

The Risk of Being Too Conservative **by Steve Gilbertson**

As a result of the stock market collapse of 2000-2002, many individuals who got burned and lost significant money are now gun-shy about the potential of declines in their retirement accounts. Consequently, they have moved all of their retirement assets to “safe” investments like money market accounts. While it is true that money market accounts are unlikely to decline in value, over the long-term, these investments are not as “safe” as many individuals would believe. Here is why:

Currently, the average one-year return on a money market account is 0.51%.ⁱ The inflation rate in May, 2004 was 3.05%. If you do the math, that means that inflation was outpacing the money market return by about 2.5% percent. So the “real rate of return”, (actual rate of return minus the inflation rate) was negative. The money market return isn’t keeping up with inflation, and consequently, this “safe” investment is actually losing “purchasing power” over time.

Another negative consequence of investing in low-yielding money market funds is the loss of compounding power. Most individuals need this power of compounding money in order to reach their retirement goals, and obviously, at 0.51%, very little compounding is occurring. Consider the following scenario: Suppose Jane is a 35 year-old who plans to work for 30 more years. She invests \$5,000 each year for these 30 years in a money market account within her retirement plan. Assuming she receives the 10-year average annual return on the money market (3.91%), at age 65, after saving \$150,000, her account would be worth only \$303,466.03, just slightly over double what she invested.ⁱⁱ

What many people don’t consider in determining their investment allocations is finding a middle ground between investing in volatile growth stocks and low-yielding money market accounts. A “happy-medium” alternative to either of these extremes is investing in a moderately conservative portfolio of both stock and bond funds. Consider the following allocation:

- Large Cap Stock Funds – 40%
- Mid Cap Stock Funds – 10%
- Small Cap Stock Funds – 10%
- High-Quality Bond Funds – 25%
- Government Bond Funds – 15%

The portfolio obviously has more risk than a money market, but the diversification of the portfolio (including 40% bond funds) significantly reduces the risk. Consider again the case of Jane, who invests the same \$5,000/year for 30 years, but this time instead invests in the moderately conservative portfolio given above. Assuming she receives the 10-year average annual return on the portfolio (8.92%), at age 65, this same \$150,000 is worth \$802,022.89, almost \$500,000 more than in the money market!ⁱⁱⁱ

While it is true that the fluctuation in your investment accounts shouldn’t give you a heart attack, the scenarios given above demonstrate that the money market account isn’t necessarily the appropriate solution over the long-term. Remember that retirement accounts have a long-term time horizon and short-term volatility in your account isn’t the end of the world. With this in mind, ask yourself if the money market account is really the best option given your time horizon and retirement objectives.

If you have questions regarding this topic or would like to discuss your investment allocation, please contact Steve Gilbertson at sgilbertson@bryton.com, 515.223.1601.

ⁱ Source: Wiesenberger Reports, July 2004

ⁱⁱ This example is hypothetical and does not represent the performance of a particular investment. 10 year time horizon used is June 30, 1994 – June 30, 2004. Source: Wiesenberger Reports, July 2004. Past performance is not indicative of future results.

ⁱⁱⁱ Again, this example is hypothetical and does not represent the performance of a particular investment. The allocation used in this example is simply intended to illustrate a scenario and should not be construed as a recommendation. 10 year time horizon used is June 30, 1994 – June 30, 2004. Source: Wiesenberger Reports, July 2004. Past performance is not indicative of future results.

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One Valmont Plaza * 4th Floor * Omaha, NE 68154**