Financial Perspective

Second Quarter 2013 A publication for Lincoln Investment Planning, Inc.

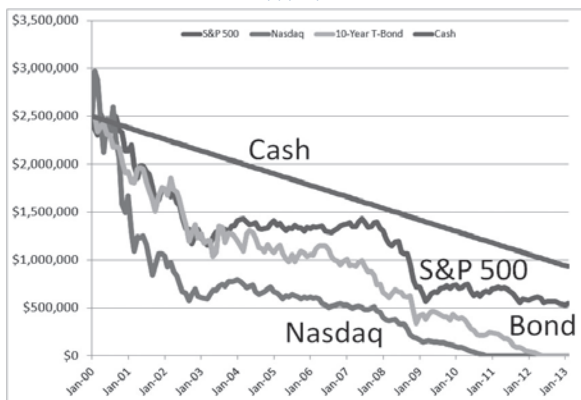
Unmanaged Index Funds Are Not Low-Risk Investments

How often have you encountered the following advice? *You can't predict the direction of the market so the safest investment is an index fund.* To an investment manager, that advice sets one's teeth on edge.

There's nothing safe about an index fund. An index fund is a creature of market direction. Whatever the index does, the fund is designed to mirror. Index funds offer no risk management, no ability to invest in top performers, and no guarantee of success. Investing in an unmanaged index fund is a gesture of faith that the economy and the industry segment represented by the index will grow during your investment time frame, and that the index will be positive when you need your money. It doesn't always happen that way.

Historically, index funds work best the longer your investment time frame, with lots of time to recover from down markets. If you happen to be retiring and you need to liquidate portions of an index fund, it matters a great deal whether the index is in an up or down trend. Withdraw in a falling market and you can quickly run out of money. The chart below shows the effect of withdrawing $10,000 a month from $2,500,000 invested in the S&P 500, Nasdaq Composite, 10-Year Treasury Bond index and cash over the last 12 years. The best investment? Cash.

Impact of Withdrawing $10,000 a Month from Index Funds or Cash 2000-2012



Data: Yahoo Finance. Past performance is not an indication of future returns. In a different time series, results would differ. The S&P 500, Nasdaq and 10-year Treasury Bond are unmanaged indexes and cannot be invested in directly. The chart above does not reflect transaction costs, which would have the impact of further lowering balances.

According to traditional investment advice, you lower the risk of investing by holding multiple low-correlation index funds covering different asset classes. The concept behind holding uncorrelated assets is that they should not all move in the same direction. When one goes down, hopefully another will increase. But this also fell apart in the time frame shown at right.

The popular market segments used in traditional portfolio diversification based on fundamentals and capitalization (large-cap value, large-cap growth, mid-cap value, mid-cap growth, small-cap value, small-cap growth) tend to become highly correlated in market downturns. In the 2008 bear market, indexes based on these segments moved lock-step downward.

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What To Do About Longevity

Ironically, one of the biggest threats to our long-term security is longevity. We are living longer, healthier lives. Even health care costs, the bogeyman in every budget, tend to be their highest at the very end of our lives. The catch, of course, is that the longer one lives in retirement, the more financial assets it requires to enjoy those years.

Financing longevity has a number of paths:

(1) Save more money now. Saving and investing is your best path to assuring the money is there when you need it. Being rich definitely helps pay the bills.

(2) Keep working. This has the benefit of allowing you to put off withdrawals from investments. Plus you can postpone receiving Social Security, increasing your eventual payments.

(3) Consider longevity insurance. This is an interesting insurance product that only pays out if you reach a designated age…such as 85. It's a bet that you will live long enough to collect more than the cost of the insurance.

(4) Long-term care insurance is also a consideration, but this only kicks in once you become incapacitated and no longer able to care for yourself. It's not exactly "enjoy your life" money, but rather "keep from bankrupting the family" money.

(5) Work with your financial adviser to position your investments to meet your financial needs, whether growth, capital preservation or income.

Identity Theft is Alive and Thriving

I was going through some old brokerage account statements from 20 years ago and was surprised to notice each statement included not only my name, address and account number, but also my Social Security number. While Social Security numbers disappeared from statements years ago, there are plenty of records like this that provide a wealth of information for identity thieves. And individuals are not the only ones being targeted. Investment advisers are encountering emails that appear to be from a client, sent from the individual's email, explaining that he is traveling and needs the adviser to wire funds to an overseas account. Account number, social security number and address are included to validate the request.

Minimizing the chance that you will be a victim of identity theft requires care that you do not unknowingly provide information to the thief, through careless handling of documents or responding to what you think is a legitimate request.

Some common techniques to gather information for identity theft include emails with fraudulent web links, attachments or phone numbers. Common topics are:

- An automatic payment has been made from your account.
- Confirming that a delivery has been made to your home or office.
- Reporting an unusual transaction on your credit card.
- Notifying you that an account has been blocked due to suspicious activity.
- Reporting that an automatic deposit has failed.

Or you may get a phone call notifying you that a transaction has failed, a credit card charge been declined or been made to your card, etc., requesting information to verify that you are the account owner.

Identity thefts like this work because they are designed to mimic communications that might ordinarily occur. Your best defense is always to NOT respond to links and numbers provided in emails or phone calls, but to contact the firm directly, whether our company or your credit card company, bank, delivery firm, etc. Never use links in emails to access account information, but rather go directly to the appropriate website to log in.

If at any time you receive an email or communication from our firm that appears suspicious, please contact the office directly. While we are committed to doing our best to protect clients, we can't control information beyond our office. That is where we ask that you be vigilant.

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Incorporating risk management in a portfolio requires active management. A mixed approach of reducing equity allocations in periods of falling prices and increasing cash positions; and the reverse in rising markets, has the potential to provide investors with the best of both worlds – the preservation of capital offered by cash and the opportunity for appreciation from an equity investment.

With that said, success in active management depends on the ability of the manager to accurately determine the direction of the trend and position assets accordingly. There can be no assurance that an active strategy will be implemented successfully.

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