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November 2014

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Callahan Financial Newsletter

Keeping you current

Saving or Investing: Is There a Difference?



Financially speaking, the terms "saving" and "investing" are often used interchangeably. But the concepts behind these terms actually have some important differences. Understanding

these differences and taking advantage of them may help you in working toward financial goals for you and your family.

Saving

You may want to set aside money for a specific, identifiable expense. You park this money someplace relatively safe and liquid so you can get the amount you want when you need it. According to the Securities and Exchange Commission brochure *Saving and Investing*, "savings are usually put into the safest places, or products, that allow you access to your money at any time. Savings products include savings accounts, checking accounts, and certificates of deposit." Some deposits may be insured (up to \$250,000 per depositor, per insured institution) by the Federal Deposit Insurance Corporation or the National Credit Union Administration. Savings instruments generally earn interest. However, the likely tradeoff for liquidity and security is typically lower returns.

Investing

While a return of your money may be an important objective, your goal might be to realize a return on your money. Using your money to buy assets with the hope of receiving a profit or gain is generally referred to as investing. Think of investing as putting your money to work for you--in return for a potentially higher return, you accept a greater degree of risk. With investing, you don't know whether or when you'll realize a gain. The money you invest usually is not federally insured. You could lose the amount you've invested (e.g., your principal), but you also have the opportunity to earn more money, especially compared to typical savings vehicles. The investment is often held for a longer period of time to allow for growth. It is important to note, though, that all investing involves risk,

including the loss of principal, and there is no assurance that any investing strategy will be successful.

What's the difference?

Whether you prefer to use the word "saving" or "investing" isn't as important as understanding how the underlying concepts fit into your financial strategy. When it comes to targeting short-term financial goals (e.g., making a major purchase in the next three years), you may opt to save. For example, you might set money aside (i.e., save) to create and maintain an emergency fund to pay regular monthly expenses in the event that you lose your job or become disabled, or for short-term objectives like buying a car or paying for a family vacation. You might consider putting this money in a vehicle that's stable and liquid. Think of what would happen if you were to rely on investments that suddenly lost value shortly before you needed the funds for your purchase or expense.

Saving generally may not be the answer for longer-term goals. One of the primary reasons is inflation--while your principal may be stable, it might be losing purchasing power. Instead, you may opt to purchase investments to try to accumulate enough to pay for large future expenses such as your child's college or your retirement. Generally, saving and investing work hand in hand. For instance, you may save for retirement by *investing* within an employer retirement account.

Why is it important?

Both saving and investing have a role in your overall financial strategy. The key is to balance your saving and investing with your short- and long-term goals and objectives. Overemphasize saving and you might not achieve the return you need to pursue your long-term goals. Ignore saving and you increase the risk of not being able to meet your short-term objectives and expenses. Get it right and you increase your chances of staying on plan.

Investor, Know Thyself: How Your Biases Can Affect Investment Decisions



In psychology, "heuristics" refers to the mental decision-making short-cuts that individuals develop over time based on past experiences. While heuristics can be helpful in avoiding unnecessary deliberation, they can also lead to misleading biases that can derail even the most well-thought-out financial plan.

Traditional economic models are based on a simple premise: people make rational financial decisions that are designed to maximize their economic benefits. In reality, however, most humans don't make decisions based on a sterile analysis of the pros and cons. While most of us do think carefully about financial decisions, it is nearly impossible to completely disconnect from our "gut feelings," that nagging intuition that seems to have been deeply implanted in the recesses of our brain.

Over the past few decades, another school of thought has emerged that examines how human psychological factors influence economic and financial decisions. This field--known as behavioral economics, or in the investing arena, behavioral finance--has identified several biases that can unnerve even the most stoic investor. Understanding these biases may help you avoid questionable calls in the heat of the financial moment.

Sound familiar?

Following is a brief summary of some common biases influencing even the most experienced investors. Can you relate to any of these?

1. **Anchoring** refers to the tendency to become attached to something, even when it may not make sense. Examples include a piece of furniture that has outlived its usefulness, a home or car that one can no longer afford, or a piece of information that is believed to be true, but is in fact, false. In investing, it can refer to the tendency to either hold an investment too long or place too much reliance on a certain piece of data or information.
2. **Loss-aversion bias** is the term used to describe the tendency to fear losses more than celebrate equivalent gains. For example, you may experience joy at the thought of finding yourself \$5,000 richer, but the thought of losing \$5,000 might provoke a far greater fear. Similar to anchoring, loss aversion could cause you to hold onto a losing investment too long, with the fear of turning a paper loss into a real loss.
3. **Endowment bias** is also similar to loss-aversion bias and anchoring in that it encourages investors to "endow" a greater value in what they currently own over other possibilities. You may presume the investments in your portfolio are of higher quality than other available alternatives, simply because you own them.
4. **Overconfidence** is simply having so much confidence in your own ability to select investments for your portfolio that you might ignore warning signals.
5. **Confirmation bias** is the tendency to latch onto, and assign more authority to, opinions that agree with your own. For example, you might give more credence to an analyst report that favors a stock you recently purchased, in spite of several other reports indicating a neutral or negative outlook.
6. The **bandwagon effect**, also known as **herd behavior**, happens when decisions are made simply because "everyone else is doing it." For an example of this, one might look no further than a fairly recent and much-hyped social media company's initial public offering (IPO). Many a discouraged investor jumped at that IPO only to sell at a significant loss a few months later. (Some of these investors may have also suffered from overconfidence bias.)
7. **Recency bias** refers to the fact that recent events can have a stronger influence on your decisions than other, more distant events. For example, if you were severely burned by the market downturn in 2008, you may have been hesitant about continuing or increasing your investments once the markets settled down. Conversely, if you were encouraged by the stock market's subsequent bull run, you may have increased the money you put into equities, hoping to take advantage of any further gains. Consider that neither of these perspectives may be entirely rational given that investment decisions should be based on your individual goals, time horizon, and risk tolerance.
8. A **negativity bias** indicates the tendency to give more importance to negative news than positive news, which can cause you to be more risk-averse than appropriate for your situation.

An objective view can help

The human brain has evolved over millennia into a complex decision-making tool, allowing us to retrieve past experiences and process information so quickly that we can respond almost instantaneously to perceived threats and opportunities. However, when it comes to your finances, these gut feelings may not be your strongest ally, and in fact may work against you. Before jumping to any conclusions about your finances, consider what biases may be at work beneath your conscious radar. It might also help to consider the opinions of an objective third party, such as a qualified financial professional, who could help identify any biases that may be clouding your judgment.



The decisions you make during open enrollment season are important, because you generally must stick with the options you've chosen until the next open enrollment season. The exception to this is if you experience a "qualifying event" such as marriage, divorce, or the birth of a child, in which case you'll be able to make changes outside of the open enrollment period.

Open Enrollment Season Is Here: Give Your Benefits a Check Up

Open enrollment season is your annual opportunity to review your employer-provided benefit options and make elections for the upcoming plan year. To get the most out of what your employer has to offer and potentially save some money, take time to read through the enrollment packets or information you receive before making any benefit decisions.

Review your health plan options

Even if you're satisfied with your current health plan, compare your existing coverage to other plans your employer is offering for next year. Premiums, out-of-pocket costs, and benefits offered often change from one year to the next and vary among plans. You may decide to keep the plan you already have, but it doesn't hurt to consider your options.

Some tips for reviewing your health coverage:

- Start by reading plan materials you've received in your open enrollment packet and find out as much as you can about your options. Look for a "What's New" section that spells out plan changes.
- List your expenses. These will vary from year to year, but what you've spent over the course of the last 12 months may be a good predictor of what you'll spend next year. Don't forget to include co-payments and deductibles, as well as dental, vision, and prescription drug expenses.
- Reevaluate your coverage to account for life changes. For example, getting married, having a baby, or retiring are events that should trigger a thorough review of your health coverage.
- Consider all out-of-pocket costs, not just the premium you'll pay. For example, if you frequently fill prescriptions, you may save money with a plan that offers the broadest prescription drug coverage with the lowest co-payments, even if it charges a higher premium than other plans.
- Compare your coverage to your spouse's if he or she is eligible for employer-sponsored health insurance. Will you come out ahead if you switch to your spouse's plan? If you have children, which plan best suits their needs?
- Take advantage of technology. Some employers offer calculators or tables that allow you to do a side-by-side comparison of health plans to help select the best option.

Decide whether to contribute to a flexible spending account

You can help offset your health-care costs by contributing pretax dollars to a health flexible spending account (FSA), or reduce your

child-care expenses by contributing to a dependent-care FSA. The money you contribute is not subject to federal income and Social Security taxes (nor generally to state and local income taxes), and you can use these tax-free dollars to pay for health-care costs not covered by insurance or for dependent-care expenses.

If your employer offers you the chance to participate in one or both types of FSAs, you'll need to estimate your expenses for the upcoming year in order to decide how much to contribute (subject to limits). Your contributions will be deducted, pretax, from your paycheck.

One thing to watch out for this open enrollment season: Because of a change to the "use-it-or-lose-it" rule, employers may now allow participants the chance to roll over \$500 of health FSA funds that are unused at the end of one plan year to the next plan year. So before you decide how much to contribute to your health FSA, read through your employer's materials to see whether this change will apply to you--employers aren't required to adopt this new carryover approach. If your employer has not, you'll lose any contributions you don't spend by the end of your benefit period (including any grace period). And remember, you must enroll in a health or dependent-care FSA each year; enrollment is not automatic.

Find out what other benefits and incentives are available

Many employers offer other voluntary benefits such as dental care, vision coverage, disability insurance, life insurance, and long-term care insurance. Even if your employer doesn't contribute toward the premium cost, you may be able to conveniently pay premiums via payroll deduction.

To avoid missing out on savings opportunities, find out whether your employer offers other discounts or incentives. Common options are discounts on health-related products and services, such as gym memberships and eyeglasses, or wellness incentives such as a monetary reward for completing a health assessment.

Get the information you need

Ask your benefits administrator for help if you have any questions about your benefits, the options available to you, or enrollment instructions or deadlines. You generally have only a few weeks to make important decisions about your benefits, so don't delay.

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Securities and advisory services
offered through LPL Financial
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Do I have to pay an additional tax on investment income?

You might, depending on a few important factors.

A 3.8% net investment income tax is imposed on the

unearned income of high-income individuals. The tax is applied to an amount equal to the lesser of:

- Your net investment income
- The amount of your modified adjusted gross income (basically, your adjusted gross income increased by an amount associated with any foreign earned income exclusion) that exceeds \$200,000 (\$250,000 if married filing a joint federal income tax return, and \$125,000 if married filing a separate return)

So if you're single and have a MAGI of \$250,000, consisting of \$150,000 in earned income and \$100,000 in net investment income, the 3.8% tax will only apply to \$50,000 of your investment income.

The 3.8% tax also applies to estates and trusts. The tax is imposed on the lesser of undistributed net investment income or the excess of MAGI that exceeds the top income tax bracket threshold for estates and trusts

(\$12,150 in 2014). This relatively low tax threshold potentially could affect estates and trusts with undistributed income. Consult a tax professional.

What is net investment income?

Net investment income generally includes all net income (income less any allowable associated deductions) from interest, dividends, capital gains, annuities, royalties, and rents. It also includes income from any business that's considered a passive activity, or any business that trades financial instruments or commodities.

Net investment income does not include interest on tax-exempt bonds, or any gain from the sale of a principal residence that is excluded from income. Distributions you take from a qualified retirement plan, IRA, 457(b) deferred compensation plan, or 403(b) retirement plan are also not included in the definition of net investment income.



How can I manage the net investment income tax?

If you are subject to the 3.8% net investment income tax, there are strategies that may help you manage that tax. The tax is applied to the lesser of

your net investment income or the amount by which your modified adjusted gross income (MAGI) exceeds the applicable income tax threshold. MAGI is basically adjusted gross income plus any associated foreign earned income exclusion. Any strategy you consider should be directed at the appropriate target.

If your net investment income is greater than your MAGI over the threshold, then your focus should be aimed at reducing your MAGI. Conversely, if your MAGI over the threshold is greater than your net investment income, you should try to reduce your net investment income.

Here are a few strategies that may help you manage the net investment income tax:

- Before selling appreciated securities, consider whether you can offset the gain with capital losses. Likewise, if you have any capital loss carryforwards, you should review your portfolio for capital gain opportunities to make use of the capital losses.

- Consider gifts of appreciated securities to tax-qualified charities.
- If passive income is from a business, offset passive income with passive losses. If you don't have passive losses, you may be able to convert the passive income to non-passive income (not subject to the tax) by becoming more active in the business.
- You may be able to reduce your MAGI by increasing contributions to a traditional IRA, 401(k), or 403(b).
- Consider investments that may have growth potential but typically do not generate dividends.
- Generally, any gains in tax-deferred annuities and cash value life insurance are not reportable as income unless withdrawn, which may help reduce both your MAGI and your net investment income.

While any of these alternatives may help reduce your net investment income or your MAGI, they may also affect your financial planning. So before implementing strategies to reduce or eliminate exposure to the net investment income tax, consult with a tax professional to help with your specific situation.

