Investor Insights & Outlook

July 2013 | Vol. No. 1 | Investment Updates

Know Your Risks

Risk is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. Investors face many forms of risk depending on the kinds of investments they choose.

Market, industry, and company risk: General market fluctuations can affect securities trading in that market. Stocks tend to fluctuate more than other asset classes, and may pose more risk over short periods of time. Investors looking to time the market run the risk of jumping into the market during the worst times, and out of the market during the best times. Security values can also decline from negative developments within an industry or company.

Credit and interest-rate risk: Credit risk is the possibility of a bond issuer not being able to make timely payments of principal and interest. The value of a bond may also decrease due to financial difficulties or the declining creditworthiness of the issuer. Interest -rate risk relates to how bonds tend to rise in value when interest rates fall, and to fall in value when interest rates rise. Typically, bonds with longer maturity exhibit greater price volatility.

Inflation risk: Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past.

Liquidity risk: Some investments may not be widely held by the public and may be difficult to sell if prices drop dramatically.

Currency risk: Returns achieved by local investors are often different from returns achieved by U.S. investors because of foreign exchange rates, even though both are investing in the same security.

Advisor Corner

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Required Minimum Distribution (RMD) Tips and Traps

The tax-deferred compounding you get via an IRA or a company retirement plan enables you to grow your savings without having to fork over taxes on your investment earnings year in and year out. However, at some point, required minimum distributions, or RMDs, will take effect. All retirees must begin taking RMDs from their tax-deferred retirement plans by April 1st of the year following the year in which they turn age 70 1/2. They must then continue to take distributions by December 31st of each year thereafter. Roth IRAs aren't subject to RMDs. However, you exert more control than you might think over the timing of your RMDs, as well as over which accounts you tap. Here are some tips for getting the most out of your RMDs, as well as some traps to avoid.

Do

1. Even though you must calculate your RMD amounts for each of your traditional IRAs, you can draw your RMD from the investment that's most advantageous for you. If you've assessed your asset allocation and determined it's time to rebalance, take your RMD from the IRAs that hold assets where you need to lighten up.

2. Rather than taking your whole distribution at year-end, consider spacing your distributions throughout the calendar year to obtain a range of sale prices for your longer-term assets.

3. Consider "bucketing" your IRA and retirement-plan assets. That means dividing assets into cash or cash-like accounts to help address RMD and other income needs, intermediate-term assets (such as bonds) that are next in line for distributions, and long-term assets.

4. Put your distributions on autopilot to avoid the last-minute rush to execute trades (or worse, to avoid missing the deadline altogether). If you go the autopilot route, be sure to maintain cash assets in your accounts to avoid having your fund company or brokerage firm sell a long-term asset that you would have preferred to hold.

5. Coach elderly parents on taking their RMDs.

Don't

1. Miss the deadline. You'll owe a tax penalty equal to 50% of the distribution amount you should have taken but didn't, as well as the taxes that are due on any retirement-plan distribution.

2. Pay a tax penalty without stating your case first. The IRS' website indicates that the penalty will be waived if "the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall." If you've missed a distribution or didn't take as much of an RMD as you should have, you'll need to fill out an IRS form. You'll also have to submit a letter detailing why you had a shortfall in your distribution and what you're doing to remedy it.

3. Spend your RMDs right away unless you've analyzed your retirement plan's viability and determined that you can afford to splurge.

4. Plow the proceeds into a Roth IRA without doing your homework first. You need to have enough earned income (generally, that means income from a job) to cover the amount of your IRA contribution. For example, if you want to contribute $6,000 to a Roth, you'd need to have at least $6,000 in earned income to do so. Unfortunately, income drawn from your retirement accounts doesn't count. Note that you can't make additional traditional IRA contributions after age 70 1/2.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

Don't Let Small Numbers Distract You From the Big Picture

Even though it's all about dollars and cents, the financial industry runs on percentages; dollar signs are few and far between. The use of percentages is an understandable, and helpful, convention when communicating financial information. After all, a headline saying “Company A’s Net Jumps by 16%" is more helpful than one that reads "Company A’s Net Jumps to $1.02 billion.” Providing percentages rather than dollars also allows investors to compare apples to apples: You can readily discern that an investment that has gained 8% during the past 10 years has been a better bet than one that has gained half as much.

Yet dealing in percentages, especially relatively small ones like inflation rates, expense ratios, and long-term annualized returns, can also distract from important information that factors into your financial plan. Those small and innocuous-looking percentage figures, when translated into dollar terms and compounded over many years, can make a huge difference between success and failure.

How Small Numbers Can Make Your Investment Plan…: Say, for example, that you stick with the 3% 401(k) contribution rate that your company uses as the default, contributing $1,500 of your $50,000 salary for 40 years and earning 5% on your money. You'd have about $190,000 at the end of the period; not too shabby. But bumping up your percentage contribution just 2 percentage points (to 5%) would have a meaningful impact on your bottom line, increasing your nest egg to nearly $320,000.

In a similar vein, you might choose to keep your child's college fund in cash. Assuming cash yields stay as low as they are now (which is, admittedly, a big assumption), a $50,000 investment that earns just 1% for the next 10 years will amount to just $55,000 at the end of the period. But by maintaining a 60% stock/40% bond portfolio and assuming a not unreasonable 4% return, you'd be able to grow your $50,000 investment to $74,000. Neither return rate will allow you to keep up with college inflation, sadly, but at least it's better than putting the money under your mattress. However, keep in mind that the 60/40 portfolio entails market risk.

…or Break It: Just as seemingly small percentage changes (either in contributions or return rates) can provide investors with an enormous helping hand, they can also work in reverse, and this is where many investors run into trouble. They blow off small percentage amounts like expense ratios and inflation rates when making investment decisions.

For example, let’s say an index fund has a fairly low expense ratio of just 0.63%. It's certainly cheaper than most actively managed funds, and it doesn't appear to be that much more expensive than most other S&P 500 index funds, some of which charge as little as 0.06%. If you opted for the expensive fund rather than a cheaper alternative and you held it for a long time, you'd be shortchanging yourself. Assuming a 10% annualized return and a $100,000 initial investment, you'd be leaving a lot of money on the table during a 25-year period by opting for the more expensive fund: nearly $170,000, to be exact. All because your fund charged 0.57% per year more than a comparable option.

Inflation is another factor that investors tend to underestimate, because the average historical inflation rate of roughly 3% looks pretty benign when viewed without any context. Should the fact that bananas that are $0.59 a pound today but might be $0.79 a pound 10 years from now cause a major rethinking of your financial plan? Yes, actually. When you extrapolate inflation across all of the items in your shopping cart and compound it over many years, it can have a hugely corrosive effect on the purchasing power of your savings, meaning you need to save a lot more than you thought you did.

10 Questions to Ask When Selecting and Titling an Annuity

While by no means a comprehensive list, these questions help cover the basics of selecting and titling an annuity.

1) Who gets the payout when different parties on the contract die? 2) Whose death triggers the enhanced death benefit to pay out? On a contract with spouses, not all contracts pay out the enhanced death benefit when either spouse dies. 3) If spousal continuation occurs, is the contract continued at the enhanced death benefit value or just the current account value? And, if continued, are the surrender charges waived? Death benefit values in excess of the account value may be available. 4) If spousal continuation occurs, what happens to the various benefits on the contract? Do they terminate, reset, or continue uninterrupted? 5) How do withdrawals impact the different living and death benefits on the contract? 6) For qualified money, how do Required Minimum Distribution (RMD) withdrawals impact the different guarantees? RMD withdrawals can erode a benefit. 7) Do guarantees on the contract stop or simply level off when clients reach older ages? 8) Is annuitization forced at a particular age? 9) If a trust is the owner of the annuity, whose death will cause the contract to pay out? 10) If a trust is the recipient of the annuity assets, and the surviving spouse is the sole beneficiary of the trust, is spousal continuation allowed? Pay special attention when working with trust ownership or trust beneficiaries.

Annuities are suitable for long-term investing, particularly retirement savings. Annuity risks include market risk, liquidity risk, annuitization risk, tax risk, estate risk, interest-rate risk, inflation risk, death and survivorship risk, and company failure risk. Consult your financial advisor, estate lawyer, or tax professional to determine which annuity product best caters to your individual needs.

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