Investor Insights & Outlook

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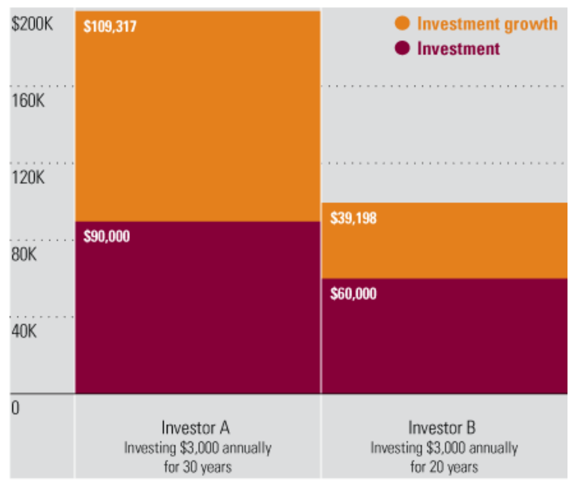
The Costs of Financial Procrastination

Retirement usually doesn't start until you're in your 60s but there is a good reason to start saving much sooner. The earlier you contribute to your nest egg, the more time your portfolio will have to grow in value.

The image illustrates the ending wealth values and effects of compounding of two investment portfolios. Consider two hypothetical investors who begin investing $3,000 at an average annual rate of return of 5%. Investor A invests $3,000 for a 30-year period, which results in an ending wealth value of $199,317. On the other hand, investor B invests $3,000 for a 20-year period, which results in an ending wealth value of $99,198. Investor A invested an additional $30,000 compared to Investor B. However, a large difference in the ending wealth value can be attributed to the compounding effect of the $30,000 for the additional 10 years. In other words, your dollars saved now will be worth a lot more than your dollars saved in retirement.

The Effect of Compounding



Source: This is for illustrative purposes only and not indicative of any investment. The image represents a hypothetical rate of return of 5%. The values represented do not account for inflation or taxes. Past performance is not a guarantee of future results. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment advice. Please consult with your financial professional regarding such services.

Advisor Corner

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The 2010 Financial Reform Explained

In the wake of what is quickly becoming known as "the worst financial crisis since the Great Depression," the global economy is still slowly rebuilding. In the U.S., the government realized that it needed to take action to prevent a similar crisis, and on July 21, after a yearlong struggle, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the Wall Street Reform Act) into law. Here are some of the most important provisions of this bill:

Consumer Protection: The law creates the Consumer Financial Protection Bureau, a new independent watchdog agency tasked with ensuring that U.S. consumers have access to clear, accurate, and timely information about financial contracts such as loans, mortgages, and credit cards. The agency will also protect consumers from hidden fees (small-type footnotes beware!) and abusive or deceptive practices.

Financial Stability: We've all probably heard the phrase "too big to fail" too often. Financial powerhouses like Bear Stearns and Washington Mutual went bankrupt and almost brought the whole system tumbling down with them, dissolving the economic security of millions in the process. Another new group, the Financial Stability Oversight Council, has been created to see these situations coming. It will monitor large, complex financial firms in order to identify and quickly address problems that could potentially snowball. Increasingly strict rules will be enforced for capital, leverage, liquidity, risk management, and other requirements. Banks and their affiliates will have restrictions on investments in hedge funds and private equity funds.

Financial System Regulation: Since "no one saw it coming" and "it wasn't our responsibility," from now on clear lines of responsibility will be defined and shared between the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve as to which agency is supervising which type of bank. A new Office of Credit Rating Agencies will be created as part of the SEC, with the mission to implement new rules for credit rating agencies, such as stronger internal controls, requirements to make key findings public, and penalties for biased ratings.

Transparency and Accountability: Derivatives have long ceased to be simple risk-management tools and have instead become speculative vehicles that enable traders to make enormous bets with no regulatory oversight. The new law now gives the SEC the authority to regulate derivatives, both over-the-counter ones and other types. Companies that sell products like the now-infamous mortgage-backed securities are required to retain at least 5% of the credit risk instead of passing it all over to investors. Hedge funds, which used to operate in their own money-filled bubbles and could not be bothered to register with the SEC, are now required to register and to provide the information necessary to assess their contribution to systemic risk.

Executive Compensation: You're the CEO, you do all the work, you take all the risks—it's only fair that you should be paid billions while the rest of us settle for less because, hey, the economy is in a crisis. However, saying that Wall Street's compensation system has been way out of control is an understatement: think about Merrill Lynch ex-CEO John Thain's $87,000 area rug, or former head of Wachovia Robert Steel's $225 million in golden-parachute (executive severance package) money. To step away from this system, the financial reform law will give shareholders the right to vote on executive pay. Public companies will be required to set policies to take back executive compensation if financial statements are shown to have been tampered with or made inaccurate, and executive compensation will be determined by taking the company's stock performance over a five-year period into account.

These are just a few highlights, but the impact on institutions, financial advisors, and investors should be significant. Overall, the provisions in this bill look great on paper, but the real challenge lies in putting all these good intentions into practice.

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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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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