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Estate Planning for Complicated Family Situations

Divorce and remarriage, blended families, children with disabilities, or even a financially irresponsible child can complicate estate planning to the point where procrastination is tempting. While accommodating all of your loved ones is a delicate balancing act with many variables to consider, the reward is peace of mind in knowing your spouse and children will be cared for in the best possible way following your death.

If You Are Divorced

Your top priorities are updating your beneficiaries, last will, trusts (along with the executor/trustee), durable power of attorney, and healthcare proxy. Likewise, because you no longer have the benefit of combining your estate and inheritance tax exemptions with a spouse, you may need to consider more strategic estate planning to avoid estate taxes.

If there are children involved, you'll have even more decisions, including guardians of any minor children. Typically, you will not want your former spouse or his/her new blended family to receive any of your assets.

While you can name anyone as your beneficiary on life insurance policies, annuities, retirement accounts (if permitted by your plan), IRAs, and health savings accounts, your children typically cannot receive these funds until they turn 18. In the meantime, your children's appointed guardian, such as their surviving parent, could be designated by the court to manage these monies until they reach adulthood. Proper estate planning can avoid any mishandling of those funds and provide you with the reassurance that your children will be financially protected.

One way to ensure this outcome is to set up a trust with an appointed trustee, such as a grandparent.

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Why Should You Consider Bonds?

Why should you consider bonds for your investment portfolio? The primary reasons include:

✔ **Bonds add diversification to your portfolio.** One strategy to help counter the effects of stock market volatility is to add investments to your portfolio that aren't highly correlated with the stock market. Historically, stocks have a low positive correlation with corporate and government bonds.

✔ **Bonds offer fixed, periodic interest payments and the return of your principal at maturity.** Thus, even in the event of a significant market decline, you receive some return in the form of interest payments, and you'll receive your principal at maturity.

✔ **Bonds are often better suited to short- and medium-term financial goals.** If you need your money in a few years, you may not want to keep those funds in stocks, since a major stock market decline could occur when you need your money.

Please call if you'd like to discuss bonds in more detail. ❍❍❍

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Estate Planning

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If You Have Remarried

While remarrying is a beautiful reminder that second chances really do exist, this can often complicate estate planning — particularly when at least one spouse has children from another marriage. The first step is to sit down with your spouse and discuss what you both feel is fair for each other and your children.

Because of state marital estate laws, unless you have a prenuptial agreement in place, your current spouse has legal entitlement of up to half of your estate.

It's important to have a plan intact that assures both your spouse and children receive what you intend. You might consider a trust, such as a marital trust, qualified terminable interest property trust (QTIP), or irrevocable life insurance trust (ILIT), which can provide lifetime income to your surviving spouse while simultaneously ensuring your heirs receive the remaining proceeds.

If You Have a Special-Needs Child

Understandably, parents of a special-needs child are often so distracted with accommodating the child's immediate needs that important financial matters are sometimes overlooked. The two most important factors to consider are preserving your child's eligibility for Medicaid and other essential benefits while continuing to provide the best possible lifestyle for them. However, without a proper action plan, an inheritance could disqualify your special-needs child from vital benefits.

To avoid this situation, parents often leave special-needs children out of the inheritance equation, listing other siblings or a designated guardian as heirs with the intention that their special-needs child will be provided for as he/she continues to receive necessary medical benefits. The truth is, intentions and reality often do not mesh. A much more reassuring path is to consider a special-needs trust, which can assure your child continues to qualify for medical benefits while providing a sound financial future.

An Irresponsible Adult Child

It's quite common for parents to worry that a child could get into serious trouble when presented with a large sum of money. This depends on a variety of factors, such as age at the time of inheritance, lifestyle, or even addiction issues. Consider establishing a trust where the appointed trustee can limit your child's inheritance to several installments throughout the course of his/her lifetime, place conditions such as good behavior on the disbursements, or even appropriate the funds for something as specific as college tuition.

Please call to discuss this topic in more detail. ❍❍❍

The ABCs of Risk Premiums

Investing in the financial markets is inherently risky. Of course, some investments are riskier than others, but they tend to offer potentially higher rates of return. That difference in expected return for riskier investments is called the risk premium. It's the investor's reward for taking greater risk.

To better understand risk premiums — what causes risk and why risk premiums are important — let's take a look at the anatomy of an investment's return, which has three components:

✔ **Inflation** — Inflation is the rate at which prices increase, typically hovering between 2% and 4%.

✔ **Risk-free rate of return** — A risk-free rate of return is the return on an extremely low-risk (so low it's termed risk free) investment. Typically, investors look at the short-term interest rate on a Treasury bill (T-bill) as a risk-free rate. Investors view the backing of the U.S. government and their short maturity as signs of the investment's stability and liquidity, in other words, low risk.

✔ **Risk premium** — The third component of an investment's return is the risk premium. On short-term T-bills, the risk premium is zero — those investments are considered risk free. But other investments, including stocks, have added elements of risk. A risk premium is the excess return of an investment that is greater than the risk-free rate of return.

Broadly, there are three reasons that some investments are more risky than others:

✔ Returns on stock investments can fluctuate, unlike predictable bond coupon payments.

✔ Corporate bond holders have the first claim to corporate earnings before stock holders, who have a residual claim.

✔ Stock returns tend to be more volatile.

Historically, bonds and cash equivalents tend to be less risky than stock investments. But even among stocks, risk premiums vary.

Understanding risk premiums is the first step in creating an asset allocation plan for your investments. To determine which assets to invest in, you'll have to determine the optimal risk-premium mix for you.

You need to honestly assess your risk tolerance level, so you can determine the amount of risk that best suits your particular needs. ❍❍❍

Bonds at Every Stage of Life

Bonds are an important component of a well-balanced portfolio throughout every stage of an investor's life. Regardless of your life stage, you should consider having bonds in your investment portfolio.

At the Beginning

As a beginning investor in your 20s or 30s, you have a long time to maximize capital and are probably in the best position to assume risks for larger returns. Even at this early stage of investing, you should develop a portfolio that also balances risk and market volatility. While higher-yield investments are important, you will still want to balance them with some lower-risk investments, including bonds. At this stage, you can:

✔ **Grow capital** with bonds that offer higher yields if you assume higher risk. Make sure you understand the terms and conditions, including the bond's rating, call features, and if it is insured.

✔ **Protect your savings** for a large purchase, such as a car, wedding, or house. Lower-risk bonds can be a better investment than a traditional savings account to save for large purchases. You may want to consider Treasury or corporate bonds with maturity dates that align with your time frame.

✔ **Diversify your employer-sponsored retirement plan** such as a 401(k). Your plan most likely offers a variety of mutual funds, and bond funds are a good way to diversify your portfolio and spread risk. The stock and bond markets do not typically move in the same direction, so bonds can stabilize and help with your overall returns.

In the Middle

Your mid-30s to late 40s should be a time of accumulating wealth and investing for retirement and other long-term goals. At this point in your life, you should rebalance your portfolio on a regular basis to ensure your allocation is keeping pace with your goals. Bonds should become a larger portion of your asset allocation, because they offer more predictable income and will continue to balance higher-risk equities.

✔ **Tax-advantaged bond investing** is a good way to help offset taxes if you're in a higher tax bracket. Municipal bonds, which are issued by state and local governments, are an attractive investment in your income-earning years because they are exempt from federal income taxes. And if you live in the same state as the issuer, they are free from state and local taxes as well.

✔ **Zero-coupon bonds can be a good, cost-effective investment for specific goals,** such as college or retirement. They are sold at a steep discount from their face value; and when they mature, the face value will include both the principal and any accumulated interest.

Approaching Retirement

Now that you're getting closer to retirement, many experts recommend you begin increasing the bond portion of your portfolio to 50% or more to lower your risk. Some issues to consider when evaluating bonds for your portfolio:

✔ **Managing interest rate risk** is important because when interest rates rise, bond prices fall, and vice versa. One way to manage this risk is with a bond ladder. This strategy allows you to invest in a portfolio of bonds with different maturity time frames to help your investments do well in any interest rate environment.

✔ **Tax-advantaged bond investing** will continue to be a good way to manage taxes, especially if you're in a higher tax bracket. Again, municipal bonds can be a good choice.

In Retirement

Now your main goal becomes protecting and maximizing your income for the remainder of your life. Social Security will most likely only replace a portion of your income, so your portfolio and any retirement benefits will need to make up the rest. Bonds will help generate retirement income while preserving your principal. Things to consider:

✔ **Guard against inflation** because you are now living on a fixed income. Treasury Inflation Protection Securities (TIPS) or Treasury Inflation Indexed Securities will help guard against inflation. TIPS have a fixed coupon rate, but their principal amount is adjusted every six months according to changes in the consumer price index.

✔ **Spend from taxable accounts first,** because when you withdraw from tax-deferred accounts, you will pay income tax on your distributions. ❍❍❍

Should You Defer Income Taxes?

Should you pay income taxes now so you can withdraw funds after retirement tax free? Or are you better off delaying income taxes until after retirement? This is a basic decision when choosing between a traditional deductible individual retirement account (IRA) and a Roth IRA, or between a 401(k) plan and a Roth 401(k). With the Roth options, you are paying taxes now so you can take qualified distributions income-tax free. With the traditional IRA and 401(k) plan, you are delaying taxes until distributions are taken.

The standard advice is to consider whether your tax bracket will be higher or lower in retirement. If you are likely to be in a higher tax bracket, you'll usually benefit from the Roth options because you are paying taxes at a lower rate now. If you're likely to be in a lower tax bracket, you may benefit more from a traditional IRA and 401(k) plan, because you'll pay taxes at a lower rate after retirement.

Most people naturally assume their tax rate will be lower in retirement since their income will typically be lower. That assumes income tax rates will stay constant over that time period, even though they are at historically low levels. No one knows how those rates will be adjusted by Congress over the years. However, many believe income tax rates have nowhere to go but up.

Thus, it may be prudent to use tax diversification for your portfolio. This strategy attempts to protect your portfolio against tax rate fluctuations. It is a concept similar to asset allocation, in which you protect your portfolio against price fluctuations. With tax diversification, you invest in a number of investment vehicles with different tax ramifications. For instance, you might invest in a Roth IRA, from which qualified distributions can be taken with no tax consequences; a 401(k) plan, where you save taxes now and pay ordinary income taxes on qualified distributions; and taxable accounts, where the capital gains taxes must be paid on sales of appreciated investments. During retirement, you can then monitor your tax situation and withdraw money from the assets that make the most sense in any particular year.

Please call if you'd like to discuss this in more detail. ❍❍❍

Bonds and Interest Rate Changes

Basically, interest rate changes affect bond prices as follows:

✔ **Interest rates and bond prices move in opposite directions.** The price of a bond will decrease in value when interest rates rise and increase in value when interest rates fall. The price of an existing bond changes to provide the same return as an equivalent, newly issued bond at prevailing interest rates. If interest rates are higher than the rate on an existing bond, it becomes less valuable because of the lower interest payments. Since you'll receive the full principal value at maturity, holding a bond until maturity eliminates the impact of interest rate changes.

✔ **Interest rate changes have a more dramatic effect on bonds with longer maturities.** Since long-term bonds have a longer stream of interest payments that don't match current interest rates, their price must change more to compensate for those interest rate changes.

✔ **Bond price changes are less significant for bonds with higher coupon rates.** Bonds with coupon interest rates near or above current interest rates will experience the least amount of price fluctuation. ❍❍❍

Financial Thoughts

A little over 14% of individuals made a contribution to their IRA in 2015, up from 12.1% in 2010. The maximum contribution was made by 54.4% of account holders in 2015. Among consistent account owners, the average annual contribution in 2015 was $4,591 to a traditional IRA and $4,161 to a Roth IRA (Source: Employee Benefit Research Institute, January 2018).

Equities accounted for 54.7% of all allocations for IRAs. Bonds comprised 15% of allocations, while cash accounted for 10.6% (Source: Employee Benefit Research Institute, January 2018).

Social Security accounts for between 75% and 85% of total retirement income for middle-income retirees who wait until age 70 to claim benefits (Source: *AAII Journal*, March 2018).

More than one-third of private sector workers lack access to an employer-sponsored retirement plan. And 31% of those who do have access don't participate in their plan (Source: The Pew Charitable Trusts, February 2018).

In a recent survey, 8% of respondents over age 50 reported to have fallen prey to at least one form of financial fraud in the last 12 months (Source: *AAII Journal*, April 2018). ❍❍❍

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