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Planning Insights

Planning Your Financial Future

Correlation and Portfolio Performance

Different types of investments are subject to different types of risk. On days when you notice that stock prices have fallen, for example, it would not be unusual to see a rally in the bond market.

Asset allocation refers to how an investor's portfolio is divided among asset classes, which tend to perform differently under different market conditions. An appropriate mix of investments typically depends on the investor's age, risk tolerance, and financial goals.

The concept of correlation often plays a role in constructing a well-diversified portfolio that strikes a balance between risk and return.

Math that matters

In the financial world, correlation is a statistical measure of how two securities perform relative to each other. Securities that are positively correlated will have prices that tend to move in the same direction. Securities that are negatively correlated will have prices that move in the opposite direction.

A correlation coefficient, which is calculated using historical returns, measures the degree of correlation between two investments. A correlation of +1 represents a perfectly positive correlation, which means the investments always move together, in the same direction, and at a consistent scale. A correlation of -1 means they have a perfectly negative correlation and will always move opposite one another. A correlation of zero means that the two investments are not correlated; the relationship between them is random.

In reality, perfectly positive correlation is rare, because distinct investments can be affected differently by the same conditions, even if they are similar securities in the same sector.

Correlations can change

While some types of securities exhibit general trends of correlation over time, it's not uncommon for correlations to vary over shorter periods. In times of market volatility, for example, asset prices were more likely to be driven by common market shocks than by their respective underlying fundamentals.

During the flight to quality sparked by the financial crisis of 2008, riskier assets across a number of different classes exhibited unusually high correlation. As a result, correlations among some major asset classes have been more elevated than they were before the crisis. There has also been a rise in correlation between different financial markets in the global economy.[1] For example, the correlation coefficient for U.S. stocks (represented by the S&P Composite Total Return index) and foreign stocks (represented by the MSCI EAFE GTR index) increased from 0.75 over the last 25 years to 0.89 over the last 10 years.[2]

Over the long run, a combination of investments that are loosely correlated may provide greater diversification, help manage portfolio risk, and smooth out investment returns. Tighter relationships among asset classes over the last decade may be a good reason for some investors to reassess their portfolio allocations. However, it's important to keep in mind that correlations may continue to fluctuate over time because of changing economic and market environments.

The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Past performance is no guarantee of future results. All investing involves risk, including the possible loss of principal. Asset allocation and diversification strategies do not guarantee a profit or protect against investment loss; they are methods used to help manage investment risk.

Investing internationally carries additional risks such as differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country. This may result in greater share price volatility. When sold, investments may be worth more or less than their original cost.

[1] International Monetary Fund, 2015

[2] Thomson Reuters, 2015, for the period 12/31/1989 to 12/31/2014

Fall 2015

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Taxes, Retirement, and Timing Social Security

Five Ways to Manage Risk in Your Retirement Savings Plan

What is the Roth IRA five-year rule?

Taxes, Retirement, and Timing Social Security

This hypothetical example is for illustrative purposes only, and its results are not representative of any specific investment or mix of investments. Actual rates of return and results will vary. The example assumes that earnings are taxed as ordinary income and does not reflect possible lower maximum tax rates on capital gains and dividends, as well as the tax treatment of investment losses, which would make the return more favorable. Investment fees and expenses have not been deducted. If they had been, the results would have been lower. You should consider your personal investment horizon and income tax brackets, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. Investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

The advantages of tax deferral are often emphasized when it comes to saving for retirement. So it might seem like a good idea to hold off on taking taxable distributions from retirement plans for as long as possible. (Note: Required minimum distributions from non-Roth IRAs and qualified retirement plans must generally start at age 70½.) But sometimes it may make more sense to take taxable distributions from retirement plans in the early years of retirement while deferring the start of Social Security retirement benefits.

Some basics

Up to 50% of your Social Security benefits are taxable if your modified adjusted gross income (MAGI) plus one-half of your Social Security benefits falls within the following ranges: $32,000 to $44,000 for married filing jointly; and $25,000 to $34,000 for single, head of household, or married filing separately (if you've lived apart all year). Up to 85% of your Social Security benefits are taxable if your MAGI plus one-half of your Social Security benefits exceeds those ranges or if you are married filing separately and lived with your spouse at any time during the year. For this purpose, MAGI means adjusted gross income increased by certain items, such as tax-exempt interest, that are otherwise excluded or deducted from your income for regular income tax purposes.

Social Security retirement benefits are reduced if started prior to your full retirement age (FRA) and increased if started after your FRA (up to age 70). FRA ranges from 66 to 67, depending on your year of birth.

Distributions from non-Roth IRAs and qualified retirement plans are generally fully taxable unless nondeductible contributions have been made.

Accelerate income, defer Social Security

It can sometimes make sense to delay the start of Social Security benefits to a later age (up to age 70) and take taxable withdrawals from retirement accounts in the early years of retirement to make up for the delayed Social Security benefits.

If you delay the start of Social Security benefits, your monthly benefits will be higher. And because you've taken taxable distributions from your retirement plans in the early years of retirement, it's possible that your required minimum distributions will be smaller in the later years of retirement when you're also receiving more income from Social Security. And smaller taxable withdrawals will result in a lower MAGI, which could mean the amount of Social Security benefits subject to federal income tax is reduced.

Whether this strategy works to your advantage depends on a number of factors, including your income level, the size of the taxable withdrawals from your retirement savings plans, and how many years you ultimately receive Social Security retirement benefits.

Example

Mary, a single individual, wants to retire at age 62. She can receive Social Security retirement benefits of $18,000 per year starting at age 62 or $31,680 per year starting at age 70 (before cost-of-living adjustments). She has traditional IRA assets of $300,000 that will be fully taxable when distributed. She has other income that is taxable (disregarding Social Security benefits and the IRA) of $27,000 per year. Assume she can earn a 6% annual rate of return on her investments (compounded monthly) and that Social Security benefits receive annual 2.4% cost-of-living increases. Assume tax is calculated using the 2015 tax rates and brackets, personal exemption, and standard deduction.

Option 1. One option is for Mary to start taking Social Security benefits of $18,000 per year at age 62 and take monthly distributions from the IRA that total about $21,852 annually.

Option 2. Alternatively, Mary could delay Social Security benefits to age 70, when her benefits would start at $38,299 per year after cost-of-living increases. To make up for the Social Security benefits she's not receiving from ages 62 to 69, during each of those years she withdraws about $40,769 to $44,094 from the traditional IRA--an amount approximately equal to the lost Social Security benefits plus the amount that would have been withdrawn from the traditional IRA under the age 62 scenario (plus a little extra to make the after-tax incomes under the two scenarios closer for those years). When Social Security retirement benefits start at age 70, she reduces monthly distributions from the IRA to about $4,348 annually.

Mary's after-tax income in each scenario is approximately the same during the first 8 years. Starting at age 70, however, Mary's after-tax income is higher in the second scenario, and the total cumulative benefit increases significantly with the total number of years Social Security benefits are received.*

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.

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What is the Roth IRA five-year rule?

Actually, there are *two* five-year rules you need to know about. The first five-year rule determines when you can begin receiving tax-free qualified distributions from your Roth IRA. Withdrawals from your Roth IRA--including both your contributions and any investment earnings--are completely tax and penalty free if you satisfy a five-year holding period *and* one of the following also applies:

- You've reached age 59½ by the time of the withdrawal
- The withdrawal is made due to a qualifying disability
- The withdrawal is made for first-time homebuyer expenses ($10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

This five-year holding period begins on January 1 of the tax year for which you made your first contribution (regular or rollover) to any Roth IRA you own. For example, if you make your first Roth IRA contribution in March 2015 and designate it as a 2014 contribution, your five-year holding period begins on January 1, 2014 (and ends on December 31, 2018). You have only one five-year holding period for determining whether distributions from any Roth IRA you own are tax-free qualified distributions. (Roth IRAs you *inherit* are subject to different rules.)

The second five-year rule is a little more complicated. When you convert a traditional IRA to a Roth IRA, the amount you convert (except for any after-tax contributions you've made) is subject to income tax at the time of conversion. However, your conversion isn't subject to the 10% early distribution penalty, even if you haven't yet reached age 59½.

But what the IRS giveth it can also taketh away. If you withdraw any portion of your taxable conversion within five years, you'll have to pay the 10% early distribution penalty on those funds that you previously avoided--unless you've reached age 59½ or qualify for another exemption from the penalty tax. This five-year holding period starts on January 1 of the year you convert your traditional IRA to a Roth IRA. And if you have more than one conversion, each will have its own separate five-year holding period for this purpose.

How can I protect my Social Security number from identity theft?

Your Social Security number is one of your most important personal identifiers. If identity thieves obtain your Social Security number, they can access your bank account, file false tax returns, and wreak havoc on your credit report. Here are some steps you can take to help safeguard your number.

Never carry your card with you. You should never carry your Social Security card with you unless it's absolutely necessary. The same goes for other forms of identification that may display your Social Security number (e.g., Medicare card)

Do not give out your number over the phone or via email/Internet. Oftentimes, identity thieves will pose as legitimate government organizations or financial institutions and contact you to request personal information, including your Social Security number. Avoid giving out your Social Security number to anyone over the phone or via email/Internet unless you initiate the contact with an organization or institution that you trust.

Be careful about sharing your number. Just because someone asks for your Social Security number doesn't mean you have to share it. Always ask why it is needed, how it will be used, and what the consequences will be if you refuse to provide it.

If you think someone has misused your Social Security number, contact the Social Security Administration (SSA) immediately to report the problem. The SSA can review your earnings record with you to make sure their records are correct. You can also visit the SSA website at www.ssa.gov to check your earnings record online.

Unfortunately, the SSA cannot directly resolve any identity theft problems created by the misuse of your Social Security number. If you discover that someone is illegally using your number, be sure to contact the appropriate law-enforcement authorities. In addition, consider filing a complaint with the Federal Trade Commission and submitting IRS Form 14039, Identity Theft Affidavit, with the Internal Revenue Service. Visit www.ftc.gov and www.irs.gov for more information.

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