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PRIZM PERSPECTIVE **FALL 2014**

How Much Flexibility Is Too Much?

When it comes to flexibility in a financial plan, it's a delicate balancing act: it is important to maintain enough flexibility that your financial plan can accommodate unexpected events that are out of your control. On the other hand, a sound financial plan needs to be firmly grounded by factors you can control so that even in the face of unexpected events, following your financial plan gets you to where you want to be.

When you develop a financial plan, you have to make certain assumptions, many of which are out of your control:

Taxes — The notoriously complicated U.S. tax code will affect your financial plan in a number of ways. For one, your effective tax rate will change as your income changes. Also, changes to the tax code itself can affect your financial plan, often dramatically. Fortunately, changes aren't typically made every year; and because Congress sets tax policy, most changes in the tax code are announced in advance of taking effect — allowing you time to plan how those changes might impact your financial plan.

Income — We all hope, of course, that our income will rise as we move forward in our careers. Typically, those kinds of income changes are predictable. More dramatic yet still predictable income changes can happen when one spouse voluntarily stops or starts working. The loss of a job or dramatic decrease in work hours can cause unexpected changes in income.

Health — Your health and the health of your spouse are significant factors in your financial plan for two reasons: first, because health is a big

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Learn Income Tax Basics

The subject of income taxes is one that most people prefer to ignore. However, since income taxes are a significant expense for most taxpayers, you should come to grips with some basics:

❍ **Realize you can exert some degree of control over how much you pay in income taxes.** While you must file and pay taxes every year, how much you pay depends on the tax strategies used. Discuss your tax situation with a tax professional, reviewing ways to help reduce your income tax bill.

❍ **Understand basic tax concepts.** You don't have to become a tax expert, but you should have a basic understanding of tax laws so you recognize when you need assistance. Before any major financial transaction, such as selling a home or investments, review the tax ramifications.

❍ **Don't make decisions solely for tax reasons.** While you want to minimize the payment of income taxes, that is only one factor in most financial decisions. You should first make sure the transaction is economically beneficial and then decide how to minimize the tax effects.

❍ **Keep good tax records.** During the year, file any records with possible tax ramifications. That way, when it comes time to file your income tax return, all your tax records will be located in one place and you won't forget a deduction. ❍❍❍

FR2014-0516-0197

How Much Flexibility?

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determinant of one's ability to earn income; and second, because healthcare costs are often one of the largest expenses, especially for older people. As you age, it's important to think about changing your assumptions about your health. Maybe you reduce the income you expect because you won't be able to work long hours. Or you increase the healthcare-related expenses you plan for. You can also take steps to mitigate the impact of health changes.

Life — Beyond job losses and health events that can affect your financial plan, other major life events can have a big impact as well. Events like the birth of a child, marriage or divorce, a spouse's death, or a relocation will affect your financial plan. Some you can plan for, some you can't; the point is to be aware that these events will impact your plan.

Economy — For most of us, our financial plans are based on the assumption that our investments will earn a certain average return in the market. Those assumptions affect decisions we make about our plans; for example, the amount you need to save every month to retire at age 70 may be larger or smaller the higher or lower your assumption about investment returns. The best way to make these assumptions is to base them on long-term historical returns in relevant market indices.

Because there are so many factors affecting your financial plan that you can't control, it's critical to know the factors you can control and to stay on track in those areas.

Live within your means — When you keep your expenses (including savings and investments) less than your income, you give yourself more flexibility to accommodate unexpected changes that you can't control. If you have some breathing space in your budget every month, you can more easily accommodate, for example, a higher tax rate or economic downturn without having to alter your financial plan.

Have a rainy day fund — Have at least three to six months worth of living expenses in an easily accessible, liquid fund that you can draw upon in the event of a rainy day — an emergency or unexpected situation. This savings should be set aside from all other savings and investments and only used for true emergency expenses — like in the case of a job loss or illness. With an adequate rainy day fund, you can deal with unexpected events without having to erode your financial plan.

Revisit your plan regularly — The number-one key to achieving your financial goals is to review and, if necessary, revise your financial plan regularly — at least once a year. That way, you can make adjustments for all the factors that have changed for better or worse. If you haven't revisited your financial plan in the last year or you need to develop one, please call. ❍❍❍

Investment Tax Strategies

With marginal tax rates of up to 39.6%, taxes can seriously erode your investment's total return. Consider these strategies, which can help you reduce income taxes:

❍ **Consider your holding period before selling.** Gains on investments held for one year or longer are taxed at the capital gains tax rate of 15% or 20% (0% if you are in the 10% or 15% tax bracket), rather than ordinary income tax rates. Thus, before selling an investment, review your holding period.

❍ **Review realized gains and losses before year-end.** If you have realized gains but are holding investments with losses, you might want to sell them before year-end to offset those gains. You can offset all of your capital gains plus take an additional $3,000 of loss against ordinary income.

❍ **Specifically identify which shares you are selling.** If you purchased an investment over time, you may have varying basis amounts for different shares. Your gain or loss will be determined by which shares you sell. Thus, you should assess your overall tax situation, decide whether you want a higher or lower gain or loss, and then designate which shares you want to sell.

❍ **Donate investments with large capital gains to charitable organizations.** You can deduct the fair market value of the investment (provided you held it over one year) as a charitable contribution, subject to limitations based on your adjusted gross income. By donating the investment, you do not pay capital gains taxes on the gain.

❍ **Keep track of your investments' bases so you don't overpay taxes.** For instance, reinvested dividends are part of your cost basis since income taxes were paid when the dividends were received. For inherited assets, the cost basis is typically the value on the date of the previous owner's death.

❍ **Consider tax-deferred or tax-exempt investments.** The interest income from municipal bonds is typically exempt from federal income taxes and possibly state and local income taxes. Contributions to 401(k) plans and IRAs can grow on a tax-deferred or tax-exempt (for Roth IRAs) basis. This deferral of income taxes can make a significant difference in the ultimate size of your portfolio.

Please call if you'd like to discuss how to structure your portfolio more tax efficiently. ❍❍❍

How Do Bond and Stock Investing Differ?

Which is best — stock investing or bond investing? As always, the answer is: It depends. There are many differences between stock investing and bond investing, and which is better depends on how those differences affect the asset allocation of your current portfolio, your financial goals, your risk appetite, and your investment time frame. Here, we detail what you need to know about the differences.

Return

❍ ***Bonds*** — The return on a bond is comprised of three elements: 1) the interest the bond pays, also known as the coupon rate; 2) the principal returned when the bond matures; 3) and the price of the bond were you to sell it before maturity in the secondary market. If you hold a bond to maturity, you'll get all the interest as well as your principal investment. If you sell the bond before maturity, you could sell it for more than its face value (par value) and realize a gain — or you could sell it for less than face value and realize a loss.

❍ ***Stocks*** — Stock returns are also comprised of three elements: 1) any dividends the company pays, which you can take out or reinvest; 2) the amount you paid for the stock; and 3) the change in the price of the stock compared to when you bought it. While there are some classes of stock that generate relatively significant income through dividends, the bulk of the return on a stock investment comes from changes in the price of the stock from when you bought it to when you sell it.

When all of the factors are accounted for, stocks outperform bonds more often than bonds outperform stocks. But bonds do sometimes outperform stocks.

Risk

❍ ***Bonds*** — As is always the case, there's a trade-off between risk and reward. Even though bonds sometimes outperform stocks, long-term bond returns are lower than long-term stock returns. But in exchange for those lower returns, on average, bonds are more predictable.

❍ ***Stocks*** — In contrast to relatively predictable bond returns, stocks are much more volatile. So while the long-term average stock return was higher than the long-term average bond return, stocks are a riskier investment than bonds.

Income

❍ ***Bonds*** — Bonds are known as fixed-income securities because they generate a fixed payment twice a year. That payment is fixed based on the coupon rate of the bond (the interest rate). Unless the bond issuer defaults, if you hold the bond to maturity, you can expect to receive the same interest payment twice a year.

❍ ***Stocks*** — Again, some stocks do generate an income of sorts, in the form of dividend payments. And these dividends can be significant for certain classes of stock, such as utilities. However, dividends are not guaranteed so are not defined as fixed income.

Liquidity

❍ ***Bonds*** — Bond liquidity — how easy it is to sell a bond before maturity — varies substantially among types of bonds. Many municipal bonds, for example, are quite illiquid. Treasuries, on the other hand, are relatively liquid.

❍ ***Stocks*** — In the vast majority of cases, stocks are typically very liquid. For the most part, getting into or out of a stock is relatively easy.

Taxes

❍ ***Bonds*** — Interest on Treasury bonds is typically not subject to state or local income tax, though it is taxable at the federal level. Interest on municipal bonds is typically not subject to federal income tax; and if you live in the state or city issuing the bond, interest is typically exempt from state/local tax as well.

❍ ***Stocks*** — Stock returns are typically taxable, though for most taxpayers, capital gains are taxed at a lower rate than earned income. When stocks are part of certain tax-advantaged retirement plans, gains may be tax free.

Which Is Best for You?

It depends; ask yourself:

❍ **What's your current asset allocation?** Diversity across asset classes is one of the most important keys to an investment portfolio that will meet your financial goals. If you're ove-invested in stocks, bonds could add the diversity you need.

❍ **What are your financial goals?** If your primary goal is to preserve wealth, bonds can be a good option. If, on the other hand, you're trying to save for retirement, bonds alone are not likely to generate the kinds of returns you need to grow your portfolio.

❍ **What is your investment time frame?** If you're investing for the relatively short term, bonds can be a good option. In contrast, stocks could turn out to have a very bad five years; and even if the next five are stellar, you're stuck deciding whether to take the losses or delay your financial goal.

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

Watch for These Estimating Mistakes

When determining how much to save by retirement age, several variables must be considered, some requiring estimates that will span decades. Err significantly on those estimates and you can end up with little or no money left during the later years of your life. Three of the most significant estimating mistakes to watch out for are:

- **Underestimating how much income you'll need in retirement.** The entire point of your retirement savings is to ensure you have sufficient income to spend your retirement doing the things you plan, so make sure you have a good estimate of how much that will cost. Various rules of thumb indicate you'll need anywhere from 70% to over 100% of your preretirement income. At first glance, it seems like you'll need less than 100%, because work-related expenses, lunches out, expensive clothes, and commuting costs will be gone. But look carefully at your current expenses and how you plan to spend your retirement years before deciding how much you'll need. If you pay off your mortgage, remain in good health, live in a city with a low cost of living, and engage in inexpensive hobbies, you might need less than 100% of your preretirement income. However, if you plan to travel extensively, must pay for health insurance, and carry significant debt, you may find that 100% of your preretirement income is not enough. You need to look closely at your current expenses and planned retirement activities to come up with a reasonable estimate.
- **Underestimating how long you'll live.** Today, the average life expectancy is 76 years for a 65-year-old man and 81 years for a 65-year-old woman. But don't just use those figures without further analysis. Average life expectancy means a woman has a 50% chance of dying before age 81 and a 50% chance of living past age 81. Since you can't be sure which will apply to you, you should probably assume you'll live at least a few years beyond your life expectancy. When deciding how many years to add, consider your health and how long other family members have lived.
- **Overestimating how much you can withdraw annually from your retirement savings.** With a retirement that could span decades, it's important to withdraw a reasonable amount so you don't deplete those savings too soon. A number of factors can make that a difficult number to calculate. First, as noted above, you can't be sure how long you'll be making withdrawals. Live significantly beyond your average life expectancy, and you could find yourself with little in the way of savings. Second, inflation over such a long period means you'll have to withdraw increasing amounts just to maintain the same purchasing power. Third, your rate of return on your investments will significantly affect how much you can withdraw annually. When withdrawals are being made, down markets can have a devastating effect on your savings. Not only will your investment value go down, but you will be withdrawing the same amount from a smaller balance. Thus, when the market rebounds, you'll have less capital available to participate in that rebound. Especially if a major market downturn occurs early in your retirement, withdrawing an amount that may have been reasonable during an up market may quickly deplete your assets. Thus, it's generally prudent to keep your withdrawal percentage as low as possible, perhaps 3% or 4% of your balance. With that level of withdrawal, your funds should last for decades. ❍❍❍

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