MF Advisers
$\$ = mf^2$

THE FINANCIAL FORMULA

Giving You The Financial Information You Need

May 2015

Hello FF readers! Summer is almost here! Please enjoy this month's edition of The Financial Formula. Any questions, please let us know - thanks!

Martin A. Federici, Jr.
MF Advisers, Inc.
CEO
marty@mfadvisers.com
570-760-6524
Fax: 570-675-7105
91 Franklin Street
Dallas, PA 18612
http://mfadvisers.com

In This Issue

Too Young to Think About Investing? Think Again!

The word compounding describes what happens when your investment earns money and this amount is reinvested and generates more earnings.

"How did it get so late so soon?" -- Dr. Seuss

Dr. Seuss's whimsical take on life has been delighting children of all ages for generations. His simple, but powerful words continue to resonate today, even in the context of planning for a financially secure future. Because when you get right down to it, the younger you are, the more you potentially have to gain by taking advantage of the time ahead of you.

Compounding: A Snowball Effect

The word compounding describeswhat happens when your investment earns money and this amount is reinvested and generates more earnings. The process of compounding has often been compared to the way a snowball grows as it rolls downhill. You might say that a longer investment time frame is akin to a bigger hill, because each creates conditions for greater growth potential.

And thanks to the potential role of compounding, the more you invest, the more significant the potential long-term benefit. For example, assume that two workers both earn $30,000 annually. Each invests 6% of income and receives a 3% raise each year. Investor A never increases her investment, but Investor B increases her investment by 1% of income each year until she is eventually investing 12% of income. Over the course of 30 years, each account earns an 8% average annual investment return.

The result? At the end of the 30-year period, Investor A would have $296,864, whereas Investor B would have $535,005 -- simply because she took advantage of time and gradually increased her investment amount.[1]

Time and Compounding -- A Simple Equation

One easy way to estimate how long it may take for compounding to help double the value of an investment is to use the "rule of 72."

Here's how it works: Divide 72 by the rate of return earned by an investment. The number you end up with equals the approximate number of years it would take for the investment to double in value, assuming it continues to earn the same return. For example, an investment earning an 8% annual return would double in value in about nine years (72/8 = 9).

Stay in It for the Long Term

Maintaining a long-term time frame may also give you the luxury of being able to tolerate short-term market volatility. Because while past performance cannot guarantee future results, it's worth noting that longer-term holding periods have often been associated with a lower likelihood of portfolio losses.

[1]*This is a hypothetical example intended for illustrative purposes only and does not represent the performance of an actual investment. Your results will vary.*

Keep Emotions at Bay With an Investment Policy Statement

Once you know how much risk you can accept, you can create an asset allocation target and a policy statement designed specifically for you.

Chances are your investment strategy calls for some portion of your portfolio to be invested in stocks to help you reach your long-term goals.[1] But when the stock market turns choppy -- as it most certainly will from time to time -- try not to let your emotions get in the way of achieving your objectives. Keep in mind that a loss in stock market value may only matter if you need access to that money within two years or less. Furthermore, history shows that the market has typically made up its losses fairly quickly, although past performance is no guarantee of future results.

If you are skittish about the markets and what might lie ahead, there are steps you can take to help you stick to your long-term strategy, some of which may best be explored and implemented with the help of a trusted financial advisor.

Put an Investment Policy in Place

Working with an advisor, you can develop a customized investment policy statement to help you pursue your short- and long-term financial goals -- throughout all economic cycles. A typical policy statement might be based on five key factors:

1. The time frames for your various financial goals (e.g., short-, medium, long).
2. Your need for liquidity in your portfolio.
3. Your personal tax situation.
4. The legal structure of the investment vehicle, such as an IRA or trust account.
5. Other special factors affecting your personal situation, such as a preference for socially responsible investing, or if you have a special needs child.

Once you know how much risk you can accept, you can create an asset allocation target and a policy statement designed specifically for you. When properly structured, your investment policy statement helps to protect you against market downturns. For example, say you may have the risk tolerance to accept a one-year decline of more than 20% on some of your long-term money, but if part of your portfolio is earmarked to pay for your daughter's wedding in 18 months, your policy would not allow that portion to be exposed to extreme market volatility.

Don't Panic

As tempting as it may be to abandon your investment policy, such a shortsighted move is likely to cause you far more harm than good. Emotional decisions are rarely the best financial decisions for your portfolio. Instead of overreacting to volatile market conditions, try to stick with your strategy and avoid a costly disruption in the balance of your investments.

As a matter of fact, you may consider using market declines as opportunities to add to your equity holdings. During times of economic downturn, stocks are often priced below market value, which means it may be a good time to "bargain shop," as long as doing so fits within the parameters of your investment policy statement.

In times of market stress, plan to revisit your investment policy with your financial advisor, and remind yourself why you set it up in the first place. If nothing has changed in your life, you probably shouldn't change your strategy. The bottom line is that only personal factors -- not the current state of the economy and/or financial markets -- should drive your investment decisions.

[1] *Investing in stocks involves risks, including loss of principal.*

Because all investments entail risk, you may want to review your mix of stocks, bonds, and cash investments with an eye toward creating a risk/return profile that is appropriate for your situation.

Does Your Portfolio Reflect Your Risk Tolerance?

When it comes to investing, many people associate risk with losing money. But investing entails different types of risk. Understanding each type -- and the potential return associated with your retirement portfolio -- can help you determine whether your investments are appropriate for your situation.

Examining Risk and Return

Stocks historically have exhibited the highest level of market risk -- or the potential that an investment may lose money in the short term. Over long periods of time, however, stocks have outperformed both bonds and cash investments.[1] This risk/return tradeoff may influence how you allocate your investments. For instance, consider weighting assets that you intend to keep invested for 10 years or more toward stock investments.

Bonds carry their own risks -- credit risk, or the possibility that a bond issuer could default on interest and principal payments; and interest rate risk -- the chance that rising interest rates could cause a bond's price to fall. Ascending interest rates historically have influenced the prices of bonds more directly than the prices of stocks.[1] When short-term rates are on the rise, investors may sell older bonds that pay a lower rate of interest -- causing their prices to fall -- in favor of newly issued bonds that pay higher interest rates. On the plus side, bonds historically have exhibited less short-term volatility that stocks, although past performance is no guarantee of future results.

It's also important to look at cash investments, such as 3-month Treasury bills, from a vantage point of risk and return.[1] Although Treasury bills typically experience a low level of volatility, they may be subject to inflation risk -- or the possibility that their returns may not keep pace with the rising cost of goods and services. For this reason, you may want to use cash investments for short-term situations when you expect to access your money within 12 months or less.

Putting Risk in Perspective

Because all investments entail risk, you may want to review your mix of stocks, bonds, and cash investments with an eye toward creating a risk/return profile that is appropriate for your situation. Owning different types of assets may increase your chances of experiencing the benefits associated with each, while mitigating the corresponding risk. Your retirement portfolio won't be risk free, but you will have the confidence of knowing that you've done what you can to manage a potential downside.

This article offers only an outline; it is not a definitive guide to all possible consequences and implications of any specific investment strategy. For this reason, be sure to seek advice from knowledgeable financial professionals.

[1]*Source: Wealth Management Systems Inc. For the 30-year period ended December 31, 2013. Stocks are represented by the Standard & Poor's Composite Index of 500 Stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Investing in stocks involves risks, including loss of principal. Bonds are represented by the Barclays U.S. Aggregate Bond index. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Cash is represented by the Barclays 3-Month Treasury Bills index. It is not possible to invest directly in an index. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value. Past performance is not a guarantee of future performance.*

The rule applies to all of an individual's IRAs -- whether traditional or Roth -- in aggregate, not separately as some may have previously assumed.

How Will the One-Per-Year IRA Rollover Rule Apply in 2015?

Early this year the U.S. Tax Court ruled that the "one-per-year" IRA rollover rule applies to all of an individual's IRAs, in aggregate, not to each separately. The IRS has backed the court's decision and offered guidance as to how the new rule will affect rollovers completed in 2014 as well as new rollovers initiated in 2015.

Timing and Transition

The IRS's latest announcement clarifies that the once-a-year rule will take effect on January 1, 2015, putting to rest any uncertainty that investors and advisors may have had regarding the status of rollovers made in 2014. In a news brief, the IRS stated that "a distribution from an IRA received during 2014 and properly rolled over (normally within 60 days) to another IRA will have no impact on any distributions and rollovers during 2015 involving any other IRAs owned by the same individual."[1] The key here is that new rollovers initiated in 2015 must involve different IRAs than those included in rollover activity in 2014.

The IRS statement went on to explain that, "Although an eligible IRA distribution received on or after January 1, 2015, and properly rolled over to another IRA will still get tax-free treatment, subsequent distributions from any of an individual's IRAs -- including both traditional and Roth IRAs -- received within one year after that distribution will not get tax-free rollover treatment."[1]

This statement further clarifies the point that the rule applies to all of an individual's IRAs -- whether traditional or Roth -- in aggregate, not separately as some may have previously assumed.

Exceptions to the Rule

It should be noted that the rule applies only to indirect IRA rollovers, in which the account holder initiates a distribution from an IRA and receives a check for the distributed amount, which is deposited into his or her personal account. It is then up to the individual to redeposit the funds into the new IRA within the allotted 60-day period to avoid possible taxation and penalties on the amount distributed.

If individuals want to move money more frequently, they can still use the direct rollover approach -- also known as a trustee-to-trustee rollover -- anytime without regard for the new once-per-year rule. With a direct rollover, the money goes directly from the former IRA custodian/trustee to the new custodian without the account holder ever touching it. The Tax Court was clear in its ruling that individuals who have more than one IRA may make multiple direct rollovers from the trustee of one IRA to the trustee of another IRA without triggering the one-year limit. Other advantages of a direct rollover include simplicity and continued tax deferral on the full amount of the account holder's retirement savings.

Also excluded from the new rule are Roth IRA conversions (rollovers from traditional IRAs to Roth IRAs) as well as rollovers between qualified retirement plans and IRAs.

These latest developments may have an impact on individual investors' retirement planning decisions. To play it safe, consult with a qualified financial and/or tax advisor before making any IRA moves. For their part, advisors should exercise caution in managing clients' rollover activity, being careful to question the rollover history of a given IRA.

[1]*Internal Revenue Service, "IRS Clarifies Application of One-Year Limit on IRA Rollovers, Allows Owners of Multiple IRAs a Fresh Start in 2015," November 10, 2014.*