INVESTMENT OUTLOOK
FIRST-QUARTER 2020

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Saying goodbye to 2019 has surely brought a mix of memories and emotions to investors as they remember the elation brought by rising equity markets and portfolio values along with the despair brought by recession fears, tariff threats, and impeachment battles. While we hope the emotional roller coaster that investors ride in 2020 will not be as wild as last year’s “Coney Island Cyclone,” we do foresee continued volatility driven in part by the morning headlines.

One event taking place this summer that we can all turn to which reminds us of our “Better Angels” is the Summer Olympics in Tokyo. As we watch some of the best among us strive for golden glory, we can hope that their example will seep into our political discourse and bring about a golden year for investors.

A Look Back and Look Ahead

One helpful exercise we encourage all investors to practice at this time of year is to look back at the prior 12 months and review the assumptions made and actions taken regarding financial markets. A clear-eyed assessment of successes and failures should lead to an understanding as to whether successes were fact based or just pure luck, and likewise if failures arose from errors in analysis or just bad timing. Here, we assess our approach in 2019 and look ahead to 2020.
The Year Ahead

We began this note with the hope for a golden year for investors. Signs of a re-acceleration in global economic growth have become numerous, which should support financial markets this year. Inflation remains subdued, which supports central bank policies intended to spur their economies. We expect equities to rise in line with earnings growth this year, which should lead to gains in the high-single-digit range. Bond markets should be fairly steady this year as the forces of growth and low inflation create a benign environment.

Naturally, a steady DIET (Debates, Impeachment, Election, and Tweets) of morning headlines and daily angst will likely serve to roil investor confidence throughout the year. That said, we believe the underlying U.S. economy is strong and the global economy is improving. That should give investors the chance to earn a golden return in 2020.
GROWTH

The U.S. economy continues to expand but at a slower rate. Global growth has ebbed. We expect slow growth, less than 2%, in the U.S. and other developed markets in 2020.

JOBS

Job growth is due to decelerate as the economy slows and the labor market gets tighter.

INFLATION

Employment cost pressures will rise in 2020, but inflation will remain within the Fed’s 2% target.

INTEREST RATES

Modest but sustained growth is likely to keep the Fed on hold through 2020. Long-term rates remain capped by global demand for U.S. debt.

OIL

Improving global growth will put upward pressure on the price of oil, but opportunities for U.S. producers will keep oil under $85 per barrel barring a major Mideast supply disruption.

THE DOLLAR

The dollar is likely to come under pressure in 2020 as U.S. trade and fiscal deficits start to outweigh the benefit of being the world reserve currency.

ECONOMIC DASHBOARD

Smart investors know that market returns are often independent of the economy. Although an economy with accelerating growth is generally good for stocks, an investor can realize positive returns in other environments.

2019 is a case in point. GDP growth slowed from 2.9% in 2018 to an estimated 2.3% in 2019, and yet the S&P 500 was on track to return nearly 30% for the year as we went to press in late December. Bond returns have been equally surprising. Amid near-record-low interest rates, the Bbg/Barclays US Agg. was on track to return nearly 9% for the year.

We will not be so fortunate in 2020. We believe that markets will be more closely tied to economic outcomes this year, partly because they were so independent of the economy in 2019. Stock returns for 2020 will depend on earnings growth because valuations have more room to go down than up. Investors paid 14.1 times future earnings per share on the S&P 500 at the start of 2019 but were paying an above-average 18 times future earnings at the end of 2019. We do not think investors will go beyond year-end valuation levels without solid evidence of earnings growth.

Earnings growth, in turn, will likely depend on sales growth. As is the case for valuation levels, profit margins have more room to go down than up, and elevated margins are subject to erosion from rising costs. Any boost in earnings will therefore depend on higher sales.

Sales growth, in turn, depends on economic growth, and economic growth depends largely on the consumer. Fortunately, the consumer is in a good position to support continued economic growth. Jobs, earnings, and household finances are as good or better than they have been since the Great Recession.

Economic growth in 2020 is not likely to be as strong as in 2019. With the unemployment rate at a 50-year low, growth of more than 1.5% depends on increases in capital investment to improve productivity. Overall, we expect economic growth of less than 2% in 2020, stock returns of 6% to 7%, and bond returns of 3% to 4%. The New Year will not be as good for investors as the Old Year, and returns will depend more on the economy than in 2019.

Albert Brenner, CFA
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## Market Perspectives

### Equity

Returns on U.S. equities will likely be more dependent on economic outcomes in 2020 than in 2019. Slow economic growth will constrain revenue growth until policy uncertainties are resolved, business confidence improves, and capital investment increases. A U.S./China trade agreement will go part way to resolving uncertainties.

**U.S. EQUITIES**

Despite relatively high valuations and trade policy uncertainties, U.S. equities offers the best risk/reward option.

**INTERNATIONAL DEVELOPED MARKETS**

Likely to benefit from an inflection in global growth. We continue to favor currency-hedged euro stocks.

**TOTAL EQUITIES**

Downside risks from elevated uncertainties do not warrant an overweight.

**GROWTH | VALUE**

The late stage of the economic cycle favors growth, but the valuation divergence between growth and value appears extreme.

**U.S. LARGE/MID/SMALL CAP**

Large-cap stocks historically outperform in the late stage of economic cycles, but the recent breakout of small-cap stocks indicates a neutral allocation.

**EMERGING MARKETS**

Economic and market conditions in Latin America and developing Europe are unfavorable. Asian emerging markets are suffering from the slowdown in global trade.

### Fixed Income

Bonds remain a vital part of diversified portfolios to mitigate equity risk—especially during periods of elevated volatility. Bond returns for 2020 will likely be lower than 2019. Slow growth, a Fed on hold, and moderate inflation will keep interest rates rangebound near 2019 year-end levels. Total returns will approximate coupon returns.

**CREDIT RISK**

The yield advantage (credit spread) of corporate and high-yield bonds over Treasuries remains at the low end of historical ranges. We continue to watch credit quality carefully as default risk rises. We favor the higher-quality ranges of high-yield bonds.

**TOTAL BONDS**

We continue to be moderately overweight to bonds in the face of expected higher volatility for equity markets.

**DURATION**

Despite low rates, interest rate risk remains relatively symmetric. We continue to move the average maturity of portfolio bonds closer to benchmark index averages.

**INFLATION-INDEXED BONDS**

Real, or inflation-adjusted, interest rates have declined over the past six months leaving inflation-adjusted bonds subject to market-value losses when real rates recover.

### Cash, Real, & Alternative Assets

Cash and real assets help mitigate risk, but current circumstances are not right. The slow-growth, low-inflation, and low real-rate environment is not favorable for this asset class. A recovery in real interest rates will likely pressure gold prices and real estate.

**CASH**

With the return to a positive yield curve, cash no longer has an advantage compared to fixed income alternatives. Inflation-adjusted yields are likely to remain near zero.

**HEDGE-FUND STRATEGIES**

Low-volatility funds may help in managing risk in select portfolios. Selection is critical given wide dispersion among hedge fund strategies and returns.

**REAL ESTATE**

REITs benefited from falling bond yields in the first half of 2019. Valuations will be key going forward, as prices are near historic highs relative to operating cash flows and interest rates are rangebound. We remain underweight.

**COMMODITIES**

Commodity-market indicators are less bearish than last quarter but do not warrant an allocation change. We continue to be underweight.

**GOLD**

As noted last quarter, a reversion towards positive real rates will be negative for gold prices.

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suppose you want to add more large-cap stock exposure to your portfolio, and you are evaluating a number of actively managed mutual funds. How do you choose the right fund?

Most people will compare the recent performance of funds, or they will look at a fund’s rating, such as its Morningstar rating. Unfortunately, choosing investments based on past performance or ratings is often ineffective. Dalbar, a research firm that studies how investors typically behave, has consistently found that investors make flawed investment choices, often connected to their urge to act based on past performance*. In other words, the typical investor has a limited understanding of performance drivers and how those translate to a fund’s future prospects.

How We Select Active Managers

Active management can be the most valuable when it’s a long-term choice: You have to hold a particular investment through a full market cycle to assess and reap benefit from a manager’s decisions. With that as a backdrop, we evaluate active managers based on a range of characteristics:

Qualitative:
- The talent and continuity of the management team
- The rationale underpinning the fund’s investment strategy
- The decision-making process for buys and sells
- The compensation incentives for managers

Quantitative:
- Long-term track record
- Performance in both up and down markets
- Risk profile

A Preference for Downside Protection

Investors dislike losses more than they enjoy gains. Large losses during volatile markets can shake investor confidence and lead to misguided attempts to time the markets. And remember, the larger the loss, the greater the return required to get back to even. Therefore, we try to keep pace with the market in up markets and minimize losses for clients in down markets.

When we evaluate managers, we search for those with demonstrated track records of delivering strong risk-adjusted returns across full cycles. We believe that an investor can outperform with less risk over the long term by mitigating losses during market sell-offs. We also look beyond standard performance to clues about a fund’s likely behavior: For example, upside/downside, capture, style tilts, and concentration patterns are all useful inputs in that evaluation.

In sum, we try to select managers who can outperform over the long run with less risk. This helps our investors stay invested through volatile market cycles.

WHAT IS ACTIVE MANAGEMENT?

Portfolios can be managed passively or actively.

PASSIVE PORTFOLIOS

A passive portfolio is one that simply aims to mimic the performance of an index, such as the S&P 500, which means limited buying and selling. An active portfolio is one where the managers are actively choosing particular stocks or bonds, buying and selling when they feel the trades are most opportune.

ACTIVE PORTFOLIOS

A truly active portfolio, therefore, is one that is not identical to its benchmark. It can differ in a number of ways:

- Sector weights or factor weights
- The concentration of individual positions
- Ownership of out-of-benchmark securities
- Active trades month-to-month

Using Factors to Rebalance a Client’s Portfolio

We normally think about investment risk factors—such as value or momentum—at the individual security level. We decided to test whether the same factor logic works at the asset-class level. Specifically, we studied whether applying the momentum factor is a useful tool to manage quantitative, tactical asset allocation and its byproduct—portfolio rebalancing—in an effective way.

Momentum is the well-researched tendency for security winners to keep winning (for a period of time) and losers to keep losing. We measured momentum at the asset class level over 12 months, and used absolute and relative scores to determine what asset classes in particular to tactically overweight and underweight in a 60/40 portfolio. In this scenario, large-cap growth stocks compete against large-cap value, for example; small caps against large caps; international fixed income vs. U.S. fixed income; stocks vs. bonds vs. alternatives. We then compared the long-term investment results of this systematic asset allocation (from January 1976 to June 2019) with those of two other typical methods of rebalancing.

**Strategy 1**

In **Strategy 1**, we used a simple technique of rebalancing asset classes back to target allocation weights (e.g. 14.5% for large-cap growth, 12.5% for large value, 4% for global REITs, 31% for US bonds) each month. This method, which uses time rather than value as the trigger to rebalance, generated an annualized return of 9.3% for a 60/40 portfolio, 13.5% portfolio turnover, and an annual tax liability of 60 basis points for those investing in the presence of taxes.

**Strategy 2**

For **Strategy 2**, we set bands, or ranges, around asset classes, a very common rebalancing technique in the investment industry. Specifically, we set 10% bands, which implies that if an asset class with a target weight of 20% appreciates to a 22% weighting in the portfolio (or falls 10% to an 18% position), then rebalancing is triggered. Compared with Strategy 1, this rebalancing strategy generated a higher annualized return (9.5% vs. 9.3%), but a higher tax cost (90 instead of 60 basis points) and much higher (29%) portfolio turnover. When viewed through the lens of returns over various rolling-year periods, Strategy 2 boasted quite a high win-rate, beating Strategy 1 pretax in 74% of the 5-year periods, 88% of the 7-year time frames, and 93% of the 10-year rolling periods.

**Strategy 3**

For **Strategy 3**, we employed the momentum factor, allowing asset-class winners to drift higher with momentum and losers to drift lower than permitted by the target bands described in Strategy 2, and we permitted this allocation skew until the momentum signal reversed. For instance, by riding winners, the large-cap growth allocation (which had a benchmark allocation of 14.5%) had an average weighting of 15.7%, while in the second strategy it averaged 15.2%.

In our study, Strategy 3 generated the highest return (10.1% annualized), lower turnover (20%) than for Strategy 2, an 80-basis point tax cost, and the best risk-adjusted return (as measured by the Sharpe ratio*). In terms of batting average, Strategy 3 is a "slugger", outperforming Strategy 1 in 97% of the 5-year rolling periods, and 100% of the 7- and 10-year periods.

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*Sharpe Ratio is a measure used to help understand the return of an investment compared to its risk. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return.
The Benefits of Estate Planning

Estate planning is a crucial component of financial stability, and it can actually be a simple process. Even for families or individuals with more complex tax planning considerations, the options are finite and straightforward. And the benefits are well worth the effort:

Ensure your wishes.
Estate planning can give you the peace of mind that your wishes will be carried out after you’re gone.

Simpler, faster resolution for heirs.
The process of administering an estate after the passing of a loved one can be simple and efficient—or cumbersome and conflicted. A small amount of structure goes a long way.

Effective planning for taxes.
For families or individuals whose net worth is expected to surpass estate tax limits, planning tools can drive efficient organization of your assets for tax purposes.

Cover your living needs.
Estate planning tools also protect your wishes and assets in a circumstance where you become incapacitated or otherwise unable to manage your own affairs. Some tools, such as life insurance or select types of trusts, can also act as dual-purpose assets meant to support loved ones after you’re gone while providing accessible value to you in your living years.

When There Is No Plan
Estates are governed primarily by state law, and if someone passes away without essential documents in place, there is a default process for how their estate is handled. While every state is different, a few basics generally apply:

Everything goes through the probate process.
Probate courts are special courts that resolve the debts and assets of the deceased. Without estate documents and structures, a probate court will collect evidence of all liabilities and assets, oversee the process of paying taxes and other debts, and distribute remaining assets to heirs. The court will appoint an executor to manage the administration. The process can take anywhere from several months to years, in extreme cases.

Assets go to next of kin.
Every state is slightly different, but assets are generally disbursed to next of kin, including spouses or children, or more distant relatives if needed.

MAXIMUM ESTATE TAXES MAY APPLY
Estates may be subject to federal or state taxes, upon death, if the total value of the estate exceeds current limits.

FEDERAL LIMIT OF $10M
(IN 2011 DOLLARS),
INDEXED TO INFLATION
FOR FUTURE YEARS

The Tax Cuts and Jobs Act of 2017 updated the base exemption amount for gift and estate taxes to $10 million (in 2011 dollars, indexed each year to inflation), up from the prior base of $5 million (also indexed to inflation). For 2020, the exemption limit is $11.58 million ($23.16 million for married couples when estates are handled properly). We do note, however, that the legislation has a “sunset” provision—the $10 million base will revert back to the old $5 million base as of 2025, unless new legislation is passed to preserve it.

Think of it this way: over your lifetime, you can gift or bequeath a total of $11.58 million to heirs. The value of your estate above that amount is subject to federal estate taxes of up to 40%. If you have distributed prior annual gifts in excess of the annual gift limit, the value of excess gifts is added back to your estate for determining taxable assets.

STATE INHERITANCE AND ESTATE TAXES
Some states have their own estate or inheritance tax (or a combination of the two), often at a lower threshold for estate value than for federal taxes. Consult your tax advisor for the specifics of your state.
Times are changing for retirees. Those approaching that milestone today, or already past it, are likely to see a new set of opportunities and challenges.

For many, 65 is no longer the magic retirement age. Some have the financial wherewithal and the desire to leave their jobs early; others retire later. Indeed, almost 20% of Americans today are still working past 65—and some much longer—either because they wish to or need to. And so with retirement more a customized process than a moment in time, what issues arise? “Heat maps” highlight important trends; here’s ours on retirement:

Less Certainty
Transitioning into retirement today comes with lots of questions. A key driver of the new uncertainty is the near-demise of “defined-benefit” (DB) pension plans in the corporate sector. Once the mainstay, DB plans (which assure predetermined income funded by employers) now cover a small minority of private-sector workers. In their stead are defined-contribution (DC) plans, funded and allocated largely or totally by employees. Since employees usually invest in the unpredictable securities markets, they may wind up in worse shape than if they had DB plans. More dangerous is a decision by employees not to fund their plans. In either case, they face the scary possibility of outliving their money.

Bigger Upside?
Uncertainty is a double-edged sword: DC plans can leave workers with a windfall. And apart from monetary issues, since the huge Baby Boomer generation is retiring, more and more leisure and self-realization activities are becoming available, especially in response to...

...Longevity
About one out of every three 65-year-olds today will live past 90, the Social Security Administration tells us. This is another double-edged sword: The extra years can be great, but the longer you live, the greater the chance you’ll require...

...Long-Term Medical Attention
The odds today are almost 50/50 that at least one member of a 65-year-old couple will live to 90. (See Figure 1 below for more information). This is another double-edged sword: The extra years can be great, but the longer you live, the greater the chance you’ll require...

The Blessing and Limits of Social Security
Social Security is rightfully beloved, and it’s not going broke. But it typically replaces only about 40% of pre-retirement income; most retirees need between 70% and 100%. So finding other funding sources is critical, especially today, when so many retirees are fending for themselves financially. For more information on Social Security, see our new white paper (peoples.com/wealth).

Savings, Savings
Accumulating a nest egg for retirement—one not totally dependent on a DC plan and Social Security—is more important than ever. Ditto for figuring out a spending budget: When the earned income stops, will easing the amount annually to account for inflation work?

Financial Advice
Since workers have become more responsible for securing their own comfortable retirements, many rely on expert advice. For most retirees, that includes not abandoning stocks; their growth potential can help portfolios last through longer retirements.

What Hasn’t Changed
Some things about retirement have always been trending. It’s always come with dislocation, especially for those whose identities were closely tied to their careers.

But it can also be a joyous transition, when retirees spend more precious time visiting with their families and following their own interests and passions.
Resolved: No Resolutions; Good Habits Instead

New Year’s resolutions are noble-minded, but they have a lot going against them: They tend to be too broad, devoid of solid implementation, and too negative—focused on who you aren’t rather than who are you are but would like to make better.

Why Habits, Not Resolutions

New-year resolutions probably won’t work out well; if surveys are correct, the failure rate for those who make them may be above 80%! Instead, say many behavioral scientists, put your energy into building good habits. Habits may take some time to fold into your routine, but they ultimately become part of your life, strengthened by repetition. And if they’re good habits, they carry the seeds of their own rewards—although an occasional celebration for a job well done can be a great reinforcer.

EIGHT INVESTMENT HABITS WORTH DEVELOPING

<table>
<thead>
<tr>
<th>Habit</th>
<th>Description</th>
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<tbody>
<tr>
<td>HAVE A PLAN</td>
<td>We’ve said it before, but it’s worth repeating: Set out your short- and long-term goals, your needs and wants (with priority to the former), and a time line for achieving them. Then monitor that plan regularly—at least once a year; your objectives are likely to change over time.</td>
</tr>
<tr>
<td>STAY INVESTED</td>
<td>Market returns have come in sudden and unpredictable bursts. If you missed just the 10 best days of the S&amp;P 500 out of roughly the last 30 years, you’d have cut your wealth in half—and in half again if you missed the best 25 days. Sure, if you missed the worst days, you’d have done great, but it’s a losing game to try to time the market. And don’t check your portfolio day in and day out: It will fluctuate in value—but it’s long-term growth that counts.</td>
</tr>
<tr>
<td>FEED YOUR PORTFOLIO THROUGH THE YEARS</td>
<td>The more you save, and the earlier you start, the better. But just as it’s never too early to begin investing, it’s never too late. And don’t forget to keep a regularly-replenished “emergency fund” of enough cash to get you through at least six months.</td>
</tr>
<tr>
<td>KEEP YOUR PORTFOLIO DIVERSIFIED</td>
<td>A global mix of different types of stocks, bonds, and, for some investors, “alternatives” like commodities helps mitigate the risk of any one asset and expand return opportunities. But you can’t guess which asset will be at the top at any given time, so you need to stay invested in all that fit your plan.</td>
</tr>
<tr>
<td>“AUTOMATE” WHAT YOU CAN</td>
<td>To help you add funds regularly, you should consider automatic deductions from your paycheck into your investments, if available.</td>
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<tr>
<td>MANAGE YOUR MONEY WITH TAXES IN MIND</td>
<td>And be aware of tax-limiting strategies all year, not only at year-end. According to Morningstar fund evaluators, U.S.-stock funds on average gave up two percentage points of annual return to taxes over the past three years. Over time, a tax drag of that magnitude would erode lots of wealth.</td>
</tr>
<tr>
<td>START PLANNING FOR RETIREMENT EARLY</td>
<td>Be prepared to replace at least 70-80% of your pre-retirement income, don’t sell all your stocks, (you’ll probably need the capital appreciation that stocks can provide over time) and contribute regularly to one or more tax-deferred savings plans. (See “A Retirement ‘Heat Map’” on Page 9.)</td>
</tr>
<tr>
<td>SEEK PROFESSIONAL ADVICE</td>
<td>Some investors—but not many—can handle all of the above (and more) by themselves. For most, though, having investment experts on their side is a powerful benefit.</td>
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*Source: U.S. News & World Report*
n fourth grade the joke went like this: What’s black and white and red all over? The answer was the newspaper.

Today, the answer to that joke might be “your financial plan,” but it’s not read all over. In fact, the challenge for many affluent Americans is that their financial plan is gathering dust. This shouldn’t be the case. The best financial plans are typically those that are updated—annually at a minimum. Life changes. Circumstances unfold in ways we couldn’t predict.

In fourth grade, you pictured life as a straight and narrow line at the end of which you’d be playing professional football or dancing in the New York City Ballet. Today, you might have a more reasonable view of reality.

Keep your plan fresh

Life changes. Your children grow. Your attitude about retirement moves in a new direction. Your parents require elder care. Your job sours. The market corrects, and then again! These are just a handful of the dynamics that may stampede through your life. Update your plan. Work with your advisor to adhere to a yearly meeting where you candidly assess your life’s needs, goals, and changes.

Keep it relevant

There are new ways to invest, new approaches to thinking about your legacy. You may discover satisfaction in applying some of those new approaches in your investments.

Greet 2020 with a refreshed financial plan

Talk with your advisor. Check in with him or her and review your data. Are your beneficiaries still in place? Do you need to adjust titling on your home or other real estate? Have you contributed fully to your IRA and have you reviewed your outstanding debt?

Whether it’s a long Hail Mary pass—your retirement—or a more baroque allocation to college funds; special purchases; a second home fund; a retirement for you; with a separate one for your spouse; who—according to the actuarial tables may outlive you by eight or twelve years—the best time to update your financial plan is today.

LET’S GET SERIOUS:
Your financial plan in seven steps

1. GET HONEST.
   Face your goals eye-to-eye. Take a breath and assess. The best plan is a plan that reflects who you are; what you’re seeking to do with your life; how you’re managing your money today, including your debt; and who and what you need to provide for.

2. GPS YOUR MONEY.
   If your take-home pay looks like the familiar 50/30/20 per cent rule, you’re in good shape. Anything other, it’s time to take control. 50% for core housing, utilities and basic recurring payments; 30% toward your standard good-living quotient; 20% toward savings and debt repayment.

3. IF IT’S THERE, USE IT!
   If your employer offers a match on the defined contribution plan (most often a 401(k)), use it!

4. RAINY DAY READINESS.
   Set aside emergency funds. One or two months salary? You’ve seen the research—according to CNBC, 40% of Americans would have difficulty paying for an unexpected $400 bill. Building good credit is crucial too: Better credit will help you with the rates you’re offered.

5. DOWNSIDE YOUR DEBT.
   Debt unintended is debt that can destroy even the best laid plans. Address your exposure by reducing debt. Credit card debt, particularly expensively-priced debt, can lead to a disaster for your finances.

6. SAVE AND INVEST.
   Recalling that 20% is ideally set aside as a monthly savings amount from your take-home pay, make sure you’re paying attention to how it’s disposed. Make that 20% work hard. Savings rates are low these days. But there are other liquid investments that can help your portfolio grow.

7. GO LONG AND GO STEADY.
   The best plans are long-term plans. Compounding is the eighth wonder of the world, said a certain Nobel Prize laureate named Albert Einstein. Let your money grow by starting to invest early and regularly.
Working with People’s United Advisors, Inc.

People’s United Advisors, Inc. helps institutions, employers, and individuals and their families navigate investment, trust, retirement, banking, and planning challenges. Our experienced professionals work as a team, bringing specialized knowledge and solutions to the conversation.

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Our culture is one of prudence and risk-aversion.

We deliver solutions that matter, and do so through honest language.

Experienced and tested, we are focused on delivering complete solutions.

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