Investor Insights and Outlook

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Don't Get Spooked by Headlines

October is full of ghosts, goblins and trick-or-treaters, so what better topic to write about than fear? Fear, if not conquered, can be a deceiving and misguiding emotion. To show you what I mean, let me ask you a question: What do you fear more, nuclear reactors or taking a selfie?

Over the last 56 years there have been three significant nuclear reactor meltdowns—Three Mile Island, Chernobyl, and Fukushima—and the number of deaths attributed to these is estimated at 56. On average, that's about one person per year. Meanwhile, so far this year 12 people have died while trying to take a selfie.[1]

We often fear the least likely dangers instead of the risks that have the greatest chance of hurting us.

Is investing any different? In his book, "Your Money & Your Brain," Jason Zweig cites a study of investors who said they believe there's a 51% chance that in any given year the U.S. stock market might drop by one-third.[2] Zweig notes that historically, the odds of the U.S. stock market losing a third of its value in a given year are actually only around 2%.

The real risk is not that the stock market will have a meltdown, he adds, but that inflation will raise your cost of living and erode your savings.

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Calculating Taxes on Mutual Funds

For mutual fund investors, earnings come from two sources: fund distributions ~ dividends or capital gains ~ and the sale of fund shares.[1] Income from these sources may be taxable. Fund companies typically send year-end statements to shareholders that summarize the information used to report investment gains or losses to the IRS. Here's a look at how taxes on your mutual funds are calculated.

Taxable Distributions: Dividends and Capital Gains

As a shareholder, you must pay taxes on dividends or capital gains passed on to you in the year they were received, even if they were automatically reinvested to buy additional fund shares. In general, dividends and capital gains attributable to a fund's underlying investments are taxed as follows:

Long-term capital gains and qualified dividends are taxed at 0% for taxpayers in the 10% and 15% tax brackets, 15% for taxpayers filing singly with incomes less than $413,200 ($464,850 for those who are married filing joint tax returns), and are subject to a top rate of 20% for single taxpayers with income in excess of $413,200 and joint filers with income in excess of $464,850. In addition, net investment income for taxpayers with AGIs in excess of $200,000 (single filers) or $250,000 (married filing jointly) may be subject to the 3.8% Medicare surcharge.

Regular interest income and short-term capital gains on securities held in a fund for less than 12 months are taxed at your ordinary federal income tax rate. Keep in mind that funds with higher turnover (i.e., funds that buy and sell securities often) can result in higher tax liabilities.

Capital Gains From the Sale of Fund Shares

Gains can also be realized when you sell fund shares that have appreciated in value since purchase. Before you can calculate the tax owed on the sale, you have to know your cost basis ~ or how much money you paid for the shares, including shares purchased with distributions.

If you sell all of your shares, your cost basis is your total investment (all purchases and reinvested distributions). If, however, you sell some of your shares, determining your cost basis is somewhat complicated. The next section outlines the IRS-approved accounting methods for conducting this calculation.

Calculating Your Cost Basis

- Specific shares: You identify which shares to sell. This method gives you the most control over the amount of gain or loss you report.
- First-in, First-out: This method assumes the first shares purchased are the first to be sold. If you do not indicate otherwise, the IRS assumes you use this method.
- Average cost, single method: With this method you calculate your gain or loss based on the average price you paid for all shares, regardless of how long you have held them. This is the method most mutual fund companies use to provide information to you.
- Average cost, double method: This is the same calculation as above, except shares are divided into short-term and long-term categories and a separate average cost is computed for each.

Keep in mind that net losses incurred from fund investments may be deductible from your income taxes, and that investments in tax-deferred retirement plans, such as a 401(k)s, traditional IRAs, or variable annuities, allow you to defer taxes on all investment earnings until the funds are withdrawn.[2]

Because federal tax laws are complex and fast changing, consult a tax advisor to determine how they apply to your situation. This information is general in nature and should not be construed as tax advice. Always consult a qualified specialist regarding tax affairs.

Source/Disclaimer:

[1]Investing in mutual funds involves risk, including loss of principal. Mutual funds are offered and sold by prospectus only. You should carefully consider the investment objectives, risks, expenses and charges of the investment company before you invest. For more complete information about any mutual fund, including risks, charges and expenses, please contact your financial professional to obtain a prospectus. The prospectus contains this and other information. Read it carefully before you invest.

[2]Withdrawals from qualified plans taken before age 59½ are generally subject to a 10% additional federal tax ~ on top of any regular income taxes owed ~ although there are a few exceptions to this rule.

Millennials: The "Slow and Steady" Generation of Investors

With some $30 trillion poised to change hands over the next several decades from parents and grandparents to so-called Millennials – those 90-million-plus Americans aged 18 to 33 – the financial services industry will have its work cut out for it. Popular investing wisdom states that the younger you are, the more time you have to ride out market cycles and therefore the more aggressive and growth-oriented you may be in your investment choices. Yet Millennials are hearing none of it.

As Investors: Wary and Conservative

Indeed living through the Great Recession and watching their parents and other older family members suffer financial losses may have taken a toll on these young investors – and made them wary of investing in general and conservative in their investment choices. For instance, according to Wealthfront, an online financial services start-up that caters to this demographic group, Millennials "have lived through two market crashes … " and … "value simple, transparent, low-cost services," typically favoring index-based fund options over more exotic investment fare.[1]

Elsewhere, research conducted by MFS Investment Management found that Baby Boomers take a more aggressive approach to retirement investing than the much younger Millennials. Further, each group's selected asset allocation is inconsistent with what financial professionals would consider to be their target asset allocation, given their age and investment time horizon.

For example, Baby Boomers, on average, reported holding retirement portfolio asset allocations of 40% stocks, 14% bonds, and 21% cash, while Millennials allocated less than 30% of their retirement assets to stocks, and had larger allocations to bonds and cash than their much older counterparts – 17% and 23% respectively.[2,3]

Further, when asked about their retirement savings priorities, 32% of Baby Boomers cited "maximizing growth" as the most important objective, while two-thirds of Millennials cited conservative objectives for their retirement assets – specifically, 31% said "generating income" was a top concern and 29% cited "protecting capital" as their main retirement savings goal.[3]

Perception Is Reality

The study's sponsors infer that the seemingly out-of-synch responses from survey participants reflect each group's reactions – and perhaps overreactions – to the recent financial crisis. For Baby Boomers, the loss of retirement assets brought on by the Great Recession has made them more aggressive in their attempts to earn back what they lost. Fully half of this group reported being concerned about being able to retire when they originally planned. For Millennials, the Great Recession was a wake-up call that investing presents real risks – and their approach is to take steps to avoid falling foul of that risk even though they have decades of investing ahead of them.

Educating Investors: An Opportunity for Advisors

Cumulatively, recent research suggests that there is a considerable opportunity for advisors to dispel fears and misperceptions by educating investors of all ages about the importance of creating and maintaining an asset allocation and retirement planning philosophy that is appropriate for their investor profile.

Source/Disclaimer:

[1]Wealthfront.com, Wealthfront News, "$1 Billion in 2.5 Years," June 4, 2014.

[2]Investing in stocks involves risks, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

[3]Plansponsor, "Baby Boomers, Millennials Should Switch Retirement Investing Goals," October 2, 2014.

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Yet only 31% of the investors surveyed were worried that they might run out of money during their first 10 years of retirement. Investors often focus their attention and concern on the market meltdown they believe is around the next corner and overlook the potential fallout from inflation.

If we were always logical, rational beings we would judge the odds of a risk by asking how often something bad has actually happened under similar circumstances in the past. As Nobel Laureate Daniel Kahneman explains in his book, "Thinking Fast and Slow," people are generally rational and their thinking is normally sound, but fear causes people to become irrational.[3]

The media can warp our perception of reality. Coverage is biased toward novelty and poignancy and is shaped by public interest. Unusual events (such as stock market meltdowns) attract disproportionate attention and are consequently perceived as more pervasive than they really are. Warped perceptions result in thoughts of danger, which exacerbate fear and lead to irrational decisions.

Media coverage of the stock market seems to focus on the negative while ignoring the positives. Think about the headlines in recent months and how many focused on stock market volatility. These headlines induce fear and emotional decision making, which can result in devastating investment outcomes.

Bertrand Russell said, "To conquer fear is the beginning of wisdom."[4] When it comes to investing, fear is an emotion to be conquered. Your retirement will thank you for it.

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[1] usatoday.com/story/news/nation-now/2015/09/23/people-died-selfies-shark-attacks/72682068

[2] Zweig, Jason, "Your Money & Your Brain," Simon & Schuster, 2007.

[3] Kahneman, Daniel, "Thinking Fast & Slow," Farrar, Straus, and Giroux, 2011.

[4] brainyquote.com/quotes/quotes/b/bertrandru132851.html

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