invest

IT'S YOUR FUTURE

inside

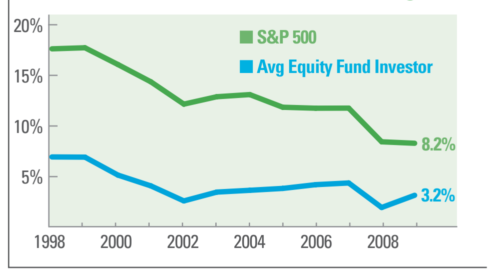
How Investors Think

Research in behavioral finance explores the battle between the emotional and the rational mind.

Stay in the Market

Investors historically have hurt their returns by jumping in and out of funds, attempting to "time" the stock market. The chart below compares the annualized 20-year return of the average stock fund investor with that of the S&P 500 since 1998. Had investors stuck with their funds during each of these years, they would have enjoyed stronger long-term growth, research firm DALBAR reports.

The Cost of Market Timing



Source: "2010 Quantitative Analysis of Investor Behavior," DALBAR, Inc.

Every investor hopes to buy low and sell high. As a group, however, investors tend to do the opposite. They follow their emotions, buying when the market is booming and prices are high, and selling after the market declines—undermining their investment returns. Their actions haven't gone unnoticed by behavioral finance researchers, who study why investors often make counterproductive choices. These researchers also offer strategies for limiting the impact emotions have on investment decisions.[1]

Common pitfalls

Investors worry so much about short-term losses, especially after market declines, that they miss opportunities for long-term gains. Behavioral economists refer to this phenomenon as *loss aversion*.[1] For example, an investor with several decades until retirement might hold a large portion of his or her long-term savings in cash rather than take advantage of the growth potential stocks offer.

Investors can also be overconfident about their skills.[2] For example, they may trade frequently, believing they can profit from short-term moves in the market—leading to high commission costs that eat into returns. In fact, even professional traders can't predict short-term returns.

Keep your cool

The following strategies can help you avoid letting emotions dictate your investment decisions:

1 **Stay on "auto-pilot."** By automatically contributing to your workplace retirement savings account, you'll invest the same amount at regular intervals, regardless of market conditions.

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How Investors Think (cont.)

As a result of this process, known as dollar-cost averaging, you'll buy more shares when prices are low and fewer shares when prices are high, potentially reducing the average price you pay per share. Because the consistency of this strategy helps even out share-price fluctuations, it can also reduce your exposure to investment risk.

2 Limit how often you monitor your investments. Rather than checking your portfolio's performance daily or weekly, try reviewing it quarterly. If you review your investments on a schedule, you might be less tempted to make changes in response to headlines or a friend's tip.

3 Stick with the program. Maintain an investment approach that reflects your long-term financial goals, taking into account the time you have before you'll need to use your savings. Generally, the more time you have, the more logical it is to pursue long-term growth. If that's the case, you might want to keep a greater percentage of your investments in stocks. As you approach retirement, you can gradually shift a portion of your assets into bonds and cash to help protect against downturns.

These strategies will give you a much better chance to reach your goals—and to live the life you envision in retirement.

[1] "The Neural Basis of Loss Aversion in Decision-Making Under Risk," *Science*, January 2007.

[2] *Nudge: Improving Decisions About Health, Wealth, and Happiness*, Richard H. Thaler and Cass R. Sunstein, Yale University Press, 2008.

Mix It Up

You may own a great stock fund—but even a winner can't provide the diversity you need.

So in addition to holding some bond and money market funds in your workplace retirement savings account, consider holding a few types of stock funds. A well-diversified portfolio includes exposure to small-cap, large-cap, and international company stocks.

Here's why it makes sense to diversify your holdings: First, you can never be sure which sector or style is poised to outperform another. Second, different types of stock may perform very differently, depending on market and economic conditions. For example, technology stocks may rally during a period when energy stocks decline, and the reasons for each move could be unrelated. Plus, international and U.S. stocks often don't perform in sync; in 2009 certain foreign markets, such as Australia and Canada, outperformed U.S. stocks.

If you're looking for stability, consider holding funds that invest in a variety of stocks. They can help smooth out your returns without sacrificing potential growth. (For more about diversification, see "Smart Moves" from SmartMoney on page 6.)

Capture the Best Days

Missing out on market rallies will dramatically reduce your ability to grow your retirement savings. That's why it's always best to take a long-term view when you invest in stocks. Many investors missed the 2009 rebound because they shielded their assets in money market funds following the 2008 stock market collapse. On March 10, 2009, stocks began their biggest two-week gain in more than 70 years, even as the economy wallowed in its worst slump since the Great Depression.[1]

Growth of a $10,000 account over 20 years through Dec. 31, 2009

Fully invested	$31,001.70
Missed 10 best days	$15,483.79
Missed 20 best days	$9,719.75
Missed 30 best days	$6,512.47

Source: yahoofinance.com. Returns are based on the performance of the S&P 500 Index from Jan. 2, 1990, to Dec. 31, 2009. Excludes dividends.

[1] Bloomberg, March 23, 2009.

We want to hear from you!

We welcome your feedback and questions. Please send all questions to **investitsyourfuture@dowjones.com.** If we print your question, your name will be withheld.

Windfall Wisdom

Say you recently received a tax refund, a bonus, an inheritance, or a monetary gift. How should you use these new funds? Make a down payment on your future by opting for one or more of the following:

1 Eliminate credit-card debt. In June, the average fixed-rate credit card charged 13.7% in interest.[1] At that rate, if you have a $5,000 balance and pay $100 a month, it will take you more than five and a half years to get rid of the debt—and you'll pay $1,999 in interest. If you put a $2,000 tax refund toward your balance and then continue paying $100 in monthly installments, you'll eliminate the debt in less than three years and reduce your interest to $495.

2 Start an emergency fund. Holding cash reserves can help you avoid taking on debt or dipping into retirement savings if you face a costly problem, such as a long illness or a leaky roof. Financial planners generally recommend keeping enough cash to fund at least three to six months' worth of expenses in easy-to-access accounts such as money market funds. If you're worried about losing your job, you might target saving for eight months' worth of expenses.

3 Contribute more to your 401(k). You can't deposit a windfall directly into your workplace retirement savings account, but you can boost your contribution rate, using the extra money to supplement your future income. By saving an extra $100 a month over 20 years, you could wind up with an additional $51,000, assuming a 7% annual return.

[1]Bankrate.com, June 2, 2010. Calculations performed using bankrate.com's credit card calculator.

Give Me a Break

Congress introduced a number of tax credits in 2009. Those listed below remain available in 2010.[1] A credit provides a dollar-for-dollar reduction in your tax bill—leaving you more money to put toward retirement.

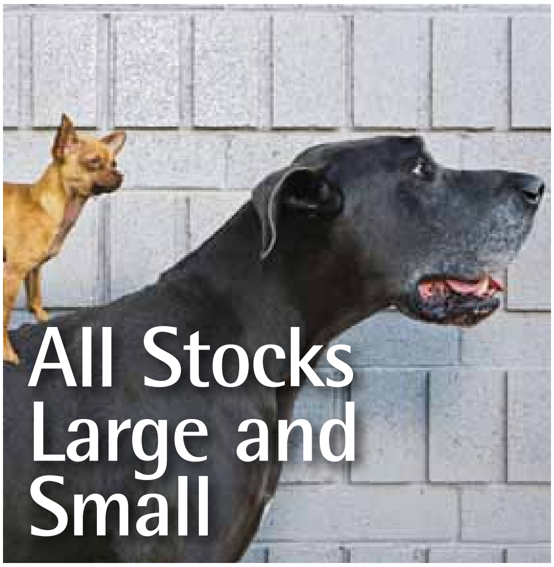
First-time/Repeat Homebuyers' Credits. Qualified first-time homebuyers receive a credit of up to $8,000 and qualified repeat homebuyers up to $6,500, as long as they signed a binding contract by April 30, 2010, and closed on the home on or before June 30, 2010.

Energy Efficiency Credit. Installing qualifying insulation, windows, and HVAC systems, as well as making other improvements, can reduce your annual tax bill by as much as 30%, saving you up to $1,500 of the cost of the product. For geothermal heat pumps, solar panels, and wind turbines, you can get a credit worth 30% of the cost, with no cap.

Making-Work-Pay Tax Credit. Eligible workers typically receive $400 ($800 per couple) during the year, as less tax is withheld from each paycheck.

American Opportunity Tax Credit (formerly the Hope Scholarship Credit). Undergraduates receive up to $2,500 for tuition, fees, and supplies, based on income.

[1]irs.gov. For more information, type "tax credits 2010" in the irs.gov home page search window.



All Stocks Large and Small

Here's a corner of the market that's done very well this year: small company stocks. In fact, between January 1 and May 4, shares of small companies gained 13.9%—more than double the return of large company stocks during the same period.[1] Why? Investors favored the strong growth potential of smaller stocks while worrying about the exposure of larger companies to economic problems in Europe.

However, small doesn't always beat big. The two size categories often take turns leading the market, which is why it makes sense to invest in both over the long term.

What is market cap?

Investors measure a stock's size using *market capitalization*, which is the price of a stock multiplied by the number of outstanding shares. So if a company's stock price were $10, with one billion shares outstanding, its market capitalization would be $10 billion. The Russell 1000 large-cap index tracks stocks with market capitalizations of more than $5 billion. The Russell 2000 small-cap index tracks stocks with market capitalizations below $5 billion.[2]

The case for holding both

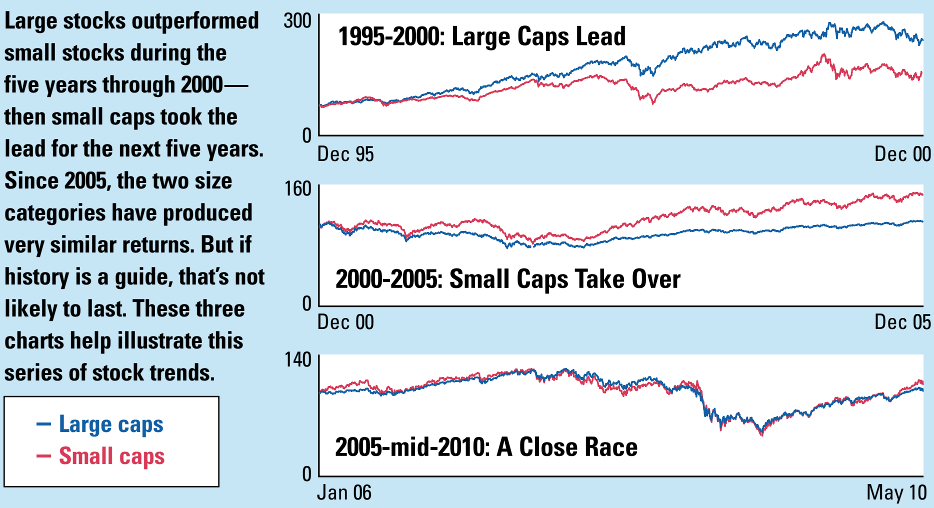
Because smaller firms tend to grow more quickly than larger firms, small-cap stocks historically have produced higher long-term returns. However, large caps may outperform small caps during a given time period, depending on economic and market conditions. For example, large caps typically have held up better during market downturns. As a result, holding both small and large stock funds in your portfolio can help you take advantage of growth opportunities in each category, while potentially producing steadier returns than if you had concentrated your investments in one category. ■

[1]Small caps measured by the Russell 2000 Index; large caps by the Russell 1000 Index.

[2]Russell Investments.

Taking Turns Leading the Market

Large stocks outperformed small stocks during the five years through 2000—then small caps took the lead for the next five years. Since 2005, the two size categories have produced very similar returns. But if history is a guide, that's not likely to last. These three charts help illustrate this series of stock trends.



Market Drivers

Developments in the economy affect large and small stocks in distinct ways. The following factors help determine which stock size leads the market at a given time.

Economic cycles. Large caps often outperform small caps when the economy weakens, because bigger companies tend to be more well established and therefore have stronger finances. However, small stocks typically rebound more when the economy is expected to recover, since smaller companies have more room to grow.

Interest rates. Compared with large firms, small companies depend more on borrowing money to fund their operations. For that reason, shares of smaller firms typically benefit when falling interest rates make loans less expensive, but struggle more when rising rates increase the cost of debt.

Overseas growth. Big companies often earn much of their profits from abroad, while smaller firms generally focus more on achieving profits within the U.S. So when foreign economies are expected to grow faster than the U.S., large-cap stocks may have an edge.

A Delicate Balance

Clearing his debts now will enable this family man to save for the future.

Miguel Meléndez with his mother, Maria Esther Ramos, and his sons, Miguel Jr. (left), and Steven.

Miguel Meléndez is struggling to pay down debt while supporting two young sons and a mother who is ailing with Parkinson's disease. Now in the midst of a divorce, he wonders if his goals, including a comfortable retirement and college educations for his children, are out of reach.

Meléndez, an accounts manager at a telecommunications company, recently met with Dana Levit, a financial planner in Newton, Mass. "Miguel is doing amazing things for his mother and his sons," says Levit. "Paying off debts and boosting retirement contributions will greatly improve his financial picture."

At a Glance

Miguel Meléndez: Age 45
Home: Paterson, NJ.
Family: Sons, ages 5 and 7; mother, 75
After-tax Income: $3,800 monthly
Average Expenses: $3,500 monthly
401(k) Savings: $120,000

Getting out of debt

During their marriage, Meléndez and his wife racked up $40,000 on credit cards and $30,000 in two loans from his 401(k) account to make repairs on two rental apartment buildings they own. Once the divorce is finalized, he will keep one building, where he currently resides, and his ex-wife will own the other. He'll also be responsible for half of their remaining $18,000 credit-card balance and $16,000 in 401(k) debt.

Meléndez has been working to reduce his expenses in order to meet a slew of monthly debt payments. These include a monthly minimum payment of $1,000 required on the remaining 401(k) loans; $500 payments (well above the required minimum) on two credit cards that each charge a whopping 29% interest rate due to missed payments; and $500 on the portion of the income-property mortgage not covered by rent. His mother's care requires another $400 a month, which will disappear after she moves in with her sister in Puerto Rico.

Building savings for the future

Levit suggests that Meléndez bump up his 401(k) contribution rate from 1% to 3%—about $100 more a month—to take full advantage of his employer match. "Missing out on the match is like missing out on free money," she says.

Next, Meléndez should start an emergency cash account that will eventually hold six months' worth of expenses, creating a cushion he can fall back on instead of taking on new debt. She suggests funding it once he's no longer paying for his mother's care.

Meléndez's first 401(k) loan will be paid off in a year, freeing up cash that he should use to bolster his emergency fund and pay off credit-card debt. Then he should further increase his 401(k) contribution rate to at least 10% of his salary.

Levit also recommends making retirement a higher priority than funding his sons' college costs. "If Miguel doesn't save enough for retirement, he could wind up being a burden on his kids," she says.

Eyes on the prize

Levit calculates that Meléndez's plan should enable him to accumulate about $600,000 in his 401(k) account by age 65, when he hopes to retire. That will generate the $2,800 monthly income he'll need to live on. "I'm planning to retire to Puerto Rico," he notes, "and that income would allow me to live very well there."

Meléndez acknowledges that the past few years have left his finances in rough shape. But with Levit's suggestions, he says he's ready to make some changes: "I have the skills and the desire to do it. I'm ready to make this happen." ■

SmartMoney
FROM THE WALL STREET JOURNAL

Strengthen Your Finances

Q: Should I prepay my mortgage or is there a better use for my money?

A: Making even one additional monthly mortgage payment a year can trim several years—and potentially tens of thousands of dollars in interest—from your loan.

That may sound attractive. However, as shown in the chart below, what you gain by paying extra on your mortgage may pale in comparison to the benefits of using that money in other ways. In particular, you may be better off investing the money in a tax-advantaged retirement account like your workplace retirement savings account.

Strategy	Benefit
Pay an extra $200 per month on a $300,000 30-year mortgage charging 4.95% interest.[1]	Save $68,200 in interest; eliminate debt in 23½ years instead of 30[1].
Save an extra $200 per month in your workplace retirement savings account.	Accumulate nearly $140,000 over the same 23½ years, assuming a 7% annual return. (Withdrawals from traditional accounts will be taxed.)

What's more, the interest you pay on your mortgage every year is probably tax-deductible, meaning those interest payments save you money on taxes. Paying down your mortgage more rapidly reduces the tax break. So before you write that extra check to your mortgage company, consider whether there's a better way to put the money to work for you. The worksheet in the smartmoney.com article, "Should You Prepay?" can help you decide.

Q: Is there such a thing as being too diversified?

A: Yes. Diversifying your portfolio involves assembling funds that invest in many parts of the market—including stocks of both small and large companies in various industries, as well as bonds and cash investments. A properly diversified portfolio can help smooth out your returns over time.

On the other hand, the more funds you own, the more work it takes to keep track of each one. Plus, holding many funds means your portfolio—and its returns—are likely to resemble the overall market. That's a problem if you invest through actively managed funds, because they charge management fees for the potential to outperform market averages. If your goal is simply to approximate broad market returns, you might be better off investing in an index fund that tracks the market as a whole. Such funds won't provide superior returns, but they charge minimal expenses.

So what's the right number of funds to hold? There's no single answer. Many experts recommend investing in just enough funds to expose your portfolio to a variety of large, small, domestic, and international stocks in various parts of the economy, as well as bonds and cash investments. Alternatively, you might invest in a single fund that adjusts its investment mix based on your retirement date, such as a target date or life cycle fund. ■

[1] Calculations performed using bankrate.com's Mortgage Payoff Calculator. 4.95% was the average 30-year fixed rate as of June 2, 2010, according to bankrate.com.