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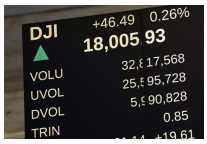
Retirement Distribution Pitfalls: Tax Consequences

Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement, which can be even more complicated.

Pitfall: One of the big mistakes of retirement distribution can be neglecting to consider tax consequences of some distributions. Distributions from traditional IRAs and 401(k)s are fully taxable at your ordinary income tax rate, so if you're not paying taxes at the time you're pulling money out, remember that the distribution is smaller than it looks because you'll be paying taxes on it at a later time.

Workaround: It may be a good idea for retirees to pay quarterly estimated taxes to avoid a penalty from the Internal Revenue Service. Also, retirees should consider the tax effects associated with IRA and 401(k) distributions when assessing their portfolio's long-term viability. Spreading assets among various account types can help lessen the tax shock, as can carefully sequencing withdrawals to lessen the drag of taxes and preserve the tax-saving features of IRAs and 401(k)s for as long as possible.

401(k) plans and IRAs are long-term retirement savings vehicles. Withdrawal of pre-tax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult with a financial or tax professional for advice specific to your situation. This article contributed by Christine Benz, Director of Personal Finance with Morningstar.



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2014 Market Performance
01-01-2015 to 2-28-2015
DJIA ^DJI Up 1.74%
S&P 500 ^GSPC Up 2.21%
NASDAQ ^IXIC Up 4.80%
Russell 2000 ^RUT Up 2.26%

* Index performance does NOT include any fees (Gross of fees)
Source: http//finance.yahoo.com

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Success Factors for Retirement, Part 1

OK, folks, here's what we're asking you to do. First, save as much money as you can while you're working, despite ongoing expenses. Next, figure out how to invest the money and, once you've gained critical mass on your savings, determine if it's going to be enough. Is it any wonder so many pre-retirees are overwhelmed by retirement planning?

However, there is good news, as well. Some of the key success factors that have the power to make or break a retirement plan can be simple if understood correctly. While investors don't need to hit the mark on every last one of them, handling the majority of them correctly increases the chances of a successful retirement plan.

Success Factor 1: A Flexible Retirement Date. For investors who analyzed the numbers on their retirement plans and found that their nest egg could come up short, one option to consider is working longer. Doing so can be advantageous on a few different levels. Investors will have more years to save and fewer years to draw from their portfolios. They may also be able to defer Social Security, which can be profitable, especially for people with a longer-than-average life expectancy. Another option to consider is a hybrid strategy, shifting into a lower-paid, but more rewarding and/or less stressful, career. Alternatively, investors could stay put in their current positions but spend (rather than bank) additional retirement-plan contributions. Such a strategy could allow some people to pay for retirement dreams, such as exotic travel, while still working. Additional retirement-plan contributions in your 60s benefit less from tax-deferred compounding than do contributions made earlier on. Of course, working longer isn't always a possibility: Health considerations (for oneself, a spouse, or a parent) may interfere, or aging employees may not be able to hang on to their jobs. That's why working longer can't be the only fallback plan; investors need to make sure they have other success factors working in their favor, too.

Success Factor 2: A Well-Considered Social Security Strategy. Deciding when to file for Social Security is one of the most consequential financial decisions most Americans will make about their retirement. The 1980s and 1990s were all about maximizing portfolio returns. But the specter of twin bear markets in the 2000s, as well as ultra-low interest rates, shone a light on more mundane matters, including trying to get the most out of Social Security. Even casual students of Social Security planning have heard the admonition to not take Social Security at age 62, when they're first eligible, as doing so will result in a permanent cut to benefits. And for people who have longevity on their side, it may be better to delay benefits for as long as possible, because benefits increase for every year from full retirement age until age 70. Keeping those rules of thumb in mind is a great first step toward getting a Social Security plan moving in the right direction, but retirement planners can also take advantage of more sophisticated strategies, especially if they're part of a married couple. More and more financial planners are focusing on Social Security maximization, and there are also a number of online tools that can help craft a prudent Social Security plan.

Success Factor 3: A Large Enough Stock Allocation. The traditional lifetime glide path calls for accumulators to hold very high weightings in stocks, and then gradually peel back equity exposure as the years go by. But make no mistake: Pre-retirees and retirees may need plenty of stocks, too. The key reason is purchasing-power preservation. If inflation runs at 3%, it's hard to see how a portfolio of nominal bonds and cash yielding 2% to 3% is going to be able to hold up. Of course, there are other ways to hedge inflation risk, but stocks are the asset class with the highest probability of out-earning inflation over time. That argues for most retirees holding at least half of their assets in stocks coming into retirement.

Success Factors for Retirement, Part 2

Of course, holding a higher equity weighting also means higher short-term volatility, but that may be an acceptable trade-off when considering the bigger risk of running out of money prematurely.

Success Factor 4: A Sensible (and Dynamic) Spending Strategy. The size and composition of a retirement portfolio are just one side of the ledger. On the other side? The strategy used for extracting the cash needed from that portfolio on an ongoing basis. Even very large portfolios aren't big enough to last for an entire retirement if the withdrawal, or spending, rate is too high. That's why financial-planning researchers have been focusing so much energy on this area in recent years. Many experts think that the old 4% rule, which involves taking 4% of a portfolio's balance in year one of retirement and inflation-adjusting that amount thereafter, still gives a person with a 60% equity/40% bond portfolio good odds of not outliving their money over a 30-year retirement. But there's also widespread agreement that retirees can greatly improve their portfolios' longevity if they're willing to be flexible about withdrawals, reducing spending in lean years for the market and potentially taking a bit more in good ones. In addition to being willing to adjust their withdrawal rates, retirees may also want to be flexible about withdrawal strategies, using an income-centric approach in more yield-rich eras and relying more on rebalancing proceeds in others.

Success Factor 5: Flexibility on In-Retirement Living Expenses. Even people who aren't in the habit of driving 16-year-old cars (and don't plan to) can make their retirement finances better if they're willing to contemplate a less costly in-retirement lifestyle. One of the easiest ways to bring costs down without throwing quality-of-life considerations out the window is to consider downsizing homes. Like working longer, downsizing can have a positive impact on a few different levels. Even if you own your home free and clear, you're apt to have lower outlays for taxes, utilities, and maintenance costs than you did in your larger home. And the sale of a home that realizes a profit means more money for retirement.

Success Factor 6: Vigilance on Portfolio Costs. As a portfolio's asset allocation gets more conservative over time, its return potential declines as well. This means that investment-related costs, on a percentage basis, will extract an even bigger toll than they did when the portfolios was younger and earning a high return. Let's say a 50% stock/50% bond portfolio earns a 4.5% annualized return, on a pre-expense basis, over the next few decades. Assuming a 3% inflation rate, that's just a 1.5% real return. And unless investors are careful, nearly all of that return could disappear in investment-related and tax costs. After all, it's not unusual for funds to have expenses over 1%, and they're just one piece of the expense pie. The good news is that investment costs are one of the easier factors for investors to control. Another area to focus on is tax management. Retirees may want to hang on to tax-advantaged accounts for as long as possible. When it comes time to pull money out, investors should carefully consider which accounts to withdraw from, with an eye toward staying in the lowest possible tax bracket.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than other asset classes. Investing does not ensure a profitable outcome and always involves risk of loss.

Asset allocation is a method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

This article contributed by Christine Benz, Director of Personal Finance with Morningstar.

These five stocks are in the Nasdaq driver’s seat

Dominic Chu | @TheDomino

Martin Bureau | AFP | Getty Images

The Nasdaq Composite remains the last major U.S. stock index that has yet to reach record territory, but as it marches towards a new milestone, there are just a handful of stocks—five to be precise—that could wield a disproportionate amount of power over any movement.

Before we name them, here's why they have so much influence right now.

The index is made up of the more than 3,000 stocks that are listed on the Nasdaq Stock Market. While some of the largest publicly traded companies are represented, there are also many small and even micro capitalization stocks as well. As a market cap weighted index, the Nasdaq Composite is influenced more by the bigger companies than the smaller ones.

That's where the Nasdaq 100 Index comes in. It takes the Composite Index, and narrows down to focus on just 100 of the largest stocks listed on the Nasdaq. Over the past year, the Composite's 16 percent gain has trailed the 100's 21 percent gain. So far in 2015, both are up about 5 percent.

5 stocks fueling Nasdaq run

Company	Ticker	YTD % Gain	Market Value	Point Impact
Apple	AAPL	20	$775B	141
Amazon.com	AMZN	22	$175B	35
Biogen Idec	BIIB	20	$96B	17
Gilead Sciences	GILD	11	$155B	15
Netflix	NFLX	38	$28B	10
			Total	218

A more detailed examination of the stocks with the greatest market value (thus, the most influential on the direction of the underlying index) shows that all of the year-to-date gains are concentrated within just five stocks.

The Nasdaq 100 is up 213 points so far in 2015 (through the close on Feb. 23). Based on current index weightings, shares of online video streaming company Netflix have contributed nearly 10 points to that total, given its 38 percent gain.

A couple of biotech companies are the biggest contributors, withGilead Sciences' 11 percent gain adding 15 points, and Biogen Idec's 20 percent gain worth 17 points. The second-biggest point contributor is online shopping giant Amazon.com, whose 22 percent rise has contributed 35 points.

And finally, there's the obvious one: Apple. The world's richest company by market value dominates the rise in the Nasdaq 100. With a market cap of $775 billion, Apple's 20 percent year-to-date gain has contributed a whopping 141 points to the total.

To sum it up, the Nasdaq 100 Index of larger-cap companies has gained 213 points so far in 2015. Netflix, Gilead, Biogen Idec, Amazon.com and Apple have combined to contribute 218 points to the overall tally.

Apple alone accounts for two-thirds of the entire Nasdaq 100's performance. That means the other 95 stocks in the index have combined for a net effect of close to zero.

The three biggest drags on the index have been Microsoft, Intel and Yahoo. Microsoft is worth -15 points on the total, Intel worth -10 points, and Yahoo worth -5 points.

While much of the focus for traders and investors will be on the Nasdaq Composite's run towards a record closing level of 5,048.62 (reached on March 10, 2000) and the intraday high of 5,132.52 on that same day, it may be worth keeping an even closer eye on just five stocks. By virtue of their market values and current upside price momentum it's very likely that Netflix, Gilead, Biogen, Amazon and Apple will be doing much, if not all, of the heavy lifting in the event we break through the peak levels from the internet stock bubble.

Why Cheap Fund Shares May Not Be a Bargain

Some investors make the mistake of treating a mutual fund's share price the way they would a stock's share price, but they're actually quite different. When considering two mutual funds of comparable quality, choosing the one with the cheapest share price may not be the best way to go.

A stock's share price represents the market value of one small slice of equity in a company. If the company appears to be growing, demand for its shares may increase because investors expect its earnings (and, thus, its dividends) to grow and/or because they think they will later be able to sell the shares at a higher price. This increased demand for the shares drives the share price higher. If demand decreases--perhaps due to a lousy earnings report or a product recall--its share price is likely to fall.

In contrast, a mutual fund's share price is determined not by market demand for the shares themselves but rather by the value of the fund's underlying holdings. This is expressed as the fund's net asset value, or NAV, meaning the value of all its holdings and cash after expenses are paid divided by the number of shares outstanding. (Also, investors can own fractional shares of mutual funds—something they can't do with stocks.)

To illustrate, let's say that the holdings in a fund's portfolio are worth a combined total of $1 billion after fund expenses are paid, and that the fund has 10 million shares outstanding. Therefore, the net asset value of each of those shares is $100, or $1 billion divided by 10 million.

But what if another fund of comparable quality has a share price of just $75? That's a much better deal, right?

Not necessarily. Remember that a fund's share price is determined in part by the number of shares outstanding. So, the lower share price may have nothing to do with the quality of the fund's holdings and everything to do with the fact that it simply has issued more shares.

As an example, let's say that Fund A has a NAV of $20 per share with 100 million shares outstanding and Fund B has a NAV of $15 per share with 200 million shares outstanding. This means that Fund A's holdings collectively are worth $2 billion (after fund expenses are taken into account) while Fund B's holdings are worth a combined $3 billion. (The fund's net asset value also includes the value of any capital gains or dividends received by the fund until they are distributed to shareholders. This is why a fund's NAV typically drops once those distributions are made.)

But the larger point is that it doesn't really matter what a fund's share price is, other than for record-keeping and tax purposes to compute gains and losses. What matters in terms of performance is the change in price on a percentage basis. A fund with a NAV of $5 per share that sees its holdings perform well enough to lift its NAV to $6 per share has effectively provided its investors with a return of 20%. But a fund with a NAV of $20 per share that increases to $21 per share has provided a much lower return of just 5%. Again, it's not the absolute price of the mutual fund's shares that matters to investors but rather the percentage change in that price.

Returns and principal invested in stocks are not guaranteed. Investing does not ensure a profitable outcome and always involves risk of loss. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money.

Target-Date Pros and Cons

Whether a target-date fund is the best choice for an investor depends on a few different factors, including the degree to which the investor wants to manage his or her own retirement portfolio. Below are some pros and cons of using target-date funds.

Pros

One-stop shopping: For an easy-to-use, all-in-one retirement savings vehicle, a good target-date fund is tough to beat. It allows investors to focus on one of the most important pieces of the retirement savings puzzle—how much to save—rather than getting bogged down in making investment decisions.

Professionally managed allocations: Fund shops typically put a great deal of thought into the design of their target-date series. That doesn't mean target-date funds are perfect, though, or suitable for all investors. Some used allocations that were overly aggressive when the 2008 market crash hit, resulting in heavy losses for their investors, including those who were close to retirement.

Automated adjustments: Target-date funds adjust their allocations automatically as the investor's retirement date approaches. No other commercially available investment product is designed to do this.

Reasonable fees: Target-date fund fees are generally in line with those of other mutual funds. Also, target-date funds built around index funds tend to be cheaper than those built around actively managed funds.

Cons

Lack of control: For investors who want more control over their investment or allocation choices, target-date funds might not be the best option. By choosing one, an investor is essentially limited to a given fund family's funds and allocation framework. Some investors may not welcome these constraints.

Added complexity if used with other holdings: As an all-in-one vehicle, target-date funds are built to serve as the only retirement holding you need. However, if you'd rather not put all your retirement savings into a target-date fund and/or wish to add satellite holdings, this will mean recalculating the asset allocation of the entire portfolio yourself to make sure it's in line with your needs.

In-retirement shortcomings: Target-date funds may become inadequate once the account holder reaches retirement. For example, those hoping to use assets invested in a target-date fund to generate income to cover living expenses in retirement may be disappointed. In fact, many retirement series put target-date investors into conservatively invested retirement income funds once the retirement date is reached.

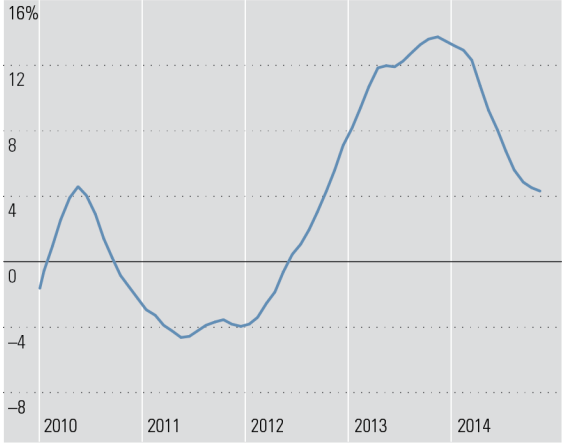
Despite these potential drawbacks, for many investors a target-date fund may be a great choice to save for retirement provided it comes from a quality fund shop and operates using quality parts—that is, quality underlying funds.

The target date is the approximate date when investors plan to start withdrawing their money. An investment in a target-date fund is not guaranteed, and you may experience losses, including losses near, at, or after the target date. The principal value of the fund(s) is not guaranteed at any time, including at the target date. There is no guarantee that the fund will provide adequate income at and through retirement. Consider the investment objectives, risks, charges, and expenses of the fund carefully before investing. Target-date funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money. Some target date funds have objectives or investment strategies that change over time—please read the prospectus of the fund you are considering carefully for further information.

Home Price Growth Returning to a More Sustainable Rate

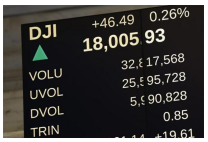
It is certain that, after a series of fast-paced increases that peaked in late 2013, the rate of home price increases is moderating. As of November, the Case-Shiller Index is showing that home prices are growing at 4.3% year-over-year, which is a much slower rate compared to nearly a 14% pace reported in 2013. The prices recovered about 82% of the previous high, and 14 states are currently either above or close to the previous 2006 peak. Nonetheless, Nevada, Florida, Arizona, and a few other states still remain 20% or more below the peak, and it will certainly take many years for those prices to return to their pre-recession level. On the positive side, slower-growing prices are good news for prospective buyers and for the health of the housing market in general, as they should improve housing affordability, providing an essential boost to this so far anemic housing recovery.

Case-Shiller Home Price Index Annual Change, 3-Month Average



This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results.

Source: S&P/Case Shiller. Data through November 2014.



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