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The Sound Investor Series #38

It's Time for Your Portfolio's Annual Tune-up

By Ed Hynes, CFA
February 22, 2006

Just as cars benefit from a timely tune up, an annual financial check-up helps your portfolio's performance. For a number of reasons this is the best time of year for such a check-up. Financial information is readily available with your tax and year-end statements spread out on your desk awaiting attention. The April 15 deadline for making 2005 contributions to your IRA is also looming.

Reviewing your taxes and investments simultaneously has other benefits. Taxes have a significant impact on investment returns and reviewing them in an integrated fashion will help you realize how each affects the other. Speaking of taxes, now is also a good time to formulate your 2006 tax plan.

Here is a 10-point portfolio tune-up list. Many of these topics were covered in previous Sound Investor articles and are available at Farmcreeksecurities.com (by referencing the number indicated).

1. Organize your financial information. It is important to consolidate all your accounts so that you know the allocation of your total portfolio to stocks, bonds and other types of assets. Using a spreadsheet will make this much easier, especially next year when you will just have to update this year's information. (#13)
2. Analyze the 1, 5 and 10 year compounded annualized performance figures of your investments. Within reason, determine why your results were above or below expectations for each investment and asset class. If you need help calculating annualized returns, ask your broker or adviser for help. (#31)
3. Review your investment strategy: Is it working? Are your actively managed investments and funds beating the market after fees (including those of your broker and/or adviser)? Are your index funds and ETFs low cost & tax-efficient?
4. Make appropriate 2005 contributions to your IRA or other tax-qualified plans. Going forward, investors need to review their tax-qualified saving plans as choices have significantly increased. In particular, Roth 401(k) and the expanded availability of Roth IRAs are worth investigating. (#32)
5. Review and update your asset allocation targets. (#33)

6. Location analysis is a relatively new idea for improving after-tax performance. The concept hinges on the fact that most investors have both tax-qualified and taxable accounts and possess the flexibility to hold certain types of investments in either account. This gives investors some control over the timing and maybe even the tax rates for different investments. Everyone should take full advantage of this opportunity to improve performance. (#22)
7. Carefully determine how to rebalance your portfolio. Watch out for the pitfalls of taxes and trading costs. Before executing any transaction, you should know the tax ramifications. Whenever possible it is a good idea to restrict trades to your tax-qualified accounts. Trading costs mount up so don't go crazy making your portfolio exactly the same as your planned asset allocation, which is only a rough target in the first place.
8. GET IT DONE! Call your broker or adviser today. If you need help, get it. (#28)
9. Control risk by following a few simple rules. Keep your portfolio diversified with investments in both stocks and bonds. Make sure your portfolio is also diversified within asset classes. Diversification in the stock market is not just how many securities you own. You are not diversified if you have 20 stocks and they are all energy related. On the other hand, you are well diversified with just one index fund if it covers the entire market such as the S&P 1500. In addition, reduce volatility risk by investing for the long term. Time is one of the best weapons for fending off volatility. (#2)
10. Think ahead. I believe investors who understand how their portfolios may evolve over time are better prepared to withstand the pressures of turbulent markets. When you update your asset allocation, think about how it will likely evolve over the next 5 and 10 years. This knowledge will give you a strong mooring to tie your financial ship to during economic storms. Investors with a clear sense of their plans are more likely to hang tough. (#14)

Cut out this article and give your portfolio a good tune-up this year. You are the only one responsible for making sure it runs smoothly. There are no "emission" checks to keep us in line, or convenient taxis available if we break down.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. There are risks to investing including the loss of principal.

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