Pettinga Insights and Outlook

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Don't Pay Tax Twice

Reinvestment can be a crucial component of the wealth accumulation process, as the reinvested amount compounds and grows over time. Yet if you are reinvesting dividends and capital gains ("distributions") in funds you hold in your taxable account, it can be important to ensure that you're not paying more tax than necessary. You pay tax on those distributions in the year in which you receive them. But if you don't keep good records, you could end up paying tax on those distributions again when you sell. For example, say you bought 1,000 shares of a fund for your taxable account at the end of 2011; you paid $18 per share for a total of $18,000. In 2012, with the share price still at $18, the fund made a dividend distribution of $0.50 per share, or $500 for your 1,000 shares. You'd owe tax on the $500 on your 2012 taxes, whether you reinvested the money or took the cash in hand. (The taxes would be deferred if you held the fund in a tax-sheltered account). If you reinvested the money in the fund, you'd now own 1,027.78 shares: your original 1,000 plus the nearly 28 additional shares that you were able to buy (at $18) with the $500 dividend distribution. If you sell now, with the fund's net asset value at $20, you'd think you'd owe taxes on your $2,555.56 profit ($20,555.56 minus $18,000), right? Wrong. You would only owe taxes on $2,055.56 ($20,555.56 minus $18,000 minus $500). Otherwise, the $500 dividends would be taxed twice.

Investments are subject to risk of principal and risk of loss. Dividends are not guaranteed. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

Get Your Estate Plan in Gear

Estate planning laws have undergone swift changes over the past several years and may change again in the years ahead. If you're creating or updating an estate plan, it's essential that you seek the advice of an attorney who's well versed in this area. Before you hire an estate-planning attorney to draft or update your estate plan, it's important to understand your role in the estate-planning process.

Find a qualified attorney: Because your estate plan will likely need to be updated as the years go by and your personal circumstances change, it makes sense to find an attorney who practices in the community where you live. This can help you meet with him/her on an ongoing basis.

Take stock of your assets: Before you meet with your attorney, spend some time enumerating your assets and their value: your investment accounts, life insurance, personal assets such as your home, and your share of any businesses that you own. Also gather current information about any debts outstanding. Your estate-planning attorney is likely to provide you with a worksheet to document your assets and liabilities, but it's helpful to collect this information in advance.

Identify key individuals: Another important aspect of estate planning is identifying the individuals you trust to ensure that your wishes are carried out once you're gone.

Executor: A person who gathers all of your assets and makes sure that they are distributed as spelled out in your will.

Durable (Financial) Power of Attorney: A person you entrust with making financial decisions on your behalf if you should become disabled and unable to manage your own financial affairs.

Power of Attorney for Health Care: A person you entrust with making health-care decisions on your behalf if you are disabled and unable to make them on your own.

Guardian: A person who would look after your children if you and your spouse were to die when your children are minors.

Know the key documents you need: When you meet with your estate-planning attorney, he or she will make recommendations about your estate plan. At a minimum, you should ask your attorney to draft the following documents.

Last Will and Testament: A legal document that tells everyone, including your heirs, how you would like your assets distributed after you're gone.

Living Will: A document that tells your loved ones and your health-care providers how you would like to be cared for if you should become terminally ill; usually includes details about your views toward life-support equipment.

Durable (Financial) Power of Attorney: A document that gives an individual the power to make financial decisions and execute financial transactions on your behalf if you are unable to do so.

Medical Power of Attorney: A document that gives an individual the power to make health-care decisions on your behalf if you are unable to do so.

Manage your documents: Once your estate-planning documents are drafted, destroy any older versions of them. Notify your executor of the whereabouts of your estate-planning documents, and provide copies of the relevant documents to your executor, powers of attorney, and the guardian for your children.

Plan to keep your plan current: Last but not least, plan to keep your estate plan current. One of the biggest estate-planning pitfalls is drafting an estate plan but not keeping it up to date. Changes may include change in marital status, assets, financial status, death or ill health of your beneficiaries, executor, power of attorneys, or guardian.

Monthly Market Commentary

February and early March saw markets continue to reach new recovery highs as investor confidence stayed strong. This occurred despite concerns with the payroll tax increase, the sequester, and the Federal Reserve Open Market Committee meeting minutes (the minutes hinted that the Fed might indeed stop easing by the end of 2013.) While consumer woes did hit low -end retailers and restaurateurs hard, home and auto sales continued to move ahead despite less-than-optimal weather. The manufacturing sector took a surprise turn for the better with some of the best data in a couple of years, and housing continued to improve. Although housing contribution currently represents only about 2% of GDP, the historical long-term average has been closer to 5%, which means there's still a lot of room for improvement.

GDP: The second estimate of real GDP in the fourth quarter of 2012 was revised upwards to 0.1% from negative 0.1%. For reference, real GDP increased by 3.1% in the third quarter. Although this is not a big numerical difference, fourth quarter GDP has gone from showing contraction to growth. The revision mainly resulted from higher exports and more business spending.

Employment: February's private sector job growth exceeded expectations, with 246,000 jobs added. The improvements were unusually broad-based, with almost no declining categories across industry sectors. Unfortunately, government employment continued to decline, with an additional loss of 10,000 jobs. To date, the U.S. has lost more than 600,000 government jobs since the recovery began. Morningstar economists believe that in an average economic recovery, the government sector would have been expected to contribute more than 600,000 jobs. Had the U.S. not lost so many government jobs, it would have replaced more than 80% of the jobs lost during the recession instead of just 65%. The unemployment rate in February fell to 7.7% from 7.9% the month before.

Housing: December's home prices, January's pending home sales, and January's new home sales all continued to show improvements. Year-over-year home prices from December 2011 to December 2012 (three-month average) were up 6.9%. Home prices most recently bottomed in March 2012, and anyone who purchased a home before mid-2003 or after late 2008 is at least at break-even levels before commissions and expenses. In addition to home price increases over the past year, the National Association of Realtors has continued to raise its price forecast from 5.75% to 7% for 2013, citing a lack of supply to meet the increasing demand.

Manufacturing: Although manufacturing is not a key economic driver at this point of the recovery, the recent string of good news can no longer be ignored. Durable goods orders (excluding aircrafts) showed surprising strength, which Morningstar economists believe may be driven by the resolution of the fiscal cliff and the better than expected consumer data late last year. These factors contributed to corporations' increased spending. Other manufacturers also reported business improvement, with the purchasing managers' survey showing its highest reading since mid-2011.

Auto: Auto sales in February came in at 15.36 million units, representing the fourth month in a row with more than 15 million units sold. Considering that this was achieved despite the government's tax and spending tightening, auto sales have shown a strong positive trend and have been the bedrock of the U.S. recovery.

Gas: Gasoline prices soared in February by almost $0.50 a gallon, caused by a combination of potential tightening from the Fed, a weaker European economy, and weather related issues (too much snow to drive.) Considering that gasoline makes up 5% of consumer purchases, large swings in prices are a big deal, especially if food prices are moving up at the same time.

Bonds: Tips to Keep From Getting Pinched

Encountering stock market losses early in one's retirement years can deliver a blow to an equity-heavy portfolio. If you've determined that your equity weighting is extremely aggressive relative to your risk appetite, reducing risk by altering your portfolio's asset allocation may be essential. The need to reduce the risk of your portfolio doesn't mean you have to move money directly from stocks to bonds. As you cut back on your equity exposure, it may be wise to move money into cash and/or short-duration bonds (duration is a measure of interest-rate sensitivity), then slowly and systematically move it into the bond market over a period of several months or years. This way, you may be able to obtain a range of purchase prices for your new bond holdings.

It's important to think about what you're trying to achieve by transitioning your portfolio to bonds as retirement draws near. Lower risk and liquidity may be the answer. One potential way to obtain both is to take some of the money you would otherwise have earmarked for bonds and use it to pay down debt, even low-interest mortgage debt. If having a paid-down mortgage will reduce your expenses in retirement, you will be reducing the need to raise cash from your portfolio to meet in-retirement living expenses.

Diversification does not eliminate the risk of experiencing investment losses. Stocks are not guaranteed and have been more volatile than other asset classes. Bonds are subject to credit/default risk, which is risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds are sensitive to interest rate changes. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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