eResources Review

Asset Management Resources' E-mail Newsletter

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Rates on the Rise: Strategies for Fixed-Income Investors

A long period of low yields has been challenging for many fixed-income investors, but owning bond investments in a rising interest-rate environment could become even trickier. When interest rates go up, the prices of existing bonds typically fall. Consequently, the Federal Reserve's rate-setting decisions could affect the entire fixed-income market.

Still, bonds are a mainstay for conservative investors who prioritize the preservation of principal over returns, and for retirees in need of a predictable income stream. Although diversification does not guarantee a profit or protect against investment loss, owning a diversified mix of bond types and maturities is one way to manage interest-rate and credit risk in your portfolio.

Consider duration

Overall, bonds with shorter maturities are less sensitive to interest-rate fluctuations than long-term bonds. A bond's maturity is the length of time by which the principal and interest are scheduled to be repaid. A bond's duration is a more specific measure of interest-rate sensitivity that takes cash flow (interest payments) into account.

For example, a five-year Treasury bond has a duration of less than five years, reflecting income payments that are received prior to maturity. A five-year corporate bond with a higher yield will have an even shorter duration, making it slightly less sensitive to interest-rate fluctuations. If interest rates increase 1%, a bond's value is generally expected to drop by approximately the bond's duration. Thus, a bond with a five-year duration could lose roughly 5% in value. (U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest.)

Build a ladder

Bond laddering is a buy-and-hold strategy that could also help cushion the potential effects of rising rates. This process puts your money to work systematically, without trying to predict rate changes and time the market.

Buying individual bonds provides some certainty, because investors know how much they will earn if they hold a bond until maturity, unless the issuer defaults. A ladder is a portfolio of bonds with maturities that are spaced out at regular intervals over a certain number of years. When short-term bonds from the low rungs of the ladder mature, the funds are reinvested at the top end of the ladder. As interest rates rise, investors may be able to increase their cash flow by capturing higher yields. A ladder may also help insulate bond portfolios from volatility, because higher yields on new bonds may help offset any paper losses on existing holdings.

Bond ladders may vary in size and structure, and could include different types of bonds depending on an investor's time horizon, risk tolerance, and goals. Individual bonds are typically sold in minimum denominations of $1,000 to $5,000, so creating a bond ladder with a sufficient level of diversification might require a sizable investment.

Rise with rates

Adding a floating-rate component to a bond portfolio may also provide some protection against interest-rate risk. These investments (long offered by U.S. corporations) have interest payments that typically adjust based on prevailing short-term rates.

The U.S. Treasury started issuing floating-rate notes with two-year maturities in January 2014. Investors receive interest payments on a quarterly basis. Rates are tied to the most recent 13-week Treasury bill auction and reset weekly, so investors are paid more as interest rates rise and less as they fall.

***Note:** Bonds redeemed prior to maturity could be worth more or less than their original cost, and investments seeking to achieve higher yields also involve a higher degree of risk. Interest payments are taxed as ordinary income. Treasury bond interest is subject to federal income tax but exempt from state and local income taxes.*

Can You Get to a Million Dollars?

In trying to accumulate $1 million (or any other amount), you should generally consider how much you have now, how much you can contribute in the future, how much you might earn on your investments, and how long you have to accumulate funds. But remember, there are no guarantees--even when you have a clearly defined goal. For example, the market might not perform as expected, or you may have to reduce your contributions at some point.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful. Review your progress periodically and be prepared to make adjustments when necessary.

Often in life, you have investment goals that you hope to reach. Say, for example, you have determined that you would like to have $1 million in your investment portfolio by the time you retire. But will you be able to get there?

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Current balance--your starting point

Of course, the more you have today, the less you may need to contribute to your investment portfolio or earn on your investments over your time horizon.

Time (accumulation period)

In general, the longer your time horizon, the greater the opportunity you have to accumulate $1 million. If you have a sufficiently long time horizon and a sufficiently large current balance, with adequate earnings you may be able to reach your goal without making any additional contributions. With a longer time horizon, you'll also have more time to recover if the value of your investments drops. If additional contributions are required to help you reach your goal, the more time you have to target your goal, the less you may have to contribute.

The sooner you start making contributions, the better. If you wait too long and the time remaining to accumulate funds becomes too short, you may be unable to make the large contributions required to reach your goal. In such a case, you might consider whether you can extend the accumulation period--for example, by delaying retirement.

Rate of return (earnings)

In general, the greater the rate of return that you can earn on your investments, the more likely that you'll reach your investment goal of $1 million. The greater the proportion of the investment portfolio that comes from earnings, the less you may need to contribute to the portfolio. Earnings can benefit from long time horizons and compound rates of return, as returns are earned on any earlier earnings.

However, higher rates of return are generally associated with greater investment risk and the possibility of investment losses. It's important to choose investments that meet your time horizon and tolerance for risk. And be realistic in your assumptions. What rate of return is realistic given your current asset allocation and investment selection?

Amount of contributions

Of course, the more you can regularly contribute to your investment portfolio (e.g., monthly or yearly), the better your chances are of reaching your $1 million investment goal, especially if you start contributing early and have a long time horizon.

Contributions needed

Now that the primary factors that affect your chances of getting to a million dollars have been reviewed, let's consider this question: At a given rate of return, how much do you need to save each year to reach the $1 million target? For example, let's assume you anticipate that you can earn a 6% annual rate of return (ROR) on your investments. If your current balance is $450,000 and you have 15 more years to reach $1 million, you may not need to make any additional contributions (see scenario 1 in the table below); but if you have only 10 more years, you'll need to make annual contributions of $14,728 (see scenario 2). If your current balance is $0 and you have 30 more years to reach $1 million, you'll need to contribute $12,649 annually (see scenario 3); but if you have only 20 more years, you'll need to contribute $27,185 annually (see scenario 4).

Scenario	1	2
Target	$1,000,000	$1,000,000
Current balance	$450,000	$450,000
Years	15	10
ROR	6%	6%
Annual contribution	$0	$14,728

Scenario	3	4
Target	$1,000,000	$1,000,000
Current balance	$0	$0
Years	30	20
ROR	6%	6%
Annual contribution	$12,649	$27,185

Note: *This hypothetical example is not intended to reflect the actual performance of any investment. Actual results may vary. Taxes, fees, expenses, and inflation are not considered and would reduce the performance shown if they were included.*

ASSET MANAGEMENT RESOURCES

Earn Too Much for a Roth IRA? Try the Back Door!

If you have taxable compensation, you can contribute up to $5,500 to an IRA in 2016, or $6,500 if you'll be 50 or older by the end of the year. You can't contribute to a traditional IRA for the year you turn 70½, or thereafter.

To be eligible for tax-free qualified distributions from a Roth IRA, you must satisfy a five-year holding period and, in addition, one of the following must apply: you have reached age 59½ by the time of the withdrawal, the withdrawal is made because of disability, or the withdrawal is made to pay first-time homebuyer expenses ($10,000 lifetime limit from all IRAs).

It's not clear how long the back door is going to remain open. There have been suggestions that this is a loophole that should be legislatively closed.

Background

Roth IRAs, created in 1997 as part of the Taxpayer Relief Act, represented an entirely new savings opportunity--the ability to make after-tax contributions that could, if certain conditions were met, grow entirely free of federal income taxes. These new savings vehicles were essentially the inverse of traditional IRAs, where you could make deductible contributions but distributions would be fully taxable. The law also allowed taxpayers to "convert" traditional IRAs to Roth IRAs by paying income taxes on the amount converted in the year of conversion.

Unfortunately, the law contained two provisions that limited the ability of high-income taxpayers to participate in the Roth revolution. First, the annual contributions an individual could make to a Roth IRA were reduced or eliminated if his or her income exceeded certain levels. Second, individuals with incomes of $100,000 or more, or whose tax filing status was married filing separately, were prohibited from converting a traditional IRA to a Roth IRA.

In 2005, however, Congress passed the Tax Increase Prevention and Reconciliation Act (TIPRA), which repealed the second barrier, allowing anyone to convert a traditional IRA to a Roth IRA--starting in 2010--regardless of income level or marital status. But TIPRA did not repeal the provision that limited the ability to make annual Roth contributions based on income. The current limits are set forth in the chart below:

Phaseout ranges for determining ability to fund a Roth IRA in 2016*	
Single/head of household	$117,000-$132,000
Married filing jointly	$184,000-$194,000
Married filing separately	$0-$10,000
***Applies to modified adjusted gross income (MAGI)**	

Through the back door...

Repeal of the provisions limiting conversions created an obvious opportunity for high-income taxpayers who wanted to make annual Roth contributions but couldn't because of the income limits. Those taxpayers (who would also run afoul of similar income limits that prohibited them from making deductible contributions to traditional IRAs) could simply make nondeductible contributions to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA--a "back door" Roth IRA.

The IRS is always at the front door...

For taxpayers who have no other traditional IRAs, establishment of the back-door Roth IRA is essentially tax free. Income tax is payable on the earnings, if any, that the traditional IRA generates until the Roth conversion is complete. However, assuming the contribution and conversion are done in tandem, the tax impact should be nominal. (The 10% penalty tax for distributions prior to age 59½ generally doesn't apply to taxable conversions.)

But if a taxpayer owns other traditional IRAs at the time of conversion, the tax calculation is a bit more complicated because of the so-called "IRA aggregation rule." When calculating the tax impact of a distribution (including a conversion) from any traditional IRA, all traditional and SEP/SIMPLE IRAs a taxpayer owns (other than inherited IRAs) must be aggregated and treated as a single IRA.

For example, assume Jillian creates a back-door Roth IRA in 2016 by making a $5,500 contribution to a traditional IRA and then converting that IRA to a Roth IRA. She also has another traditional IRA that contains deductible contributions and earnings worth $20,000. Her total traditional IRA balance prior to the conversion is therefore $25,500 ($20,000 taxable and $5,500 nontaxable).

She has a distribution (conversion) of $5,500: 78.4% of that distribution ($20,000/$25,500) is considered taxable ($4,313.73), and 21.6% of that distribution ($5,500/$25,500) is considered nontaxable ($1,186.27).

Note: These tax calculations can be complicated. Fortunately, the IRS has provided a worksheet (Form 8606) for calculating the taxable portion of a conversion.

There's also a side door...

Let's assume Jillian in the example above isn't thrilled about having to pay any income tax on the Roth conversion. Is there anything she can do about it?

One strategy to reduce or eliminate the conversion tax is to transfer the taxable amount in the traditional IRAs ($20,000 in our example) to an employer qualified plan like a 401(k) prior to establishing the back-door Roth IRA, leaving the traditional IRAs holding only after-tax dollars. Many 401(k) plans accept incoming rollovers. Check with your plan administrator.

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Should I loan my child money for a down payment on a house?

For a lot of young people today, it's difficult to purchase a home without at least some financial assistance. As a result, many young adults turn to their parents or other family members for help with a down payment.

If you plan on lending your child money for a down payment on a house, you should try to assume the role of a commercial lender. Setting the terms of the loan in writing will demonstrate to your child that you take both your responsibility as lender and your child's responsibility as borrower seriously.

While having an actual loan contract may seem too businesslike to some parents, doing so can help set expectations between you and your child. The loan contract should spell out the exact loan amount, the interest rate and a repayment schedule. To avoid the uncomfortable situation of having to remind your child that a payment is due, consider asking him or her to set up automatic monthly transfers from his or her bank account to yours.

This type of loan documentation is also important for IRS purposes because there may be potential income and gift tax issues with these types of loans. For example, interest paid by your child will be considered taxable income, and if adequate interest is not charged for the loan, special imputed interest rules may apply.

If you don't feel comfortable lending your child money, you may want to consider making a smaller, no-strings-attached gift that doesn't have to be repaid. Currently, you can gift up to $14,000 annually per person under the gift tax exclusion. However, if you do gift money for a down payment, your child's lender may still require him or her to put up some of his or her own money, depending on the type of mortgage chosen.

Keep in mind that lending money to family members can be a tricky proposition. Before entering into this type of financial arrangement, you should take the time to carefully weigh both the financial and emotional costs.

Can you separate college financial aid myths from facts?

For all you parents out there, how knowledgeable are you about college financial aid? See if you know whether these financial aid statements are myth or fact.

1. Family income is the main factor that determines eligibility for aid. Answer: Fact. But while it's true that family income is the main factor that determines how much financial aid your child might receive, it's not the only factor. The number of children you'll have in college at the same time is also a significant factor. Other factors include your overall family size, your assets, and the age of the older parent.

2. If my child gets accepted at a more expensive college, we'll automatically get more aid. Answer: Myth. The government calculates your expected family contribution (EFC) based on the income and asset information you provide in its aid application, the FAFSA. Your EFC stays the same, no matter what college your child is accepted to. The cost of a particular college minus your EFC equals your child's financial need, which will vary by college. A greater financial need doesn't automatically translate into more financial aid, though the more competitive colleges will try to meet all or most of it.

3. I plan to stop contributing to my 401(k) plan while my child is in college because colleges will expect me to borrow from it. Answer: Myth. The government and colleges do not count the value of retirement accounts when determining how much aid your child might be eligible for, and they don't factor in any borrowing against these accounts.

4. I wish I could estimate the financial aid my child might receive at a particular college ahead of time, but I'll have to wait until she actually applies. Answer: Myth. Every college has a college-specific net price calculator on its website that you can use to enter your family's financial information before your child applies. It will provide an estimate of how much aid your child is likely to receive at that college.

5. Ivy League schools don't offer merit scholarships. Answer: Fact. But don't fall into the trap of limiting your search to just these schools. Many schools offer merit scholarships and can provide your child with an excellent education.