Capital Advice

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A Mid-Year Financial Review: More Time to Plan

Mid-year is an ideal time to take a look at your finances, because the demands on your time may be fewer, and the planning opportunities greater, than if you wait until the end of the year. Here are a few tips to get you started.

Identifying your needs

Financial plans often need to be modified when personal circumstances change. Answering these questions can help you identify the financial issues you want to address within the next few months.

- Are any life-changing events coming up soon, such as marriage, the birth of a child, retirement, or a career change?
- Will your income or expenses substantially increase or decrease this year?
- Are you concerned about the performance of your investment portfolio?
- Do you have any needs or concerns that you would like to address?

Tax planning

Completing a mid-year estimate of your income tax liability can reveal tax-planning opportunities. You can use last year's tax return as a basis, then make any anticipated adjustments to your income and deductions for this year. Check your withholding, especially if you owed taxes when you filed your most recent income tax return or if you received a large refund. Doing that now, rather than waiting until the end of the year, will help you avoid a big tax bill or having too much of your money tied up with Uncle Sam. If necessary, adjust the amount of federal or state income tax withheld from your paycheck by filing a new Form W-4 with your employer.

One of the easiest things you can do right now to help avoid missed tax-saving opportunities for the year is to set up a system for saving receipts and other tax-related documents. This can be as simple as dedicating a folder in your file cabinet to this year's tax return so that you can keep track of important paperwork.

Retirement planning

If you're working and you received a pay increase for this year, don't overlook the opportunity to increase your retirement plan contributions by asking your employer to apply a higher percentage of your salary. This year, you may be able to contribute up to $16,500 to your retirement plan at work ($22,000 if you're age 50 or older). If you have a traditional IRA, you may also want to weigh the benefits of converting it to a Roth IRA this year, when you may be able to take advantage of a special deferral rule that applies only to 2010 conversions. This deferral rule gives you the option of reporting half of any resulting taxable income that results on your 2011 tax return and half of the income on your 2012 return.

If you're already retired, take a new look at your retirement income needs and whether your current investments and distribution strategy will continue to provide enough income.

Investment planning

Have you recently reviewed your portfolio to make sure that your asset allocation is still in line with your financial goals, time horizon, and tolerance for risk? Though it's common to rebalance a portfolio at the end of the year, if the market is volatile, you may need to rebalance more frequently.

Insurance planning

Do you know exactly how much life and disability insurance coverage you have? Are you familiar with the terms of your homeowners, renters, or auto insurance policies? If not, it's time to add your insurance policies to your summer reading list. Insurance needs frequently change, and it's possible that your coverage hasn't kept pace with your income or family circumstances.

"Understanding the nature and level of the risks you face can be critical in sticking to a long-term investing strategy."

Evaluating Risk in Your Portfolio

If you're like most people, you probably evaluate your portfolio in terms of the return it earns. However, as we were all reminded in 2008, returns aren't the only factor you should consider when determining whether your portfolio is allocated appropriately. Also important is the level of risk you take in pursuing those returns.

There are a number of ways to estimate the level of risk in a portfolio. The term "risk" is often used interchangeably with "volatility" (the tendency of a portfolio's value to rise or fall sharply, especially within a relatively short period of time). However, for most people, a portfolio is simply a means to an end--paying for retirement or a child's college tuition, for example. In that context, "risk" also means the risk of not meeting your financial needs.

Volatility measures

One of the most common measures of volatility is standard deviation, which gauges the degree of an investment's up-and-down moves. It shows how much the investment's returns have deviated from time to time from its own average. The higher the standard deviation of an investment or portfolio, the bumpier the road to those returns has been.

Another way to assess a portfolio's volatility is to determine its beta. This statistic compares a portfolio's ups and downs to those of a benchmark index, such as the S&P 500, and indicates how sensitive the portfolio might be to overall market movements. An investment or portfolio with a beta of 1 would have exactly as much market risk as its benchmark.

The higher the beta, the more volatile the portfolio. A beta of 1.05 means the portfolio involves 5% more market risk than the benchmark to which it's compared. If the benchmark rises 10%, a portfolio with a beta of 1.05 should theoretically rise 10.5%; a fall of 10% in the benchmark should mean a corresponding 10.5% decline in the portfolio.

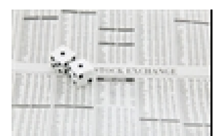
A 0.95 beta means a portfolio has 5% less market risk than that index; in theory, the portfolio would rise and fall 5% less than the benchmark. (However, remember that investments also have unique risks that are not related to market behavior. Those risks can create volatility patterns that are different from the underlying benchmark.)

The risk of not achieving your goals

Another way to evaluate risk is to estimate the chances of your portfolio achieving a desired financial goal. In this case, "risk" means not volatility but the odds that your portfolio will succeed in meeting a specific financial liability. A technique known as Monte Carlo simulation uses computer modeling based on multiple scenarios for how various types of investments might perform based on their past returns. Though past performance is no guarantee of future results, such a projection can estimate how close your plan might come to meeting a future target amount.

Let's look at a hypothetical example. Let's say Bob wants to retire in 15 years. A Monte Carlo simulation might suggest that, given his current level of saving and his portfolio's asset allocation, Bob has a 90% chance of achieving his retirement target. If he chose to save more, he might increase his odds of success to 95%. Or Bob might decide that he's comfortable with having an 85% chance of success in reaching his target amount if that also means his portfolio might be less volatile. (However, be aware that though a projection might show a high probability that you'll reach your financial goals, it can't guarantee that outcome.)

Are you getting paid enough to take risk?



Another approach to thinking about portfolio risk involves the reward side of the risk-reward tradeoff. You can compare a portfolio's return to that of a relatively risk-free investment, such as the inflation-adjusted return on a short-term (3 months or less) U.S. Treasury bill. Modern portfolio theory is based on the assumption that you should receive greater compensation for taking more risk (though there's no guarantee it will work out that way, of course). A stock should offer a potentially higher return than a Treasury bond; the difference between the two returns is the equity's risk premium. A small-cap stock that's relatively new should offer a higher risk premium than a well established, dividend-paying stock. While understanding risk premium doesn't necessarily minimize risk, it can help you evaluate whether the return you're getting is worth the risk you're taking.

Whatever your approach to portfolio risk, understanding the nature and level of the risks you face can be critical in sticking to a long-term investing strategy.

Got Stock? The Long and Short of Capital Gains

If you buy or sell shares of stock, you need to be familiar with the rules that govern the way capital gains are taxed. That's because the amount you owe in tax can depend on a number of factors, including the length of time you hold the shares and the federal income tax bracket you're in. Here are the basics.

Basis and holding period

"Basis" refers to your investment in the shares of stock you hold. Generally, your basis is the amount you paid for the stock, plus any commissions you paid to purchase the shares. (Note, however, that special rules apply if you received the stock as a gift or as part of an inheritance.) If you sell a share of stock and the sales price--less any commission--is more than your basis, you have a *gain*; if the amount you receive is less than your basis, you have a *loss*.

Your holding period is generally the length of time that you hold a share of stock before you sell or exchange it. If you hold a share of stock for a year or less before selling it, any gain you have is *short-term* capital gain. If you sell a share of stock after holding it for more than a year, any gain is *long-term* capital gain. Your holding period typically starts on the trade date the share is purchased, and ends on the trade date it's sold.

Short-term capital gain

Short-term capital gain is treated as ordinary income, just like interest on your savings account or wages from your employer. It's added in with all of your other income, and the amount of federal income tax you owe depends on the federal marginal income tax bracket you're in. For example, if you're in the top tax bracket in 2010, you'll pay tax on ordinary income at a maximum rate of 35%.

Long-term capital gain

If you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, and special maximum tax rates apply. If you're in the 10% or the 15% marginal income tax bracket in 2010, you'll pay no federal income tax on long-term capital gains (a "0% tax rate" applies). So, for single individuals with taxable income of $34,000 or less ($68,000 for married individuals filing jointly), long-term capital gains are federal income tax-free in 2010.

For those who aren't in the lowest two federal income tax brackets (i.e., those in the 25%, 28%, 33%, and 35% brackets), a 15% maximum tax rate generally applies to long-term capital gains. There are limited cases, however, when individuals in the higher tax brackets can still benefit from the 0% tax rate.

For example, a retired couple with taxable income of $60,000 would be in the 15% marginal income tax bracket in 2010 if they file jointly (the bracket covers married couples with taxable income less than or equal to $68,000). The couple sells stock, resulting in a long-term capital gain of $40,000. This increases their taxable income to $100,000, placing them in the 25% marginal income tax bracket. In this situation, they would pay no federal tax on the first $8,000 of long-term capital gain, and the maximum 15% rate would apply to the remaining $32,000 in gain.

Offsetting gains with losses

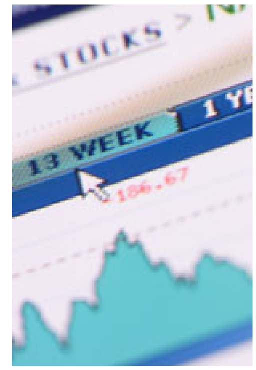
Any capital losses that you may have realized during the year can offset some or all of your capital gain. If your losses offset all capital gains, any excess capital loss can be applied against up to $3,000 of ordinary income ($1,500 for married individuals who file separately), and any unused capital loss can be carried forward to future years.

Big exception: retirement plans, IRAs

All of this assumes your stock is not being held in a tax-advantaged retirement account like a 401(k) plan or IRA. Special tax rules apply to investments, including stock, held within these plans. If you sell shares of stock within one of these plans, there's no immediate tax consequence. Instead, you'll generally pay federal income tax when you take withdrawals from the plan, and any income will be considered ordinary income--even if the earnings are attributable to capital gains. (Certain Roth retirement plans and Roth IRAs provide for tax-free treatment of qualified withdrawals.)

Uncertainty in 2011

The special federal income tax rates that currently apply to long-term capital gains expire at the end of 2010. Absent new legislation, in 2011, individuals in the 15% tax bracket (under current law the 10% bracket disappears in 2011) will pay tax on long-term capital gain at a rate of 10%. For everyone else, a 20% rate will generally apply. Special rules (and slightly lower rates) will apply for qualifying property held five years or more.



Small business stock

Special rules apply to qualified small business stock. Generally, a portion of any gain realized upon the sale of qualified small business stock held for more than 5 years can be excluded from income. The portion of the gain that is not excluded from income is generally taxed at a maximum rate of 28%. For additional information, see IRS Publication 550.

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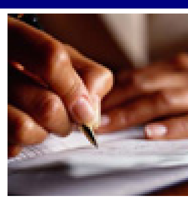
Ask the Experts



What is the premature distribution tax?

Taxable distributions you receive from an IRA, 403(b), 401(k), or qualified employer plan before age 59½ are generally referred to as premature distributions, or early withdrawals.

To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) in addition to any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax. Not all distributions before age 59½ are subject to this penalty, however.

Here are the most important exceptions:

- Distributions due to a qualifying disability
- Distributions to your beneficiary after your death
- Distributions up to the amount of your tax-deductible medical expenses
- Distributions made pursuant to a qualified domestic relations order (QDRO)
- Qualified reservist distributions
- Distributions from an IRA (but not an employer plan) to pay first-time homebuyer expenses (up to $10,000 lifetime)
- Distributions from an IRA (but not an employer plan) to pay qualified higher education expenses
- Distributions from an employer plan (but not an IRA) after separation from service at 55 or older
- Certain distributions from an IRA (but not an employer plan) while you're unemployed up to the amount you paid for health insurance premiums
- Amounts levied by the IRS
- Distributions that qualify as a series of substantially equal periodic payments (SEPPs)

If you must take a distribution from your IRA or employer plan before age 59½, be sure to determine if one of these exceptions applies to you.