

U.S. STRATEGY REPORT

WHY WE INVEST

Most people invest to help pay for something in the future. It may not necessarily be a tangible item, like a house or a car. But that doesn't mean it's not important. Maybe you're paying for a child's education or possibly even something more critical – having money to do what you'd like during retirement. Retirement may mean different things to different people, but everyone is going to need income to live the lifestyle he or she envisions.

What Can I Make?

Having money to live retirement on your terms means developing a strategy to reach a specific goal. Part of that strategy includes estimating what you might earn on specific investments. Here's how we'd calculate the returns you might expect over the long term.

Stocks – If the economy grows at 3%, inflation averages 3% and the current dividend yield is 3%, then the rate of return on stocks over the long term might be close to $3 + 3 + 3$, or 9% (Actually, with the recent stock market rally, the current dividend yield is closer to 2.5%, so investors may earn a little less than 9% in the future.) Over the course of time, stocks will rise and fall along with investor emotions. We certainly can't predict the future, but for planning purposes, we believe a return of 8% – 9% is probably realistic. Keep in mind that equity investments fluctuate in price and, when sold, may return more or less than your original investment.

Bonds – The current yield, or interest rate, on the fixed-income investments you own will likely be a close estimate of your annual rate of return. This is probably about 5%, which is a good number for planning purposes. But don't chase rates because investments with higher rates tend to be of lower quality. These bonds may not provide higher returns if the company runs into trouble and defaults on principal or interest payments. Also, an increase in interest rates usually leads to lower bond prices if the bond isn't held to maturity. Make sure you understand the risks of fixed-income investing, including interest rate risk, market risk and credit risk.

Short-term income investments – While the principal value of these investments is generally safer than that of stocks or bonds, the return can vary widely with changes in short-term interest rates. Because they offer greater safety and liquidity, short-term income investments can play a critical role in the portfolio. However, owning too many can make it harder to reach your long-term goals. A rough average return you might earn on short-term income investments is the expected future rate of inflation, or about 3%. Take note, however, that the current return on many short-term investments is lower than this.

Do the Math

Once you have some idea of what the long-term rate of return might be on the major investment categories, the next step is to multiply your asset allocation by these rates. For instance, say an investor had an asset allocation of 65% stocks, 25% bonds and 10% cash. The expected annual return might be calculated as follows:

Estimated Portfolio Return		
% in Investment Category	Estimated Rate of Return	Return of Asset Class
Stocks – 65%	9%	5.85%
Bonds – 25%	5%	1.25%
Short-term income – 10%	3%	0.30%
Overall portfolio return (estimate)		7.40%

Source: Edward Jones

By multiplying the estimated rate of return for each asset class in the portfolio by its weighting, and adding those figures together, we can estimate the portfolio's expected return: $(9 \times .65) + (5 \times .25) + (3 \times .10) = 5.85 + 1.25 + .3 = 7.4\%$.

But before you use this number for planning purposes, there are a few things to take into consideration.

Estimation, not prediction – This figure should be considered a potential expectation for planning purposes, not a prediction. As the past 10 years have certainly illustrated, future returns can be difficult to forecast due to unpredictable changes in the economy and the financial markets.

Gross, not net – This figure represents a “gross” return. “Net” returns are those you receive after taking into account all factors that can reduce investment returns.

5 Factors That Can Reduce Investment Returns

We believe there are five major factors that can reduce investment returns.

1. Taxes – Taxes are a problem nearly all investors face. Considering the outlook for the federal budget deficit, it's very likely future tax rates will be higher for many investors. Taxes can have a big impact on investment performance. There are several ways you can reduce this impact, however:

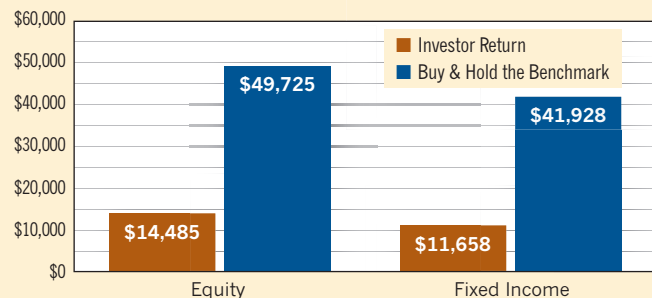
- Reduce buying and selling activity because sales are taxable events.
- Tax-free municipal bonds can reduce your overall tax burden.
- Contributions to traditional IRAs, 401(k)s and certain annuities are “tax-advantaged.”
- Equities can offer a tax benefit because, historically, dividends and capital gains have been taxed at a lower rate than regular income.

2. Inflation – Inflation has been a fact of life for most of the past 200 years. While it's currently low, we believe the historical inflation rate of about 3% is a realistic expectation going forward. For some investors, especially those in retirement who may spend more on health care, a 3% estimate may be too low. At a rate of just 3%, everything you buy today will likely cost twice as much in 24 years. If you're hoping to keep pace with rising prices, we recommend investing an appropriate amount in equities that offer the potential for rising income – those that pay dividends and offer the potential to increase them on a regular basis. These can be owned directly or through mutual funds. Keep in mind, however, that dividends can be increased, decreased or totally eliminated at any time without notice.

3. Expenses (commissions and fees) – Paying some expenses is appropriate and should be expected for the investments you own and the professional advice you receive. However, it's important to hold investments for the long term because frequent trading, in addition to generating taxes, can mean more investment expenses. Sometimes a higher level of expenses can be appropriate if you receive certain benefits such as professional advice, tax benefits or guaranteed income (annuities), or a higher level of investment management associated with some fee-based accounts.

4. Market timing – Market timing isn't typically listed as an investment “expense,” but it can be one of the biggest costs to investors. One study, conducted by Dalbar Research, showed the average stock mutual fund earned an average annualized return of 8.4% from 1989 through the end of 2008. During the same period, bond funds earned an annual return of 7.4%. However, the average stock fund investor earned just 1.9% per year, while the average bond fund investor earned 0.8%.

The Cost of Market Timing (20 year annualized returns, as of 12/31/08)



Source: Dalbar QAIB 2009 Equity benchmark is the S&P 500, Fixed Income Benchmark is The LB Long-Term Gov't Bond Index. \$10,000 invested in 1/1/1989. 20-year annualized returns through 12/31/2009. An index is unmanaged and not available for direct investment.

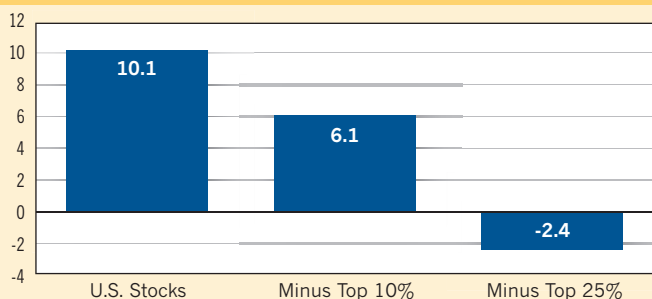
Why the drastic difference? The average investor held his or her funds for just three years. Investors often buy when they feel good and sell when they feel bad, rather than staying committed to a long-term investment strategy.

5. Not being diversified – Poor security selection, or inadequate diversification, is another reason why some investors' returns may be much less than those of the broad market benchmarks, such as the S&P 500. A recent study we conducted with Ned Davis Research illustrates the challenges of inadequate diversification. Basically, the results showed that a portfolio of just a few equities, however carefully chosen, could easily wind up including none of the best-performing stocks – and produce flat or negative returns over many years. Here are some of the specific findings:

- From 1980 to 2008, the top-performing 25% of stocks were responsible for all the gains in the broad market.
- Missing the best-performing 10% of all stocks would have reduced returns from 10.1% to 6.1%.
- The bottom 75% of stocks collectively generated annual losses of 2.4%.

Missing the Mark

Annual Total Returns (1980 – 2008)



Source: Edward Jones. Includes publicly traded stocks on NYSE, AMEX, Nasdaq. Data source: Ned Davis Research

For investors who choose to build their own portfolios, in general it's important to make sure no one stock or bond represents more than 5% of the portfolio's value. Remember that diversification does not guarantee a profit or protect against loss.

Investors who don't do an adequate job controlling issues in these five categories will likely see that their “gross” investment returns can be reduced pretty quickly. After all, it's not just what you make, it's what you keep.

4 Strategies for More Money in Retirement

In addition to understanding the factors that can reduce your returns, there are other ways to help ensure you have the income you need in retirement.

Control your spending – You can't control financial market returns, but you can control how much you withdraw from your accounts and your spending. Withdrawal rates should be applied using “the haircut rule.” If the barber doesn't take enough off, you can always take more off later. But if he takes off too much, it's tough to put it back. Investors who start off with a conservative withdrawal rate reduce the odds of running out of money in retirement.

Invest more – Investing more can help you potentially increase the size of your portfolio. You can increase the amount you invest by earning more income, or spending less. You can also consider automatically reinvesting dividends and capital gains.

Have an appropriate asset allocation – Invest enough in asset classes that have earned higher returns over the long run. The ideal asset allocation for most people is the one you can stick with in good times and bad, and that provides a return for you to reach your long-term goals. If too much of your portfolio is in short-term income investments, you might fall short.

Control expenses and mistakes – By working to avoid major mistakes and control expenses, you can increase your odds of reaching your retirement goals.

Your Edward Jones financial advisor has tools that can help determine if your retirement strategy is on track. Make an appointment today.

Past performance does not guarantee future results. Edward Jones does not offer tax or legal advice. Please contact your tax or legal professional for more information.