

Evaluating Retirement Communities

Moving to a continuing-care facility presents financial risks. Asking a few key questions can minimize the downside.

by **Kerry A. Lynch, Senior Fellow**

Continuing-care retirement communities (CCRCs) are designed to provide residents with a full spectrum of care, from independent living to assisted living to nursing-home care. The number of CCRCs has increased rapidly in the past two decades, and there are now more than 1,800 nationwide. A major concern for anyone considering a move to a CCRC, or already living at one, is whether it is financially stable.

Moving to a CCRC requires a huge financial (and emotional) commitment. Many people sell their homes, which are often their major asset, to pay the high entrance fees (typically \$100,000 or more). In addition, there is a monthly fee, which varies depending on the community and the contract. It typically runs from \$2,500 to \$5,000 and may increase over time.

Moreover, once you move into a CCRC, your options for moving out are limited. Depending on the contract, there may be significant fines, or the refundable portion of your entrance fee may be reduced.

In short, when you move to a CCRC, your future becomes closely tied to the long-term future of the

CCRC itself.

There is no federal regulation of CCRCs, and the quality of state oversight varies widely. Twelve states have no CCRC-specific regulations at all (Alaska, Alabama, Hawaii, Mississippi, Montana, Nebraska, Nevada, North Dakota, Ohio, Utah, West Virginia, and Wyoming). Ohio, one of the unregulated states, has 144 CCRCs, the second highest number among all states, behind Pennsylvania.

There is no consistent standard for licensing or monitoring CCRCs or for the extent of consumer protection provided to residents.

Among states with regulations, oversight is provided by a variety of state departments—most often the department of insurance, but sometimes the departments of banking, finance, social services, or health care. In short, there is no consistent standard for licensing or monitoring CCRCs or for the extent of consumer protection provided to residents.

The Government Accountability Office (GAO) released a report in June that warned about the financial risks of these communities. It noted that developing and operating a

CCRC is a complex process, from the start-up phase of building and selling units through efforts to forecast future costs and revenues. These forecasts require projections of life expectancy, health status, health care costs, occupancy rates, financing costs, etc. If the actual numbers don't match the forecasts, a CCRC can quickly run into liquidity problems and even become insolvent.

The GAO report also warned that “many CCRCs may be financially vulnerable during periods of economic decline—such as the recent downturn—that can result in tight real estate and credit markets.” The slow real estate market has made it harder for people to sell their homes to pay CCRC entrance fees. As a result, occupancy levels have fallen, resulting in reduced revenue. CCRCs also depend on access to credit to finance the development of new units and to maintain and upgrade their facilities, and thereby attract new residents.

In light of the evidence and analysis provided by the GAO report, anyone considering moving to a CCRC should ask a number of questions.

Inside this report The government's deficit reduction plan may seem drastic. But the fact is that the proposed measures may not go far enough to correct fiscal imbalances. Research Fellow Polina Vlasenko examines the costs of delaying significant change and concludes that it's not just the fragile recovery that's standing in the way of progress. See back page.

Also With students borrowing more money for college, some parents may lose tax deductions. See Ask the Expert on page 3.

Will my deposit or entrance fee will be placed in escrow? Some states require this, others do not. Placing funds in escrow ensures that they will be safeguarded by a third party until the terms of the escrow agreement are met. According to the GAO report, escrow requirements “are aimed at ensuring the stability of a CCRC during start-up and construction and its ability to provide the services set out in the contract with residents.” They provide an added layer of financial protection to consumers.

What is the refund policy? The GAO report suggests there is wide variation here. Some CCRCs allow you to cancel your contract without forfeiting any of your paid entrance fee (and some states require this). Full-refund periods range from seven days after signing a contract to as long as a year after occupancy. After that, partial refund policies may apply over a longer period. Refunds may be contingent on a new resident moving into your unit, which means you’ll wait longer for a refund if occupancy rates drop (which they have in recent years).

What is the fee schedule? Ask for three things: a detailed list of which services are covered by the monthly fee for each level of care, a history of fee increases for the past five years, and a description of the fee adjustment policy. This information gives you a better idea of what your likely costs will be and what your future financial risks might be. For ex-

ample, if a CCRC’s finances worsen, it might begin to charge fees for services that used to be free. Some states, including California, New York, and Pennsylvania, require disclosure of this information. Others do not. Even if it’s not required, be wary of any CCRC that refuses to provide it.

What do my accountant and lawyer think? Various audited financial statements can help you evaluate the financial condition of a CCRC, including the balance sheet, income statement, and cash flow information. But the GAO notes that these statements “generally provide a snapshot of a point in time, and are not assessments of longer-term financial trends or financial stability.”

The best tool for evaluating long-term trends, the report says, is an actuarial study that takes into account mortality, morbidity, etc. But few states require CCRCs to conduct these studies and they are rarely disclosed to consumers. The best course is to gather as much information as you can. Unless you are an accountant, you probably lack the expertise to evaluate it. Given how much is at stake, you are well-advised to ask an accountant to review it.

The same goes for the resident’s contract. This document is often long and complex. While some states require that it be written in understandable language, others don’t. Even if a contract seems clear and readable, a lawyer can help you interpret confusing or

ambiguous language and flag any items of concern.

According to CCRC experts cited in the GAO report, “residents were often focused on certain elements of care and housing, such as amenities and culture, when choosing a CCRC and might not, for example, pay enough attention to financial information that could affect them.” Consulting your own experts can help you avoid this situation.

Is the CCRC accredited by the Continuing Care Accreditation Commission? This is an independent organization, and accreditation is voluntary. A CCRC that chooses to become accredited must undergo an extensive analysis of various financial measures, including profitability, liquidity, and solvency. Industry officials cited by the GAO say that the Commission’s standards represent best practices and guidelines for CCRCs. As of April 2010, 300 CCRCs nationwide were accredited.

What is the transfer policy? The GAO notes that a transfer from one level of care to another is one of the most stressful events that residents face. Find out who decides when a transfer is called for. What happens if the resident disagrees? Will the next level of care be provided on-site or at another location? If no housing is available at that level, where will the resident go, and who will pay for it? If a couple is involved, will they be split up? How will this affect costs?

How are residents kept informed? Some states require CCRCs to periodically disclose information to residents on financial conditions, fee increases, policy changes, etc. Some require the information to be posted publicly, some require management to meet periodically with residents, and still others that information be made available on request. Regula-

Learn the Details

In June 2010, the Government Accountability Office released a report on the CCRC industry. The full report, “Older Americans: Continuing Care Retirement Communities Can Provide Benefits, but Not Without Some Risk,” is available at www.gao.gov.

tions aside, a good CCRC aims for transparency and encourages residents to communicate with management. Some have residents' groups or councils to facilitate this. Ask if a CCRC has one and, if it does, ask to talk to a member.

What happens if I run out of money? CCRCs closely screen applicants' finances to ensure that residents will be able to pay monthly fees over time. But fees may rise faster than expected. According to the GAO, such increases can occur for a number of reasons—for example, if occupancy rates drop, if operating costs rise unexpectedly, or if the CCRC has to lower its entrance fees in an effort to remain competitive and attract new residents. Even if fees don't rise, a resident's income or wealth might shrink unexpectedly (a common situation these days.)

If a resident can no longer afford monthly fees, many CCRCs will tap the refundable portion, if any, of the entrance fee. After that, it depends on the terms of the contract and management's policy.

What happens if the CCRC runs into financial trouble? If entrance fees and monthly fees are insufficient to cover a CCRC's costs, it may have to cut services or raise fees more than expected. A seriously troubled CCRC might eventually be bought by another facility. If it closes, residents may be forced to transfer to another facility.

Or it might file for bankruptcy. In that event, any claim that residents have will be subordinate to the claims of mortgage lenders, bondholders, and other secured creditors. Such events are rare, but they have happened. When they do, residents are at risk of losing their refundable entrance fees—which, among other things, limits their ability to move.

To this point, there have been relatively few problems in this

industry, according to the GAO report. CCRCs don't want residents who can't afford to be there or who will be unhappy. They screen applicants carefully, which helps to minimize risks on both sides. They also aim to manage their complex finances in ways that will preserve their long-term viability.

Still, there's always been uncertainty about how well these communities will fare as their residents age. They start out with residents who are relatively young, healthy, and independent, but as residents age, the cost of care will increase. It's difficult to accurately predict the long-term trends of care, costs, and revenues.

The financial crisis has added another element of risk because of the unexpected stresses it has put on the industry. Prospective residents can't sell their houses for as much as they hoped. Stock market losses have wiped out wealth. Tighter lending standards have reduced CCRCs' access to the credit they need to maintain facilities and expand.

For a hint of what can happen if the forecasts are wrong, consider the recent problems in the market for long-term care insurance. Many insurance companies are having trouble with these policies, because they severely underestimated how many people would file claims. They are now raising premiums sharply and suspending sales of new policies.

The CCRC industry is based on an actuarial model similar to long-term care insurance. The lesson is that even the experts can get it wrong.

Overall, the GAO report underscores that while CCRCs offer many benefits, they also carry risks. Perhaps the biggest risk is that once you move in, you have little flexibility to alter arrangements. You can't avoid this risk, but you can minimize it by asking key questions about the facility's finances and management beforehand.

ASK THE EXPERT College Deductions

Students are borrowing more money than ever before to pay for college and are finding other ways to provide their own funding. Because of this, some parents could be at risk of losing the personal exemption and higher education tax benefits. This could be a significant dollar amount.

On their personal income tax returns, parents can claim education credits and deductions for tuition and fees for their dependent children. The deductions only apply to their own children, step-children, foster children, or the descendants of their children, who have lived with the parents for six months or more. A part-time student must be under age 19; a full-time student under age 24.

The students' financial situation plays a critical role. In essence, a college student who provides more than 50 percent of his or her own support through loans, employment, or other means will not qualify as a dependent. This support includes amounts paid for food, shelter, clothing, and medical care as well as for tuition and books. Parents have to calculate how much of the total cost of an education they provide. The IRS provides worksheets for this, but using them can be arduous.

The treatment of expenses paid with distributions from 529 College Education Saving Plans and other college saving plans in the support test is uncertain because each plan has its own set of regulations. The IRS does not give clear guidance. In this, careful calculation for each plan is the best course to follow.

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To submit questions for future columns, email asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.

Deficit Reduction, Anyone?

The longer the country waits to stabilize its fiscal imbalances, the higher the costs become. But the fragile recovery is not the only reason Congress is delaying reform.

by Polina Vlasenko, PhD, Research Fellow

Congress is poised to adopt the tax deal proposed by the president to extend a number of tax cuts for individuals and businesses for another two years. (As of this writing, the Senate has approved the bill 81 to 19, and the House is set to follow.) Despite all the talk about fiscal responsibility, Congress seems unwilling to adopt any deficit reduction measures. With economic recovery still fragile, this may make sense.

But the fiscal imbalances, if not addressed, will only grow worse. Eventually, the debt burden may become unsustainable. The Congressional Budget Office (CBO) projects that, without changes in policy, federal debt held by the public would grow from 62 percent of GDP today to 100 percent of GDP by 2022 and 200 percent of GDP by 2037.

Such high levels of debt bring costs. Higher debt reduces the amount of savings available for productive investment, reducing future output, income, and consumption. Higher debt makes it harder for policymakers to respond to unexpected problems, such as future recessions. Higher debt increases the possibility that investors would lose confidence in the government's ability to meet its obligations, triggering a Greek-style fiscal crisis.

Some deficit reduction will have to be undertaken eventually. The longer we wait, the higher the real costs become. A CBO study examined the impact of postponing, from 2015 to 2025, fiscal reform that stabilizes the ratio of debt to output. They found that in the long run, output will be at least 2.5 percent lower, consumption 1.5 percent lower, and capital stock 7 percent

lower than it would have been had the reform been enacted sooner. This means a substantial reduction in the standard of living for the average American.

According to the CBO, over the long term the federal deficit is driven entirely by growth in mandatory spending programs such as Social Security and health care (including Medicare, Medicaid, Children's Health Insurance Program, and the subsidies introduced by the recent health care legislation).

Postponing fiscal reform from 2015 to 2025 means a substantial reduction in the standard of living for the average American.

Under projections that assume a continuation of current fiscal policies, federal health care outlays will increase from 5.5 percent of GDP in 2010 to 10.9 percent in 2035 and will continue to grow thereafter. Social Security outlays are projected to increase from 4.8 percent of GDP in 2010 to 6.2 percent in 2035. Together, these mandatory outlays will account for 65 percent of all outlays (other than interest expense) in the federal budget in 2035, up from about 45 percent today.

The deficit reduction plan proposed by the National Commission on Fiscal Responsibility and Reform, released earlier this month, includes what many would consider to be drastic measures. But it may not go far enough to address the long-term fiscal imbalance.

Among the proposed changes are several measures that would force Medicare beneficiaries to pay more out-of-pocket before Medicare or Medigap insurance kicks in. By restricting first-dollar coverage,

these changes are intended to reduce over-utilization of care and overall spending. The Commission also proposed a number of changes to Social Security, all of them in the direction of reducing future benefits and increasing tax revenue.

All of these changes would be highly contested, had they been considered by Congress today. Even though the costs of waiting are high, politicians seem all too willing to postpone the unpleasant measures required to address the deficit problem.

It would be too simple to say that the reason for this is only the politicians' myopia. Politicians behave this way because voters reward such behavior. There are reasons for that.

The reforms that address fiscal imbalances have different effects on different generations. CBO estimates that older generations (people who are older than 50 today) will benefit the most from postponing the reform consisting of cuts in benefits and increases in taxes. The cost of this delay, in the form of higher debt and the problems it brings, will fall most heavily on those who are not old enough today to vote yet.

AIER | gold corner



Price of gold, December 16, 2010, London PM fix.

The Asset Allocation Decision

Investment choices should be based on realistic forecasts of the risk-return trade-off and the investor's personal preferences about how much risk to undertake.

by **Donald R. Chambers**

A key implication of Modern Portfolio Theory is that investors need keep their money in only two places: a highly diversified portfolio of risky assets (the market portfolio) and a selection of short-term assets that are virtually risk-free. In addition, the more of your money you place in the risky market portfolio, the higher your expected annual returns, on average.

As an example, Suzanne is a financially comfortable 60-year-old widow who has recently retired with a moderate pension and approximately \$1,000,000 in investable wealth. With a life expectancy of about 25 years, Suzanne could only tap her savings for about \$40,000 per year in today's dollars if she kept all of the funds in riskless assets (since there would likely be no earnings after taxes and inflation).

She uses financial tables and determines that if she could earn just two more percentage points each year on her savings she could increase her annual withdrawals to over \$50,000 per year in today's dollars.

But how can she get the extra 2 percent a year rate of return? According to MPT, she would need to place more of her investments into what we have called the market portfolio—and less in CDs, money-

market funds, and short-term bonds.

The problem? By moving more of her savings into the market portfolio she would be taking on more risk. By risk we mean volatility: the ups and downs of stock prices from year to year. The higher long-term average returns she can expect would come only at the price of greater year-to-year volatility.

Suzanne's situation illustrates two basic points from MPT. First, the only reason to bear risk is to receive higher expected return. Second, the only way to earn higher

Asset allocation should attempt to balance reasonable estimates of risk and reward—not attempt to outguess the market.

expected returns is by taking on more systematic risk. By extension, the decision of how much market risk to bear (how much money to place in the market portfolio) will depend on how much expected return results.

The Decision. How does an investor make that crucial decision as to how much risk to bear in the pursuit of higher return? This choice is known in MPT as “the asset allocation decision.”

The asset allocation decision is

typically the primary determinant of investment success or failure. It should be made in an attempt to balance reasonable estimates of risk and reward—not in an effort to out-guess others as to where the market might be headed. Otherwise, investors may over-allocate to risky assets during good economic times and over-correct into ultra-safe portfolios during bad economic times.

As a painful example, many investors reacted to the sharp drop in stock prices in late 2008 by selling their holdings at the stock market's nadir. (This turned on its head the old dictum: Buy low, sell high.) The result was that such panicked investors missed out on the substantial resurgence in stock prices that has occurred since the market

bottom.

The goal, in short, is to reach an asset allocation that reflects a balance of risk and return.

But how do we come up with a realistic view of that trade-off? How can you decide how much of your assets should be in risk-free investments and how much in the market portfolio?

The answer? It depends on you—and above all, on your appetite for risk. At this point, you may recall the old saying about investors in the stock market. To wit: You can either eat well or sleep well, but you can't do both. Why not? To eat well, you need high returns. But to

get the high returns over time, you will have to go through bull and bear markets, and that will keep you up at night. Experience suggests that preferences vary. Some people would rather eat well than sleep well, and vice-versa.

Balancing Risk and Return. What if you knew that you could invest your retirement money for the next year in a combination of only the two funds? A money market fund pays a fixed rate of 2 percent. A portfolio of risky assets earns, say, 8 percent on average, but with big swings in performance from year to year.

At this point, we need to get more specific about how to measure or estimate risk—which refers to the degree of year-to-year volatility in stocks, both domestic and foreign.

As we saw in the last article in this series (Part 3), we can borrow from the field of statistics the concept of “standard deviation” to measure the risk of investment returns. The intuition of standard deviation is that it serves roughly as a typical deviation of actual returns in any given year from average or expected returns.

Suppose the expected annual return of the market portfolio is 8 percent and that its standard deviation is 20 percent. A standard deviation of 20 percent means that roughly two out of every three years we should anticipate that our actual returns will lie within 20 percent of the expected return (-12 percent to +28 percent). Only about one in six years should show returns lower than -12 percent or above 28 percent (each being more than a full standard deviation from the expected return).

In extremely bad years, the return could fall two standard deviations below the expected return. That is roughly what happened in 2008, when the S&P 500 dropped over 35 percent.

The idea here is for investors to think about the range of risk that they would feel comfortable bearing in an attempt to earn higher return. Then each investor should select an asset allocation that achieves the preferred level of risk and return.

The good news is that an investor can control the standard deviation of his or her entire portfolio by adjusting the asset allocation (i.e., the mix of safe and risky assets). To achieve a target standard deviation of, say, 15 percent, an investor should use an estimate of the standard deviation of the market portfolio, which we are assuming is 20 percent.

The way to shrink the total portfolio’s standard deviation is to reduce the share of your investments in the market portfolio. To repeat, we assume the market portfolio has

The primary idea is to find a balance between the joy of higher expected return and the agony of higher risk.

a standard deviation of 20 percent.

Then the standard deviation of the entire portfolio will vary with how large a share of your investments is in the market portfolio. If the share is three-fourths (75 percent), the outcome would be as follows:

$$\text{Target Std. Dev.} = \text{Std. Dev. of Market} \times \text{Percentage in Market.}$$

Then, for a target of 15 percent:

$$15\% = 20\% \times 75\%$$

Similarly, if the goal is a total standard deviation of only 5 percent, reduce the share of your holdings in the market portfolio from 75 to 25 percent—or a third as much.

The other side of the coin is that you would hold a larger share of your portfolio in risk-free assets. You would be hedging against the high volatility of the market portfolio.

So much was covered in Part 3. Now we can move on to implications and refinements.

The Market Risk Premium. MPT teaches that investors who bear systematic risk (i.e., market or non-diversifiable risk) can expect to receive higher returns on average.

MPT refers to the added return from bearing systematic risk as the market risk premium or the equity risk premium. This premium is the expected return of the overall market minus the risk-free rate. If the market portfolio is expected to earn 8 percent (on average) and if the short-term money market yields are 2 percent, then the market risk premium is 6 percent.

So the premium is the added return investors demand for bearing the risk of being in the market portfolio rather than in riskless assets.

In this example, the question each investor faces is: How much systematic risk are you willing to bear if you are being rewarded with a 6 percent higher expected return on all of the money that is placed in the market portfolio rather than in riskless bonds? Of course, the answer would rarely be as much as possible or none. Instead it is usually some.

That answer needs to be translated into a specific portfolio allocation. However, MPT does not provide an objective estimate of the expected risk premium of the market. At a particular point in time, we do not know whether investors are expecting the market to outperform risk-free assets by 2 percent, 8 percent, or even 12 percent per year.

The Premium with a One-Year Time Horizon. Still, most scholars and industry experts tend to expect the long-term average returns of a highly diversified equity portfolio to exceed short-term riskless rates by perhaps 4 percent to 8 percent per year.

So let's settle on 6 percent as a moderate estimate of the risk premium. This 6 percent forecast is only an estimate of the expected return. Actual annual returns will likely vary tremendously, displaying huge losses during bear markets and huge gains during bull markets.

Another key issue in analyzing the risk-return trade-off is selecting an appropriate time horizon—the length of time into the future for which projections are being made in portfolio planning and analysis.

For simplicity, our analysis can use annual returns and a one-year investment horizon.

The Volatility of Market Returns. In an earlier example, we assumed a 20 percent standard deviation for the market portfolio. In theory, this figure could then be used to manage the volatility for a total portfolio. But where does such an estimate come from in practice? And how much confidence should we place in it?

We have two different ways to come up with a realistic expectation of the future annual standard deviation of the returns of the market portfolio. The first is simply to check the record of swings in the stock market over time. In other words, we can draw upon the historical evidence on stock market volatility.

The second approach is more technical. It uses financial derivatives (futures contracts) to measure market expectations of future volatility. The instrument in question is the Volatility Index (or VIX) for the S&P 500. Increases in the VIX mean that market participants expect the S&P 500 to display increased volatility. To that extent, the market portfolio can also be expected to display a higher standard deviation.

As of the fall of 2010, both historical evidence and data implied by the VIX derivatives contracts point to an expected standard deviation of annual returns of about 20 percent.

In short, it makes sense to use 20

percent as a forecast of the one-year standard deviation of stock-market returns—which is why we used that figure for the market portfolio's standard deviation in our earlier example. At the same time, an investor would be well-advised to keep an eye on the VIX. If it changes over a longer period of time, his or her estimate of the market portfolio's volatility might need to be adjusted accordingly.

Linking Expected Return and Risk. The question remains for an individual investor: How should I select the share of my total portfolio allocated to risk-free investments? This is the question, once again, of how much risk an investor is willing to take in exchange for a higher expected return.

So far we have said that this decision will vary in accordance with the individual investor's appetite for risk. Now let's explore the risk-return balancing act with a little more precision. We can continue to use a 2 percent short-term riskless return and an 8 percent expected annual return of the market portfolio (6 percent above a 2 percent riskless rate).

The chart below uses these values as well as the 20 percent figure for the standard deviation of the market

portfolio. It illustrates ranges of annual returns and their probabilities that investors might anticipate for various portfolio allocations.

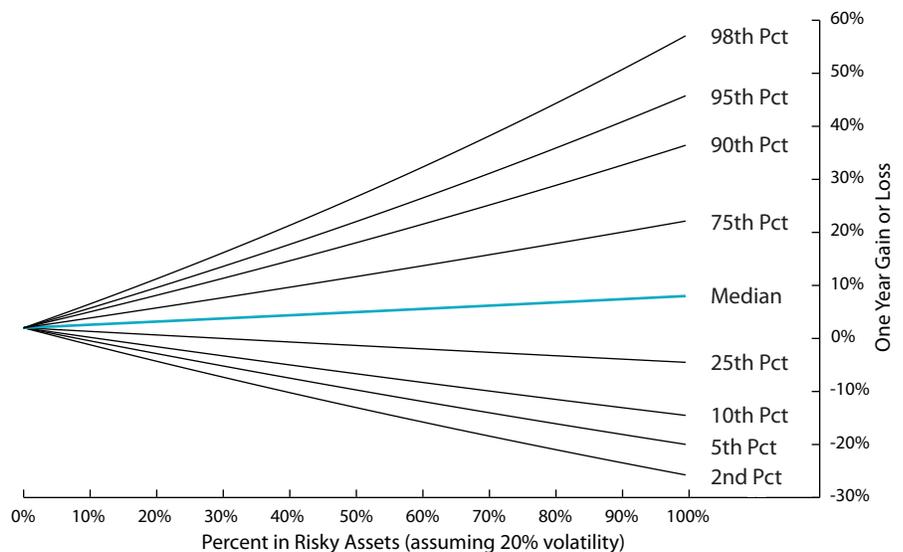
The risk-free extreme occurs at the far left of the chart, where all of the lines come together. This shows that if an investor puts 100 percent of her portfolio into riskless assets, it will generate the low but certain return of 2 percent per year. As already noted, history suggests that after taxes and inflation are considered, this would lead to no real gains.

A balanced alternative would find an investor allocating 50 percent to low-risk short-term bonds and 50 percent to risky assets. The chart shows the likely levels and volatility of annual returns that can be expected with various probabilities by locating 50 percent on the horizontal axis and examining the ranges above that point.

From left to right, the lines portray both higher variability and higher average return. The 6 percent risk premium described earlier is the reason the median (50th percentile) return tilts upward from left to right.

In other words, as the lines move from left to right they illustrate the risk-return trade-off. Higher average performance is accompanied by

Likely Gains/Losses with 6 Percent Market Risk Premium



greater variability or dispersion—i.e., greater risk.

To recap, the investor's asset allocation decision should be based on two things. One is realistic forecasts of the trade-off between risk and expected return. The other is personal preferences that reflect the investor's financial situation, financial objectives, and attitudes towards risk.

In that light, let's return to Suzanne's decision, as described at the outset of this article. She wants to raise her expected return to generate more for living expenses, but she is wary of taking on added risk. What use might she make of chart on the previous page?

She notes that if she puts more money into risky assets, the median (50th percentile) line of her hypothetical asset allocation drifts higher. As she examines the chart she sees that she would clearly be uncomfortable if the dispersion of her end-of-year wealth reached the level indicated for an allocation of 40 or 50 percent to risky assets. So she decides to place 33 percent of her investable wealth in risky assets and 67 percent in riskless assets.

What does this increase in risk get her? According to the chart, the median expected return on Suzanne's portfolio rises from the riskless 2 percent rate to about 4 percent a year when she resets her portfolio to hold one-third in risky assets. Based on financial tables, this increase in expected returns over time should allow her to increase her annual withdrawals to her goal of \$50,000.

The premise here is that the assumptions behind the chart are accurate. In reality, alternative projections for the expected return of the market and the standard deviation of the market are reasonable and common. Moreover, the chart also assumes that returns are normally distributed. As discussed in Part 3, in the past very bad returns have been more common than would be expected with a normal distribution. And history has shown that devas-

tating underperformance can persist for years or even decades.

Reality Checks: The Age Rule. Another way of selecting the right risk-return balance is to compare one's own decisions with the decisions of others facing similar situations in the last few decades.

The decisions of your peers can provide a reality check for people facing important decisions involving limited information and uncertainty. For example, a person considering the purchase of an auto or a house might well consider the following question as a starting point: What are other people in my circumstances deciding to do?

The idea of what a typical asset allocation should look like for various types of investors has changed through time. However, a rule-of-thumb worth considering is to invest your age as a percentage in bonds—and the rest in stocks. Thus, a 60-year-old should consider holding 60 percent in bonds and 40

percent in stocks.

This prescription needs to be adjusted for differences in risk tolerance, objectives, wealth, income, and so forth. So there would likely be a substantial difference between the appropriate asset allocation of a middle-class 60-year-old who has recently retired and a wealthy 60-year-old who is still enjoying a lucrative career.

Summary. The precise process of refining the asset allocation based on investor-specific issues is not clear, both because individual preferences toward risk differ and because the future is uncertain.

The chart uses projections of the expected return and standard deviation of the market portfolio to provide a somewhat simplistic but potentially revealing framework for setting an investor's key decision: the asset allocation decision. The primary idea is to find a balance between the joy of higher expected return and the agony of higher risk.

American Investment Services, Inc. (AIS), a wholly owned subsidiary of AIER, offers a Professional Asset Management Service (PAM) based on the tenets of Modern Portfolio Theory and is consistent with AIER's empirical research methodology.

Our research finds that portfolio returns can be explained by three factors. The first is that stocks are riskier than bonds and therefore have greater expected returns. Relative performance among stocks is largely driven by two additional dimensions: value and size. Many economists believe small cap and value stocks outperform because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk.

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