Nicholson Financial Services

Did You Know...?

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Another year has come and gone, and it was an eventful one. One of the most polarizing elections in history dominated the headlines in the second half of the year. After the election, many clients have asked my opinion as to what the change could mean for their investments. I thought the markets and the economy would continue to improve no matter who the president was. We just needed to remove the uncertainty of the "who." That said, if President Trump is able to follow through on some of his proposals (lowering taxes for corporations & incentives for companies to keep jobs in or bring them back to the US are examples), it could be very positive for the markets. So far, the markets appear to agree. Still, all politicians talk a good game during the election. I firmly believe that once in office, they learn many of the things they promised are simply not feasible. As they say, follow through is everything, so it will be interesting to see what happens next.

Year End 2016/Winter 2017

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Chasing Performance

In the past seven years or so, we have seen a trend in place where US stocks have been the best place to be. Many other asset classes, such has bonds, international stocks, emerging markets, and commodities, have underperformed in comparison. 2016 was no different, except that small cap and mid cap companies out-performed their large cap counterparts for the first time since 2013. Is that a bad thing? Of course not. However, it creates the problem where investors start to ask the questions, "Why should I own these other asset classes? Shouldn't I just have everything in the S&P 500?" In fact, I was just invited to a webinar entitled "is diversification dead?" because so many investor ARE asking those questions, or just making the change. My advice: don't fall for it.

Trends such as this one have happened before. Let me take you back to the late 1990's, when large cap growth stocks averaged over 30% PER YEAR from 1996 to 1999. That type of performance has a magnetic effect, drawing investors to it in large numbers. I recall that being one of the most difficult times in my career, because it was <u>so difficult</u> to keep some clients from making very bad choices. In 1999, I had client in her 80's call me and say that she wanted to sell 1/2 of the bonds that she owned to buy Yahoo stock...because her friend made 400% in it the year before. It took me over an hour to explain why that wasn't a prudent decision for her (mind you, she was very conservative). This was one of the times when greed was an even more powerful driver than fear.

If you stayed diversified and rebalanced from 1996 to 1999, that meant you were selling assets that performed well to buy those that didn't for several years in a row. It is easy to understand how conventional wisdom would make any investor question those decisions. However, when the trend broke in 2000, it broke in a big way. The worst places to have your money from '95 - '99 because the best places to be from '00 to '02. The best places to be from '95 - '99 became the worst places to be for the next 3 years.

For those who over-weighted large cap growth stocks in the late '90s, if they didn't adjust their portfolio before 2000, they gave back a ton of the gains that had accumulated. For those who chased emerging internet stocks (the hot play at the time), the next 3 years were financially devastating. Keep in mind that many people who decided to bail on their diversified financial plans didn't do so until 1999, or even early 2000. They bought into asset classes that had run for years and were primed for a sell-off.

To be clear, I am not saying that I think US stocks are poised to decline or are in for a 2000 to 2002 type bear market. However, my belief is that diversified investors will be rewarded for their patience as they have been in the past. As of now, US stocks are close to fairly valued. On the whole, they aren't overpriced, but they certainly aren't cheap. Compare that to non-US companies from developed countries that are roughly 30% cheaper. Emerging Market stocks are roughly 50% cheaper. Eventually, such drastic differences in valuation *do matter.*

Much of the data in this article comes from one of my favorite charts, "Variability of Investment Returns." I like to call it the "quilt chart" and you understand why when you see it. If you would like to see the updated version including 2016, go to my website and look under "Education & Resources" in the section titled "Investment Concepts."

My favorite aspect of that chart is this: you can clearly see that it is impossible to predict the best place to have your money for the next year. Asset classes don't go out of business, but they do rotate and each has it's day in the sun. The great Wayne Gretzky was once asked how he was able to be so good for so long. He replied that instead of going to where the puck is, he goes to where the puck is *going to be.* The best way to predict where the investment "puck" is going next is to keep a diversified portfolio and fight the urge to chase performance.

Why Diversification Matters

Diversification and asset allocation are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.

When investing, particularly for long-term goals, there is one concept you will likely hear about over and over again — diversification. Why is diversification so important? The simple reason is that it helps ensure that your risk of loss is spread among a number of different investments. The theory is that if some of the investments in your portfolio decline in value, others may rise or hold steady, helping to offset the losses.

Diversifying within asset classes

For example, say you wanted to invest in stocks. Rather than investing in just domestic stocks, you could diversify your portfolio by investing in foreign stocks as well. Or you could choose to include the stocks of different size companies (small-cap, mid-cap, and/or large-cap stocks).

If your primary objective is to invest in bonds for income, you could choose both government and corporate bonds to potentially take advantage of their different risk/return profiles. You might also choose bonds of different maturities, because long-term bonds tend to react more dramatically to changes in interest rates than short-term bonds. As interest rates rise, bond prices typically fall.

Investing in mutual funds

Because mutual funds invest in a mix of securities chosen by a fund manager to pursue the fund's stated objective, they can offer a certain level of "built-in" diversification. For this reason, mutual funds may be an appropriate choice for novice investors or those wishing to take more of a hands-off approach to their portfolios. Including a variety of mutual funds with different objectives and securities in your portfolio will help diversify your holdings that much more.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Diversifying among asset classes

You might also consider including a mix of different types of asset classes — stocks, bonds, and cash — in your portfolio. Asset allocation is a strategic approach to diversifying your portfolio. After carefully considering your investment goals, time horizon, and risk tolerance, you would then invest different percentages of your portfolio in targeted asset classes to pursue your goal.

Winning asset classes over time

The following table, which shows how many times during the past 30 years each asset class has come out on top in terms of performance, helps illustrate why diversifying among asset classes can be important.

	Number of winning years, 1987-2016
Cash	3
Bonds	5
Stocks	10
Foreign stocks	12

Performance is from December 31, 1986, to December 31, 2016. Cash is represented by Citigroup 3-month Treasury Bill Index. Bonds are represented by the Citigroup Corporate Bond Index, an unmanaged index. Stocks are represented by the S&P 500 Composite Price Index, an unmanaged index. Foreign stocks are represented by the MSCI EAFE Price Index, an unmanaged index. Investors cannot invest directly in any index. However, these indexes are accurate reflections of the performance of the individual asset classes shown. Returns reflect past performance and should not be considered indicative of future results. The returns do not reflect taxes, fees, brokerage commissions, or other expenses typically associated with investing.

The principal value of cash alternatives may fluctuate with market conditions. Cash alternatives are subject to liquidity and credit risks. It is possible to lose money with this type of investment.

The return and principal value of stocks may fluctuate with market conditions. Shares, when sold, may be worth more or less than their original cost.

U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest, whereas corporate bonds are not. The principal value of bonds may fluctuate with market conditions. Bonds are subject to inflation, interest rate, and credit risks. Bonds redeemed prior to maturity may be worth more or less than their original cost.

The risks associated with investing on a worldwide basis include differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country.

Investments offering the potential for higher rates of return also involve higher risk.

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What It Means to Be a Financial Caregiver for Your Parents

A large majority of caregivers provide care for a relative (85%), with 49% caring for a parent or parent-in-law.

Source: Caregiving in the U.S. 2015, National Alliance for Caregiving

If you are the adult child of aging parents, you may find yourself in the position of someday having to assist them with handling their finances. Whether that time is in the near future or sometime further down the road, there are some steps you can take now to make the process a bit easier.

Mom and Dad, can we talk?

Your first step should be to get a handle on your parents' finances so you fully understand their current financial situation. The best time to do so is when your parents are relatively healthy and active. Otherwise, you may find yourself making critical decisions on their behalf in the midst of a crisis.

You can start by asking them some basic questions:

- What financial institutions hold their assets (e.g., bank, brokerage, and retirement accounts)?
- Do they work with any financial, legal, or tax advisors? If so, how often do they meet with them?
- Do they need help paying monthly bills or assistance reviewing items like credit-card statements, medical receipts, or property tax bills?

Make sure your parents have the necessary legal documents

In order to help your parents manage their finances in the future, you'll need the legal authority to do so. This requires a durable power of attorney, which is a legal document that allows a named individual (such as an adult child) to manage all aspects of a person's financial life if he or she becomes disabled or incompetent. A durable power of attorney will allow you to handle day-to-day finances for your parents, such as signing checks, paying bills, and making financial decisions for them.

In addition to a durable power of attorney, you'll want to make sure that your parents have an advance health-care directive, also known as a health-care power of attorney or health-care proxy. An advance health-care directive will allow you to make medical decisions according to their wishes (e.g., life-support measures and who will communicate with health-care professionals on their behalf).

You'll also want to find out if your parents have a will. If so, find out where it's located and who is named as personal representative or executor. If the will was drafted a long time ago, your parents may want to review it to make sure their current wishes are represented. You should also ask if they made any dispositions or gifts of specific personal property (e.g., a family heirloom to be given to a specific individual).

Prepare a personal data record

Once you've opened the lines of communication, your next step is to prepare a personal data record that lists information you might need in the event that your parents become incapacitated or die. Here's some information that should be included:

- *Financial information:* Bank, brokerage, and retirement accounts (including account numbers and online user names and passwords, if applicable); real estate holdings
- *Legal information:* Wills, durable powers of attorney, advance health-care directives
- *Medical information:* Health-care providers, medication, medical history
- *Insurance information:* Policy numbers, company names
- *Advisor information:* Names and phone numbers of any professional service providers
- *Location of other important records:* Social Security cards, home and vehicle records, outstanding loan documents, past tax returns
- *Funeral and burial plans:* Prepayment information, final wishes

If your parents keep some or all of these items in a safe-deposit box or home safe, make sure you can gain access. It's also a good idea to make copies of all the documents you've gathered and keep them in a safe place. This is especially important if you live far away, because you'll want the information readily available in the event of an emergency.

Don't be afraid to get support and ask for advice

If you're feeling overwhelmed with the task of handling your parents' finances, don't be afraid to seek out support and advice. A variety of local and national organizations are designed to assist caregivers. If your parents' needs are significant enough, you may want to consider hiring a geriatric care manager who can help you oversee your parents' care and direct you to the right community resources. Finally, consider discussing the specifics of your situation with a professional, such as an estate planning attorney, accountant, and/or financial advisor.

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What happens to my property if I die without a will?

If you die without a will, your property will generally pass according to state law (under the rules for intestate succession). When this happens, the state essentially makes a will for you. State laws specify how your property will pass, typically in certain proportions to various persons related to you. The specifics, however, vary from state to state.

Most state laws favor spouses and children first. For example, a typical state law might specify that your property pass one-half or one-third to your surviving spouse, with the remainder passing equally to all your children. If you don't have children, in many states your spouse might inherit all of your property; in other states, your spouse might have to share the property with your brothers and sisters or parents.

But not all property is transferred by will or intestate succession. Regardless of whether you have a will, some property passes automatically to a joint owner or to a designated beneficiary. For example, you can transfer property such as IRAs, retirement plan benefits, and life insurance by naming a beneficiary. Property that you own jointly with right of survivorship will pass automatically to the surviving owners at your death. Property held in trust will pass to your beneficiaries according to the terms you set out in the trust.

Only property that is not transferred by beneficiary designation, joint ownership, will, or trust passes according to intestate succession. You should generally use beneficiary designations, joint ownership, wills, and trusts to control the disposition of your property so that you, rather than the state, determine who receives the benefit of your property.

Even if it seems that all your property will be transferred by beneficiary designation, joint ownership, or trust, you should still generally have a will. You can designate in the will who will receive any property that slips through the cracks.

And, of course, you can do other things in a will as well, such as name the executor of your estate to carry out your wishes as specified in the will, or name a guardian for your minor children.

Will I owe income taxes when I sell my home?

In general, when you sell your home, any amount you receive over your cost basis (what you paid for the home, plus capital improvements, plus the costs of selling the home) is subject to capital gains taxes. However, if you owned and used the home as your principal residence for a total of two out of the five years before the sale (the two years do not have to be consecutive), you may be able to exclude from federal income tax up to $250,000 (up to $500,000 if you're married and file a joint return) of the capital gain when you sell your home. You can use this exclusion only once every two years, and the exclusion does not apply to vacation homes and pure investment properties.

For example, Mr. and Mrs. Jones bought a home 20 years ago for $80,000. They've used it as their principal residence ever since. This year, they sell the house for $765,000, realizing a capital gain of $613,000 ($765,000 selling price minus a $42,000 broker's fee, minus the original $80,000 purchase price, minus $30,000 worth of capital improvements they've made over the years). The Joneses, who file jointly and are in the 28% marginal tax bracket, can exclude $500,000 of capital gain realized on the sale of their home. Thus, their tax on the sale is only $16,950 ($613,000 gain minus the $500,000 exemption, multiplied by the 15% long-term capital gains tax rate).

What if you don't meet the two-out-of-five-years requirement? Or you used the capital gain exclusion within the past two years for a different principal residence? You may still qualify for a partial exemption, assuming that your home sale was due to a change in place of employment, health reasons, or certain other unforeseen circumstances.

Special rules may apply in the following cases:

- You sell vacant land adjacent to your residence
- Your residence is owned by a trust
- Your residence contained a home office or was otherwise used for business purposes
- You rented part of your residence to tenants
- You owned your residence jointly with an unmarried taxpayer
- You sell your residence within two years of your spouse's death
- You're a member of the uniformed services

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