PRESCRIPTION FOR RETIREMENT

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USING MARKET INDEXES TO BENCHMARK YOUR PORTFOLIO'S RESULTS

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Steve Kaneski and his team at Kaneski Associates have over 50 years combined experience providing financial education workshops and implementing unmatched, holistic, and meaningful financial strategies for physicians and other medical professionals in the medical community.

Steve's extensive knowledge and appreciation of the medical marketplace, and of the financial challenges facing medical professionals in all stages of their careers, enables Steve and his team to tailor their financial strategies to the unique needs of medical professionals in varying occupational specialties.

Using market indexes to benchmark your portfolio's results

There's more to being a smart investor than simply choosing securities for your portfolio. You also need to effectively measure your portfolio's performance. One way to do this is to compare your returns to those of relevant benchmark indexes. Knowing the right benchmarks to use can help you determine whether you're on track to reach your investment goals.

Primary yardstick

If you own mutual funds, you already may understand how benchmarks are used. Every fund is required to measure its results regularly against an appropriate broad-based index and provide that information to shareholders in its prospectus and shareholder reports.

Typically, fund companies look for benchmarks that closely resemble the types of securities owned in their portfolios. Dozens of established market indexes are widely used as benchmarks.

Probably the most familiar equity fund benchmark is the S&P 500, which measures the average stock performance of 500 large U.S. companies. Because it's so universally

REBALANCING IS A BALANCING ACT

Financial market movements that reward some securities and increase the size of their positions relative to other holdings in a diversified portfolio can lead to greater investment risk. When this happens, one option is to rebalance the portfolio.

Why not just let the winners ride? This strategy can work for a while, sometimes even years. But left on its own, the portfolio likely will become lopsided, too heavily tilted toward recent strong performers. This imbalance can set the portfolio up for big losses when market trends shift — as they typically will.

To bring a portfolio back into balance, an investor might want to consider selling some of the securities that have overgrown their target allocation — then use the proceeds to buy more of the underrepresented investments. Another option may be to keep the "overgrown" securities but invest more money in the recent underperformers to bring them in line with a target weighting.

However, before investing more in underperformers, an investor needs to figure out why they're lagging. If the entire sector — such as high-yield bonds or small-cap stocks — is hurting, a corresponding market index should reflect similar performance. If not, the investments could have security-specific issues that may warrant selling.

Keep in mind that performance isn't the only measure of a portfolio or investment. Many factors must be considered, including your situation, specific goals and time horizon.

recognized, many investment companies — as well as individual investors — use the S&P 500 as their primary yardstick for measuring their own portfolios' performance. Bear in mind that you can't directly invest in an index. Also, past performance doesn't guarantee future results.

Other options

The S&P 500 is a useful reference point, but knowing how it performed won't give you much meaningful information if the investments you own differ significantly from the makeup of this index. For example, you probably won't see much of a relationship between the results of the S&P 500 and your high-yield municipal bond holdings.

To better evaluate bond performance, you might instead look to the Barclays Capital High-Yield Municipal Bond Index, for example. Because this index is composed exclusively of high-yield municipal bonds, it's a more valid point of comparison for a portfolio that owns these types of securities.

Here are some other popular indexes that might be appropriate benchmarks, depending on the securities in your portfolio:

Dow Jones Wilshire 5000 Composite Index. This index of 5,000 U.S. companies is considered the broadest measure of the U.S. stock market. The Russell 3000 index is another example.

Russell 2000. This index is a common benchmark for U.S. small-cap stocks.

Russell 1000 Growth Index and Russell 1000 Value Index. These indexes are two widely cited measures of U.S. large-cap growth and value stock performance, respectively.

MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, Far East). This index reflects the performance of international stocks in many of the developed markets outside North America.

Bloomberg Barclays U.S. Aggregate Bond Index. This index is often used as a proxy for the broad U.S. bond market.

Finding the right mix

No single benchmark will exactly match the contents of your investment portfolio — especially if you own a relatively large, diversified collection of securities. Talk to your financial advisor about what set of benchmarks will help you evaluate your portfolio's results over time.

Should you accelerate taxes?

Employers often use restricted stock to attract, retain and motivate employees. But to fully enjoy the benefits of restricted stock awards, employees need to be careful about how they pay taxes on them. For example, a Section 83(b) election accelerates taxes on restricted stock and can deliver substantial tax savings in the long run.

Taxing dilemma

When an employer grants restricted stock to an employee, the stock is nontransferable and can be forfeited until it vests. Vesting generally is based on years of service, achievement of performance goals or a combination of the two.

Under Internal Revenue Code Sec. 83, restricted stock isn't subject to tax when granted if it's still at risk of forfeiture. Rather, its value is included in gross income as compensation only when and if it vests. If your stock appreciates significantly in value, you could end up with a big tax bill — at ordinary income tax rates — without receiving the cash you need to pay the tax liability. (Once the stock vests, additional appreciation is treated as capital gain.)

One possible solution

To help you avoid getting hit with taxes you can't pay, Sec. 83(b) allows you to elect to be taxed at the time restricted stock is granted. Such an election provides two important advantages:

1. If you believe the stock's growth prospects are strong, the election allows you to minimize the amount of ordinary income taxes and avoid a bigger tax hit later when the stock vests.

2. It triggers the capital gains holding period sooner, so you can enjoy long-term capital gains rates if you sell the stock more than one year after the grant date, rather than one year after it vests.

Suppose, for example, that your employer grants you 100,000 shares of restricted stock, valued at $0.10 per share and vesting one year after the grant date. Assume that the stock is worth $2 per share a year later when it vests and $10 per share when you sell it more than a year after that. Also assume that you're currently in the 35% federal income tax bracket and that the long-term capital gains rate is 20%. (For the sake of simplicity, payroll and state income taxes aren't included in this example.)

Under one scenario, you *don't* make an 83(b) election. No tax is due when the stock is granted, but you'll owe $70,000 in ordinary income taxes when it vests (100,000 × $2 × 35%). When you sell the stock more than a year after it vests, you'll recognize a taxable gain of $8 per share ($10 per share minus the $2 per share that was already taxed) for an additional $160,000 in tax (100,000 × $8 × 20%). Your total tax liability: $230,000.

Under a second scenario, you *do* file an 83(b) election when the stock is granted, paying a much smaller $3,500 in ordinary income taxes (100,000 × $0.10 × 35%) at that time. When you sell the stock two years later (one year after vesting), your entire $9.90-per-share gain is treated as long-term-capital gain, resulting in a $198,000 tax bill (100,000 × $9.90 × 20%). Your total tax liability: $201,500.

The 83(b) election potentially represents a $28,500 tax savings. Perhaps more important, in this second scenario, you pay only $3,500 in taxes up front, avoid a big tax bill when the stock vests and don't have to pay additional taxes until you've received cash from the stock sale.

Not without risk

Despite some significant benefits, an 83(b) election comes with certain risks. First, there's the risk of loss associated with owning any stock. But with restricted stock, there's also a chance that you'll forfeit the stock. For example, you may not meet performance targets or you may leave your job before the stock vests. In that case, you'll have paid tax at ordinary-income rates on stock you never received (although eventually you're likely to incur a capital loss).

Carefully weigh such risks as you decide how you want your award taxed. If you want to take advantage of Sec. 83(b), consult with your tax advisor regarding your specific situation. Be sure to file with the IRS within 30 days after the restricted stock is granted and to give a copy of the election to your employer. ■

For good financial health, take your RMDs

Employer-sponsored retirement plans and traditional IRAs offer participants almost unbeatable tax-saving and wealth-building opportunities. But the benefits come with a catch. At a certain point, you have to stop investing and start withdrawing — in the form of required minimum distributions (RMDs) — or pay a severe price.

Note what qualifies

The magic number is 70½. After you reach that age, you must begin taking RMDs. If you don't, the IRS applies a penalty based on the difference between what you should have taken and what you actually took — a whopping 50% penalty.

RMD rules apply to 401(k), 403(b) and 457(b) plans, SIMPLEs and traditional IRAs, including Simplified Employee Pension (SEP) plans. The regulations don't apply to Roth IRAs if you're the original owner of the account (and didn't inherit it). So if you have a Roth 401(k), Roth 403(b) or Roth 457(b), you can avoid RMDs by rolling the funds into a Roth IRA.

Calculate withdrawals

To calculate the minimum amount you must take from your retirement accounts

each year, you divide your balance at the end of the previous tax year by the applicable IRS divisor. Your RMD will vary with the balance in the account, your age and possibly your spouse's age.

If your retirement funds are spread across multiple accounts, you'll need to figure out your RMD based on the balance in each. So, for example, if you have three IRA accounts with $25,000 in each, your RMD must include all three balances. You can take the distribution from any or all of the IRA accounts, as long as the amount is at least equal to the RMD. However, RMDs from other accounts, such as 401(k) plans, are determined separately.

Also, don't forget that your RMDs generally are taxed for the simple reason that the funds have been saved through tax-deferred accounts. However, if a distribution portion is a return of basis (which may occur, for example, if you made nondeductible contributions to a traditional IRA) or is a qualified distribution from a Roth 401(k), Roth 403(b) or Roth 457(b), it will be tax-free.

Mark your calendar

Most account owners must take their initial distribution by April 1 of the year *after* they turn 70½, though they can take it during the year in which they actually turn 70½. However, waiting until the following year to take your initial distribution may have negative ramifications. Because you'll then be required to take two taxable distributions within the same year, you may end up in a higher tax bracket.

What's more, the amount of the second distribution must be calculated using the account balance from December 31 of the previous year — not based on the balance remaining after the first RMD is taken. As a result, the RMD will be slightly larger, increasing the chance you'll be pushed into a higher bracket.

After the initial RMD, you'll need to take subsequent ones by the end of each calendar year. The IRS allows distributions to be taken in installments during a calendar year, so long as the total by the end of the year equals the RMD. Of course, you're free to make withdrawals in excess of your RMD. This will reduce the balance used to calculate your RMD in future years. But keep in mind that the excess over the RMD you withdraw one year doesn't count toward your RMD in another year.

Make good decisions

If you're like most retirees, you have multiple sources of income and it can be hard to decide which accounts to tap first. Just remember that, after 70½, you *must* start taking RMDs from deferred-tax retirement accounts. To help ensure you're making good retirement income decisions specific to your situation, consult your financial advisor.

5 tips for keeping student loans under control

Given the skyrocketing cost of higher education, fewer and fewer families can afford college without some form of financial assistance. For many students, loans are what make the difference between attending college and not. But it's important to plan these loans carefully to avoid a financial nightmare after graduation. Here are five tips for keeping student loans under control.

1. Work backwards. Most families look at the cost of college and determine the amount to borrow based on how much they need to cover their student's expenses. But failure to think realistically about how loans will be repaid can lead to trouble down the road.

A better approach is to try to estimate your student's monthly loan payments after graduation and determine whether his or her expected income is likely to meet all financial obligations — including the loan. Many resources are available to predict a grad's job and income prospects based on major, degree, institution and other factors. These include PayScale College Salary Report (payscale.com) and the College Scorecard (collegescorecard.ed.gov).

If you expect a shortfall, there are several options to consider. For example, your student might work while in school to cover some living expenses or plan to live at home for a time after graduation. Your student could look for lower (or no-) cost financial aid, attend a less-expensive school or reconsider his or her field of study.

2. Avoid using loans for living expenses. Try to borrow only what's needed for tuition, school fees, books and educational supplies. Although it's tempting to use loans for room and board and other living expenses, doing so can easily double student loan amounts. Better options include working part-time, living at home or participating in a work-study program.

3. Keep an eye on interest. Interest can quickly spiral out of control, especially if it accrues (that is, accumulates without the need to pay it currently) while your student is attending college. Consider paying accrued interest during college to minimize the financial burden after graduation. Note that subsidized federal loans *don't* accrue interest while a student is still enrolled.

4. Scrutinize the terms. Student loans generally are categorized as either federal student loans (FSLs), which can be subsidized or unsubsidized, or private student loans (PSLs) from banks or other lenders. Generally, FSLs have lower interest rates and more flexible terms. But regardless of the loan type, it's critical to discuss the terms with your lender and to carefully read the promissory note and other loan documents. Loans may contain clauses that can increase parents' or students' risk. For example, some PSLs provide that, if a co-signer dies, the entire loan balance is due immediately.

5. Get professional help. Financial aid is extremely complicated and missteps now can lead to financial hardship later when the new graduate is trying to strike out on his or her own. It pays to discuss your options with experienced financial advisors who can help you develop a realistic plan for financing college expenses.