

December 2009 Issue

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Calmly Reassess Your Portfolio

The recent market volatility has been more pronounced and of longer duration than many expected, making it difficult to determine how to adjust your portfolio. Should you leave it alone, hoping the market will quickly rebound to much higher levels? Or should you sell everything and stick your money in cash accounts? The appropriate answer probably lies somewhere between those two extremes. What you should do is thoroughly review your portfolio and make any necessary adjustments. Consider these tips when analyzing your portfolio:

- **Take another look at your financial goals.** Now it's time to face reality. If your portfolio declined substantially over the past couple of years, it will probably affect your financial goals. Recalculate how much you need to save on an annual basis to reach those goals, based on your portfolio's current value and a reasonable rate of return. Be prepared to readjust your goals. For many people, one of the most painful results of the market declines has been the realization that they are now going to have to delay retirement to ensure they have an adequate retirement portfolio.
- **Set an allocation strategy for the long term.** The most basic investment decision you'll make is how to allocate your portfolio among the various investment categories, such as cash, bonds, and stocks. You want to ensure your portfolio is diversified among a variety of investments, so when one category is declining, hopefully other categories will be increasing or at least not decreasing as much. To decide how to allocate

your portfolio, you'll first need to come to terms with your risk tolerance. Factors like your time horizon for investing and return expectations will also impact your decision. Once you've decided on an asset allocation strategy, you'll need to adjust your current portfolio to get it in line with that allocation.

- **Thoroughly review each investment in your portfolio, and decide whether you should continue to own it.** Some stocks will rebound from the recent market declines, while others will probably never rebound. If you think an investment won't rebound or will take a long time to do so, sell it and reinvest in others with better prospects. It's a painful thing to do, since most investors have an aversion to selling at a loss. But it's an important step if you want to make sure your portfolio is on track going forward. Also make sure your remaining investments are all adding diversification benefits to your portfolio. Just because you own a number of investments doesn't mean that your portfolio is properly diversified. Often, investors keep purchasing investments that are similar in nature. That doesn't add much in the way of diversification, while making the portfolio more difficult to monitor.
- **Look for investments you'll be comfortable owning for the long term.** It's tempting to look for the biggest winners in investments and put your money there. In essence, however, you are chasing yesterday's winners rather than tomorrow's winners. You need to keep in mind that the best performing investment category will change from year to year. A better strategy may be to select a diversified portfolio of investments you'll be comfortable owning for the long term, so you have some money invested in each of the major investment categories.
- **Use dollar cost averaging to invest.** If you've been investing throughout the market declines, you have probably been purchasing at lower and lower prices, making you wonder whether it makes sense to keep putting money in the market. The point of dollar cost averaging is to invest a set amount of money in a certain investment on a periodic basis. When prices are lower, you will purchase more shares than when prices are higher, following half of the investment principle of "buy low and sell high." But the most important part of dollar cost averaging is that it forces you to continue investing when you really don't want to invest. In the long run, when and if the stock market rebounds, you will probably be glad you had the discipline to continue investing during the market downturn. (Keep in mind that dollar cost averaging does not guarantee a profit or protect against losses. Because it involves continual investment regardless of fluctuating prices levels, you should consider your ability to continue investing through periods of low price levels.)
- **Pay attention to taxes.** Taxes are probably your portfolio's most significant expense. Ordinary income taxes on short-term capital gains and interest income can go as high as 35%, while long-term capital gains and dividends are taxed at rates not exceeding 15% (0% if you are in the 10% or 15% tax bracket). Using strategies that defer income taxes for as

long as possible can make a substantial difference in the ultimate size of your portfolio. Some strategies to consider include utilizing tax-deferred investment vehicles (such as 401(k) plans and individual retirement accounts), minimizing portfolio turnover, selling investments with losses to offset gains, and placing assets generating ordinary income or that you want to trade frequently in your tax-deferred accounts.

- **Review your portfolio at least annually.** You can't just adjust your portfolio now and then leave it on autopilot. You need to keep an eye on your portfolio, in case market or company situations require changes. By reviewing your portfolio annually, you'll have an opportunity to make adjustments on an ongoing basis, which should prevent major overhauls in the future.

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Answer These Questions

First

Investments in bonds should be tailored to your investment objectives, risk tolerance, and other personal circumstances. Answering some fundamental questions will help you determine the role bonds should have in your portfolio:

What are your overall investment objectives? Investors committed to growth are looking for appreciation of capital with little concern for income, so bonds will have a minimal role in their portfolios. Total return investors want a balance of income and capital appreciation, so bonds will be more important in their portfolios. Income investors are looking for interest or dividend income with capital appreciation a secondary concern, so bonds will have a significant role in their portfolios.

What's your investment time frame? When selecting bonds, you should consider when you will need the principal. Typically, yield increases as the maturity date lengthens, since you assume more risk by holding the bond for a longer time. Investors are often tempted to purchase bonds with long maturity dates to lock in higher yields. However, use that strategy with care. If you purchase a long-term bond and sell it before maturity, interest rate changes can significantly affect the bond's market value. Although you can't control interest rate changes, you can limit the effects of those changes by selecting bonds with maturity dates close to when you need your principal.

What is your risk tolerance? Typically, the higher a bond's return, the greater its risk. Thus, U.S. Treasury securities, which are considered one of the safest bonds, typically carry lower rates than municipal or corporate bonds. Make sure you understand the risks involved before purchasing a specific bond.

Are you concerned with minimizing taxes? Interest income from U.S. Treasury securities is exempt from state and local income taxes, but it is subject to federal income taxes. Interest income from municipal bonds is exempt from federal income taxes, and typically is exempt from state and local income taxes for residents in the issuing state. Interest income from corporate bonds is subject to federal and state income taxes. Investors in higher tax brackets typically find tax exemption of interest income more valuable. Be aware that any exemption from income taxes applies only to interest income. Capital gains from the sale of a bond are still subject to taxes.

What variables should you consider before purchasing a bond? Before you purchase a specific bond, make sure you fully understand its features and can answer the following questions:

- What is the bond's maturity?
- What is the bond's credit rating, and is it insured?
- Does the bond have call provisions?
- What is the coupon rate?
- What is the bond's price?
- What is the yield to maturity?
- How is the bond's interest income taxed?

Keep in mind that bonds are subject to purchasing power risk, or the risk that its purchasing power will decrease due to inflation; interest rate risk, or the risk that interest rates will increase and cause the bond's value to decrease; and default risk, or the risk that the issuer will not repay the principal or interest on the bonds.

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Should You Pay Off Your Mortgage before Retirement?

A recent study found that 41% of homeowners between the ages of 60 and 69 still have a mortgage on their home. Of those, 51% had sufficient assets to repay

their mortgage (Source: Center for Retirement Research, July 2009). The study found that most households would be better off paying their mortgage off, since the cost of the mortgage is higher than their investment earnings. But is that good advice for your situation?

Before making this decision, be sure to consider these factors:

- **Compare your mortgage interest rate to the rate you are earning on your investments.** If you retain your mortgage because you believe you will earn more on your investment assets, make sure that is really happening. When paying off a mortgage, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk. Very few investment alternatives have a guaranteed return with no risk.
- **Consider the tax benefits of the mortgage interest.** Interest paid on mortgages with balances of up to \$1,000,000 and on home-equity loans up to \$100,000 is deductible on your federal tax return, provided you itemize deductions. You only benefit if your total itemized deductions exceed the standard deduction amount, which in 2009 is \$11,400 for married couples filing jointly and \$5,700 for single taxpayers. According to the IRS, approximately two out of three taxpayers use the standard deductions. Even if you do itemize deductions, you are paying most of the interest cost yourself anyway. For instance, if you're in the 25% tax bracket, you save 25 cents in taxes for every dollar of interest, but you're still paying the remaining 75 cents.
- **Pay off consumer debt first.** Consumer debt typically carries higher interest rates than mortgage rates, and interest payments are not typically tax deductible, unless it's a home-equity loan. Thus, you should probably pay off your consumer debt in full before paying down your mortgage.
- **Consider which funds you would use to pay off the mortgage.** If you are planning to use tax-deferred monies, such as those in a traditional IRA or 401(k) plan, to pay off your mortgage, those withdrawals could be subject to income taxes, which will impact your decision to pay off the mortgage. Financially, it is typically better to use taxable accounts to pay off your mortgage.
- **Retain some savings.** You don't want to use so much of your investment assets to pay off your mortgage that you have difficulty paying for unexpected expenditures.

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The Recession's Impact on Higher-Income Families

It's commonly believed that recessions impact lower-income families more than higher-income families. However, a recent study by economists at Northwestern University found that the relative income loss during recessions for the top 10% of the population is 26% greater than the average household, while it is double the average household for the top 1% of the population. It is still probably tougher for the average family to deal with income declines, but the impact on the economy is certainly greater when higher-income families lose income. Consider the following (Source: *Newsweek*, July 20, 2009):

- **A significant portion of consumption spending is made by higher-income families.** For instance, in 2009, households with over \$200,000 of income represented 3.4% of the number of households, but generated almost 14% of consumer spending. Households with income between \$100,000 and \$200,000 represented 14% of the number of households and 34% of spending. Combined, these two groups generated almost half of all consumer consumption, while accounting for only a sixth of the total population.
- **Higher-income families pay a significant portion of all income taxes.** In 2006, taxpayers with the highest 1% of income paid 28% of all federal taxes, while the top 10% paid 55% of all federal taxes.
- **A substantial portion of charitable giving is made by higher-income families.** In 2004, the top 1.5% of American families based on net worth made approximately 27% of all charitable contributions, while the next 7% made 20% of all contributions. Thus, one tenth of all American families made nearly half of all charitable contributions.

Thus, when higher-income families are faced with a substantial income loss, it can seriously drag down the economy. For instance, from 2007 to 2008, families with income between \$150,000 and \$250,000 reduced spending by 8%, while families with incomes over \$250,000 reduced spending by 15%.

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Review Your Estate Plan

Between the fluctuating stock market and declining home values, the value of your assets has probably changed dramatically over the past couple of years. Thus, you should probably take a look at your estate plan, considering the following:

- **Take another look at your plans for distributing your estate.** Your estate plan may distribute specific assets to specific heirs, such as a business to one child and investments to another child. While those assets may have been equal in value in the past, that may have changed. You may want to place provisions in your estate plan to equalize distributions.
- **Review amounts being placed in different trusts.** Many estate planning documents indicate that trusts should be funded with assets equal to the exemption amount or the generation-skipping transfer tax exemption amount. Lower asset values coupled with significantly larger exemption amounts could result in placing too large a percentage of your estate into trusts.
- **Use lower asset values to leverage your lifetime gifting strategies.** In 2009, you can gift up to \$13,000 (\$26,000 if the gift is split with your spouse) to any individual free of gift taxes. This amount is adjusted annually for inflation, in \$1,000 increments. You can also gift up to \$1,000,000 during your lifetime without paying gift taxes. When asset values are low, you might want to gift some of those assets to your heirs. There are other strategies to leverage gifts, such as setting up trusts that discount the value of the gift and using family limited partnerships or limited liability companies.
- **Consider converting traditional individual retirement accounts (IRAs) to Roth IRAs.** While your adjusted gross income cannot exceed \$100,000 in 2009 to convert, anyone can convert next year. Amounts rolled over from a qualified pension plan, such as a 401(k) plan, to a traditional IRA can also be converted to a Roth IRA. Transferred amounts must be included in income if they would be taxable when withdrawn (e.g., contributions and earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal tax penalty. While there are many factors to consider before converting, a major factor is the ability to pay the income taxes with funds outside the IRA. With lower investment values, your tax bill will be lower also. Once the IRA is converted to a Roth IRA, qualified distributions, whether taken by you or your heirs, will be received on a tax-free basis.