The Tax Impact of a 529 Rollover

Thirty-four states offer some sort of tax deduction or tax credit for contributions made to a 529 plan. But in 29 of those 34 states, the tax break is available only for contributions made to an in-state plan. Only Arizona, Kansas, Maine, Missouri, and Pennsylvania give residents a tax break for contributing to any state's plan. If you own an out-of-state 529 plan, you may be missing out on this tax break advantage, and it may be worthwhile to do some research and consider rolling your out-of-state plan to an in-state one.

The tax break can be a real plus, but the quality of the 529 plan (its investment options and fees, in particular) is important, too. If you've already opened an out-of-state 529 plan a while ago, you may want to revisit that decision because 529 plans can change over time. If your state now offers a better plan, check with the plan or a tax professional to see if there are tax advantages to rolling funds over. Many states do not provide a tax break for inbound 529 rollovers, but some do. States that do may limit deductions to just the contribution portion of the out-of-state 529 or let you deduct the entire amount including earnings.

529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax. An investor should consider the investment objectives, risks, and charges and expenses associated with municipal fund securities before investing. More information about municipal fund securities is available in the issuer's official statement, and the official statement should be read carefully before investing. Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a legal, tax, or financial professional with any questions or concerns.

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Alpha, Beta, and Now…Gamma

When it comes to investing, traditional measurements of portfolio performance can generally be summarized by two metrics: alpha and beta. Alpha measures the excess return generated by a portfolio that goes beyond the benchmark, and is the residual (skill or luck-based) component of active management. Beta measures the risk factors of a portfolio to the market, and can usually be achieved through asset allocation. However, alpha and beta are just two elements of a myriad of important financial planning decisions. Currently, neither alpha nor beta quantifies the intangible benefits of "good" financial planning decisions, which may include achieving long-term retirement goals or offering peace of mind during times of uncertainty.

Morningstar recently introduced a new concept called "Gamma", designed to measure the additional expected return achieved by an investor from making more intelligent financial planning decisions in retirement. Gamma is a metric that is similar in concept to alpha (excess return), but can be expressed as the relative improvement in return that an investor experiences from optimal financial decision making.

The objective of investors is typically to achieve a goal, such as an annual stream of income during retirement increased by inflation. Morningstar believes that doing the things that help an investor achieve those goals (adding gamma) is just as important as alpha and beta. Good financial planning impacts investors in different ways. Examples of gamma factors include, but are not limited to, understanding mortality, investors' emotions, asset location and tax planning, as well as withdrawal strategies.

If a financial advisor only manages a portfolio of assets, and does nothing else to add value for the client (the advisor does not offer any additional advice regarding anything other than the investment of the client's assets), then the concepts of alpha and beta should be relatively good measures of the value of a financial advisor. Unfortunately, things are never this simple. With more complex engagements, especially when providing financial planning services to clients, value cannot be defined in such simple terms as alpha and beta. Advisors often do much more than just invest a client's money. Hence, it is possible for a financial advisor to generate negative alpha for a client, but still provide other value-added services that enable a client to achieve his or her financial goals. In light of all these other various decision factors, asset-only metrics may be an incomplete means of fully measuring retirement strategy performance.

Unlike traditional alpha, which is a zero-sum game, gamma can be achieved by anyone following an efficient financial planning strategy. Investors should appreciate their financial advisors not just on investment performance, but also on intangible elements of service they provide by helping them make better investment decisions to reach retirement goals. Of course, gamma varies for different types of investors as every investor has different preferences and risk tolerance. Investors are encouraged to take a holistic approach when evaluating financial advisors, and may choose to use performance metrics such as alpha, beta, and now gamma as well.

Source: David Blanchett, CFA, CFP & Paul Kaplan, Ph.D., CFA. Alpha, Beta, and Now…Gamma, Morningstar Whitepaper, September 8, 2012

Investment-Related Taxes: Must-Knows for 2013

As 2012 wound down, fairly decent-sized tax hikes loomed for 2013, and tax-savvy investors and their advisors were scrambling. Dividends were set to once again be taxed at ordinary income tax rates, long-term capital gains were to jump to 20%, and estates of more than $1 million would be taxable at a 55% rate. In the end, however, the changes that did pass through Congress were much more modest. That said, maximizing tax-sheltered accounts, putting the right types of assets in tax-sheltered and taxable accounts, and properly sequencing withdrawals in retirement can still help improve after-tax returns. Here's an overview of some key tax-related changes taking effect with the 2013 tax year that may affect investment plans.

Dividend Tax: Although the impending hike in the dividend tax rate had led to a lot of hand-wringing, the modest increase that passed through Congress won't affect most investors. As in the past, investors in the 10% and 15% tax brackets will pay nothing on qualified dividends, and those in the 25%, 28%, 33%, and 35% tax brackets will pay a 15% rate on their qualified dividend income. The only change is for single filers earning more than $400,000 and married couples filing jointly who earn more than $450,000; for them, a new 20% dividend tax rate will kick in starting this year.

In general, it makes sense to place dividend payers in tax-sheltered accounts and reserve taxable accounts for holdings that don't pay dividends. The key reason is loss of control. If a company stock held in a taxable account pays a dividend, that's a taxable event for the investor, whether the investor wanted that dividend or not. (Those who hold a dividend-paying fund owe taxes on any dividends paid out, even if they reinvested those dividends back into the fund.) In contrast, by holding non-dividend payers in taxable accounts, investors won't owe taxes unless they take action and sell shares.

Tax on Long-Term Capital Gains: As with dividend taxes, much is staying the same with long-term capital gains rates. Those in the 10% and 15% brackets will not owe capital gains tax on securities held for more than a year, while those in the 25%–35% brackets will see their long-term capital gains taxed at a 15% rate.

The 20% capital gains rate will kick in for the same taxpayers who are seeing a dividend tax hike: single filers earning more than $400,000 and married couples filing jointly who earn more than $450,000.

Medicare Surtax: An outgrowth of the new health-care law, this new tax was moving full steam ahead regardless of what happened with the fiscal cliff negotiations. The 3.8% tax will be imposed on the lesser of an individual's net investment income for the year or adjusted gross income in excess of $200,000 for single filers and $250,000 for married taxpayers filing jointly.

Estate Tax: Although the estate tax was poised to affect many more estates starting in 2013, the estate tax exemption will remain over $5 million ($5.25 million, to be exact) per individual, and the top estate tax rate will increase to 40% from 35% last year.

Gift Tax: The annual gift tax exclusion amount is $14,000 for 2013. That means an individual can gift $14,000 apiece to an unlimited number of people this year without having to worry about a gift tax. Savers in 529 college-savings plans can actually gift $70,000 to a single individual in a single year without triggering a gift tax, assuming they make no further contributions to that person's college plan in the subsequent four years. In that case, the Internal Revenue Service assumes that the contribution is spread over five years. Married couples can actually contribute $140,000 to one child's college-savings plan in 2013, assuming they make no further gifts from 2014 through 2017, without triggering the gift tax. Also, when gifting to pay educational or medical expenses, taxpayers can circumvent the gift tax system altogether by making payments directly to the educational or medical institution.

Modern Portfolio Theory Statistics and What They Mean

After the 2007-2009 financial crisis, investors have become more attuned to the risk characteristics of investments. As volatility in the market continues, investors are paying more attention to the relationship between the potential for reward and the likelihood of experiencing losses. Modern Portfolio Theory (MPT) is used by many investment professionals to help investors make appropriate investing and asset allocation decisions. MPT is rooted in the assertion that there is no free lunch, as investors can only obtain higher returns if they are willing to take on more risk. Knowledge of MPT statistics such as alpha, beta, and R-squared are useful to understanding and quantifying this risk/reward landscape.

Beta: Although alpha precedes beta in the Greek alphabet, beta is a necessary precursor to understanding alpha. Beta can generally be defined as the risk factor of a portfolio to the market, which is usually achieved through asset allocation. A beta number of 1.00 implies that the portfolio will perform exactly how the market performs. A beta number greater than 1.00 implies that the portfolio will perform better than the market when the market is going up, and worse than the market when the market is going down. Conversely, a beta number lower than 1.00 means that the portfolio is expected to perform worse than the market when the market is going up, and better than the market when the market is going down.

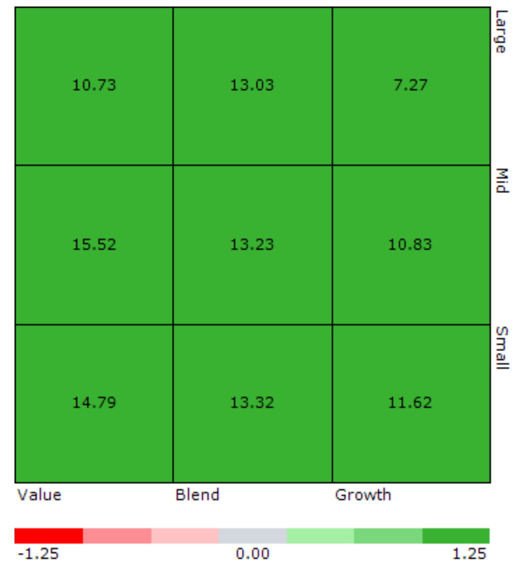
Alpha: Alpha, a measure of the excess return generated by a portfolio that goes beyond the benchmark, is the residual (or skill/luck-based) component of active management, allowing financial advisors to display their value. The benchmark is usually a market index that the portfolio can be compared against to assess its performance relative to the market. If alpha is positive, it means that the portfolio returned more than its expected return from the market, whereas a negative alpha indicates that the portfolio returned less.

Should investors be impressed if a financial advisor is generating positive alpha for their retirement portfolio? In general, yes, being able to generate alpha is touted as the holy grail of investing; it's an indication that your financial advisor has been able to generate an above-average return relative to the risk that he or she is taking on. However, before investors put too much stock in the statistic, it's important to know what these statistics mean, and why they are important. Investors should be cognizant of the fact that a higher beta does not necessarily equate to a higher alpha; a portfolio with a high beta may well sport a negative alpha. This is due to the fact that the greater the risk the portfolio assumes, the higher the hurdle the portfolio must overcome in order to outperform the market.

R-squared: The R-squared value is a number that measures the strength of a relationship (correlation), demonstrating how much a portfolio's performance can be explained by the performance of its benchmark. The higher the R-squared value, the more closely the portfolio's performance can be explained by the index it tracks. The lower the R-squared value, the more likely the portfolio doesn't behave much like its index. R-squared values can range from zero, meaning there's no degree of performance correlation between a market benchmark and a given portfolio, to 100, meaning that a portfolio is highly correlated with the index. More importantly, a higher R-squared number validates the relevance of the alpha and beta numbers.

Alpha and beta are the heart of traditional performance (risk and return) analysis, although they do come with their own caveats and limitations. Investors trying to understand or interpret these MPT statistics are best advised to seek professional investment advice to ensure they are allocating risk appropriately. A better understanding of these statistics can go a long way in making better financial planning decisions.

Quarterly Market Barometer



3 Month, ending March 31, 2013. The U.S. Market returned 11.02% (YTD 11.02%).

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are “value” and “growth” while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.

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