Bloom Insight

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Don't Pay Tax Twice

Reinvestment can be a crucial component of the wealth accumulation process, as the reinvested amount compounds and grows over time. Yet if you are reinvesting dividends and capital gains ("distributions") in funds you hold in your taxable account, it can be important to ensure that you're not paying more tax than necessary. You pay tax on those distributions in the year in which you receive them. But if you don't keep good records, you could end up paying tax on those distributions again when you sell. For example, say you bought 1,000 shares of a fund for your taxable account at the end of 2011; you paid $18 per share for a total of $18,000. In 2012, with the share price still at $18, the fund made a dividend distribution of $0.50 per share, or $500 for your 1,000 shares. You'd owe tax on the $500 on your 2012 taxes, whether you reinvested the money or took the cash in hand. (The taxes would be deferred if you held the fund in a tax-sheltered account). If you reinvested the money in the fund, you'd now own 1,027.78 shares: your original 1,000 plus the nearly 28 additional shares that you were able to buy (at $18) with the $500 dividend distribution. If you sell now, with the fund's net asset value at $20, you'd think you'd owe taxes on your $2,555.56 profit ($20,555.56 minus $18,000), right? Wrong. You would only owe taxes on $2,055.56 ($20,555.56 minus $18,000 minus $500). Otherwise, the $500 dividends would be taxed twice.

Investments are subject to risk of principal and risk of loss. Dividends are not guaranteed. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

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Get Your Estate Plan in Gear

Estate planning laws have undergone swift changes over the past several years and may change again in the years ahead. If you're creating or updating an estate plan, it's essential that you seek the advice of an attorney who's well versed in this area. Before you hire an estate-planning attorney to draft or update your estate plan, it's important to understand your role in the estate-planning process.

Find a qualified attorney: Because your estate plan will likely need to be updated as the years go by and your personal circumstances change, it makes sense to find an attorney who practices in the community where you live. This can help you meet with him/her on an ongoing basis.

Take stock of your assets: Before you meet with your attorney, spend some time enumerating your assets and their value: your investment accounts, life insurance, personal assets such as your home, and your share of any businesses that you own. Also gather current information about any debts outstanding. Your estate-planning attorney is likely to provide you with a worksheet to document your assets and liabilities, but it's helpful to collect this information in advance.

Identify key individuals: Another important aspect of estate planning is identifying the individuals you trust to ensure that your wishes are carried out once you're gone.

Executor: A person who gathers all of your assets and makes sure that they are distributed as spelled out in your will.

Durable (Financial) Power of Attorney: A person you entrust with making financial decisions on your behalf if you should become disabled and unable to manage your own financial affairs.

Power of Attorney for Health Care: A person you entrust with making health-care decisions on your behalf if you are disabled and unable to make them on your own.

Guardian: A person who would look after your children if you and your spouse were to die when your children are minors.

Know the key documents you need: When you meet with your estate-planning attorney, he or she will make recommendations about your estate plan. At a minimum, you should ask your attorney to draft the following documents.

Last Will and Testament: A legal document that tells everyone, including your heirs, how you would like your assets distributed after you're gone.

Living Will: A document that tells your loved ones and your health-care providers how you would like to be cared for if you should become terminally ill; usually includes details about your views toward life-support equipment.

Durable (Financial) Power of Attorney: A document that gives an individual the power to make financial decisions and execute financial transactions on your behalf if you are unable to do so.

Medical Power of Attorney: A document that gives an individual the power to make health-care decisions on your behalf if you are unable to do so.

Manage your documents: Once your estate-planning documents are drafted, destroy any older versions of them. Notify your executor of the whereabouts of your estate-planning documents, and provide copies of the relevant documents to your executor, powers of attorney, and the guardian for your children.

Plan to keep your plan current: Last but not least, plan to keep your estate plan current. One of the biggest estate-planning pitfalls is drafting an estate plan but not keeping it up to date. Changes may include change in marital status, assets, financial status, death or ill health of your beneficiaries, executor, power of attorneys, or guardian.

Investing with a Long-Term Focus

It’s easy to follow a long-term investment strategy in good times; the hard part is sticking with it during bad times. What should you do if you are a long-term investor sitting in the midst of a bear market? If you are holding a well-diversified portfolio, the answer is rather straightforward: stay the course.

Volatile markets can cause investors to abandon their long-term goals for risky short-term investment strategies. Volatility can range from a single-day market crash to extended periods of jagged performance. The market has undergone cycles with high and low annual returns from 38% (1995) to -37% (2008) over the past 50 years. It can be tough to stay the course in the face of such fluctuations.

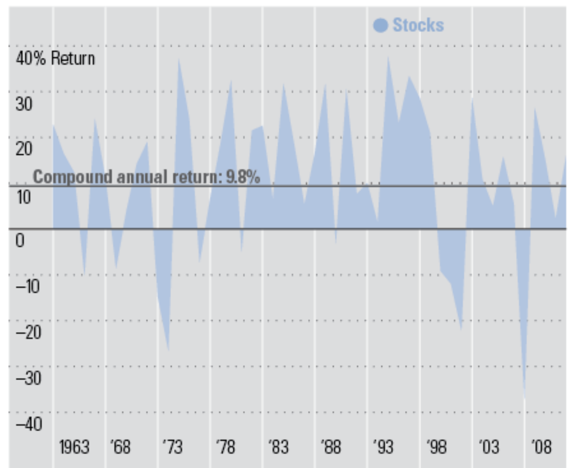
The graph illustrates annual stock market performance since 1963. The bull market from 1991 to 1999 lasted the longest, with an average annual return of 21%. In contrast, a majority of the downturns shown in the image have lasted for shorter periods of time. Despite the ups and downs over the years, the stock market generated a compound annual return of 9.8% over this historical time period.

It goes without saying that the market will head south at times, but history shows that despite this, the market’s long-term trend is upward. Consequently, the sooner an individual implements an investment plan, the better. By contributing early and as often as possible to such a plan, an investor's money compounds over time. Compounding is the ability of an asset to generate earnings from previous earnings, which serves to accelerate the growth of your assets as time moves on.

A disciplined investment approach is still the best strategy for handling market downturns. This includes maintaining a well-diversified portfolio and using dollar-cost averaging, instead of lump-sum purchases, to ease into new investments. Dollar-cost averaging involves the purchase of securities, usually mutual funds, in fixed dollar amounts at regular intervals. This strategy is maintained no matter what direction the market is moving. Finally, staying focused on a long-term investment plan may enable you to participate in recoveries.

Overall, the stock market has exhibited positive performance in the past, but be prepared for periods of underperformance. The fact is no one can predict market declines with any type of certainty. As a result, a portfolio consisting of both stocks and bonds can serve as a good strategy for short-term diversification. On the contrary, investors who have a larger appetite for risk may want to consider long-term investments in stocks. With a disciplined approach to investing, one may be able to take advantage of market rebounds and may enjoy superior returns in the long run. Don’t be sidelined by market expansions and contractions.

Annual Stock Market Performance: 1963–2012



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed.

Source: Stocks—Standard & Poor’s 500,® which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general.

Bonds: Tips to Keep From Getting Pinched

Encountering stock market losses early in one's retirement years can deliver a blow to an equity-heavy portfolio. If you've determined that your equity weighting is extremely aggressive relative to your risk appetite, reducing risk by altering your portfolio's asset allocation may be essential. The need to reduce the risk of your portfolio doesn't mean you have to move money directly from stocks to bonds. As you cut back on your equity exposure, it may be wise to move money into cash and/or short-duration bonds (duration is a measure of interest-rate sensitivity), then slowly and systematically move it into the bond market over a period of several months or years. This way, you may be able to obtain a range of purchase prices for your new bond holdings.

It's important to think about what you're trying to achieve by transitioning your portfolio to bonds as retirement draws near. Lower risk and liquidity may be the answer. One potential way to obtain both is to take some of the money you would otherwise have earmarked for bonds and use it to pay down debt, even low-interest mortgage debt. If having a paid-down mortgage will reduce your expenses in retirement, you will be reducing the need to raise cash from your portfolio to meet in-retirement living expenses.

Diversification does not eliminate the risk of experiencing investment losses. Stocks are not guaranteed and have been more volatile than other asset classes. Bonds are subject to credit/default risk, which is risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds are sensitive to interest rate changes. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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