

KEYSTONE FINANCIAL PLANNING
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Death is a certainty, but many do not plan for it

Every living American will die, but more than half of them have not made adequate—or even any—preparations for that inevitable event. A recent survey by Lawyers.com found that about 60% of Americans do not even have a basic will. In addition, about 70% do not have a living will or health care directive. Only 27% have a medical proxy and just 26% have a power of attorney for their finances. Only one in five survey participants have created a trust as part of their estate plan. “It’s a sad situation,” said attorney Alan Kopit of Lawyers.com. “Without having crucial documents like living wills and powers of attorney in place, many Americans are leaving their loved ones vulnerable to the heartache—and in some cases expense—of having to make life or death decisions that could easily have been addressed at a time when the emotional strain is not nearly so intense.”

The survey identified some of the reasons why Americans fail to plan their estates. Some 20% said they didn’t believe they had sufficient assets to warrant an estate plan. Another 15% believe they are not old enough to plan yet. Lack of planning has caused real pain for some survivors, the survey found. About 18% of those surveyed said they had problems after the incapacity or death of someone close to them due to the lack of an estate plan. Those problems included conflicts over the distribution of a deceased relative’s assets. If you love those who will have to take care of you when you become incapacitated, or who will have to clean up your affairs after you die, then you should do estate planning now.

A will, a health care proxy, and a financial power of attorney are the basic planning tools. A qualified attorney can quickly help you get these documents in order. The cost will not be overwhelming: simple estate plans should not cost more than a few hundred dollars. Parents of minor children especially should do planning as soon as possible. Their attorneys may suggest that their wills establish trusts for their children’s inheritances. No matter what, you should name personal guardians for children before you die rather than let a court do it after you are gone.

Even if you are unsure of your choices, do not wait to do planning. Wills and trusts can be amended later if your wishes change. Periodic reviews of your plan are essential.

Avoid dangerous investor mistakes

Investment research has long shown that an investor does best by holding investments in a variety of different assets whose returns are not closely correlated. This type of investing, known as “asset class investing,” has plenty of support in academic research and in practice. In general, a well-diversified asset-class portfolio behaves in a more stable fashion over time and, given enough time, delivers a return that is higher than most or all of its components. That’s because during any time period certain components go up enough to pull up the performance of the whole portfolio and to make up for declines in other asset classes.

Such a portfolio also takes a lot of the guesswork out of investing. The investor does not have to make risky decisions on when to invest in individual asset classes. Such decisions are dangerous because wrong moves can be very costly. By holding a widely diversified portfolio you are assured that wrong moves will not severely damage the entire portfolio. You also have a very good chance that at any one time you will hold one or more asset classes that are doing well. Unfortunately, the majority of investors do not hold portfolios composed of many asset classes.

Author and investment manager Roger C. Gibson, who wrote the investment classic “Asset Allocation,” has identified three reasons some investors don’t invest wisely. First, they don’t understand the full power of diversification. Many investors intuitively understand that a diversified portfolio will be less volatile than a non-diversified portfolio. But they also intuitively feel the diversified portfolio will have inferior returns, because non-performing assets will negate the big wins by those assets that are climbing. In the short term, this will often be true, but in the long term, multiple asset class portfolios usually beat most or all individual asset classes. Diversification not only reduces risk but it improves long-term returns.

A second reason investors stumble is their belief that someone, somehow must be able to forecast returns. If that is true, one need only make the correct forecast and then put everything into the asset class that will do best in the future. They get plenty of support from Wall Street and the media, which constantly publicize “star” investment pickers and strategists who beat the markets. Again, this is a mistake. Gibson says the evidence on actual returns on money managers shows that few, if any, consistently even match the market’s returns, much less beat it.

The final reason for lack of diversification involves the reference frame within which most investors judge their results. For American investors that frame is usually “the stock market.” And by “stock market” they generally mean the big stocks that dominate the market and whose returns are reflected in the Dow Jones Industrial Average or the Standard & Poor’s 500 Index. When the U.S. market is doing badly, a diversified portfolio holding foreign stocks and other assets often looks good. But in those inevitable years when the S&P 500 beats everything else, the diversified portfolio doesn’t look as good. This is a big problem for investors who check the daily market averages or compare portfolios with neighbors at cocktail parties, Gibson says: “There is pain in being different!”

Investors who want to do well over the long term with less risk should use a diversified asset class portfolio. They should also acknowledge the potential cognitive roadblocks to sticking with their portfolio.

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