Investment Newsletter

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CLIENT INVESTMENT UPDATE NEWSLETTER

Essential Financial-Planning Numbers for 2017

Source: Alina Lamy, Morningstar
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In the wake of the election, some market participants have gotten concerned about inflation, owing to President Trump's stated plans for infrastructure spending, tax cuts, and curbs on imports. But various measures that are keyed off of inflation rates, including Social Security income and company retirement-plan contributions, are seeing low or nonexistent increases for 2017. That's because actual, rather than projected, inflation determines whether there are increases in any of those figures, and inflation has been pretty modest overall.

Here is a roundup of some of the key financial-planning numbers to have on your radar.

Company Retirement Plans: 401(k), 403(b), and 457
The basic contribution limits for 401(k)s, 403(b)s, and 457 plans are staying the same for 2017 as they were in 2016. Contribution limits to 401(k)s, 403(b)s, and 457s remain at $18,000 for investors younger than 50 and $24,000 for those 50-plus. The total allowable contribution to a 401(k)--including employee contributions (pretax, Roth, and aftertax) as well as employer's contributions--is increasing a bit for 2017, to $54,000 from $53,000 last year.

IRAs
The contribution limit to IRAs is also remaining the same for 2017: Investors younger than 50 can contribute $5,500 to an IRA in 2017, and those older than 50 can make an additional catch-up contribution of $1,000. (Remember that you don't need to wait until you turn 50 to make the increased contribution; for example, if you're turning 50 in September 2017, you could go ahead and make a 2017 IRA contribution of $6,500 in January.) That limit is the same for both Roth and traditional contributions.

The income limits to be able to deduct a traditional IRA contribution are nudging up a bit for 2017, however. Individual filers who can make a retirement-plan contribution at work can make a fully deductible IRA contribution if their 2017 income is under $62,000; they cannot deduct their IRA contribution if their income is more than $72,000. (The amount of the contribution that is deductible is reduced--or phased out--for single taxpayers whose income lands between $62,000 and $72,000.) For married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, traditional IRA contributions are fully deductible if their income falls below $99,000; contributions aren't deductible if their income exceeds $119,000. (Contributions are partially deductible if income falls between those two thresholds.)

Roth contributions aren't deductible, but income limits are increasing. Singles earning less than $118,000 can make a full Roth contribution, but Roth IRA contributions are out of reach for single filers who earn more than $133,000. (Contributions are reduced if the single taxpayer's income falls between these two bands.)

Married couples filing jointly can make a full Roth IRA contribution if their income is less than $186,000; they are ineligible to make a Roth contribution if their income exceeds $196,000. (Contributions are reduced for married couples filing jointly who earn between $186,000 and $196,000.)

For investors who are shut out of a direct Roth IRA contribution because they earn too much, the 'backdoor' Roth IRA maneuver remains alive and well as we head into 2017. That means that higher-income investors can open a traditional IRA--for which there is no income limit if they're not deducting that contribution--then convert those assets to Roth at some later date. Assuming the investments have not appreciated in the account--and importantly, that the investor has no other traditional IRA assets that have not yet been taxed--the maneuver should be close to tax-free.

Long-Term Capital Gains on Investments Outside of Tax-Sheltered Retirement Accounts
For investors selling stocks and funds from their taxable accounts (that is, outside of their tax-deferred and retirement accounts), the long-term capital gains bands of 0% (for investors in the 10% and 15% income-tax brackets), 15% (for investors in the 25%, 28%, 33%, and 35% income tax-brackets), and 20% (for investors in the 39.6% income-tax bracket) carry over for 2017, though the income that falls into each of these brackets is edging up a bit.

Social Security
Social Security recipients will be receiving a small cost-of-living adjustment in 2017, amounting to 0.3%.

Many folks are continuing to work even after they've started receiving Social Security benefits. In 2017, the amount that a Social Security recipient who's under the full retirement age can earn without prompting a temporary withholding of benefits is $16,920; someone who reaches 66 (full retirement age) in 2017 will be able earn up to $44,880 without triggering the temporary withholding in Social Security benefits. Those who are of full retirement age in 2017 can earn an unlimited amount without any benefits withholding. Any withheld benefits are added back to benefits after an individual reaches full retirement age.

The amount of workers' income that is subject to Social Security tax is also increasing for 2017, to $127,200.

Health Savings Accounts
The parameters for high-deductible healthcare plans and health savings accounts are generally remaining the same for 2017. For 2017, a high-deductible plan is defined as one with at least a $1,300 deductible for individuals and a $2,600 deductible for families; the maximum out-of-pocket expenses that covered people can incur are $6,550 for individuals and $13,100 for families. For 2017, those with single coverage can contribute $3,400 to an HSA (a slight increase for 2017), while those with family coverage can contribute $6,750. Investors age 55 and older can make an additional $1,000 catch-up contribution to their HSAs.

For those who are making the maximum allowable contributions to their company retirement plans and IRAs, the HSA provides another way to amass tax-advantaged savings. The investor makes pretax contributions, the money accumulates tax-free, and qualified withdrawals are also tax-free. Unfortunately, many HSAs are full of fees.

Education Savings
Each individual can contribute up to $14,000 a year to a 529 college savings plan on behalf of a specific individual without having that contribution count toward the gift tax. Additionally, investors who would like to make a large upfront contribution to a 529 can contribute up to $70,000 on behalf of a single individual in a given year; as long as he or she makes no future contributions on behalf of the same individual for the next five years, the contribution will not count toward the gift tax.

Coverdell Education Savings Account contribution limits are much lower; for 2017, they are capped at $2,000 per beneficiary, and income limits apply. For 2017, single filers earning more than $110,000 cannot contribute to a Coverdell, and contributions are reduced for individuals earning between $95,000 and $110,000. Married couples filing jointly can contribute to a Coverdell if they earn less than $220,000 in 2017; contributions are reduced if the couple's income falls between $190,000 and $220,000.

Estate and Gift Tax
The annual gift-tax exclusion for 2017 is staying the same as in 2016, at $14,000. The amount of assets that are exempt from the estate and gift tax is getting a bump-up for 2017, to $5,490,000. With the spousal portability election, discussed here, that means that married couples can escape gift/estate taxes if their total assets and lifetime gifts are less than $10,980,000.

This article contributed by Christine Benz, Morningstar's director of personal finance. This is for informational purposes only and should not be considered tax or financial planning advice.

401(k) and IRA plans are long-term retirement-savings vehicles. Funds grow tax-deferred. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Direct contributions to a Roth IRA are not tax-deductible but may be withdrawn free of tax at any time. Earnings may be withdrawn tax and penalty free after a five-year holding period if the age of 59 1/2 (or other qualifying condition) is met. Otherwise, a 10% federal tax penalty may apply. Please consult with a financial or tax professional for advice specific to your situation. 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.

Investment Shock Absorbers

Source: Dimensional Fund Advisors

February 2017

Ever ridden in a car with worn-out shock absorbers? Every bump is jarring, every corner stomach-churning, and every red light an excuse to assume the brace position. Owning an undiversified portfolio can trigger similar reactions.

In a motor vehicle, the suspension system keeps the tires in contact with the road and provides a smooth ride for passengers by offsetting the forces of gravity, propulsion, and inertia.

You can drive a car with a broken suspension system, but it will be an extremely uncomfortable ride and the vehicle will be much harder to control, particularly in difficult conditions. Throw in the risk of a breakdown or running off the road altogether and there's a real chance you may not reach your destination.

In the world of investment, a similarly bumpy and unpredictable ride can await those with concentrated and undiversified portfolios or those who constantly tinker with their allocation based on a short-term rough patch in the markets.

Of course, everyone feels in control when the surface is straight and smooth, but it's harder to stay on the road during sudden turns and ups and downs in the market. And keep in mind the fix for your portfolio breaking down is unlikely to be as simple as calling a tow truck.

For that reason, the smart thing to do is to diversify, spreading your portfolio across different securities, sectors, and countries. That also means identifying the right mix of investments (e.g., stocks, bonds, real estate) that aligns with your risk tolerance, which helps keep you on track toward your goals.

Using this approach, your returns from year to year may not match the top performing portfolio, but neither are they likely to match the worst. More importantly, this is a ride you are likelier to stick with.

Just as drivers of suspensionless cars change their route to avoid potholes, people with concentrated portfolios may resort to market timing and constant trading as they try to anticipate the top-performing countries, asset classes, and securities.

Here's an example to show how tough this is. Among developed markets, Denmark was number one in US dollar terms in 2015 with a return of more than 23%. But a big bet on that country the following year would have backfired, as Denmark slid to bottom of the table with a loss of nearly 16%.[1]

It's true that the US stock market (by far the world's biggest) has been a strong performer in recent years, holding the number three position among developed markets in 2011 and 2013, first in 2014, and sixth in 2016. But a decade before, in 2004 and 2006, it was the second worst-performing developed market in the world.[1]

Predicting which part of a market will do best over a given period is also tough. For example, while there is ample evidence to support why we should expect positive premiums from small cap, low relative price, and high profitability stocks, these premiums are not laid out evenly or predictably across the map. US small cap stocks were among the top performers in 2016 with a return of more than 21%. A year before, their results looked relatively disappointing with a loss of more than 4%.

International small cap stocks had their turn in the sun in 2015, topping the performance tables with a return of just below 6%. But the year before that, they were the second worst with a loss of 5%.[2]

If you've ever taken a long road trip, you'll know that conditions along the way can change quickly and unpredictably, which is why you need a vehicle that's ready for the worst roads as well as the best. While diversification can never completely eliminate the impact of bumps along your particular investment road, it does help reduce the potential outsized impact that any individual investment can have on your journey.

With sufficient diversification, the jarring effects of performance extremes level out. That, in turn, helps you stay in your chosen lane and on the road to your investment destination.

Happy motoring and happy investing.

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3 Tricks for Getting the Most Out of Your HSA

Source: Alina Lamy, Morningstar
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Anytime you read about health-savings accounts (HSAs), there's the obligatory windup about how quickly they're growing. And the uptake has been notable, mainly because of the growth in high-deductible health plans (HDHPs), which workers must be covered by in order to contribute to an HSA.

But plenty of workers who are eligible to contribute to HSAs don't take full advantage of them. Even though HSAs offer the best tax treatment of any savings vehicle--pretax contributions, tax-free compounding, and tax-free withdrawals for qualified healthcare expenses--only 4% of HSA holders choose to invest their funds, according to research from HelloWallet, a Morningstar company.

Of course, not everyone has the wherewithal to use an HSA as an investing vehicle; most people need to spend the amounts they've accumulated in their HSAs to cover out-of-pocket healthcare costs. But even those where workers who use a 'spend as you go' approach probably aren't saving enough: The HelloWallet study found that the average HSA deferral was $1,600; the median deferral was $700. Families, especially, are apt to blow through that amount in a hurry in a given year.

Also, HSA-eligible investors may be mixed up about the difference between a flexible spending account (FSA) and an HSA; the former is 'use it or lose it,' while HSA balances roll over from one year to the next. That confusion may deter them from putting more into their HSAs.

Other would-be HSA investors are rightfully deterred by the layers of fees and low opacity that mark the HSA landscape. Holders of health-savings accounts can face a number of fees just to go about their regular healthcare business, ranging from debit-card charges to account-maintenance fees. In addition, HSA holders who wish to invest their funds can confront transaction fees to purchase fund or exchange-traded fund shares; they'll also pay mutual fund and ETF expense ratios on an ongoing basis, just as all other investors do. Those expenses can stack up, eroding the tax benefits of HSAs.

If you're considering using your HSA as an investment vehicle, here are three strategies to help get the most mileage out of this valuable account type.

Trick 1: Obtain a payroll deduction while also getting away from a lousy employer-provided HSA.

High-deductible healthcare-plan participants are free to use any HSA custodian they choose, not just the one their employers have chosen. To do so, they would simply steer their contributions into their own HSA, then deduct the contribution on their tax return. (Note that HSA contributions don't fall under the heading of qualified medical expenses, the latter of which can only be deducted to the extent they exceed 10% of adjusted gross income. Rather, HSA contributions are an 'above-the-line' deduction, so they help reduce your adjusted gross income directly, thereby reducing your income to enable Roth contributions and the like.)

But from a practical standpoint, that can be cumbersome and won't likely yield exactly the same tax benefits as having your contribution extracted from your payroll. For one thing, using the payroll deduction enables you to get the tax break right away versus waiting to reap the benefit of the deduction on your tax return. Additionally, HSA dollars extracted via payroll deduction are not subject to Social Security and Medicare taxes, provided the plan is a Section 125 or cafeteria plan.

A workaround is to contribute to your employer's chosen HSA for convenience and tax benefits, then annually roll over or transfer that money to the HSA of your choice. (A rollover, which is allowed once a year, means that you get a check from the first HSA custodian and must get it over to the second HSA custodian within 60 days. A transfer means the two custodians deal with one another on the transaction; you don't receive a check. You can complete multiple transfers per year.) That strategy lets you enjoy the best of both worlds: You get the tax benefit of payroll deductions as well as the long-term benefits of steering your HSA investments to a custodian with better and/or lower-cost options.

A couple of caveats: You can have more than one HSA going at one time, but like IRAs, your combined HSA contribution for a given year cannot exceed the limits--in 2017, that's $3,400 for individuals and $6,750 for families. And if you're employing

the two-part strategy outlined above, it's worth thinking through your investment approach to the employer-provided HSA. Because it's essentially a short-term parking place under the two-part strategy, you'd either want to keep your money liquid while you hold it there or make sure that your hand-chosen HSA includes analogous investment products that you hold in your employer-provided HSA. That way, if one of the investment choices in your employer-provided HSA happens to be in the dumps at the time you plan to transfer your money, you can swap into a similar investment option to maintain like-minded market exposure.

Trick 2: Take a hybrid 'spend/invest' approach.

HSAs offer prodigious tax features--tax-free contributions, tax-free compounding, and tax-free withdrawals for qualified healthcare expenditures. That explains why HSA-eligible investors are often advised to let their HSA assets ride while using non-HSA assets to defray their healthcare costs as they arise. (Doing so has the salutary effect of not triggering point-of-purchase fees that some HSA debit cards carry.)

Yet, even as that makes all the sense in the world by the numbers, from a practical standpoint, paying healthcare expenses with non-HSA assets can be disruptive to a household's budget. For employees who have spent most of their careers covered by traditional healthcare plans like PPOs, it's disconcerting to be suddenly on the hook for hundreds or even thousands of dollars of out-of-pocket healthcare costs.

In that instance, it can be comforting to split the difference: Contribute the maximum to your HSA if you can swing it, park enough in the savings-account option to cover your expected healthcare outlays and pay for them from that account, and invest the rest in long-term investments. If you have had an HDHP for the past few years, your previous out-of-pocket outlays can help you figure out how much to hold in cash.

Trick 3: Use your HSA to cover emergency non-healthcare costs later on.

Despite the very good case to be made for paying healthcare expenses with aftertax assets and letting the assets build inside an HSA, some investors might demur. The HSA is, after all, a single-purpose vehicle--that is, you only enjoy the full range of tax benefits if you earmark your withdrawals for healthcare expenditures.

That's mostly true, but there's actually a workaround in case you need to crack into your HSA for non-healthcare expenses later on. Even if you paid out of pocket (using non-HSA assets) for healthcare expenses in previous years, you can still make a tax-free withdrawal later on for non-healthcare expenses, provided you hung on to receipts for the earlier healthcare costs. An unlimited amount of time can elapse between when you actually incurred the healthcare cost and when you reimburse yourself; the withdrawal will be tax-free as long as you have the proper documentation of the prior expense.

To use a simple example, let's say a person paid $5,000 out of her taxable monies to cover healthcare expenses incurred at the end of 2016. Throughout 2016, she racked up the maximum family contribution of $6,750 in her HSA, letting the money build up rather than spending from it. If she needed a new roof in 2017, she could pull $5,000 from her HSA to steer toward that expense, and that withdrawal would be tax-free provided she could document the 2016 out-of-pocket healthcare costs.

That's not ideal, of course, because she's better off letting the money grow. But a tax-free HSA withdrawal beats other forms of emergency funding, such as credit cards, HELOCs, or 401(k) loans. The key to preserving this escape hatch, as noted above, is to maintain scrupulous documentation of healthcare expenditures. It's also worth noting that the HSA participant must have established the HSA and made the contribution before she incurred the healthcare cost.

This article was contributed by Christine Benz, Morningstar's director of personal finance. This is for informational purposes only and should not be considered tax or financial planning advice. 401(k) plans are long-term retirement savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Please consult with a financial or tax professional for advice specific to your situation. Barring a disaster in the back part of earnings season, the S&P 500 will have likely patched together two successive quarters of earnings growth, with a real possibility of fourth-quarter growth topping 5%. Still, there have been a lot of misses and outlook downgrades. Overall earnings-growth rates are neither breaking out in a big way nor collapsing. Instead, earnings are showing modest upticks despite individual company issues.

Disclosure

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