INVESTMENT STRATEGIES

Investment Basics: What You Should Know

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The world of investing can seem mind-boggling for a beginning investor. How do you decide what type of security to invest in? Should you choose stocks, bonds or a combination of investments? What about mutual funds? How do you choose a particular fund, stock or bond? How do you assess the risk to your money?

This Financial Guide provides a starting point for inexperienced investors. It describes how securities markets work, what protections are afforded, the general types of securities available, the interaction of risk and reward and how to select the investments appropriate for your risk tolerance.

How Securities Are Bought and Sold

The term "securities" encompasses a broad range of investments, including stocks, corporate bonds, government bonds, mutual funds, options, and municipal bonds. Investment contracts, through which investors pool money into a common enterprise managed for profit by a third party, are also securities. Securities may be traded on an organized exchange or traded "over the counter" between investors.

Exchanges

Securities are bought and sold in a number of different markets. The best known are the New York Stock Exchange and the American Stock Exchange, both located in New York City. In addition, six regional exchanges are located in cities throughout the country.

A corporation's securities may be traded on an exchange only after the issuing company has applied to the exchange and met any listing standards relating, for example, to the company's assets, number of shares publicly held, and number of stockholders. Organized markets for other instruments, including standardized options, impose similar restrictions. The exchanges facilitate a liquid market for securities where buyers and sellers are brought together. Listing on an exchange, however, does not constitute approval of the securities or provide any assurance as to risk and return.

Over-The-Counter

Many securities are not traded on an exchange but are traded over the counter (OTC) through a large network of securities brokers and dealers. In the National Association of Securities Dealers' Automated Quotation System (NASDAQ), which is run by the Financial Industry Regulatory Authority (FINRA), trading in OTC stocks is done via on-line computer listings of bid, which asks prices and completes transactions.

Like the exchanges, NASDAQ has listing standards that must be met for securities to be traded in that market. Similar to an exchange it provides a "meeting place" for buyers and sellers. The typical investor generally will not know whether their security is bought or sold through an exchange or over the counter. The investor engages a broker who arranges the transaction in the appropriate market at the desired price.

Brokers

If you buy or sell securities on an exchange or over the counter, you will probably use a broker, and your direct contact will be with a registered representative. The registered representative often called an account executive or financial consultant, must be registered with FINRA, a self-regulatory organization whose operations are overseen by the Securities and Exchange Commission (SEC), and with the states in which the broker is conducting business. The registered representative is the link between the investor and the traders and dealers who actually buy and sell securities on the floor of the exchange or elsewhere.

How Prices are Established

How are the stock prices that appear in the financial section of the newspaper arrived at? Market prices for stocks traded over the counter and for those traded on exchanges are established in somewhat different ways.

Exchange Prices

The exchanges centralize trading in each security at one location, on the floor of the exchange. There, auction principles of trading set the market price of a security according to current buying and selling interests. If such interests do not balance, designated floor members known as specialists are expected to step in to buy or sell for their own account, to a reasonable degree, as necessary to maintain an orderly market.

Over the Counter (OTC)

In the OTC market, brokers acting on behalf of their customers (the investors) contact a brokerage firm which holds itself out as a market-maker in the specific security, and negotiates the most favorable purchase or sale price. Commissions received by brokers are then added to the purchase price or deducted from the sale price to arrive at the net price to the customer.

In some cases, a customer's brokerage firm may itself act as a dealer, either selling a security to a customer from its own inventory or buying it from the customer. In such cases, the broker hopes to make a profit on the purchase and sale of the security, but no commission is charged. Instead, a retail "mark-up" is added to the price charged by the firm when a customer buys securities and a "mark down" is deducted from the price paid by the firm when a customer sells securities.

Bid and Ask Prices

In both cases, a stock is quoted in terms of bid and ask. The bid is the price at which the market or market maker is willing to buy the security from you. Similarly, the ask is the price at which the market or market maker is willing to sell the security to you. Not surprising, the ask price is higher than the bid price. The difference between the two is called the spread. For example, if a stock is quoted 18-18 ¼, this means that the investor could sell the stock for $18 a share or purchase the stock for $18.25. The higher the spread the more the market maker profits and the higher the cost is to investors. Heavily traded securities typically have narrow spreads while infrequently traded securities can have wide spreads.

How Your Investments are Protected

Investors' money is protected in three ways: by federal laws and regulations that are enforced by the SEC (Securities and Exchange Commission); by self-policing in the industry; and by state law.

Under federal securities laws, those engaged in the business of buying and selling securities have a great deal of responsibility for regulating their own behavior through SROs (self-regulatory organizations) operating under the oversight of the SEC. These SROs include all of the exchanges; the FINRA; the Municipal Securities Rulemaking Board (MSRB), which establishes rules that govern the buying and selling of securities offered by state and local governments; and other organizations concerned with somewhat less visible activities such as the processing of transactions.

The SROs are responsible for establishing rules governing trading and other activities, setting qualifications for securities industry professionals, regulating the conduct of their members, and disciplining those who fail to abide by their rules.

In addition, the federal securities laws provide investors with certain protections, including the ability to sue if they have been harmed as a result of certain violations of those laws.

Many brokerage firms require that their customers sign an agreement containing an arbitration clause when they open a brokerage account. If you sign an agreement with an arbitration clause, you are agreeing to settle any future disputes with the broker through binding arbitration, instead of through the courts.

Arbitration proceedings are administered by the SROs, and the rules that apply in arbitration proceedings are specified by each SRO. Although the SEC oversees the arbitration process, it cannot intervene on behalf of, or directly represent individual investors. Nor can the SEC modify or vacate an arbitration decision. The grounds for judicial review are very limited.

Further protection for investors is provided by state laws designed to regulate the sale of securities within state boundaries.

The Function of the SEC

The SEC, an independent agency of the U.S. Government, was established by Congress in 1934 to administer the federal securities laws. It is headed by five Commissioners, appointed by the President, who direct a staff of lawyers, accountants, financial analysts, and other professionals. The staff operates from its headquarters in Washington, D.C. and from five regional offices and six district offices in major financial centers throughout the country.

The SEC's principal objectives are to ensure that the securities markets operate in a fair and orderly manner, that securities industry professionals deal fairly with their customers, and that corporations make public all material information about themselves so that investors can make informed investment decisions. The SEC accomplishes these goals by:

- Mandating that companies disclose material business and financial information;
- Overseeing the operations of the SROs;
- Adopting rules with which those involved in the purchase and sale of securities must comply; and
- Filing lawsuits or taking other enforcement action in cases where the law has been violated.

Despite the many protections provided by federal and state securities laws and SRO rules, it is important for investors to remember that they have the ultimate responsibility for their own protection. In particular, the SEC cannot guarantee the worth of any security. Investors must make their own judgments about the merits of an investment.

What Companies Must Disclose

Before any company offers its securities for sale to the general public (with certain exceptions), it must file with the SEC a registration statement and provide a "prospectus" to investors. In its registration statement, the company must provide all material information on the nature of its business, the company's management, the type of security being offered and its relation to other securities the company may have on the market, and the company's financial statements as audited by independent public accountants. A copy of a prospectus containing information about the company and the securities offered must be provided to investors upon or before their purchase. In addition, most companies must continue to update (quarterly and annually), in filings made with the SEC, this disclosure information to ensure an informed trading market.

The SEC reviews registration statements and periodic reports for completeness, but the SEC does not review every detail and verification of each statement of fact would be impossible. However, the securities laws do authorize the SEC to seek injunctives and other relief for registration statements containing materially false and misleading statements.

Persons who willfully violate the securities laws may also be subject to criminal action brought by the Department of Justice leading to imprisonment or criminal fines. The laws also provide that investors may be able to sue to recover losses in the purchase of a registered security if materially false or misleading statements were made in the prospectus or through oral solicitation. Investors must seek such recovery through the appropriate courts since the SEC has no power to collect or award damages or to represent individuals.

How the SEC Supervises Industry Professionals

Another important part of the SEC's role is supervision of the securities markets and the conduct of securities professionals. The SEC serves as a watchdog to protect against fraud in the sale of securities, illegal sale practices, market manipulation, and other violations of investors' trust by broker-dealers, investment advisers, and other securities professionals.

In general, individuals who buy and sell securities professionally must register with the appropriate SRO, meet certain qualification requirements, and comply with rules of conduct adopted by that SRO. The broker-dealer firms for which they work must, in turn, register with the SEC and comply with the agency's rules relating to such matters as financial condition and supervision of individual account executives. In addition, broker-dealer firms must also comply with the rules of any exchange of which they are a member and, usually, with the rules of the FINRA.

The SEC can deny registration to securities firms and, in some cases, may impose sanctions against a firm and/or individuals in a firm for violation of federal securities laws (such as, manipulation of the market price of a stock, misappropriation of customer funds or securities, or other violations). The SEC polices the securities industry by conducting inspections and working in conjunction with the securities exchanges, the FINRA, and state securities commissions.

Protecting Yourself

You should be as careful about buying securities as you would be about any other costly purchase. The vast majority of securities professionals are honest, but misrepresentation and fraud do take place. Observe the following basic safeguards when "shopping" for investments:

- *Never* buy securities offered in unsolicited telephone calls or through "cold calls." Ask for information in writing before you decide. Check on the credentials of anyone who tries to sell you securities.

Tip: Beware of salespeople who try to pressure you into acting immediately.

- Don't buy on tips or rumors. Not only is it safer to get the facts first, but also it is illegal to buy or sell securities based on "inside information" which is not generally available to other investors.
- Get advice if you don't understand something in a prospectus or a piece of sales literature.

Tip: Be sure you understand the risks involved in trading securities, especially options and those purchased on margin. Be skeptical of guarantees or promises of quick profits. There is no such thing, at least not without an accompanying increase in risk.

- Remember that prior success is no guarantee of future success in an investment arrangement.
- With tax-sheltered investments, partnerships, and other "liquid" investments be sure to ask about the liquidity and understand that there may not be a ready market when you want to sell.
- Don't speculate. Speculation can be a useful investment tool for those who can understand and manage the risks involved and those who can afford to lose money, but it is dangerous for most people.

Tip: For the average investor, more conservative investment strategies are generally appropriate.

Professional guidance can be very helpful in developing a sound investment program.

Types of Investments

Two broad categories of securities are available to investors: equity securities, which represent ownership of a part of a company and debt securities, which represent a loan from the investor to a company or government entity. Within each of these types, there are a wide variety of specific investments. In addition, different types can be combined (e.g., through mutual funds) or even split apart to form derivative securities.

Each type has distinct characteristics plus advantages and disadvantages, depending on an investor's needs and investment objectives. In this section, we provide an overview of the most common classes of investment securities.

Stocks

The type of equity securities with which most people are familiar is stock. When investors buy stock, they become owners of a "share" of a company's assets. If a company is successful, the price that investors are willing to pay for its stock will often go up and shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. The rise in the price of a stock is termed appreciation or "capital gain." The stockholder is also entitled to dividends, which may be paid out from the company. Investors, therefore, have two sources of profit from stock investments, dividends, and appreciation. Some stocks pay out most of their earnings as dividends and may have little appreciation. These stocks are sometimes referred to as income stocks. Other stocks may pay out little or no dividend, preferring to reinvest earnings within the company. Since all of an investor's potential earnings comes from appreciation these stocks are sometimes referred to as growth stocks. Stock prices are also subject to both general economic and industry-specific market factors. There is no guarantee of a return from investing in stocks and hence there is risk incurred in investing in this type of security.

As owners, shareholders generally have the right to vote on electing the board of directors and on certain other matters of particular significance to the company. Under the federal securities laws, most companies must send to shareholders a proxy statement providing information on the business experience and compensation of nominees to the board of directors and on any other matter submitted for shareholder vote. This information is required so that stockholders can make an informed decision on whether to elect the nominees or on how to vote on matters submitted for their consideration.

Stock investments are typically common stock, which is the basic ownership share of a company. Some companies also offer preferred stock, which is another class of stock. Preferred stock typically offers some set rate of return (although it is still not guaranteed), and pays dividends before dividends are paid for common stock. Preferred stock may not, however, participate in as much upside as common stock. If a company does really well, preferred stockholders may receive the same dividend as any other year while common stockholders reap the rewards of a great year.

Corporate Bonds

The most common form of corporate debt security is the bond. A bond is a certificate promising to repay, no later than a specified date, a sum of money which the investor or bondholder has loaned to the company. In return for the use of the money, the company also agrees to pay bondholders a certain amount of "interest" each year, which is usually a percentage of the amount loaned.

Since bondholders are not owners of the company, they do not share in dividend payments or vote on company matters. The return on their investment is not usually dependent upon how successful the company is. Bondholders are entitled to receive the amount of interest originally agreed upon, as well as a return of the principal amount of the bond if they hold the bond for the time period specified.

Companies offering bonds to the public must file with the SEC a registration statement, including a prospectus containing information about the company and the security.

Government Bonds

The U.S. Government also issues a variety of debt securities, including Treasury bills (commonly called T-bills), Treasury notes, and U.S. Government agency bonds. T-bills are sold to selected securities dealers by the Treasury at auctions.

Government securities can also be purchased from banks, government securities dealers, and other broker-dealers.

Similar to corporate bonds, these bonds pay interest and the amount of principal at maturity. Some bonds, such as Treasury Bills, may not pay cash interest. Instead, the bond is purchased at a discount and the interest is built into the amount the investor receives at maturity. Contrary to popular belief investors must pay income tax on U.S. government bond interest.

Municipal Bonds

Bonds issued by states, cities, or certain agencies of local governments such as school districts are called municipal bonds. An important feature of these bonds is that the interest a bondholder receives is not subject to federal income tax. In addition, the interest is also exempt from state and local tax if the bondholder lives in the jurisdiction of the issuing authority. Because of the tax advantages, however, the interest rate paid on municipal bonds is generally lower than that paid on corporate bonds.

Municipal bonds are exempt from registration with the SEC; however, the MSRB establishes rules that govern the buying and selling of these securities.

Stock Options

A stock option is a type of derivative security and refers to the right to buy or sell something at some point in the future. There are a wide variety of these specialized instruments such as futures, options, and swaps. Most are not appropriate for the average investors. The type of options with which we are concerned here are standardized, exchange-traded options to buy or sell corporate stock.

These options fall into two categories:

- "Calls," which give the investor the right to buy 100 shares of a specified stock at a fixed price within a specified time period, and
- "Puts," which give the investor the right to sell 100 shares of a specified stock at a fixed price within a specified time period.

While options are considered by many to be very risky securities, if used properly they can actually reduce the risk of a portfolio. Generally, if you are bullish on a stock (i.e. you expect the price to go up), you buy a call option. The price you pay is called the premium. You would purchase a put option if you are bearish on a stock (i.e. you expect the price to go down). If the stock moves in the right direction you can profit handsomely. If it doesn't you lose the premium that you paid. Buying puts and calls is not a risky strategy, but selling puts and calls is. One exception is selling a call option on a stock you already own. This is known as a "covered call." This actually reduces the overall risk of your portfolio in exchange for you giving up some of your upside.

Mutual Funds

Companies or trusts that principally invest their capital in securities are known as investment companies or mutual funds. Investment companies often diversify their investments in different types of equity and debt securities in the hope of obtaining specific investment goals. When you invest in a mutual fund, the fund invests in individual equity and debt securities. There's no need to make individual purchase and sale decisions. Mutual funds also provide an easy way to diversify a portfolio. Rather than purchasing 50 stocks yourself, you can purchase a single mutual fund.

Investment Contracts and Limited Partnerships

Investors sometimes pool money into a common enterprise managed for profit by a third party. This is called an investment contract. Such enterprises may involve anything from cattle breeding programs to movie productions. This is often done through the establishment of a limited partnership in which investors, as limited partners, own an interest in a venture but do not take an active management role. Some of these securities have been issued in the past primarily for purposes of reducing income tax liability. Such opportunities are limited today. Care should be taken in investing in these securities since they can be illiquid and require a great deal of expertise. Consult with your financial advisor before investing in these types of investments.

Real Estate Investment Trust (REIT)

Real estate investment trusts are set up in a fashion similar to mutual funds. Instead of investing in stocks or bonds, however, REIT investors pool their funds to buy and manage real estate or to finance real estate construction or purchases. Real estate limited partnerships are also common. This is a way to get diversification from real estate investment without the headaches of property ownership and management.

Asset Allocation

Asset allocation is the process of allocating your investments among several broad categories, including stocks, corporate bonds, and government bonds and is **extremely**important in investment success. In fact, portfolio selection should generally be based on asset allocation, whether formal or informal. This process can be complicated, but computer programs are available to assist in performing the allocation.

Risk vs. Return

One of the most basic relationships in investing is that between risk and reward. Investments that offer potentially high returns are accompanied by higher risk factors. It is up to you to decide how much risk you can assume. Always keep in mind your current and future needs.

Risk

There are many types of risk. The one most people think of is **market risk**, which is the risk that market prices can fluctuate. If you have a short investment horizon, generally something less than five years, this risk is important since the market could be down at the time you most need the money. On the other hand, if you have a long time horizon, for example when saving for retirement, you may be unconcerned with market risk. The investment has the opportunity to come back prior to the time you need the funds.

Another risk, which many people don't think about, is **purchasing power risk**. This is the risk that your investment will not keep up with inflation and you will not be able to maintain your desired standard of living. A bank CD, for example, might pay interest of 3 percent and have no market risk. Your principal does not fluctuate in value and you are insured against loss. However, if inflation exceeds 3 percent you will lose purchasing power.

> **Tip:** In general, prospective investors should avoid "risky" investments unless they have a steady income, adequate insurance, and an emergency fund of readily accessible cash.
>
> **Tip:** U.S. Treasury bills, notes, and bonds are the safest possible investments.

You need to assess how much risk you can tolerate. In general the longer your investment horizon the greater the amount of risk you can afford to take. Your financial advisor can assist you in measuring your risk tolerance.

Risk can also be reduced through diversification. Rather than buying one stock, buy a basket of 20 to 30 stocks. This reduces your overall risk. You can also reduce risk by combining different investment types such as stocks, corporate bonds, and government bonds. These securities are not highly correlated, in other words, they tend not to go up or down at the same time.

Return

Why would one want to take on more risk? Because it generally comes with a higher expected return. While stocks may have the greatest market risk, they have also had the highest market return over the long haul. Stock returns have averaged between 10 and 11 percent since the early part of this century. Corporate bonds, on the other hand, have averaged between 6 and 7 percent, and government bonds closer to 5 percent. As you can see the lower the risk the lower the expected return. You must balance the amount of risk you are willing to tolerate with the amount of return you expect to achieve. There is no such thing as a high return/low-risk investment.

Planning Techniques

You should first assess your current resources and future goals because this will assist you and your advisors in determining what rate of return is necessary to achieve your goals, and how much risk you can tolerate. Here is a suggested checklist:

- Assess your current financial resources. How much do you have to invest?
- Assess your future financial resources. Do you have an excess of income over expenses that can be invested?
- Determine your financial goals. How much money do you need and when do you need it?
- Determine the rate of return you need to achieve your goals.
- Determine how much risk you can tolerate based upon your time horizon and personal preferences.
- Choose an appropriate asset allocation to achieve the desired risk/return relationship. How should you allocate your investment among the various classes of investments?
- Choose the individual securities within each asset class. Which securities should you buy?

Security Selection

Once you have decided what percentage of your assets should go in each asset class, you need to select the appropriate individual securities. For each security, you must evaluate its unique risk and its expected return. There are a number of sources of information about specific securities that you can explore, but generally, the most important of these for mutual funds and new stock issues is the prospectus. The prospectus is the security's selling document, containing information about costs, risks, past performance (if any) and the investment goals. The prospectus is obtained from the company or mutual fund or from your financial advisor. Read it and exercise your judgment carefully, before you invest.

In the case of a mutual fund, there is also a Statement of Additional Information (SAI). A SAI is sometimes referred to as Part B of the prospectus and explains a fund's operations in greater detail than the prospectus. It's also possible to get a clearer picture of a fund's investment goals and policies by reading its annual and semi-annual reports to shareholders. If you ask, the fund must send you a SAI and/or its periodic reports; however, this process is time-consuming and requires a great deal of time and expertise.

Six Investing Pitfalls to Avoid

Here are the top mistakes that cause investors to lose money unnecessarily.

1. Using a Cookie-Cutter Approach

Most investors, along with many of the people who advise the, are satisfied with a one-size-fits-all investment plan. The "model portfolio" is useless to most investors. Your individual needs as an investor must govern any plans you make for investment. For instance, how much of your investment can you risk losing? What is your investment timetable...are you retired, a young professional, or middle-aged? The allocation of your portfolio's assets among various types of investments, including Treasuries, blue-chip stocks, equity mutual funds, and other, should match your needs perfectly.

2. Taking Unnecessary Risks

You do not have to risk your capital to make a decent return on your money. There are many investments that offer a return that beats inflation and more-without unduly jeopardizing your hard-earned money. For instance, Treasuries, the safest possible investment, offer a decent return with virtually no risk. Blue-chip preferred stocks, common stocks, and mutual funds offer high returns with a fairly low level of risk.

3. Allowing Fees and Commissions to Eat Up Profits

Many investors allow brokers' commissions and other return-eating costs to cut into their returns. Professionals need to be compensated for their time; however, you should make certain that the fees you are paying are appropriate for the services performed.

4. Not Starting Early Enough

Many investors are not cognizant of the power of interest compounding. By starting out early enough with your investment plan, you can invest less, and still, come out with double or even quadruple the amount you would have had if you started later. Another way to look at it is that by investing as much as possible earlier on, you'll be able to meet your goals and have more current cash on hand to spend.

5. Ignoring the Cost of Taxes

Every time you or your mutual fund sells stocks, there is a capital gains tax to pay. Unless you are in a tax-deferred retirement account, taxes will eat into your profits, therefore, you should invest in funds that have low turnover (i.e., funds in which shares are bought and sold less frequently). Your portfolio, overall, should have a turnover of 10 percent or less per year.

6. Letting Emotion Govern Your Investing

Never give in to pressure from a broker to invest in a "hot" security or to sell a fund and get into another one. The key to a successful portfolio lies in planning, discipline, and reason. Emotion and impulse have no role to play in investing. Similarly, do not be too quick to unload a stock or fund just because it slips a few points. Try to stay in a security or fund for the long haul. On the other hand, when it's time to unload a loser, then let go of it.

Finally, do not fall prey to the myth of "market timing." This is the belief that by getting into or out of a security at exactly the right moment, we can retire rich. Market timing does not work. Instead, use the investment strategies that do work: a balanced allocation of your portfolio's assets among securities that suit your individual needs, the use of dividend reinvestment programs and other cost-saving strategies, and a well-disciplined, long-haul approach to saving and investment.

Government and Non-Profit Agencies

- The SEC

Most companies whose stock is traded over the counter or on a stock exchange must file "full disclosure" reports on a regular basis with the SEC. The annual report (Form 10-K) is the most comprehensive of these. It contains a narrative description and statistical information on the company's business, operations, properties, parents, and subsidiaries; its management, including their compensation and ownership of company securities: and significant legal proceedings which involve the company. Form 10-K also contains the audited financial statements of the company (including a balance sheet, an income statement, and a statement of cash flow) and provides management's discussion of business operations and prospects for the future.

Companies file regular reports with the SEC in a computer database known as EDGAR. For example, a company declaring bankruptcy will file a form 8-K that tells where the case is pending and which chapter of bankruptcy was filed. You can access EDGAR through your computer at: www.sec.gov. If you don't have access to a computer, your public library may have a computer you can use. You can also request a copy of Form 8-K or any other reports that the company files with the SEC, see "How to Request Public Documents." Or, you can visit the SEC's Public Reference Room, 100 F Street NE, Washington, DC 20549. You might also be able to get copies of SEC filings from your full-service stockbroker, or the company itself.

Other sources of information filed with the SEC include public or law libraries, securities firms, financial service bureaus, computerized on-line services, and the companies themselves.

American Association of Individual Investors Offers a collection of Investor Guides provides you with a continuing stream of "how-to" investment knowledge and guidance.

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Mutual Fund Education Alliance (pricing and performance information on thousands of mutual funds plus news and educational information about fund investing.

Glossary

Ask
The lowest price a broker asks customers to pay for a security.

Beneficial Owner
The true owner of a security which may, for convenience, be recorded under the name of a nominee.

Bid
The highest price a broker is willing to pay for a security.

Bond
A certificate that is evidence of a debt in which the issuer promises to repay a specific amount of money to the bondholder, plus a certain amount of interest, within a fixed period of time.

Broker-Dealer
An entity engaged in the business of buying and selling securities.

Call
The right in options contracts to buy underlying securities at a specified price at a specified time. It also refers to provisions in bond contracts that allow issuers to buy back bonds prior to their stated maturity.

Cash Account
A type of account with a broker-dealer in which the customer agrees to pay the full amount due for the purchase of securities within a short period of time, usually five business days.

Closed-end Fund

A type of investment company whose securities are traded on the open market rather than being redeemed by the issuing company.

Commission
The fee charged by a broker-dealer for services performed in buying or selling securities on behalf of a customer.

Discretionary Account
A type of account with a broker-dealer in which the investor authorizes the broker to buy and sell securities, selected by the broker, at a price, amount, and time the broker believes to be best.

Dividend
A payment by a corporation to its stockholders, usually representing a share in the company's earnings.

Equity Security
An ownership interest in a company, most often taking the form of corporate stock.

Face Value
The amount of money that the issuer of a bond promises to repay to the bondholder on or before the maturity date.

Form 8-K
A current report required to be filed with the SEC if a certain specified event occurs, such as a change in control of the registrant, acquisition or disposition of assets, bankruptcy or receivership, or another material event. Form 8-K is required to be filed within 15 days of the event.

Form 10-K
The designation of the official audited financial report and narrative which publicly owned companies must file with the SEC. It shows assets, liabilities, equity revenues, expenses, and so forth. It is a reflection of the corporation's condition at the close of the business year, and the results of operations for that year.

Form 10-Q
Quarterly reports containing interim information, which is "material" and important for investors to know. These must be filed with the SEC.

Interest

The payment a corporate or governmental issuer makes to bondholders in return for the loan of money.

Investment Company
A company engaged primarily in the business of investing in securities.

Margin Account
A type of account with a broker-dealer, in which the broker agrees to lend the customer part of the amount due for the purchase of securities.

Money Market Account
Generally, a mutual fund which typically invests in short-term debt instruments such as government securities, commercial paper, and large denomination certificates of deposit of banks.

Mutual Fund
A pool of stocks, bonds, or other securities purchased by a group of investors and managed by a professional/registered investment company. The investment company itself is also commonly referred to as a mutual fund.

NASDAQ
National Association of Securities Dealers Automated Quotation System (NASDAQ) is a system that provides broker-dealers with bid and ask prices for some securities traded over the counter.

Net Asset Value
The dollar value of one share of a mutual fund at a given point in time, which is calculated by adding up the value of all of the fund's holdings and dividing by the number of outstanding shares.

No-load Fund
A type of mutual fund that offers its shares directly to the public at their net asset value with no accompanying sales charge.

Odd Lot
Fewer than 100 shares of stock.

Open-end Fund
A type of investment company that continuously offers shares to the public and stands ready to buy back such shares whenever an investor wishes to sell.

Option

A contract providing the right to buy or sell something often 100 shares of corporate stock at a fixed price, within a specified period of time.

Over the Counter (OTC)

A market for buying and selling stock between broker-dealers over the telephone rather than by going through a stock exchange.

Prospectus

The document required to be furnished to purchasers of newly registered securities, which provides detailed information about the company issuing the securities and about that particular offering.

Proxy

A written authorization given by shareholders for someone else to cast their votes on such corporate issues as election of directors.

Proxy Statement

A document which the SEC requires a company to send to its shareholders (owners of record) that provides material facts concerning matters on which the shareholders will vote.

Put

The right, in an options contract, to sell underlying securities at a specified price at a specified time.

Quotation (or Quote)

The price at which a security may be bought or sold at any given time.

Registered Securities

Stocks or bonds or other securities for which a registration statement has been filed with the SEC.

REIT

Real Estate Investment Trust, a type of company in which investors pool their funds to buy and manage real estate or to finance construction or purchases.

Restricted Securities

Stocks or bonds which were issued in a private sale or other transaction riot registered with the SEC.

Round Lot
Generally, one hundred shares of stock or multiples of 100.

Specialist
A member of a stock exchange who operates on the trading floor buying and selling shares of particular securities as necessary to maintain a fair and orderly market.

Stock
An ownership interest in a company, also known as "shares" in a company.

Street Name
A name other than that of the beneficial owner (e.g., a broker-dealer) in which stock may be recorded, usually to facilitate resale.

Unit Investment Trust
A type of investment company with a fixed unmanaged portfolio, typically invested in bonds or other debt securities in which the interests are redeemable.

Yield
Generally, the return on an investment in a stock or bond, calculated as a percentage of the amount invested.

Asset Allocation: How To Diversify For Maximum Return

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- What Is Right For You?
- The Efficient Frontier

Contrary to popular belief, asset allocation, which refers to the types or classes of securities owned, is generally the most important factor in determining the return on your investments, responsible for about 90 percent of the return according to experts. The remaining 10 percent of the return is determined by <u>which</u> particular investments (stock, bond, mutual fund, etc.) you select and <u>when</u> you decide to buy them.

What is not so important is what's referred to as "market timing."

Likewise, buying a "hot" stock or mutual fund recommended by a financial magazine or newsletter, a brokerage firm or mutual fund family, an advertisement or any other source is generally not a good move.

> **Tip:** Recommendations in publications may be out-of-date, having been prepared several months prior to the publication date.

Market timing refers to the concept of moving in and out of an investment or an investment class in anticipation of a rise or fall in the market; however, it's been proven over and over again that the modern market cannot be timed. In other words, market timing is a strategy that just does not work.

Asset allocation, on the other hand, is the cornerstone of good investing. Each investment made is part of an overall asset allocation plan. Further, this plan must not be generic (one-size-fits-all), but rather must be tailored to *your specific needs*.

Sound financial advice from a trusted and competent advisor is very important as the investment world is populated by many "advisors" who either are unqualified or don't have your best interests at heart.

That said, here are the basic investment guidelines you should live by:

- First, determine your financial profile based on your time horizon, risk tolerance, goals, and financial situation. For more sophisticated investment analysis, this profile should be translated into a graph or curve by a computer program. It's important to use a good computer program because of the complexity of the task.
- Find the right mix of "asset classes" for your portfolio. Asset classes should balance each other in a way that will give the best return for the degree of risk you are willing to take. Using computer programs, financial advisors can determine the proper mix of assets for your financial profile. Over time, the ideal allocation for you will not

remain the same; it will change as your situation changes or in response to changes in market conditions.

- Choose investments from each class, based on performance and costs.

These concepts are discussed further in the following sections.

> **Note:** If the discussion that follows seems theoretical, keep in mind that even increasing your investment return by only two percent - with no increase in risk - can amount to a $94,000 increase in the value of a $100,000 portfolio ($307,000 portfolio value at 10 percent vs. $213,000 at 8 percent) at the end of 20 years. Even more dramatically, it can amount to an increase of more than $2.2 million on a $1 million investment ($5.3 million portfolio value at 10 percent vs. $3.1 million at 8 percent) at the end of 30 years. Is this type of reward worth making the effort to polish your investment approach? The difference in total return is based largely on investing wisely and following the proper principles, and can often mean the difference between a comfortable retirement and struggling to survive.

What is Asset Allocation?

Asset allocation is based on the proven theory that the *type or class* of security you own is much more important than the particular security itself. Asset allocation is a way to control risk in your portfolio. The risk is controlled because the six or seven asset classes in the well-balanced portfolio will react differently to changes in market conditions such as inflation, rising or falling interest rates, market sectors coming into or falling out of favor, a recession, etc.

Asset allocation should not be confused with simple diversification. Suppose you diversify by owning 100 or even 1,000 different stocks. You really haven't done anything to control risk in your portfolio if those 1,000 stocks all come from only one or two different asset classes--say, blue chip stocks (which usually fall into the category known as large-capitalization, or large-cap, stocks) and mid-cap stocks. Those classes will often react to market conditions in a similar way they will generally all either go up or down after a given market event. This is known as "correlation."

Similarly, many investors make the mistake of building a portfolio of various top-performing growth funds, perhaps thinking that even if one goes down, one or two others will continue to perform well. The problem here is that growth funds are highly correlated-they tend to move in the same direction in response to a given market force. Thus, whether you own two or 20 growth funds, they will tend to react in the same way.

Not only does it lower risk, but asset allocation maximizes returns over a period of time. This is because the proper blend of six or seven asset classes will allow you to benefit from the returns in all of those classes.

How Does Asset Allocation Work?

Asset allocation planning can range from the relatively simple to the complex. It can range from generic recommendations that have no relevance to your specific needs (dangerous) to recommendations based on sophisticated computer programs (very reliable although far from perfect). Between these extremes, it can include recommendations based only on your time horizon (still risky) or on your time horizon adjusted for your risk tolerance (less risky) or any combination of factors.

> **Tip:** Most mutual fund families, brokerage firms and financial service companies offer computerized asset allocation analysis. Unfortunately, many of them, in recommending a specific portfolio of mutual funds or stocks, include only funds in their family (in the case of fund families) or those on which they receive the highest commissions (in the other cases). However, these may not be the best-performing investments. Don't undercut the benefit of a sophisticated asset allocation analysis by allowing yourself to be steered into funds or stocks that are based on biased recommendations.

Computerized asset allocations are based on a questionnaire you fill out. Your answers provide the information the computer needs to become familiar with your unique circumstances. From the questionnaire will be determined:

- Your investment time horizon (mainly, your age and retirement objectives).
- Your risk threshold (how much of your capital you are willing to lose during a given time frame), and
- Your financial situation (your wealth, income, expenses, tax bracket, liquidity needs, etc.).
- Your goals (the financial goals you and your family want to achieve).

The goal of the computer analysis is to determine the best blend of asset classes, in the right percentages, that will match your particular financial profile.

At this point, the "efficient frontier" concept comes into play. It may sound complex, but it is a key to investment success.

> **Note:** For an in-depth discussion of this important concept, see The Efficient Frontier, below.

What Are Asset Classes?

The securities that exist in today's financial markets can be divided into four main classes: stocks, bonds, cash, and foreign holdings, with the first two representing the major part of most portfolios. These categories can be further subdivided by "style." Let's take a look at these classes in the context of mutual fund investments:

Equity Funds: The style of an equity fund is a combination of both (1) the fund's particular investment methodology (growth-oriented, value-oriented or a blend of the two) and (2) the size of the companies in which it invests (large, medium and small). Combining these two variables - investment methodology and company size - offers a broad view of a fund's holdings and risk level. Thus, for equity funds, there are nine possible style combinations, ranging from large capitalization/value for the safest funds to small capitalization/growth for the riskiest.

Fixed Income Funds: The style of a domestic or international fixed-income fund is to focus on the two pillars of fixed-income performance - interest-rate sensitivity (based on maturity) and credit quality. Thus, fixed-income funds are split into three maturity groups (short-term, intermediate-term, and long-term) and three credit-quality groups (high, medium and low). These groupings display a portfolio's effective maturity and credit quality to provide an overall representation of the fund's risk, given the length and quality of bonds in its portfolio.

How Are Asset Allocation Models Built?

Simply stated, financial advisors build asset allocation models by (1) taking historic market data on classes of securities, individual securities, interest rates, and various market conditions; (2) applying projections of future economic conditions and other relevant factors; (3) analyzing, comparing and weighting the data with computer programs; and (4) further analyzing the data to create model portfolios.

There are three key areas that determine investment performance for each asset class:

1. *Expected return. This is an estimate of what the asset class will earn in the future-both income and capital gain-based on both historical performance and economic projections.*
2. *Risk. This is measured by looking to the asset class's past performance. If an investment's returns are volatile (vary widely from year to year), it is considered high-risk.*
3. *Correlation. Correlation is determined by viewing the extent in which asset classes tend to rise and fall together. If there is a high correlation, a decision to invest in these asset classes increases risk. The correct asset mix will have a low correlation among asset classes. Correlation coefficients are calculated by looking back over the historical performance of the asset classes being compared.*

Tip: *The ideal asset allocation model for you will change over time, due to changes in your portfolio, market conditions and your individual circumstances. There will probably be shifts in the percentages allocated to asset classes, and possibly some changes in the asset classes themselves.*

What Is Right For You?

It's important to be informed about asset allocation so as to avoid the "cookie cutter" approach that many investors end up accepting. Many of the asset allocations performed today take this "one size fits all" approach.

There are all sorts of investment recommendations, but the question is whether they are suitable for you. Regardless of the approach you take, be sure that an asset allocation takes into account your financial profile to the extent feasible.

The Efficient Frontier

The "efficient frontier" concept is a key to investment success. A graph demonstrating the efficient frontier is shown below.

*Any expected return (left side of graph) carries with it an expected risk (bottom of graph)**.** This risk-reward relationship varies from individual to individual. Conservative investors* *cannot tolerate more than a low level of risk, and are willing to accept a return commensurate with that level of risk. More aggressive investors are willing to tolerate higher levels of risk in the expectation of higher returns.*

The efficient frontier is a line on the graph that represents a series of optimal risk-return relationships. That is, every dot on the line represents the highest return for a given level of risk or, stated conversely, the lowest risk for a given rate of return. Conservative investors will aim for a spot on the left side of the efficient (low return, low risk) while aggressive investors will aim for the right side (high return, high risk). If your portfolio (present or proposed) falls on the efficient frontier line, it has an optimal risk-return relationship, but nonetheless still may not be suitable for you because it may be too aggressive or too conservative. Your portfolio should be at that spot on the efficient frontier that approximates your particular risk-return goal.

> ***Note:*** *The efficient frontier is the result of mathematical calculations of expected risk and return. Risk is shown in levels of standard deviation, a commonly used measure of volatility.*

As shown on the graph, if you are willing to tolerate an expected risk (standard deviation) of, say, 12, then you can reasonably (not definitely) expect an approximate return of 10 percent over a period of time (Portfolio C) - if your portfolio is efficient.

It is unlikely, over time, that returns will be higher than those shown on the efficient frontier. Of course, you may, in specific instances, achieve a higher return than that shown, but your average return over time will generally not exceed the amount shown.

If your portfolio falls below the efficient frontier, then it is "inefficient" in that it exposes you to too much risk for the specified return or, conversely, provides too low a return for the specified risk. Unfortunately for investors, most portfolios fall substantially below the efficient frontier.

> ***Example:*** *Portfolio A represents an inefficient portfolio in that it falls below the efficient frontier, meaning that the investor might reasonably expect a return of 10 percent for a risk of 25. However, if the investor is comfortable with that risk level, he can theoretically increase his return to 12 percent with no increase in risk by making his portfolio efficient (i.e., modifying it to resemble Portfolio B, which is on the efficient frontier). Conversely, if he wants to lower his risk, he can maintain the 10 percent return while reducing the risk to 12 (by modifying his portfolio to resemble Portfolio C on the efficient frontier).*

Portfolio D is also efficient (as are B and C, all on the efficient frontier), but represents a portfolio that will enjoy a lower return with lower risk.

> ***Caution:*** *A diversified portfolio does not assure a profit or protect against loss in a declining market.*
> ***Caution:*** *Asset allocation will not guarantee a profit or protect you from loss however, it may provide a hedge against risk and create opportunities in both bull and bear markets.*

Buying On Margin: How It Works and What To Watch Out For

"Buying on margin" is borrowing money from your broker to buy a stock and using your investment as collateral. Investors generally use margin to increase their purchasing power so that they can own more stock without fully paying for it. But margin exposes investors to the potential for higher losses.

This Financial Guide discusses the basics of buying on margin, some of the pitfalls inherent in margin buying, whether this financial tool is for you and how you can best use it.

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How Does Margin Work?

Let's say you buy a stock for $50 and the price of the stock rises to $75. If you bought the stock in a cash account and paid for it in full, you'll earn a 50 percent return on your investment. But if you bought the stock on margin - paying $25 in cash and borrowing $25 from your broker - you'll earn a 100 percent return on the money you invested. Of course, you'll still owe your brokerage $25 plus interest.

The downside to using margin is that if the stock price decreases, substantial losses can mount quickly. For example, let's say the stock you bought for $50 falls to $25. If you fully paid for the stock, you'll lose 50 percent of your money. But if you bought on margin, you'll lose 100 percent, and you still must come up with the interest you owe on the loan.

> **Caution:** In volatile markets, investors who put up an initial margin payment for a stock may, from time to time, be required to provide additional cash if the price of the stock falls. Investors have been shocked to learn that a broker has the right to sell the securities that were bought on margin - without any notification, and at a potentially substantial loss to the investor.

> **Caution:** If your broker sells your stock after the price has plummeted, then you've lost out on the chance to recoup your losses if the market bounces back.

The Risks

Margin accounts can be very risky and they are not for everyone. Before opening a margin account, be aware that:

- You can lose more money than you have invested;
- You may have to deposit additional cash or securities in your account on short notice to cover market losses;
- You may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and
- Your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

You can protect yourself by knowing how a margin account works and what happens if the price of the stock purchased on margin declines.

> **Tip:** Your broker charges you interest for borrowing money; take into account how that will affect the total return on your investments.

Tip: Ask your broker whether it makes sense for you to trade on margin in light of your financial resources, investment objectives, and tolerance for risk.

Read Your Margin Agreement

To open a margin account, you must sign a margin agreement. The agreement may either be part of your account agreement or separate. The margin agreement states that you must abide by the rules of the Federal Reserve Board, the New York Stock Exchange, the Financial Industry Regulatory Authority (FINRA), and the firm where you have set up your margin account.

Caution: Carefully review the agreement *before* signing.

As with most loans, the margin agreement explains the terms and conditions of the margin account. The agreement describes how the interest on the loan is calculated, how you are responsible for repaying the loan, and how the securities you purchase serve as collateral for the loan. Carefully review the agreement to determine what notice, if any, your firm must give you before selling your securities to collect the money you have borrowed.

Know the Margin Rules

The Federal Reserve Board and many self-regulatory organizations (SROs), such as the NYSE and FINRA, have rules that govern margin trading. Brokerage firms can establish their own requirements as long as they are at least as restrictive as the Federal Reserve Board and SRO rules.

Here are some of the key rules you should know:

Before You Trade - Minimum Margin. Before trading on margin, the NYSE, and FINRA, for example, requires you to deposit with your brokerage firm a minimum of $2,000 or 100 percent of the purchase price, whichever is less. This is known as the "minimum margin." Some firms may require you to deposit more than $2,000.

Amount You Can Borrow - Initial Margin. According to Regulation T of the Federal Reserve Board, you may borrow up to 50 percent of the purchase price of securities that can be purchased on margin. This is known as the "initial margin." Some firms require you to deposit more than 50 percent of the purchase price.

Tip: Not all securities can be purchased on margin.

Amount You Need After You Trade - Maintenance Margin. After you buy stock on margin, the NYSE and FINRA require you to keep a minimum amount of equity in your margin account. The equity in your account is the value of your securities less how much you owe to your brokerage firm. The rules require you to have at least 25 percent of the total market value of the securities in your margin account at all times. The 25 percent is called the "maintenance requirement." In fact, many brokerage firms have higher maintenance requirements, typically between 30 to 40 percent and sometimes higher, depending on the type of stock purchased.

Example: You purchase $16,000 worth of securities by borrowing $8,000 from your firm and paying $8,000 in cash or securities. If the market value of the securities drops to $12,000, the equity in your account will fall to $4,000 ($12,000 - $8,000 = $4,000). If your firm has a 25 percent maintenance requirement, you must have $3,000 in equity in your account (25 percent of $12,000 = $3,000). In this case, you do have enough equity because the $4,000 in equity in your account is greater than the $3,000 maintenance requirement.

But if your firm has a maintenance requirement of 40 percent, you would not have enough equity. The firm would require you to have $4,800 in equity (40 percent of $12,000 = $4,800). Your $4,000 in equity is less than the firm's $4,800 maintenance requirement. As a result, the firm may issue you a "margin call," since the equity in your account has fallen $800 below the firm's maintenance requirement.

Margin Calls

If your account falls below the firm's maintenance requirement, your broker generally will make a margin call to ask you to deposit more cash or securities into your account. If you are unable to meet the margin call, your firm will sell your securities to increase the equity in your account up to or above the firm's maintenance requirement.

Tip: Your broker may not be required to make a margin call or otherwise tell you that your account has fallen below the firm's maintenance requirement. Your broker may be able to sell your securities at any time without consulting you first. Under most margin agreements, even if your firm offers to give you time to increase the equity in your account, it can sell your securities without waiting for you to meet the margin call.

- Margin accounts involve a great deal more risk than cash accounts, where you fully pay for the securities you purchase. You may lose more than your initial investment when buying on margin. If you cannot afford to do so, then margin buying is not for you.
- Read the margin agreement, and ask your broker questions about how a margin account works and whether it's appropriate for you to trade on margin. Your broker should explain the terms and conditions of the margin agreement.
- Know how much you will be charged on money you borrow from your broker, and know how these costs affect your overall return.
- Remember that your brokerage firm can sell your securities without notice to you when you don't have sufficient equity in your margin account.

Financial Planning Checklist

Once you've finished with your tax planning for the year, and your return is safely on its way to the IRS, you're at an excellent point for a quick financial check-up. Your tax return is handy, as a quick snapshot of your financial situation and the figures are recent and accurate. Take a few minutes to consider these questions:

1. Have you determined your short- and long-term financial goals?

Have you consistently reviewed and updated them for any changes?

2. Are you saving and investing sufficient sums to fund your short- and long-term goals?

By defining goals that are time and dollar specific, you can regularly assess if you are on track to reach them.

3. Are you making the best use of tax-deferred savings plans, such as IRAs, 401(k)s, and Keoghs?

Are you contributing the maximum you can? Did you make plan investment choices consistent with your investment time frame and risk tolerance? Alternatively, are you satisfied that you have worked out the most appropriate way to take withdrawals for both yourself and your designated beneficiaries, with a careful balancing of income tax and estate tax considerations?

4. If you are an employee, are you getting the optimum from your employee benefits?

Do you understand and use any flexible spending accounts that you may be eligible for? Have you developed a strategy for exercising your employer stock options and using any deferred compensation plans?

5. If you are concerned about paying for a child's education, are you saving and spending in the most appropriate ways?

Are you using tax-deferred savings, tax-favored loans, and tax credits? Are you striking an appropriate balance between saving in the child's name (either outright or in trusts) and saving in your own accounts?

6. Do you have an "emergency fund?"

Many experts recommend that you have the equivalent of three to six month's take-home pay in an account where you can get at it quickly. An emergency fund gives you cash to weather a squall or two without having to disturb your investment portfolio or sell off any other assets.

7. Have you checked the asset allocation of your portfolio lately?

Run-ups and downturns in the market can each disrupt the allocation of your investments, leaving you with more or less in any one asset class than you consider optimal. Should you be thinking about tax-free or taxable fixed income securities, based on your marginal tax rate and risk tolerance?

8. Do you have adequate insurance?

If you die unexpectedly do you have enough life insurance to protect your family? What about disability insurance if you or your spouse couldn't work for an extended period of time? Most people have auto insurance is required by law and most homeowners also are required to have adequate homeowner's insurance, but did you know that it's just as important to have insurance to protect the contents of your home even if you rent it?

9. Do you have all of the necessary legal documents in place?

Is your will up-to-date? How about your estate plan? Trusts for you and/or your spouse and other heirs? A living will or other health care directives? A durable power of attorney for managing your assets if you can't? Have you told family members or trusted friends where they can find these documents?

10. Is your credit under good control?

Is the interest rate on your mortgage the best you can do, or should you be applying for a lower rate? Should you be shopping for a credit card with a lower interest rate, or perhaps for a home equity loan?

11. Are you maximizing your cash flow through income tax strategies?

How are you funding charitable contributions -- with cash or securities? Do you prepay itemized deductions to accelerate the tax benefit?

12. If you own your own business, do you have a plan for smoothly passing on that business to family members or trusted employees?

Are you aware of and planning for any income and related estate taxes? Are you making optimum use of insurance to safeguard your transition plans?

13. Have there been significant changes in your family this year?

Births, deaths, graduations, engagements, and the beginning and ending of marriages can all have multifaceted effects on your financial plans. Consider their effect on your own situation. You may want to start a college fund for a new baby, or make a plan for investing assets you've inherited, or make provision for your daughter's wedding next summer. On the other hand, if you have recently divorced, you will want to review the beneficiary designations on your insurance policies and retirement plans.

Investment Clubs: What You Need To Know

In recent years, interest in investment clubs has grown tremendously. This Financial Guide tells you what you need to know about investors' clubs before getting involved with one.

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- Applicability of the Investment Advisers Act of 1940
- Applicable State Laws

An investment club is a group of people who pool their money to make investments. Usually, investment clubs are organized as partnerships. After the members study different investments, the group decides to buy or sell based on a majority vote. Club meetings can be educational in nature, and each member may actively participate in investment decisions.

SEC Laws That Might Apply

Investment clubs do not usually need to register, or to register the offer and sale of their own membership interests, with the SEC. But since each investment club is unique, each club should decide if it needs to register and comply with securities laws.

We'll discuss two securities laws that might apply to investment clubs:

- Under the Securities Act of 1933, membership interests in the investment club may be securities. If so, the offer and sale of membership interests could be subject to Federal regulation.
- Under the Investment Company Act of 1940, an investment club may be an investment company, and subject to regulation.

When Registration Is Required Under the Securities Act of 1933

Since the 1933 Securities Act requires registration of the offer and sale of most securities, the investment club must register if its membership interests are "securities." Generally, a membership interest is a security if it is an "investment contract."

Generally, a membership interest is an investment contract if members invest and expect to make a profit from the entrepreneurial and managerial efforts of others.

> **Tip:** If every member in an investment club actively participates in deciding which investments to make, membership interests in the club would probably not be considered securities. On the other hand, if the club has any inactive members, it may be considered to be issuing securities.

Sometimes offers and sales of securities do not have to be registered because they are exempt under the law. For example, a non-public offering is exempt.

When Registration Is Required Under the Investment Company Act of 1940

An investment club must register with the SEC as an investment company under the Investment Company Act of 1940 if all of the following three apply:

1. The club invests in securities,
2. The club issues membership interests that are securities (see above), and
3. The club is not able to rely on an exclusion from the definition of "investment company."

Example: A "private investment company" may not need to register with the SEC. To qualify as a private investment company, an investment club:

- Must not make, nor propose to make, a public offering of its securities, and
- Must not have more than 100 members.

An announcement that a club is looking for new members might be considered a public offering, but the analysis is made on a case-by-case basis.

Tip: An attorney with experience in securities law can help the club determine whether its membership interests are securities, and whether the club is making a public offering of those securities.

Applicability of the Investment Advisers Act of 1940

If an adviser is compensated for providing advice regarding the club's investments, the adviser may need to register under the Investment Advisers Act of 1940. Also, if one person chooses investments for the club, that person may have to register as an investment adviser.

In general, a person who has $25 million or more in assets under management is required to register with the SEC under the Investment Advisers Act of 1940.

A person managing less than $25 million may be required to register under the securities laws of the state or states in which the adviser transacts business.

Neither the Investment Advisers Act of 1940 nor many state laws require registration for advisers with small numbers of clients.

Applicable State Laws

State securities laws may differ from federal securities laws. To learn more about the laws in your state, call your state securities regulator. To get the telephone number for your state, visit the North American Securities Administrators Association (NASAA) website.

> **Tip:** It is a good idea to seek the advice of a securities attorney or to contact the securities regulator for the state in question before getting involved with an investment club.

Swap Tactic Lets You Defer Capital Gains Tax

If you're a savvy investor, you probably know that you must generally report as income any mutual fund distributions whether you reinvest them or exchange shares in one fund for shares of another. In other words, you must report and pay any capital gains tax owed.

But if real estate's your game, did you know that it's possible to defer capital gains by taking advantage of a tax break that allows you to swap investment property on a tax-deferred basis?

Named after Section 1031 of the tax code, a like-kind exchange generally applies to real estate and was designed for people who wanted to exchange properties of equal value. If you own land in Oregon and trade it for a shopping center in Rhode Island, as long as the values of the two properties are equal, nobody pays capital gains tax even if both properties may have appreciated since they were originally purchased.

Section 1031 transactions don't have to involve identical types of investment properties. You can swap an apartment building for a shopping center, or a piece of undeveloped, raw land for an office or building. You can even swap a second home that you rent out for a parking lot.

There's also no limit as to how many times you can use a Section 1031 exchange. It's entirely possible to roll over the gain from your investment swaps for many years and avoid paying capital gains tax until a property is finally sold. Keep in mind, however, that gain is deferred, but not forgiven, in a like-kind exchange and you must calculate and keep track of your basis in the new property you acquired in the exchange.

Section 1031 is not for personal use. For example, you can't use it for stocks, bonds, and other securities, or personal property (with limited exceptions such as artwork).

Properties of unequal value

Let's say you have a small piece of property, and you want to trade up for a bigger one by exchanging it with another party. You can make the transaction without having to pay capital gains tax on the difference between the smaller property's current market value and your lower original cost.

That's good for you, but the other property owner doesn't make out so well. Presumably, you will have to pay cash or assume a mortgage on the bigger property to make up the difference in value. This is referred to as "boot" in the tax trade, and your partner must pay capital gains tax on that part of the transaction.

To avoid that you could work through an intermediary who is often known as an escrow agent. Instead of a two-way deal involving a one-for-one swap, your transaction becomes a three-way deal.

Your replacement property may come from a third party through the escrow agent. Juggling numerous properties in various combinations, the escrow agent may arrange evenly valued swaps.

Under the right circumstances, you don't even need to do an equal exchange. You can sell a property at a profit, buy a more expensive one, and defer the tax indefinitely.

You sell a property and have the cash put into an escrow account. Then the escrow agent buys another property that you want. He or she gets the title to the deed and transfers the property to you.

Mortgage and other debt

When considering a Section 1031 exchange, it's important to take into account mortgage loans and other debt on the property you are planning to swap. Let's say you hold a $200,000 mortgage on your existing property but your "new" property only holds a mortgage of $150,000. Even if you're not receiving cash from the trade, your mortgage liability has decreased by $50,000. In the eyes of the IRS, this is classified as "boot" and you will still be liable for capital gains tax because it is still treated as "gain."

Advance planning required

A Section 1031 transaction takes advance planning. You must identify your replacement property within 45 days of selling your estate. Then you must close on that within 180 days. There is no grace period. If your closing gets delayed by a storm or by other unforeseen circumstances, and you cannot close in time, you're back to a taxable sale.

Find an escrow agent that specializes in these types of transactions and contact your accountant to set up the IRS form ahead of time. Some people just sell their property, take cash and put it in their bank account. They figure that all they have to do is find a new property within 45 days and close within 180 days. But that's not the case. As soon as "sellers" have cash in their hands or the paperwork isn't done right, they've lost their opportunity to use this provision of the code.

Personal residences and vacation homes

Section 1031 doesn't apply to personal residences, but the IRS lets you sell your principal residence tax-free as long as the gain is under $250,000 for individuals ($500,000 if you're married).

Section 1031 exchanges may be used for swapping vacation homes, but present a trickier situation. Here's an example of how this might work. Let's say you stop going to your condo at the ski resort and instead rent it out to a bona fide tenant for 12 months. In doing so, you've effectively converted the condo to an investment property, which you can then swap for another property under the Section 1031 exchange.

However, if you want to use your new property as a vacation home, there's a catch. You'll need to comply with a 2008 IRS safe harbor rule that states in each of the 12-month periods following the 1031 exchange you must rent the dwelling to someone for 14 days (or more) consecutively. In addition, you cannot use the dwelling more than the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented out for at fair rental price.

You must report a section 1031 exchange to the IRS on Form 8824, *Like-Kind Exchanges* and file it with your tax return for the year in which the exchange occurred. If you do not specifically follow the rules for like-kind exchanges, you may be held liable for taxes, penalties, and interest on your transactions.

While they may seem straightforward, like-kind exchanges can be complicated. There are all kinds of restrictions and pitfalls that you need to be careful of. If you're considering a Section 1031 exchange or have any questions, don't hesitate to call.

Changing Jobs? Don't Forget Your 401(k)

One of the most important questions you face when changing job is what to do with the money in your 401(k) because making the wrong move could cost you thousands of dollars or more in taxes and lower returns.

Let's say you put in five years at your current job. For most of those years, you've had the company take a set percentage of your pretax salary and put it into your 401(k) plan.

Now that you're leaving, what should you do? The first rule of thumb is to leave it alone. You have 60 days to decide whether to roll it over or leave it in the account. Resist the temptation to cash out. The worst thing an employee can do when leaving a job is to withdraw the money from their 401(k) plans and put it in his or her bank account. Here's why:

If you decide to have your distribution paid to you, the plan administrator will withhold 20 percent of your total for federal income taxes, so if you had $100,000 in your account and you wanted to cash it out, you're already down to $80,000.

Furthermore, if you're younger than 59 ½, you'll face a 10 percent penalty for early withdrawal come tax time. Now you're down another 10 percent from the top line to $70,000.

> If you separate from service during or after the year you reach age 55 (age 50 for public safety employees of a state, or political subdivision of a state, in a governmental defined benefit plan) there is an exception to the 10 percent early withdrawal tax penalty. This applies to 401(k) plans only. IRA, SEP, SIMPLE IRA, and SARSEP Plans do not qualify for the exception.

In addition, because distributions are taxed as ordinary income, at the end of the year you'll have to pay the difference between your tax bracket and the 20 percent already taken out. For example, if you're in the 32 percent tax bracket, you'll still owe 12 percent, or $12,000. This lowers the amount of your cash distribution to $58,000.

But that's not all. You also might have to pay state and local taxes. Between taxes and penalties, you could end up with little over half of what you had saved up, short-changing your retirement savings significantly.

What are the Alternatives?

If your new job offers a retirement plan, then the easiest course of action is to roll your account into the new plan before the 60-day period ends. This is known as a "rollover" and is relatively painless to do. Contact The 401(k) plan administrator at your previous job should have all of the forms you need.

The best way to roll funds over from an old 401(k) plan to a new one is to use a direct transfer. With the direct transfer, you never receive a check and you avoid all of the taxes and penalties mentioned above and your savings will continue to grow tax-deferred until you retire.

One word of caution: Many employers require that you work a minimum period of time before you can participate in a 401(k). If that is the case, one solution is to keep your money in your former employer's 401(k) plan until the new one is available. Then you can roll it over into the new plan. Most plans let former employees leave their assets several months in the old plan.

60-Day Rollover Period

If you have your former employer make the distribution check out to you, the Internal Revenue Service considers this a cash distribution. The check you get will have 20 percent taken out automatically from your vested amount for federal income tax.

But don't panic. You have 60 days to roll over the lump sum (including the 20 percent) to your new employer's plan or into a rollover individual retirement account (IRA). Then you won't owe the additional taxes or the 10 percent early withdrawal penalty.

> If you're not happy with the fund choices your new employer offers, you might opt for a rollover IRA instead of your company's plan. You can then choose from hundreds of funds and have more control over your money. But again, to avoid the withholding hassle, use direct rollovers.

Leave It Alone

If your vested account balance in your 401(k) is more than $5,000, you can usually leave it with your former employer's retirement plan. Your lump sum will keep growing tax-deferred until you retire.

However, if you can't leave the money in your former employer's 401(k) and your new job doesn't have a 401(k), your best bet is a direct rollover into an IRA. The same applies if you've decided to go into business for yourself.

Once you turn 59 ½, you can begin withdrawals from your IRA without penalty and your withdrawals are taxed as ordinary income. The IRS "Rule of 55" allows you to withdraw funds from your 401(k) or 403(b) without a penalty at age 55 or older.

With both a 401(k) and an IRA, you must begin taking required minimum distributions (RMDs) when you reach age 72, whether you're working or not.

How Brokers Execute Trades: What Every Investor Should Know

When you place an order to buy or sell stock, you might not think about where or how your broker will execute the trade. But where and how your order is executed can impact the overall costs of the transaction, including the price you pay for the stock. Here's what you should know about trade execution.

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Trade Execution Isn't Instantaneous

Many investors who trade through online brokerage accounts assume they have a direct connection to the securities markets. But they don't. When you press "enter," your order is sent over the Internet to your broker - who in turn decides which market to send it to for execution. A similar process occurs when you call your broker to place a trade.

While trade execution is usually seamless and quick, it does take time. And prices can change quickly, especially in fast-moving markets. Because price quotes are only for a specific number of shares, investors may not always receive the price they saw on their screen or the price their broker quoted over the phone. By the time your order reaches the market, the price of the stock could be slightly - or very - different.

> No SEC regulations require a trade to be executed within a set period of time. But if firms advertise their speed of execution, they must not exaggerate or fail to tell investors about the possibility of significant delays.
>
> To avoid buying or selling a stock at a price higher or lower than you wanted, place a limit order rather than a market order. A limit order is an order to buy or sell a security at a specific price. A buy limit order can only be executed at the limit price or lower, and a sell limit order can only be executed at the limit price or higher. When you place a market order, you can't control the price at which your order will be filled.
>
> You want to buy the stock of a "hot" IPO that was initially offered at $9, but don't want to end up paying more than $20 for the stock. Place a limit order to buy the stock at any price up to $20. By entering a limit order rather than a market order, you will not be caught buying the stock at $90 and then suffering immediate losses as the stock drops later in the day or the weeks ahead.
>
> Your limit order may never be executed because the market price may quickly surpass your limit before your order can be filled. But by using a limit order you also protect yourself from buying the stock at too high a price.

Your Brokers' Choices for Executing Your Trade

Just as you have a choice of brokers, your broker generally has a choice of markets in which to execute your trade:

- For a stock listed on an exchange, such as the New York Stock Exchange (NYSE), your broker may direct the order to that exchange, to another exchange (such as a regional exchange), or to a firm called a "third market maker." A "third market maker" is a firm that stands ready to buy or sell a stock listed on an exchange at publicly quoted prices. As a way to attract orders from brokers, some regional exchanges or third market makers will pay your broker for routing your order to that exchange or market maker - perhaps a penny or more per share for your order. This is called "payment for order flow."

Upon the opening of a new account and on an annual basis, firms must inform customers in writing whether they receive payment for order flow and, if they do, a detailed description of the type of payments. Firms must also disclose on trade confirmations whether they receive payment for order flow and that customers can make a written request to find out the source and type of the payment as to that particular transaction.

- For a stock that trades in an over-the-counter (OTC) market, such as the NASDAQ, your broker may send the order to a "NASDAQ market maker" in the stock. Many NASDAQ market makers also pay brokers for order flow. Note: A "market maker" is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price. You'll most often hear about market makers in the context of the NASDAQ or other "over the counter" (OTC) markets. Market makers that stand ready to buy and sell stocks listed on an exchange, such as the New York Stock Exchange, are called "third market makers." Many OTC stocks have more than one market-maker.

Market-makers generally must be ready to buy and sell at least 100 shares of a stock they make a market in. As a result, a large order from an investor may have to be filled by a number of market-makers, perhaps at different prices.

- Your broker may route your order - especially a "limit order" - to an electronic communications network (ECN) that automatically matches buy and sell orders at specified prices. A "limit order" is an order to buy or sell a stock at a specific price.
- Your broker may decide to send your order to another division of your broker's firm to be filled out of the firm's own inventory. This is called "internalization." With this option, your broker's firm can make money on the "spread" - the difference between the purchase price and the sale price.

Your Broker Has a Duty of "Best Execution"

Many firms use automated systems to handle the orders they receive from their customers. In deciding how to execute orders, your broker has a duty to seek the best execution reasonably available for its customers' orders. That means your broker must evaluate the orders it receives from all customers in the aggregate and periodically assess which competing markets, market makers, or ECNs offer the most favorable terms of execution.

The opportunity for "price improvement" - which is the opportunity, but not the guarantee, for an order to be executed at a better price than what is currently quoted publicly - is an important factor a broker should consider in executing its customers' orders. Other factors include the speed and the likelihood of execution.

> You enter a market order to sell 500 shares of a stock. The current quote is $20. Your broker may be able to send your order to a market or a market maker where your order would have the possibility of getting a price better than $20. If your order is executed at $20 1/16, you would receive $10,031.25 for the sale of your stock - $31.25 more than if your broker had only been able to get the current quote for you.

Of course, the additional time it takes some markets to execute orders may result in your getting a worse price than the current quote - especially in a fast-moving market. So your broker is required to take into account any trade-off between providing its customers' orders with the possibility of better prices and the extra time it may take to do so.

You Can Direct Your Trades

If for any reason you want to direct your trade to a particular exchange, market maker, or ECN, you may be able to call your broker and ask him or her to do this. But some brokers may charge for that service.

> Some brokers now offer active traders the ability to direct orders in NASDAQ stocks to the market maker or ECN of their choice.

New Rules on Execution Practices

On November 15, 2000, the SEC adopted new rules aimed at improving public disclosure of order execution and routing practices. Beginning April 2001, all market centers that trade national market system securities must make monthly, electronic disclosures of basic information concerning their quality of executions on a stock-by-stock basis, including how market orders of various sizes are executed relative to the public quotes and information about effective spreads - the spreads actually paid by investors whose orders are routed to a particular market center. In addition, market centers will disclose the extent to which they provide executions at prices better than the public quotes to investors using limit orders.

The new rules also require brokers that route orders on behalf of customers to disclose quarterly the identity of the market centers to which they route a significant percentage of their orders. In addition, the rule mandates that brokers respond to the requests of customers interested in learning where their individual orders were routed for execution during the previous six months.

With this information now readily available, you can better learn where and how your firm executes its customers' orders and what steps it takes to assure the best execution.

> Ask your broker about the firm's policies on payment for order flow, internalization, or other routing practices - or look for that information in your account agreement. You can also write to your broker to find out the nature and source of any payment for order flow it may have received for a particular order.
>
> If you're comparing brokerage firms, ask each how often it obtains price improvement on customers' orders. And then consider that information in deciding with which firm you will do business.

Investing In Mutual Funds: The Time-Tested Guidelines

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Mutual funds are an excellent way to invest in stocks, bonds and other securities. They are a good choice of investment because:

- They are managed by professional money managers, so most of the investment research is done for you (most investors don't have the time or know-how to do all the necessary research).
- You diversify your investment risk by owning shares in a mutual fund, instead of buying individual stocks or bonds directly.
- Transaction costs are often lower than what you would pay if you invested in individual securities (the mutual fund buys and sells large amounts of securities at a time).

Before getting into our discussion of mutual funds, there are three important points to keep in mind:

1. Past performance is not a reliable indicator of future performance. Beware of dazzling performance claims. Many publications recommend mutual funds based only on past performance.
2. Mutual funds are not guaranteed or insured by any bank or government agency. Even if you buy through a bank and the fund carries the bank's name, there is no guarantee. You can lose your investment.
3. All mutual funds have costs that lower your investment returns. Thus, even an index fund that mirrors a broad market index cannot perform as well as its mirror index, since the fund has transaction and operating costs that the index does not.

How To Choose A Mutual Fund

Once you determine your asset allocation model, you can implement the recommended portfolio with mutual funds. You need only six to ten funds to achieve diversification and your asset allocation objectives, as opposed to having to buy many more individual securities to achieve the same results.

Caution: Keep in mind that mutual funds ALWAYS carry investment risks. Some carry more risk than others; a higher rate of return typically involves a higher risk. don't buy a fund without knowing--and being willing to accept--the risk. The types of risks that attend a mutual fund depend on the type of fund. Risks are discussed later in the section on "Types of Mutual Funds and Their Varying Risk Factors."

Once you identify the asset classes that will be represented in your portfolio, it's time to select *specific funds* in those categories-i.e., funds that meet *your* investment goals. To choose wisely, it's necessary to assess:

- A fund's risk/reward history and characteristics, which should match your own financial profile;
- A fund's philosophy and investment style, which should match your own investment goals;
- A fund's costs, including loads and ongoing expenses; and
- The customer service available from the fund.

Tip: Find out whether the fund will stop offering shares to the public once its assets have grown to a certain point (sometimes the case with small-cap funds).

What About Recommendations?

Most sources of mutual fund recommendations are inadequate. They either depend solely on past performance or fail to take into account your particular needs. Newsletters and magazines, for example, often simply recommend last year's hot fund-which, even though it may remain hot for the current year, may be totally wrong for you.

Comparing Performance

A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings tell you how well a fund has performed in the past. But studies show that the future is often different. This year's "No. 1" fund can easily become next year's dog.

Tip: Although past performance is not a reliable indicator of future performance, past *volatility* is a good indicator of future volatility.

Here are some tips for comparing fund performances:

- *Check the fund's total return*. You will find it in the Financial Highlights of the prospectus (near the front). Total return measures increases and decreases in the value of the investment over time, after subtracting costs. This is just one of many return measures.
- *Find out how the fund ranked in its investment category class*. There are various rating systems available to show how a fund ranked among its peers.
- *See how the total return has varied over the years*. The Financial Highlights in the prospectus show yearly total return for the most recent 10-year period. An impressive 10-year total return may be based on one spectacular year followed by many average years. Looking at year-to-year changes in total return is a good way to see how stable the fund's returns have been.
- *Check the fund's Sharpe ratio*. The Sharpe ratio is intended to give investors an understanding of the fund's performance *relative to the risk*. The Sharpe ratio is calculated by subtracting the average monthly return of the 90-day Treasury Bill-basically a risk-free return-from the average monthly return of the fund. The difference-the "excess" return- is then annualized and divided by the fund's annual standard deviation (a common measure of volatility).

Tip: Mathematical theory aside, the important point is that the higher the Sharpe ratio, the higher the fund's performance with less of a risk.

Comparing Costs

Costs are important because they lower your returns. A fund that has a sales load and high expenses will have to perform better than a low-cost fund, just to stay even.

Find the fee table near the front of the fund's prospectus, where the fund's costs are laid out. You can use the fee table to compare the costs of different funds.

The fee table breaks costs into two main categories:

- Sales loads and transaction fees (paid when you buy, sell or exchange your shares) and
- Ongoing expenses (paid while you remain invested in the fund).

Sales Loads

The first part of the fee table will tell you if the fund charges any sales loads. No-load funds by definition, do not charge sales loads. There are no-load funds in every major fund category. Even no-load funds have ongoing expenses, however, such as management fees.

A sales load usually pays for commissions to the brokers who sell the fund's shares to you, as well as other marketing costs. Sales loads buy you a broker's services and advice; they do not assure superior performance.

Front-end load: A front-end load is a sales charge you pay when you buy shares. This type of load, which by law cannot be higher than 8.5 percent of your investment-although in practice are often much less-reduces the amount of your investment in the fund.

Back-end load: A back-end load (also called a deferred load) is a sales charge you pay when you sell or exchange your shares. It usually starts out at 5 or 6 percent for the first year and gets smaller each year after that until it reaches zero say, in year six or seven year of your investment.

Example: You invest $1,000 in a mutual fund with a 6 percent back-end load that decreases to zero in the seventh year. Let's assume that the value of your investment remains at $1,000 for seven years. If you sell your shares during the first year, you will get back only $940 (the $60 will go to pay the sales charge). If you sell your shares during the seventh year, you will get back $1,000.

Tip: Many funds allow you to exchange your shares for those of another fund managed by the same adviser. The first part of the fee table will tell you if there is any exchange fee.

Ongoing Expenses

The second part of the fee table tells you the kinds of ongoing expenses you will pay while you remain invested in the fund. It shows expenses as a percentage of the fund's assets, generally for the most recent fiscal year. Here, the table will tell you the management fee for managing the fund's portfolio, along with any other fees and expenses.

Caution: Check the fee table to see if any part of a fund's fees or expenses has been waived. If so, the fees and expenses may increase suddenly when the waiver ends (the part of the prospectus after the fee table will tell you by how much).

High expenses do not assure superior performance. Higher-expense funds do not, on average, perform better than lower-expense funds. But there may be circumstances in which you decide it is appropriate to pay higher expenses. For example, you can expect to pay higher expenses for certain types of funds that require extra work by managers, such as international stock funds, which require sophisticated research.

Caution: You may also pay higher expenses for funds that provide special services, like toll-free telephone numbers, check-writing and automatic investment programs.

A difference in expenses that may look small to you can make a big difference in the value of your investment over time.

Example: You invest $1,000 in a fund, which yields an annual return of 5 percent before expenses. If the fund has expenses of 1.5 percent, after 20 years you would end up with roughly $2,012. If the fund has expenses of 0.5 percent, you would end up with more than $2,455 - a 22 percent difference. If your investment is $100,000 instead of $1,000, that means a difference of more than $44,000.

Rule 12b-1 fee: One type of ongoing fee that is taken out of fund assets has come to be known as a Rule 12b-1 fee. It most often is used to pay commissions to brokers and other salespersons, and occasionally to pay for advertising and other costs of promoting the fund to investors. It usually is between 0.25 percent and 1.00 percent of assets annually.

Funds with back-end loads usually have higher Rule 12b-1 fees. If you are considering whether to pay a front-end load or a back-end load, think about how long you plan to stay in the fund. If you plan to stay in for six years or more, a back-end load will usually cost less than a front-end load.

Caution: Yet, even if your back-end load has fallen to zero, you could pay more in Rule 12b-1 fees over time than if you paid a front-end load.

Comparing Investment Philosophy

Here are some suggestions for examining a fund's approach to investing.

1. Determine the fund's overall investment objectives.

Tip: Morningstar's system of rating mutual funds includes 40 investment objectives. This extensive list can be helpful in narrowing the comparison of funds' objectives. Morningstar's style boxes can also be used to compare funds' styles.

2. Determine whether the fund's portfolio matches its stated investment objectives. The fund should fully reveal how it invests.

Tip: Morningstar's "style boxes" are extremely useful in determining (1) whether a fund's investment approach has a low, moderate, or high risk/return profile and (2) the types of securities invested in.

3. Determine whether the fund invests overseas.

Caution: Generally, international equities are a longer-term, higher-risk investment.

4. For an equity fund, determine the industry sectors in which it's invested.

5. For a bond fund, determine the years to maturity of its holdings and whether it holds any tax-exempt bonds.

6. Find out how long the fund's management has been in place and whether one particular manager has been responsible for the success of the fund.

Caution: If the manager is relatively new, this may add risk to the fund, unless the manager has had experience elsewhere.

Comparing Customer Service

You'll want to find out what services the fund offers. Among the questions you should ask are:

1. How long does it take to reach a representative?
2. Which account options does the fund offer?
3. How quickly are questions about returns or investments answered?

Risk Factors In General

You take risks when you invest in any mutual fund. You may lose some or all of the money you invest (your principal) because the securities held by a fund go up and down in value. What you earn on your investment (dividends and interest) also may go up or down. The various types of risk are:

- *Volatility*: The unpredictability of changes in stock prices.
- *Interest-rate risk*: The fluctuation in bond prices due to interest rate changes.
- *Credit risk*: The likelihood that payments of bond interest and principal will not be made as promised.
- *Inflation risk*: The risk that the lowered purchasing power of the dollar will erode your return.

Each kind of mutual fund has different risks and rewards. Generally, the higher the potential return, the higher the risk of loss. The following discussion of risk for the various types of funds is intended to aid you in choosing a fund that meets your requirements as an investor.

Money Market Fund Risks

Money market funds are relatively low risk compared to other mutual funds. They are limited by law to certain high-quality, short-term investments. They try to keep their net asset value (NAV) at a stable $1.00 per share.

Caution: Contrary to popular belief, NAV may fall below $1.00 if the funds' investments perform poorly. Although investor losses have been rare, they are possible.

Caution: Banks now sell mutual funds, some of which carry the bank's name. But mutual funds sold by banks, including money market funds, are not bank deposits. Don't confuse a "money market fund" with a "money market deposit account." The names are similar, but they are completely different:

- A *money market fund* is a type of mutual fund. It is not guaranteed, and comes with a prospectus.
- A *money market deposit account* is a bank deposit. It is guaranteed, and comes with a "Truth in Savings" form.

Caution: Many bank funds are just "private label" funds, i.e., run by a fund family for the bank. This adds an extra layer of cost.

Bond Fund Risks

Bond funds (also called fixed-income funds) have higher risks than money market funds, but usually pay higher yields. Unlike money market funds, bond funds are not restricted to high-quality or short-term investments. Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards.

Most bond funds have credit risk, the risk that companies or other issuers whose bonds are owned by the fund may fail to pay their bond holders. Some funds have little credit risk, however, such as those that invest in insured bonds or U.S. Treasury bonds. Keep in mind that nearly all bond funds have interest rate risk, which means that the market value of their bonds will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or Treasury bonds. Long-term bond funds invest in bonds with longer maturities (the length of time until the final payout). The net asset values (NAVs) of long-term bond funds can go up or down more rapidly than those of shorter-term bond funds.

Tip: Morningstar's rating system uses specific times to maturity to distinguish between long-term, short-term and medium-term bonds. This system can help you choose the bond fund that is most suitable with regard to interest-rate risk.

Stock Fund Risks

Stock funds (also called equity funds) generally involve more risk-volatility-than money market or bond funds, but they also offer the highest returns. A stock fund's value can rise and fall quickly over the short term, but historically stocks have performed better over the long term than other types of investments.

Mutual fund rating companies use "beta" to measure risk. Beta measures a fund's price fluctuations relative to those of the whole market-that is, its sensitivity to market movements.

Not all stock funds are the same. For example, growth funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains. Others specialize in a particular industry segment such as technology stocks.

The level of volatility in a stock fund depends on the fund's investments, e.g., small-cap growth stocks are more volatile than large-cap value stocks. The level of volatility is also affected by industry sector. Also, international stocks are generally more volatile than domestic stocks.

The foregoing generalizations are intended only as such. It is important, when examining a fund for risk/reward characteristics, to analyze each fund on a case-by-case basis.

Caution: Funds that invest in derivatives face special risks. Derivatives - which come in many different types and have many different uses - are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. Their value can be affected dramatically by even small market movements, sometimes in unpredictable ways. However, they do not necessarily increase risk, and may in fact reduce risk. A fund's prospectus will disclose how it may use derivatives. You may also want to call a fund and ask how it uses these instruments.

Summary

There are a number of sources of information that you should explore before investing in mutual funds. The most important of these is the prospectus, which is the fund's selling document and contains information about costs, risks, past performance and the fund's investment goals. Request the prospectus from the fund or from a financial professional if you are using one. Read the prospectus, and exercise your judgment carefully, before you invest.

Read the sections of the prospectus that discuss the risks, investment goals and investment policies of the fund you are considering. Funds of the same type can have significantly different risks, objectives and policies.

All mutual funds must prepare a Statement of Additional Information (SAI, also called Part B of the prospectus). It explains a fund's operations in greater detail than the prospectus. If you ask, the fund must send you an SAI.

You can get a clearer picture of a fund's investment goals and policies by reading its annual and semi-annual reports to shareholders. If you ask, the fund will send you these reports. You can also research funds at most libraries or by using an on-line service.

Government and Non-Profit Agencies

- The SEC

The SEC has public reference rooms at its headquarters in Washington, D.C., and at its Northeast and Midwest Regional offices. Copies of the text of documents filed in these reference rooms may be obtained by visiting or writing the Public Reference Room (at a standard per page reproduction rate) or through private contractors (who charge for research and/or reproduction).

Other sources of information filed with the SEC include public or law libraries, securities firms, financial service bureaus, computerized on-line services, and the companies themselves.

Most companies whose stock is traded over the counter or on a stock exchange must file "full disclosure" reports on a regular basis with the SEC. The annual report (Form 10-K) is the most comprehensive of these. It contains a narrative description and statistical information on the company's business, operations, properties, parents, and subsidiaries; its management, including their compensation and ownership of

company securities: and significant legal proceedings which involve the company. Form 10-K also contains the audited financial statements of the company (including a balance sheet, an income statement, and a statement of cash flow) and provides management's discussion of business operations and prospects for the future.

Quarterly financial information on Form 8-K may be required as well.

Anyone may obtain copies (at a modest copying charge) of any corporate report and most other documents filed with the Commission by visiting the SEC website

American Association of Individual Investors (offers an annual guide to low-load mutual funds):

625 North Michigan Avenue

Chicago, IL 60611

Tel: 800-428-2244

Investment Company Institute (a trade association of fund companies that publishes an annual directory of mutual funds):

1401 H Street NW, Suite 1200

Washington, DC 20005

Tel: 202-326-5800

Mutual Fund Education Alliance (publishes an annual guide to low-cost mutual funds:

Mutual Fund Taxation: How To Cut The Tax Bite

How are distributions from mutual funds taxed? What happens when they are reinvested? How are capital gains on sales of mutual funds determined? This Financial Guide provides you with tips on reducing the tax on mutual fund activities.

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A basic knowledge of mutual fund taxation and careful record-keeping can help you cut the tax bite on your mutual fund investments.

You must generally report as income any mutual fund distributions, whether or not they are reinvested. The tax law generally treats mutual fund shareholders as if they directly owned a proportionate share of the fund's portfolio of securities. Thus, all dividends and interest from securities in the portfolio, as well as any capital gains from the sales of securities, are taxed to the shareholders.

The fund itself is not taxed on its income if certain tests are met and substantially all of its income is distributed to its shareholders.

Taxable Distributions

There are two types of taxable distributions: (1) ordinary dividends and (2) capital gain distributions:

1. **Ordinary Dividends**. Distributions of ordinary dividends, which come from the interest and dividends earned by securities in the fund's portfolio, represent the net earnings of the fund. They are paid out periodically to shareholders. Like the return on any other investment, mutual fund dividend payments decline or rise from year to year, depending on the income earned by the fund in accordance with its investment policy. These dividend payments are considered ordinary income and must be reported on your tax return.
   Qualified dividends. Qualified dividends are ordinary dividends that are subject to the same tax rates that apply to net long-term capital gains. Dividends from mutual funds qualify where a mutual fund is receiving qualified dividends and distributing the required proportions thereof. Dividends from foreign corporations are qualified where their stock or ADRs are traded on U.S. exchanges or with IRS approval where the dividends are covered by U.S. tax treaties.
2. **Capital gain distributions**. When gains from the fund's sales of securities exceed losses, they are distributed to shareholders. As with ordinary dividends, these capital gain distributions vary in amount from year to year. They are treated as long-term capital gain, regardless of how long you have owned your fund shares. A mutual fund owner may also have capital gains from selling mutual fund shares.

Capital gains rates

The beneficial long-term capital gains rates on sales of mutual fund shares apply only to profits on shares held more than a year before sale. Profit on shares held a year or less before the sale is ordinary income, but capital gain distributions are long-term regardless of the length of time held before the distribution.

In 2022, tax rates on capital gains and dividends remain the same as 2021 rates (0%, 15%, and a top rate of 20%); however, threshold amounts are different in that they don't correspond to new tax bracket structure as they did in the past. The maximum zero percent rate amounts are $41,675 for individuals and $83,350 for married filing jointly. For an individual taxpayer whose income is at or above $459,750 ($517,200 married filing jointly), the rate for both capital gains and dividends is capped at 20 percent. All other taxpayers fall into the 15 percent rate amount (i.e., above $41,675 and below $459,750 for single filers).

> In 2022, say your taxable income, apart from long-term capital gains and qualified dividends, is $87,000. Even though you're in a middle-income tax

bracket (22 percent on a joint return in 2022) you'll get the benefit of a lower capital gains tax rate, in this case, 15 percent for long-term gains and qualified dividends.

For tax years 2013-2017 dividend income that fell in the highest tax bracket (39.6%) was taxed at 20 percent. For the middle tax brackets (25-35%) the dividend tax rate was 15 percent, and for the two lower ordinary income tax brackets of 10% and 15%, the dividend tax rate was zero.

At tax time, your mutual fund will send you a Form 1099-DIV, which tells you what earnings to report on your income tax return, and how much of it is qualified dividends. Because tax rates on qualified dividends are the same as for capital gains distributions and long-term gains on sales, Congress wants these items combined in your tax reporting, that is, qualified dividends added to long-term capital gains. Also, capital losses are netted against capital gains before applying favorable capital gains rates. Losses will not be netted against dividends.

Undistributed capital gains. Mutual funds sometimes retain a part of their capital gain and pay tax on them. You must report your share of such gains and can claim a credit for the tax paid. The mutual fund will report these amounts to you on Form 2439. You increase your shares' "cost basis" (more about this in Tip No. 5, below) by 65 percent of the gain, representing the gain reduced by the credit.

Medicare Tax

Starting with tax year 2013, an additional Medicare tax of 3.8 percent is applied to net investment income for individuals with modified adjusted gross income above $200,000 (single filers) and $250,000 (joint filers). These amounts are not indexed for inflation.

Now that you have a better understanding of how mutual funds are taxed, here are 13 tips for minimizing the tax on your mutual fund activities:

Keep Track of Reinvested Dividends

Most funds offer you the option of having dividend and capital gain distributions automatically reinvested in the fund - a good way to buy new shares and expand your holdings. While most shareholders take advantage of this service, it is not a way to avoid being taxed. Reinvested ordinary dividends are still taxed (at long-term capital gains rates if qualified), just as if you had received them in cash. Similarly, reinvested *capital gain distributions* are taxed as long-term capital gain.

If you reinvest, add the amount reinvested to the "cost basis" of your account, i.e., the amount you paid for your shares. The cost basis of your new shares purchased through automatic reinvesting is easily seen from your fund account statements.

Be Aware That Exchanges of Shares Are Taxable Events

The "exchange privilege," or the ability to exchange shares of one fund for shares of another, is a popular feature of many mutual fund "families," i.e., fund organizations that offer a variety of funds. For tax purposes, exchanges are treated as if you had sold your shares in one fund and used the cash to purchase shares in another fund. In other words, you must report any capital gain from the exchange on your return. The same tax rules used for calculating gains and losses when you redeem shares apply when you exchange them.

Gains on these redemptions and exchanges are taxable whether the fund invests in taxable or tax-exempt securities.

Be Wary of Buying Shares Just Before Ex-Dividend Date

Tax law requires that mutual funds distribute at least 98 percent of their ordinary and capital gain income annually. Thus, many funds make disproportionately large distributions in December. The date on which a fund's shareholders become entitled to future payment of a distribution is referred to as the ex-dividend date. On that date, the fund's net asset value (NAV) is reduced on a per-share basis by the exact amount of the distribution. Buying mutual fund shares just before this date can trigger an unexpected tax.

You buy 1,000 shares of Fund XYZ at $10 a share. A few days later, the fund goes ex-dividend, entitling you to a $1 per share distribution. Because $1 of your $10 NAV is being distributed to you, the value of your 1,000 shares is reduced to $9,000. As with any fund distribution, you may receive the $1,000 in cash or reinvest it and receive additional shares. In either case, you must pay tax on the distribution.

If you reinvest the $1,000, the distribution has the appearance of a wash in your account since the value of your fund investment remains $10,000. The $1,000 reinvestment results in the acquisition of 111.1 new shares with a $9 NAV and increases the cost basis of your total investment to $11,000. If you were to redeem your shares for $10,000 (their current value), you would realize a $1,000 capital loss.

In spite of these tax consequences, in some instances it may be a good idea to buy shares right before the fund goes ex-dividend. For instance, the distribution could be relatively small, with only minor tax consequences. Or the market could be moving up, with share prices expected to be higher after the ex-dividend date.

> To find out a fund's ex-dividend date call the fund directly.
>
> If you regularly check the mutual fund quotes in your daily newspaper and notice a decline in NAV from the previous day, the explanation may be that the fund has just gone ex-dividend. Newspapers generally use a footnote to indicate when a fund goes ex-dividend.

Do Not Overlook the Advantages of Tax-Exempt Funds

If you are in the higher tax brackets and are seeing your investment profits taxed away, then there is a good alternative to consider: tax-exempt mutual funds. Distributions from such funds that are attributable to interest from state and municipal bonds are exempt from federal income tax (although they may be subject to state tax).

The same is true of distributions from tax-exempt money market funds. These funds also invest in municipal bonds, but only in those that are short-term or close to maturity, the aim being to reduce the fluctuation in NAV that occurs in long-term funds.

Many taxpayers can ease their tax bite by investing in municipal bond funds. The catch with municipal bond funds is that they offer lower yields than comparable taxable bonds. For example, if a U.S. Treasury bond yields 2.8 percent, then a quality municipal bond of the same maturity might yield 2.45 percent. If an investor is in a higher tax bracket, the tax advantage makes it worthwhile to invest in the lower-yielding tax-exempt fund. Whether the tax advantage actually benefits a particular investor depends on that investor's tax bracket.

To figure out how much you would have to earn on a taxable investment to equal the yield on a tax-exempt investment, use this formula: Tax-exempt yield divided by (1 minus your tax bracket) = equivalent yield of a taxable investment.

> You are planning for the 32% bracket. The yield of a tax-exempt investment is 2.8 percent. Applying the formula, we get .028 divided by .68 (1 minus .32) =

.041. Therefore, 4.1 percent is the yield you would need from a taxable investment to match the tax-exempt yield of 2.8 percent.

In limited cases based on the types of bonds involved, part of the income earned by tax-exempt funds may be subject to the federal alternative minimum tax.

Although income from tax-exempt funds is federally tax-exempt, you must still report on your tax return the amount of tax-exempt income you received during the year. This is an information-reporting requirement only and does not convert tax-exempt earnings into taxable income.

Your tax-exempt mutual fund will send you a statement summarizing its distributions for the past year and explaining how to handle tax-exempt dividends on a state-by-state basis.

Capital gain distributions paid by municipal bond funds (unlike distributions of interest) are not free from federal tax. Most states also tax these capital gain distributions.

Keep Records of Your Mutual Fund Transactions

It is very important to keep the statements from each mutual fund you own, especially the year-end statement.

By law, mutual funds must send you a record of every transaction in your account, including reinvestments and exchanges of shares. The statement shows the date, amount, and number of full and fractional shares bought or sold. These transactions are also contained in the year-end statement.

In addition, you will receive a year-end Form 1099-B, which reports the sale of fund shares, for any non-IRA mutual fund account in which you sold shares during the year.

Why is record keeping so important? When you sell mutual fund shares, you will realize a capital gain or loss in the year the shares are sold. You must pay tax on any capital gain arising from the sale, just as you would from the sale of individual securities. (Losses may be used to offset other gains in the current year and deducted up to an additional $3,000 of ordinary income. Remaining loss may be carried for comparable treatment in later years.)

The amount of the gain or loss is determined by the difference between the cost basis of the shares (generally the original purchase price) and the sale price. Thus, in order to figure the gain or loss on a sale of shares, it is essential to know the cost basis. If you have kept your statements, you will be able to figure this out.

> In 2012, you purchased 100 shares of Fund JKL at $10 a share for a total purchase price of $1,000. Your cost basis for each share is $10 (what you paid for the shares). Any fees or commissions paid at the time of purchase are included in the basis, so since you paid an up-front commission of two percent, or $20, on the purchase, your cost basis for each share is $10.20 ($1,020 divided by 100). Let's say you sell your Fund JKL shares this year for $1,500. Assume there are no adjustments to your $ 1,020 basis, such as basis attributable to shares purchased through reinvestment (for an example of the effect of reinvestment on the cost basis, see Tip #6.). On this year's income tax return, you report a capital gain of $480 ($1,500 minus $1,020).
>
> Since they are taken into account in your cost basis, commissions or brokerage fees are not deductible separately as investment expenses on your tax return.

One of the advantages of mutual fund investing is that the fund provides you with all of the records that you need to compute gains and losses--a real plus at tax time. Some funds even provide cost basis information or compute gains and losses for shares sold. That is why it is important to save the statements. However, you are not required to use the fund's gain or loss computations in your tax reporting.

Re-investing Dividends & Capital Gain Distributions when Calculating

Make sure that you do not pay any unnecessary capital gain taxes on the sale of mutual fund shares because you forgot about reinvested amounts. When you reinvest dividends and capital gain distributions to buy more shares, you should add the cost of those shares (that is, the amount invested) to the cost basis of the shares in that account because you have already paid tax on those shares. Failure to include reinvested dividends and capital gain distributions in your cost basis is a costly mistake.

> You bought 500 shares in Fund PQR 15 years ago for $10,000. Over the years, you reinvested dividends and capital gain distributions in the amount of $8,000, for which you received 100 additional shares. This year, you sell all 600 of those shares for $40,000. If you forget to include the price paid for the 100 shares purchased through reinvestment (even though the fund sent you a statement recording the shares you received in each transaction), you will unwittingly report on your tax return a capital gain of $30,000 ($40,000 - $ 10,000) on your redemption of 600 shares, rather than the correct capital gain of 22,000 ($40,000 - [$10,000 + $8,000]).

Adjust Cost Basis for Non-Taxable Distributions

Sometimes mutual funds make distributions to shareholders that are not attributable to the fund's earnings. These are nontaxable distributions, also known as returns of capital. Because a return of capital is a return of part of your investment, it is not taxable. Your mutual fund will show any return of capital on Form 1099-DIV in the box for nontaxable distributions.

If you receive a return-of-capital distribution, your basis in the shares is reduced by the amount of the return.

> Fifteen years ago, you purchased 1,000 shares of Fund ABC at $10 a share. The following year you received a $1-per-share return-of-capital distribution, which reduced your basis in those shares by $1, to give you an adjusted basis of $9 per share. This year you sell your 1,000 shares for $15 a share. Assuming no other transactions during this period, you would have a capital gain this year of $6 a share ($15 - $9) for a total reported capital gain of $6,000.

Nontaxable distributions cannot reduce your basis below zero. If you receive returns of capital that, taken together, exceed your original basis, you must report the excess as a long-term capital gain.

Your *overall* basis will not change if non-taxable distributions are reinvested. However, your per-share basis will be reduced.

Use the Best Method of Identifying Sold Shares

Calculating the capital gain or loss on shares you sell is somewhat more complicated if, as is usually the case, you are selling only some of your shares. You then must use some accounting method to identify which shares were sold to determine your capital gain or loss. The IRS recognizes several methods of identifying the shares sold:

- First-in, first-out (FIFO),
- Average cost (single category and double category), and
- Specific identification.

Reports from your funds may include a computation of gain or loss on your sale of mutual fund shares. Typically, these will use the average cost method, single category rule. This is done as a convenience. You are allowed to adopt one of the other methods.

First-In, First-Out (FIFO)

Under this method, the first shares bought are considered the first shares sold. Unless you specify that you are using one of the other methods, the IRS will assume you are using FIFO.

Average Cost

This approach allows you to calculate an average cost for each share by adding up the total cost of all the shares you own in a particular mutual fund and dividing by the number of shares. If you elect to take an average cost approach, you must then choose whether to use a single-category method or a double-category method.

- With the *single category* method, you simply group all shares together, add up the cost, and divide by the number of shares. Under this method, you are deemed to have sold first the shares you have held the longest.
- The *double category* method enables you to separate short-term and long-term shares. Shares held for one year or less are considered short-term; shares held for more than one year are considered long-term. You average the cost of shares in each category separately. In this way, you may specify whether you are redeeming long-term or short-term shares.

Keep in mind that once you elect to use either average cost method, you must continue to use it for all transactions in that fund unless you receive IRS approval to change your method.

Specific Identification

Under this method, you specify the individual shares that are sold. If you have kept track of the purchase prices and dates of all your fund shares, including shares purchased with reinvested distributions, you will be able to identify, for example, those shares with the highest purchase prices and indicate that they are the shares you are selling. This strategy gives you the smallest capital gain and could save you a significant amount on your taxes.

To take advantage of this method, you must, at the time of the sale or exchange, indicate to your broker or to the mutual fund itself the particular shares you are selling. The IRS also insists that you receive written confirmation of your instructions.

> To see the advantages and disadvantages of these methods of identifying sold shares, see *How The Various Identification Methods Compare* (below).

Money market funds present a very simple case when you redeem shares. Because most money market funds maintain a stable net asset value of $1 per share, you have no capital gain or loss when you sell shares. Thus, you only pay tax on any earnings distributed.

Avoid Backup Withholding

One way the IRS makes sure it receives taxes owed by taxpayers is through backup withholding. In the mutual fund context, this means that a mutual fund company is required to deduct and withhold a specified percentage (see below) of your dividend and redemption proceeds if one of the following situations has occurred:

- You have not supplied your taxpayer identification number (Social Security number) to the fund company;
- You supplied a TIN that the IRS finds to be wrong;
- The IRS finds you have underreported your interest and dividend payments; or
- You failed to tell the fund company you are not subject to backup withholding.

The backup withholding percentage is 24 percent for tax years 2018-2025 (28 percent in prior years).

Don't Forget State Taxation

Many states treat mutual fund distributions the same way the federal government does. There are, however, some differences. For example,:

- If your mutual fund invests in U.S. government obligations, states generally exempt from state taxation dividends attributable to federal obligation interest.
- Most states do not tax income from their own obligations, whether held directly or through mutual funds. On the other hand, the majority of states do tax income from the obligations of other states. Thus, in most states, you will not pay state tax to the extent you receive, through the fund, income from obligations issued by your state or its municipalities.
- Most states don't grant reduced rates for capital gains or dividends.

Don't Overlook Possible Tax Credits for Foreign Income

If your fund invests in foreign stocks or bonds, part of the income it distributes may have been subject to foreign tax withholding. If so, you may be entitled to a tax deduction or credit for your pro-rata share of taxes paid. Your fund will provide you with the necessary information.

> Because a tax credit provides a dollar-for-dollar offset against your tax bill, while a deduction reduces the amount of income on which you must pay tax, it is generally advantageous to claim the foreign tax credit. If the foreign tax doesn't exceed $300 ($600 on a joint return), then you may not need to file IRS form 1116 to claim the credit.

Be Careful About Trying the "Wash Sale" Rule

If you sell fund shares at a loss (so you can take a capital loss on your return) and then repurchase shares in the same fund shortly thereafter, beware of the wash sale rule. This rule bars a loss deduction when a taxpayer buys "substantially identical" shares within 30 days before or after the date of sale.

> Be sure to wait more than thirty (30) days before reinvesting.

Choose Tax-Efficient Funds

Many investors who hold mutual funds directly may hold others through tax-sheltered accounts such as 401(k)s, IRAs, and Keoghs. Your aggressive high-turnover funds and high-income funds should be in tax-sheltered accounts. These generate more current income and gains, currently taxable if held directly but tax-deferred in tax-sheltered accounts. Buy-to-hold funds and low activity funds such as index funds should be owned directly (as opposed to a tax-sheltered account). With relatively small currently distributable income, such investments can continue to grow with only a modest reduction for current taxes.

For some investors, the simpler approach may be to hold mutual funds personally and more highly taxed income (such as bond interest) in the tax-sheltered account.

As you can see, there are many tax pitfalls that await the unwary mutual fund investor. Professional guidance should be considered to minimize the tax impact.

How The Various Identification Methods Compare.

To illustrate the advantages and disadvantages of the various methods of identifying the shares that you sell, assume that you bought 100 shares of Fund PQR in January 2005 at $20 a share, 100 shares in January 2006 at $30 a share, and 100 shares in November 2010 at $46 a share. You sell 50 shares in June of this year for $50 a share. Here are your alternative ways to determine cost basis.

1. ***First-In, First-Out (FIFO)***.The FIFO method identifies the 50 shares sold as among the first 100 shares purchased. Your cost basis per share is $20. This rate gives you a capital gain of $1,500 ($2,500 - (50 x $20)).
2. ***Advantages/Disadvantages***. In this example, this method produces the highest amount of capital gain on which you are taxed. FIFO provides the lowest capital gain amount when the fund's net asset value has declined, and the first shares purchased were the most expensive. It can also sometimes save tax when shares bought later weren't held long enough to qualify for long-term capital gains treatment.
3. ***Average Cost/Single Category***. Average cost/single category allows you to calculate the average price paid for all shares in the fund. Here, your cost basis per share is $32 (your 300 shares cost $9,600: $9,600 divided by 300 = $32), giving you a capital gain of $900 ($2,500 - (50 x $32)).
4. ***Advantages/Disadvantages.:*** Compared to FIFO, this method can reduce the amount of your capital gain if the fund's net asset value has increased over time. You could generate a lower long-term capital gain by using specific identification, but average cost/single category is useful if you did not designate shares at the time of sale or you simply do not want to do the record-keeping required to use the specific identification method.
5. ***Average Cost/Double Category***. Under this method, you average the cost of the short-term shares (those held for one year or less) and the cost of the long-term shares (those held for more than one year) separately. Thus, in the long-term category, you have 200 shares at $5,000 for an average cost of $25 per share ($5,000 x 200), and in the short-term category, you have 100 shares at $4,600 for an average cost of $46 per share ($4,600 divided by 100). Comparing the two categories, your taxable gain using the long-term shares would be $1,250 ($2,500 - (50 x $25)), to be taxed at up to 20 percent, while your taxable gain using the short-term shares would be $200 ($2,500 - (50 x $46)), to be taxed at up to 37 percent (top rate for 2022).

6. ***Advantages/Disadvantages***. In this example, using the average cost of short-term shares produces a better result. However, because of the current spread between the top marginal income tax rates and the maximum rate on long-term capital gains, it could make sense in some instances to choose the long-term shares. Furthermore, as with specific identification, you must plan ahead to use this method by specifying to the broker or mutual fund company at the time of sale that you are selling short-term or long-term shares, and you must receive confirmation of your specification in writing. If you have elected to use average cost-double category but do not specify for a particular redemption whether you are redeeming short-term or long-term shares, the IRS will deem you to have redeemed the long-term shares first.
7. ***Specific identification.*** With this method, you designate which shares you are selling. To reduce your capital gains tax bill the most, you would select the shares with the highest purchase price. In this case, you would identify the 50 shares sold as among those purchased in 1999. Your cost basis, therefore, is $46 per share, giving you a capital gain of $200 ($2,500 - (50 x $46)).
8. ***Advantages/Disadvantages:*** This method can produce favorable results in lowering the capital gain, but IRS regulations require you to think ahead by providing instructions before the sale and then receiving confirmation of your specification in writing. The IRS will not let you designate shares after the fact.

Government and Non-Profit Agencies

- US Securities and Exchange Commission (SEC)

Securities and Exchange Commission

100 F Street, NE

Washington, D.C. 20549

(202) 942-8088

The SEC has public reference rooms at its headquarters in Washington, D.C., and at its Northeast and Midwest Regional offices. Copies of the text of documents filed in these reference rooms may be obtained by visiting or writing the Public Reference Room (at a standard per page reproduction rate) or through private contractors (who charge for research and/or reproduction).

Other sources of information filed with the SEC include public or law libraries, securities firms, financial service bureaus, computerized on-line services, and the companies themselves.

Most companies whose stock is traded over the counter or on a stock exchange must file "full disclosure" reports on a regular basis with the SEC. The annual report (Form 10-K) is the most comprehensive of these. It contains a narrative description and statistical information on the company's business, operations, properties, parents, and subsidiaries; its management, including their compensation and ownership of company securities: and significant legal proceedings which involve the company. Form 10-K also contains the audited financial statements of the company (including a balance sheet, an income statement, and a statement of cash flow) and provides management's discussion of business operations and prospects for the future.

Quarterly financial information on Form 8-K may be required as well.

Anyone may search the **SEC's Company Filings database** for information regarding to including quarterly and annual reports, registration statements for IPOs and other offerings, insider trading reports, and proxy materials.

American Association of Individual Investors

(Offers an annual guide to low-load mutual funds):

625 North Michigan Avenue

Chicago, IL 60611

Tel: 312-280-0170 or 800-428-2244

Investment Company Institute

(Publishes an annual directory of mutual funds):

1401 H Street NW, Suite 1200

Washington, DC 20005

Tel: 202-326-5800

Investment Management Education Alliance

(Offers a free Portfolio tool, complete with data from Morningstar, Inc.):

2345 Grand Boulevard

Kansas City, MO 64108

Tel: 816-454-9427

Penny Stocks: How To Investigate Them and Avoid the Traps

Information is the investor's best tool when it comes to investing wisely. But accurate information about "microcap stocks" -- low-priced stocks issued by the smallest of companies, often called "penny stocks" -- may be difficult to find. Many microcap companies do not file financial reports with the SEC, so it's hard for investors to get the facts about the company's management, products, services, and finances. When reliable information is scarce, wrongdoers can easily spread false information about microcap companies, making profits while creating losses for unsuspecting investors.

This Financial Guide gives you the basics about microcap or "penny" stocks, discusses how to find information on them, and points out what "red flags" to watch out for.

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- Some Common Penny Stock Fraud Schemes
- How Do I Get Information About Microcap Companies?
- Steps You Should Take Before Investing

What is a Microcap Stock?

The term "microcap stock" applies to companies with low or "micro" capitalizations -- meaning the total value of the company's stock. Microcap companies typically have limited assets. For example, in recent cases where the SEC suspended trading in microcap stocks, the average company had only $6 million in net tangible assets - and nearly half had less than $1.25 million. Microcap stocks tend to be low priced and trade in low volumes.

Where do Microcap Stocks Trade?

Many microcap stocks trade in the "over-the-counter" (OTC) market and are quoted on OTC systems, such as the OTC Bulletin Board (OTCBB) or the "Pink Sheets."

- **OTC Bulletin Board.** The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities not listed on the NASDAQ or a national securities exchange. Brokers who subscribe to the system can use the OTCBB to look up prices or enter quotes for OTC securities.

  Although the FINRA oversees the OTCBB, the OTCBB is not part of the NASDAQ. Wrongdoers often claim that an OTCBB company is a NASDAQ company to mislead investors.

- **The "Pink Sheets."** The Pink Sheets - named for the color of paper they've historically been printed on - are a weekly publication of a company called the National Quotation Bureau. They are updated daily electronically. Brokers who subscribe to the Pink Sheets can find out the names and telephone numbers of the "market makers" in various OTC stocks - meaning the brokers who commit to buying and selling those OTC securities. Unless your broker has the Pink Sheets or you contact the market makers directly, you'll have a difficult time finding price information for most stocks quoted in the Pink Sheets.

How Are Microcap Stocks Different From Other Stocks?

Microcap stocks differ from other stocks in a number of ways:

Lack of Public Information. The biggest difference between a microcap stock and other stocks is the amount of reliable, publicly available information about the company. Larger public companies file reports with the SEC that any investor can get for free from the SEC's website. Professional stock analysts regularly research and write about larger public companies, and it's easy to find larger companies' stock prices. In contrast, information about microcap companies can be extremely difficult to find, making them more vulnerable to investment fraud schemes.

> The SEC has proposed new rules that will increase the amount of information brokers must gather about microcap companies before quoting prices for their stocks in the OTC market.

No Minimum Listing Standards. Companies that trade their stocks on major exchanges and in the NASDAQ must meet minimum listing standards. For example, they must have certain minimums when it comes to net assets, and minimum numbers of shareholders. In contrast, companies on the OTCBB or the Pink Sheets do not have to meet any minimum standards.

Risk. While all investments involve risk, microcap stocks are among the most risky. Many microcap companies are new, with no track record. Some of these companies have no assets or operations. Others have products and services that are still in development or have yet to be tested in the market.

Which Companies File Reports With the SEC?

In general, the federal securities laws require all but the smallest of public companies to file reports with the SEC. A company can become "public" in one of two ways - by issuing securities in an offering or transaction that's registered with the SEC or by registering the company and its outstanding securities with the SEC. Both types of registration trigger ongoing reporting obligations, meaning the company must file periodic reports that disclose important information to investors about its business, financial condition, and management.

This information is a treasure trove for investors: it tells you whether a company is making money or losing money and why.

> You'll find this information in the company's quarterly reports on Form 10-Q, annual reports (with audited financial statements) on Form 10-K, and periodic reports of significant events on Form 8-K.

A company must file reports with the SEC if:

- It has 500 or more investors and $10 million or more in assets; or
- It lists its securities on the following stock markets:
- American Stock Exchange
- Boston Stock Exchange
- Cincinnati Stock Exchange
- Chicago Stock Exchange
- NASDAQ
- New York Stock Exchange
- Pacific Exchange
- Philadelphia Stock Exchange

Currently, only about half of the 6,500 companies whose securities are quoted on the OTCBB file reports with the SEC.

> In January 1999, the SEC approved a new FINRA rule allowing the FINRA to require that all OTCBB companies file updated financial reports with the SEC or with their banking or insurance regulators. The new rule now applies to all companies on the OTCBB. Companies refusing to file with the SEC or their banking or insurance regulators cannot remain on the OTCBB.

With few exceptions, companies that file reports with the SEC must do so electronically using the SEC's EDGAR system. EDGAR stands for electronic data gathering and retrieval. The EDGAR database is available on the SEC's Web site at www.sec.gov. You'll find many corporate filings in the EDGAR database, including annual and quarterly reports and registration statements. Any investor can access and download this information for free from the SEC's Web site.

> As with any information, SEC filings should be read with a questioning and critical mind.

Which Companies Don't Have to File Reports With the SEC?

Smaller companies - those with less than $10 million in assets - generally do not have to file reports with the SEC. But some smaller companies, including microcap companies, may choose voluntarily to register their securities with the SEC. As described above, companies that register with the SEC must also file quarterly, annual, and other reports.

Offering Requirements and Exemptions

Any company that wants to offer or sell securities to the public must either register with the SEC or meet an exemption. Here are two of the most common exemptions that many microcap companies use:

- *"Reg. A" Offerings.* Companies raising less than $5 million in a 12-month period may be exempt from registering their securities under a rule known as Regulation A. Instead of filing a registration statement through EDGAR, these companies need only file a printed copy of an "offering circular" with the SEC containing financial statements and other information.
- *"Reg. D" Offerings.* Some smaller companies offer and sell securities without registering the transaction under an exemption known as Regulation D. Regulation D exempts from registration companies that seek to raise less than $1 million dollars in a twelve-month period. It also exempts companies seeking to raise up to $5 million, as long as the companies sell to 35 or fewer individuals or any number of "accredited investors" who must meet high net worth or income standards. In addition, Regulation D exempts some larger private offerings of securities. While companies claiming an exemption under Reg. D don't have to register or file reports with the SEC, they must still file what's known as a "Form D" within a few days after they first sell their securities. Form D is a brief notice that includes the names and addresses of owners and stock promoters, but little other information about the company.

  You may be able to find out more about Reg. D companies by contacting your state securities regulator.

Unless they otherwise file reports with the SEC, companies that are exempt from registration under Reg. A, Reg. D, or another offering exemption, do not have to file reports with the SEC.

Why Public Information Is So Important?

Many of the microcap companies that don't file reports with the SEC are legitimate businesses with real products or services. But the lack of reliable, readily available information about some microcap companies can open the door to fraud. It's easier to manipulate a stock when there's little or no information available about the company.

Microcap fraud depends on spreading false information. Here's how some perpetrators carry out their scams:

- *Questionable Press Releases.* Con artists often issue press releases that contain exaggerations or lies about the microcap company's sales, acquisitions, revenue projections, or new products or services.
- *Paid Promoters.* Some microcap companies pay stock promoters to recommend or "tout" the microcap stock in supposedly independent and unbiased investment newsletters, research reports, or radio and television shows. The federal securities laws require the newsletters to disclose who paid them, the amount, and the type of payment. But many con artists fail to do so and mislead investors into believing they are receiving independent advice.
- *Internet Fraud.* Con artists often distribute junk e-mail or "spam" over the Internet to spread false information quickly and cheaply about a microcap company to thousands of potential investors. They also use aliases on Internet bulletin boards and chat rooms to hide their identities and post messages urging investors to buy stock in microcap companies based on supposedly "inside" information about impending developments at the companies.
- *"Boiler Rooms"* and Cold Calling. Dishonest brokers set up "boiler rooms" where a small army of high-pressure salespeople use banks of telephones to make cold calls to as many potential investors as possible. These strangers hound investors to buy "house stocks" - stocks that the firm buys or sells as a market maker or has in its inventory.

Never buy stock in response to a cold call.

Some Common Penny Stock Fraud Schemes

Microcap fraud schemes can take a variety of forms. Here's a description of the two most common:

The Classic "Pump and Dump" Scheme. It's common to see messages posted on the Internet that urge readers to buy a stock quickly or to sell before the price goes down, or a telemarketer will call using the same sort of pitch. Often the promoters will claim to have "inside" information about an impending development or to use an "infallible" combination of economic and stock market data to pick stocks. In reality, they may be company insiders or paid promoters

who stand to gain by selling their shares after the stock price is pumped up by the buying frenzy they create. Once these con artists sell their shares and stop hyping the stock, the price typically falls, and investors lose their money.
The Off-Shore Scam. Under a rule known as "Regulation S," companies do not have to register stock they sell outside the United States to foreign or "off-shore" investors. In the typical off-shore scam, an unscrupulous microcap company sells unregistered Reg. S stock at a deep discount to con artists posing as foreign investors. These con artists then sell the stock to U.S. investors at inflated prices, pocketing huge profits, which they share with the microcap company insiders. The flood of unregistered stock into the U.S. eventually causes the price to plummet, leaving unsuspecting U.S. investors with enormous losses.
The SEC recently strengthened Reg. S to make this type of fraud harder to conduct.

How Do I Get Information About Microcap Companies?

If you're working with a broker or an investment adviser, you can ask your investment professional if the company files reports with the SEC and to get you written information about the company and its business, finances, and management. Be sure to carefully read the prospectus and the company's latest financial reports.

You can also get information on your own from these sources:

- *From the company.* Ask the company if it is registered with the SEC and files reports with us. If the company is small and unknown to most people, you should also call your state securities regulator to get information about the company, its management, and the brokers or promoters who've encouraged you to invest in the company.
- *From the SEC.* A great many companies must file their reports with the SEC. Using the EDGAR database, you can find out whether a company files with the SEC, and get any reports you're interested in. For companies that do not file on EDGAR, check with the SEC's Public Reference Room to see whether the company has filed an offering circular under Reg. A.
- *From your state securities regulator.* We strongly urge you to contact your state securities regulator to find out whether they have information about a company and the people behind it. Look in the government section of your phone book or visit the website of the North American Securities Administrators Association to get the relevant name and phone number. Even though the company does not have to register its securities with the SEC, it may have to register them with your state. Your

regulator will tell you whether the company has been legally cleared to sell securities in your state.

- *From other government regulators.* Many companies, such as banks, do not have to file reports with the SEC. But banks must file updated financial information with their banking regulators.
- *From reference books and commercial databases.* Visit your local public library or the nearest law or business school library. You'll find many reference materials containing information about companies. You can also access commercial databases for more information about the company's history, management, products or services, revenues, and credit ratings. But there are a number of commercial resources you may consult, including: Bloomberg, Dun & Bradstreet, Hoover's Profiles, Lexis-Nexis, and Standard & Poor's Corporate Profiles.
- *The Secretary of State Where the Company Is Incorporated.* Contact the secretary of state where the company is incorporated to find out whether the company is a corporation in good standing. You may also be able to obtain copies of the company's incorporation papers and any annual reports it files with the state.

If you've been asked to invest in a company but you can't find any record that the company has registered its securities with the SEC or your state, or that it's exempt from registration, call or write your state's securities regulator or the SEC immediately with all the details. You may have come face to face with a scam.

Steps You Should Take Before Investing

To invest wisely and avoid investment scams, research each investment opportunity thoroughly and ask questions. These simple steps can make the difference between profits and losses:

1. Find out whether the company has registered its securities with the SEC or your state's securities regulators.
2. Make sure you understand the company's business and its products or services.
3. Read the most recent reports the company has filed with its regulators and pay attention to the company's financial statements, particularly if they are not audited or not certified by an accountant. If the company does not file reports with the SEC, be sure to ask your broker for what's called the "Rule 15c2-11 file" on the company. That file will contain important information about the company.
4. Check out the people running the company with your state securities regulator, and find out if they've ever made money for investors before. Also ask whether the people running the company have had run-ins with the regulators or other investors.

5. Make sure the broker and his or her firm are registered with the SEC and licensed to do business in your state. And ask your state securities regulator whether the broker and the firm have ever been disciplined or have complaints against them.

Also, watch out for these "red flags":

- *SEC Trading Suspensions.* The SEC has the power to suspend trading in any stock for up to 10 days when it believes that information about the company is inaccurate or unreliable. Think twice before investing in a company that's been the subject of an SEC trading suspension.
- *High Pressure Sales Tactics.* Beware of brokers who pressure you to buy before you have a chance to think about and investigate the "opportunity." Dishonest brokers may try to tell you about a "once-in-a-lifetime" opportunity or one that's based on "inside" or "confidential" information. Don't fall for brokers who promise spectacular profits or "guaranteed" returns. These are the hallmarks of fraud. If the deal sounds too good to be true, then it probably is.
- *Assets Are Large But Revenues Are Small.* Microcap companies sometimes assign high values on their financial statements to assets that have nothing to do with their business. Find out whether there's a valid explanation for low revenues, especially when the company claims to have large assets.
- *Odd Items in the Footnotes to the Financial Statements.* Many microcap fraud schemes involve unusual transactions among individuals connected to the company. These can be unusual loans or the exchange of questionable assets for company stock, which may be discussed in the footnotes.
- *Unusual Auditing Issues.* Be wary when a company's auditors have refused to certify the company's financial statements or if they've stated that the company may not have enough money to continue operating. Also question any change of accountants.
- *Insiders Own Large Amounts of the Stock.* In many microcap fraud cases - especially "pump and dump" schemes - the company's officers and promoters own significant amounts of the stock. When one person or group controls most of the stock, they can more easily manipulate the stock's price at your expense. You can ask your broker or the company whether one person or group controls most of the company's stock, but if the company is the subject of a scam, you may not get an honest answer.

Don't deal with brokers who refuse to provide you with written information about the investments they're promoting.

Never tell a cold caller your social security number or numbers for your banking and securities accounts.

Be extra wary if someone you don't know and trust recommends foreign investments.

Annuities: How They Work and When You Should Use Them

Annuities may help you meet some of your mid and long-range goals such as planning for your retirement and for a child's college education. This Financial Guide tells you how annuities work, discusses the various types of annuities, and helps you determine which annuity product (if any) suits your situation. It also discusses the tax aspects of annuities and explains how to shop for both an insurance company and an annuity, once you know which type you'll need.

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How Annuities Work

While traditional life insurance guards against "dying too soon," an annuity, in essence, can be used as insurance against "living too long." In brief, when you buy an annuity (generally from an insurance company, that invests your funds), you in turn receive a series of periodic payments that are guaranteed as to amount and payment period. Thus, if you choose to take the annuity payments **over your lifetime** (keep in mind that there are many other options), you will have a guaranteed source of "income" until your death. If you "die too soon" (that is, you **don't** outlive your life expectancy), you will get back from the insurer far **less** than you paid in. On the other hand, if you "live too long" (and **do** outlive your life expectancy), you may get back far **more** than the cost of your annuity (and the resultant earnings). By comparison, if you put your funds into a traditional investment, you may run out of funds before your death.

The earnings that occur during the term of the annuity are tax-deferred. You are not taxed on them until they are paid out. Because of the tax deferral, your funds have the chance to grow more quickly than they would in a taxable investment.

How Annuities Best Serve Investors

> **Tip:** Assess the costs of an annuity relative to the alternatives. Separate purchase of life insurance and tax-deferred investments may be more cost effective.

The two primary reasons to use an annuity as an investment vehicle are:

1. You want to save money for a long-range goal, and/or
2. You want a guaranteed stream of income for a certain period of time.

Annuities lend themselves particularly well to funding retirement and, in certain cases, education costs.

One negative aspect of an annuity is that you cannot get to your money during the growth period without incurring taxes and penalties. The tax code imposes a 10 percent premature-withdrawal penalty on money taken out of a tax-deferred annuity before age 59½, and insurers impose penalties on withdrawals made before the term of the annuity is up. The insurers' penalties are termed "surrender charges," and they usually apply for the first seven years of the annuity contract.

These penalties lead to a de facto restriction on the use of annuities primarily as an investment. It only makes sense to put your money into an annuity if you can leave it there for at least ten years and the withdrawals are scheduled to occur after age 59½. These restrictions explain why annuities work well for either retirement needs or for cases of education funding where the depositor will be at least 59½ when withdrawals begin.

> **Tip:** The greater the investment return, the less punishing the 10 percent penalty on withdrawal under age 59½ will appear. If your variable annuity

investments have grown substantially, you may want to consider taking some of those profits (despite the penalty, which applies only to the taxable portion of the amount withdrawn).

Annuities can also be effective in funding education costs where the annuity is held in the child's name under the provisions of the Uniform Gifts to Minors Act. The child would then pay tax (and 10 percent penalty) on the earnings when the time came for withdrawals.

Caution: A major drawback is that the child is free to use the money for any purpose, not just education costs.

Types Of Annuities

The available annuity products vary in terms of (1) how money is paid into the annuity contract, (2) how money is withdrawn, and (3) how the funds are invested. Here is a rundown on some of the annuity products you can buy:

- **Single-Premium Annuities:** You can purchase a single-premium annuity, in which the investment is made **all at once** (perhaps using a lump sum from a retirement plan payout). The minimum investment is usually $5,000 or $10,000.
- **Flexible-Premium Annuities:** With the flexible-premium annuity, the annuity is funded with a **series** of payments. The first payment can be quite small.
- **Immediate Annuities**: The immediate annuity starts payments right after the annuity is funded. It is usually funded with a single premium and is usually purchased by retirees with funds they have accumulated for retirement.
- **Deferred Annuities**: With a deferred annuity, payouts begin many years after the annuity contract is issued. You can choose to take the scheduled payments either in a lump sum or as an annuity, that is, as regular annuity payments over some guaranteed period. Deferred annuities are used as long-term investment vehicles by retirees and non-retirees alike. They are used to fund tax-deferred retirement plans and tax-sheltered annuities. They may be funded with a single or flexible premium.
- **Fixed Annuities**: With a fixed annuity contract, the insurance company puts your funds into conservative fixed income investments such as bonds. Your principal is guaranteed and the insurance company gives you an interest rate that is guaranteed for a certain minimum period from a month to several years. This guaranteed interest rate is adjusted upwards or downwards at the end of the guarantee period. Thus, the fixed annuity contract is similar to a CD or a money market fund, depending on the length of the period during which interest is guaranteed. The fixed annuity is considered a low-risk investment vehicle. All fixed annuities also guarantee you a certain minimum rate of interest of 3 to 5 percent for the entirety of the contract. The

fixed annuity is a good choice for investors with a low-risk tolerance and a short-term investing time horizon. The growth that will occur will be relatively low. Fixed annuity investors benefit if interest rates fall, but not if they rise.

- **Variable Annuities**: The variable annuity, which is considered to carry with it higher risks than the fixed annuity--about the same risk level as a mutual fund investment--gives you the ability to choose how to allocate your money among several different managed funds. There are usually three types of funds: stocks, bonds, and cash-equivalents. Unlike the fixed annuity, there are no guarantees of principal or interest. However, the variable annuity does benefit from tax deferral on the earnings.

> **Tip:** You can switch your allocations from time to time for a small fee or sometimes for free.

The variable annuity is a good annuity choice for investors with a moderate to high-risk tolerance and a long-term investing time horizon.

> **Caution:** Variable annuities have higher costs than similar investments that are not issued by an insurance company.

> **Caution:** The taxable portion of variable annuity distributions is taxable at full ordinary rates, even if they are based on stock investments. Unlike dividends from stock investments (including mutual funds), there is no capital gains relief.

> **Tip:** Annuities are available that combine both fixed and variable features.

> **Tip:** Before buying an annuity, contribute as much as possible to other tax-deferred options such as IRA's and 401 (k) plans. The reason is that the fees for these plans are likely to be lower than those of an annuity and early-withdrawal fees on annuities tend to be steep.

> **Tip:** IRA contributions are sometimes invested in flexible premium annuities with IRA deduction, if otherwise available. You may prefer to use IRAs for non-annuity assets. Non-annuity assets gain the ability to grow tax-free when held in an IRA. The IRA regime adds no such benefit to annuity assets which grow tax-free in or outside IRAs.

Choosing A Payout Option

When it's time to begin taking withdrawals from your deferred annuity, you have a number of choices. Most people choose a monthly annuity-type payment, although a lump sum withdrawal is also possible.

> **Caution:** Once you have chosen a payment option, you cannot change your mind.

The size of your payout (settlement option) depends on:

1. The size of the amount in your annuity contract
2. Whether there are minimum required payments
3. Your life expectancy (or other payout period)
4. Whether payments continue after your death

Here are summaries of the most common forms of payout:

Fixed Amount

This type gives you a fixed monthly **amount** (chosen by you) that continues until your annuity is used up. The risk of using this option is that you may live longer than your money lasts. Thus, if the annuity is your only source of income, the fixed amount is not a good choice. And, if you die before your annuity is exhausted, your beneficiary gets the rest.

Fixed Period

This option pays you a fixed amount over the time **period** you choose. For example, you might choose to have the annuity paid out over ten years. If you are seeking retirement income before some other benefits start, this may be a good option. If you die before the period is up, your beneficiary gets the remaining amount.

Lifetime or Straight Life

This type of payment continues until you die. There are no payments to survivors. The life annuity gives you the highest monthly benefit of the options listed here. The risk is that you will die early, thus leaving the insurance company with some of your funds. The life annuity is a good choice if (1) you do not need the annuity funds to provide for the needs of a beneficiary and (2) you want to maximize your monthly income.

Life With Period Certain

This form of payment gives you payments as long as you live (as does the life annuity) but with a minimum period during which you or your beneficiary will receive payments, even if you die earlier than expected. The longer the guarantee period, the lower the monthly benefit.

Installment-Refund

This option pays you as long as you live and guarantees that, should you die early, whatever is left of your original investment will be paid to a beneficiary. Monthly payments are less than with a straight life annuity.

Joint And Survivor

In one joint and survivor option, monthly payments are made during the annuitants' joint lives, with the same or a lesser amount paid to whoever is the survivor. In the option typically used for retired employees (employment model), monthly payments are made to the retired employee, with the same or a lesser amount to the employee's surviving spouse or another beneficiary. The difference is that with the employment model, the spouse's (or other co annuitant's) death before the employee won't affect what the survivor employee collects. The amount of the monthly payments depends on the annuitants' ages, and whether the survivor's payment is to be 100 percent of the joint amount or some lesser percentage.

How Payouts Are Taxed

The way your payouts are taxed differs for qualified and non-qualified annuities.

Qualified Annuity

A tax-qualified annuity is one used to fund a qualified retirement plan, such as an IRA, Keogh plan, 401(k) plan, SEP (simplified employee pension), or some other retirement plan. The tax-qualified annuity, when used as a retirement savings vehicle, is entitled to all of the tax benefits (and penalties) that Congress saw fit to attach to such qualified plans.

The tax benefits are:

1. Any nondeductible or after-tax amount you put into the plan is not subject to income tax when withdrawn
2. The earnings on your investment are not taxed until withdrawal

If you withdraw money from a qualified plan annuity before the age of 59½, you will have to pay a 10 percent penalty on the amount withdrawn in addition to paying the regular income tax. There are exceptions to the 10 percent penalty, including an exception for taking the annuity out in a series of equal periodic payments over the rest of your life.

Once you reach age 70½, you will have to start taking withdrawals in certain minimum amounts specified by the tax law (with exceptions for Roth IRAs and for employees still working after age 70½).

Non-Qualified Annuity

A non-qualified annuity is purchased with **after-tax** dollars. You still get the benefit of tax deferral on the earnings; however, you pay tax on the part of the withdrawals that represent earnings on your original investment.

If you make a withdrawal before the age of 59½, you will pay the 10 percent penalty only on the portion of the withdrawal that represents earnings.

With a non-qualified annuity, you are not subject to the minimum distribution rules that apply to qualified plans after you reach age 70½.

Tax on Your Beneficiaries or Heirs

If your annuity is to continue after your death, other taxes may apply to your beneficiary (the person you designate to take further payments) or your heirs (your estate or those who take through the estate if you didn't designate a beneficiary).

Income tax: Annuity payments collected by your beneficiaries or heirs are subject to tax on the same principles that would apply to payments collected by you.

Exception: There's no 10 percent penalty on withdrawal under age 59½ regardless of the recipient's age, or your age at death.

Estate tax: The present value at your death of the remaining annuity payments is an asset of your estate, and subject to estate tax with other estate assets. Annuities passing to your surviving spouse or to charity would escape this tax.

If a particular fund has a great track record, ascertain whether the same management is still in place. Although past performance is no guarantee, consistent management will grant you better odds.

How To Shop For An Annuity

Although annuities are typically issued by insurance companies, they may also be purchased through banks, insurance agents, or stockbrokers.

There is considerable variation in the amount of fees that you will pay for a given annuity as well in the quality of the product. Thus, it is important to compare costs and quality before buying an annuity.

First, Check Out The Insurer

Before checking out the product itself, it is important to make sure that the insurance company offering it is financially sound. Because annuity investments are not federally guaranteed, the soundness of the insurance company is the only assurance you can rely on. Consult services such as A.M. Best Company, Moody's Investor Service, or Standard & Poor's Ratings to find out how the insurer is rated.

Next, Compare Contracts

The way you should go about comparing annuity contracts varies with the type of annuity.

- *Immediate annuities*: Compare the settlement options. For each $1,000 invested, how much of a monthly payout will you get? Be sure to consider the interest rate and any penalties and charges.
- *Deferred annuities*: Compare the rate, the length of guarantee period, and a five-year history of rates paid on the contract. It is important to consider all three of these factors and not to be swayed by high interest rates alone.
- *Variable annuities*: Check out the past performance of the funds involved.

If a particular fund has a great track record, ascertain whether the same management is still in place. Although past performance is no guarantee, consistent management will grant you better odds.

Costs, Penalties, And Extras

Be sure to compare the following points when considering an annuity contract:

Surrender Penalties

Find out the surrender charges (that is, the amounts charged for early withdrawals). The typical charge is seven percent for first-year withdrawals, six percent for the second year, and so on, with no charges after the seventh year. Charges that go beyond seven years, or that exceed the above amounts, should not be acceptable.

> **Tip:** Be sure the surrender charge "clock" starts running with the date your contract begins, not with each new investment.

Fees And Costs

Be sure to ask about all other fees. With variable annuities, the fees must be disclosed in the prospectus. Fees lower your return, so it is important to know about them. Fees might include:

- Mortality fees of 1 to 1.35 percent of your account (protection for the insurer in case you live a long time)
- Maintenance fees of $20 to $30 per year
- Investment advisory fees of 0.3 percent to 1 percent of the assets in the annuity's portfolios.

Extras

These provisions are not costs per se, but should be asked about before you invest in the contract.

Some annuity contracts offer "bail-out" provisions that allow you to cash in the annuity if interest rates fall below a stated amount without paying surrender charges.

There may also be a "persistency" bonus which rewards annuitants who keep their annuities for a certain minimum length of time.

In deciding whether to use annuities in your retirement planning (or for any other reason) and which types of annuities to use, professional guidance is advisable.

Risk To Retirees of Using An Immediate Annuity

At first glance, the immediate annuity would seem to make sense for retirees with lump-sum distributions from retirement plans. After all, an initial lump-sum premium can be converted into a series of monthly, quarterly, or yearly payments that represent a portion of principal plus interest and is guaranteed to last for life. The portion of the periodic payout that constitutes a return of principal is excluded from taxable income.

However, this strategy contains risks. For one thing, when you lock yourself into a lifetime of level payments, you fail to guard against inflation. Furthermore, you are gambling that you will live long enough to get your money back. Thus, if you buy a $150,000 annuity and die after collecting only $60,000, the insurer often gets to keep the rest. Unlike other investments, the balance doesn't go to your heirs. Finally, since the interest rate is fixed by the insurer when you buy it, you may be locking yourself into low rates.

You can hedge your bets by opting for a "period certain," or "term certain" which, in the event of your death, guarantees payment for some years to your beneficiaries. There are also "joint-and-survivor" options (which pay your spouse for the remainder of his or her life after you die) or a "refund" feature (in which some or all of the remaining principal is resumed to your beneficiaries).

Some plans offer quasi-inflation adjusted payments. One company offers a guaranteed increase in payments of $10 at three-year intervals for the first 15 years. Payments then get an annual cost-of-living adjustment with a three percent maximum. However, for these enhancements to apply, you will have to settle for much lower monthly payments than the simple version.

Recently, a few companies have introduced immediate annuities that offer potentially higher returns in return for some market risk. These "variable immediate annuities" convert an initial premium into a lifetime income; however, they tie the monthly payments to the returns on a basket of mutual funds.

Older seniors--75 years of age and up--may have fewer worries about inflation or liquidity. Nevertheless, they should question whether they really need such annuities at all.

If you want a comfortable retirement income, consider a balanced portfolio of mutual funds. If you want to guarantee that you will not outlive your money, you can plan your withdrawals over a longer time horizon.

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10 Retirement Saving Tips

1. **Save As Much As You Can As Early As You Can.**
   Though it's never too late to start, the sooner you begin saving, the more time your

money has to grow. Gains each year build on the prior year's -- that's the power of compounding, and the best way to accumulate wealth.

2. **Set Realistic Goals.**
   Project your retirement expenses based on your needs, not rules of thumb. Be honest about how you want to live in retirement and how much it will cost. Then calculate how much you must save to supplement Social Security and other sources of retirement income.
3. **A 401(k) Is One Of The Easiest And Best Ways To Save For Retirement.**
   Contributing money to a 401(k) gives you an immediate tax deduction, tax-deferred growth on your savings, and - usually - a matching contribution from your company.
4. **An IRA Can Also Give Your Savings A Tax-Advantaged Boost.**
   Like a 401(k), IRAs offer huge tax breaks. There are two types: a traditional IRA offers tax-deferred growth, meaning you pay taxes on your investment gains only when you make withdrawals, and, if you qualify, your contributions may be deductible; a Roth IRA, by contrast, doesn't allow for deductible contributions but offers tax-free growth, meaning you owe no tax when you make withdrawals, but contributions are not deductible.
5. **Focus On Your Asset Allocation More Than On Individual Picks.**
   How you divide your portfolio between stocks and bonds will have a big impact on your long-term returns.
6. **Stocks Are Best For Long-Term Growth.**
   Stocks have the best chance of achieving high returns over long periods. A healthy dose will help ensure that your savings grows faster than inflation, increasing the purchasing power of your nest egg.
7. **Don't Move Too Heavily Into Bonds, Even In Retirement.**
   Many retirees stash most of their portfolio in bonds for the income. Unfortunately, over 10 to 15 years, inflation easily can erode the purchasing power of bonds' interest payments.
8. **Making Tax-Efficient Withdrawals Can Stretch The Life Of Your Nest Egg.**
   Once you're retired, your assets can last several more years if you draw on money from taxable accounts first and let tax-advantaged accounts compound for as long as possible.
9. **Working Part-Time In Retirement Can Help In More Ways Than One.**
   Working keeps you socially engaged and reduces the amount of your nest egg you must withdraw annually once you retire.
10. **There Are Other Creative Ways To Get More Mileage Out Of Retirement Assets.**
    You might consider relocating to an area with lower living expenses or transforming the equity in your home into income by taking out a reverse mortgage.

Your Retirement Plan: How To Get Started

The number of people who are financially unprepared for retirement is staggering. One study revealed that more than half of the adults in the U.S. were planning to depend solely on Social Security for retirement income. Another study indicated that the great majority of Americans do not save nearly enough money. This Financial Guide provides you with the information you need to get started on this important task.

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To enjoy your retirement years, you need to begin planning early. With longer life expectancies and the growing senior population, people need to begin planning and saving for retirement in their 30s or even sooner. Adequate planning can help to ensure that you will not outlive your savings and that you will not become financially dependent on others.

It is never too late to start or to improve a retirement plan. This Financial Guide shows you the basics of retirement planning, and will enable you to get started or to revamp an existing plan. Basically, there are three steps to retirement planning:

1. Estimating your retirement income
2. Estimating your retirement needs
3. Deciding on investments

> In making estimates of future income needs and sources of income, be sure to estimate conservatively. This will ensure that you do not shortchange yourself.

Estimating Your Retirement Income

Most people have three possible sources of retirement income: (1) Social Security, (2) pension payments, and (3) savings and investments. The income that will have to be provided through savings and investments (which you can plan for) can be determined only after you have estimated the income you can expect from Social Security and from any pension plans (over which you have little control).

Social Security

Estimate how much you can expect in the way of Social Security retirement income. To do this, you should file a "Request for Earnings and Benefits Estimate" with the Social Security Administration. This form can be obtained from SSA by calling their toll-free number: 800-772-1213. You can also request a benefits statement online through the Social Security Administrations Web Site.

> **Planning Aid:** You can also request a benefits statement online through the Social Security Administration's Web site.
>
> Many people are being sent estimates of their future Social Security benefits without having to make a request. You may have received such an estimate in the mail.

The amount of Social Security benefits you will receive depends on how long you worked, the age at which you begin receiving benefits, and your total earnings.

If you wait until your full retirement age (65 to 67, depending on your year of birth) to begin receiving benefits, your monthly retirement benefit will be larger than if you elect to receive benefits beginning at age 62. The full retirement age will increase gradually to age 67 by the year 2027.

> Be aware that Social Security benefits may be subject to income tax. The basic rule is that if your adjusted gross income plus tax-exempt interest plus half of your Social Security benefits are more than $25,000 for an individual or more than $32,000 for a couple, then some portion of your Social Security benefit will be subject to income tax. The amount that is subject to tax increases as the level of adjusted gross income goes up.

Pension Plans

Estimate how much you can expect to receive from a traditional pension plan or other retirement plan. If you are covered by a traditional pension plan and you are vested, ask your employer for a projection of what you can expect to receive if you continue working until retirement age or under other circumstances, for example, if you terminate before retirement age. You may already have received such an estimate.

If you are covered by a 401(k) plan, a profit-sharing plan, a Keogh plan, or a Simplified Employee Pension, make an estimate of the lump sum that will be available to you at retirement age. You may be able to get help with this estimate from your employer.

> If you are in the military or formerly served in the military, contact the relevant branch of service to find out about retirement benefits.

Establishing Goals For Retirement

Determine how much income you will need (or want) after retirement. Once you have determined this amount, you can figure out how much you will need to put away to have a big enough nest egg to fund your desired income level.

Many people don't realize that their retirement could last as long as their careers: 35 years or longer. Your nest egg may have to last much longer than you might think. Remember that the earlier you retire, the more you will have to save. If you want to retire at age 55, you'll have to save a lot more than if you retire at age 65.

A general guideline is that you will want to have at least 70 percent of whatever income stream you have before retirement. If you have any special needs or desires, for example, a desire to travel extensively-the percentage should be adjusted upward. The 70 percent figure is not a substitute for a thorough analysis of your income needs after retirement, but is only a guideline.

Here are some suggestions for estimating how much of an income stream you will want to have coming in after retirement:

Figure Your Current Annual Expenses. The first step in trying to figure out what your annual expenses will be after retirement is to figure what your expenses are now. Take a year's worth of checkbook, credit card, and savings account records, and add up what you paid for insurance, mortgage, food, household expenses, and so on.

Figure Out How Your Expenses Will Differ After Retirement. After you retire, your expenses will generally be a lot lower than they are while you are working. To help determine how much lower, here are some questions you might ask yourself:

- Will your mortgage be paid off?
- Will you still be paying for commuting expenses?
- How much will you pay for health insurance?

If you are not among the lucky few that will have post-retirement health insurance coverage from an ex-employer, you will probably pay more for health coverage after you retire and have to take out so-called "Medigap" coverage.

- Will you increase or decrease your life insurance coverage?
- How much will you pay for travel expenses? (Do you want to travel after you retire, either on vacation or to visit relatives? Will you be commuting between a winter and summer home?)
- Will you be spending more on hobbies after retirement?
- Will your children be financially independent by the time you retire or will you have to factor in some sort of support for them?
- Will your income tax bills be the same, lower, or higher?

If you are planning to retire to another state, take into account the different state taxes you will be paying.

The answers to these questions will help you determine your estimated annual expenses after retirement. Then subtract from this estimate the anticipated annual income from already-viable sources. (Do not subtract the lump-sum payments you expect to receive, for example, lump sum payments from 401(k) plans, which will be discussed later). The difference is the annual shortfall that will have to be financed by the nest egg you will need to accumulate.

How do you determine how much you need to save each year to accumulate a nest egg of that size by retirement age? You can do this by using the table below which, assumes an after-tax return of 5 percent per year. Just multiply the required nest egg by the Savings Multiplier for the number of years until retirement.

You are 40 years old and want to retire at age 65. You determine that you need a nest egg of $350,000 to fund your annual shortfall. To find out how much you must save each year to have that $350,000 nest egg by the time you are 65, multiply $350,000 by the 25-year savings multiplier (2.1 percent). You will need to save $7,350 (2.1 percent times $350,000) a year for 25 years.

Subtract from this nest egg any lump sums that you expect to receive at retirement. To project the value at retirement of a present asset (retirement account, savings, investments, etc.); multiply the current value of this asset by the Growth Multiplier for the number of years until retirement.

You already have $75,000 in a 401(k) plan. To find out what that amount will grow to in 25 years, multiply it by the growth multiplier for 25 years. This $75,000 will grow to $254,250 (339 percent times $75,000) by the time you retire. Subtract this $254,250 from the $350,000 needed in the previous example. This amount ($95,750) is the amount you must accumulate by age 65 to meet the income shortfall. Multiply this $95,750 by the 25-year savings multiplier (2.1 percent). You now know that, after taking the projected lump sum into consideration, you will still need to save $2,010.75 per year to accumulate $95,750.

Years Until Retirement	Savings Multiplier	Growth Multiplier
5	18.1%	128%
10	8.0%	163%
15	4.6%	208%
20	3.0%	265%
25	2.1%	339%
30	1.5%	432%

Deciding on Investments

Generally, the longer you have until retirement, the more of your savings should be invested in vehicles with a potential for growth. If you are very close to or at retirement, you may wish to put the bulk of your savings into low-risk investments. However, this formula is subject to your own financial profile: your tolerance for risk, your income level, your other sources of retirement income (e.g., pension payments), and your unique needs.

Here is a summary of the pros and cons of various retirement-savings investments and their pros and cons. Please note that each of these is discussed in more detail in related Financial Guides.

Tax-Deferred Retirement Vehicles

Each year, maximize your deposits in a 401(k) plan, an IRA, a Keogh plan, or some other form of tax-deferred savings. Because this money grows tax-deferred, returns will be greater. Further, if the amount you put in is deductible, you are reducing your income tax base.

Lowest Risk Investments

Money market funds, CDs, and Treasury bills are the most conservative investments. However, of the three, only the Treasury bills offer a rate that will keep up with inflation. For the average individual saving for retirement, it is recommended that these vehicles make up only a portion of investments.

Bonds

Bonds provide a fixed rate of income for a certain period. The income from bonds is higher than income from Treasury bills.

Bonds fluctuate in value depending on interest rates, and are thus riskier than the lowest risk investments. If bonds are used as a conservative investment, it is a good idea to use those of a shorter term, to minimize the fluctuation in value that might occur.

Stocks

Although common stock is riskier than any other investment yet discussed, it offers greater return potential.

Mutual Funds

Mutual funds are an excellent retirement savings vehicle. By balancing a mutual fund portfolio to minimize risk and maximize growth, a higher return can be achieved than with safer investments.

Roth IRAs: How They Work and How To Use Them

Roth IRAs differ from other tax-favored retirement plans, including other IRAs (called "traditional IRAs"), in that they promise complete tax exemption on distribution. There are other important differences as well, and many qualifications about their use. This Financial Guide shows how they work, how they compare with other retirement devices--and why YOU might want one, or more.

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- Converting From a Traditional IRA or Other Retirement Plan
- Undoing a Conversion to a Roth IRA
- Withdrawal Requirements
- Retirement Savings Contributions Credit
- Use in Estate Planning

With most tax-favored retirement plans, the contribution to (i.e., investment in) the plan is deductible, the investment compounds tax-free until distributed, and distributions are taxable as received. There are variations from this pattern, as with 401(k)s where the exemption for salary diverted to a 401(k) takes the place of a deduction and for after-tax investments where invested capital is tax-free when distributed.

With a Roth IRA, there's never an up-front deduction for contributions. Funds contributed compound tax-free until distributed (standard for all tax-favored plans) and distributions are completely exempt from income tax.

How Contributions Are Treated

The 2022 annual contribution limit to a Roth IRA is $6,000 (same as 2021). An additional "catch-up" contribution of $1,000 (same as 2021) is allowed for people age 50 or over bringing the contribution total to $7,000 for certain taxpayers. To make the full contribution, you must earn at least $6,000 ($7,000 if age 50 or older) from personal services and have income (modified adjusted gross income or MAGI) below $129,000 if single or $204,000 on a joint return in 2022. The $6000 limit in 2022 phases out on incomes between $129,000 and $144,000 (single filers) and $204,000 and $214,000 (joint filers). Also, the $6,000 limit is reduced for contributions to traditional IRAs though not SEP or SIMPLE IRAs.

You can contribute to a Roth IRA for your spouse, subject to the income limits above. So assuming earnings (your own or combined with your spouse) of at least $12,000, up to $12,000 ($6,000 each) can go into the couple's Roth IRAs. As with traditional IRAs, there's a six percent penalty on excess contributions. The rule continues that the dollar limits are reduced by contributions to traditional IRAs.

How Withdrawals Are Treated

You may withdraw money from a Roth IRA at any time; however, taxes and penalty could apply depending on the timing of contributions and withdrawals.

Qualified Distributions

Since all your investments in a Roth IRA are after-tax, your withdrawals, whenever you make them, are often tax-free. But the best kind of withdrawal, which allows earnings, as well as contributions and conversion, amounts to come out completely tax-free, are qualified distributions. These are withdrawals meeting the following conditions:

1. At least, five years have elapsed since the first year a Roth IRA contribution was made or, in the case of a conversion since the conversion occurred and

2. At least **one** of these additional conditions is met:

- The owner is age 59 1/2.
- The owner is disabled.
- The owner has died (distribution is to estate or heir).
- Withdrawal is for a first-time home that you build, rebuild, or buy (lifetime limit up to $10,000).

    A distribution used to buy, build or rebuild a first home must be used to pay qualified costs for the main home of a first-time home buyer who is either yourself, your spouse or you or your spouse's child, grandchild, parent or another ancestor.

Non-Qualified Distributions

To discourage the use of pension funds for purposes other than normal retirement, the law imposes an additional 10 percent tax on certain early distributions from Roth IRAs unless an exception applies. Generally, early distributions are those you receive from an IRA before reaching age 59 1/2.

Exceptions. You may not have to pay the 10 percent additional tax in the following situations:

- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You use the distribution to pay certain qualified first-time homebuyer amounts.
- The distributions are part of a series of substantially equal payments.
- You have significant unreimbursed medical expenses.
- You are paying medical insurance premiums after losing your job.
- The distributions are not more than your qualified higher education expenses.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Part of any distribution that is not a qualified distribution may be taxable as ordinary income and subject to the additional 10 percent tax on early distributions. Distributions of conversion contributions within a 5-year period following a conversion may be subject to the 10 percent early distribution tax, even if the contributions have been included as income in an earlier year.

Ordering Rules for Distributions

If you receive a distribution from your Roth IRA, that is not a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Order the distributions as follows.

1. Regular contributions.
2. Conversion contributions, on a first-in-first-out basis (generally, total conversions from the earliest year first). See Aggregation (grouping and adding) rules, later. Take these conversion contributions into account as follows:
   - Taxable portion (the amount required to be included in gross income because of conversion) first, and then the
   - Nontaxable portion.
3. Earnings on contributions.

Disregard rollover contributions from other Roth IRAs for this purpose.

Aggregation (grouping and adding) rules.

Determine the taxable amounts distributed (withdrawn), distributions, and contributions by grouping and adding them together as follows.

- Add all distributions from all your Roth IRAs during the year together.
- Add all regular contributions made for the year (including contributions made after the close of the year, but before the due date of your return) together. Add this total to the total undistributed regular contributions made in prior years.
- Add all conversion and rollover contributions made during the year together.

For years prior to 2018, add any recharacterized contributions that end up in a Roth IRA to the appropriate contribution group for the year that the original contribution would have been taken into account if it had been made directly to the Roth IRA. Disregard any recharacterized contribution that ends up in an IRA other than a Roth IRA for the purpose of grouping (aggregating) both contributions and distributions. Also, disregard any amount withdrawn to correct an excess contribution (including the earnings withdrawn) for this purpose.

On October 15, 2016, Justin converted all $80,000 in his traditional IRA to his Roth IRA. His Forms 8606 from prior years show that $20,000 of the amount converted is his basis. Justin included $60,000 ($80,000 - $20,000) in his gross income. On February 23, 2017, Justin makes a regular contribution of $4,000 to a Roth IRA. On November 7, 2017, at age 60, Justin takes a $7,000 distribution from his Roth IRA.

- The first $4,000 of the distribution is a return of Justin's regular contribution and is not includible in his income.
- The next $3,000 of the distribution is not includible in income because it was included previously.

Distributions after Owner's Death

Qualified distributions after the owner's death are tax-free to heirs. Nonqualified distributions after death, which are distributions where the 5-year holding period wasn't met, are taxable income to heirs as they would be to the owner (the earnings are taxed), except there's no penalty tax on early withdrawal. However, an owner's surviving spouse can convert an inherited Roth IRA into his or her own Roth IRA. This way, distribution can be postponed, so that nonqualified amounts can become qualified, and the tax shelter prolonged.

Roth IRA assets left at death are subject to federal estate tax, just as traditional IRA assets are.

Converting from a Traditional IRA or Other Eligible Retirement Plan to a Roth IRA

The conversion of your traditional IRA to a Roth IRA was the feature that caused most excitement about Roth IRAs. Conversion means that what would be a taxable traditional IRA distribution can be made into a tax-exempt Roth IRA distribution. Starting in 2008, further conversion or rollover opportunities from other eligible retirement plans were made available to taxpayers.

Conversion Methods

You can convert a traditional IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used.

You can convert amounts from a traditional IRA to a Roth IRA in any of the following three ways.

- **Rollover.** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.

- **Trustee-to-trustee transfer.** You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
- **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

  Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Prior to 2008, you could only roll over (convert) amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You can now roll over amounts from the following plans into a Roth IRA.

- A qualified pension, profit-sharing or stock bonus plan (including a 401(k) plan),
- An annuity plan,
- A tax-sheltered annuity plan (section 403(b) plan),
- A deferred compensation plan of a state or local government (section 457 plan), or
- An IRA.

Any amount rolled over is subject to the same rules for converting a traditional IRA to a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

There is a cost to the rollover. The amount converted is fully taxable in the year converted, except for the portion of after-tax investment in the traditional IRA. So you must pay tax now (though there's no early withdrawal penalty) for the opportunity to withdraw tax-free later, an opportunity that can extend to your heirs.

Undoing a Conversion to a Roth IRA

> The information in this section only applies to taxable years beginning after December 31, 2017.
> Under tax reform (Tax Cuts and Jobs Act of 2017), if a contribution to a regular IRA has been converted into a contribution to a Roth IRA, it can no longer be converted back into a contribution to a regular IRA. This provision prevents a taxpayer from using recharacterization to unwind a Roth conversion.

Since everyone recognizes that conversion is a high-risk exercise, the law, and liberal IRS rules provide an escape hatch: You can undo a Roth IRA conversion by what IRS calls a "recharacterization." This move, by which you move your conversion assets from a Roth IRA back to a traditional IRA, makes what would have been a taxable conversion into a tax-free rollover between traditional IRAs. Re-characterization can be done any time until the due date for the return for the year of conversion.

> If your assets are worth $180,000 at conversion and fall to $140,000 later, you're taxed on up to $180,000, which is $40,000 more than you now have. Undoing-re-characterization-avoids the tax, and gets you out of the Roth IRA.
>
> One reason to do this, dramatized by a volatile stock market, is where the value of your portfolio drops sharply after the conversion.

Can you undo one Roth IRA conversion and then make another one a reconversion? Yes, but only one time and subject to the following requirements: Reconversion must take place in the tax year following the original conversion to Roth IRA, and the reconversion date must also be more than 30 days after the previous recharacterization transfer from the Roth IRA back to the traditional IRA.

Withdrawal Requirements

You are not required to take distributions from your Roth IRA once you reach a particular age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs

Also, unlike traditional IRAs (but like other tax-favored retirement plans), a Roth IRA owner who continues working may continue to contribute to the Roth IRA.

Retirement Savings Contributions Credit (Saver's Credit)

Also known as the saver's credit, this credit helps low and moderate-income workers save for retirement. Taxpayers age 18 and over who are not full-time students and can't be claimed as dependents, are allowed a tax credit for their contributions to a workplace retirement plan, traditional or Roth IRA if their modified adjusted gross income (MAGI) in 2022 for a married filer is below $68,000 ($66,000 in 2021). For heads-of-household MAGI is below $51,000 ($49,500 in 2021) and for others (single, married filing separately) it is below $34,000 ($33,000 in 2021). These amounts are indexed for inflation each year. The credit, up to $1,000, is a percentage from 10 to 50 percent of each dollar placed into a qualified retirement plan up to the first $2,000 ($4,000 married filing jointly). The lower the MAGI is, the higher the credit percentage, resulting in the maximum credit of $1,000 (50 percent of $2,000).

> Both you and your spouse may be eligible to receive this credit if you both contributed to a qualified retirement plan and meet the adjusted gross income limits.

The following table details the percentage of Saver's credit based on Adjusted Gross Income (AGI):

2022 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$20,500	$0-$30,750	$0-$41,000
20% of contribution	$20,501 - $22,000	$30,751 - $33,000	$41,001- $44,000
10% of contribution	$22,001 - $34,000	$33,001 - $51,000	$44,001 - $68,000
Credit Not Available	more than $34,000	more than $51,000	more than $68,000

2021 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$19,750	$0-$29,625	$0-$39,500
20% of contribution	$19,751-$21,500	$29,626-$32,500	$39,501-$43,000
10% of contribution	$21,501-$33,000	$32,251-$49,500	$43,001-$66,000

Credit Not Available	more than $33,000	more than $49,500	more than $66,000

2020 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$19,500	$0-$29,250	$0-$39,000
20% of contribution	$19,501-$21,500	$29,250-$31,875	$39,001-$42,500
10% of contribution	$21,251-$32,500	$31,876-$48,750	$42,501-$65,000
Credit Not Available	more than $32,500	more than $48,750	more than $65,000

The saver's credit is available in addition to any other tax savings that apply. Further, IRA contributions can be made until April 15 of the following year and still be considered in the current tax year.

Use in Estate Planning

Though Roth IRAs enjoy no estate tax relief, they are already figuring in estate plans. The aim is to build a large Roth IRA fund largely through conversion of traditional IRAs-to pass to beneficiaries in later generations. The beneficiaries will be tax exempt on withdrawals (of qualified distributions) and the Roth IRA tax shelter continues by spreading withdrawal over their lifetimes.

Long-term planning with Roth IRAs. If you would be allowed a deduction for a contribution to a traditional IRA, contributing to a Roth IRA means surrendering current tax reduction for future tax reduction (to zero) for qualified distributions. This can be presented as an after-tax return-on-investment calculation involving assumed future tax rates. The higher the projected tax rate at withdrawal, the more tax Roth IRA saves.

Comparable considerations apply to conversions to Roth IRAs. Here the taxpayer incurs substantial current tax cost (directly or indirectly reducing the amount invested) for future tax relief to the taxpayer or an heir. So the return on investment resulting from conversion increases as projected future rates rise.

A key element in making such projections is the possibility that current and future federal deficits will lead to future tax rate increases a factor which would tend to encourage current Roth IRA investment and conversion. On the other hand, there's the question whether Roth IRA benefits currently promised will survive into future decades.

Highly sophisticated planning is required for Roth IRA conversions. Consultation with a qualified advisor is a must. Please call if you have any questions.