Investor Insights and Outlook

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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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Five Year-End Tax Tips

1. Contribute to your tax-advantaged accounts: One of the best ways to cut your tax bill is to reduce your taxable income. It is important to take advantage of any retirement-plan contributions you can make to reduce your taxable income. You can contribute $17,000 to your 401(k) plan in 2012, and those age 50 or older can save an additional $5,500. Consider ratcheting up your contribution before the end of the year if you're on pace to fall below that contribution limit.

Some taxpayers might also be able to contribute up to $5,000 to a traditional IRA (individuals 50 and older can contribute $6,000), and you'll be able to deduct that contribution from the income you report on your tax return. Keep in mind that in order to be eligible for a traditional deductible IRA, your income must come in below a certain threshold. Please be sure to consult the IRS Web site (www.irs.gov) or a financial professional for detailed information.

2. Beware of ticking tax time bombs: Have you had any big mutual fund winners in your portfolio? If so, there's a very good chance that they'll be making capital gains payouts later this year—which means you could wind up owing taxes on those gains. If you were planning to purchase any one of these funds, it would be wise to wait until after they've made their distributions for the year. That way, you won't be responsible for taxes on gains you weren't around to enjoy.

Many fund shops begin making capital gains distribution estimates available later in October and into November, and capital gains payouts typically occur in December. If your fund company doesn't list this information anywhere on its website, call to find out whether your fund is planning a distribution, how much it will be, and when it will occur. And remember, past performance is no guarantee of future results.

3. Harvest your losers: Selling losing investments and reinvesting the money in investments that are similar in style might allow investors to maintain their long-term asset allocation and enjoy the benefits of a potentially lower tax bill. Although long-term investors know that it is better to buy and hold than to try timing the market, there are times when selling and taking losses could be worthwhile. For instance, if an investor suffers losses from a large-cap stock fund, she can sell it at a loss to offset other capital gains she might have and then reinvest the money in another large-cap stock fund to maintain the asset allocation. Federal tax laws allow capital gains to be offset dollar for dollar with realized capital losses.

4. Taxable versus non-taxable accounts: Pay attention to which funds are in your taxable and non-taxable accounts. To the extent that you own taxable bonds and bond funds, particularly high-yield offerings (such as junk-bond and emerging-markets bond funds), be sure to hold them in your tax-sheltered accounts. The same applies for high-turnover stock funds that generate a lot of short-term capital gains.

5. Be generous: If you contribute to a charity, your generosity could come in handy come tax time. If you itemize deductions, you can deduct charitable contributions; just be sure to save receipts and canceled checks as proof. And if you're helping those near and dear to you, remember that you can contribute up to $13,000 per year per recipient in 2012 without triggering gift tax.

Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns.

The Ins and Outs of the 5-Year Rule for Roth IRAs

If you want to take a tax- and penalty-free withdrawal of the portion of a Roth that consists of investment earnings (amount above your initial contribution), you need to be age 59 1/2, disabled, or using the money to pay for a first-time home. However, there's more to this rule.

The five-year clock doesn't start on the day you opened or funded your Roth IRA account. Rather, it starts on the first day of the tax year for which the IRA is opened and funded. This means if you funded a 2011 Roth contribution in early April 2012, your five-year clock started on January 1st, 2011. This implies you could withdraw your investment earnings free of penalty and tax, provided you meet the other criteria for Roth IRA withdrawals (you're 59 1/2, disabled, or using the money for a first-time home), as of January 1st, 2016. The five-year waiting period doesn't start again each time you make additional contributions. Using the previous example, even if you made additional contributions for the 2012 and 2013 tax years (following your initial contribution for 2011), you'll still have satisfied your five-year holding period at the beginning of 2016, because your five-year clock started at the beginning of 2011.

Unfortunately, the five-year rule gets a bit more complicated if you've gotten the assets into a Roth through converting a traditional IRA. In that case, you need to be either 59 1/2 or five years must have elapsed since your conversion for you to be able to take penalty-free withdrawals on the converted amounts on which you paid taxes at the time of conversion. Moreover, if you've converted amounts to a Roth over a period of years, each conversion amount has its own five-year holding period. The penalty will be waived if you meet certain conditions (for example, if you're using the money for qualified education or medical expenses).

Whether a penalty applies depends on the nature of your IRA at the time of conversion, and hinges on the Internal Revenue Service's ordering rules for distributions. If you're taking a withdrawal from a Roth, the IRS assumes that contributions are withdrawn first (always tax- and penalty-free), followed by the taxable portion of a conversion, followed by the nontaxable portion of a conversion, followed by investment earnings. For example, let's say you had a $100,000 rollover IRA set up when you left your old firm, which you rolled into a Roth IRA in 2010. If you wanted to withdraw that money prior to age 59 1/2, you'd have to wait until 2015 to do so penalty-free. Because you owed taxes on your whole IRA amount at the time of conversion, that amount will be subject to the 10% penalty if withdrawn before five years have elapsed.

If you convert a traditional IRA that consists of nondeductible and deductible contributions, things get trickier. For example, you've built up $15,000 in a traditional IRA, $10,000 consisting of nondeductible contributions and $5,000 of deductible contributions. When converted, you'll owe tax on the $5,000 (money on which you never paid taxes). If in three years you need to withdraw $5,000, before you're 59 1/2, that amount will be subject to penalty because the IRS assumes that the amount withdrawn first is the taxable portion of your rollover, in this case, $5,000. Withdrawing the other $10,000 wouldn't trigger a penalty. Backdoor Roth IRA investors can usually avoid the 10% penalty because all or nearly all of their converted amounts will consist of money they already paid taxes on and they'll owe nothing in taxes at conversion.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

PIIGS Performance

The "PIIGS" acronym refers to the economies of Portugal, Ireland, Italy, Greece, and Spain. The term became popular during the European sovereign debt crisis in highlighting the weaker performance of these economies coming out of the economic downturn. As shown in the image, the PIIGS economies have yet to fully recover from the 2007 financial crisis and the subsequent European sovereign debt crisis. In fact, an initial $1,000 invested in Greek stocks at the start of 1992 would have yielded a mere $592 by the end of 2011 (a 41% decline in value).

If an investor desires to invest in international markets, it is important to remember to diversify across not just asset classes, but also country exposure. Diversification may minimize the financial impact to your portfolio if a specific country or region ends up in financial distress.

Growth of $1,000
January 1992 – December 2011

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Greece, Ireland, Portugal, Italy and Spain are each represented by the corresponding Morgan Stanley Capital International Index. Returns in U.S. dollars are based on the exchange rate over the selected time period. Returns and principal invested in stocks are not guaranteed. The 1992 start date for this analysis was chosen in order to analyze the most recent 20-year time period. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Diversification does not eliminate the risk of experiencing investment losses.

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