Investor Insights & Outlook

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Investing Your Year-End Bonus

What to do with that year-end bonus is a pressing concern because bonuses are increasingly supplanting annual pay raises as a means of rewarding employees. Here are a few ways to make the most of your bonus.

Pay Down Debt: Before you put any money into the market, consider paying off your debt. Credit-card debt, which often has a high interest rate, is an obvious don't. Consider sending an extra payment to your mortgage lender, which can help shorten the life of your loan.

Maximize Your Match: Check with your employer to find out whether your 401(k) contribution is being deducted from your bonus. If it is, you may want to lower the percentage amount that you're contributing to your 401(k) before you receive the bonus. In so doing, you'll ensure that your contributions are spaced throughout the year, and you'll be able to take full advantage of your employer's matching contributions.

Feed Your Tax-Sheltered Accounts: If you haven't already done so, consider contributing to a regular or Roth IRA. Tax-deferred portfolios can grow more quickly than taxable ones, and the gains on Roth IRAs are tax-free.

Match Your Investments to Your Time Horizon: Pay attention to your investment time horizon. If you're in your 30s and saving for retirement, aggressively positioned stock funds may be a good option. But if you plan to tap the money within a shorter time frame, you may want to focus on conservative investments.

Returns and principal invested in stocks are not guaranteed. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free. A 10% penalty may apply for withdrawals prior to the age of 59 1/2.

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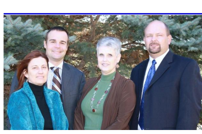

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Five Year-End Tax Tips

1. Contribute to your tax-advantaged accounts: One of the best ways to cut your tax bill is to reduce your taxable income. It is important to take advantage of any retirement-plan contributions you can make to reduce your taxable income. You can contribute $17,000 to your 401(k) plan in 2012, and those age 50 or older can save an additional $5,500. Consider ratcheting up your contribution before the end of the year if you're on pace to fall below that contribution limit.

Some taxpayers might also be able to contribute up to $5,000 to a traditional IRA (individuals 50 and older can contribute $6,000), and you'll be able to deduct that contribution from the income you report on your tax return. Keep in mind that in order to be eligible for a traditional deductible IRA, your income must come in below a certain threshold. Please be sure to consult the IRS Web site (www.irs.gov) or a financial professional for detailed information.

2. Beware of ticking tax time bombs: Have you had any big mutual fund winners in your portfolio? If so, there's a very good chance that they'll be making capital gains payouts later this year—which means you could wind up owing taxes on those gains. If you were planning to purchase any one of these funds, it would be wise to wait until after they've made their distributions for the year. That way, you won't be responsible for taxes on gains you weren't around to enjoy.

Many fund shops begin making capital gains distribution estimates available later in October and into November, and capital gains payouts typically occur in December. If your fund company doesn't list this information anywhere on its website, call to find out whether your fund is planning a distribution, how much it will be, and when it will occur. And remember, past performance is no guarantee of future results.

3. Harvest your losers: Selling losing investments and reinvesting the money in investments that are similar in style might allow investors to maintain their long-term asset allocation and enjoy the benefits of a potentially lower tax bill. Although long-term investors know that it is better to buy and hold than to try timing the market, there are times when selling and taking losses could be worthwhile. For instance, if an investor suffers losses from a large-cap stock fund, she can sell it at a loss to offset other capital gains she might have and then reinvest the money in another large-cap stock fund to maintain the asset allocation. Federal tax laws allow capital gains to be offset dollar for dollar with realized capital losses.

4. Taxable versus non-taxable accounts: Pay attention to which funds are in your taxable and non-taxable accounts. To the extent that you own taxable bonds and bond funds, particularly high-yield offerings (such as junk-bond and emerging-markets bond funds), be sure to hold them in your tax-sheltered accounts. The same applies for high-turnover stock funds that generate a lot of short-term capital gains.

5. Be generous: If you contribute to a charity, your generosity could come in handy come tax time. If you itemize deductions, you can deduct charitable contributions; just be sure to save receipts and canceled checks as proof. And if you're helping those near and dear to you, remember that you can contribute up to $13,000 per year per recipient in 2012 without triggering gift tax.

Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns.

The Ins and Outs of the 5-Year Rule for Roth IRAs

If you want to take a tax- and penalty-free withdrawal of the portion of a Roth that consists of investment earnings (amount above your initial contribution), you need to be age 59 1/2, disabled, or using the money to pay for a first-time home. However, there’s more to this rule.

The five-year clock doesn't start on the day you opened or funded your Roth IRA account. Rather, it starts on the first day of the tax year for which the IRA is opened and funded. This means if you funded a 2011 Roth contribution in early April 2012, your five-year clock started on January 1st, 2011. This implies you could withdraw your investment earnings free of penalty and tax, provided you meet the other criteria for Roth IRA withdrawals (you're 59 1/2, disabled, or using the money for a first-time home), as of January 1st, 2016. The five-year waiting period doesn't start again each time you make additional contributions. Using the previous example, even if you made additional contributions for the 2012 and 2013 tax years (following your initial contribution for 2011), you'll still have satisfied your five-year holding period at the beginning of 2016, because your five-year clock started at the beginning of 2011.

Unfortunately, the five-year rule gets a bit more complicated if you've gotten the assets into a Roth through converting a traditional IRA. In that case, you need to be either 59 1/2 or five years must have elapsed since your conversion for you to be able to take penalty-free withdrawals on the converted amounts on which you paid taxes at the time of conversion. Moreover, if you've converted amounts to a Roth over a period of years, each conversion amount has its own five-year holding period. The penalty will be waived if you meet certain conditions (for example, if you're using the money for qualified education or medical expenses).

Whether a penalty applies depends on the nature of your IRA at the time of conversion, and hinges on the Internal Revenue Service's ordering rules for distributions. If you're taking a withdrawal from a Roth, the IRS assumes that contributions are withdrawn first (always tax- and penalty-free), followed by the taxable portion of a conversion, followed by the nontaxable portion of a conversion, followed by investment earnings. For example, let’s say you had a $100,000 rollover IRA set up when you left your old firm, which you rolled into a Roth IRA in 2010. If you wanted to withdraw that money prior to age 59 1/2, you'd have to wait until 2015 to do so penalty-free. Because you owed taxes on your whole IRA amount at the time of conversion, that amount will be subject to the 10% penalty if withdrawn before five years have elapsed.

If you convert a traditional IRA that consists of nondeductible and deductible contributions, things get trickier. For example, you've built up $15,000 in a traditional IRA, $10,000 consisting of nondeductible contributions and $5,000 of deductible contributions. When converted, you'll owe tax on the $5,000 (money on which you never paid taxes). If in three years you need to withdraw $5,000, before you're 59 1/2, that amount will be subject to penalty because the IRS assumes that the amount withdrawn first is the taxable portion of your rollover, in this case, $5,000. Withdrawing the other $10,000 wouldn't trigger a penalty. Backdoor Roth IRA investors can usually avoid the 10% penalty because all or nearly all of their converted amounts will consist of money they already paid taxes on and they'll owe nothing in taxes at conversion.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

Property and Casualty Insurance

Just as in driving, when planning your finances you have to learn to be defensive. While the word "insurance" makes some people cringe, it might not seem so bad if you can find ways to protect your family and save money at the same time. Let's investigate homeowners, auto, and umbrella insurance coverage.

Homeowners Insurance: As scary as it might be to even think of, homeowners are at the risk of losing their property to a fire. Those who live in certain parts of the country are also prone to floods, tornadoes, hurricanes, you name it. Unfortunately, none of us is immune. Homeowners insurance protects what is most likely your biggest investment (your house) and all of its contents. It also provides much-needed liability coverage in case you are ever sued. Because disasters happen when we least expect them, proper preparation is a must. It is recommended that homeowners take an inventory of the contents of their houses, preferably on videotape if possible. Then put the video record in a safe deposit box or a flame-resistant home safe. Next, take a closer look at your insurance policy. Does it provide for 100% guaranteed replacement value for your house and possessions? Is there an inflation clause? Is there "loss of use" coverage that pays for expenses while you can't live in your house? What are the limits on items such as computers, cameras, jewelry, furs, or other valuables? If you've accumulated more "stuff" over the past few years, have you included it in your inventory of assets? Most people should update that at least every two years. Also, it never hurts to comparison shop. You can obtain free insurance quotes from a number of companies on the Internet. Be sure to get the best bang for your buck. For renters, you should be covered by renters insurance. The building owner's property coverage will not pay to replace your apartment's contents. You never can predict if an upstairs neighbor will leave a candle lit or trip over one of your kids' roller skates.

Auto Insurance: Most importantly, your auto insurance policy needs to cover liability. It is not unusual for people to end up in multimillion-dollar lawsuits if they were at fault in an auto accident. You might also need medical coverage, but check your health policy to make sure you are not duplicating coverage. Furthermore, be sure you have protection from uninsured or underinsured drivers—not everyone is as responsible as you are. Physical damage is another important aspect of car insurance. There are two basic types of coverage: collision and comprehensive. As the value of your car goes down, it may not make sense to continue collision coverage. You can check out the value of your car according to Kelly Blue Book. If you know you'll replace your car if you have an accident, you probably don't need the collision protection. Comprehensive covers all risks other than collision (fire, theft, storm damage, etc.).

Umbrella Insurance: Umbrella coverage gets its name because it sits on top of your homeowners and auto insurance. It extends the liability coverage of those policies. You must have the underlying coverage (assuming you own the asset) in place. Be careful to read the underlying coverage liability limits. You don't want to have a gap between what the homeowners coverage pays for and what the umbrella policy pays for. If you do, you will be responsible for the gap. Be sure to check into discounts if you purchase all of these policies from the same insurance company. Umbrella insurance may be worth considering especially if you have a swimming pool, a big dog, teenage drivers, or if you employ babysitters or cleaning people. Here's the good news: this coverage is cheap. It will cover accidents at your home, in your car, slander, defamation of character, invasion of privacy, libel, and plagiarism. The more assets you have, the more you need this coverage.

So remember to protect those assets that you've worked so hard to accumulate. You never know when something unexpected can ruin not just your day but your financial plans for the future.

Monthly Market Commentary

Markets in October and early November were mostly distracted from the positive economic news in the U.S. by poor earnings reports, election jitters, and Hurricane Sandy. The earnings reports have not been pretty, with negative news from slowing emerging markets, a weak Europe (and, to a lesser degree, China), and large currency swings. Although the U.S. won't remain immune to the rest of the world forever, and our fiscal situation remains in disarray, there still are a few factors that will help the domestic economy. These include Boeing's ongoing ramp-up, a nicely improved and stable auto industry, increased oil production, a relatively stabilized banking industry, and a lumbering housing industry that has finally begun to recover.

GDP: Third-quarter real GDP grew by 2%, ahead of the second quarter's 1.3% rate. Much of this improvement was due to a very strong consumer, an improved housing market, and strong government spending. Consumption, which represents about 70% of GDP, is always the most important factor, because if consumers continue to spend, businesses will have to invest in plant and equipment, inventory, and most importantly, employees.

Employment: In October, 171,000 jobs were added, sharply exceeding expectations. While this was great news, Morningstar economists believe that at the current pace of job growth, an additional 23 months is still required to recover pre-recession jobs. Employment recovery across sectors has not been consistent. The overall service sector is nearly back to pre-recession levels, while good-producing sectors (mining, manufacturing, and construction) have only recovered 15% of the jobs lost. Furthermore, massive efficiency gains in manufacturing have moved industrial production levels to near pre-recession levels, even as manufacturing has regained a measly 25% or less of the jobs lost. The unemployment rate inched upward to 7.9%.

Housing: Despite the arrival of fall, which typically brings a drop in real estate activities, home prices, new home sales, and pending home sales all showed improvement. On a year-over-year basis, the August Federal Housing Finance Agency (FHFA) Home Price Index was up 4.6%, with all nine regions in the U.S. showing positive growth. While almost always moving in the same direction, pending sales (contract executed but not closed) have exceeded closed sales by a large margin for many months, as below-market appraisals and mortgage denials caused many contracts to not close. Recently, the gap between growth in pending and closing sales has narrowed to about 2% from as much as 6%, which Morningstar economists believe points toward an improving housing market.

Manufacturing: October's manufacturing data showed gains in new orders and an increase in employment, which suggested that the manufacturing sector in the U.S. may have bottomed and is now recovering. Auto sales in October were better than a year ago, but slumped from 14.9 million units in September to 14.2 million units in October. Hurricane Sandy was most likely the cause of this shortfall, as a large portion of auto sales occur on the last few days of the month, and the area hit by the storm accounted for 20%-25% of all auto sales. Outside of the U.S., China showed meaningful improvement between September and October as the Chinese construction market continued to show signs of bottoming. Europe's manufacturing, on the other hand, continued to contract and is currently at its lowest level in 40 months.

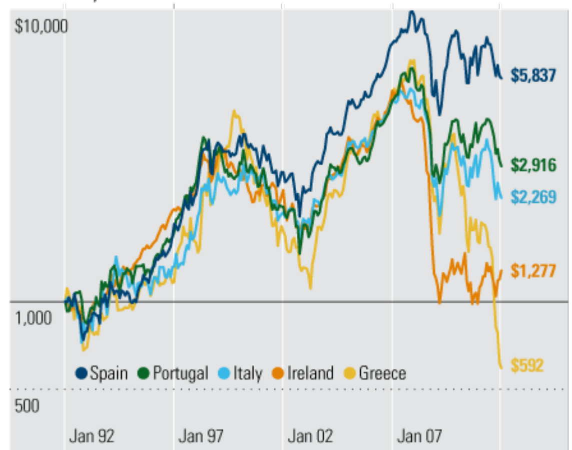
Election results: With President Barack Obama narrowly beating out Republican challenger Mitt Romney to win a second term in office, all attention has now turned to global woes and the looming fiscal cliff. If nothing is resolved by the end of 2012, massive spending cuts and across-the-board tax increases may occur. Markets reacted negatively on Wednesday November 7th, falling by as much as 2.73%, with energy and banking sectors among the hardest hit.

PIIGS Performance

The “PIIGS” acronym refers to the economies of Portugal, Ireland, Italy, Greece, and Spain. The term became popular during the European sovereign debt crisis in highlighting the weaker performance of these economies coming out of the economic downturn. As shown in the image, the PIIGS economies have yet to fully recover from the 2007 financial crisis and the subsequent European sovereign debt crisis. In fact, an initial $1,000 invested in Greek stocks at the start of 1992 would have yielded a mere $592 by the end of 2011 (a 41% decline in value).

If an investor desires to invest in international markets, it is important to remember to diversify across not just asset classes, but also country exposure. Diversification may minimize the financial impact to your portfolio if a specific country or region ends up in financial distress.

Growth of $1,000
January 1992–December 2011



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Greece, Ireland, Portugal, Italy and Spain are each represented by the corresponding Morgan Stanley Capital International Index. Returns in U.S. dollars are based on the exchange rate over the selected time period. Returns and principal invested in stocks are not guaranteed. The 1992 start date for this analysis was chosen in order to analyze the most recent 20-year time period. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Diversification does not eliminte the risk of experiencing investment losses.

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