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Expenses And Behavior Are Key To Investment Success

John Bogle, 84, is a hero to investors. His common sense message about controlling investment expenses helped him build The Vanguard Group into one of the world's largest mutual fund companies.

Bogle, for decades, has decried high fees extracted by Wall Street for managing mutual funds, and his message about the importance of low-expense investing is well-known. Nonetheless, the picture of retirement savings painted by Bogle in the PBS news-documentary series, *Frontline*, in March 2013, was astonishing. In a segment aptly titled, "The Retirement Gamble," Bogle shows that Americans, who save for retirement for their entire working lives in 401(k)s and IRAs, often wind up paying most of their nest eggs to Wall Street.

Using the accompanying chart, Bogle showed the ravaging effects of paying high fees on mutual funds. Paying 2% annually to a mutual fund that earns a return of 7% annually for 50 years, results in 63% of your nest egg going to pay Wall Street fees. Because of the magic of compounding, much of your retirement savings can go to paying mutual funds to manage your money.

Bogle shows why low-cost mutual funds can be crucial to retirement success. He criticizes the use of "actively managed" funds that try to pick the right stock or bond to hold in a portfolio in favor of the use of index funds and Exchange Traded Funds (ETFs), which offer much lower expenses.

Bogle and *Frontline* did a great service and low-expense investments are a no-brainer. Where it gets complicated, however, is in choosing the right allocations for low-expenses investments. Creating a mix of investments that is less likely to prompt you to sell a strategic holding after it has dropped sharply can be just as crucial to achieving retirement success as maintaining low expenses. In fact, research indicates that "behavioral finance" issues actually lower investor returns more than the use of high-expense investments.

In the 20 years that ended December 31, 2012, the average annual return of all investors in U.S. stock mutual funds was 4.25%, according to a study by Dalbar, a Boston-based financial research group. Over the same period, the benchmark Standard & Poor's 500-stock index returned an annualized gain of 8.21%. That's a huge gap—nearly four-percentage points every year for over two decades. To be clear, failing to make a long-term investment plan and stick to it caused fund investors to lose four percentage points a year—twice the drag of high-expense funds.

Why do fund investors fare so poorly? Because they tend to buy high and sell low. Dalbar and academic studies have shown repeatedly that investors become rattled when stock prices fall and they sell what were intended to be long-term holdings. In a pattern that keeps repeating itself, investors historically and repeatedly overreacted to short-term emotional volatility. How do you avoid doing this?

There is no perfect answer because

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Down but Not Out

After a smooth ascent for most markets during the year's first quarter, volatility returned to stock and bond markets during the later stages of the second quarter. U.S. stocks gained nearly 3% for the quarter. Developed international stocks were down slightly for the quarter, while emerging-markets stocks posted larger losses. Bond markets saw a sharp sell-off in May and June.

The markets particularly reacted to Chairman Bernanke's indication on June 19 that the Fed might begin to "taper" the pace of monthly bond purchases sooner than expected. Despite Bernanke's best efforts to manage market expectations and communicate that a potential tapering does not mean an actual tightening of monetary policy, investors responded with alarm. While we continue to expect interest rates to move higher over the next five years, we do not try to predict when that may happen or what the trigger might be. Many investors' first thought has been to sell their bonds, a thought we largely do not share. While small changes to a bond portfolio's duration may be in order for some, it is important to remember the role that bonds serve in a portfolio. Bonds offset the much higher volatility of the stock market (look no further than 2008), create income for living expenses and provide a source for near term capital requirements. They also deliver the important but sometimes hard to value "sleep at night" factor for clients. If you have any questions or concerns about your bond portfolio, or other issues, please contact us. Thank you for your continued confidence and trust.

Want To Shift Income? Give It Away

With three key tax provisions that took effect in 2013 raising the ante for high-income earners, you may be inclined to look for ways to shift income-producing assets to family members in lower tax brackets. That can be effective, as long as you're comfortable with the trade-offs.

By now, you know about the tax changes affecting those in upper-income brackets. There's a higher top rate for income—now 39.6%, up from 35%, which applies to single tax filers with income above $400,000 and joint filers above $450,000. There also has been a tax hike on capital gains and qualified dividends, with the usual maximum 15% rate for long-term capital gains and qualified dividends jumping to 20% for tax filers above those same income thresholds. And, finally, there's the Medicare surtax, a new 3.8% tax that applies to the lesser of net investment income or the amount by which your modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers.

What is the end result? If you earn enough, you might be forced to pay a combined 43.4% tax rate on some of your income, and that doesn't even count additional state or local income taxes.

To lighten this heavier tax load, there are several possibilities, including sophisticated trust arrangements. But by far the simplest—and potentially one of the most effective—ways to shift income is to give outright gifts to your children or to other low-taxed family members. Not only will the earnings from property you give away be taxed to your offspring—instead of to you in your higher tax bracket—but you also may be able to reduce or eliminate the 3.8% Medicare surtax.

Suppose you're in that combined 43.4% tax bracket and you shift $10,000 of annual taxable income to each of three children in the 25% tax bracket and two grandchildren in the 15% bracket. You'll save a total of $11,200 in taxes, this year, next year, and every year until the rules change again. (You will, however, have to watch out for the "kiddie tax," which calls for unearned income above a threshold—$2,000 in 2013—received by a dependent child under age 24 to be taxed at the parents' top tax rate.)

Though transfers to your kids are subject to gift tax, you can use the annual gift-tax exclusion ($14,000 per recipient in 2013) to limit that liability. And the annual exclusion is doubled for joint gifts by a married couple. If there's an excess, it may be covered by the lifetime gift-tax exclusion ($5.25 million in 2013). Similarly, direct gifts to grandchildren are sheltered from the generation-skipping tax by an exemption of the same amount.

Realize, though, that these are irrevocable gifts, so you're giving up complete control over the property. If you're not comfortable with that, you'll need to consider other options for reducing those higher taxes. ●

Gimme Tax Shelter! Find It At Home

Despite recent tax law changes that have chipped away at some of the benefits, a home remains a top tax shelter for homeowners, as well as a prime investment opportunity. Let's briefly review the basics.

Current deductions: The tax law generally allows you to deduct property taxes on a home you own as well as mortgage interest paid on the first $1 million of debt used to acquire the home. In addition, you may be able to deduct the interest on up to $100,000 of home equity debt, regardless of how you used the proceeds (when permitted by state law). These deductions may offset some of the everyday expenses of owning a home.

However, certain itemized deductions—including those for property taxes and mortgage interest—now are reduced by 3% of the amount of adjusted gross income (AGI) exceeding $250,000 for single tax filers, and $300,000 for joint filers (but the reduction can be no more than 80% overall).

Home sale exclusion: If you've owned and used your home as your principal residence for at least two of the past five years, you can exclude from your income up to $250,000 of your profit from selling it if you're a single filer and $500,000 if you're a joint filer. There is no limit on the number of times you can claim this exclusion during your lifetime. When you're forced to sell before you qualify due to a change in employment, for health reasons, or because of other unforeseen circumstances, you may be eligible for a partial exclusion.

Any excess gain is taxed at capital gain rates. The maximum tax rate on a long-term capital gain is currently 15%, increased to 20% for single filers with taxable income above $400,000 and $450,000 for joint filers.

Home improvements: As mentioned earlier, you may deduct

Why Do GRATs Remain In Such High Demand?

The "death" of the Grantor Retained Annuity Trust – commonly known as the GRAT in financial planning circles -- has been greatly exaggerated. In fact, GRATs may be reaching their zenith in popularity due to a few recent developments. Nevertheless, you are well-advised to keep an eye on a revenue-hungry Congress that has threatened to reduce or eliminate GRAT benefits in the past.

With a GRAT, you may be able to transfer a significant amount of your wealth to your heirs without any dire estate and gift tax consequences, taking full advantage of the current laws of the land.

Here is how it works in brief: As the "grantor," you transfer certain assets into the trust, while retaining the right to receive annual annuity payments for a specified number of years. When the term of the GRAT ends, the remainder is distributed to the beneficiaries you've named, who are typically your children and/or grandchildren (OR TRUSTS FOR THEIR BENEFIT)

The amount of the annuity payment you receive during the term of the GRAT is calculated by using a special interest rate – called the Section 7520 rate – established at the outset. The Section 7520 is adjusted by the government on a monthly basis. This is one of the key factors currently affecting the popularity of GRATs. For June, 2013, the Section 7520 rate was a set at a miniscule 1.2 percent (see chart for first half of 2013).

Thus, for a transfer occurring in June 2013, all future growth above 1.2 percent is effectively transferred to the designated beneficiaries of the trust. That's because all of the present value of what was transferred into the GRAT would be returned to you, in the form of the annuity payments. Ordinarily, the transfer of assets by an individual to an irrevocable trust would be deemed to be a gift for federal gift tax purposes. However, in theory since all of the GRAT assets could revert to you, assuming the assets don't appreciate by more than the Section 7520 rate, so the gift is valued at zero for tax purposes. This technique is called "zeroing out a GRAT."

Valuation Month	120% of Applicable Federal Midterm Rate	Section 7520 Interest Rate
January 2013	1.04%	1.0%
February 2013	1.21%	1.2%
March 2013	1.31%	1.4%
April 2013	1.31%	1.4%
May 2013	1.20%	1.2%
June 2013	1.14%	1.2%

Source: www.irs.gov

With this approach, you're hoping that the appreciation in value of the assets transferred to the GRAT will exceed the Section 7520 rate, a pretty safe bet when the rate is only 1.2 percent. While you continue to receive the annuity payments based on a relatively low rate during the GRAT term, the beneficiaries will be entitled to receive the appreciation in in excess of the Section 7520 rate.

Generally, you would prefer to transfer assets to the GRAT that you would reasonably expect to appreciate substantially in value. Conversely, you might hold onto other assets projected to have a lower rate of appreciation.

Does this estate planning device sound too good to be true? It's not, but be aware that there are possible downsides to setting up as GRAT, including the following.

1. No one can absolutely guarantee that the assets will appreciate in value at a rate higher than the Section 7520 rate. Even with a low 1.2 percent rate, it's possible that some assets may grow at a lower rate or the GRAT could even suffer a loss. In that case, you'' receive the trust assets back at their depreciated value without any tax consequence. In essence, the GRAT "failed" to produce an estate tax savings.

2. You might die during the GRAT term. If that should happen, all of the assets transferred to the GRAT, plus any earnings, will revert to your taxable estate.

3. If you use professional services, you will incur fees for establishing and administering the GRAT, usually based on a percentage of assets in the trust.

Be mindful that legislation proposed in Congress in recent years that, if passed, would have adversely affected GRATs, particularly as to the zeroing-out technique. The same or similar proposals are likely to be raised again in subsequent talks. If you're contemplating the use of a GRAT, you might want to move quickly before Congress strikes. ●

interest on loans used for home improvements, based on the limit for home equity debt. Also, if you make an improvement for medical reasons (for example, installing a pool to help alleviate a child's asthma), the increase in the home's value is added to your other deductible medical expenses (plus any annual costs). And you may claim a 10% credit for qualified energy-saving improvements up to a maximum of $500.

Rental properties: When you own a home as a rental property, you're entitled to deduct depreciation plus other expenses attributable to the rental activity, such as insurance, repairs, property taxes, mortgage interest, etc. These deductions can help offset tax on the rental income you receive. Note that special rules apply to a "vacation home" you rent to others but that also is used personally. If your personal use exceeds the greater of 14 days or 10% of the days the home is rented out, you can't claim a loss for the year. Other special rules may apply.

Of course, this is only a broad overview. Obtain more details on all the tax breaks of home ownership from a tax professional. ●

How To Bridge A Retirement Shortfall

Suppose you've scrimped and saved for retirement but you still haven't met your goals. Or perhaps an illness or a business venture that went south has exhausted your discretionary funds. Or maybe you just didn't count on costs rising so quickly. In any event, you're standing on the precipice of retirement, but you don't think you'll have enough to live comfortably for the next 20 or 30 years. These four practical suggestions might help:

1. Relocate to a less expensive home. According to the Social Security Administration, housing is the largest component of living expenses for people over age 55, accounting for 35% of the cost pie. One of the best ways to save money during retirement may be to downsize your home. Do you really need that rambling four-bedroom colonial in which you raised your kids? You probably do not.

And it's not just size that matters. You might consider moving to a location where the climate is agreeable and the costs are lower than what you're currently paying. Just don't forget to factor in state income taxes and other taxes. For the adventurous, a move out of the country could be an option.

Here's another thing to add to the equation if you're considering relocation—it's usually less expensive for people to live together than alone. A recent study by the Pew Research Center, based on 2011 Census Bureau data, reveals that the number of Americans living in multi-generational family households increased 4.9 million from 2007 to 2009. You could move in with your children, pay your share of the housing costs, and still come out ahead.

2. Refinance your mortgage. With interest rates at historic lows, now's a good time to refinance an existing mortgage if you don't plan on moving anytime soon. If you can cut your monthly bill by hundreds of dollars or more, it won't take too long to recoup the refinancing costs.

3. Figure out your bottom line. Budgeting isn't exciting, but making realistic projections of your likely expenses in retirement can be crucial. Frequently, costs for life insurance and spending on children will disappear as you move closer to traditional retirement age, only to be replaced by travel expenses or other new costs.

4. Go to work part-time. Being "retired" doesn't mean you have to quit working completely. The job market for seniors has been improving, with the Bureau of Labor Statistics showing a 5.6% unemployment rate for those 55 and older in February 2013, compared with 6.1% the year before. Getting a paycheck, even a relatively small one, can remove some of the pressure and supplement your income from investments, Social Security, and distributions from retirement plans.

Finally, take stock of your situation while you're still employed full-time. Planning ahead is the best solution for bridging a potential retirement shortfall. ●

Key To Investment Success

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we're all subject to human foibles. In good or bad times, people have a natural tendency to extrapolate recent events into the future. People forget that, in the past, better times have always returned after bad times. While there is never a guarantee that good times will return after every downturn, betting on a rebound was statistically and historically the right choice in the past. To fight the human predilection for selling when a market is bottoming, three pillars seem crucial to support your effort.

1. An investment policy statement written in unemotional times that commits you to holding on through downturns and that is in tune with your risk profile and how much money you need to fund your goals in life.

2. Spreading investments across a range of markets that are not highly correlated with one another to try to dampen the effects of the next investment downturn and make you less susceptible to reacting emotionally in bad financial times.

3. A relationship with a financial professional who tracks markets daily but understands their history and who can help you stick with your long-term strategy, even in tough times. ●

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