



SOCIETY FOR FINANCIAL EDUCATION AND PROFESSIONAL DEVELOPMENT

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financial



U C C E S S

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Bond Strategies for Varying Goals

The strategies used for bond investing will depend on the financial objectives you are pursuing. Consider these financial objectives and bond strategies:

✓ **Earning interest while preserving principal.** This is the most typical role for bonds and is usually accomplished with a buy-and-hold strategy. With this strategy, you purchase a bond and hold it to maturity, looking for the highest return potential for a given time frame within a comfortable risk level. By holding the bond to maturity, you don't have to worry about interest rate changes impacting your bond's price. If an investor sells the bond prior to maturity, there is a possibility of loss.

✓ **Maximizing income.** One way to lock in higher yields is to buy bonds with longer maturities, as they typically have higher inter-

est rates. Another strategy to help achieve this objective is to invest in high-yield bonds, which are bonds with lower credit ratings. Due to the lower credit rating, these bonds often have to offer higher interest rates to obtain investor interest. A third strategy would be to purchase bonds priced at a premium. These bonds have higher coupon rates and, thus, higher cash flows than bonds priced at par or at a discount.

✓ **Managing interest rate risk.** One of the most significant bond risks is interest rate risk, or the risk that increases in interest rates will cause a decrease in your bond's price. Bond ladders can help manage this risk. A bond ladder is a

portfolio of bonds of similar amounts maturing in several different years. When one of the bonds matures, the principal is reinvested in another bond at the bond ladder's longest maturity. By spreading out maturity dates, you lessen the impact of interest rate changes. Holding the bond to maturity eliminates the possibility of selling bonds at a loss. Since your bonds mature every year or so, your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal maturing every year or so to reinvest at higher rates. In a

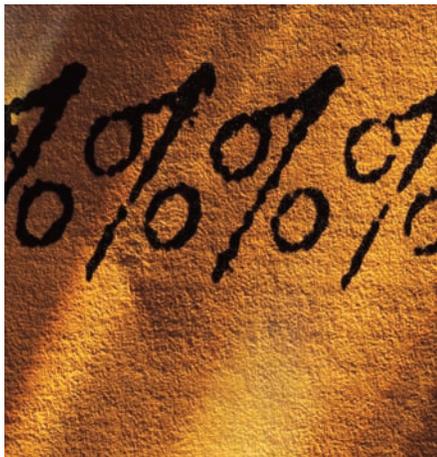
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Selecting the Right Guardian

While your first inclination may be to select your parents, make sure they have the energy to raise your children. A better alternative may be a sibling or friend. If you have several children, decide whether it is reasonable to expect one person to raise them all. Once you've settled on a guardian, discuss your decision with that person to make sure he/she is willing to take on the responsibility. Name a contingent guardian in case your first choice is unable to serve. Make sure to indicate your preferences for education, religion, lifestyle, and other important issues.

You wouldn't want your children to be a financial burden, or their presence may be resented. Determine how much is needed for living expenses, hobbies, medical expenses, and college. The person with physical custody of your children may not be the best person to handle their finances. Thus, you may want to select another individual for that role.

As your children grow, you may realize that the person you originally selected as guardian is no longer the right choice, so review this decision every year. ○○○



Bond Strategies

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declining interest rate market, you have locked in some funds in longer-term bonds with higher interest rates. But the main advantage is you don't continue to hold only short-term bonds while you wait for interest rates to peak, an event that is difficult to predict.

✔ **Help reduce the volatility of stock investments.** The advantage of including both stocks and bonds in your portfolio is that when one asset class is declining, the other will hopefully help offset this decline. For instance, in 2008, the Standard & Poor's 500 (S&P 500) returned -37%, while long-term government bonds returned 25.9%, and intermediate-term government bonds returned 13.1%.* One way to assess the percentage of bonds to include in your portfolio is to look at how holding varying percentages of stocks and bonds would have impacted your average return.

✔ **Investing for a specific future goal.** Because bonds have a definite maturity date, you can select maturity dates to coincide with when you need your principal. You might want to consider zero-coupon bonds for this purpose. Zero-coupon bonds are issued with a deep discount from face value and

do not pay interest during the bond's life. The return results from the bond's price increasing gradually from the discounted value to face value, which is reached at maturity. The longer a zero-coupon bond has until maturity, the greater its price discount will be. Like other fixed-income investments, a zero-coupon's price moves up when interest rates fall and down when rates rise. However, since zeros lock in a fixed reinvestment rate of return, they are affected more drastically by interest rate changes. One important fact to consider is taxation. Even though you do not receive any interest income until the zero-coupon bond matures, you may be taxed on the yearly growth in the zero's value (called accretion).

✔ **Recognizing a loss for tax purposes.** A bond swap, which is simply the sale of one bond and the purchase of another, can help achieve this objective without changing the basic composition of your bond portfolio. In essence, you sell a bond with a current market value less than your purchase price to realize a loss and deduct it on your tax return. You then use the proceeds to purchase similar bonds. The end result is that you still own a comparable bond, but you also have a tax loss. Review the cost of the swap before executing the transactions to ensure costs don't offset most of your expected tax savings. Make sure to comply with the wash sale rules or your loss won't be deductible. A wash sale occurs when an investor sells a security and within 30 days before or after, purchases a substantially similar security. Bonds purchased within the 30-day window must differ from the bonds sold in a material way, which includes different issuers, coupon rates, or maturity dates.

✔ **Reducing income taxes.** One strategy would be to invest in municipal securities, since municipi-

pal bond interest is generally exempt from federal, and sometimes state and local, income taxes. However, some investors may be subject to the alternative minimum tax (AMT). You should compare a muni bond's yield to the after-tax yield of a comparable taxable bond. To do that, calculate the muni bond's taxable equivalent yield. If you're not investing in a municipal bond issued in your resident state, the calculation is: the taxable equivalent yield equals the tax-exempt interest rate divided by one minus your marginal tax bracket. For instance, if you are considering a municipal bond with a yield of 4.5% and you're in the 25% tax bracket, the taxable equivalent yield is 6.0% (4.5% divided by 1 - 25%). Thus, you should compare 6.0% to any corporate bonds you are considering.

Please call if you'd like help developing bond strategies to pursue your financial objectives.

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* Source: *Stocks, Bonds, Bills, and Inflation 2010 Yearbook*, Ibbotson Associates. The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future results. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.



The Basics of the New Health Care Law

On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 was signed into law, representing a massive overhaul of the health care system that will affect almost all taxpayers, many employers, and much of the health care industry. However, the provisions will be implemented over a number of years. Here is a summary of the major provisions by implementation date:

2010

Medicare beneficiaries will receive a \$250 rebate when they reach the gap in coverage for prescription drugs, known as the “doughnut hole.” The gap exists when total costs exceed \$2,830 until they reach \$6,440.

A national high-risk insurance pool will offer insurance to individuals who have a preexisting condition and have been uninsured for at least six months until 2014.

All insurance policies must offer dependent coverage to children who have not yet attained age 27.

Insurance companies must cover certain preventive services. They also can no longer impose lifetime coverage limits, rescind coverage for any reason other than fraud, or exclude preexisting conditions for children.

Businesses with less than 25 full-time workers who are paid less than \$50,000 per year in salary get a tax credit of up to 35% of the health insurance premiums paid for employees. The credit rises to 50% in 2014.

2011

The costs for over-the-counter drugs not prescribed by a doctor can no longer be reimbursed through a health reimbursement account (HRA) or health flexible spending account (FSA) or be reimbursed on a tax-free basis through a health savings account (HSA) or Archer Medical Savings Account (MSA).

The tax on distributions from a HSA or an Archer MSA that are not used for qualified medical expenses is increased to 20% of the disbursed

amount, up from 10% for HSAs and 15% for Archer MSAs.

Medicare recipients receive free preventive services and a 50% discount on brand name drugs purchased in the Part D doughnut hole.

2013

Starting in 2013, single individuals with earned income in excess of \$200,000 and married couples with earned income in excess of \$250,000 will pay an additional 0.9% Medicare tax on the excess over those base amounts.

A 3.8% Medicare tax will be imposed on net investment income of single individuals with adjusted gross income over \$200,000 and joint filers over \$250,000. Net investment income includes interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and the net gain from the disposition of property (other than property held in a trade or business). This tax applies only to income in excess of the thresholds. Thus, if a couple earns \$150,000 in wages and \$150,000 in capital gains, \$50,000 will be subject to the new tax.

The threshold for deducting medical expenses on a tax return increases from 7.5% to 10% of AGI. Individuals age 65 and older are exempt from this increase through 2016.

Allowable flexible spending account contributions are limited to \$2,500 per year. The dollar amount will be indexed for inflation after 2013.

2014

All U.S. citizens and legal residents must have qualifying health insurance or pay a tax penalty. The tax penalty will be the greater of:

✓ \$95 per year (maximum of three times that amount or \$285 per family) or 1% of taxable income in 2014

✓ \$325 per year (maximum of three times that amount or \$975 per family) or 2% of taxable income in 2015

✓ \$695 per year (maximum of three times that amount or \$2,085 per family) or 2.5% of income in 2016

After 2016, the penalty will be increased annually by a cost-of-living adjustment. Exemptions will be granted for financial hardship, religious objections, American Indians, individuals without coverage for less than three months, aliens not lawfully in the United States, incarcerated individuals, individuals who find the lowest-cost plan option exceeds 8% of household income, individuals with incomes below the tax filing threshold (\$9,350 for singles and \$18,700 for couples in 2010), and individuals residing outside the U.S.

Individuals and small businesses with fewer than 100 workers will be able to purchase health insurance on state-based health insurance exchanges. When insurance is purchased on the exchange, the individual reports his/her income. Low- and middle-income individuals and families may then be eligible for a tax credit based on the income reported. The IRS will pay the premium assistance credit directly to the insurance plan, with the individual paying the difference in premium. The premium assistance credit is available for individuals and families with incomes up to 400% of the federal poverty level (\$43,320 for an individual or \$88,200 for a family of four, based on 2009 poverty levels) who are not eligible for Medicaid, employer-sponsored insurance, or other coverage.

Businesses with 50 or more workers will pay an annual penalty if they do not provide health insurance coverage to workers.

2018

“Cadillac” health insurance plans must pay a 40% tax on the portion of coverage worth more than \$10,200 for individuals and \$27,500 for families.

(Source: *Federal Taxes Weekly Alert*, April 8, 2010) ○○○

Dealing with a Letter from the IRS

When a letter from the Internal Revenue Service (IRS) is found in the mailbox, most people immediately assume that they have been selected for a full audit of their return. However, millions of notices are mailed each year requesting additional tax and penalties from taxpayers. A significant number of these notices are a result of four common errors — math errors; income, interest, and dividends declared in an amount that differs from that reported to the IRS; tax returns filed late without an extension; and incorrect estimated tax payments.

Many taxpayers simply pay without question due to a fear of the IRS, the confusing nature of the notice, or a concern that fighting will result in a full audit of their return. Review the notice carefully to make sure you do, in fact, owe the additional taxes. If you believe the IRS is wrong, contest the notice. When dealing with the IRS, follow these guidelines:

✓ **Don't ignore the notice.** You will continue to receive notices until you respond. Each letter will become more threatening in tone.

✓ **Respond quickly.** If you feel you owe the additional money, pay as soon as possible to stop further notices and to reduce interest charges. If you intend to contest the matter, respond in writing, sending the letter via certified mail with a return receipt to prove the IRS received your response.

✓ **Keep your response simple.** Stick to the facts, stating your case simply and concisely. Do not discuss other matters that were not raised in the letter.

✓ **Follow up.** One response may not end the matter. Often, your response will cross in the mail with another IRS notice. If that happens, just send copies of your first response with the second notice.

✓ **Get professional help if needed.** If the notice involves a technical matter, you may need the help of a tax professional to clearly present your side to the IRS.
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Avoid Tax Refunds

Most people are delighted when they find out they're getting a large tax refund. What they fail to realize is that the government is giving them back their own money that they loaned to the government interest free.

Don't view tax refunds as a forced savings program, since there are better ways to save than through interest-free loans to the government. If you're concerned that you would just spend the extra money every paycheck, have that amount automatically transferred to an investment account. *(Keep in mind that an automatic investing program, such as dollar cost averaging, does not assure a profit or protect against a loss in declining markets. Because such a strategy involves periodic investments, consider your financial ability and willingness to continue purchases through periods of low price levels.)*

If too much federal tax is being withheld from your paycheck, fill out a new W-4 to determine how many allowances you should claim. Every allowance exempts \$3,650 of income from withholding in 2010. Don't confuse allowances with exemptions claimed on your tax return. You can claim additional allowance for items such as itemized deductions that exceed the standard deduction, the child tax credit, and education credits.
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Financial Thoughts

In a recent survey, almost half (46%) of those currently working plan to delay retirement. However, most retirees (64%) retired ahead of schedule, with only 3% retiring later than they originally planned. Only one-third of those who want to work after retirement have looked into a new career (Source: MetLife, 2010).

New estimates indicate that

U.S. workers need to accumulate more than 15 times their final pay to maintain their preretirement standard of living after retirement. Social Security is expected to provide 4.7 times final pay, leaving workers to provide the remaining 11 times final pay through employer-sponsored retirement accounts and other personal savings. Researchers predict that only 18% of workers who contribute to

a defined-contribution plan and work a full career are likely to meet this goal (Source: Hewitt Associates, 2010).

Approximately 3.7 million individuals age 65 and over are not able to meet basic daily expenses, and another 10 million are considered low income, approximately one-third of the elderly population (Source: AARP, 2010).
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