Capital Advice

Capital Financial Advisors of New York, LLC

Capital Financial Advisors of New York
7 Corporate Drive
Clifton Park, NY 12065
518-280-0030
paul.corr@cfany.com
www.cfany.com

Paul J. Corr, CPA/PFS, CFP®
Walton A. Williams, CPA/PFS
Kerry G. Mayo, CFP®
Julie Sciandra, CFP®

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The Fed's Great Unwind and Your Portfolio

After more than five years of unprecedented support for the economy, the Federal Reserve Board has begun to reduce its purchases of bonds. And though the Fed has said interest rates may stay low even after unemployment has fallen to 6.5%, higher rates increasingly seem to be a question of timing. Both of those actions can affect your portfolio.

Bond purchases: the tale of the taper

In the wake of the 2008 credit crisis, the Fed's purchases of Treasury and mortgage-backed bonds helped keep the bond market afloat, supplying demand for debt instruments when other buyers were hesitant. Fewer purchases by one of the bond markets' biggest customers in recent years could mean lower total overall demand for debt instruments. Since reduced demand for anything often leads to lower prices, that could hurt the value of your bond holdings.

On the other hand, retiring baby boomers will need to start generating more income from their portfolios, and they're unlikely to abandon income-producing investments completely. Those boomers could help replace some of the lost demand from the Fed. Also, the Fed's planned retreat from the bond-buying business has roiled overseas markets in recent months; when that kind of uncertainty hits, global investors often seek refuge in U.S. debt.

Rising interest rates

When interest rates begin to rise, investors will face falling bond prices, and longer-term bonds typically feel the impact the most. Bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future. The later a bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. You can hold individual bonds to maturity; you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield.

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average maturity. The longer a fund's duration, the more sensitive it may be to interest rate changes. ***Note:*** *All investing involves risk, including the loss of principal, and your shares may be worth more or less than you paid for them when you sell. Before investing in a mutual fund, carefully consider its investment objective, risks, fees, and expenses, which are outlined in the prospectus available from the fund. Read it carefully before investing.*

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash equivalents such as savings accounts or certificates of deposit, higher interest rates could be a boon, as rising rates would increase their potential income. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices.

Balancing competing risks

Bonds may be affected most directly by Fed action, but equities aren't necessarily immune to the impact of rate increases. Companies that didn't take advantage of low rates by issuing bonds may see their borrowing costs increase, and even companies that squirreled away cash could be hit when they return to the bond markets. Also, if interest rates become competitive with the return on stocks, that could reduce demand for equities. On the other hand, declining bond values could send many investors into equities that offer both growth potential and a healthy dividend.

Figuring out how future Fed decisions may affect your portfolio and how to anticipate and respond to them isn't an easy challenge. Don't hesitate to get expert help.

See disclaimer on final page

Two Popular Charitable Trusts for You to Consider

Trusts with both charitable and noncharitable beneficiaries must follow special rules if you wish to receive income, gift, and estate tax charitable deductions for the amounts going to charity. Consult a tax or estate planning attorney familiar with charitable trusts.

A couple of charitable trusts are very popular with people making significant gifts to charity: the charitable lead annuity trust (CLAT) and the charitable remainder unitrust (CRUT). They each allow income, gift, and estate tax charitable deductions for a trust with both charitable and noncharitable beneficiaries. A CLAT leads off with a stream of annuity payments for the charity, while the CRUT provides a remainder interest for the charity when the trust ends.

Charitable lead annuity trust (CLAT)

With a charitable lead annuity trust, the charity generally receives the right to a fixed annuity amount each year (or at more frequent intervals). The annuity payments are generally made for a fixed term of years, or for one or more lives. After the specified term, the remaining trust property passes to you or another noncharitable beneficiary you designate.

An income tax charitable deduction is available to you at the time you create and fund the CLAT if the trust is structured so that you (as the grantor or creator of the trust) will be taxed on trust income each year. The up-front charitable deduction can be especially useful if you have a large amount of taxable income in the year the trust is created. If you take the up-front charitable deduction and cease to be taxed on trust income during the trust term (e.g., you die before the trust term ends), you may have to recapture part of the charitable deduction by adding the recaptured amount to your taxable income. For years in which you are not taxable on trust income, the trust may generally take charitable deductions against trust taxable income for distributions to charity.

The value of the up-front charitable deduction is based on the amount of the annuity going to the charity each year, how long the payments will be made to charity, and the appropriate interest rate used by the IRS to value the future payments.

A gift or estate tax charitable deduction is also available for the present value of the annuity interest the charity receives. Any remainder interest passing to a noncharitable beneficiary will be subject to gift or estate tax when the CLAT is created and will not qualify for the annual gift tax exclusion. The value of the remainder interest will be discounted to reflect that it will be received in the future. If the remainder interest passes to a person two or more generations younger than you, the generation-skipping transfer (GST) tax may apply.

Charitable remainder unitrust (CRUT)

With a charitable remainder unitrust, the noncharitable beneficiary receives a payment (the unitrust amount) from the trust property every year (or at more frequent intervals), which is based on the value of the trust assets each year. The unitrust payments are generally made for a fixed term of years, or for one or more lives. At the end of the trust term, the remaining property passes to the charity.

One CRUT variation permits payment of the lower of the unitrust amount or trust income for a period of years. Another CRUT variation then allows makeup distributions of the forgone unitrust payments at a later time. These variations may allow payments to be delayed until a later time, when the trust has income or the noncharitable beneficiary is in a lower income tax bracket.

An income tax, and gift or estate tax, charitable deduction is available to you at the time you fund the CRUT. The value of the up-front charitable deduction is based on the unitrust payout rate, how long the charity will have to wait to receive the remainder interest, and the appropriate interest rate used by the IRS to value the future interest. Any unitrust interest passing to a noncharitable beneficiary may be subject to gift or estate tax, as well as GST tax, when the CRUT is funded. The unitrust interest may qualify for the annual exclusion for purposes of the gift tax, but not for GST tax.

A CRUT is generally not subject to income tax. Instead, CRUT beneficiaries are taxable on unitrust payments as received. Distributions are treated as drawing out taxable income, capital gain, tax-exempt income, and trust corpus from the trust, in that order. In other words, distributions are generally treated as drawing out amounts taxable worst first. However, one advantage of a CRUT is that a CRUT can sell property and the beneficiary will not be taxed on capital gain from the sale until the beneficiary receives a distribution that is treated as capital gain.

Charitable deduction limits

The amount of your income tax charitable deductions are generally limited to 50% (or 30% or 20%) of your adjusted gross income (AGI), depending on the type of charity and the property transferred to the charity or charitable trust. Charitable deductions disallowed because of the percentage of AGI limits may be carried over and taken during the next five years, subject to the percentage of AGI limits in those years. Gift and estate tax charitable deductions are not subject to any percentage of AGI limit.

Personal Finance Tips for New Graduates

Tips for paying off student loans:

- ***To make your payment schedule easier, consider consolidating or refinancing your student loans***
- ***To shorten the overall repayment term and save on interest charges, try to divert extra funds toward monthly principal prepayment***
- ***If you are having trouble paying your federal student loans, look into the government's Income-Based Repayment (IBR) plan***

You've marched along to *Pomp and Circumstance* and collected your diploma--now you're ready to finally head out on your own. Maybe you have student loans that you need to start paying back. Perhaps you're looking forward to making your first car purchase or starting a new job. Whatever your situation, you'll definitely have new financial challenges you'll need to address and financial goals that you'll want to accomplish during this stage in your life. Fortunately, there are some relatively simple steps you can take to get started on the right track with your personal finances.

Create a budget

An easy way to maintain control of your finances is to create a budget. Ideally, a budget will assist you in making sure that you are spending less than you earn.

In order to create a budget, you'll need to identify your current monthly income and expenses. Income includes your regular salary and wages, along with other types of income such as dividends and interest.

When it comes to identifying your expenses, it may be helpful to divide them into two categories: fixed and discretionary. Fixed expenses include things that are necessities, such as rent, transportation, and student loan payments. Discretionary expenses include things like entertainment, vacations, and hobbies. You'll want to include out-of-pattern expenses (e.g., holiday gifts, auto repair bills) in your budget as well.

The most important part of budgeting is sticking to it. To help you stay on track:

- Try to make budgeting a part of your daily routine
- Build the occasional reward into your budget (e.g., splurge on a latte at the local coffee shop or have dinner at a restaurant instead of cooking at home)
- Be sure to evaluate and monitor your budget regularly and adjust/make changes as needed

Make saving a priority

Whether it's setting enough aside on a regular basis to accumulate an emergency cash reserve or putting money into an employer-sponsored retirement plan, if your budget allows, you should make saving a priority. And being a young investor means that you have one powerful advantage over older generations--time. By making saving a priority early in your life, your money can have more time to potentially grow and take advantage of the value of compound interest. To make it even easier to save, you can arrange to have a portion of your paycheck/earnings directly deposited into a savings or investment account.

Get a handle on your debt situation

Whether it's debt from student loans or credit cards, it's important to avoid the financial pitfalls that sometimes go hand-in-hand with borrowing. In order to manage your debt situation properly:

- Keep track of loan balances and interest rates
- Develop a plan to manage your payments and avoid late fees
- Pay off high interest debt first or take advantage of debt consolidation/refinancing

Understand the importance of having good credit

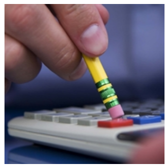
Credit reports affect so many different aspects of one's financial situation--from being able to obtain a car loan to being a prerequisite for employment. Having a good credit report will allow you to obtain credit when you need it, and often at a lower interest rate. As a result, it's important to establish and maintain a good credit history by avoiding late payments on existing loans and eliminating unpaid debts. Finally, it's important to monitor your credit report on a regular basis for possible errors.

Evaluate your insurance needs

As a younger individual, insurance is probably not the first thing that comes to mind when you think about your finances. However, having the right amount of insurance to protect yourself against possible losses is an important part of any financial plan. Your insurance needs will depend on your individual circumstances. For example, if you rent an apartment, you'll need to obtain renters insurance to protect against loss or damage to your personal property. If you own a car, you'll need to have appropriate coverage for that as well. You'll also want to evaluate your needs for other types of insurance (e.g., disability and life).

Finally, under the Affordable Care Act, everyone, regardless of age, must have qualifying health insurance or risk paying a possible penalty. If you don't have access to health insurance through your parent's health plan or an employer- or government-sponsored health plan, you may purchase an individual health plan through either the federal or a state-based health insurance Exchange Marketplace. You can visit www.healthcare.gov for more information.

Capital Financial Advisors of New York
7 Corporate Drive
Clifton Park, NY 12065
518-280-0030
paul.corr@cfany.com
www.cfany.com



What is duration, and why should I pay attention to it?

The Federal Reserve's actions over the next year could be important to bond markets, particularly if and when the Fed decides to increase its target interest rate. Since bond prices typically move in the opposite direction from yields, rising bond yields will translate into a decline in bond prices.

If you have bonds or bond mutual funds in your portfolio, you might want to pay attention to the duration of each one. Technically, a bond or bond fund's duration calculates the length of time it will take to receive the full true value of the investment; duration takes into account the present value of expected future payments of interest and principal.

However, duration's biggest value to an investor is as a gauge of how sensitive a bond might be to changes in interest rates. The longer a bond's duration, the more its price is likely to be affected by an interest rate change. A mutual fund's duration can be found in its prospectus; for an individual bond, you'll probably need to ask your broker or the bond's issuer.

To estimate the impact of an interest rate change on a specific bond holding, simply multiply its duration by the change in interest rates. For example, for a bond fund with a duration of 5 years, a 1% increase in interest rates would generally result in a 5% drop in the fund's value (1% x 5 years = 5%). Though the Fed's target rate is already at its historic low, the same principle would apply in reverse if interest rates were to fall. A 1% decline in interest rates would likely result in a 3% gain for a bond holding with a duration of 3 years.

Note: *These hypothetical examples are intended as an illustration only and do not reflect the performance of any specific investment. They should not be considered financial advice. Before investing in a mutual fund, consider its investment objective, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.*

Bear in mind that duration can work somewhat differently for specific types of bonds--for example, floating-rate bonds whose interest payments get reset. That's also true for mortgage-backed bonds, since interest rate changes can cause homeowners to refinance their loans.

Is there a new one-rollover-per-year rule for IRAs?

Yes--starting in 2015.

The Internal Revenue Code says that if you receive a distribution from an IRA, you can't make a tax-free (60-day) rollover into another IRA if you've already completed a tax-free rollover within the previous 12 months. The long-standing position of the IRS, reflected in Publication 590 and proposed regulations, was that this rule applied separately to each IRA you own.

Using an IRS example, assume you have two traditional IRAs, IRA-1 and IRA-2. You take a distribution from IRA-1 and within 60 days roll it over into your new traditional IRA-3. Under the old rule, you could not make another tax-free 60-day rollover from IRA-1 (or IRA-3) within one year from the date of your distribution. But you could still make a tax-free rollover from IRA-2 to any other traditional IRA.

Recently a taxpayer, Mr. Bobrow, did just what the example above seemed to allow, taking a distribution from IRA-1 and repaying it back to IRA-1 within 60 days, and then taking a distribution from IRA-2 and repaying it back to IRA-2 within 60 days. Unfortunately for the taxpayer, the IRS decided this was no longer the correct interpretation, and told Mr. Bobrow that his transactions violated the one-rollover-per-year rule. The case made its way to the Tax Court, which agreed with the IRS and held that regardless of how many IRAs he or she maintains, a taxpayer may make only one nontaxable 60-day rollover within each 12-month period.

Not surprisingly, the IRS has announced that it will follow the Bobrow case beginning in 2015 (more technically, the new rule will not apply to any rollover that involves a distribution occurring before January 1, 2015). For the rest of 2014 the "old" one-rollover-per-year rule in IRS Publication 590 (see above) will apply to any IRA distributions you receive. But keep in mind that you can make unlimited direct transfers (as opposed to 60-day rollovers) between IRAs--these aren't subject to the one-rollover-per-year rule. So if you don't have a need to actually use the cash for some period of time, it's generally safer to use the direct transfer approach and avoid this potential problem altogether.

(Note: The one-rollover-per-year rule also applies--separately--to your Roth IRAs.)