Investor Insights & Outlook

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Investing Your Year-End Bonus

What to do with that year-end bonus is a pressing concern because bonuses are increasingly supplanting annual pay raises as a means of rewarding employees. Here are a few ways to make the most of your bonus.

Pay Down Debt: Before you put any money into the market, consider paying off your debt. Credit-card debt, which often has a high interest rate, is a good place to start. Also, consider sending an extra payment to your mortgage lender, which can help shorten the life of your loan.

Maximize Your Match: Check with your employer to find out whether your 401(k) contribution is being deducted from your bonus. If it is, you may want to lower the percentage amount that you're contributing to your 401(k) before you receive the bonus. In so doing, you'll ensure that your contributions are spaced throughout the year, and you'll be able to take full advantage of your employer's matching contributions.

Feed Your Tax-Sheltered Accounts: If you haven't already done so, consider contributing to a regular or Roth IRA. Tax-deferred portfolios can grow faster than taxable ones, and the gains on Roth IRAs are tax -free.

Match Your Investments to Your Time Horizon: Pay attention to your investment time horizon. If you're in your 30s and saving for retirement, aggressively positioned stock funds may be a good option. But if you plan to tap the money within a shorter time frame, you may want to focus on conservative investments.

Returns and principal invested in stocks are not guaranteed. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free. A 10% penalty may apply for withdrawals prior to the age of 59 1/2.

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Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the past president of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at http://brcapitalinc.com. To subscribe to articles and daily market updates go to http://brcapitalinc.com/subscribe/

Monthly Market Commentary

November and early December saw Hurricane Sandy's destructive powers sweep their way through a series of economic data, including new home sales, personal income, and same store sales, making them difficult to interpret. These economic data will likely remain muddled for the next few months. With the U.S. presidential election done, earnings season done, and minimal news coming out of Europe and China, all attention is now focused on whether the U.S. can avoid the fiscal cliff. Similar to how markets made wide swings during the debt ceiling negotiations in 2011, investors may experience déjà vu should Congress fail to come to an agreement by the end of December.

GDP: The second estimate for third quarter real GDP growth was revised sharply higher to a very robust 2.7%, up from an initial estimate of 2.0% and up from the second quarter real GDP growth rate of 1.3%. This positive revision was mostly attributed to higher inventories and higher exports. Higher inventories are generally not a good thing as they could indicate slumping sales. Consumer spending and business investments were also revised downward.

Employment: November's employment report came in far better than expected, with job growth of 146,000: 147,000 private-sector jobs were added, while 1,000 government jobs were lost. The Bureau of Labor Statistics also indicated that Hurricane Sandy had minimal impact on the November job numbers. Overall, the job market has been relatively stable over the last 12 months, adding an average of 161,000 new jobs per month. At that rate, it will still take about another two years to gain back all the private-sector jobs lost in the recession. Unfortunately, job growth has not been distributed evenly across industries, with services strongly outperforming manufacturing and construction. The unemployment rate fell slightly to 7.7% from 7.9% in October.

Housing: Overall housing data continued to be positive, with homes prices expected to be up as much as 5% for 2012. November's Builder Sentiment, which is compiled by the National Association of Home Builders and tends to be a good predictor of housing starts and new home sales in the months ahead, is now at its best level since May 2006 and marks the seventh consecutive month of improvement. Even the Northeast region, which was hit by Hurricane Sandy during the survey period, showed improvements. More importantly, home inventories fell 1.1% in October to 2.14 million units, their lowest level since 2006.

Auto: Auto sales were up significantly in November. As a recap, Hurricane Sandy caused a dip from 14.9 million units in September to 14.2 million in October, but sales rebounded sharply to 15.5 million units in November. Morningstar economists believe that, with vehicles damaged by Sandy still in need of replacement, auto sales may remain above the 15-million mark again in December.

Retail: November's same-store sales (excluding drugstores) were only up a miserly 1.7%, a far cry from expectations of 3%-4%. Many economists had believed that a strong Black Friday would offset the earlier-in-the-month effects of Hurricane Sandy. Unfortunately, they failed to realize that even though previous storms may have been more damaging than Sandy, this was one of the few times that a storm has made a direct hit on such a highly populated, high-income, and high-spending part of the country. Also, sales from cyber Monday will count in December's report this year versus November last year.

Looking forward to next year and hopes of Congress reaching a settlement, consumers should realize that such a settlement may mean bad short-term news for the economy. Some tax increases will likely still occur, impeding growth in the first half of the year. On the other hand, even if no settlement is reached, the worst of the immediate impacts can probably be delayed by some sort of administrative action (for example, defense cuts can be saved for later in the year).

The Ins and Outs of the 5-Year Rule for Roth IRAs

If you want to take a tax- and penalty-free withdrawal of the portion of a Roth that consists of investment earnings (amount above your initial contribution), you need to be age 59 1/2, disabled, or using the money to pay for a first-time home. However, there's more to this rule.

The five-year clock doesn't start on the day you opened or funded your Roth IRA account. Rather, it starts on the first day of the tax year for which the IRA is opened and funded. This means if you funded a 2011 Roth contribution in early April 2012, your five-year clock started on January 1st, 2011. This implies you could withdraw your investment earnings free of penalty and tax, provided you meet the other criteria for Roth IRA withdrawals (you're 59 1/2, disabled, or using the money for a first-time home), as of January 1st, 2016. The five-year waiting period doesn't start again each time you make additional contributions. Using the previous example, even if you made additional contributions for the 2012 and 2013 tax years (following your initial contribution for 2011), you'll still have satisfied your five-year holding period at the beginning of 2016, because your five-year clock started at the beginning of 2011.

Unfortunately, the five-year rule gets a bit more complicated if you've gotten the assets into a Roth through converting a traditional IRA. In that case, you need to be either 59 1/2 or five years must have elapsed since your conversion for you to be able to take penalty-free withdrawals on the converted amounts on which you paid taxes at the time of conversion. Moreover, if you've converted amounts to a Roth over a period of years, each conversion amount has its own five-year holding period. The penalty will be waived if you meet certain conditions (for example, if you're using the money for qualified education or medical expenses).

Whether a penalty applies depends on the nature of your IRA at the time of conversion, and hinges on the Internal Revenue Service's ordering rules for distributions. If you're taking a withdrawal from a Roth, the IRS assumes that contributions are withdrawn first (always tax- and penalty-free), followed by the taxable portion of a conversion, followed by the nontaxable portion of a conversion, followed by investment earnings. For example, let's say you had a $100,000 rollover IRA set up when you left your old firm, which you rolled into a Roth IRA in 2010. If you wanted to withdraw that money prior to age 59 1/2, you'd have to wait until 2015 to do so penalty-free. Because you owed taxes on your whole IRA amount at the time of conversion, that amount will be subject to the 10% penalty if withdrawn before five years have elapsed.

If you convert a traditional IRA that consists of nondeductible and deductible contributions, things get trickier. For example, you've built up $15,000 in a traditional IRA, $10,000 consisting of nondeductible contributions and $5,000 of deductible contributions. When converted, you'll owe tax on the $5,000 (money on which you never paid taxes). If in three years you need to withdraw $5,000, before you're 59 1/2, that amount will be subject to penalty because the IRS assumes that the amount withdrawn first is the taxable portion of your rollover, in this case, $5,000. Withdrawing the other $10,000 wouldn't trigger a penalty. Backdoor Roth IRA investors can usually avoid the 10% penalty because all or nearly all of their converted amounts will consist of money they already paid taxes on and they'll owe nothing in taxes at conversion.

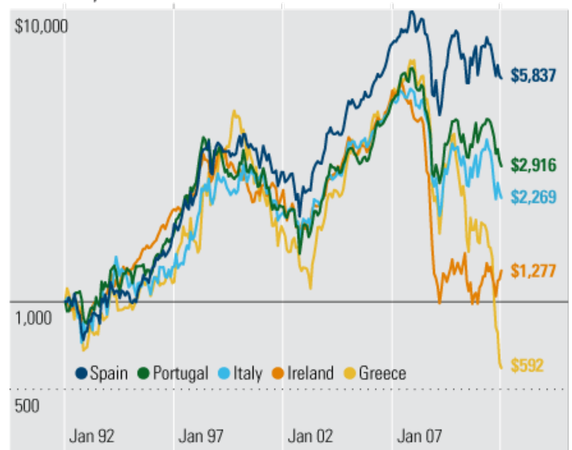
Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

PIIGS Performance

The "PIIGS" acronym refers to the economies of Portugal, Ireland, Italy, Greece, and Spain. The term became popular during the European sovereign debt crisis in highlighting the weaker performance of these economies coming out of the economic downturn. As shown in the image, the PIIGS economies have yet to fully recover from the 2007 financial crisis and the subsequent European sovereign debt crisis. In fact, an initial $1,000 invested in Greek stocks at the start of 1992 would have yielded a mere $592 by the end of 2011 (a 41% decline in value).

If an investor desires to invest in international markets, it is important to remember to diversify across not just asset classes, but also country exposure. Diversification may minimize the financial impact to your portfolio if a specific country or region ends up in financial distress.

Growth of $1,000
January 1992–December 2011



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Greece, Ireland, Portugal, Italy and Spain are each represented by the corresponding Morgan Stanley Capital International Index. Returns in U.S. dollars are based on the exchange rate over the selected time period. Returns and principal invested in stocks are not guaranteed. The 1992 start date for this analysis was chosen in order to analyze the most recent 20-year time period. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Diversification does not eliminte the risk of experiencing investment losses.

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