

AFIM Issues & Updates

December 2011

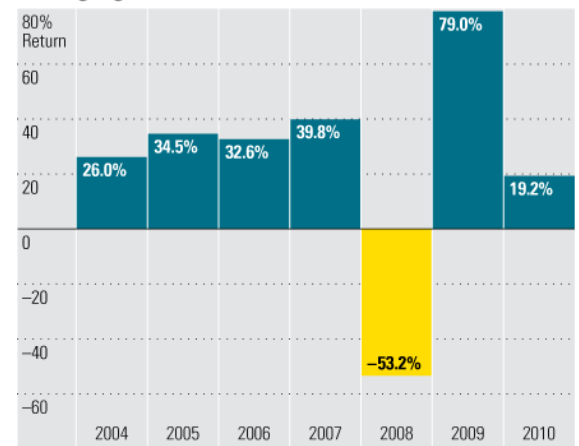
Vol. No. 1

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Overconfidence: False Perception

Consider the performance of emerging-market stocks from 2004 to 2010. For the first four years, stocks in these regions produced impressive returns. Based on this stellar track record, a typical investor may expect more of the same. Well, 2008 was quite dismal for emerging-market investors, as they lost more than half of their investment—53.2%. In 2009, however, emerging markets rebounded, producing a return of 79.0%. In 2010, emerging-market returns were still positive, but down to 19.2%. When investing, investors must consider the possibility of another year like 2008 in the future. Strong positive returns may be enough to create overconfidence among investors. Investors should avoid overestimating their ability to predict future outcomes and avoid focusing on only the upside potential while dismissing the possibility of poor performance.

Historical performance of emerging-market stocks 2004–2010



Source: Emerging-market stocks are represented by the Morgan Stanley Capital International Emerging Markets Index. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. Emerging-market investments are more risky than investments in developed markets.

Advisor Corner



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A Quick Guide to Lagging Economic Indicators

Lagging indicators are economic indicators that lag behind the overall pace of the economy, and can confirm or deny the trend shown by leading indicators. Examples of lagging indicators include the average duration of unemployment, average prime rate, inventory-to-sales ratio, and the change in the Consumer Price Index.

The average duration of unemployment measures the average number of weeks an unemployed individual has been out of work, and is inverted to indicate a lower reading during a recession and a higher reading during an expansion of the economy. This statistic is measured by the Bureau of Labor Statistics on a monthly basis, and is seasonally adjusted to reflect the impact of predictable seasonal patterns. For example, retail businesses tend to hire more part-time employees during the holiday season. This is a lagging indicator because during an economic recovery, real wages increase first, followed by hours worked, and finally by an increase in hiring. This indicator is a good gauge for the overall business confidence sentiment.

The Consumer Price Index is released mid-month and measures the average rate of change month-to-month in the prices paid by consumers for a broad basket of consumer goods and services. This is the most widely-used measure of inflation today and is used as a guide by both Congress and the Federal Reserve to formulate fiscal and monetary policies. More specifically, the Core Consumer Price Index, which excludes the most volatile components of the index like energy and food prices, is used by the Fed to measure whether it is meeting its annual target inflation rate of 1.7% to 2.0%. For example, depressed CPI numbers coupled with high unemployment figures were key factors in the Fed's decision to start buying \$600 billion in Treasury bonds to boost investment and consumption rates at the end of 2010. Thus, investors who are interested in investing in government bond ETFs should take note of this indicator (prices of long-term bonds might go up, while yields would fall). This is a lagging indicator because it represents prices that

have already changed; announces that inflation arrived—one month ago.

The prime rate is what banks charge their most credit-worthy customers, mainly large corporations. Since Dec. 16, 2008, the Wall Street Journal determines this rate by polling the 10 largest banks in the United States, and will update the published rate when at least 7 of these banks have changed their rates. The prime rate is largely based upon the Federal Funds Rate set by the Federal Open market Committee every 6 weeks. The rule of thumb for the value of the prime rate is 300 basis points (3%) above the current fed funds rate, which is currently between 0% and 0.25%. This is a lagging indicator because the Federal Reserve sets this interest rate in response to economic growth rates, and to stimulate growth, the federal funds rate will be set low for a period after the economy is recovering. This is important to investors because many banks use the prime rate as a basis to price loan products such as student loans, credit cards, and car loans, and is a good indicator if one wants to invest in stocks or ETFs in the financial sector.

The inventory-to-sales ratio is reported by the Department of Commerce and measures how many months it would take to deplete the backlog of goods, adjusted for inflation. An increase in this ratio generally means that sales estimates were missed, and businesses will respond by postponing future orders and cutting production rates, resulting in a slowing economy. Beyond looking at the overall figures published monthly, serious investors should look at the numbers for manufacturers, retailers and merchant wholesalers since each sector has different sensitivities to an economic downturn.

Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes.

Destination Correlation

"Correlation" and "correlated assets" are mainstay expressions in the jargon of investors and financial professionals, and while the concept of correlation can be confusing to novice investors, a quick explanation can clarify why correlation is a key factor in portfolio construction.

Let's say you or your financial advisor are trying to choose two investments in the construction of a portfolio. Would you prefer investments that are similar (move in the same direction) or investments that are dissimilar? Think about it this way: If you are going on vacation to an unknown island, what type of clothes will you put in your suitcase? If you only take summer clothes and the island nights turn out to be cold, or if you only bring winter clothes and the climate is tropical, your vacation will probably end in tears. It's the same with investing: You're better off diversifying than putting all your money in similar investments.

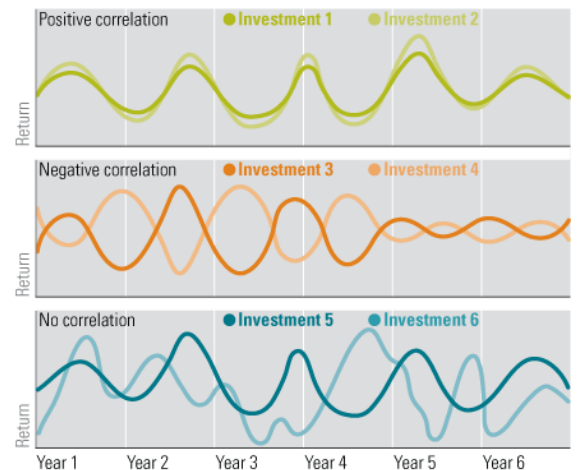
In order to create a truly diversified portfolio, the investments in the portfolio have to compensate for each other's shortcomings. If investment A declines in value, ideally you would want investment B to increase in value, or at least decline less than investment A. In order to achieve this, you need two investments that behave differently, meaning they have a low correlation.

Correlation is a statistical measure designed to quantify the interrelationship of two investments (again, investment A and investment B). By taking into account the characteristics of the two investments, a mathematical formula calculates a number between -1.00 and $+1.00$. This number is called the correlation coefficient. If this coefficient is negative (for example, -0.81), we say the two asset classes are negatively correlated. This simply means they tend to move in different directions: if asset class A declines in value, asset class B is likely to increase in value, and vice versa. If the correlation coefficient is positive (for example, $+0.34$), the two asset classes tend to move in the same direction: they are positively correlated. A correlation coefficient of zero means

the asset classes are completely uncorrelated; their movements in relation to one another are random.

Adding investments with low correlation to a portfolio can soften the impact of market swings because the investments do not all react to economic and market conditions in the same manner. For example, building a portfolio with large, small and international stocks would probably not be such a good idea because stocks are generally highly correlated to one another—if large stocks go down, the other stock categories will probably go down, too. The same logic applies to a portfolio with only bonds. However, combining stocks and bonds in a portfolio could provide a significant diversification benefit because these two types of investments do not tend to move together (they have a low correlation).

Various Levels of Correlation



Past performance is no guarantee of future results. Diversification does not eliminate the risk of investment losses. Investment returns shown and correlation numbers mentioned in the text are based on hypothetical data. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

The Ins and Outs of Long-Term Care Insurance

When planning for retirement it would be wise to at least consider the purchase of long-term care (LTC) insurance. While not everyone needs LTC insurance, it is recommended that people educate themselves about the issues surrounding this type of coverage. There are a dizzying array of options and features you'll need to understand if you are thinking about buying such a policy.

What daily benefit will you need? The higher the daily benefit, the higher your premium. But you'll need to find a balance between daily benefit and cost. According to the 2009 MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs, the average annual cost for a private room at a nursing home in 2009 was \$79,935. The national average for a semi-private room was \$72,270. The national average for an individual living in an assisted living community was \$37,572.

How long will benefits last? The typical stay at a nursing home is between three and five years, so make sure your coverage lasts for at least that long. Think about your own family's health history when choosing benefit periods. Does longevity run in your family or is there a history of family illness? Many policies offer unlimited benefits, although that obviously gets quite expensive.

What's the elimination period? The elimination period is comparable to the deductible on your other insurance policies. Your long-term care policy won't begin paying out for a certain number of days. Most policies start with a 30- to 90-day elimination period, but you can increase that. The longer the elimination period, the cheaper your premium. Consider, too, that you may be able to pay out of pocket for a limited amount of time.

Is the benefit inflation-protected? Inflation is the rate at which the price of goods and services is increasing. If you are going to need benefits for a number of years, they need to keep pace with inflation. Most policies offer a guaranteed annual inflation increase (more expensive) or the

opportunity to increase daily benefits down the road.

What level of care does the policy cover? The policy should cover all levels of care, both skilled and nonskilled. Nurses are generally the ones providing skilled care. Nonskilled care includes assistance with activities that don't require a nurse, such as bathing, walking, and dressing. You should be able to use the benefits not only for care at a nursing home but also for home health care, daycare, or assisted living.

Does the policy cover help at home? Some policies will cover the costs of bringing people into your home to help with physical therapy, bathing, dressing, walking, and so on. Make sure the policy doesn't require a prior hospital stay before this benefit is available.

How financially stable is the insurer? Research the financial rating of the company offering the policy. Check out ratings at A.M. Best's Web site. If you have a policy with a company that goes under, you still have a binding contract with that company.

What are "limited pay" options? A relatively new feature in long-term care policies is the ability to pay the entire cost at once or in a specified number of payments. This can help ensure that you don't have price increases in the future. For example, with a "single pay" option, you would pay all costs at once in one premium.

TIPS to Inflation Proof Your Portfolio

When signs of inflation creep into the economy, investors seek to protect their portfolios by turning to defensive market sectors (utilities, health care). But certain fixed-income investments, like Treasury inflation-protected securities, or TIPS, can be just as useful.

The interest rate does not change over the life of TIPS, but the underlying principal rises and falls with changes in the inflation rate. So the amount an investor will receive as income also changes. At maturity, you either receive the adjusted principal or the original principal, whichever is larger. The table singles out those years since 1990 when inflation was 3.0% (its long-term average) or higher and shows how TIPS fared. Out of the seven years illustrated in the table, TIPS outperformed inflation in five of them—and by a considerable margin.

TIPS Performance During Inflationary Periods: 1990–2010

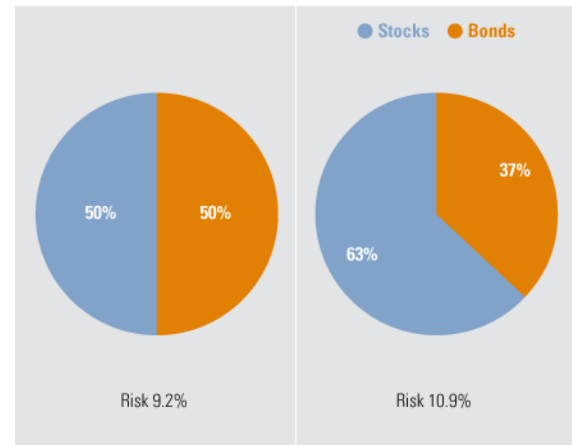
Year	Inflation	TIPS
1990	6.1	23.9
1991	3.1	-13.7
1996	3.3	7.2
2000	3.4	13.2
2004	3.3	8.5
2005	3.4	2.9
2007	4.1	11.8

The Importance of Rebalancing

Over time, your asset-allocation policy can veer off track because of market ups and downs. This is illustrated quite clearly in the attached image; a strong stock performance can cause a simple 50/50 portfolio mix to become unbalanced over time. After 30 years, what was once a 50% allocation to stocks now sits at 63%—quite a jump. Moreover, not only does the portfolio's allocation change, but the portfolio's risk also changes, rising sharply from 9.2% to 10.9%. If your needs and/or risk tolerance have not changed, your allocation shouldn't either.

But why would anyone want to sell investments that have done great in order to purchase laggards? While rebalancing might seem odd at first, it is all about risk control. If more and more of your total portfolio winds up in one investment, you risk losing a lot should that investment stumble.

Change of Portfolio Allocation: January 1981–December 2010



Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The sale of an investment for the purposes of rebalancing may be subject to taxes. Risk is measured by standard deviation. Standard deviation is a statistical measure of the extent to which returns vary from the expected returns. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and is considered to be representative of the stock market in general; Bonds—five-year U.S. Government bond.

The 2010 Financial Reform Explained

In the wake of what is quickly becoming known as “the worst financial crisis since the Great Depression,” the global economy is still slowly rebuilding. In the U.S., the government realized that it needed to take action to prevent a similar crisis, and on July 21, after a yearlong struggle, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the Wall Street Reform Act) into law. Here are some of the most important provisions of this bill:

Consumer Protection: The law creates the Consumer Financial Protection Bureau, a new independent watchdog agency tasked with ensuring that U.S. consumers have access to clear, accurate, and timely information about financial contracts such as loans, mortgages, and credit cards. The agency will also protect consumers from hidden fees (small-type footnotes beware!) and abusive or deceptive practices.

Financial Stability: We’ve all probably heard the phrase “too big to fail” too often. Financial powerhouses like Bear Stearns and Washington Mutual went bankrupt and almost brought the whole system tumbling down with them, dissolving the economic security of millions in the process. Another new group, the Financial Stability Oversight Council, has been created to see these situations coming. It will monitor large, complex financial firms in order to identify and quickly address problems that could potentially snowball. Increasingly strict rules will be enforced for capital, leverage, liquidity, risk management, and other requirements. Banks and their affiliates will have restrictions on investments in hedge funds and private equity funds.

Financial System Regulation: Since “no one saw it coming” and “it wasn’t our responsibility,” from now on clear lines of responsibility will be defined and shared between the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve as to which agency is supervising which type of bank. A new Office of Credit Rating Agencies will be created as part of the SEC, with

the mission to implement new rules for credit rating agencies, such as stronger internal controls, requirements to make key findings public, and penalties for biased ratings.

Transparency and Accountability: Derivatives have long ceased to be simple risk-management tools and have instead become speculative vehicles that enable traders to make enormous bets with no regulatory oversight. The new law now gives the SEC the authority to regulate derivatives, both over-the-counter ones and other types. Companies that sell products like the now-infamous mortgage-backed securities are required to retain at least 5% of the credit risk instead of passing it all over to investors. Hedge funds, which used to operate in their own money-filled bubbles and could not be bothered to register with the SEC, are now required to register and to provide the information necessary to assess their contribution to systemic risk.

Executive Compensation: You’re the CEO, you do all the work, you take all the risks—it’s only fair that you should be paid billions while the rest of us settle for less because, hey, the economy is in a crisis. However, saying that Wall Street’s compensation system has been way out of control is an understatement: think about Merrill Lynch ex-CEO John Thain’s \$87,000 area rug, or former head of Wachovia Robert Steel’s \$225 million in golden-parachute money (executive severance package). To step away from this system, the financial reform law will give shareholders the right to vote on executive pay. Public companies will be required to set policies to take back executive compensation if financial statements are shown to have been tampered with or made inaccurate, and executive compensation will be determined by taking the company’s stock performance over a five-year period into account.

These are just a few highlights, but the impact on institutions, financial advisors, and investors should be significant. Overall, the provisions in this bill look great on paper, but the real challenge lies in putting all these good intentions into practice.

Government Health-Care Spending: Medicare

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of government health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years.

Medicare and Medicaid were both created in the mid-1960's as part of Lyndon Johnson's Great Society agenda. As of 1970, 62% of total health-care spending was still private, with out-of-pocket spending the single most significant source. During the subsequent forty years, however, Medicare and Medicaid each expanded by more than 11% annually due to benefit expansions and demographic change, pushing public-sector spending up to nearly 50% of total health-care expenditures. During the same time, private-sector spending also grew at a robust 8.7% annually, as employer-sponsored insurance became the predominant conduit of health-care spending.

Looking forward, the Centers for Medicare & Medicaid Services (CMS) project 6.5% annual health-care spending growth over the next decade. Public sector growth is again expected to outpace private spending growth, with a 6.9% growth rate compared to 6% for the private sector. Combined, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010 and 17% in 1970.

Medicare is a federal government program that provides health insurance to people over age 65, and people with certain disabilities. In 2009, more than 43 million people received health insurance benefits through Medicare at a total cost of approximately \$510 billion. Medicare benefits are divided into three parts: Part A Hospital Insurance, Part B Medical Insurance, and Part D Prescription Drug Insurance. Part C created a private version of Medicare, now called Medicare

Advantage. More details about these benefits can be found in the attached table.

Original Medicare's relatively high cost-sharing provisions and lack of a limit on out-of-pocket spending can leave beneficiaries exposed to potentially devastating expenses in the case of a serious adverse health event. For this reason, most Medicare beneficiaries also carry supplemental insurance. Employer-sponsored retiree health plans, though becoming less common, still cover approximately 30% of the Medicare population. 20% of Medicare beneficiaries purchase individual supplemental policies, also called Medigap policies. Medicaid helps pay Medicare's premiums and cost-sharing for another 20% of the Medicare population. Only about 10% of Medicare beneficiaries are estimated to be completely without supplemental coverage.

Medicare Benefits Breakdown

Benefit	Approx. % of Spending	What Does It Cover?	What Does It Cost Beneficiaries?
Part A	39	Inpatient hospital care, skilled nursing facilities, and in some cases hospice or home care.	Generally no monthly premium as long as the beneficiary paid sufficient payroll taxes while working. Deductible and co-insurance for hospital stays exceeding 60 days.
Part B	26	Physician services, outpatient care, and in some cases physical or occupational therapy and home health care.	Monthly premium, deductible, and 20% co-insurance after the deductible is met.
Part C	23	Same benefits as Part A, Part B, and often Part D. Medicare Advantage plans are offered by private insurance companies as an alternative to original government-run Medicare.	Monthly premium, deductibles, co-pays, and co-insurance.
Part D	11	Prescription drugs.	Part D benefits are only offered through private insurance companies, which charge a premium in addition to deductibles, co-pays, and co-insurance.

Source: Kaiser Family Foundation and Medicare.gov

Government Health-Care Spending: Medicaid

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Medicaid is a joint federal-state program that provides health insurance to low-income people. Each state runs its own program and has discretion over benefits and eligibility within federal guidelines. A related program, the State Children's Health Insurance Program (SCHIP or CHIP), covers children from families who make too much to qualify for Medicaid but not enough to afford private insurance.

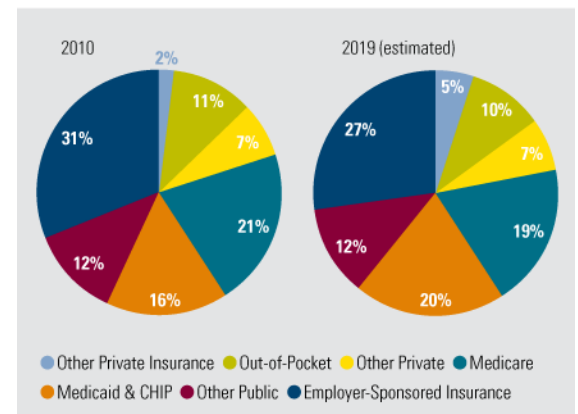
In 2007, on average 49.1 million people received health benefits from Medicaid. However, 61.9 million people received benefits at some point during the year, as varying economic circumstances led people to transition into or out of Medicaid. Medicaid cost \$390 billion in 2009, with about two-thirds of that money coming from the federal government and the remainder from the states. The federal share of costs—called the Federal Medical Assistance Percentage (FMAP)—depends on income levels in the states but is at least 50%. As part of the 2009 stimulus package (the American Recovery and Reinvestment Act), the FMAP was temporarily increased on condition that states accepting the increase could not reduce their Medicaid eligibility levels.

Medicaid beneficiaries are very diverse with widely varying health-care needs. Although children, their parents, and pregnant women accounted for around 75% of Medicaid enrollees in 2007, they only accounted for 32% of Medicaid spending. Aged, blind, and disabled members are

generally much more expensive. Approximately eight million Medicaid enrollees also receive Medicare benefits, and are known as “dual eligibles.” Medicaid does not require beneficiaries to pay premiums, and cost sharing is generally very limited, making Medicaid the nation's most important payer of long-term care services.

Medicaid will experience some of the most radical changes under the Patient Protection and Affordable Care Act. Starting in 2014, the program will be expanded to cover nearly anyone under age 65 with income up to 133% of the federal poverty level, including adults without dependent children. This is expected to result in 16 million new Medicaid beneficiaries, representing half of the health-reform-related increase in the number of people with insurance. The federal government will pay for 100% of the costs of newly-eligible Medicaid beneficiaries from 2014–2016, phasing down to 90% by 2020.

U.S. Health-care Spending by Source in 2010 and 2019



Source: CMS National Health Expenditure Data

Staying in Style

Most financial professionals agree that the asset-allocation decision is one of the most important factors in determining both the risk and the return of an investment portfolio. Asset allocation is the process of combining asset classes such as stocks, bonds, and cash into a portfolio that will meet your goals. Taking this process a step further means selecting mutual funds to represent a certain segment or style for your overall portfolio (large stocks vs. small stocks, growth stocks vs. value stocks, etc.).

This can be a challenging task, and once the process is complete and the portfolio of mutual funds built, you'll need to consider something else: style drift. Style drift occurs when actively-managed mutual funds deviate from a particular investment style over time in an effort to potentially improve performance. While improved performance might not seem like a bad thing, a shift in style can be hazardous because it alters your risk exposure and return profile.

For example, let's say you held a large percentage of your portfolio in a large-cap stock fund. Now, at a certain point in time, this fund's manager got convinced that small stocks would benefit due to certain market conditions. Acting on this belief, he shifted the strategy of what was supposed to be a large-cap stock fund by buying an unusual amount of small stocks. This not only unnecessarily increased the risk of your overall portfolio, but also potentially set you up for large losses if small stocks were not going to behave the way this manager expected.

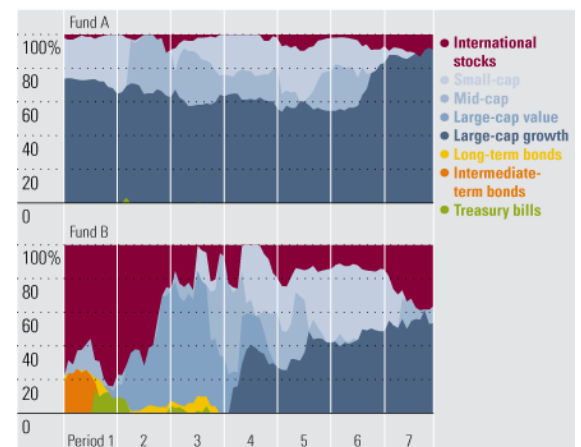
Style analysis is a technique used to understand investment style and identify the behavioral characteristics of a fund. It matches the returns of a fund to a mix of asset-class benchmarks that best describe the fund's behavior. This process can aid investors and advisors in the selection of funds to assemble a diversified portfolio.

The graph shows the rolling style analysis over time of two hypothetical mutual funds with the same stated objective. Although these two funds have the same objective, their style and

consistency differ greatly. Look at international stocks, for example: In Period 1 and Period 2, Fund B had a much higher exposure to international stocks than Fund A. Such style drift can indicate that your manager is not following the fund's stated objective.

If you notice your fund manager jumping on the bandwagon of past trends, he may be trying to save his own hide. Remember, the goal is to buy low and sell high, not jump in late and hope for the best. It takes real discipline to stick to a set of stated investment objectives. So always keep an eye on your investments and evaluate funds periodically to make sure they fit your asset allocation appropriately.

Understanding Fund Behavior: Some Funds Do Not Behave as Advertised



The percentages illustrated in the image are based on each hypothetical fund's returns-based style analysis results using 36-month rolling periods. Style analysis represents the best combination of benchmarks that match the variation in fund returns over the time period. It does not represent actual holdings.

A Quick Guide to Preferred Stocks

When a corporation needs capital, it generally has two options for raising it: by issuing equity (stock) or debt (bonds). A stock is a financial instrument that gives the holder ownership in the company; an investor who buys a stock owns a part of the corporation. A bond, on the other hand, is a debt instrument. When an investor purchases a bond, he or she lends money to the company. The company, in turn, agrees to pay the investor interest every year, as well as to give back the amount borrowed (the principal) when the loan comes due.

When investors and financial professionals talk about stocks, they refer, in most cases, to common stock, the more popular form of equity. However, there exists a second, less-known type of stock: preferred stock. Preferred stock can be seen as a hybrid investment vehicle combining characteristics of both stocks and bonds. Similar to common stock, preferred stock also gives investors ownership in the corporation, but the advantages and drawbacks of such ownership are a little different.

On the upside, holders of preferred stock are entitled to a fixed dividend payment before any common stock dividend is paid. If the company decides to pay a dividend in any given year, it must pay the preferred stockholders first, and only then can it distribute a dividend to common stockholders. In general, preferred dividends are distributed quarterly. Another preferred privilege is that investors are entitled to a claim on the company's assets in the event of a bankruptcy or liquidation right after bondholders and before common stockholders. In other words, creditors have to be compensated first, then preferred stockholders, and only in the end (if there is anything left) do common stockholders get a piece of the liquidated assets.

On the downside, preferred shareholders are typically not awarded voting rights like common shareholders and therefore do not have a say when the company's board of directors is elected. In addition, there is less potential for price appreciation for preferred stocks when compared

with common stocks, which may translate into lower capital gains. The preferred dividend payment is fixed; this is where preferred stock behaves more like a bond. Therefore, even if the company is prosperous and common stockholders enjoy dividend growth, preferred stockholders might not get extra profit from this prosperity. For these reasons, preferred stock is generally viewed more as a current income investment rather than a growth investment.

Some preferred stocks might contain a call provision, meaning the company has the right to buy back shares from shareholders at any time, usually at a premium. When a callable (or redeemable) preferred stock is called, investors are obligated to sell it back to the company. Preferred stocks can also be cumulative (unpaid dividends accumulate) or convertible (investors have the option to convert preferred shares into common shares).

Just like common stocks, preferred stocks normally trade on the major exchanges (NYSE, NASDAQ), and sometimes even over the counter. Institutional investors are usually the largest players in the preferred market, but more and more individual investors are joining in. In general, preferred stocks trade like corporate bonds, and are affected by changes in interest rates (because of the fixed dividend payments).

In conclusion, even though it shares characteristics of both common stocks and bonds, preferred stock is an asset class in itself, with its own particular privileges and risks, and should be regarded as such in analysis and portfolio construction.

Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. Historical data indicates stocks have been more volatile than bonds.

Common Investing Mistakes

Almost all of us have made investing mistakes. The key is not to make the same mistake twice. These mistakes can directly affect whether or not you achieve your desired goals. By repeating even just one mistake, individual investors can quickly become their own worst enemy. Below are some common mistakes that many fall prey to and some suggestions on how to sidestep them.

Starting Too Late

The first mistake a large number of investors make is waiting too long to initiate a long-term investment plan. The earlier you can start the investment process, the more likely it is that the plan will succeed. For example, let's consider two investors—Bill and Tim. Bill began investing \$5,000 per year 30 years ago. Tim began investing \$10,000 per year 20 years ago. Assuming a hypothetical return of 10% per year, Bill's ending wealth value was \$822,470 compared to \$572,750 for Tim. Thanks to the power of compounding, a small amount of money, wisely invested early on, can turn into a large sum over time. Avoid procrastinating; start investing today.

Lack of Diversification

By investing all of your money into just one asset class, industry, or company, you are placing all of your eggs into one basket—and this can be extremely risky. It is better to combine a variety of investments, such as stocks, bonds, and cash, which are unlikely to move in the same direction. Your risk exposure should be lessened as a result.

Chasing Past Performance

Yesterday's hot stocks or mutual funds may not be today's best investments. A good number of investors purchase assets when they have already reached their peak, only to watch their performance subsequently suffer. It may be a good idea to choose investments with a history of good performance as well as quality management.

Lack of Research

No matter what type of investment you plan to make, be sure to conduct the proper research. It is unwise to allocate your money to an investment you do not understand. There are a number of helpful resources that you can explore—ranging from public information to professional advice. Take advantage of these when possible.

Unrealistic Expectations

Many investments require time to grow. Investors often become frustrated with the early performance of their investments, decide to sell too quickly, and move the proceeds into other investments. This will result in too much trading, which is not only expensive, but also usually unnecessary. It is important to maintain a long-term view and to not be distracted by short-term results.

Overconfidence

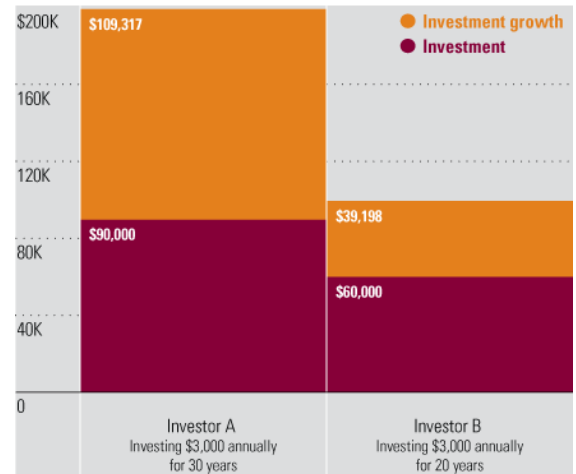
Confidence is a good thing, but overconfidence can cause investors to improperly select investments. Too much assurance in one's knowledge and ability can lead investors to focus on the upside and deemphasize the potential downside of investments. Instead, a solid financial plan constructed by a professional can go a long way.

The Costs of Financial Procrastination

Retirement usually doesn't start until you're in your 60s but there is a good reason to start saving much sooner. The earlier you contribute to your nest egg, the more time your portfolio will have to grow in value.

The image illustrates the ending wealth values and effects of compounding of two investment portfolios. Consider two hypothetical investors who begin investing \$3,000 at an average annual rate of return of 5%. Investor A invests \$3,000 for a 30-year period, which results in an ending wealth value of \$199,317. On the other hand, investor B invests \$3,000 for a 20-year period, which results in an ending wealth value of \$99,198. Investor A invested an additional \$30,000 compared to Investor B. However, a large difference in the ending wealth value can be attributed to the compounding effect of the \$30,000 for the additional 10 years. In other words, your dollars saved now will be worth a lot more than your dollars saved in retirement.

The Effect of Compounding



Source: This is for illustrative purposes only and not indicative of any investment. The image represents a hypothetical rate of return of 5%. The values represented do not account for inflation or taxes. Past performance is not a guarantee of future results. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment advice. Please consult with your financial professional regarding such services.

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