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Capital Advice

Capital Financial Advisors of New York, LLC

Understanding Fixed Income Maturities

Bonds and notes are collectively called fixed income because they pay a fixed rate of income to the holder for a specified period of time. Bonds and notes are used by companies and governments to borrow money under defined terms. These terms are yield - how much income the buyer will earn - and maturity - how long investors will receive income before they get their principal back.

When deciding whether to buy a bond, an investor has to decide if the yield on the bond adequately compensates him for the risk involved in lending the funds. Typically, the longer the maturity, the higher the return because the farther out into the future one goes, the more uncertainty there is. There are, however, several schools of thought on this. Of course, you want the highest yield you can get for a given maturity and credit quality. Bonds that pay a fixed coupon rate for a fixed period of time are called bullets. Some bonds can be called, meaning the borrower (called the issuer) can pay the bonds off early. Most brokerage statements show the maturity date of the bonds in an investment account, not the call date.

An important consideration when evaluating the maturity or call date of a bond is the opportunity cost of waiting. With rates at extreme lows, short maturity bonds pay very little. The bond investor is faced with a choice. Short maturity bonds can be purchased with the hope that rates will go up in time for the bond to mature so the proceeds can be reinvested at the higher rates. The other option is to invest in longer maturity bonds at higher rates and risk getting a below market rate for a time when rates go up. The investor in a longer maturity bond may or may not earn the below market rate in the future, but he knows that he is getting more income now. In an economy that is growing very slowly, it may make sense to invest in longer maturity bonds and take the higher coupon rates now.

There are also bonds that pay step coupons, meaning that as the bond gets older, it pays a higher coupon. This certainly makes sense because bonds with longer maturities pay higher coupons.

There is an entire segment of the bond market that sets its coupon payments based on market factors such as indexes. For example, the S&P 500 is an index representing the stock market, and the CPI is an index that measures inflation. Bonds that calculate coupon payments based on the CPI pay more interest if inflation goes up. There are bonds that pay a high coupon as long as the stock market, represented by the S&P 500, stays above a certain level. There are bonds, called steepeners, that calculate interest based on the difference between long maturity interest rates and short interest rates. Most of these types of bonds are callable and have what is called a relatively high teaser rate, perhaps 10% or more, which is intended to entice the customer.

Bonds and notes can also be backed by packages of loans, most commonly residential mortgages. When you pay your mortgage you pay principal and interest, and you might prepay some of your principal. A simple mortgage-backed security will pay out all of these cash flows as they are paid by the borrower. These types of securities can be unpredictable because the buyer doesn't know when a borrower is going to prepay her mortgage by refinancing or selling her home. Collateralized Mortgage Obligations ("CMO") are constructed to make the cash flows generated by the underlying mortgages more predictable. The important thing to know about CMOs is that the cash flows are directed into what are called tranches which will receive the cash flows at different times. The first tranche will get all of the principal that is repaid until that tranche is paid off, then the next tranche, and so on. In this manner, the maturity of the CMO becomes more predictable. When investors see CMOs on their brokerage statement, the maturity is shown as the end of the 30-year mortgage terms of the home loans in the pool. In reality, only one tranche in the pool will actually last 30 years; the remaining tranches will be shorter.

Long-Term Care Planning Is Important for Women

Women are more likely than men to face the need for long-term care without the help of their spouse. According to the United States Administration on Aging, 42% of older women were widows in 2010 and half of the women over age 75 lived alone (www.aoa.gov). And the Centers for Disease Control reports that over 70% of nursing home residents are women (www.cdc.gov).

The prospect of needing long-term care is an important, yet sometimes overlooked, part of financial and retirement planning. Yet it may be especially vital for women to consider as they often face the need for long-term care as both a caregiver and recipient.

Women as caregivers

While you may think most long-term care is received in a nursing home setting, the National Clearinghouse for Long-Term Care Information (National Clearinghouse) estimates that about 80% of care is provided at home by informal (unpaid) family caregivers. Of those caregivers, about 60% are women (www.longtermcare.gov).

In many instances, the care provided for chronically disabled older adults is quite intensive and time-consuming. Women who act as family caregivers of older people with high levels of personal-care needs may face considerable financial, emotional, and physical strain. For instance, caregivers may face financial challenges due to lost wages from reduced work hours, time out of the workforce, extended family leave, or early retirement. Reduced work hours or extended time out of work may also affect the ability to contribute toward retirement savings, potentially resulting in a loss of retirement income.

Caregivers also may face emotional strains and poor health related to their caregiving responsibilities. This may be especially true for older women caregivers and younger women who may be caring for an older family member in addition to managing their own household.

Women as long-term care recipients

According to the Centers for Disease Control and Prevention (CDC), women outlive men by an average of 6 years (www.cdc.gov). Because they tend to live longer, women are at a higher risk than men of needing long-term care (source: National Clearinghouse). And the National Clearinghouse reports that women, on average, need care over a longer time than men (3.7 years vs. 2.2 years). With a longer life expectancy and a greater likelihood of needing long-term care, women often must confront their long-term care needs without the help of their spouse or other family members.

Paying for long-term care

Long-term care can be expensive. An important part of planning is deciding how to pay for these services.

Buying long-term care (LTC) insurance is an option. Many LTC insurance policies pay for the cost of care provided in a nursing home, assisted-living facility, or at home, but the premium paid generally depends on the age of the insured and the policy benefits and options purchased. And premiums can increase if the insurer raises its overall rates. Even with LTC insurance, you still may have some out-of-pocket contributions in addition to premium payments. For example:

- Not all policies provide coverage for care in your home, even though that's where most care is provided. While the cost of in-home care may be less than the cost of care provided in a nursing home, it can still be quite expensive.
- Most policies allow for the selection of an elimination period of between 10 days and 1 year, during which time the insured is responsible for payment of care.
- The LTC insurance benefit is often paid based on a daily or monthly maximum amount, which may not be enough to cover all of the costs of care.
- While lifetime coverage may be selected, it can increase the premium cost significantly, and some policies may not offer that option. Most common LTC insurance benefit periods last from 1 year to 5 years, after which time the insurance coverage generally ends regardless of whether care is still being provided.

Government benefits provided primarily through a state's Medicaid program may be used to pay for long-term care. To qualify for Medicaid, however, assets and income must fall below certain limits, which vary from state to state. Often, this requires spending down assets, which may mean using savings to pay for care before qualifying for Medicaid.

Women may have to confront particular challenges when planning for long-term care. A financial professional can help with some of the complex issues you may face when preparing for the possibility of long-term care, both as a caregiver and a receiver of care.

Making Benefit Decisions during Open Enrollment

The decisions you make during open enrollment season are important, because you generally must stick with the options you've chosen until the next open enrollment season. The exception to this is if you experience a "qualifying event" such as getting married or divorced, or having a child, in which case you'll be able to make changes outside of the open enrollment period.

The end of the year is traditionally open enrollment season, your annual opportunity to review your employer-provided benefit options and make elections for the upcoming plan year. Even if you're busy, take a look at the enrollment packets or information you receive from your employer. You generally only have a few weeks (or less) to make important decisions about your benefits, and with health-care costs rising, it's more important than ever to choose your benefits wisely.

Are you happy with your health plan?

During open enrollment season, many employers roll out new health plan options. Even if you're satisfied with your current health plan, it's a good idea to check out the plans your employer is offering for next year and compare these to your existing health coverage. If you decide to stick with the same health plan you have now, look for differences between this year's plan and next year's. Premiums, out-of-pocket costs, and coverage offered often change from one year to the next.

Some tips for reviewing your health plan:

- Start by reading any plan materials you've received in your open enrollment packet and find out as much as you can about your options. Look for a "What's New" section that spells out plan changes.
- List your expenses. These will vary from year to year, but what you've spent over the course of the last 12 months may be a good predictor of what you'll spend next year. Don't forget to include co-payments and deductibles, as well as dental, vision, and prescription drug expenses.
- Reevaluate your coverage to account for life changes. For example, getting married, having a baby, or retiring are events that should trigger a thorough review of your health coverage.
- Consider all out-of-pocket costs, not just the premium you'll pay. For example, if you frequently fill prescriptions, you may save money with a plan that offers the broadest prescription drug coverage with the lowest co-payments, even if it charges a higher premium than other plans.
- Compare your coverage to your spouse's if he or she is eligible for employer-sponsored health insurance. Will you come out ahead if you switch to your spouse's plan? If you have children, which plan best suits their needs?
- Take advantage of technology. Some employers offer calculators or tables that allow you to do a side-by-side comparison of health plans to help select the best option.

Should you contribute to a flexible spending account?

You can help offset your health-care costs by contributing pretax dollars to a health flexible spending account (FSA) or reduce your child-care expenses by contributing to a dependent care FSA. The money you contribute is not subject to federal income and Social Security taxes (nor generally to state and local income taxes) and you can use these tax-free dollars to pay for health-care costs not covered by insurance or for dependent care expenses.

If your employer offers you the chance to participate in one or both types of FSAs, you'll need to estimate your expenses for the upcoming year in order to decide how much to contribute (subject to limits). Your contributions will be deducted, pretax, from your paycheck. If you're currently participating in an FSA, it's also an ideal time to find out how much money you have in this year's account. Unused contributions are lost if you don't spend them by the end of your benefit period. And remember, you must enroll each year--you won't automatically be reenrolled in a health or dependent care FSA.

What other benefits or incentives are available?

Health insurance coverage is a valuable benefit, especially if your employer pays a large percentage of the cost, but many employers offer other voluntary benefits such as dental care, vision coverage, disability insurance, life insurance, and long-term care insurance. Even if your employer doesn't contribute toward the premium cost, you may be able to conveniently pay premiums via payroll deduction.

Many employers sweeten benefit packages by offering discounts on various health-related products and services, such as gym memberships, wellness programs, and eyeglasses. Find out what your employer offers--otherwise you may miss out on some saving opportunities. Your employer may also offer incentives for employees who take steps to maintain a healthy lifestyle. For example, you may be eligible for a monetary reward for completing a health assessment, or you may be reimbursed for the cost of fitness classes.

Do you need more information?

Ask your benefits administrator for help if you have any questions about your health plan, the options available to you, or enrollment instructions or deadlines.

Ask the Experts

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I'm retiring to a state with no income tax. Can my former state tax my retirement benefits?

The short answer is "no."

In the past, several states enacted "source tax" laws that attempted to tax retirement benefits if they were earned in that state, regardless of where a taxpayer resided when the benefits were ultimately paid. For example, if you earned a $50,000 annual pension while working in California, and then retired to Florida, California would attempt to tax those benefits, even though you were no longer a California resident.

But, in 1996, a federal law was enacted (P.L. 104-95) that prohibited states from taxing certain retirement benefits paid to nonresidents. As a result, if your retirement benefits are covered by the law (most are, see below), only the state in which you reside (or are domiciled) can tax those benefits.

Whether you're a resident of, or domiciled in, a state is determined by the laws of that particular state. In general, your residence is the place you actually live. Your domicile is your permanent legal residence; even if you don't currently live there, you have an intent to return and remain there.

The law applies to all qualified plans (this includes 401(k)s, profit-sharing plans, and defined benefit plans), IRAs, SEP-IRAs, Internal Revenue Section 403(a) annuities, Section 403(b) plans, Section 457(b) plans, and governmental plans.

The law provides only limited protection for nonqualified deferred compensation plan benefits. Benefits paid from nonqualified plans that are designed *solely* to pay benefits in excess of certain Internal Revenue Code limits (for example, Section 415 excess benefit plans) are covered by the law. Also covered are nonqualified plan (for example, top-hat plan) benefits that are paid over the employee's lifetime, or over a period of at least 10 years.

Examples of benefits that are not covered by the law include stock options, stock appreciation rights (SARs), and restricted stock.

What state tax issues should I consider when deciding where to retire?

If you're retired, or about to retire, you may be thinking about relocating to a state that has low (or no) income taxes, or that provides special tax benefits to retirees. Here are some state tax issues to investigate before making your move.

State income taxes typically account for a large percentage of the total taxes you pay. So, consider yourself lucky if you're planning a move to one of the seven no-income-tax states--Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming (New Hampshire and Tennessee impose income tax only on interest and dividends).

If you're considering a state that does impose an income tax, you'll need to know how that state treats Social Security and retirement income. Social Security is completely exempt from tax in more than half the states. Some states tax your Social Security benefits only if your income is above certain levels. Still others provide a general retirement income exclusion that takes Social Security benefits into account. Most of the remaining states tax Social Security benefits to the same extent they're taxed for federal income tax purposes.

Most states with an income tax fully or partially exempt retirement income--only California, Indiana, Nebraska, Rhode Island, and Vermont do not. But the exemptions vary considerably by state. Some states exempt public pensions from taxation but tax private pensions, or exempt public pensions earned in that state, but not public pensions earned in another state.

Some states exempt employer retirement benefits from tax, but not IRA income. Other states exempt a specific dollar amount of retirement income, but only if you've reached a certain age or have income within certain limits. In certain states, military pensions are fully or partially exempt, while in others they're fully taxable. Some states exempt defined benefit pension payments, but tax 401(k) benefits.

Remember that states may also impose many other kinds of taxes (for example, sales, real estate, and gift and estate taxes). Check to see if the state you're considering offers tax breaks to seniors, like property tax reductions, or additional exemptions, standard deductions, or credits based on age.

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