matters of money and investing, there are a handful of topics that make my head hurt. One of them is "asset location"—essentially, the placement of investments in taxable or tax-sheltered accounts.

Why is asset location such a sticky wicket? For one thing, the tax treatment of investments changes frequently, so what might be an optimal asset placement today might not be a few years from now.

Dividends provide a great case in point. Before 2003, income from stock dividends was taxed at the ordinary income tax rate, so you'd generally want to hold income-rich stocks in your tax-sheltered accounts. But when dividends began to be taxed at the lower capital gains tax rate, they were no longer verboten for taxable accounts. When the currently low dividend-tax rates are set to expire at the end of 2012, dividend-tax treatment will again be up for grabs, which is one reason I think it's a mistake to go whole-hog into dividend-paying stocks for your taxable account. In addition to tax treatment confusion, practical considerations sometimes completely contradict advice that makes good tax sense. When we're in accumulation mode, most of us naturally use our retirement accounts (401(k)s and other company-retirement plans and IRAs) as a storehouse for our longest-term savings, so it's only logical that we'd be inclined to invest in long-term assets (namely, stocks) there.

Meanwhile, from a practical standpoint it's logical to want to hold more safe, stable, and liquid assets (namely, bonds and cash) in accounts that we can readily tap without strictures or penalties—our taxable accounts. Yet as much logical sense as those asset-placement arrangements might seem to make, they precisely contradict what a tax advisor would tell you to do. Because income from bonds and cash is taxed at your ordinary income tax rate, that's a powerful argument for holding bonds in your tax-sheltered accounts while keeping at least some stocks in your taxable account.

So how should you navigate this confusing landscape? There are no one-size-fits-all solutions, and it's worth revisiting your asset-location framework every few years to make sure your plan syncs up with the current tax rules. But here are some general guidelines.

Hold in Your Tax-Sheltered Accounts: High-Returning Assets With High Tax Costs

Because you don't have to pay taxes from year to year on income or capital gains you earn in tax-sheltered accounts like IRAs and 401(k)s, these are good receptacles for higher-returning investments that also have heavy tax consequences. The best example would be junk bonds, junk-bond funds, and multi-sector-bond funds, all of which kick off a high percentage of taxable income. And while it's a stretch to call high-quality bonds and bond funds "high-returning" right now, they're also a better fit for tax-sheltered accounts than for taxable because their payouts are taxed at an investor's ordinary income tax rate. So generally speaking, to the extent that you hold bonds, you're better off doing so within the confines of a tax-sheltered account.

By contrast, stocks and stock funds are generally a better bet for taxable accounts, for reasons I'll detail in a minute. That said, not all stocks belong in the taxable bin. Although they enjoy relatively low tax treatment currently, dividend-paying stocks are arguably a better fit for tax-sheltered rather than taxable accounts.

As I noted earlier, the tax treatment of dividend income is set to expire at the end of 2012; unless Congress takes action, dividends will again be taxed as ordinary income beginning in 2013. Also, dividend income, like bond income, isn't discretionary. Whereas stock investors can delay the receipt of capital gains simply by hanging on to the stock, investors in dividend-paying stocks don't have that kind of control; they get a payout whether they like it or not. That makes dividend payers, regardless of tax treatment, less attractive than nondividend payers from a tax standpoint.

Your tax-sheltered accounts are also the right spot for REITs, whose payouts are generally considered nonqualified and taxed at ordinary income tax rates. Preferred stock, too, is on the bubble, depending on the type of preferred you're dealing with, and therefore is apt to be a better fit within the confines of a tax-sheltered account. Traditional preferreds generally qualify for dividend-tax treatment, whereas income from trust preferreds is taxed at an investor's ordinary income tax rate. Dividends from some foreign stocks and funds may also be classed as nonqualified, meaning they will be taxed as income.

Finally, to the extent that you hold mutual funds that churn through their portfolios frequently, you're better off doing so within your company-retirement plan or IRA. Such funds tend to generate a lot of short-term capital gains, which are also taxed as ordinary income.

Hold in Your Taxable Accounts: Higher-Returning Assets with Low Tax Costs

The above exceptions notwithstanding, there are compelling reasons to hold stocks in your taxable rather than tax-sheltered accounts.

As I noted earlier, long-term capital gains, which is what you have when you sell a stock that you've held for at least a year, are taxed at a much lower rate than is bond income—currently zero for investors in the 10% and 15% tax brackets, and 15% for investors in the 25% tax bracket and above. (Those favorable tax rates, like dividend tax rates, are set to expire at the end of 2012.) When they do, they'll revert back to the rates in place before 2003—20% for most investors.)

Another key reason to hold stock in your taxable accounts is that stock investors can also exert a higher level of control over the receipt of capital gains than bond investors—for example, by buying and holding individual stocks or by investing in exchange-traded funds, which have a built-in mechanism for limiting taxable capital gains payouts. Tax-managed funds and traditional broad-market stock-index funds also tend to do a good job of keeping the lid on distributing capital gains.

Hold in Either Account Type: Lower-Returning Assets with High Tax Costs

So the key rules of thumb are that stocks go in taxable accounts and bonds go in tax-sheltered wrappers. But what about lowly old cash? From a pure tax standpoint, holding the assets in a tax-sheltered account makes the most sense, as income from cash investments is taxable as ordinary income, just like bond income.

Here's a case, however, where practical considerations may override the tax argument. One of the key benefits of cash is easy access to your money when you need it, so it simply may not make sense to store cash for near-term income needs in tax-sheltered accounts, where you may face taxes and other penalties to pull it out prematurely. And because you're receiving a minuscule income stream from most cash investments these days (you might be holding them for stability as much as real income), the tax hit associated with holding cash in a taxable account is apt to be quite low for most investors.

The bottom line is that if you're holding cash for near-term income needs or as an emergency fund, it makes sense to hold it in a taxable account. If you're holding a sleeve of cash as a component of your retirement portfolio's long-term strategic asset-allocation plan, it's fine to hold it within the context of your tax-sheltered account.

Preparing for College

Questions to Ask Before Investing for College

By Christine Benz
Director of
Personal Finance

The answers to these questions will go far in determining how to save

We've all heard tales of competitive, well-heeled young parents applying for elite preschools when their children are infants or even still in the womb. But one of my friends upped the ante by saving for her child's college education before she was expecting a baby or even dating her husband.

That may sound strange, but her logic was straightforward. She knew that she wanted to have a child no matter what the future held, so she figured that getting started on college savings would help her baby's college fund fully benefit from the power of compounding. Ten years and three little ones later, she and her husband feel grateful for her foresight.

The more I've talked to parents and would-be parents, the more I've realized how rare my friend's preparedness is. Most will tell you that their children went from onesies to "Can I borrow the car keys?" in the blink of an eye, giving them little time to devote to building a college fund. Parents also have to juggle saving for college alongside competing financial priorities, including squirreling away money for their own retirements.

It would also be hard to blame would-be college savers for being put off by the magnitude of the task at hand. Not only are college costs sky-high and rising fast, but college savers also have to sort through an alphabet soup of options: 529 plans, Coverdell accounts, and UGMA/UTMA accounts, to name some of the most commonly used vehicles. College savers also have to consider how financial aid fits into the mix and whether any of these vehicles jeopardize their eligibility for it.

Here are the key steps to take when determining which type of college-savings vehicle makes the most sense for you.

01

It's gut-check time. Use Morningstar's College Savings Calculator, located on the Portfolio tab of Morningstar Investment Research Center, to define your college target goals. Do some research on average tuition plus room and board at a private and public university, both in-state and out-of-state. (Of course, the school your child selects may be more or less costly than the number you use in your calculations.) You can then enter your own information to see how much you'd need to invest—and how much you'd need to earn on your money—to hit your savings target.

Don't be discouraged if it looks like you'll fall short of the amount you need to save. In an ideal world, you'd be able to cover four years' worth of tuition and you'd have that money in hand during your child's senior year of high school. In reality, however, only a small fraction of families have that luxury. Instead, most children and their families pay for college using a combination of savings, loans, work-study, out-of-pocket payments, and financial aid.

The point of looking at these numbers isn't to scare you to death but rather to show you what you're aiming for. This step will also help you set expectations with your child. If your child needs to revisit his or her preferences about college because of financial constraints, it's better to start that discussion sooner rather than later.

More Resources

Morningstar College Savings Calculator

► *Visit Morningstar Investment Research Center and click the Portfolio tab to use this calculator*

02

Next, answer the following six questions.

How much do you plan to contribute to college savings per year until your child goes to college?
If you plan to amass a lot of assets in a college savings fund, none of the major college-savings vehicles is automatically off-limits, but you may have to use them in conjunction with another vehicle. For example, as of 2013, the Coverdell Education Savings Account currently has a contribution limit of $2,000 per year unless Congress takes action. If you were planning to tap your Roth IRA to pay for college, that vehicle allows contributions of only $5,500 per year ($6,500 if you're over 50). If you'd like to contribute to just one type of college funding vehicle, a 529 plan or taxable account will allow you to amass the most assets.

Which vehicles are you eligible to contribute to?
In addition to limits on contributions, some of the college funding vehicles won't let you contribute (or receive tax breaks) if your income is over a certain threshold. Thus, the next step is to determine which of them you're eligible to contribute to.

The Coverdell Education Savings Account and Roth IRA both carry income limits; married couples filing jointly and earning more than $220,000 can't make a Coverdell contribution in 2013, and those married couples filing jointly who earn more than $188,000 can't fund a Roth IRA. (Not directly, anyway; higher-income savers can make a "backdoor" Roth IRA contribution.) And if your income comes in above a certain level, you can't take tax-free withdrawals from Series I or EE savings bonds, either. So, if your income level disqualifies you from any of these vehicles, you can cross it off your list.

How much flexibility do you need?
Are you determined to save for college and confident that you'll never need the money for another use? If so, you can feel free to consider dedicated college savings vehicles such as a 529 plan or Coverdell Education Savings Account.

If, on the other hand, you're looking for a college savings vehicle that will allow you to multitask—perhaps saving for retirement or shorter-term goals at the same time that you're saving for college—you'll want to shy away from 529 plans or Coverdells. That's because those vehicles require you to pay taxes and/or penalties if you need to withdraw the money prematurely or for another purpose. Instead, you should focus on a more versatile vehicle for college savings, such as Roth IRAs or taxable accounts. You can withdraw your Roth contributions at any time and for any reason (though it's rarely a good idea to rob your retirement account to pay for college). Saving and investing in a taxable account offers you the most ready access to your money, though you will have to pay taxes on any investment appreciation when you withdraw.

Do you expect that you'll need to rely on financial aid to fund your child's education?
If so, bear in mind that assets held in the child's name are generally less advantageous than assets in the parents' names when it comes to qualifying for financial aid. Coverdell accounts and 529 plans held by the parents have less impact on financial aid eligibility. UGMA/UTMA accounts, on the other hand, are less desirable if you expect that you'll be applying for financial aid.

Does your state offer a generous tax deduction for contributions in its 529 college savings plan? Do you live in a state with a particularly high tax rate? Currently, many states offer tax deductions if you invest in your home state's 529 plan, and a handful of states offer so-called tax parity, allowing residents to obtain a state-tax deduction even if they invest in another state's 529. If your state offers a large deduction and you live in a high-tax state, you have a strong incentive to prioritize a 529 plan over other types of college savings vehicles. (There are a few exceptions, but you generally won't be able to receive a state tax deduction if you buy a 529 plan offered by another state.)

Keep the tax benefit in perspective, however. Because state tax deductions are capped at a fixed dollar amount, they'll tend to be less valuable, in percentage terms, the more you accumulate in the plan. Morningstar's research shows that savers who plan to amass a very large sum in a 529 plan will enjoy a lesser tax benefit, in percentage terms, than smaller investors.

How much control would you like to exercise over your investments?
You can put almost anything inside Coverdell Education Savings Accounts, Roth IRAs, taxable accounts, and UGMA/UTMA accounts. While you can shop around among 529 plans, you'll still be choosing from a fixed menu of investment options.

03

Once you've answered the preceding questions, you should have a clearer view of the vehicle(s) that will work best for you. If you've decided to invest in a Coverdell, UGMA/UTMA, Roth IRA, or in your own taxable account, you can set that up by contacting the investment provider directly.

Assessing the Student Loan Landscape

By Christine Benz
Director of
Personal Finance

Often-costly private loans should be a last resort

In the past, many people put their student loans in the "good debt" column: Because the rates on these loans were typically quite low, it didn't often make sense to prioritize paying them off over other financial objectives, such as investing for retirement.

These days, however, those borrowing to pay for college need to be a lot more defensive. Not only may student-loan terms be less attractive than they were in the past—particularly for those who need to go to the private market to secure one—but new grads may also get squeezed if they have to begin repaying their loans before they land a job. Owing in no small part to the still-anemic economic recovery, the student loan default rate has been on the rise, recently jumping from 7% to nearly 9% for new grads with loans, according to the U.S. Department of Education. (High default rates among graduates of for-profit colleges push up the averages.)

As with mortgage borrowers, student-loan shoppers face a bewildering array of options that carry varying interest rates, fees, and terms. In all, it pays to do your homework—and investigate other alternatives—before signing on the dotted line for a student loan.

Determine Your Need

The first step in the college-funding process is to determine how much of your child's education expenses your family will likely be on the hook for. Submitting the Free Application for Federal Student Aid is the way to officially check on financial aid eligibility, and your specific package will vary by school. That means you'll have to wait until acceptance letters start rolling in to get a true handle on how much of your child's college bills will be covered by grants, scholarships, and/or work-study programs and how much you'll have to cough up on your own, either by dipping into savings or taking out loans. However, you can also use online calculators such as the Quick EFC (Estimated Family Contribution) Calculator on finaid.org to help assess these variables in advance of submitting applications and filing your FAFSA form.

Discuss the Payoff

If it looks like you and/or your child will have to borrow a sizable sum to cover the cost of college, it's wise to begin discussing those numbers in the context of your child's expected career path. If your child will graduate with $100,000 in student-loan debt but plans to venture into a field where starting salaries are in the $25,000 per year range, it doesn't take a math major to see that it will take many years to retire that debt, and doing so could impede your child's ability to reach other financial goals. Finaid.org's Loan Calculator enables you to stress-test various loan amounts based on anticipated salary level. If the loan amount needed to finance a given school appears unaffordable based on your child's anticipated career path, it's better to have that discussion when there's still time to enroll in a cheaper school.

Know the Different Types

College loans come in a number of different varieties, but there are a few key categories to be aware of. The first choice for most students seeking additional funding is loans extended by the federal government. Perkins loans are available exclusively to low-income students. Stafford loans, meanwhile, come in two key varieties. With subsidized Stafford loans, students aren't on the hook for interest until after graduation, whereas interest begins accruing on unsubsidized Stafford loans immediately. Students applying for subsidized Stafford loans must demonstrate financial need, whereas students needn't demonstrate a financial need to qualify for an unsubsidized Stafford loan. (Many students combine both subsidized and unsubsidized loans.) Loan limits apply to all federal student loans, however, as laid out in the tables found on finaid.org, so many students will have trouble covering all of their costs by exclusively relying on these loans.

The second key category is federal loans made directly to parents, usually called PLUS loans. On the positive side, parents can typically borrow much more than students. However, interest begins accruing immediately and payments must also begin immediately. Moreover, the cost of a PLUS loan is apt be higher than other forms of financing that a parent might secure, such as a home equity loan, and paying down such a loan may impede the parent's ability to save for other financial goals.

The final category of student loan is a private loan extended by a bank. In general, the cost of a private student loan will be much higher than a federal loan. Finaid.org includes an excellent table to help compare the rates, terms, fees, and loan limits associated with various college-loan products.You can also use sites like bankrate.com to comparison-shop among different products. Without doing a deep dive, you can readily see that private loans are costly: Often keyed off of the one- or three-month LIBOR or the prime rate, interest rates on private student loans are frequently in the double-digit range.

Don't Overestimate the Value of the Interest Deduction

You may have heard that you'll be eligible to deduct the interest on student loan debt. That's true, but don't overestimate the value of that deduction. In 2012, you can only deduct $2,500 in student loan interest per year; single parents earning more than $75,000 and married couples filing jointly who earn more than $150,000 per year cannot deduct the interest at all.

More Resources

finaid.org links

- *finaid.org/calculators/quickefc.phtml*
- *finaid.org/calculators/loanpayments.phtml*
- *finaid.org/loans/studentloan.phtml*

Consider Additional Options

Rather than assuming that student loans are the only way to cover the cost of college, it's important to take a step back. Fully exploring financial aid packages, scholarships, and work-study programs can help reduce the strain that such loans can impose on families and new grads; some grandparents may also have the wherewithal to help defray college costs. Parents may also contemplate tapping home equity lines of credit or using their Roth IRAs to fund college.

Find the Right Stock/Bond Mix for College Savings

By Christine Benz
Director of
Personal Finance

Helpful tips for hands-on and hands-off investors looking to save for a college education

"I can't understand this. We've tried to do everything right from the day she was born."

So lamented a friend, right after telling me that the college fund of her daughter, a senior in high school, had dropped by nearly 50% in 2008. My friend and her husband were facing a tough choice: They could either tell their daughter to look at cheaper schools or they could try to finance tuition at a more costly college by dipping into their retirement savings or asking their daughter to take out loans.

Ultimately, their daughter opted to go to a public university that cost thousands less than some of the private schools she was originally eyeing. That wasn't a calamity—in fact, she was happy with her decision, and the school she chose is highly rated. However, this family's predicament was a common one. The reason? As their child approached college, they hadn't steered enough of their 529 portfolio toward cash and bonds, thereby exposing their college kitty to the stock-market's dramatic downturn. (Some 529 college-savings plans also featured poorly performing investments that were supposed to be conservative but in reality were anything but, including bond funds that were loaded with risky derivative securities.)

When it comes to selecting specific investments for a college portfolio, asset allocation is every bit as crucial—if not more so—than it is for retirement savers. Retirement dates can be a little squishy: Although they may not do so happily, retirees can delay retirement or work part-time longer than they had originally planned if their retirement portfolios come up short. Most young people, on the other hand, want to go to college right after high school, making the target date for a college fund much more specific than is the case for a retirement portfolio. Moreover, because retirement may be 25 or 30 years long, retiree portfolios have time to make up lost ground if they lose money early in retirement. But because it takes most students only four to five years to get through college, a college fund's drop in value during the high school or early college years can be catastrophic.

Here are some key tips for determining an appropriate asset-allocation mix for your child's 529 college-savings account.

Look to Age-Based Options, But Conduct Due Diligence First

Because arriving at an appropriate asset allocation can be complicated for any age or goal, it's not surprising that a healthy share of the assets flowing into 529 plans is now directed toward the age-based options. Much like target-date mutual funds, age-based options contain a mix of stocks, bonds, and cash and grow progressively more conservative as your child nears college age.

If hands-off simplicity is your goal, such programs can seem like a godsend. But it's important to conduct due diligence on an age-based plan before entrusting your hard-earned college-savings dollars to it. Some important things to look for are if a given age-based 529 plan is more aggressive, more conservative, or right in line with other 529 options in that same age band. Some argue that a more equity-heavy posture is necessary if college savers are to keep up with rising cost of college, but would-be investors in such a program should be comfortable with the volatility that a higher equity weighting entails.

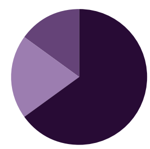
And if your 529 plan's age-based options are dramatically out of whack with the industry averages, that's a red flag to look to another 529 plan, create your own age-appropriate portfolio using individual funds, or supplement the age-based plan with individual stock, bond, or cash holdings. Alternatively, an increasing number of plans offer age-based options that are geared toward investors with varying risk tolerances. For example, New York's 529 Program comprises age-based tracks for moderate, conservative, and aggressive investors.

Start With a Blueprint When Building Your Own

If you would like to select your own investments within the 529 framework, it's fairly simple to create a portfolio with an appropriate target allocation using broadly diversified holdings that are found in most 529 plans. The following asset-allocation parameters, based on industry averages for age-based target-date funds, provide a good starting point for most college savers.

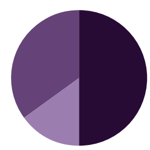
Child's Age: 0–5

U.S. Stock	65%
Foreign Stock	20%
Bonds	15%
Cash	0%



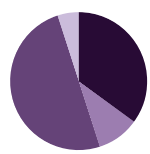
Child's Age: 6–10

U.S. Stock	50%
Foreign Stock	15%
Bond	35%
Cash	0%



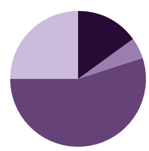
Child's Age: 11–15

U.S. Stock	35%
Foreign Stock	10%
Bond	50%
Cash	5%



Child's Age: 16-18

U.S. Stock	15%
Foreign Stock	5%
Bond	55%
Cash	25%



Note that these are just baselines, and you should customize your 529 asset allocation based on your situation. You'll notice that the allocations for children who are in their teens and in college are very conservative—predominantly bonds and cash. That means that your college fund won't grow much once your child is in that age range, but nor will it suffer a big drop. If you're just beginning to build a college fund for a child who's within five or six years of college, it's wise to stick with safe investments and know that you'll have to make up any shortfalls in your college portfolio by saving more, obtaining financial aid, or taking out loans. By all means, avoid building a more stock-heavy portfolio in an effort to make up for lost time; the risks of doing so are simply too great.

On the flip side, if you're one of the (rare) individuals who has socked away enough to cover four years of expenses at the school of your child's choice, there's no need to lose it by holding stocks in your child's college fund. Conservatism should be your watchword.

Schedule Regular Checkups

Making your college fund more conservative as your child gets closer to college age is an essential part of the process, and it's particularly important once a child is nearing or in high school. For that reason, I'd recommend doing a full checkup on your college-savings program every year. At that time, you can determine whether you need to adjust your asset allocation because your child is getting closer to needing the money.

Maintaining Your Investments

Five Steps to Rebalancing Your Portfolio

By Christine Benz
Director of
Personal Finance

Restore your asset allocation with this step-by-step guide

If you've put off rebalancing because the process seems daunting, read on. This guide simplifies the process using tools in Morningstar Investment Research Center.

01
Determine Your Asset-Allocation Targets

Your first step in the rebalancing process is to make sure you have an asset-allocation framework. If you had a stock/bond target that made sense for you before the recent market downturn, it should still fit now. And if you don't have an asset-allocation plan, it's time to make sure you have one. My favorite "quick and dirty" method of getting in the right asset-allocation ballpark is to look at the asset allocations of target-date mutual funds geared toward individuals in your age range. Of course, there are no one-size-fits-all asset-allocation solutions—none of us knows how long we'll live, for one thing. These funds also vary widely in their asset allocations and in their overall quality. But I still think the stock/bond mixes of the Vanguard Target (middle-of-the-road asset allocations) and T. Rowe Price Retirement funds (more aggressive asset allocations) can be a good starting point for your asset-allocation framework.

02
Find Your Current Asset Allocation

After you've determined what your optimal asset allocation should be, it's time to take a look at where you are now. If you're like many people, you may have been moving your investment statements directly from the mailbox to your desk drawer, afraid to glimpse how much money you've lost. But it's time to pull all of those statements out and take a look, or go online for an even more current view of your portfolio. Focus not so much on your recent losses, but instead take note of your current asset allocation.

Keeping track of your portfolio's asset allocation by hand can be a bit cumbersome and inexact, particularly because most mutual funds aren't pure stock or bond. It's not uncommon for stock funds to hold double-digit cash stakes, for example. For the clearest possible read on your asset allocation, I recommend Morningstar Investment Research Center's Portfolio X-Ray tool, which drills into each of your fund holdings to determine how they're allocated by asset class and investment style. There you can see your current split among cash, U.S. and foreign stocks, bonds, and other. The X-Ray also depicts how your holdings are dispersed across the Morningstar Style Box.

More Resources

Morningstar Portfolio X-Ray

► *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

Take note of your current asset allocation and compare that with your asset-allocation targets in Step 1. Determine where you need to add and subtract to restore your portfolio to your target levels.

03
Identify Candidates for Tax-Loss Selling

Before you begin altering your portfolio to put your asset allocation back in line with your targets, you also want to scout around for tax-loss candidates that you hold in your taxable accounts. If you're like most people, you won't have to look too hard to identify securities that are now priced more cheaply than what you paid for them.

04
Formulate a Rebalancing Plan

If your portfolio is in line with your target asset allocation and you're not making any inadvertent style or sector bets, your work is done.

Most likely, however, your analysis of your current asset allocation versus your targets indicates that your portfolio is light on stocks. At the same time, the securities that you've identified for tax-loss selling are also likely to be stocks and stock funds. If you're in the market for high-quality stock funds to consider for your portfolio, check out our list of Fund Favorites. If individual stocks are part of your portfolio plan, utilize the screening tool in Morningstar Investment Research Center to find those companies with high star ratings.

When it comes to deciding which securities to add, as well as how much to add to each, you'll probably find that the process of overhauling your portfolio is a matter of trial and error. Here again, I'd recommend Morningstar's Portfolio X-Ray to help you evaluate the impact of various holdings on your asset-allocation mix before you decide to buy. Also, pay attention to the impact that various holdings have on your style-box positioning and sector weightings. Your stock portfolio doesn't need to be an exact clone of the broad market, but you should at least be aware of whether your portfolio is skewing heavily to one style or sector.

In some cases, the alterations you need to make are obvious—if you're heavy on bonds, for example, adding to stocks should resolve the problem. Getting to the bottom of other bets might take a little more research. For example, if your portfolio has more cash than you want it to, that could be because one of your stock-fund managers is holding a lot of cash. You could decide to live with it, and reduce your designated cash holdings accordingly, or else pare back your holdings in the cash-heavy stock fund.

It also pays to consider tax consequences when rebalancing. Conventional wisdom holds that you should concentrate your rebalancing efforts in your tax-sheltered accounts, because you won't have to pay capital gains tax if you determine that you need to sell shares. That advice may be less relevant if many of your taxable holdings are well in the red since you won't face tax consequences if you need to unload something. Alternatively, you could try to correct your portfolio's imbalances not by selling but by directing a bigger share of future contributions to those holdings that need beefing up. In so doing, you'll save on tax and transaction costs.

05
Plan to Make a Habit of It

There are two ways to rebalance—either you can rebalance on a set schedule, say, every December, or you can rebalance whenever your portfolio gets dramatically out of whack with your targets. My advice is to split the difference. While I think it makes sense to give your portfolio a thorough review once a year, you don't want to get into the habit of trading too frequently. Schedule a top-to-bottom portfolio review at a fixed time each year, but rebalance only if your portfolio's allocations have gotten dramatically out of whack with your targets.

More Resources

Morningstar
Stock & Fund Favorites
► *Visit Morningstar Investment Research Center and click Stock Favorites or Fund Favorites on the Home tab*

A Five-Step Quarterly Checkup

By Christine Benz
Director of
Personal Finance

Get in and get out with our quick and dirty portfolio review

Scheduled. Streamlined. Surgical.

Those adjectives describe to a "T" how to check up on your portfolio.

First, you want to put your reviews on a regular schedule—quarterly, semiannual, or even annual reviews are plenty. If you're checking up on a more frequent, ad hoc basis, you risk getting buffeted by news flow and performance-chasing, dumping perfectly good holdings due to short-term weakness and piling into those that appear to have the hot hand. That's a recipe for poor investment results.

You'll also want to keep your portfolio review streamlined and surgical, for a couple of key reasons. First, by focusing on a few big-picture factors as you conduct your review—your asset allocation, the fundamental attributes of your holdings, and whether you're on track to meet your financial goals—you're not likely to get bogged down in less-important details, such as which of your funds has the most invested in Japan or what securities performed best over the past week or month. Keeping your portfolio review focused has another key benefit. If it's not an overwrought chore that sucks up hours of your time, you're more likely to get it done. And, of course, you surely have better things to do with your time.

Below are five key steps to undertaking your quarterly review. The lynchpin of this monitoring session is a well-articulated investment policy statement that spells out how often you'll check up on your holdings and what you'll be looking for when you do. If you don't have such a policy statement, consider building one before undertaking your review. You will find instructions in the article, *Making Your Investment Policy Statement* on page 71.

More Resources

- bankrate.com
- troweprice.com/ric

01
See How You're Progressing Toward Your Goals

Are you on track to meet your goals, whether it's retirement, college funding, or a shorter-term goal such as amassing a home down payment? For many of you—especially those saving for goals that are far into the future—the answer may be "I have no idea." That's a problem, because by the time you find out that you'll come up short, it may be too late to address the problem spots by increasing your contribution rate or shifting your asset mix; instead, your only option will be to defer or alter your goal. If you haven't run the numbers on your investment program recently—using either a general savings calculator, like the one found on bankrate.com, or a retirement-specific one like the T. Rowe Price Retirement Income Calculator or Morningstar's Retirement Savings Calculator, located on the Portfolio tab of Morningstar Investment Research Center—make that the first step in your quarterly checkup. If things are looking good, resolve to keep on keepin' on. If it looks like you'll come up short, assess what changes you can make to get on track, including bumping up your savings rate or nudging your equity exposure upward to allow for greater long-term growth potential.

02
Check Up on Your Asset Mix

Next, conduct a quick review of your portfolio's overall positioning. Start by assessing its allocations to U.S. and foreign stocks, bonds, and cash. You can type in your portfolio using Morningstar's Portfolio X-Ray tool. Enter a ticker for each of your holdings (don't forget company stock and cash), along with the dollar value for that holding, then click View Your Portfolio. You'll see a pie chart depicting how much you have in each of the major asset classes, which you can then compare with your target allocation.

If you don't know how much you should have in stocks (U.S. and foreign), bonds, and cash, the Morningstar Lifetime Allocation Indexes found on page 86, powered by research from Morningstar Ibbotson Associates, can help you see if your asset allocation is in the right ballpark.

Don't be too concerned if your portfolio is currently a few percentage points away from your targets. But if you see divergences of five or 10 percentage points or more relative to your planned allocations, you'll need to implement a rebalancing plan.

If you have a bit of extra time, you can also eyeball your investment-style and sector positioning in X-Ray. But that's definitely secondary to checking up on your asset allocation.

03
Review The fundamentals

Once you've checked out your aggregate portfolio's positioning, it's time to conduct a quick checkup on each of your individual holdings. At the bottom of the Portfolio X-Ray page, you'll see links for each of your funds or stocks; click on the links to see a detailed report for each.

Morningstar's Analyst Reports are a quick and easy way to get a handle on the key issues at most prominent mutual funds, exchange-traded funds, closed-end funds, and publicly traded companies. Our analysts will also tell you whether they think a security is worth owning.

If you'd like to conduct your own research on your holdings, you'll need to drill down into the data. For funds, take note of any manager changes, strategy alterations, or upheaval at the fund-company level. As you assess individual stocks, take note of price multiples and profitability trends, among other factors. (If your portfolio is heavily skewed toward individual stocks, you're probably already aware that it will require more rigorous oversight than is required for a mutual fund- or ETF-centric portfolio.)

04
Examine Performance

It's a big mistake to focus too much attention on short-term performance, but your quarterly portfolio review should include a quick assessment of which of your holdings are providing the biggest boost to, or drag on, your portfolio's overall return. It's fine to glance at year-to-date performance, but focus most of your attention on the longer-term numbers—each holding's return during the past three and five years relative to that of other offerings within that same category.

Also take note of absolute returns. Which of your holdings have contributed the most or detracted the most from your portfolio's bottom line? Sustained underperformance can be an indication that something's seriously amiss with one of your holdings. But assuming that your rationale for buying a stock or fund is still intact (and your fundamental review should help you determine that), a spate of weak returns can also provide you the opportunity to add to that holding on the cheap when you rebalance.

More Resources

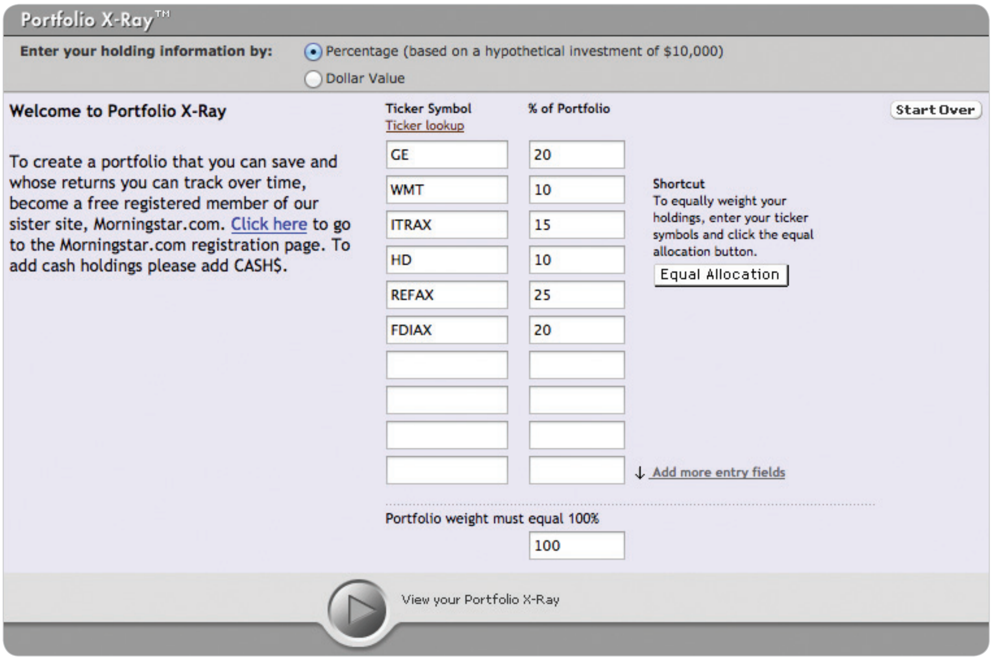
Morningstar Portfolio X-Ray
▸ *Visit Morningstar Investment Research Center to use this portfolio tool*

Or turn to page 122 to learn more about Portfolio X-Ray

05
Plan Your Next Move

After you've reviewed your portfolio's current status, it's time to plan your next move. It's not likely that you'll uncover a portfolio problem you need to address right away, but you should make sure to schedule a more thorough portfolio review later on in the year. At that time you can consider whether tax-loss harvesting is in order, make sure that you've contributed as much as you can to your tax-advantaged retirement accounts for the year, and determine whether rebalancing is in order.

Morningstar® Portfolio X-Ray™



Morningstar's Portfolio X-Ray tool allows you to dissect your portfolio and view your holdings in a whole new light. You'll be able to make smarter decisions about asset allocation once you know exactly how diversified your portfolio is, see how you compare to industry standards, and keep an eye on your costs.

Access the Portfolio X-Ray by logging into your library's subscription of Morningstar Investment Research Center. Look for the Portfolio X-Ray link on the home page or select the Portfolio tab and click X-Ray a Portfolio.

You can take a closer look at your actual portfolio or try out a hypothetical portfolio. Make adjustments along the way to see how new investments will impact the overall picture.

Portfolio X-Ray

► *Interpreter*

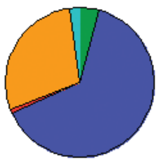
Portfolio X-Ray™

Views: + Interpreter

Click the button to go back and edit your holdings.

Asset Allocation | Holding Details ▸▸

	Portfolio
Cash	4.12
U.S. Stocks	63.98
Foreign Stocks	0.89
Bonds	28.79
Other	2.23
Not Classified	0.00



Your portfolio is moderately risky. Financial planners typically recommend this type of portfolio for investors who have three- to 10-year investment horizons and who are concerned by volatility but not preoccupied by it. Such portfolios often generate a healthy stream of current income.

Style Box Diversification | Holding Details ▸▸

	Your Portfolio (%)	Wilshire 5000 (%)
Large Cap Value	**56.86**	37.10
Large Cap Growth	**39.30**	36.48
Mid/Small Value	**2.43**	13.67
Mid/Small Growth	**1.41**	12.76

Your overall portfolio style: **Large Value**

Compared with the broader market, your portfolio's stock exposure is biased toward large-cap value companies. Depending on your investment goals, you may want to further diversify your portfolio by increasing your exposure to other areas of the market.

Stock Sector | Holding Details ▸▸

	Portfolio (% of Stocks)	Large Value (%)
Cyclical	**26.48**	**32.85**
Basic Materials	0.23	3.62
Consumer Cyclical	23.51 ◆	9.29
Financial Services	2.03 ◇	18.42
Real Estate	0.72	1.52
Sensitive	**47.21**	**40.35**
Communication Services	0.43 ◆	4.75
Energy	1.16 ◇	12.54
Industrials	43.41 ◇	11.35
Technology	2.22 ◇	11.73
Defensive	**26.30**	**26.78**
Consumer Defensive	22.82 ◇	10.15
Healthcare	3.24 ◆	12.93
Utilities	0.25	3.69
Not Classified	0.00	0.00

Change Benchmark: S&P 500 | similar investment style

You have a large value portfolio. Compared to a benchmark with a similar investment style:

◆ You have a lot of exposure to sectors marked by this icon. Please take special note of your extremely high exposure to healthcare. Most financial planners would advise you to diversify your portfolio among a variety of stock sectors.

◇ You have very little exposure to sectors marked by this icon. You should take special note of your low exposure to technology. Granted, these stocks can be risky, but collectively they are also a large segment of the market and represent some of the most

Stock Type | Holding Details ▸▸

	Portfolio (% of Domestic Stocks)	Large Value (%)
High Yield	**0.56** ◇	6.78
Distressed	**0.20**	0.62
Hard Asset	**1.45** ◇	12.67
Cyclical	**69.29** ◆	40.81
Slow Growth	**1.26** ◇	13.71
Classic Growth	**0.95**	1.29
Aggressive Growth	**25.33**	17.33
Speculative Growth	**0.08**	3.89
Not Classified	**0.89**	2.89

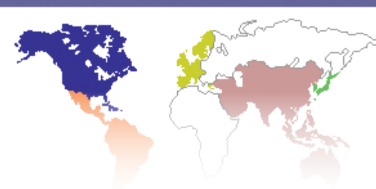
Change Benchmark: S&P 500 | similar investment style

You have a large value portfolio. Compared to a benchmark with a similar investment style:

◆ You have a lot of exposure to stock types marked by this icon. You have an extremely high weighting in the cyclical area. Most financial advisors would suggest that you diversify your stock exposure among a broader variety of stock types.

◇ You have very little exposure to types marked by this icon.

World Regions | Holding Details ▸▸



Try selecting additional views from the drop-down menu at the top of the page. Our "Interpreter" view will analyze your portfolio, compare it to benchmarks, and provide an explanation of what the data means along with suggestions on how to modify your portfolio.

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