Wealth Management

INVESTMENTS, ADVICE & TRUST SERVICES

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3RIVERS®

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Diversification: A Tool To Temper Risk

Market volatility is a given in the investment world, so employing strategies to cope with fluctuating market values should be a priority. Diversification* — spreading your money among many different investments and investment types — is one such strategy. Although you can't eliminate volatility, diversifying your investment portfolio may help you manage it.

A First Step

Different asset classes often respond differently to similar market conditions, so investing in a mix of stock, fixed income, and cash investments is the first step in creating a diversified portfolio. Investing across all three major asset classes reduces the possibility that a decline in any single investment or asset type will put your entire investment portfolio in jeopardy. For example, having fixed income and cash investments may help moderate your losses if the stock market suffers a decline.

You'll also want to diversify within each investment type. Holding a variety of small-, mid-, and large-cap stocks and investment-grade bonds with varying maturity dates may help reduce your risk.

Taking It to Another Level

You can further diversify your portfolio by investing in a variety of stocks from different market sectors. A market sector is a segment of the economy that includes companies or industries offering the same or similar products or services. Investing across several market sectors may help control risk and provide greater portfolio diversification than investing in only one or two industries.

Cyclical Versus Defensive

Some industries are notably affected by economic highs and lows. *Cyclical* stocks come from industries, such as housing, transportation, and technology, that typically are sensitive to the health of the economy. Consumer demand for their

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Economic Update

Kate Braddock, CFA

The uncertainty surrounding Brexit was a dominant theme in the second quarter. The UK vote in late June to separate from the European Union caused a plunge in worldwide markets. The terms of the breakup will be negotiated over the next several years. Since the vote, we have experienced improvements both in the market and with most economic indicators. In August, 151,000 jobs were added, bringing the rolling three-month average to 232,000. The unemployment rate stands at 4.9%. Inflation is not yet at the Federal Reserve's 2% target, but it is increasing. Overall, economic growth was sluggish in the first half of the year. Expectations are for this to improve from the current 1% level to the 2.5%-3% range in the third and fourth quarters. Concerns over global growth and political instability have driven a flight to quality. Globally, sovereign yields on fixed income have continued to decline. The Federal Reserve did not raise interest rates at their September meeting, but it is quite likely that we will see one more increase before year-end.

Giving with Donor-advised Funds

If you're looking for a different way to support philanthropic causes, a donor-advised fund may be a good option for you to consider. You can set up a donor-advised fund by making an irrevocable charitable gift to a sponsoring organization for future distribution to qualified charities. You can recommend which charities you want the donations to go to, but the sponsoring organization has the final say in how the money is eventually distributed.

Although the money won't be distributed until later, you'll generally be able to claim an income tax deduction for the year in which you make the donation. If you're donating securities that have risen in value, you'll avoid capital gains taxes on the donated assets.

Check with the sponsoring organization regarding the types of assets it accepts and any minimum contribution or grant amounts that may apply. Generally, you can contribute cash, securities, and, possibly, real property.

Due Diligence for Your Contributions

Consider asking the following questions of a prospective sponsoring organization for your donor-advised fund.

- **Are there restrictions on the type or location of the charity?**
- **What are the investment options and who has control?**
- **What recordkeeping is provided to the donor?**
- **Are a portion of the donations earmarked for specific organizations?**
- **What fees and expenses are charged?**

Combine Your Zigging with Zagging

Investing in securities that tend to behave differently under various market conditions can help you manage risk and potentially result in more consistent returns. By understanding how two investments move in relation to each other — their *asset correlation* — you may be able to position your portfolio to better withstand market ups and downs.

A Look at Correlation

Positive correlation occurs when two investments tend to move in the same direction. So, if one security moves up (or down), the other will move up (or down) as well. Selecting investments with a positive correlation does not help reduce risk.

Zero correlation means there's no relationship between the returns of two investments. Since their returns are random, the up or down movement of one won't predict the movement of the other.

Negative correlation means that if one investment moves up or down, the other investment will move in the opposite direction. Combining investments with very low or negative correlation can help reduce risk.

A Note of Caution

Using correlation in constructing an investment portfolio isn't an infallible method. Correlations for investments can change substantially over a short period of time, particularly in volatile markets. Your portfolio can face a higher exposure to risk if assets that previously had shown low or negative correlation suddenly become more highly correlated.

Is There a Place in Your Portfolio for Dividend-paying Stocks?

If you're looking for a source of investment income, you might want to consider adding dividend-paying stocks to your portfolio. These stocks combine an income stream with the potential for appreciation and can help provide protection against inflation.

A Steady Income

Companies that pay cash dividends to stockholders on a quarterly basis are often large and well established. They generally experience less volatility than smaller companies that don't pay dividends. Continuing to pay out dividends — or even increasing them — during downturns in the economy may indicate that a company is profitable and stable. During periods of market declines, investors often pursue dividend-paying stocks, which, in turn, may help boost the stock's price.

Favorable Tax Rates

For federal tax purposes, the long-term capital gains rate applies to "qualified" dividends. Investors in the highest 39.6% regular tax bracket pay tax on qualified dividends at 20%.* The rate on qualified dividends falls to 15% for most other individual taxpayers (0% for taxpayers whose regular tax rate is lower than 25%). Dividend income that isn't considered qualified under the tax law rules is taxed as ordinary income at the taxpayer's regular tax rates.

Factors To Consider

Although it's important to review the company's dividend payment history before investing, there is no guarantee that firms that have paid dividends in the past will continue to do so. Further analysis can provide insight as to whether the company is capable of continuing to produce the cash flow necessary to support dividend payments.

A stock's dividend yield — determined by dividing the company's annual dividend by the stock's current share price — indicates how much the company pays out in dividends relative to the share price. A high yield doesn't necessarily indicate that a stock is a good investment. It could be a sign that the share price has recently dropped or that the company is trying to attract new investors but may not have the cash flow to sustain the high yield in the future.

* The 3.8% net investment income tax may also apply.

Avoiding Problems with Probate

Probate is the procedure used to validate a will before its terms can be executed and the decedent's property distributed to heirs. Probating a will can be a long and costly process. You may want to consider using strategies for transferring assets that bypass probate court.

"Probating a will can be a long and costly process."

- Make gifts during your lifetime. This removes property from your future estate. Keep in mind that large gifts can have gift-tax consequences.
- Own your home, other real estate, and bank and brokerage accounts in joint tenancy with rights of survivorship.
- Designate a beneficiary for each of your retirement accounts and life insurance policies.
- Create a revocable living trust. The property you place in the trust can benefit you during your lifetime and then be distributed upon your death according to the trust's terms. It keeps you in control of your property and eventually allows it to pass without delay to your family or other beneficiaries.

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products and services tends to rise when the economy is flourishing and decline when the economy experiences a downturn.

Defensive stocks come from industries such as utilities, food, and other staples where demand tends to be relatively steady. Investing in both cyclical and defensive stocks from different industries may improve your portfolio's diversification.

Traveling Abroad

You can provide another layer of diversification and add exposure to new markets by including investments from different countries and regions of the world in your portfolio. International markets may respond differently to various economic conditions than U.S. markets do. Investing overseas may help cushion your portfolio when U.S. markets are underperforming.

Not a One-time Undertaking

Periodically checking your portfolio for changes to your asset allocation can help you maintain the proper diversification. If market conditions have altered your asset mix, the risk level in your portfolio may have shifted, and your investments may need to be rebalanced to return to your original asset mix and risk level.

In the Long Run

Your portfolio's asset allocation should reflect your risk tolerance and investing time frame. Beyond that, diversifying your portfolio can help you reach your investment goals by better preparing you for the uncertainties of market performance. The value of diversification may reveal itself only over time, so it's important to be patient.

** Diversification does not ensure a profit or protect against loss in a declining market.*

This publication involves sophisticated tax and financial planning concepts. Before applying anything you read to your situation, you should consult with your professional advisor.