The Downside of Taxes Determining Investment Strategy

While you should always keep the tax consequences of investment decisions in mind, it's a mistake to let them drive those decisions. Why? Because the goals for each are fundamentally different: the goal of investing is to make money over the long run, while the goal of tax planning is to minimize paying taxes in the short run.

Ideally, these goals should complement each other to achieve the maximum long-term growth of your portfolio given your investment objectives and risk tolerance. The danger is that by trying to avoid paying taxes today, you will frustrate your efforts to make the money you could have made or need for tomorrow. A few examples of what can go wrong will illustrate the point.

Skewing Your Asset Allocation

Studies have found that the most important factor in determining an investor's long-term rate of return is asset allocation, or how your portfolio is spread out among different classes of investments: stocks, bonds, cash, real estate, and commodities. When properly structured, your portfolio aims for a given rate of return that's chosen to meet your long-term financial needs.

One way to decrease the absolute dollar amount of the taxes paid is to minimize returns. You can accomplish that by concentrating in low-return investments, like money market funds, savings accounts, certificates of deposit, or bonds. But if your investment goals require the higher rate of return only obtained through stocks, this strategy will succeed at minimizing returns, but fail at meeting your investment goals.

Concentrating Investment and Credit Risk

Municipal bonds are a great way to reduce your exposure to both federal and state taxes. While a municipal bond from any state shelters interest payments from federal taxation, only municipal bonds issued from within your resident state will lower your liability for state income taxes. For that reason, investors frequently confine their investments in municipal bonds to in-state issues. The problem with that is concentrating exposure to the risk that your home state could run into financial problems that jeopardize your returns.

When it comes to municipal bond portfolios, it can pay to diversify, both away from a single issuer and single state. That way, you reduce the risk the market value of your bonds will suffer from a default or credit downgrade.

Holding onto an Investment Too Long

The higher tax rate on short-term capital gains — those realized in less than a year — than on long-term gains encourages some investors to hold on to an investment too long. Stock prices can move quickly, and holding on to a stock just because you want a more favorable tax rate can cause you to lose some or all of your profits or deepen the losses you've already suffered.

Selling an Investment Too Soon

Conversely, investors can be tempted to sell a stock prematurely in an attempt to harvest capital losses to shelter capital gains. While it might be a good idea to exit a stock position before its losses mount, you could regret it if the sold stock later results in big gains. Selling may also leave a hole in your asset allocation strategy and diminish your portfolio's level of risk-reducing diversification.

The Proper Approach to Tax-Efficient Investing

That doesn't mean taxes are a good thing or you shouldn't try to minimize the taxes your investments trigger. But there's a wrong way to go about it — and a right way, which consists of doing the following:

- ✔ Taking full advantage of tax-sheltered investment retirement accounts, like IRAs, 401(k) plans, and annuities.
- ✔ Investing in municipal bonds only when they generate a higher after-tax rate of return.
- ✔ Selling stocks based on their intrinsic ability to generate gains or losses.
- ✔ Prudently culling losing stocks from your portfolio when harvesting capital losses.

Please call if you'd like to discuss this in more detail. ❍❍❍

5 Reasons to Start Saving More

If you're interested in getting started with savings or want to save more, here are five reasons to help keep you motivated.

1. You'll be prepared for emergencies — Here's an alarming fact: most Americans don't have enough money saved to cover even relatively small, unexpected expenses, such as emergency room copays, minor car repairs, or a broken furnace. Without cash on hand to cover these irregular but inevitable costs, you're more likely to turn to credit cards or loans when the need arises. Not only will you be forced to take on debt, but you won't have time to shop around, making it more likely you will end up with an expensive, high-interest loan. Plus the more debt you have, the more difficult it is to save.

2. You'll be more independent — With a healthy amount of savings, you can feel more free to take risks, like starting your own business, heading back to school to train for a new career, purchasing a home of your own, or moving to a new city. Without savings, you're living on the financial edge and are more likely to find yourself stuck in situations you may not be satisfied with — working just to pay off debt, trapped in an unfulfilling job, or stuck in a less-than-desirable neighborhood. Committing to saving today will start to give you the freedom to make different choices.

3. You'll be able to reach your goals — Whatever your dreams, they likely have one thing in common — you're probably going to need some money if you want them to become a reality. Few of those dreams are achievable if you don't save for them.

4. You'll be able to earn more money — Saving isn't just about setting aside what you've already earned. It's also about putting your money to work for you. Depending on where you save and invest your money, you can earn more just by being diligent about saving rather than spending. And because of the power of compound earnings, even relatively small amounts can grow significantly, provided you don't touch your principal.

5. You'll be happier — No one wants to suggest that money is the only thing that can make us happy. But there's also evidence that *saving* money, even in small amounts, can make you happier. In contrast, having debt (often a consequence of a lack of savings) tends to lead to more unhappiness. ❍❍❍

Jennifer

A Tax-Planning Mentality

While it can be easy to think tax planning is synonymous with tax preparation, each serves a different function. When you plan for taxes throughout the year, you can make decisions that may save you tax dollars. By the time you get to tax preparation — when it's time to file your taxes — it's too late to do much that can lower your tax bill. That's why it's best to have an all-year mentality when it comes to tax planning.

Early in the year, take time to assess your tax situation and take steps to become better informed about ways to reduce your tax bill, like doing self-research or speaking with a tax professional. Consider the tax consequences throughout the year before making important financial decisions and transactions. In the fall, take another look at your situation and give yourself enough time to implement any additional tax-planning strategies before the end of the year.

By taking the time throughout the year to assess your tax situation and plan accordingly, you can ensure you won't look back and regret not implementing small changes that would have lowered your tax bill. ❍❍❍

Financial Thoughts

Approximately 50% of American parents surveyed with children under age 18 have some savings put aside for college. And 51% of parents say they have a plan for funding all four years of college for their children (Source: Sallie Mae, 2018).

Over the past 20 years, the cost of attending an in-state public university has increased by 237% (Source: *U.S. News and World Report*, 2018).

The average cost of one year at a public university for an in-state student is $20,090 versus $34,220 for an out-of-state student (Source: College Board, 2018).

Approximately 44 million Americans hold a total of $1.3 trillion in student loan debt (Source: Federal Reserve, 2018).

It is estimated that 50% of people will need help with daily activities like bathing and eating, making up the bulk of their long-term-care costs (Source: U.S. Department of Health and Human Services, 2018).

The economic value of care that unpaid family caregivers give to their loved ones is $470 billion per year. And family caregivers over age 50 who leave the work force to provide care lose $300,000 in wages and benefits (Source: AARP, 2018). ❍❍❍

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