Investor Insights & Outlook

Investment Updates For Younger Investors

Provided to you by
St. Matthew's UMC
Endowment Committee

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Risk, Not Volatility, Is the Real Enemy

What would you do if your investments lost 10% in a single day? A) Add more money to my account. B) Hold steady with what I've got. C) Yank my money; I wouldn't be able to stand any more losses.

If investors buy the right investments but sell them at the wrong time because they can’t handle the price fluctuations, they may have been better off avoiding those investments in the first place. Most investors are poor judges of their own risk tolerance, feeling more risk-resilient in up markets and more risk-averse after market losses. However, focusing on an investor's response to short-term losses inappropriately confuses risk and volatility. Understanding the difference between the two and focusing on the former is a potential way to make sure you reach your financial goals.

Volatility encompasses the changes in the price of a security, a portfolio, or a market segment, both on the upside and downside, during a short time period like a day, a month, or a year. Risk, by contrast, is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. So how can investors focus on risk while putting volatility in its place? The first step is to know that volatility is inevitable, and if you have a long enough time horizon, you may be able to harness it for your own benefit. Diversifying your portfolio among different asset classes can also help mute the volatility. It helps to articulate your real risks: your financial goals and the possibility of falling short of them. Finally, plan to keep money you need for near-term expenses out of the volatility mix altogether.

Investing in securities always involves risk of loss. Diversification does not eliminate the risk of experiencing investment losses.

Advisor Corner

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Assessing the Student Loan Landscape

These days, borrowing to pay for college has become a lot more defensive. Not only may student-loan terms be less attractive than they were in the past, but new graduates may also get squeezed if they have to begin repaying their loans before they land a job. Owing in no small part to the still-anemic economic recovery, the student loan default rate has been on the rise, according to the U.S. Department of Education (September 2012).

As with mortgage borrowers, student-loan shoppers face a bewildering array of options that carry varying interest rates, fees, and terms. In all, it pays to do your homework and investigate other alternatives before signing on the dotted line for a student loan.

Determine Your Need: The first step in the college-funding process is to determine how much of your child's education expenses your family will likely be on the hook for. Submitting the Free Application for Federal Student Aid (FAFSA) is the way to officially check on financial aid eligibility, and your specific package will vary by school.

Discuss the Payoff: If it looks like you and/or your child will have to borrow a sizable sum to cover the cost of college, it's wise to begin discussing those numbers in the context of your child's expected career path. If your child will graduate with $100,000 in student-loan debt but plans to venture into a field where starting salaries are in the $25,000 per year range, it doesn't take a math major to see that it will take many years to retire that debt, and doing so could impede your child's ability to reach other financial goals.

Know the Different Types: College loans come in a number of different varieties, but there are a few key categories to be aware of. The first choices for most students seeking additional funding are those extended by the federal government. Perkins loans are available exclusively to low-income students. Stafford loans come in two key varieties. With subsidized Stafford loans, students aren't on the hook for interest until after graduation, but with unsubsidized Stafford loans, interest begins accruing immediately. Students applying for subsidized Stafford loans must demonstrate financial need, whereas students needn't demonstrate financial need to qualify for unsubsidized Stafford loans. The second key category is federal loans made directly to parents, usually called PLUS loans. On the positive side, parents can typically borrow much more than students. However, interest begins accruing immediately and payments must also begin immediately. The final student-loan category is a private loan extended by a bank. In general, the cost of a private student loan can be much higher than that of a federal loan.

Don't Overestimate the Value of the Interest Deduction: You may have heard that you'll be eligible to deduct the interest on student loan debt. That's true, but don't overestimate the value of that deduction. In 2012, you can only deduct $2,500 in student loan interest per year; single parents earning more than $75,000 and married couples filing jointly who earn more than $150,000 per year cannot deduct the interest at all.

Consider Additional Options: Rather than assuming student loans are the only way to cover the cost of college, it's important to take a step back. Fully exploring financial aid packages, scholarships, and work-study programs can help reduce the strain that such loans can impose on families and new graduates; some grandparents may also have the wherewithal to help defray college costs. Parents may also contemplate tapping home equity lines of credit or using their own savings plans to fund college.

Please consult with a financial or tax professional for advice specific to your situation.

Dividends and Taxes: Dos and Don'ts

Dividend-paying stocks have enjoyed a renaissance during the past several years. Despite the high-profile blowups of many financial stocks, dividend payers generally outperformed non-dividend payers during the financial crisis. Further burnishing dividend payers' appeal is the currently benign tax treatment of dividends: Those in the 25% tax bracket and above pay taxes at a 15% rate on qualified dividends, while those in the 10% and 15% tax brackets pay no taxes at all on such dividends. That's a big attraction, but investors need to do their research before embracing dividend payers for their taxable accounts. Here are some dos and don'ts.

Do Understand the Difference between Qualified and Nonqualified Dividends: You often hear that the dividend tax rate is either 15% or 0%, depending on your tax bracket. But if it's not the right kind of dividend, you could actually owe ordinary income tax on your dividends (as much as 35%, depending on your tax bracket). That's because the Internal Revenue Service separates dividends into qualified and nonqualified categories. One big type of nonqualified dividends are those that REITs kick off; while their yields might be lush relative to the income you receive from other stocks, you'll owe ordinary income tax on that income. Owing to that tax treatment, investors in the typical real estate fund have paid a tax-cost ratio of 1.9% per year during the past decade, far higher than any other equity category. (Foreign-stock dividends may not necessarily qualify for the low tax treatment, either.)

Do Watch Out for Income-Focused Funds: If you buy and hold individual stocks, you can do your homework and downplay nonqualified dividend payers. But if you own stock mutual funds focused on dividend payers, such as those with "Equity Income" or "Dividend" in their names, you won't have the same opportunity to pick and choose. Unless a dividend-focused fund is explicitly tax managed, the manager's only goal is to maximize income and total return. That means it's highly possible that the fund will hold companies that kick off nonqualified dividends, and such a fund may even own some bonds, to boot. So before you park an equity-income fund in your taxable account, first spend some time looking under the hood.

Don't Assume It Will Stay This Way: We've gotten spoiled with the low tax rate on dividends. But the current policy has only been around since 2003, and it's set to revert to pre-2003 levels in 2013. That means that dividend income will again be taxed at investors' ordinary income tax rates. If that happens, you might decide you want to get those dividend payers into a tax-sheltered wrapper like an IRA or 401(k) post-haste. After all, it's better to let those dividends compound rather than letting the IRS take a big cut right off the top.

Don’t Hold Very High Dividend Payers in Taxable Accounts: Even if a company's or fund's dividends are qualified all the way, companies and funds that kick off very high levels of income are still usually best left in your tax-sheltered accounts. That's because you're going to receive that high income stream whether you need the money or not, and in turn, you'll owe taxes on that dividend for the year in which you received it. By holding non-dividend payers in your taxable accounts, by contrast, you won't be on the hook for taxes unless you take action and sell shares. Of course, you might decide that dividend payers' fundamental attractions supersede the tax considerations, but all else equal, dividend payers are less tax-efficient than non-dividend payers, even in the current low-tax environment.

What's the Number?

"The 2012 Retirement Confidence Survey: Job Insecurity, Debt Weigh on Retirement Confidence, Savings," published by the Employee Benefit Research Institute in March 2012, includes the following highlights.

1) Only 14% of Americans are very confident they will have enough money to live comfortably in retirement. 42% of Americans identify job uncertainty as the most pressing financial issue facing Americans today.

2) 60% of workers report that the total value of their household's savings and investments, excluding the value of their primary home and any defined benefit plans, is less than $25,000.

3) 37% of workers in 2012 said they expected to retire after age 65, up from 11% in 1991. 62% of workers and 37% of retirees consider their current level of debt to be a problem.

4) 56% of workers report they and/or their spouse have not tried to calculate how much money they will need to have saved by the time they retire so that they can live comfortably in retirement.

5) 16% of workers and 11% of retirees are very confident that their investments will grow in value. But 67% of workers state that they are a little or a lot behind schedule when asked to evaluate their progress in planning and saving for retirement.

6) 24% of retirees are very confident about having enough money to cover medical expenses in retirement, and 18% of retirees are very confident about having enough money to pay for long-term care in retirement.

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