Prescription For WEALTH

EMERGING MARKETS: HIGHER REWARD (AND RISK) POTENTIAL FOR LONG-TERM INVESTORS

MANAGING RETIREMENT SAVINGS AFTER A JOB CHANGE

STRESS TEST YOUR INVESTMENT PORTFOLIO

Trusts and taxes
AN IDGT CAN SHIFT INCOME TAX LIABILITY
Emerging markets: Higher reward (and risk) potential for long-term investors

Emerging markets have gained a significant share of the global economy during the past few decades. According to the International Monetary Fund, by one measure of global output emerging markets represented half of the world’s economy in 2013, up from a third in 1993. China, the largest emerging market, overtook Japan in 2009 as the world’s second-largest economy and now, by some metrics, exceeds the U.S. economy.

Such rapid growth can make emerging markets an exciting investment destination, but they also come with special risks. These nations may be modernizing their economies, but their financial markets tend to be volatile. That’s why you should consider the trade-offs carefully when evaluating the opportunities emerging markets offer to your investment portfolio.

Into the developed world

Emerging markets, also known as developing markets, are countries whose economies are growing rapidly and possibly transitioning to developed-market (meaning more fully industrialized) status. Policymakers in these countries generally are taking steps to make their economies more attractive for investors, perhaps by enhancing productivity, improving business regulation, stabilizing currencies and strengthening financial markets.

While emerging-market economies may still be developing, their existing global importance shouldn’t be underestimated. For example, China has become a major trading partner with many developed and emerging nations, and commands an outsized influence on commodity prices. As China has become more integrated with the world economy, its cooling growth rate has been a big factor behind the world’s recent sluggish economic performance.

Because emerging-market economies have tended to grow faster than developed-market economies, investing in them can offer both diversification and growth potential. This can make them an attractive proposition, as long as you’re mindful of their risks.

Think long term

A main benefit of having emerging-market stocks or bonds in your portfolio is increased diversification. Emerging-market economies can move in cycles different from those of developed markets, which means their stocks and bonds may similarly move out of sync. Granted, in some periods emerging and developed markets will move in tandem. But, over time, diversifying with emerging-market stocks or bonds can decrease your portfolio’s overall volatility.

The next frontier

As emerging markets have matured considerably during the past 20 years, some intrepid investors looking for even higher-growth opportunities have turned to so-called “frontier” markets. Countries such as Kuwait, Argentina and Nigeria — to name only a few — may not yet have reached emerging-market status, but they’re considered on that growth path. Frontier markets are riskier, more speculative investments that aren’t for everyone. But depending on your needs and the size of your portfolio, a small allocation may provide valuable diversification benefits and growth opportunities.
Furthermore, if your time horizon is long term, emerging markets’ growth potential over time can make them attractive for certain investors. Faster economic growth doesn’t necessarily translate to faster appreciation in stock or bond prices. But there’s a correlation between strong economic growth and healthy corporate earnings, which in turn can be a positive factor for securities’ performance over an extended period.

**Proceed with caution**

In exchange for their higher growth potential, emerging-market investments have unique risks. You should be prepared for substantially greater market volatility, as performance can vary dramatically over short time frames.

Because emerging markets tend to have less-liquid securities exchanges, lax regulation and political instability, their financial markets are more easily disrupted, making big losses a possibility. But by maintaining a longer time horizon, limiting your exposure to this volatile asset class and diversifying among different emerging markets, you can manage your portfolio’s volatility.

**Growth or income opportunities**

Emerging markets’ growth potential and diversification benefits are available through a variety of means. If you’re prioritizing growth over income, emerging-market stocks may be appropriate. Rather than buying shares of individual companies located in emerging markets — a strategy fraught with risk and complexity — most investors opt for the easier and more cost-effective option of a professionally managed portfolio, such as a mutual fund* or an exchange-traded fund (ETF). These funds can be focused purely on emerging markets, or may include an emerging-market component as part of a more broadly diversified regional or global portfolio.

Income-oriented investors may consider an emerging-market bond fund or an ETF. Emerging-market debt, not surprisingly, is riskier than that of developed markets, but it has historically offered higher yields in return. That said, not all emerging markets are created equal, and some issuers carry investment-grade credit ratings, making these bonds a potentially more appealing option for risk-averse investors.

**Less can be more**

Because of their greater risks and potential rewards, a little exposure to emerging-market investments can go a long way. Your financial advisor can help you determine the level appropriate for you.

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* Mutual funds are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund. The fund prospectus provides this and other important information. Please contact your representative or the mutual fund company to obtain a prospectus. Please read the prospectus carefully before investing or sending money.
Managing retirement savings after a job change

When Jane decided to make a career change and resign from her employer of 20 years, it wasn’t without much consideration. This included meeting with her financial advisor. Noting the sizable balance in her 401(k) plan, he said it was important to effectively manage this retirement nest egg. If you’re in a position similar to Jane’s, you have a few options.

**Taking no action**

If your qualified retirement plan with your previous employer has a balance of at least $5,000, the plan is required to allow you to leave your money there. This is the simplest course of action, but it might not be the best.

Your ex-employer may restrict your ability to make changes to your portfolio, to take distributions or to update beneficiaries. As a nonactive participant, you may incur higher fees and receive less-effective communications about plan changes than active participants do. And you’re limited to whatever investment options the plan offers.

However, if the plan offers an appealing and hard-to-duplicate investment option, it could make sense to keep your money there. Such options might include a high-yielding guaranteed investment contract or a stable value plan.

**Rolling over funds**

Rolling over your savings to your new employer’s plan can help you avoid the potential downsides of sticking with your old plan or the complications of keeping track of multiple plans. But first review the investment options available in your new employer’s plan. In addition, be aware that you may incur a sales charge on the rollover.*

If the investment options from your new employer’s plan aren’t very attractive, you might be better off keeping your existing savings in the old plan — or rolling them over to an IRA (see the next option) — while also contributing to your new plan.

If a rollover to your new employer’s plan seems like the best option, confirm that the new plan accepts rollovers. If it does, request a direct trustee-to-trustee rollover.

Otherwise, your old employer will mail a distribution check to you, minus mandatory tax withholding of 20% that you won’t need. You then have just 60 days to deposit these funds in your new plan. You also must deposit the 20% that was withheld for taxes, which means finding cash elsewhere, because you won’t get your withholding back until after you file your annual tax return.

If you fail to meet the deadline, or if you don’t have the cash available to cover the taxes that were withheld, you must pay income tax on the amount that wasn’t rolled over. You may also incur a 10% early withdrawal penalty if you’re under age 59½.

**Opening an IRA**

Transferring your retirement savings into an IRA offers several advantages. An IRA typically provides a wider array of investment options.
than most 401(k) plans do, such as mutual funds from a variety of companies, as well as individual stocks and bonds. Holding all of your assets in one account or with a single financial services company also makes it easier to get a clear view of your entire retirement savings portfolio.

Most financial services companies will accept a direct transfer of your retirement savings, which can streamline the process and avoid the potentially costly mistakes previously discussed. In many cases, assets can be transferred “in kind,” meaning you don’t need to sell the investments and then repurchase them in your IRA. Be aware, however, that you may be charged an annual fee.

**Cashing out**

Cashing out your retirement savings typically isn’t recommended. Any distributions you take will be taxed as ordinary income, and, if you’re under age 59½, you may have to pay an additional 10% penalty.

There are exceptions to the penalty in cases of economic hardship or separating from service after age 55. But in either case, you’ll still owe the income tax. In addition, although IRA distributions are exempt from the 3.8% net investment income tax (NIIT), they’re included in modified adjusted gross income (MAGI) and could trigger or increase the NIIT on other income. This is because the thresholds for that tax are based on MAGI.

**Making the right moves**

If you’re considering a job change or have changed jobs recently, don’t forget that a change to your retirement savings might also be warranted. Making the wrong move can significantly harm your retirement nest egg.

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* When considering rolling over the proceeds of your retirement plan to another tax-advantaged plan, such as an IRA, please note that you may have the option of leaving the funds in your existing plan or transferring them into a new employer’s plan. Consult with the human resources department of the applicable employer to learn about the options available to you under your plan and any applicable fees and expenses. Tax consequences might apply if you withdraw the funds, and there are additional tax consequences to transferring stock out of your retirement plan. Please consult a tax advisor before taking such an option. Also be aware that, depending on the state where you reside, assets held in a retirement plan may enjoy greater protection from creditors than in other types of tax-advantaged vehicles. Also consider the different fees and services that apply to your plan and compare them to any new option you’re considering.

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**Stress test your investment portfolio**

As anyone who held investments during 2008 can attest, even careful planning doesn’t necessarily protect your portfolio from unforeseen events. Your investments are particularly vulnerable to painful losses, especially if you’re near or already in retirement.

In many cases, unexpected events are beyond your control. But what you can do is give yourself a head start on preparing for challenges by conducting a “stress test” to understand the sensitivities in your portfolio.

**Test a variety of scenarios**

A stress test gauges how your investments might perform under various circumstances. The results can tell you how resilient your portfolio may be in the face of different types of risks.
Some of the scenarios your stress test should consider include:

**Changes in the market environment.** Rising inflation and higher interest rates are particularly important to consider if you have a bond- or cash-heavy portfolio. Inflation erodes your purchasing power, which is detrimental to the value of your savings and can hurt bonds with yields lower than the rate of inflation. And, as interest rates increase, bond prices fall, particularly for longer-term bonds.

In this scenario, your financial advisor can help you determine whether to add bonds with lower inflation sensitivity, or other investments such as:

- Shorter-maturity bonds or Treasury Inflation-Protected Securities,
- Inflation-hedging hard assets, such as precious metals or real estate, and
- Stocks, which have tended to beat inflation during the long term.

Bear in mind that stocks and many hard assets come with greater risk, so you also need to consider how a prolonged or severe stock market or sector-specific decline would affect your ability to reach your goals. Diversification and rebalancing are key strategies for withstanding market fluctuations. However, bear in mind that diversification doesn’t guarantee profit or protect against loss in declining markets.

**Changes in your income needs.** What if you have an unexpected and significant medical expense? Or if legislative changes reduce your Social Security income or tax laws become less favorable to your financial situation? Make sure your portfolio has a cash component (or an asset that can be easily converted to cash), in case of an immediate or short-term income need.

**Outliving your money.** You may fear losing money during market downturns, but taking too little risk can hurt you over the long term. Conservative investments may not outpace inflation and, by staying on the sidelines, you can miss important rallies that might otherwise bolster your returns. The key to a well-positioned portfolio is to consider how much growth and safety you need in order to maximize the odds of reaching your goals.

**Factoring in surprise, improbable events.** Also known as “black swan” events, these occurrences are significant, rare and impossible to predict — think natural disasters, the Sept. 11, 2001, terrorist attacks or the collapse of Lehman Brothers. You may not be able to plan ahead for these types of events, but you typically can reduce the impact of market volatility on your portfolio by diversifying sufficiently across multiple noncorrelated asset classes.

**Plan for the unexpected**

All investors want to maximize returns. But to keep those earnings to help fund your retirement, you have to assess the risks. Finding the right risk-return balance today is the key to giving yourself the best opportunity to reach your retirement goals, while simultaneously making it possible for you to rest easy at night. Talk with your financial advisor about how to best prepare your portfolio.
Trusts and taxes

An IDGT can shift income tax liability

Trusts often are a key component of an estate plan. But because trusts are considered separate legal entities, they’re subject to income tax. The income tax rate thresholds for trusts are low, so it’s important to consider the potential tax impact on your estate plan. An intentionally defective grantor trust (IDGT) can provide the estate planning benefits of a trust while avoiding its potentially negative income tax consequences.

2015 tax rates for trusts

For 2015, the top federal income tax rate for trusts is 39.6%, the same as for individuals. But the threshold for triggering this rate is low: It applies to trust income in excess of $12,300. In addition, trusts are subject to the 20% capital gains rate to the extent their taxable income exceeds that same threshold.

Finally, the 3.8% net investment income tax (NIIT) is imposed on the lesser of a trust’s net investment income or the amount of the trust’s adjusted gross income that exceeds $12,300. So trusts trigger the highest tax rates much more quickly than individuals do.

Strategies to minimize tax liability

How can an IDGT help? An IDGT is an irrevocable trust designed so that contributions to the trust are considered completed gifts for gift tax purposes — removing them from your taxable estate — even though the trust is considered a “grantor trust” for income tax purposes. (That’s the intentionally designed “defect.”)

This means that you, as the grantor, pay the income taxes on the trust’s earnings, rather than the trust paying them. As a result, you avoid the NIIT and the low thresholds for top rates that apply to trusts.

Because the earnings stay in the trust rather than being used to pay taxes, you’re essentially making additional tax-free gifts to your beneficiaries. And, because a grantor trust is considered your “alter ego” for income tax purposes, payments you receive from the trust generally will be tax-free.

However, keep in mind that, if your personal income exceeds the applicable thresholds for triggering top tax rates and the NIIT, an IDGT won’t save income taxes. Still, the IDGT allows you to make the additional gift of paying income taxes on the trust assets, and thus enhances the estate planning benefits.

Seek your advisors’ help

If you’re using trusts in your estate plan, be prepared for the potential tax bill associated with them. An IDGT can ease the tax burden, but the trust will require the proper drafting when it’s set up. Discuss your options with your tax and legal advisors before taking any action.