Our Two Cents

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The Asset Allocation Puzzle

Possessing a considerable amount of knowledge about stocks, bonds, and cash is only a small part of the investment planning process. Many investors are under the false notion that the greatest determinant of portfolio performance is the specific investment choices that they make. In reality, the biggest decision you will make is how much to allocate to different investment categories. Asset allocation is all about finding the mix of investments that is right for your situation. Goals, time horizon, and risk tolerance are some of the key factors that should be taken into consideration when allocating assets.

Goals: Determining what asset allocation is appropriate depends largely on the goals you seek to achieve. Are you saving for retirement, college education for your children, or a vacation home? Each goal must be considered in creating the appropriate asset mix.

Time Horizon: Time horizon is the length of time your portfolio will remain invested before withdrawals need to be taken. If your average investment horizon is fairly short, you will most likely want a more conservative portfolio—a portfolio with returns that do not fluctuate too much. If your investment time horizon is longer, you can most likely invest more aggressively.

Risk Tolerance: Everyone has a different emotional reaction to sudden changes in their portfolio value. Some people have trouble sleeping at night because they are too busy worrying about how their portfolio is performing. Other investors are unfazed by fluctuations in the market and can endure the uncertainty associated with more risky investments.

As you can see, the asset allocation decision is not an easy one and it may be best to work with an investment advisor who can piece together a plan that is right for you.

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Advisor Corner

I hope you enjoy our new newsletter. We want to bring you informative and timely information for your consideration. Let us know if you have a specific topic in mind and your feedback is certainly welcome.

We are also in the process of updating our website and social networking. Details to come.

Thank you for your business and we look forward to seeing many of you this fall during our investment and tax planning meetings.

The Future of Taxes

Now that our 2009 taxes have been filed and the lucky ones have received their refunds, nobody even wants to think about next year's returns. The Obama administration is pushing for major tax increases in 2011, which is causing many unhappy Americans to take to the streets in so-called tea-party rallies. It is important that you, as a taxpayer, be informed about these changes and consider which ones will affect you most.

Income Tax: The current tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are set to expire at the end of 2010. The proposed change for next year will eliminate the bottom bracket of 10% and change the remaining five to 15%, 28%, 31%, 36%, and 39.6%. The income thresholds that define these tax brackets will also change. It is highly likely that we will all pay more taxes next year.

Capital Gains Tax: Currently, long-term capital gains on investments are taxed at 0% for taxpayers in the two lowest brackets, and at 15% for everyone else. When these rates expire at the end of 2010, capital gains tax is projected to become 10% for taxpayers in the lowest tax bracket, and 20% for everyone else.

Dividend Tax: Whenever you receive dividends from your investments, you're supposed to pay tax on those dividends. In 2003, President George W. Bush signed a law under which qualified dividends were taxed at the same rate as long-term capital gains: 15%. This tax law is also set to expire in 2011; the current plan is to bring dividend taxes in line with ordinary income tax rates. So, if you're in the top tax bracket, you will pay 39.6% dividend tax, as opposed to only 15% last year.

Estate Tax: In 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001, a 10-year tax act that would expire in 2011. This act eliminated the federal estate tax for people dying in 2010. However, there is talk of maintaining the 2010 estate tax at its 2009 parameters. What will happen in 2011 is also uncertain. Unless changed beforehand, 2011 estate taxes will revert to pre-2001 rates, which could mean a marginal rate of up to 55%.

Other Taxes: For families with children, it may be good to know that the $1,000 child tax credit will revert to $500 after 2010.

After reading and understanding in detail which changes will apply to your situation, the next step is to decide how you want to reorganize your investments in order to minimize the impact of these tax increases. One option you might want to consider is municipal bonds, which are generally exempt from federal income taxes. These bonds can also be exempt from state and local taxes, but different states have different rules, so be sure to check before investing.

Another option would be relocating your investments, for example putting high-tax investments in your 401k (tax-deferred) account and low-tax investments in your taxable one. Since you will probably fall under a lower tax bracket in retirement, tax-deferred retirement plans can be a valuable investing tool.

Proposed Changes to Tax Rates

	2010	2011
Personal income tax	10% to 35%	15% to 39.6%
Long-term capital gains tax	Maximum of 15%	Maximum of 20%
Qualified dividends tax	15%	Ordinary income tax rate
Estate tax	Maximum of 45%	Maximum of 55%

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How to Handle Beneficiary Designations

Designating beneficiaries for your company retirement plan, life insurance policies, and other assets might seem like a no-brainer. Chances are you would like those near and dear to you to inherit any money you've accumulated during your lifetime, so making sure that happens should be as simple as writing their names on the appropriate forms, right? Well, if only it were that simple. Naming beneficiaries can be more complicated than you might think, and it's a decision that may have significant repercussions for your loved ones.

Know the Basics: You can name almost anyone, or anything, as your beneficiary, including individuals, charities, and trusts. However, it is important to note that children under the age of majority—18 or 21, depending on the state in which you live—cannot be named as beneficiaries of life insurance policies, retirement plans, or annuities. If a beneficiary is not designated, assets will have to go through probate, which can be a lengthy and costly process. Also, be aware that beneficiary designations will override bequests you've made in your will, so please do not rely on your will to sort out these issues. This leads to our second point.

Keep Your Designations up to Date: It would be advisable to review your beneficiary designations on a regular schedule, ideally as part of an annual review of your finances. Major life events, such as a marriage, a divorce, the birth of a child, or the death of a loved one may require that you make changes to your designations. Don't procrastinate on this, as it may end up affecting others' lives. Moreover, you'll also want to review your designations if you or your employer have recently switched retirement-plan or insurance providers. You should not assume that the beneficiaries you specified with your previous provider will automatically carry over to the new one.

Bear in Mind the Tax Consequences: If you decide to designate someone other than your spouse as the beneficiary of your company retirement-plan assets, he or she may have to take mandatory distributions from that plan and, in turn, pay taxes on the money. Your spouse, on the other hand, will be able to roll over your retirement-plan assets into his or her own individual retirement account (IRA) and won't have to pay taxes until distributions begin. There can also be estate taxes to keep in mind if you name a beneficiary other than your spouse. Needless to say, it would be in your best interest to speak with a tax advisor or someone who specializes in estate planning to go over possible tax ramifications.

Be Specific: It pays to be as specific as possible when designating beneficiaries. Most beneficiary designation forms allow you to name multiple primary and contingent beneficiaries and to specify what percentage of assets you'd like distributed to each upon your death. For example, you can state: "I hereby designate my wife, Jane Smith, as primary beneficiary" or "I hereby designate my two children, John Smith and Allison Smith, as contingent beneficiaries, with the proceeds to be divided equally among them." Of course, it is recommended that you discuss these important matters with your family members beforehand, so that they are prepared and know what to expect.

You Can Use a Legal Trust as a Beneficiary: What if you are in a situation where you can't (or you don't want to) name a person as a beneficiary? You can use what is called a legal trust. A trust means that you don't leave the money directly to the beneficiary, but to an institution (such as a bank) who manages it for the beneficiary. This is especially useful when minor children or disabled relatives are involved. A trust can be revocable (you can change the provisions later), or irrevocable (can't be undone).

Dangers of Market Timing

Two of the most dangerous words in the investing world are “market timing.” Market timing occurs when investors try to predict which direction the stock market will head. While some investors have been known to make money timing the market, it is highly inadvisable for long-term investors to try this extremely risky strategy. Opponents of Market Timing: Most investors and academics believe it is impossible to forecast market movements. Such a technique amounts to gambling when compared to a sound investment approach. It fails far more than it works, and market timers often end up buying high and selling low. Furthermore, you run the risk of missing periods of exceptional returns. For example, over the past 20 years, a $1 investment in stocks, as represented by the Standard & Poor’s 500®, would have grown to $4.84. If that same $1 investment happened to miss the best 10 months of stock returns over the past 20 years, the ending value would have equaled only $2.04. This would have been less than the value for an investor in a 30-day Treasury bill, a.k.a. cash, $2.12. Only those who remained invested in stocks through the entire period were sure to get market exposure during the crucial hot months.

Advocates of Market Timing: On the contrary, a number of websites, newsletters, and other trading services boast they can time the market. While their returns may have in fact beaten the market by a considerable margin, it’s safe to assume that these systems can’t consistently hold up over the long term. On some occasions and during some stretches of time, market timing can help generate impressive profits. However, you must be familiar with the dangers behind such an approach.

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