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Your Source for Financial Well-Being

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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.

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

What's New in the World of Higher Education?

What is the federal funds rate?

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.

What's New in the World of Higher Education?



Tools for students

The Department of Education and the Consumer Financial Protection Bureau have launched the "Know Before You Owe" campaign, which includes a standard financial aid award letter for colleges to use so that students can better understand the type and amount of aid they qualify for and more easily compare aid packages from different colleges. In addition, to help students search for and select suitable colleges, the Department has launched its College Scorecard online tool at collegescorecard.ed.gov.

Sources

- ¹ College Board, *Trends in College Pricing 2015*
- ² The Institute for College Access and Success, *Student Debt and the Class of 2014*, October 2015
- ³ Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, November 2015

If you're a parent or grandparent of a college student or soon-to-be college student, you might be interested to learn what's new in the world of higher education.

Higher college costs

Total average costs for the 2015/2016 school year increased about 3% from the previous year: \$24,061 for public colleges (in-state), \$38,855 for public colleges (out-of-state), and \$47,831 for private colleges.¹

Total average costs include direct billed costs for tuition, fees, room, and board; and indirect costs for books, transportation, and personal expenses. Together, these items are officially referred to as the "total cost of attendance." Note that the cost figure for private colleges cited by the College Board is an average; many private colleges cost substantially more--over \$60,000 per year.

Higher student debt

Seven in 10 college seniors who graduated in 2014 (the most recent year for which figures are available) had student loan debt, and the average amount was \$28,950 per borrower.² It's likely this amount will be higher for the classes of 2015 and 2016.

Student loan debt is the only type of consumer debt that has grown since the peak of consumer debt in 2008; balances have eclipsed both auto loans and credit cards, making student loan debt the largest category of consumer debt after mortgages. As of September 2015, total outstanding student loan debt was over \$1.2 trillion.³

Reduced asset protection allowance

Behind the scenes, a stealth change in the federal government's formula for determining financial aid eligibility has been quietly (and negatively) impacting families everywhere. You may not have heard of the asset protection allowance before. But this figure, which allows parents to shield a certain amount of their nonretirement assets from the federal aid formula, has been steadily declining for years, resulting in higher expected family contributions for families. For the 2012/2013 year, the asset protection allowance for a 47-year-old married parent was \$43,400. Today, for the 2016/2017 year, that same asset protection allowance is \$18,300--a drop of \$25,100. The result is a \$1,415 decrease in a student's aid eligibility (\$25,100 x 5.64%, the federal contribution percentage required from parent assets).

New FAFSA timeline

Beginning with the 2017/2018 school year, families will be able to file the government's

financial aid application, the FAFSA, as early as October 1, 2016, rather than having to wait until after January 1, 2017. The intent behind the change is to better align the financial aid and college admission timelines and to provide families with information about aid eligibility earlier in the process.

One result of the earlier timeline is that your 2015 federal income tax return will do double duty as a reference point for your child's federal aid eligibility--it will be the basis for the FAFSA for *both* the 2016/2017 and 2017/2018 years.

School Year	Tax Return Required	FAFSA Earliest Submission
2016/2017	2015	January 1, 2016
2017/2018	2015	October 1, 2016
2018/2019	2016	October 1, 2017

American Opportunity Tax Credit now permanent

The American Opportunity Tax Credit was made permanent by the Protecting Americans from Tax Hikes Act of 2015. It is a partially refundable tax credit (meaning you may be able to get some of the credit even if you don't owe any tax) worth up to \$2,500 per year for qualified tuition and related expenses paid during your child's first four years of college. To qualify for the full credit, single filers must have a modified adjusted gross income (MAGI) of \$80,000 or less, and joint filers must have a MAGI of \$160,000 or less. A partial credit is available for single filers with a MAGI over \$80,000 but less than \$90,000, and for joint filers with a MAGI over \$160,000 but less than \$180,000.

New REPAYE plan for federal loans

The pool of borrowers eligible for the government's Pay As You Earn (PAYE) plan for student loans has been expanded as of December 2015. The new plan, called REPAYE (Revised Pay As You Earn), is available to *all* borrowers with federal Direct Loans, regardless of when the loans were obtained (the original PAYE plan is available only to borrowers who took out loans after 2007).

Under REPAYE, monthly student loan payments are capped at 10% of a borrower's discretionary income, with any remaining debt forgiven after 20 years of on-time payments for undergraduate loans and 25 years of on-time payments for graduate loans. To learn more about REPAYE or income-driven repayment options in general, visit the federal student aid website at studentaid.gov.

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What is the federal funds rate?

In December 2015, the Federal Open Market Committee (FOMC) raised the federal funds target rate to a range of 0.25% to 0.50%, the first shift from the rock-bottom 0% to 0.25% level where it had remained since December 2008.

The federal funds rate is the interest rate at which banks lend funds to each other from their deposits at the Federal Reserve, usually overnight, in order to meet reserve requirements. The Fed also raised a number of other rates related to funds moving between Federal Reserve banks and other banks. The Fed does not directly control consumer savings or credit rates, but the federal funds rate serves as a benchmark for many short-term rates, such as savings accounts, money market accounts, and short-term bonds.

The prime rate, which commercial banks charge their best customers, is typically about 3% above the federal funds rate. Other forms of business and consumer credit--such as small-business loans, adjustable-rate mortgages, auto loans, and credit cards--are often directly linked to the prime rate. Actual

rates can vary widely. Fixed-rate home mortgages and other long-term loans are generally not linked directly to the prime rate, but may be indirectly affected by it

The FOMC expects economic conditions to "warrant only gradual increases" in the federal funds rate. Most Committee members projected a target range between 0.75% and 1.75% by the end of 2016, so you can probably expect a series of small increases this year. Although rising interest rates make it more expensive for consumers to borrow, higher rates could be good for retirees and savers who seek current income from bank accounts, CDs, bonds, and other fixed-interest investments.

The FDIC insures CDs and bank savings accounts, which generally provide a fixed rate of return, up to \$250,000 per depositor, per insured institution. The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.

Source: Federal Reserve, 2015



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.