Three Ways To Make The Most Of Tax Time

BY EILEEN O'CONNOR

Come tax time, many people seek to make the wisest choices with their refund (or plan better next year if they owe money to Uncle Sam). While a noble pursuit, the wealth of information that individuals are frequently bombarded with can be complex and confusing. If you properly filter advice on how to maximize the benefit of a tax refund, there are three basic concepts that could make a significant difference in your financial picture:

1. Understand asset allocation;
2. Understand that planning is important;
3. Understand how to protect what you already have.

Understand Asset Allocation

Most investors seem to understand basic principles, such as stock market efficiency or modern portfolio theory, the importance of diversifying and the benefit of taking a long-term view. But while these concepts are fairly straightforward and widely accepted in theory, many people have difficulty incorporating them into their personal investment strategy. As a result, few investors have a successful investment experience.

Many investors remember the good years and blame the bad ones on some random world event or unforeseen economic outcome. But how do individual investors really perform? From the years 1980–2004, the average investor only returned 3.7 percent on his portfolio while during the same period the S&P 500 returned 13 percent(1). What is going on here?

The enticing draw of a quick hit/easy money (real estate, anyone?), the noise in the marketplace and the ubiquitous media often creates a "perfect storm" where individuals react negatively to investment advice. Instead of systematically investing, they buy high and sell low while trying to take advantage of "an opportunity" in the market, such as the tech boom, the falling dollar or an "increasing interest rate environment." Such attempts to time the market and chase the current investment theme lend themselves to shorter-term investment horizons, a reduction in investment discipline and eventual lower returns.

In addition to trying to time the market and/or pick the next great stock or mutual fund, many investors do not diversify enough. They put money across multiple mutual funds, accounts or even across different advisors all in an attempt to spread risk. This results in their portfolios holding many of the same underlying securities and winding up not reaping the benefits of a properly diversified portfolio.

Understanding the power of asset allocation can shelter your portfolio from major downturns and enhance your overall return in the long run. Asset allocation is generally defined as the diversification among a number of “major” asset classes. An asset class is a grouping of securities that have similar risk/return characteristics. In order to diversify, you must add positions in asset classes that are different than ones you currently own, and you must continue to add them until there is no incremental benefit from either expected return or lower portfolio volatility (risk).

There are large, mid-, small and micro-cap classes in the U.S., internationally and in emerging markets. There are also growth and value classes within each size category. For example, international small cap value is a class distinct from international small cap growth. By understanding this concept and incorporating it into your portfolio, you can significantly enhance your investment returns over the long run while maintaining a level of risk commensurate with your overall financial objective.

Plan

As tedious as it may be, planning and monitoring your financial picture is an absolute must. In addition to facilitating a savings strategy, planning will provide you with an informed answer on how you can structure your investments so that you have the greatest chance of achieving your goals. Conveying to clients their investment returns within the context of their progress toward achieving a particular objective should always be the main focus of any financial practice. After all, investing is not the end game. It is the means to achieve something, whether it is financial independence, funding children’s education, enabling philanthropies or leaving a legacy. Often, uncertainty leads to investor anxiety and the need to consistently produce superior market returns. It is a liberating experience to understand what you need to do to accomplish your

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objectives and embark on a well thought-out plan to achieve it.

For individuals and families in need of basic planning advice, there are many tools available online. For those with more complicated financial pictures or who are looking to outsource their financial planning and investment management, getting good advice from a qualified professional may be well worth it. Given the increasingly complex financial services landscape, financial advice is not just for the super-wealthy anymore. Just make sure your advisor is someone whom you can trust and whose service offerings (and fees) match your needs. But, either on your own or with professional help, always do the planning.

Protect What You Have

As a financial advisor, I am consistently surprised by the widespread lack of adequate asset protection. It may be the difficulty in addressing the underlying question, "Who could possibly take care of the children if something happened to me?", which explains why smart and successful people often drag their feet when it comes to protecting their loved ones against catastrophic circumstances. Protecting what assets you have goes far beyond life, home and auto insurance. It should include estate planning (wills, medical directives, power(s) of attorney), titling of assets, personal liability policies, trust planning and the many other aspects of your situation. Protecting what assets you already have should always be a higher priority than accumulating more.

Here, too, good advice goes a long way. Working with a good financial advisor will help you sort through your options before approaching an insurance agent or attorney. Your financial advisor should act as a "quarterback," and bring in the right resources consistent with a good overall financial plan. This will help you avoid being sold products you may not need.

Even better than New Year's Eve, tax time is the ideal time to take stock of your financial picture. Answers to "How much do I need?", "How should I invest what I have?" and "How should I protect what I have accumulated?" should help and are an obvious place to start.

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(1) Source: Dalbar's Quantitative Analysis of Investor Behavior (QAIB) 2005