Personal Finance Management for New Oncologists: Part 2

In the January 2009 issue of *Journal of Oncology Practice*, “Personal Finance Management for New Oncologists: Part 1,” the first part of this two-part series, offered details and advice on the essential first steps of sound financial planning. Once you have set aside an emergency cash reserve and eliminated credit card debt, as described in the first article, you are in a good position to begin investing funds to meet specific goals.

The current economic downturn and market turmoil will certainly change how you—and the rest of the world—will approach investing. This article is not intended to guide you toward or away from specific financial moves. The basic principles of sound investing apply in any economic climate, and the purpose of this article is to lay out these fundamental principles and offer a brief primer on investment terminology and financial transactions. The resources listed at the end of this article are good places to learn more.

Before Investing a Dime

The first step to successful investing may surprise you. It does not involve researching yields on investment, checking out interest rates, or looking into bond ratings. The most important first step is a self-assessment of your values, your goals, and your emotional approach to money. Do you want to be able retire early? Is a family vacation home important?

Understanding how comfortable you are with the uncertainty of investing is important, because your risk tolerance should help guide how aggressive or conservative your investments are. Questionnaires have been developed that will help you determine your tolerance for risk, and numerous finance-related Web sites feature online risk-tolerance quizzes (as listed under Additional Resources). If you and your spouse have different feelings about risk, you will need to work out a compromise regarding your investments. A financial advisor can be helpful in making your investment strategy a joint effort. Financial advisors report that they often help couples identify differences in their approaches, and one of their key roles is to offer resolutions.

Investment Terms and Principles

Basic Principles of Investing With Which You Should Become Familiar

Risk and return. This is where your emotions related to risk come into play. Investments that are safer—meaning you are less likely to lose money—have lower rates of return.

Time horizon. The time horizon with regard to investing is the length of time before you need money for a particular financial goal. Money you need over the long term—for

example, for retirement—can be invested more aggressively, because you will be able to wait out the ups and downs of the market. If you might need the money in the next 2 or 3 years, it should be invested much more cautiously, so you will not have to cash in your investment in a down market.

Diversification. Diversification affords the greatest protection against business risk, financial risk, and volatility. Stocks, bonds, and cash equivalents are the most common asset categories, but categories such as real estate, precious metals, and other investments may also be part of a portfolio. Historically, returns in the three major categories have not moved in the same direction at the same time, so by diversifying, you can reduce the risk that the value of your entire portfolio will fall. You should also diversify within asset categories by investing in a diverse range of industries, such as technology, manufacturing, and utilities. Keep in mind that diversification is a method used to manage risk, not to guarantee against loss.

Rebalancing. As your various investments grow or decline over time, the asset allocation you began with will change. Assets may also need to be reallocated as you near your time horizon or as your goals change. You should periodically—at least once a year—look at whether your asset allocation is aligned as you wish. For example, if you want stocks to represent 50% of your total, but a surge in the stock market or in your particular holdings has raised their relative value to 65%, you will need to rebalance. You could sell some of your stocks or put more money into one of the other asset categories that has become underweighted.

Stocks

A stock represents a share in the ownership of an incorporated company. An umbrella term sometimes used for buying and selling stocks is equity investing. You are likely to encounter a variety of terms describing different types of stock as you consider stock investments.

Growth stocks. The stock of a company that has the potential to increase in value consistently over a long period of time is considered a growth stock. The downside of growth stocks is that they are often riskier and more expensive than other stocks. A growth stock pays little or nothing in dividends; profits are reinvested in the business.

Income stocks. Income stocks have lower levels of volatility and pay dividends that are higher than average over sustained periods of time. These dividends tend to be paid by large, established companies with stable earnings. Utilities and telephone company stocks are often classified as income stocks.

Value stocks. Value stocks are stocks considered to be undervalued. They are currently out of favor with investors but are expected to appreciate when market conditions change. Investors who buy value stocks believe that these stocks will soon experience great growth.

Small-cap stocks. These stocks are issued by small companies that have the potential to grow rapidly, but they are unpredictable. Many small-cap companies are relatively new, and because of their small size, growth spurts can affect their prices and earnings dramatically. Small-cap stocks are popular among investors who are looking for growth, who do not need current dividends, and who can tolerate price volatility. If successful, these investments can generate significant gains.

Mid-cap stocks. Mid-cap stocks are usually stocks of medium-sized companies. Stocks of many well-known companies that have been in business for decades are mid-cap stocks. As with small-cap stocks, growth is emphasized, but in contrast, mid-cap stocks pay relatively larger shares of earnings as dividends.

Large-cap stocks, or blue chip stocks. Stocks of the largest, most well-established companies, such as IBM or GE, are classified as large-cap stocks. Because of their large size, they are not expected to grow as rapidly as small-cap companies. Successful mid-cap and small-cap stocks tend to outperform them over time, but large-cap stocks pay relatively more in dividends. Investors who want their money to remain relatively safe over the long term are often attracted to large-cap stocks.

Price to earnings ratio. The price to earnings (P/E) ratio is the price of a share of stock divided by the earnings per share for the company's most recent four quarters. The P/E ratio is considered a much better indicator of the value of a stock than is the market price alone. Theoretically, the P/E ratio of a stock indicates how much investors are willing to pay per dollar of earnings. If the P/E ratio of a stock is quite a bit higher than the P/E ratios of other companies in the same industry, the stock may be overpriced; a relatively low P/E ratio may indicate the stock is undervalued.

Bonds

Bonds are issued by corporations, federal or state governments, and municipalities. A bond is a type of fixed-income security, meaning the principal that is invested provides a fixed return. With a bond, your investment will be repaid at a set date—called the maturity date—and in the meantime, you will receive periodic interest payments. Typically, longer-term bonds pay higher interest rates. Interest earned on US Government and corporate bonds is taxable, whereas interest from municipal bonds generally is not. Bonds are considered safer investments than stocks, and thus their rates of return are typically lower than those of stocks. Bond prices are inversely related to general market

Answers From Senior Oncologists

“What is the best financial advice you ever received?”

- “Save, save, and save some more!”
—Peter Eisenberg, MD, Greenbrae, CA
- “Avoid any investments made without three days of careful consideration. When anyone says ‘it’s not about the money,’ it’s usually all about the money.” —Dean Gesme, MD, Minnetonka, MN
- “Pay yourself 10% for retirement plans and long-term investments; live on the rest, but not beyond.” —Jack Keech, DO, Chico, CA
- “Buy less house than you can afford. Use financial advisors who are salaried rather than paid on commission for trades.” —Patricia Legant, MD, PhD, Salt Lake City, UT
- “Diversify your investments. Save some all the time. Live at the level you can sustain, not the level you can attain.” —Thomas Marsland, MD, Orange Park, FL
- “Work hard, be conservative in your spending, and pay attention to the overhead. Only a rich man can afford to buy cheap junk.”
—Albert Wendt, MD, Phoenix, AZ

interest rates, so as these interest rates rise, the prices of bonds will fall, and vice versa.

Bonds often have certain features that affect how they are traded. Two bond options commonly encountered.

Callable bonds. A call feature allows the issuer to pay off the bond early. Usually, the price of a callable bond will be a little higher than face value (called the par value). Calling a bond is usually done when market interest rates fall below the rate at which the bond was issued. If you hold a bond that is called, you receive the full amount of your original deposit, but you then have to shop for another place to invest your money at a time when the going interest rate is lower.

Convertible bonds. A convertible bond, issued by a corporation, may be converted into stock in the company that issued the bond, usually at a price substantially discounted compared with the market value of the stock. The corporation issuing a convertible bond sets the conditions for the conversion, including the stock price at which the conversion can occur. The risk for the investor is that the interest rate of a convertible bond is lower than those of other corporate bonds, and the stock price may never reach the target required for conversion. But the potential return is that the investor can benefit from a rise in the price of the stock of the company.

Mutual Funds

A mutual fund pools money from many investors and invests in many different stocks, bonds, and other securities, or some combination of these investments. The net asset value (NAV) of a fund represents the price of one share and is determined once a day.

You can earn money from mutual funds in three ways: dividend payments, capital gains distribution, and increased NAV, or the growth of the value of your shares. Mutual funds are not guaranteed or insured by the Federal Deposit Insurance Corporation (ie, the FDIC) or any other government agency, even if you buy through a bank and the fund carries the name of the bank. Thus, mutual fund investments will fluctuate, and when shares are redeemed, they may be worth more or less than they were when the money was originally invested.

A good figure to check out is the expense ratio of a mutual fund. This is the percentage of the total assets of a fund that go toward its administrative and operating expenses. The expense ratio of a fund is listed in both its prospectus and its annual report. There are a few main types of mutual funds.

Pros and Cons of Investing in a Mutual Fund

Advantages

- Professional management. Professional money managers research and choose the fund's investments.
- Spread-out risk. A mutual fund offers protection against the risk of a single company going bankrupt because it spreads investment across a wide range of companies and industries.
- Affordability. A mutual fund may set relatively low dollar amounts for purchases.
- Liquidity. You can redeem your shares at any time.

Disadvantages

- Costs despite negative returns. You must pay sales charges, annual fees, and other expenses regardless of how the fund performs.
- Lack of control. The fund's managers—or the computer model of an index fund—make the decisions. You cannot directly influence which securities are bought or sold, or the timing of those trades.
- Price uncertainty. You can monitor how the price of an individual stock changes from hour to hour, or even second to second. The net asset value of a mutual fund, in contrast, is calculated at least once every business day, typically after the major US exchanges close. Thus, you may place an order to buy or sell mutual fund shares, but the price will not be calculated until many hours later.

Money market funds. These assets are highly liquid, and investors are often able to write drafts on them, as with checking accounts. Money invested in a money market fund has traditionally not been guaranteed, but in the economic turmoil of 2008, the US Treasury initiated a temporary program to guarantee that money market mutual funds would not lose money. Each fund has to decide if it will participate in the program, which as of this writing has been extended through April 30, 2009. The US Treasury has advised investors to contact their money market funds directly to determine if they are participating in the program.

Bond funds, or fixed income funds. The three basic types of bond funds are those invested in US Government bonds, municipal bonds, or corporate bonds. A bond mutual fund offers more liquidity than does an individual bond, because trading shares in a fund is much easier than redeeming an individual bond. Bond funds are considered lower risk investments than are equity investments. As with individual bonds, the market value of bond funds goes down when interest rates go up.

Stock funds, or equity funds. Stock funds can rise and fall quickly (and dramatically) over the short term, but historically, stocks have performed better over the long term than have other types of investments, including corporate bonds, government bonds, and Treasury securities. Stock funds typically invest in certain types of stock, such as growth or income stocks, giving the funds profiles like the stock profiles described under Stocks.

Index funds. An index fund is a type of stock fund that buys stock in all or a sample of the companies in a particular market index, such as Standard & Poor's 500 Composite Stock Price Index. Index funds use computer models to buy and sell stocks, making the funds much cheaper to run than funds with fund managers who make these decisions.

Exchange-traded funds. An exchange-traded fund (ETF) is a type of index fund. Although ETFs are mutual funds, their assets are traded throughout the trading day, like stocks; they do not have daily NAVs like other stock mutual funds. Investing in an ETF carries the same risks as owning stock directly. ETFs have some tax advantages because the earnings are taxed at the capital gains rate (currently 15%) rather than at the rate for income in your tax bracket. This tax feature is a benefit only for after-tax investments, not for investments in retirement accounts such as 401(k)s or IRAs.

Government Issues or Treasuries

Government securities are the safest investments, but with the low risk of guaranteed investments comes the downside of relatively low returns. In addition to their low risk, treasuries have the advantage of being exempt from state and local taxes, although they are subject to federal tax.

You can buy treasuries through brokerages and financial institutions as well as online through the US Department of Treasury Web site (Additional Resources). There are a few common types of Treasury securities.

Treasury bills, or T-bills. You buy a Treasury bill for less than its face value and get the full value at maturity. The time to maturity can be from a few days to a year after the date the bill is issued.

Fixed-rate Treasury notes. You pay full face value, and they pay interest at fixed rates every 6 months until maturity. The dates of maturity can be 2, 3, 5, or 10 years out.

Treasury inflation-protected securities, or TIPS. As indicated by its name, a Treasury inflation-protected security provides a hedge against inflation. The principal of this 10-year investment goes up and down with inflation and deflation, as measured by the Consumer Price Index. You receive interest semiannually, and at maturity, you receive the original principal or the adjusted principal, whichever is greater.

EE/E savings bonds. These long-term bonds earn fixed interest rates that are determined every 6 months. Their maturity dates can be 20 to 30 years out.

Certificates of Deposit

With a certificate of deposit (CD), you invest a sum of money for a fixed period of time, such as 6 months or 1 to 5 years, and receive interest on it. You will receive a higher rate of interest if your money is tied up for a longer period. CDs are considered one of the safest investment vehicles, and therefore, they have relatively low rates of return. Most CDs have fixed interest rates, but some have variable rates. When you cash in a CD, you receive the money you originally invested plus the accrued interest. If you redeem the CD before it matures, you usually have to pay an early withdrawal penalty. Some long-term, high-yield CDs have a call feature similar to that described in Bonds.

Annuities

Annuities are long-term, tax-deferred investments commonly used for retirement income. An annuity is a life insurance product with a death benefit that will pay your beneficiary a guaranteed minimum. Annuities are not insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration, the federal agency that insures savings in federal and most state-chartered credit unions. There are two basic types of annuities.

Fixed annuities. With a fixed annuity, the rate of return is set, and the annuity pays you a fixed or guaranteed dollar amount over a defined period, such as 1, 3, or 5 years. Once the guaranteed period is over, the issuer sets a new rate for the

Additional Resources

- US Department of Treasury
www.treasurydirect.gov
- Securities and Exchange Commission
CDs: www.sec.gov/investor/pubs/varannty.htm
Annuities: www.sec.gov/answers/annuity.htm
- Bond Market Association
www.investinginbonds.com
- Morningstar (a mutual fund analysis company)
www.morningstar.com
- Risk Tolerance Quizzes
www.rce.rutgers.edu/money/riskquiz/default.asp
www.wellsfargo.com/retirement_tools/risk_tolerance?_requestid=24,139

next period. The rate of return is generally low, because this is a conservative, safe investment.

Variable annuities. With a variable annuity, the rate of return fluctuates, depending on how the investment performs. The value depends on the performance of a market index or a portfolio of securities in which the annuity is invested. In some cases, you can choose the investments within the account.

Annuity earnings are taxed as ordinary income when they are distributed. Like other tax-deferred accounts, if money is withdrawn before age 59 1/2 years, it may be subject to a 10% federal tax penalty.

Remain Disciplined in Your Investment Strategy

The current global economic turmoil makes it especially hard to determine what investment decisions to make. But today's financial volatility underscores the importance of diversification and knowing your own emotional tendencies regarding risk.

Financial experts recommend developing a systematic, monthly plan of investing, and using a disciplined buy-and-hold approach. Your investment plan should factor in your risk tolerance right from the start, so when the market becomes volatile, you will be able to sleep at night. The more you educate yourself on the basics of investing, and create and stick to a plan to reach your goals, the more likely it is that your future will be what you want it to be.

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