Nicholson Financial Services

Did You Know...?

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I was going to make my next newsletter the "Winter 2015" version. Frankly, I, like everyone else here in New England, am so sick of winter that I made this my "Spring" edition in hopes that it is prophetic. Technically, it is spring already, but you wouldn't know it as it was snowing again this morning in late March. This has been a brutal winter here in the northeast, and don't think that will not have some effect on the economy. We've already seen some retailers with soft sales numbers, largely because people didn't want to leave their homes. Some realtors that I know have said the weather has kept many people from listing their houses. The silver lining to such a terrible winter is that it will end. When it does, I believe there is a ton of pent up demand that will turn into business. I expect that we will see weakness in the first quarter economic numbers due to the weather, but a rebound in the second quarter.

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Spring 2015

The Problems with Indexing

For those who are unfamiliar, "Indexing" refers to investing in an index fund. The most commonly used of these funds mirrors the return of the S&P 500 index, minus a management fee. As most of my clients know, I am not a fan of pure indexing. Although I have advised the use of index funds through particular strategies, I do not recommend that clients use them as long-term hold investments. For that, I prefer actively managed funds. In this article, I will offer some explanations as to why.

Over the past couple of years, large-cap US stocks have performed very well, making indexing even more attractive. This is a low cost way to participate in the market. To be clear, I do believe that growth oriented investors are better off investing in an index fund rather than sit in cash. However, here are some of the main reasons why I favor active management:

• By investing in an index fund, you can <u>never</u> outperform that index. This may not be an issue in good years, but in bad ones an active manager can make a significant difference.

• The S&P 500 is a market-cap weighted index. This means that the larger market cap (market price X total number of shares of stock) companies represent a larger portion of the index. So, when a particular sector has dominated for a time, it can significantly overweight the index. In the late '90s and early 2000, technology stocks had a tremendous run. At that time, they accounted for a massive portion of the S&P 500's value. This made the bursting of the tech bubble even more painful for index investors. By late 2007, financial stocks had grown significantly and represented the largest sector weight in the S&P 500. I am sure you know what happened in 2008.

• Indexes are always 100% invested. This means they will not ever build up cash to take advantage of better buying opportunities. Sometimes being 100% invested is a good thing, sometimes it is not.

• The 500 stocks in the S&P 500 are some of the largest in the US stock market by market capitalization, not the 500 "best" stocks. S&P (Standard and Poors) offers research on thousands of companies. They use a 5 STAR system with 5 STARs being a "strong buy" to 3 STARs a "hold" and 1 STAR a "strong sell." By S&P's own research (which I subscribe to), more than half of the stocks in the S&P 500 are rated 3 STARs or less (hold, sell, or strong sell). Going back to the STARs inception in December of 1986, S&P has tracked the comparative performance of the STARs with the S&P 500. From 12/86 to 2/15, the 1 STAR stocks averaged 1.81% per year, the S&P 500 averaged 7.98%, and the 5 STAR stocks averaged 13.76% per year. In my opinion, S&P's own research offers a strong case for active management.

One mistake that investors often make is that they chase performance. They see that the S&P 500 has been one of the best places to be for a few years in a row and they think "why should I keep putting money into asset classes that aren't doing well when I could put ALL of my investment dollars into ones that ARE." Well, we have seen this before. From 1995 to 1999, large-cap US stocks were one of the best places to be (especially technology stocks). During that time, it got increasingly hard to keep clients diversified and focused on their long-term plans. The draw to chase performance was very strong. When 2000 arrived, we witnessed one of the biggest asset class reversals in many years. The top 4-5 asset classes from '95 to '99 became the worst places to be for the next 3 years. Conversely, the worst places to be from '95 to '99 became the best places to have money from '00 to '02. Those who were diversified and rebalanced occasionally generally did fairly well from 2000 to 2002. Those who overweighed their portfolios into the S&P 500, or large-cap growth or tech stocks, had their portfolios suffer significant losses. Although I can't see the future, I can tell you that many of the mistakes that investors have made in the past will be made by others in the future. My goal is to help my clients avoid these pitfalls if at all possible.

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10 Financial Terms Everyone Should Know

Understanding financial matters can be difficult if you don't understand the jargon. Becoming familiar with these 10 financial terms may help make things clearer.

1. Time value of money

The time value of money is the concept that money on hand today is worth more than the same amount of money in the future, because the money you have today could be invested to earn interest and increase in value.

Why is it important? Understanding that money today is worth more than the same amount in the future can help you evaluate investments that offer different potential rates of return.

2. Inflation

Inflation reflects any overall upward movement in the price of consumer goods and services and is usually associated with the loss of purchasing power over time.

Why is it important? Because inflation generally pushes the cost of goods and services higher, any estimate of how much you'll need in the future--for example, how much you'll need to save for retirement--should take into account the potential impact of inflation.

3. Volatility

Volatility is a measure of the rate at which the price of a security moves up and down. If the price of a security historically changes rapidly over a short period of time, its volatility is high. Conversely, if the price rarely changes, its volatility is low.

Why is it important? Understanding volatility can help you evaluate whether a particular investment is suited to your investing style and risk tolerance.

4. Asset allocation

Asset allocation means spreading investments over a variety of asset categories, such as equities, cash, bonds, etc.

Why is it important? How you allocate your assets depends on a number of factors, including your risk tolerance and your desired return. Diversifying your investments among a variety of asset classes can help you manage volatility and investment risk. Asset allocation and diversification do not guarantee a profit or protect against investment loss.

5. Net worth

Net worth is what your total holdings are worth after subtracting all of your financial obligations.

Why is it important? Your net worth may fund most of your retirement years. So the faster and higher your net worth grows, the more it may help you in retirement. For retirees, a typical goal is to preserve net worth to last through the retirement years.

6. Five C's of credit

These are character, capacity, capital, collateral, and conditions. They're the primary elements lenders evaluate to determine whether to make you a loan.

Why is it important? With a better understanding of how your banker is going to view and assess your creditworthiness, you will be better prepared to qualify for the loan you want and obtain a better interest rate.

7. Sustainable withdrawal rate

Sustainable withdrawal rate is the maximum percentage that you can withdraw from an investment portfolio each year to provide income that will last, with reasonable certainty, as long as you need it.

Why is it important? Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio.

8. Tax deferral

Tax deferral refers to the opportunity to defer current taxes until sometime in the future.

Why is it important? Contributions and any earnings produced in tax-deferred vehicles like 401(k)s and IRAs are not taxed until withdrawn. This allows those earnings to compound, further adding to potential investment growth.

9. Risk/return trade-off

This concept holds that you must be willing to accept greater risk in order to achieve a higher potential return.

Why is it important? When considering your investments, the goal is to get the greatest return for the level of risk you're willing to take, or to minimize the risk involved in trying for a given return. All investing involves risk, including the loss of principal, and there can be no assurance that any investing strategy will be successful.

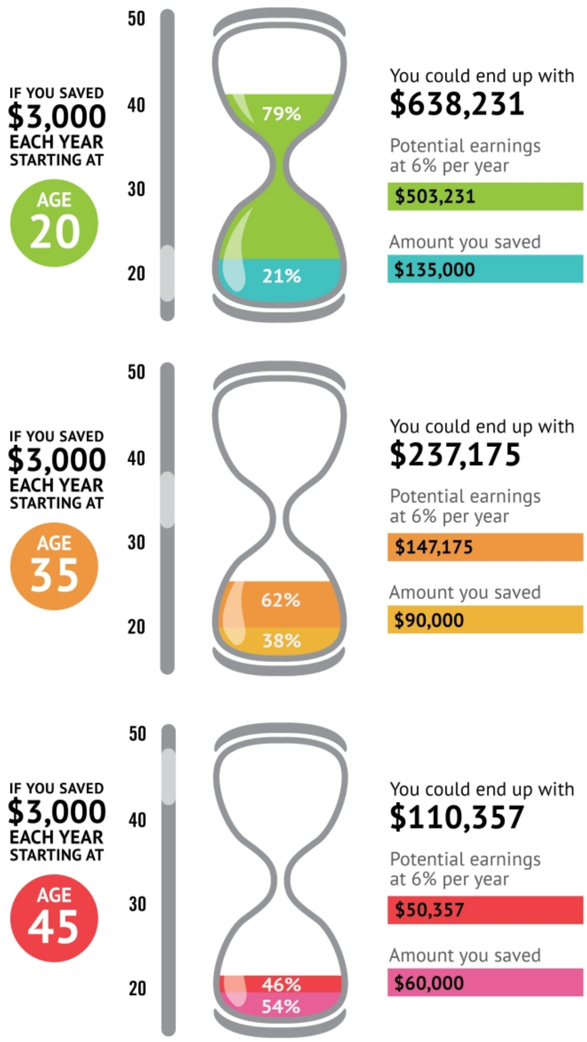
10. The Fed

The Federal Reserve, or "the Fed" as it's commonly called for short, is the central bank of the United States.

Why is it important? The Fed has three main objectives: maximum employment, stable prices, and moderate long-term interest rates. The Fed sets U.S. monetary policy to further these objectives, and over the years its duties have expanded to include maintaining the stability of the entire U.S. financial system.

The Cost of Waiting

Starting to save early means your money has more time to go to work for you. Even if you can only afford to set aside small amounts, compounding earnings can make them really add up. It's never too late to begin, but as this illustration shows, the sooner you start, the less you may need to rely solely on your own savings to build your total nest egg.



This illustration assumes annual investments made at the end of each year through age 65 and a 6% fixed annual rate of return. The rate of return on your actual investment portfolio will be different, and will vary over time, according to actual market performance. This is particularly true for long-term investments. It is important to note that investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

The examples do not take into account the impact of taxes or inflation; if they did, the amounts would have been lower. They are intended as hypothetical illustrations of mathematical principles and should not be considered financial advice.

All investing involves risks, including the possible loss of principal, and there can be no guarantee that any strategy will be successful. Past performance is no guarantee of future results.

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I owe a large amount of money to the IRS. Can I pay what I owe in installments?

Unfortunately, not everyone gets a refund during tax season. If you are in the unenviable position of owing a large amount of money to the IRS, you may be able to pay what you owe through an installment agreement with the IRS.

With an installment agreement, the amount of your payment will be based on how much you owe in unpaid taxes and your ability to pay that amount within the agreement's time frame. Although you are generally allowed up to 72 months to pay, your plan may be for a shorter length of time.

To request an installment agreement, fill out Form 9465, Installment Agreement Request, and attach it to your tax return, or mail it by itself directly to your designated Internal Revenue Service Center. If your balance due is not more than $50,000, you can apply for an installment agreement online at IRS.gov.

The IRS will generally let you know within 30 days after receiving your request whether it is approved or denied (if you apply online, you'll get immediate notification of approval). If the request is approved, the IRS will send you a notice detailing the terms of your agreement. You will also be required to pay a fee of $120 ($52 if you make your payments by direct debit). You can make your payments by check, money order, credit card, payroll deduction, or direct debit from your bank account.

Keep in mind that even if your request for an installment agreement is granted, you will still be charged interest and may be charged a late-payment penalty on any tax not paid by its due date. This interest and any applicable penalties will be charged until the balance you owe to the IRS is paid in full.

It is important to realize that the fees and interest charged by the IRS for an installment agreement can add up. As a result, before you enter into an installment agreement, the IRS suggests that you consider other alternatives, such as getting a bank loan or using available credit on a credit card.

How much can I contribute to my IRA in 2015?

The combined amount you can contribute to your traditional and Roth IRAs remains at $5,500 for 2015, or $6,500 if you'll be 50 or older by the end of the year. You can contribute to an IRA in addition to an employer-sponsored retirement plan like a 401(k). But if you (or your spouse) participate in an employer-sponsored plan, the amount of traditional IRA contributions you can deduct may be reduced or eliminated (phased out), depending on your modified adjusted gross income (MAGI). Your ability to make annual Roth contributions may also be phased out, depending on your MAGI. These income limits (phaseout ranges) have increased for 2015:

Income phaseout range for deductibility of traditional IRA contributions in 2015	
1. Covered by an employer-sponsored plan and filing as:	
Single/Head of household	$61,000 - $71,000
Married filing jointly	$98,000 - $118,000
Married filing separately	$0 - $10,000
2. Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan	$183,000 - $193,000

Income phaseout range for ability to contribute to a Roth IRA in 2015	
Single/Head of household	$116,000 - $131,000
Married filing jointly	$183,000 - $193,000
Married filing separately	$0 - $10,000

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