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The New Tax Package and Your Portfolio

On Dec. 16, 2010, Congress approved $801 billion in tax cuts and $57 billion for extended unemployment insurance. It includes other tax breaks, such as college tuition credit for some families, an expanded child tax credit, and the earned income tax credit. Here is how some of these changes may impact your portfolio.

Social Security Tax: The one-year payroll tax cut would reduce the Social Security tax to 4.2% from 6.2%. Although this was intended to increase consumer spending levels and stimulate the economy, a better option would be to increase your contribution to your 401k plan to match your employer's contribution, at a minimum, if you do not need extra cash in the near future. The contribution limit for 401k plans remains at $16,500 for those under 50, and $22,000 for those age 50 or older.

Dividends/Capital Gains Tax Rates: Dividend and long-term capital gains taxes will remain at 15% for the next two years. Many had suggested selling securities in your portfolios that were projected to have huge capital gains before the end of 2010, since the capital gains tax rate was projected to increase to 20%. Now, you can sell your securities if your investment strategy dictates.

Estate Taxes: The new tax package sets new estate tax parameters with an exemption of $5 million per person, or $10 million per couple, and a maximum rate of 35% for the next two years. You should speak to your financial advisor about creating an estate plan that will detail how you would like your assets distributed after you are gone, and who should act on your behalf should you become disabled.

Dividends are not guaranteed and are paid solely at a company's discretion. Please consult with your tax professional for specific tax advice.

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Market Performance
1-1-11 to 3-31-11
DJIA ^DJI +6.41%
S&P 500 ^GSPC +5.42%
NASDAQ ^IXIC +4.83%
Russell 2000 ^RUT +7.61%
Source: http://finance.yahoo.com

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Retirement Planning in Your 20's and 30's

Is it too early to start planning for retirement in your 20s? The answer is no. As life expectancy continues to increase, planning early can ensure a comfortable retirement. While planning for retirement at this age may be the last thing on your mind, the earlier you start the better chance you have of achieving your retirement goal. An early start also allows more time for your investment to grow through compound interest. In addition to starting early, here are some steps you should consider when planning for retirement in your 20s and early 30s.

Maximize your employer match: Young investors should consider maximizing their employer 401(k) match, since failure to utilize this benefit means missing out on free money. According to a recent study by Hewitt Associates, younger, lower-tenured, and lower-salaried workers remained, on average, less likely to save. This study found that 40.8% of workers in their 20s did not contribute enough to receive the full employer match. Typically employers match 50 cents per dollar invested by an employee, up to a predetermined maximum contribution percentage. If your employer provides this, make sure to put enough money in your 401(k) plan to maximize your employer match.

Consider a Roth investment: Much like a company-sponsored retirement plan, traditional IRAs are a common investment vehicle for investors. Traditional IRA contributions are not taxed, but withdrawals are taxed. A Roth IRA or Roth 401(k) gives you the option of taxing your contribution up-front at the time of investment while the account grows in value tax-free thereafter. This means that withdrawals during retirement are not subject to income tax, provided you are at least 59 1/2 and the account is held for five years or more. This is a great way for younger investors to take advantage of lower tax rates, especially if they expect to be in a higher tax bracket closer to retirement.

Manage your risk: One mistake young investors make is selecting a less than optimal stock/bond allocation based on their age. Typically, investors in the 20s or 30s are best advised to select a stock-heavy portfolio with a minimal allocation to bonds. For investors who feel less comfortable with selecting their own investments, target-date funds can serve as a convenient alternative. Target-date funds start out with heavier allocations to stocks and become more income-oriented depending on the participant's age. If you are in your 20s or 30s, it might make sense to choose an aggressive portfolio allocation and limit your investment in bonds.

Avoid market timing: A look back in time suggests that some of the biggest gains in the stock market have followed periods of poor market returns. Investors can make the mistake of timing the market by pulling out of their investments during market losses and buying back when the market has rebounded. Investors who attempt to time the market run the risk of missing periods of exceptional returns. With time on your side, it is best to adopt a long-term approach to investing.

Keep in mind that you should first determine how much money you may need in retirement as well as determine your annual expenses such as living, health-care, and miscellaneous spending before considering the options outlined above. It is always a good practice to track your spending in addition to identifying your savings and investments.

Source: "How Well are Employees Saving and Investing in 401(k) Plans," 2010 Hewitt Universe Benchmarks.

Compound and Compare

Approaching retirement with too little money is unfortunate. Furthermore, getting sucked into the daily hype that has people jumping in and out of the stock market can be disastrous. The market will inevitably go down once in a while, but history proves that despite this, the long-term trend for the market is up. Taking that into account, the earlier an individual begins to invest, the better.

Data from the Bureau of Economic Analysis indicates that the U.S. overall savings rate has been drastically falling since the early 1980s, and only recently started to recover a little (since 2005). Even so, most people simply aren't saving enough for retirement, in an era when even more responsibility for retirement savings has been shifted from corporations to individuals.

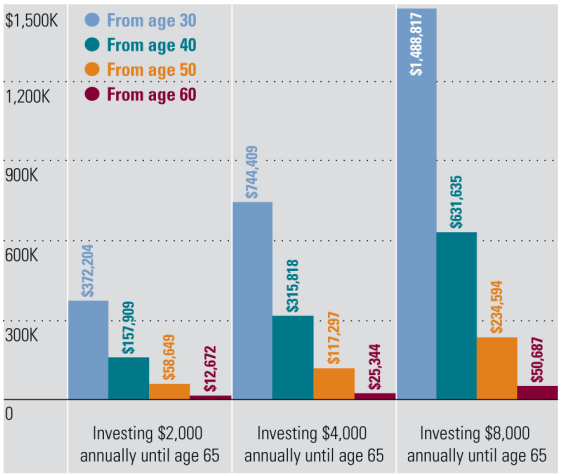
This long-term lack of savings is partly a cultural phenomenon. Baby boomers have a stronger sense of optimism than the World War II generation, and have not placed the same priority on saving. Worse yet, they have relatively easy access to credit and a habit of spending beyond their means, regardless of how much money they make. This trend continued in subsequent generations. The problem is that nowadays people should be saving more, considering the declining availability in pensions provided by employers and the level of confidence in receiving Social Security benefits. The good news is that people have started to realize this recently.

By contributing early and often to an investment plan, an investor's money compounds over time. Compounding, otherwise known as the ability of an asset to generate earnings from previous earnings, accelerates the growth of your assets over time. How does compounding work, exactly? Let's say you begin in year 1 by investing $1,000. Year 1 proves to be a very good year for the market, and your investment returns 12%. You now have $1,000 + $120 = $1,120. Year 2, however, is not so great, and your return for year 2 is now only 7%. The power of compounding is that you have now gained not 7% of your principal value (7% of $1,000 = $70), but 7% of your total investment value at the beginning of year 2: 7% of $1,120 = $78.4. Now imagine what continuous compounding over a longer period or time can do.

The image below illustrates the growth of an account based on an investor's age and the amount contributed annually until age 65. The 30-year-old investor contributing $8,000 per year will have nearly $1.5 million at the age of 65. This is more than double the ending wealth value of an investor who saved the same amount per year but waited until age 40 to begin saving. It is quite clear that the earlier you start and the more you invest, the easier it is to achieve your retirement savings goal, thanks to the power of compounding investment returns.

But all is not lost for investors who do not start to aggressively save for retirement until they reach their 40s or 50s. The good news for these investors is that they still have enough time to change their savings behavior and achieve their goals, but they will need to act quickly and be extremely disciplined about their savings. Time waits for no one, so don't procrastinate-get started now.

The Power of Compounding



The image is for illustrative purposes only and does not represent an investment in any specific security. The calculations assume an 8% annual rate of return, compounded annually. The values represented do not account for inflation or taxes. Savings rate information from the Bureau of Economic Analysis.

Borrowing from Your Retirement

Barbara is 40 years old, has a child in college, and needs to take out a loan to help with tuition. She is considering either a home-equity loan or a loan from her 401(k), and is not sure which would be the better choice. She has heard that taking out a loan from a 401(k) is painless, since "you don't pay penalties and pay the interest to yourself, not to a bank." What should she do?

Many 401(k) plans offer a loan provision and the process is fairly easy. There is no credit check (since you are borrowing from yourself); the interest rate is usually low (maybe a percentage point or two above prime); you can generally borrow up to 50% of your vested account balance to a maximum of $50,000; you have up to five years to repay the loan (longer for loans used to purchase a primary residence), and the plan administrator usually deducts the loan payments automatically from your paycheck.

However, the real cost of borrowing from your 401(k) is not the rate you pay yourself in interest, but the amount you would have earned on your balance had you just left the money in the account. This is called an "opportunity cost," and it can be significant. In addition, if Barbara loses or changes jobs, a 401(k) loan will most likely come "due in full" within a limited amount of time, while a home-equity loan will not. The balance is taxed as if it were ordinary income and, unless she is at least 59½ years old, failure to pay the 401(k) loan back by the due date triggers a 10% penalty.

So, what are Barbara's choices? In general, if she can take out a home-equity loan at a lower after-tax cost than the return she expects to receive on her 401(k), she should choose the home-equity loan.

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