STRATEGIC
Wealth Advisors

December 2014 | Vol. No. 33 | Newsletter

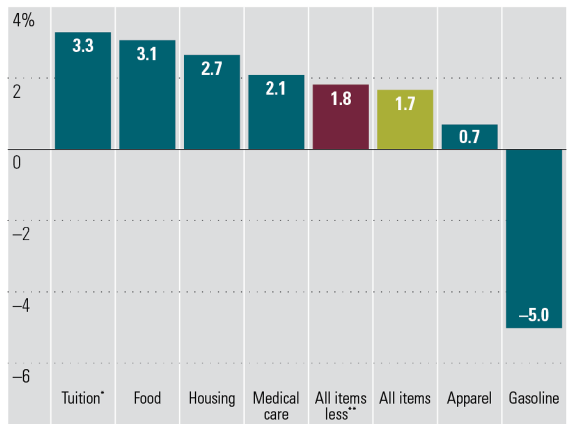
Inflation Can Vary by Category

The general inflation number (the “All items” category) may be a good measure for the economy at large, but the cost of certain goods and services could rise much faster than the average cost of living.

For the past year, tuition, food, housing, and medical care have all experienced much higher inflation rates than the headline number. Gasoline prices, on the other hand, have been declining and are now near four-year lows.

People who need to focus on savings for college or medical care may be left short, as the cost for such items often tends to rise at a faster rate than the average cost of living. Those investors might not be able to keep pace with rising costs if they do not take their real inflation rate into account when planning their investment goals.

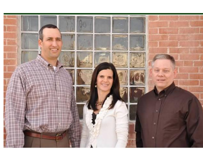
Consumer Price Index Components, Year-Over-Year Change



*other school fees and child care **less food and energy

Source: Bureau of Labor Statistics, Morningstar calculations. Data as of October 2014.

What's Happening at SWA



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If retired, ask yourself: How much can I sustainably spend each month and am I missing anything in my spending plan? The first question can be answered using SWA’s planning process. The second is more elusive. Many monthly expenses are fixed or fall within a range. A review of credit card and bank statements may reveal many other expenses that don’t occur monthly. Should these irregular expenses be part of your monthly spending plan? Yes.

Some expenses that don’t occur monthly but for most of us should be part of our spending plan are: property taxes, technology replacement (smartphones, laptops, tablets), uncovered medical/dental procedures, deductibles and copays, auto replacement and repairs, home maintenance and upkeep, unplanned travel (to see family or attend a reunion or wedding), vacations, hobby startup costs, and pet care. It is important to allocate a portion of your sustainable monthly spending to these items, otherwise you may spend more than you can afford. Contact SWA for more information.

Monthly Market Commentary

As 2014 draws to a close, the U.S. is still experiencing a slow and longer-than-normal recovery.

GDP: The GDP growth rate in the third quarter was boosted to 3.9%, up from 3.5%, and well ahead of expectations of 3.3%. A lot of that improvement was due to high-quality items—more consumer and business spending. Unfortunately, that will make growth that much harder to achieve in the fourth quarter, which is now likely to be less than 3%. That would still leave the full-year GDP growth rate at about 2.3%, not much changed from 2012 and 2013. Consumption, business investment, net exports, and even government made decent-size contributions to overall GDP. As expected, residential housing was relatively disappointing, contributing just 0.1%. During this recovery, it has not been unusual for one category to drive most of the growth, while almost everything else showed limited growth or even a negative contribution.

Employment: The jobs report did far better than expected, with job growth of 321,000 for the month of November, the best result of calendar 2014 and the best report since 2012. However, it's not clear whether this data reflects misplaced seasonal factors or newfound economic strength. November was also a great month a year ago, when 274,000 jobs were added. Indeed, November has generally been in the top half of the 12 months for job growth over the past four years. So maybe at least a portion of the high growth was due to overly aggressive seasonal factors.

Wages: Like the raw employment data, the hourly wage growth was unusually strong in November. Month-to-month wages grew 0.4%, which annualizes to almost 5%. However, monthly data tends to be volatile; looking at year-over-year data, averaged over three months, presents a truer picture of economic activity. The year-over-year, hourly wage growth trend has been consistent at around 2.0–2.1% for the past 12 months.

Consumption and Income: The government restated recent consumption and income numbers so some of the short- term good news has disappeared. In the original government data, incomes went up a whopping 1.4% between March and September while consumption grew a measly 0.6%. The revisions to the six-month data now show that spending increased by 1% while incomes increased just 0.8%. In other words, savings decreased, not increased, over the past six months. In addition, the restated income data would seem to imply that eventually some of the job growth in the period April through June will be revised sharply down.

Housing: 2014 was a rough year for existing-home sales, which now appear likely to fall from 5.1 million units in 2013 to 5 million units in 2014. However, the 2013 data was aided by a rush to close homes before interest rates increased. Slower investor sales, poor weather, higher mortgage rates, and a dramatic price spike all conspired to hit existing-home sales hard in 2014, especially in the early parts of the year. Now interest rates are lower again and the weather has improved some. Sales have moved up from an annual rate of 4.6 million units during the winter to 5.3 million units in October, which just about equaled the best month of 2013.

The pending home sales index, which often portends changes in existing-home sales, was off modestly, just 1.2%, from 105.3 in October to 104.1 in November. However, pendings growth is still ahead of existing-home sales, which means that we can probably expect more improvement in year-over-year existing-home sales. Looking to 2015, Morningstar economists expect existing-home sales to grow at a 6%–8% rate, which would mean about 300,000–400,000 more units than in 2014. That would bring sales to 5.3 million–5.4 million units for the full year.

On the positive side, home prices are growing at a slower rate. This trend, coupled with lower interest rates, should improve affordability, providing an essential boost to this so-far anemic housing recovery.

Avoid These Mistakes With Your IRA, Part 1

Funding an IRA may seem like a simple financial task: Pick your provider, send in your money, and choose your investments. Done.

But a look at Internal Revenue Service Publication 590, which details the ins and outs of IRAs, suggests there's more to it. There are two key IRA types (Traditional or Roth), as well as two subtypes of Traditional IRAs (deductible and nondeductible), not to mention byzantine rules regarding rollovers, conversions, and recharacterizations. And what about when you begin taking IRA withdrawals in retirement? More kooky rules there, too.

There are a few obvious IRA mistakes, such as pulling money out of a Traditional IRA before age 59 1/2, but here are some IRA pitfalls that might be less familiar.

Mistake 1: Not taking full advantage of the tax benefits. One of the key benefits of any type of IRA, whether Roth or Traditional, is the ability to avoid taxes as the money grows. Investors who hold stocks and bonds in a taxable account are likely to receive taxable income and capital gains distributions from their holdings each year. Investors who hold the assets in an IRA, by contrast, have the potential to be taxed at a lower rate, or not at all, on those payouts, assuming they don't take the money out prior to age 59 1/2. That represents an opportunity to stash high-income-producing securities, such as dividend-paying stocks, for example, within the IRA wrapper, while saving more tax-efficient assets, such as broad market equity index funds, in taxable accounts.

Mistake 2: Being dogmatic about asset location. The key consideration here is when investors expect to need the money. For young accumulators, IRAs may be stock-heavy, and there may be no reason to add income producers into the mix. Meanwhile, for a 35-year-old holding bonds to fund a remodeling project, for example, it may make more sense to hold them in a taxable account, without any strictures to withdraw the money before retirement. The same reasoning applies to retirees who would like to pull some money for living expenses from their taxable accounts. It doesn't make sense to have all of the bonds residing in an IRA; bonds' relative liquidity might be helpful in taxable accounts, too. Finally, it's worth noting that it's often desirable to tap Roth assets toward the back end of retirement—if at all—because their tax-saving features are generally the greatest and should be stretched out for as long as possible.

Mistake 3: Not giving due care to IRA beneficiaries. The importance of beneficiary designations (they actually trump other bequests laid out in estate plans) is an under-discussed topic. As with any type of beneficiary designation, it's important to keep your IRA beneficiary designations up to date as your life situation changes—marriages, divorces, parents passing away, and so forth. Most people will name their spouses as their IRA beneficiaries; when the account owners die, their spouses can generally roll the assets into their own IRAs.

Mistake 4: Triggering a tax bill on a Roth IRA withdrawal. One of the key benefits of funding a Roth IRA is the ability to take tax- and penalty-free withdrawals in retirement. The Roth may also be a great vehicle for accumulators who worry about tying their assets up for a long time, as it's possible, under certain conditions, to withdraw contributions at any time and for any reason without triggering taxes or a penalty. Things get more complicated, however, when it comes to withdrawing investment earnings, or if your money got into the Roth because you converted it from a Traditional IRA or 401(k).

Mistake 5: Triggering a tax bill on a rollover. When it comes to the financial tasks that might crop up on your to-do list during your investment career, an IRA ranks as easy on the degree-of-difficulty scale. But it's still possible to goof up a rollover.

Retirement Distribution Pitfalls: Not Reinvesting RMDs You Don’t Need

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. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be not reinvesting RMDs you don't need. Retirees may experience a situation where the amount they must withdraw from 401(k)s and IRAs for required minimum distributions can take them over their desired distribution threshold. The RMD rules require that people initially withdraw less than 4% of assets at age 70 1/2, but distributions can quickly step up into the 5%, 6%, and 7% range.

Workaround: What people might not realize is that there's nothing saying they have to spend their RMDs; they can reinvest in a taxable account if they'd like that money to stay invested in the market. This can be a wise strategy for retirees who are concerned with legacy planning or long-term care needs down the line. It's possible to build a taxable account that has many of the tax-saving features of a tax-deferred account.

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.

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