



# American Financial Management Group

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*Have you ever wondered if your company retirement plan offers the lineup of investments you might like, such as Exchange Traded Funds and Individual Securities? Or if expenses in the fund choices offered are as low as you could get in a self-directed IRA? Do you have and use the tools financial professionals employ to seek to control market volatility? Have you considered a sequential conversion of some of your retirement accounts to Roth so you have tax-free retirement income with which to pay such non-deductible expenses as Medicare premiums and uninsured expenses that will be less than 10% of adjusted gross income?*

Best Regards,

Jeff

### August 2015

Reviewing Your Finances Mid-Year

Five Ways to Manage Risk in Your Retirement Savings Plan

Self-Directed IRAs

What return are you really earning on your money?



## Reviewing Your Finances Mid-Year



You made it through tax season and now you're looking forward to your summer vacation. But before you go, take some time to review your finances. Mid-year is an ideal time to do so, because the demands on

your time may be fewer, and the planning opportunities greater, than if you wait until the end of the year.

### Think about your priorities

What are your priorities? Here are some questions that may 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?
- Have you managed to save as much as you expected this year?
- Are you comfortable with the amount of debt that you have?
- Are you concerned about the performance of your investment portfolio?
- Do you have any other specific needs or concerns that you would like to address?

### Take another look at your taxes

Completing a mid-year estimate of your tax liability may 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.

You'll want to check your withholding, especially if you owed taxes when you filed your most recent income tax return or you received a large refund. Doing that now, rather than waiting until the end of the year, may 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.

To help avoid missed tax-saving opportunities for the year, one basic thing you can do right now 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.

### Reconsider your retirement plan

If you're working and you received a pay increase this year, don't overlook the opportunity to increase your retirement plan contributions by asking your employer to set aside a higher percentage of your salary. In 2015, you may be able to contribute up to \$18,000 to your workplace retirement plan (\$24,000 if you're age 50 or older).

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

### Review your investments

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, you may need to rebalance more frequently if the market is volatile.

**Note:** Asset allocation is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

### Identify your insurance needs

Do you know exactly how much life and disability insurance coverage you have? Are you familiar with the terms of your homeowners, renters, and 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.



*All investing involves risk, including the possible loss of principal. There can be no assurance that any investing strategy will be successful. Investments offering higher potential rates of return also involve a higher level of risk.*

*Asset allocation and diversification are methods used to manage investment risk; they do not guarantee a profit or protect against a loss.*

## Five Ways to Manage Risk in Your Retirement Savings Plan

Your employer-sponsored retirement savings plan is a convenient way to help you accumulate money for retirement. Using payroll deductions, you invest for the future automatically, following that oft-noted advice to "pay yourself first." But choosing to participate is just one important step. Another key to making it work for you is managing risk in your portfolio. Following are five ways to tackle this important task.

### 1. Know your personal risk tolerance

Gauging your personal risk tolerance--or your ability to endure losses in your account due to swings in the market--is an important first step. All investments come with some level of risk, so it's important to be aware of how much volatility you can comfortably withstand before choosing investments.

One way to do this is to reflect on a series of questions, such as:

- How well would you sleep at night knowing your retirement portfolio dropped 5%? 10%? 20%?
- How much time do you have until you will need the money? Typically, the longer your time horizon, the more you may be able to hold steady during short-term downturns in pursuit of longer-term goals.
- Do you have savings and investments outside of your plan, including an emergency savings account?

Your plan's educational materials may offer worksheets and other tools to help you gauge your own risk tolerance. Such materials typically ask a series of questions similar to those above, and then generate a score based on your answers that may help you choose appropriate investments.

### 2. Develop a target asset allocation

Once you understand your risk tolerance, the next step is to develop an asset allocation mix that is suitable for your savings goal while taking your risk tolerance into consideration. Asset allocation is the process of dividing your investment dollars among the various asset categories offered in your plan, generally stocks, bonds, and cash/stable value investments. If you're a young investor with a hardy tolerance for risk, you might choose an allocation composed heavily of stocks. On the other hand, if retirement is less than 10 years away and you fear losing money, your allocation might lean more toward bonds and cash investments.

### 3. Be sure to diversify

Even the most aggressive investor can potentially benefit from diversification, which generally means not putting all your eggs in one basket. Let's take one example from above: Although that young investor may choose to put a large chunk of her retirement account in stocks, she should still consider putting some of the money into bonds and possibly cash to help balance any losses that may occur in the stock portion. Even within the stock allocation, she may want to diversify among different types of stocks, such as domestic, international, growth, and value stocks.

### 4. Understand dollar cost averaging

Your plan also helps you manage risk automatically through a process called dollar cost averaging (DCA). When you contribute to your plan, chances are you contribute an equal dollar amount each pay period, which then purchases shares of the investments you have selected. This process--investing a fixed dollar amount at regular intervals--is DCA. As the prices of the investments you purchase rise and fall over time, you take advantage of the swings by buying fewer shares when prices are high and more shares when prices are low--in essence, following the old investing adage to "buy low." After a period of time, the average cost you pay for the shares you accumulate may be lower than if you had purchased all the shares with one lump sum.

Remember that DCA involves continuous investment in securities regardless of their price. As you think about the potential benefits of DCA, you should also consider your ability to make purchases through extended periods of low or falling prices.

### 5. Perform regular maintenance

Although it's generally not necessary to review your retirement portfolio too frequently (e.g., every day or even every week), it is advisable to monitor it at least once per year and as major events occur in your life. During these reviews, you'll want to determine if your risk tolerance has changed and check your asset allocation to determine whether it's still on track. You may want to rebalance--shifting some money from one investment to another--to bring your allocation back in line with your target. Or you may want to make other changes in your portfolio to keep it in line with your changing circumstances. Such regular maintenance is critical to help manage risk in your portfolio.



**The IRS has warned: "IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction." (Source: IRS Instructions to Form 1099-R, 2015)**

**Note: All investing involves risk, including the potential loss of principal.**

## Self-Directed IRAs

A self-directed IRA isn't a different type of IRA. Rather, the term refers to any individual retirement account (traditional or Roth) that allows you to direct the investment of your IRA assets into nontraditional investments. For example, in addition to the usual IRA mainstays (stocks, bonds, mutual funds, and CDs), a self-directed IRA might invest in real estate, limited partnership interests, a small business, or anything else the law (and your IRA trustee/custodian) allows. In fact, the only investment you can't have in an IRA is life insurance. Collectibles (artwork, stamps, wine, and antiques) aren't strictly prohibited, but if your IRA purchases these items, you could suffer adverse tax consequences.

### Getting started

First, you'll need to find a trustee or custodian that specializes in self-directed IRAs. Make sure you understand the expenses involved—some trustees charge transaction fees and/or asset-based fees, depending on the particular investment. You also need to be aware of the prohibited transaction rules. These rules are designed to make sure that only your IRA, and not you (or your immediate family), benefits from your IRA transactions. If you violate these rules, your account will cease to be treated as an IRA, with potentially devastating tax consequences.

Finally, you need to understand the UBIT (unrelated business income tax) rules. Even though IRA investments usually grow tax deferred (or even potentially tax free in the case of a Roth IRA), if your IRA conducts certain business activities or has debt-financed income, then your IRA could be taxed currently on all or part of the income generated.

### What are prohibited transactions?

Generally, a prohibited transaction is any improper use of an IRA by you, your beneficiary, or a "disqualified person" including certain family members. The following are examples of prohibited IRA transactions:

- Selling property to, or buying property from, the IRA
- Borrowing money from it
- Receiving unreasonable compensation for managing it
- Using it as security for a loan
- Buying property for personal use (present or future) with IRA funds

The IRS has warned: "IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA

owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction." (Source: IRS Instructions to Form 1099-R, 2015)

### Consequences of engaging in a prohibited transaction

Generally, if you (or your beneficiary after your death) engage in a prohibited transaction at any time during the year, the account stops being an IRA as of the first day of that year. The account is also treated as distributing all its assets to you at their fair market values on the first day of the year. For a traditional IRA, if the total of those values exceeds your basis in the IRA, you'll have taxable income that's included in your income. If you're not yet age 59½, the 10% premature distribution penalty tax may also apply.

The IRS hasn't yet provided specific guidance describing how these rules apply to Roth IRAs. However, it's likely that if you've satisfied the requirements for a qualified distribution, the distribution will still be tax free. A nonqualified distribution from a Roth IRA will result in taxable income to the extent the distribution exceeds your Roth IRA contributions (and again, the premature distribution penalty tax may apply if you haven't yet reached age 59½).

### What is UBIT?

UBIT, as noted earlier, stands for "unrelated business income tax." While not common, it can apply to your traditional (and Roth) IRA. In simple terms, if your IRA regularly conducts a trade or business (for example, your IRA buys and operates a bakery), then the income from that trade or business (less any expenses directly connected with carrying on the trade or business) is subject to UBIT. The IRA is taxed on the income (unrelated business taxable income, or UBTI) at trust tax rates.

The term "trade or business" has been broadly interpreted to apply even if an IRA doesn't directly conduct a business, but instead invests in a pass-through entity, like a partnership, that conducts a trade or business. If an IRA invests in a partnership that conducts a trade or business, then the IRA must calculate its UBTI based on its share of the partnership's gross income and deductions.

As you can see, a self-directed IRA can provide you with almost unlimited investment flexibility, but also presents some traps for the unwary. Carefully weigh the benefits and risks to determine if it's the right choice for you.

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### What return are you really earning on your money?

If you're like most people, you probably want to know what return you might expect before you invest. But to translate a given rate of return into actual

income or growth potential, you'll need to understand the difference between *nominal return* and *real return*, and how that difference can affect your ability to target financial goals.

Let's say you have a certificate of deposit (CD) that's about to expire. The yield on the new three-year CD you're considering is 1.5%.

But that 1.5% is the CD's nominal rate of return; it doesn't account for inflation or taxes. If you're taxed at the 28% federal income tax rate, roughly 0.42% of that 1.5% will be gobbled up by federal taxes on the interest. Okay, you say, that still leaves an interest rate of 1.08%; at least you're earning something.

However, you also need to consider the purchasing power of the interest that the CD pays. Even though inflation is relatively low today, it can still affect your purchasing power, especially over time. Let's say that consumer prices have gone up by 1% over the past year

and you adjust your 1.08% after-tax return for inflation. Suddenly, you're barely breaking even on your investment.

What's left after the impact of inflation and taxes is your real return, because that's what you're really earning in actual purchasing power. If the nominal return on an investment is low enough, the real return can actually be negative, depending on your tax bracket and the inflation rate over time. Though this hypothetical example doesn't represent the performance of any actual investment, it illustrates the importance of understanding what you're really earning.

Knowing the difference between nominal and real return may help you make better decisions when it comes to investing your money. You'll want to choose investments that match your financial goals and tolerance for risk. In some cases, the security an investment offers may be important enough that you're willing to accept a low real return; in other cases, you may choose an investment that has the potential for a higher real return but carries a higher degree of risk.



### What is asset allocation?

Each type of investment has specific strengths and weaknesses that enable it to play a specific role in your overall investing strategy.

Some investments may offer growth potential. Others may provide regular income or relative safety, or simply serve as a temporary place to park your money. And some investments may even serve to fill more than one role. Because you likely have multiple needs and objectives, you probably need some combination of investment types, or asset classes.

Balancing how much of each asset class should be included in your portfolio is a critical task. The balance between growth, income, and safety is determined by your asset allocation, and it can help you manage the level and types of risks you face.

The combination of investments you choose can be as important as your specific investments. Your mix of various asset classes such as stocks, bonds, and cash alternatives generally accounts for most of the ups and downs of your portfolio's returns.

Ideally, your portfolio should have an overall combination of investments that minimizes the

risk you take in trying to achieve a targeted rate of return. This often means balancing conservative investments against others that are designed to provide a higher potential return but also involve more risk. However, asset allocation doesn't guarantee a profit or eliminate the possibility of investment loss.

Someone living on a fixed income, whose priority is having a regular stream of money coming in, will probably need a very different asset allocation than a young, well-to-do working professional whose priority is saving for a retirement that's 30 years away. Even if two people are the same age and have similar incomes, they may have very different needs and goals, and their asset allocations should be tailored to their unique circumstances.

And remember, even if your asset allocation was appropriate for you when you chose it, it may not be appropriate for you now. It should change as your circumstances do and as new ways to invest are introduced. A piece of clothing you wore 10 years ago may not fit now; you just might need to update your asset allocation, too.