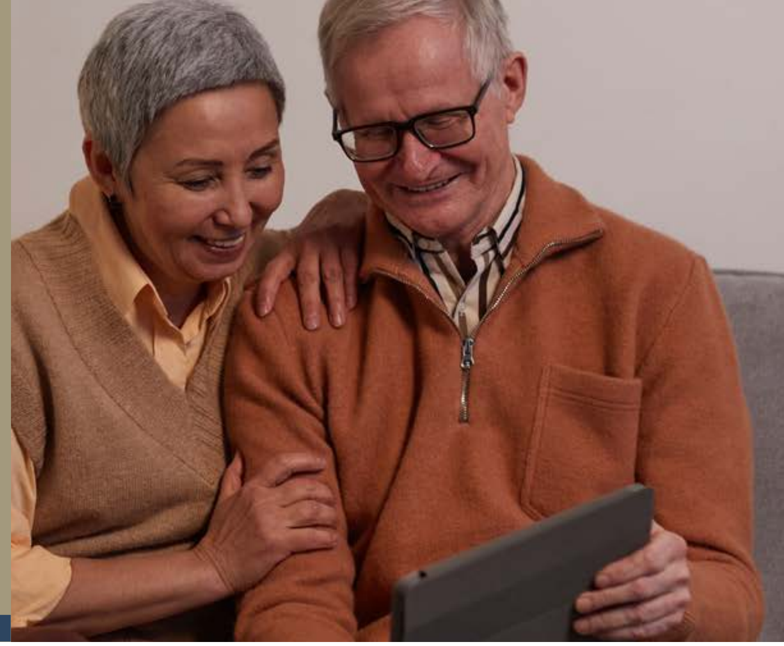
RETIREMENT PLANNING

3 Critical Questions to Answer

Retirement planning creates plenty of anxiety for many. We move clients from a place of fear and frustration to being confident in their retirement plan. In that light, we are providing you with three questions and their answers that are critical to the success of your retirement plan. These questions focus on managing your investment risk and reducing taxes over the long-term. Many more variables exist, but if you are successful in handling the three questions below, you are well on your way to a successful retirement.



1. How Will You Retire Without the Risk of Bonds?

"Risk of bonds? Bonds provide safety." We've heard that comment many times and for the past four decades it has been true. As interest rates steadily declined over four decades, bonds provided a wonderful source of steady income while also increasing in value. But what now? How to we handle bonds when interest rates don't have much more room to move lower?

The Relationship of Bonds and Interest Rates

Interest rates and bonds values share an inverse relationship. As interest rates fall, existing bonds become more valuable. As interest rates rise, existing bonds become less valuable.

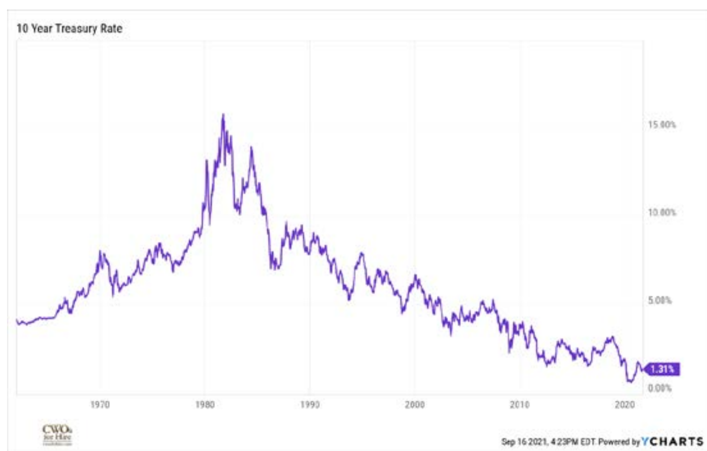
Here is a simple example: Assume you hold a 10-year Apple bond paying 3%. Then, overall interest rates fall, and new Apple bonds are only paying interest of 2.75%. If someone offered to buy your Apple bond, what would you say? You'd only sell it if the buyer paid you a premium, right? Because if you sold your bond and wanted to buy a new one, you'd only get 2.75% versus your current 3%. Therefore, you'll demand a premium price for the bond you hold.

The inverse of this is the same. If you hold the 3% Apple bond and interest rates rise and now new Apple bonds are paying 3.5%, then people won't buy your bond unless you sell it at a discount. Why? Because they can simply buy the new bonds that are paying a higher rate. Therefore, the 3% bonds you hold are worth less because interest rates have risen.

Where We Are Now

Look at the chart below of the history of 10-year treasury rates. Clearly, the past 40 years has been a period of steadily declining interest rates. That was fantastic for bonds! If you bought a bond or bond fund, you not only received the interest payments, but also received the benefits of higher bond values due to falling interest rates.

Now, with interest rates being historically low, high-quality bonds don't pay much interest and, even worse, they risk becoming less valuable if interest rates move higher. In the end, bonds don't have much opportunity to increase in value (from lower overall interest rates) and are not paying high interest rates themselves either.



What Do We Do Then?

If bonds aren't a great investment because of the low risk-reward they offer, then what do we do? How can we make money without going to the stock market and accepting the potential of large losses, especially if we are near or in retirement?

The answer: Use Options…

2. How Are You Using Stock Options to Reduce Investment Risk?

"Options?!? Options are risky." Again, a comment we have heard many times. It's partially true! Options can be very dangerous if you don't know how to use them well. But consider this: there are two sides to every options trade. You can buy an option, or you can sell an option. Either side may be risky depending upon how you use it. There are also calls versus puts, depending upon which direction you want to invest.

Simply saying that options are risky misses the point about why options exist in the first place. Some option strategies are risky, and some option strategies reduce risk.

Option Basics

An option gives you the right to buy (Calls) or sell (Puts) a stock or fund. Typically, one option contract gives you control of 100 shares of a stock / fund. If you buy a Call option, then you are paying for the right to buy 100 shares at a set price by a specific date.

For example, if you wanted to buy 100 shares of Apple and the current price is $150, then it would cost you $15,000 to buy the stock. You would get all the benefit of any price increases, but also you would be at risk for any losses.

Alternatively, you could buy a Call option to purchase 100 shares of Apple stock at $150 at any point over the next 3 months. That might cost something like $8 per share (that price varies); $800 (100 shares X $8 per share). Why would you do that? First, you are only risking 5.3% of the stock that you would have bought ($800 / $15,000). So, if the stock price doesn't increase, you lose the $800 that you paid for the Call option. But that is the maximum loss on this trade. If you bought the stock instead, you could potentially lose much more than 5.3%.

An option trade such as this would allow you to control 100 shares of stock with much less money. It's one possible way to use options, but perhaps not the best one in all situations. How else could we use options to reduce risk?....

Buying Puts

The most straightforward way to use options for protection is to buy Puts. When you buy a Put, you are buying the right to sell a stock or fund at a set price by a specific date. To be clear, buying a Put is not the same as shorting a stock. We'll explain that later.

Let's say you own 100 shares of Apple at $150. You want to continue holding it for the long-term but are concerned about the stock might drop. One option that you have is to buy a Put, which effectively acts as insurance against losses. You decide that you'd be willing to absorb a 10% loss, but no more. You could buy a $135 Put contract so that if Apple drops below $135, your losses are capped at $15 per share because you have purchased the right to sell the stock at $135 per share.

This is a fantastic and relatively straightforward way to protect your investments against the risk of significant losses. It allows you to continue holding good investments for the long-term, take advantage of stock growth over time, and still be protected from large declines.

A word of caution: too much Put buying can be expensive. You are effectively buying insurance against losses. That's great, but if you are constantly loading up on insurance, you can put a significant dent in your gains over time. Choose Put option contracts wisely. Buy some additional time by using longer options if you need it, instead of purchasing new short-term option contracts over and over again.

Buying Puts on an Index

It can also be overly expensive to buy Put contracts on every stock or fund that you own if you own multiple stocks/funds. A simple way to overcome that problem is to purchase Puts on an overall index if you are concerned that the stock market overall will decline significantly and bring down your investments with it.

When you buy a Put, you do not need to own the stock, fund, or index itself to profit on the Put contract. You can purchase a Put contract by itself and if that stock/fund goes down, then your Put contract is worth more and can be sold as a profit. This allows you the opportunity to purchase a Put contract on an index such as the S&P 500, Russell 2000, etc. without actually owning a fund that tracks that index.

This strategy then is to own a well-diversified set of high-quality investments and, when needed, buy Puts on an overall index to guard against substantial overall market declines. That way, you decrease the cost of protection overall because you are not buying lots of different Put contracts. Then, if that index does in fact go down, your Put is sold for a profit and you now have cash to use to buy stocks while they are lower!

How Is Buying a Put Different Than Shorting a Stock?

You may have heard that shorting a stock is a dangerous thing to do. That is correct. When you short a stock, you are betting it will go down. You don't own the stock, but instead you are borrowing shares in order to "short" the stock and bet that it will go lower. Because you are borrowing the shares of the stock, if the stock moves higher, you could be at risk for unlimited losses. In fact, if the stock does move sharply higher, the custodian/broker will call you and demand payment to cover the transaction before the stock moves even higher than it already did.

Buying Puts is different. You are not borrowing the stock. Even if you don't own the stock or fund itself and are simply betting it will go down, your risk of loss is limited to the amount you spent on the put contract. There is no unlimited risk from buying Puts like you have by shorting a stock.

Use ETFs That Use Options

A relatively new choice for investors is to use Exchange Traded Funds (ETFs) that use option contracts inside the fund to provide either a buffer against market declines or additional income in a particular range of overall market outcomes. If you want to invest in these funds, it is critical that you first have a solid understanding of how option contracts work. That way, you can make the funds properly fit into your investment portfolio and take advantage of opportunities in these funds as they arise.

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3. What Are You Doing Now to Save Taxes in the Future?

We tend to focus on problems that are directly in front of us and perhaps not always address long-term issues until later. When it comes to lowering the amount of taxes we pay, we often focus on reducing our current tax owed, but may neglect to form a strategy to lower taxes over the long-term. Now more than ever, that needs to change.

Current Tax Rates vs. Future Tax Rates

We currently have some of the lowest federal tax rates in many decades. Unfortunately, that isn't likely to last. Like it or not, unless government spending declines, the government will have to raise taxes to pay for continued budget deficits and rising levels of debt. Therefore, when we are planning for retirement, it is critical to focus on lowering taxes over the next couple decades, even if it means we need to pay higher amounts of tax in the near-term.

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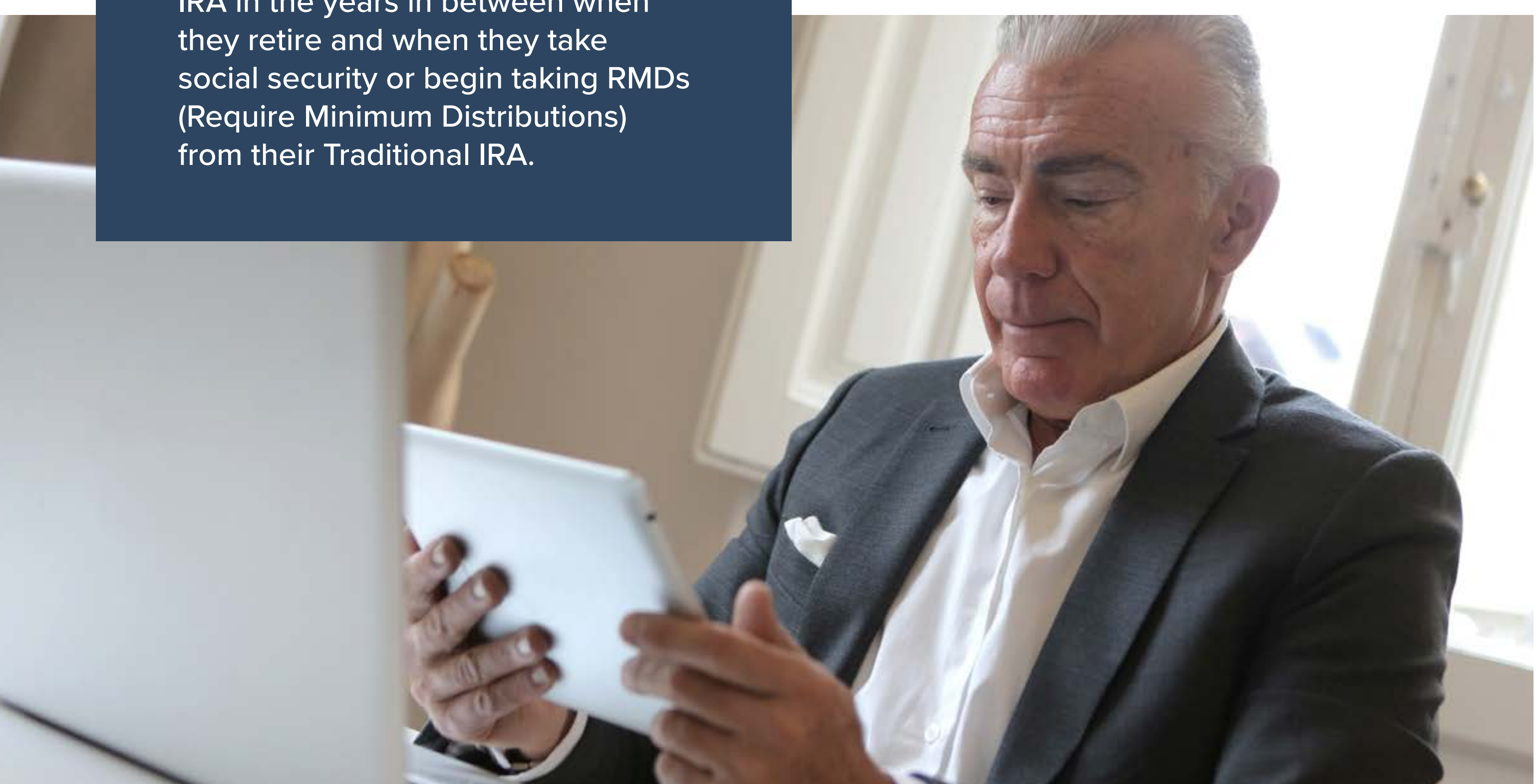
Paying Taxes Now vs. Later

To take advantage of current historically low tax rates, a strategy that we often find beneficial is steadily converting portions of a Traditional IRA over to a Roth IRA. In a Traditional IRA, you receive a tax benefit for contributions, but pay taxes on withdrawals in retirement. In a Roth IRA, you receive no tax benefit for contributions, but can withdraw money from the account tax-free in retirement.

When you convert money from a Traditional IRA to a Roth IRA, you pay ordinary income tax on any amount converted that year. Hence, this conversion allows you to pay tax on the converted amount now and move it to a Roth IRA where it will never again be taxed. It's important to note that you do not want to convert too much in any one year. Doing so could put you in higher income tax brackets, thereby negating the benefit of using currently low tax rates to save on taxes over the long-term.

We typically see the greatest benefit occurring in scenarios where clients convert a portion of their Traditional IRA in the years in between when they retire and when they take social security or begin taking RMDs (Require Minimum Distributions) from their Traditional IRA. Doing so could provide tremendous tax savings and increased overall investment account balances over the long-term.



Conclusion

Retirement planning indeed has many variables, many of which are out of your control. But you can have control over managing your investment risk and reducing taxes over the long-term. It takes time and detailed planning, but the specific tactics we discussed above can go a long way towards controlling investment risk and tax reduction.

Want help? We are here for you. We can work with you in a comprehensive, fee-only manner to:

1. Ensure you have a detailed retirement plan that will be adjusted throughout your retirement as life changes
2. Calculate the best way to reduce your taxes over the long-term and execute that plan for you
3. Determine how to get the most of our social security
4. Grow your investments while also providing protection against significant declines

Contact Us Today

(314) 649-PLAN

info@cwosforhire.com

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CPA Wealth Planners & Advisors
cwosforhire.com