The Thoughtful Investor™

James W. Olsen, CFP® | Legacy Investment Strategies | Third Quarter 2012

How Is It Possible to Lose $2 billion? Start by Overlooking Risk

In early May, JP Morgan announced that the bank had suffered a trading loss of at least $2 billion on a failed hedging strategy. Since then accusations and investigations have been flying, trying to determine where the fault lies. One would think the SEC and legislators might have taken time over the past years to read the disclosure statements that appear on virtually every investment adviser's marketing materials. All investments carry the risk of loss. $2 billion is a lot of money, but to understand its significance, you have to put it in perspective of the total portfolio. J P Morgan has in excess of $200 billion in assets. The firm had first-quarter 2012 net income of $5.4 billion on revenues of $27.4 billion.

For the trading unit that lost the $2 billion, however, the loss was not only significant but also job ending. All investments carry risk. The higher the potential return, the higher the potential loss if the trade turns against you. Unfortunately, many investors see only the potential return and not the possibility of loss, or how much that loss could be. Based on information that has emerged to date, it looks like JP Morgan's traders chose to overlook the risk of their positions turning against

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Jan. 1, 2013, the Bush tax cuts expire…again

Taxes matter. It's ironic that many investment gurus will spend hours on the importance of buying a mutual fund with low management fees, but ignore the question of taxes. Fees may move performance 1 to 2% in a year. Taxes can cost you up to 35% of your gains. In 2013, it will be even more unless Congress acts and the President signs an extension of the Bush tax cuts or a new tax schedule. Given the federal government's performance to date, planning for higher taxes seems like the more realistic assumption.

The federal income tax is a progressive income tax system which means that the first $33,950 of your income in 2013 may be taxed at 15% and the next $48,300 at 28%. The more you make the less of your additional income you take home. In addition to these taxes, effective 2013, the new health care law increases the Medicare payroll tax on employee wages and salaries from 1.45% to 2.35% on earnings

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Flexibility is Essential in Retirement

How much can you afford to spend each year from your retirement account? The answer is…it depends. It depends very much on how much your account balance is and current market returns.

In declining markets, you typically want to cut back on withdrawals as much as possible. You want as much of your capital intact as possible to gain value when financial markets turn back up. There is also the uncertainty of not knowing how long a downturn might last. If you maintain pre-decline withdrawal levels, your account may not have the ability to recover and last throughout your retirement.

For example, suppose an investor begins withdrawing $10,000 a month from a $1,000,000 portfolio in 1990. By January 2008, the money would be gone. If at the end of 2000, the investor faced facts and reduced withdrawals to $5,000 the portfolio would still have approximately $210,000 in early 2012. Better yet would be an initial $7,000 monthly withdrawal rate reduced to $6,000 in 2001. In this situation, the investor would still have approximately $960,000 in early 2012, despite two bear markets.

This is a hypothetical example only. The S&P 500 is an index and one cannot invest directly in the index. Past performance is not indicative of future returns. There can be no guarantee that an actual account will mirror the performance shown here, or that comparable withdrawal rates will have similar results in the future.

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Taxable Income	2012 Tax Rate	Potential 2013 Tax Rate
0 to $8,350	10%	15%
$8,350 to $33,950	15%	15%
$33,950 to $82,250	25%	28%
$82,250 to $117,550	28%	31%
$117,550 to $372,950	33%	36%
More than $372,950	35%	39.6%
Long term capital gains	0% (income under $33,950) or 15%	10% (income under $33,950) or 20% (8%/18% on gains from assets acquired after Dec. 31, 2000 and held over 5 years)
Dividends	0 (income under $33,950) or 15%	15% -39.6% depending upon top income bracket

above $200,000 for individuals and $250,000 for couples who file jointly. The bill would also apply Medicare taxes of 3.8% to several forms of "unearned income" — capital gains, dividends, interest, royalties and other sources besides wages and salaries — above the $200,000 and $250,000 thresholds.

Higher tax rates lower taxable income

What is particularly interesting about the prospect of increasing taxes is that there seems to be a level at which people feel taxes are fair and they are willing to pay them and there is a point at which income diminishes in response to higher tax rates.

While a number of studies have indicated that higher tax rates produce lower taxable income, Emmanuel Saez, Joel Slemrod, and Seth H. Giertz attempted to quantify the relationship in the March 2012 issue of the *Journal of Economic Literature* in "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review." The short answer to their research is .25: a 10% rise in marginal tax rates will tend to reduce taxable income by 2.5%. If the Bush tax cuts expire, it will be interesting to see if 2013 tax revenues decline as their study indicates.

Why is this important now? Because you may want to take steps to recognize income in 2012 and to push deductions into 2013 where they may do you more good.

Going forward your goal is to keep your take-home income as high as possible by reducing the impact of taxes. This doesn't necessarily mean reducing your overall income, although that will work as well, but reducing your *taxable* income.

How can you personally reduce your taxable income and thus cut the tax bite? There are three primary tactics:

- Reduce your income,
- Increase your deductions, and
- Take advantage of tax credits.

Contribute to retirement accounts

The most direct way to reduce your income is to contribute money to an IRA, 401(k) or similar retirement plan at work. Your contribution reduces your wages and lowers your tax bill. How your assets are invested can also impact when you recognize gains. Deferring compensation at work could allow you to schedule receiving that income at a period when you know you will have higher deductions, or lower overall family income.

Take advantage of adjustments

You can also reduce your Adjusted Gross Income through various adjustments to income found on the front pages of the forms 1040 and 1040A. These adjustments include:

- Classroom expenses for teachers and educators
- Qualified performing artists and other professions
- Student loan interest deduction
- Tuition and fees deduction
- Health savings account deduction
- Moving expenses
- Self-employment tax deduction
- Self-employment health insurance
- SEP-IRA, SIMPLE IRA and 401(k) deductions for the self-employed
- Early withdrawal penalties
- Alimony paid
- Domestic Production Activities deduction for certain types of businesses.

Track itemized deductions

Itemized deductions include expenses for health care, state and local taxes, personal property taxes (such as car registration fees), mortgage interest, gifts to charity, job-related expenses, tax preparation fees, and investment-related expenses. By keeping track of your itemized expenses throughout the year you can compare itemized expenses with your standard deduction and take the higher of the two.

Many investors overlook their ability to reduce income from the sale of assets by failing to track capital and short term gains on taxable mutual fund investments. These gains are reported and taxed each year. If they are also reinvested in the mutual fund, they can reduce profits (or show a greater loss) when the funds are sold.

There are tax credits for college expenses, for saving for retirement, and for adopting children. The Hope Credit is for students in their first two years of college. The Lifetime Learning Credit is for anyone taking college classes.

Taxes matter. And while they may be inevitable, there are steps you can take to influence how much you pay. The time to start looking at those options is sooner rather than later.

Not Talking to Your Spouse Can Cost You

You and your spouse have saved diligently. You think you are positioned to enjoy retirement without financial issues and you are looking forward to that first day of pursuing your dreams rather than the company's goals. But before you walk out the door, make certain your retirement plans mesh with those of your spouse.

Often retirement is the first time couples have spent a prolonged period together. If their views differ on how to spend retirement and there's no compromising, the result can be messy. A retirement fund built for two typically doesn't work as well split in half.

Over 50 couples are divorcing at twice the rate they did 20 years ago. They accounted for 9.7% of all divorces in 2009 compared to 4.7% of divorces in 1990, according to census data. In addition to the emotional turmoil of divorce, there's a considerable financial impact, including legal fees if the divorce becomes hostile. Divorce can also eliminate survivor benefits for retirement plans and insurance products.

Planning for retirement needs to start with a sound financial understanding involving both spouses. That's why we advocate that both members of a couple attend investment review sessions and understand what their investments are and how much they can reasonably assume those assets will return under current market conditions. Next, the couple needs to discuss what they want from retirement. Assuming your spouse's goals are the same as yours can be dangerous. Conflicting goals need to come out into the open. And then there's the question of whether or not your goals feasible in light of what you have saved for retirement.

Sharing goals and talking about finances is important throughout a relationship, but when retirement is approaching, it is even more important. In fact one of major stresses of retirement can be watching your savings diminish. While this is a natural part of retirement – you saved the money in order to be able to spend it – having less money can be a source

of considerable insecurity. Will you have enough? Can you afford that trip? Should you sell the house and move into somewhere less expensive?

Putting your decisions in perspective is often easier with the help of your financial adviser. Not only does that introduce a neutral third party to the discussion, but your adviser can bring considerable experience to the discussion including expected returns, withdrawal rates, and alternative sources of income. Retirement planning works best when both members of a couple are involved and you have the right financial advice.

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them. Under estimating the risk of an investment is one of the greatest weaknesses of investors. It is followed by failing to prepare for the unexpected.

What is risk? Put simply, it is the chance that you will lose money. How much money depends upon the investment and your time frame. There is a tendency within the financial industry to try to quantify risk by standard deviation, beta or volatility. Where these measures fail is their inability to distinguish good risk from bad. A stock that increases 15% in a year will almost inevitably have a higher standard deviation, beta or volatility than one that increases 5%, but no investor is going to object to that volatility.

Risk measures are also backward looking. They are based on what has happened over a specified time period. The future is unknown territory. To be successful, investors need to be prepared or at least have a response plan for the unexpected. At its most basic this is nothing more than a stop loss which says "I will tolerate up to this amount of loss and then I am out of the position."

The core of active management is the belief that while history doesn't repeat, it does rhyme. There are patterns of human behavior that occur time after time. If you banish from your investing approach the idea that "this time it is different," then you begin to put in place tools to control your risk.

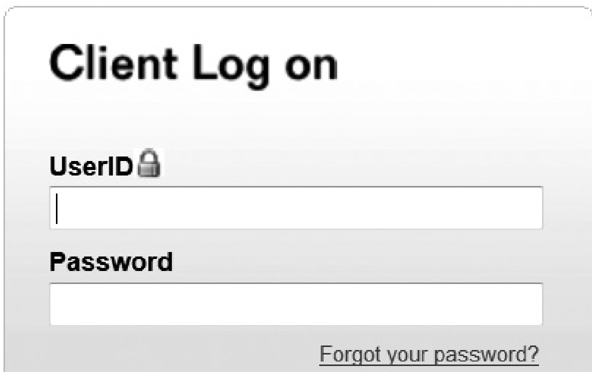
When we talk about investment risk, it's not the 1% loss that comes to mind, but the big losses. The bursting of investment bubbles. Black swans are the unpredictable events that carry a massive impact on market valuations. More commonly bubbles burst from predictable surprises, surprises that are often anticipated, gradually worsening and explode into crisis. Analyst and legendary investor James Montier of GMO identifies five obstacles to recognizing predictable surprises:

- Over optimism
- The illusion of control
- Self-serving bias
- Myopia
- Inattentional blindness

If we accept that these factors can come into play, then we built systems to prevent them from destroying portfolios. The risk is always going to be there. There is no flawless investment approach. But there are also tools that can be used to assess the level of risk in the market and determine when it is higher than our comfort zone.

Those Pesky Online Passwords

Today, much of our life is conducted online. And that means login IDs and passwords to innumerable sites. The catch is whether or not that information will be accessible to others in the event of the user's death or incapacitation. If you haven't already, we would encourage you to establish a secure record of online accounts, login names and passwords and let someone know where that information can be found in the event of a problem.



This is particularly urgent in the case of a business where partners or employees would need access to password protected email accounts, online payroll, automatic bill payments and online order fulfillment systems, etc. if a managing partner becomes ill or dies. Without passwords to domain registrations, web hosting access, Facebook accounts, and more, continuing a business can become an obstacle course.

With many bank and credit card accounts going paperless, it's possible your successors may never know an account exists much less how to access it to shut off automated functions. If you have an Amazon account with a stored credit card information for purchases, it could remain active long after your death along with the possibility of the account security being breached and your card used for purchases. Then there's the Facebook account that remains ghostlike with new postings and tags. Or subscriptions that automatically renew.

One recommendation for good account security is to change your passwords on a regular basis and avoid linking passwords to any information that might make them easier to crack, such as an address or birth date. Which means you need to have a system in place to keep continually changing passwords available.

With that thought, make a list of critical web sites that you access through a login ID and password, and then where passwords can be found. This would include:

- Bank accounts
- Investment accounts
- Credit card accounts
- Tax related accounts such as a payroll tax function, or electronic filing info
- Utilities – phone, electric
- Social media sites
- Membership accounts
- Email accounts
- Subscription accounts that renew automatically
- On line shopping sites that hold your credit card information
- Travel sites that hold personal information for booking convenience

If you are in the position of closing an account after someone's death, be aware that unless you are the executor or on the account name, your use of the login and password could be illegal. In particular, it is illegal to move funds that are now part of an estate, change ownership of an account without legal authority, or even post information. If there are accounts where you want others to have access after your death, you need to look at how those accounts are titled and if necessary, add that individual or business name to the account.

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