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Investors Are Human, Too

In 1981, the Nobel Prize-winning economist Robert Shiller published a groundbreaking study that contradicted a prevailing theory that markets are always efficient. If they were, stock prices would generally mirror the growth in earnings and dividends. Shiller's research showed that stock prices fluctuate more often than changes in companies' intrinsic valuations (such as dividend yield) would suggest.[1]

Shiller concluded that asset prices sometimes move erratically in the short term simply because investor behavior can be influenced by emotions such as greed and fear. Many investors would agree that it's sometimes difficult to stay calm and act rationally, especially when unexpected events upset the financial markets.

Researchers in the field of behavioral finance have studied how cognitive biases in human thinking can affect investor behavior. Understanding the influence of human nature might help you overcome these common psychological traps.

Herd mentality

Individuals may be convinced by their peers to follow trends, even if it's not in their own best interests. Shiller proposed that human psychology is the reason that "bubbles" form in asset markets. Investor enthusiasm ("irrational exuberance") and a herd mentality can create excessive demand for "hot" investments. Investors often chase returns and drive up prices until they become very expensive relative to long-term values.

Past performance, however, does not guarantee future results, and bubbles eventually burst. Investors who follow the crowd can harm long-term portfolio returns by fleeing the stock market after it falls and/or waiting too long (until prices have already risen) to reinvest.

Availability bias

This mental shortcut leads people to base judgments on examples that immediately come to mind, rather than examining alternatives. It may cause you to misperceive the likelihood or frequency of events, in the same way that watching a movie about sharks can make it seem more dangerous to swim in the ocean.

Confirmation bias

People also have a tendency to search out and remember information that confirms, rather than challenges, their current beliefs. If you have a good feeling about a certain investment, you may be likely to ignore critical facts and focus on data that supports your opinion.

Overconfidence

Individuals often overestimate their skills, knowledge, and ability to predict probable outcomes. When it comes to investing, overconfidence may cause you to trade excessively and/or downplay potential risks.

Loss aversion

Research shows that investors tend to dislike losses much more than they enjoy gains, so it can actually be painful to deal with financial losses.[2] Consequently, you might avoid selling an investment that would realize a loss even though the sale may be an appropriate course of action. The intense fear of losing money may even be paralyzing.

It's important to slow down the process and try to consider all relevant factors and possible outcomes when making financial decisions. Having a long-term perspective and sticking with a thoughtfully crafted investing strategy may also help you avoid expensive, emotion-driven mistakes.

Note: *All investments are subject to market fluctuation, risk, and loss of principal. When sold, investments may be worth more or less than their original cost.*

1 *The Economist,* "What's Wrong with Finance?" May 1, 2015

2 *The Wall Street Journal,* "Why an Economist Plays Powerball," January 12, 2016

August, 2016

Investors Are Human, Too

Be Prepared to Retire in a Volatile Market

Understanding the Net Investment Income Tax

Should I pay off my student loans early or contribute to my workplace 401(k)?

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Be Prepared to Retire in a Volatile Market

Market losses on the front end of your retirement could have an outsized effect on the income you might receive from your portfolio.

In an ideal world, your retirement would be timed perfectly. You would be ready to leave the workforce, your debt would be paid off, and your nest egg would be large enough to provide a comfortable retirement--with some left over to leave a legacy for your heirs.

Unfortunately, this is not a perfect world, and events can take you by surprise. In a survey conducted by the Employee Benefit Research Institute, only 44% of current retirees said they retired when they had planned; 46% retired earlier, many for reasons beyond their control.[1] But even if you retire on schedule and have other pieces of the retirement puzzle in place, you cannot predict the stock market. What if you retire during a market downturn?

Sequencing risk

The risk of experiencing poor investment performance at the wrong time is called sequencing risk or sequence of returns risk. All investments are subject to market fluctuation, risk, and loss of principal--and you can expect the market to rise and fall throughout your retirement. However, market losses on the front end of your retirement could have an outsized effect on the income you might receive from your portfolio.

If the market drops sharply before your planned retirement date, you may have to decide between retiring with a smaller portfolio or working longer to rebuild your assets. If a big drop comes early in retirement, you may have to sell investments during the downswing, depleting assets more quickly than if you had waited and reducing your portfolio's potential to benefit when the market turns upward.

Dividing your portfolio

One strategy that may help address sequencing risk is to allocate your portfolio into three different buckets that reflect the needs, risk level, and growth potential of three retirement phases.

Short-term (first 2 to 3 years): Assets such as cash and cash alternatives that you could draw on regardless of market conditions.

Mid-term (3 to 10 years in the future): Mostly fixed-income securities that may have moderate growth potential with low or moderate volatility. You might also have some equities in this bucket.

Long-term (more than 10 years in the future): Primarily growth-oriented investments such as stocks that might be more volatile but have higher growth potential over the long term.

Throughout your retirement, you can periodically move assets from the long-term bucket to the other two buckets so you continue to have short-term and mid-term funds available. This enables you to take a more strategic approach in choosing appropriate times to buy or sell assets. Although you will always need assets in the short-term bucket, you can monitor performance in your mid-term and long-term buckets and shift assets based on changing circumstances and longer-term market cycles.

If this strategy appeals to you, consider restructuring your portfolio before you retire so you can choose appropriate times to adjust your investments.

Determining withdrawals

The three-part allocation strategy may help mitigate the effects of a down market by spreading risk over a longer period of time, but it does not help determine how much to withdraw from your savings each year. The amount you withdraw will directly affect how long your savings might last under any market conditions, but it is especially critical in volatile markets.

One common rule of thumb is the so-called 4% rule. According to this strategy, you initially withdraw 4% of your portfolio, increasing the amount annually to account for inflation. Some experts consider this approach to be too aggressive--you might withdraw less depending on your personal situation and market performance, or more if you receive large market gains.

Another strategy, sometimes called the endowment method, automatically adjusts for market performance. Like the 4% rule, the endowment method begins with an initial withdrawal of a fixed percentage, typically 3% to 5%. In subsequent years, the same fixed percentage is applied to the remaining assets, so the actual withdrawal amount may go up or down depending on previous withdrawals and market performance.

A modified endowment method applies a ceiling and/or a floor to the change in your withdrawal amount. You still base your withdrawals on a fixed percentage of the remaining assets, but you limit any increase or decrease from the prior year's withdrawal amount. This could help prevent you from withdrawing too much after a good market year, while maintaining a relatively steady income after a down market year.

Note: *Asset allocation is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.*

[1] Employee Benefit Research Institute, "2016 Retirement Confidence Survey"

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Understanding the Net Investment Income Tax

The 3.8% net investment income tax, sometimes referred to as the Medicare surtax on net investment income, originated in revenue provisions included in the Affordable Care Act of 2010. Unlike payroll tax revenues, funds collected from this surtax are deposited into the general fund of the U.S. Treasury; they are not applied to the Medicare Trust Fund.

It's been around since 2013, but many are still struggling to come to grips with the net investment income tax. The 3.8% tax, which is sometimes referred to as the Medicare surtax on net investment income, affected approximately 3.1 million federal income tax returns for 2013 (the only year for which data is available) to the tune of almost $11.7 billion.[1] Here's what you need to know.

What is it?

The net investment income tax is a 3.8% "extra" tax that applies to certain investment income in addition to any other income tax due. Whether you're subject to the tax depends on two general factors: the amount of your modified adjusted gross income for the year, and how much net investment income you have.

Note: *Nonresident aliens are not subject to the net investment income tax.*

What income thresholds apply?

Modified adjusted gross income (MAGI) is basically adjusted gross income--the amount that shows up on line 37 of your IRS Form 1040--with certain amounts excluded from income added back in.

The net investment income tax applies only if your modified adjusted gross income exceeds the following thresholds:

Filing Status	MAGI
Married filing jointly or qualifying widow(er)	$250,000
Married filing separately	$125,000
Single or head of household	$200,000

What is net investment income?

Investment income generally includes interest, dividends, capital gains, rental and royalty income, income from nonqualified annuities, and income from passive business activities and businesses engaged in the trade of financial instruments or commodities. Investment income does not include wages, unemployment compensation, Social Security benefits, tax-exempt interest, self-employment income, or distributions from most qualified retirement plans and IRAs.

Note: *Even though items like wages and retirement plan distributions aren't included in net investment income, they are obviously a factor in calculating MAGI. So higher levels of non-investment income can still make a difference in whether the net investment income tax applies.*

Gain from the sale of a personal residence would generally be included in determining investment income. However, investment income does not include any amount of gain that is excluded from gross income for regular income tax purposes. Qualifying individuals are generally able to exclude the first $250,000--or $500,000 for married couples filing jointly--of gain on the sale of a principal residence; any of the gain that's excluded for regular income tax purposes would not be included in determining investment income.

To calculate *net* investment income, you reduce your gross investment income by any deductible expenses that can be allocated to the income. So, for example, associated investment interest expense, investment and brokerage fees, expenses associated with rental and royalty income, and state and local income taxes can all be factored in.

How is the tax calculated?

You know your modified adjusted gross income. You know your net investment income. To calculate the net investment income tax, first subtract the threshold figure (shown above) for your filing status from your MAGI. Then compare the result with your net investment income. Multiply the lower of the two figures by 3.8%.

For example, assume you and your spouse file a joint federal income tax return and have $270,000 in MAGI and $50,000 in net investment income. Your MAGI is $20,000 over the $250,000 threshold for married couples filing jointly. You would owe $760 (3.8% multiplied by $20,000), because the tax is based on the lesser of net investment income or MAGI exceeding the threshold.

How is it reported?

If you're subject to the net investment income tax, you must complete IRS Form 8960, Net Investment Income Tax--Individuals, Estates, and Trusts, and attach it to your federal income tax return (you must file IRS Form 1040). The instructions for IRS Form 8960 provide an overview of the rules that apply and can be a good source of additional information. If you think you may be affected by the net investment income tax, though, it's a good idea to consider discussing your individual situation with a tax professional.

[1] IRS Statistics of Income Bulletin, Spring 2015

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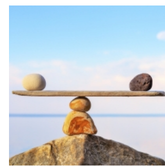

Should I pay off my student loans early or contribute to my workplace 401(k)?

For young adults with college debt, deciding whether to pay off student loans early or contribute to a 401(k) can be tough. It's a financial tug-of-war between digging out from debt today and saving for the future, both of which are very important goals. Unfortunately, this dilemma affects many people in the workplace today. According to a student debt report by The Institute for College Access and Success, nearly 70% of college grads in the class of 2014 had student debt, and their average debt was nearly $29,000. This equates to a monthly payment of $294, assuming a 4% interest rate and a standard 10-year repayment term.

Let's assume you have a $300 monthly student loan payment. You have to pay it each month--that's non-negotiable. But should you pay more toward your loans each month to pay them off faster? Or should you contribute any extra funds to your 401(k)? The answer boils down to how your money can best be put to work for you.

The first question you should ask is whether your employer offers a 401(k) match. If yes, you shouldn't leave this free money on the table. For example, let's assume your employer matches $1 for every dollar you save in your 401(k), up to 6% of your pay. If you make $50,000 a year, 6% of your pay is $3,000. So at a minimum, you should consider contributing $3,000 per year to your 401(k)--or $250 per month--to get the full $3,000 match. That's potentially a 100% return on your investment.

Even if your employer doesn't offer a 401(k) match, it can still be a good idea to contribute to your 401(k). When you make extra payments on a specific debt, you are essentially earning a return equal to the interest rate on that debt. If the interest rate on your student loans is relatively low, the potential long-term returns earned on your 401(k) may outweigh the benefits of shaving a year or two off your student loans. In addition, young adults have time on their side when saving for retirement, so the long-term growth potential of even small investment amounts can make contributing to your 401(k) a smart financial move.

All investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.

Have you heard about the newest employee perk?

What's one of the most cutting-edge employee benefits right now? Company-provided student loan assistance for employees who are paying back student loans.

With a record amount of student loan debt attached to the incoming workforce (visit finaid.org to see a student debt clock that now tops $1.3 trillion), companies that rely on a college-educated workforce--and want to attract and retain the best workers--are starting to offer student loan assistance to meet this immediate financial concern of many employees.

How do these programs work? Generally, an employer will contribute a certain amount each month toward an employee's student loans, typically from $100 to $250 per month, up to a lifetime cap (for example, $10,000). Programs may restrict participation to employees who have been with the company for a minimum period of time, and may require employees to remain at the company for a certain period of time after they receive loan repayment benefits.

But participants beware: Unlike matching 401(k) contributions that companies may give to employees, money given to help repay student loans is considered taxable income. Yet for college graduates facing thousands of dollars of debt and years of loan repayment, this employee benefit can be an attractive perk. Along with the actual financial help, borrowers may get a psychological boost from knowing that they have a plan in place to successfully pay off their loans and that their employer is invested in the outcome.

Even with the early hype, company student loan repayment programs are still a relatively uncommon employee benefit. According to a 2015 employee benefit survey by the Society for Human Resource Management, these plans were offered by only 3% of the more than 450 companies surveyed. Essentially, a handful of large employers that hire a large number of college grads are at the forefront of this trend.

Industry observers expect a lot of pent-up demand for this employee benefit as millennials' student debt burdens continue to garner widespread attention and employee retention efforts intensify as the economy improves. A company's contribution probably won't cover 100% of a young employee's student debt, but it might make a meaningful and welcome dent.

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The Other Cost of Taxes

Chances are, you know how much you pay in taxes. But how much are taxes costing you in time and preparation fees?

According to a Tax Foundation report, using statistics from the Office of Information and Regulatory Affairs and the Bureau of Labor Statistics, tax compliance will cost the U.S. economy $409 billion this year. In all, Americans will spend 8.9 billion hours—more than 222 million work weeks—complying with IRS tax filing requirements for 2016.

The biggest part of the problem? Tax reform, which has taken the U.S. Tax Code from 409,000 words in 1955 to 2.4 million words today—plus an estimated 7.7 million words worth of tax regulations. The tax code is estimated to grow at about 89 words per day.

Sometime after the upcoming Presidential elections, you'll see a tax simplification movement in Congress, pushed by both sides of the aisle. A cynic would say that this will be a way to shake special interests for more campaign contributions if they want to protect their exemptions. The cynic might also note that past tax simplification movements have added more pages than they've subtracted.

Pay attention to whether the reform proposals would actually reduce the complexity to the point where you, by yourself, would have no trouble filling out your tax returns, and if you see any goal other than that one, consider writing a stern note to your Congressional representatives.

Sources:

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Does Wealth Equate to Quality of Life?

If you want to see a fascinating chart, take a look at this graphic which charts each country's GDP per capita with its "social progress," defined by a cumulative measure of economic opportunity, access to quality healthcare and education, tolerance of minorities and general quality of life. This is a subjective measure, but if you look at the countries toward the bottom of the chart, you'll see that the Social Progress Index mostly gets it right.

What's interesting is the correlation between economic wealth and social progress. Interestingly, the article describing this chart (see here: http://uk.businessinsider.com/social-progress-index-country-ranking-of-best-quality-of-life-versus-gdp-2016-6?linkId=26233334?r=US&IR=T) from the U.K. Business Insider focuses on the fact that some countries (like Finland, Canada, New Zealand and the Netherlands) are enjoying more social progress with less wealth, while others (United Arab Emirates, Kuwait, Saudi Arabia) have more wealth and less social progress.

But if you look at the line that curves through the data, and especially if you imagine that the line were curved a bit higher on the top end, you see that the correlation between the two is pretty close. The other interesting thing is how the United States, while high on the scale, ranks behind at least a dozen other countries on the Social Progress Index. Is it really less pleasant to live in the U.S. than Slovenia?

Culture clearly plays a part in the rankings, which tells us that wealth isn't everything. The Scandinavian countries, Canada, New Zealand and Australia clearly put more emphasis on quality of life than on per-capita wealth, while many Arab nations plus Russia have relatively high incomes but fall below the Social Progress curve.

Source:

- http://www.marketwatch.com/story/how-couples-can-make-smart-retirement-decisions-together-2016-03-28

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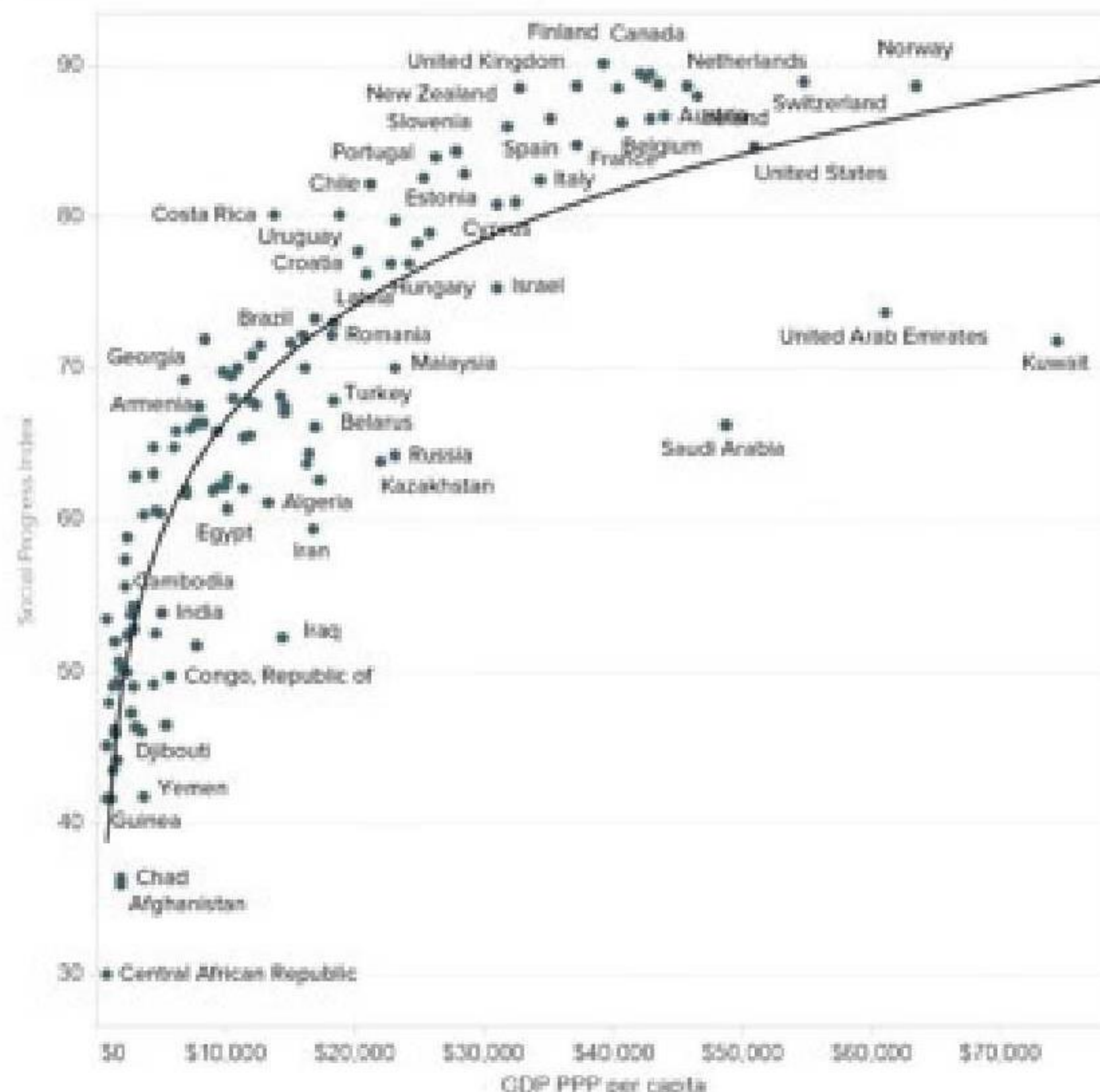
SOCIAL PROGRESS DOES INCREASE WITH GDP PER CAPITA
BUT ECONOMIC GROWTH IS NOT THE WHOLE STORY



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Where Have All the Male Workers Gone?

The White House Council of Economic Advisers has released a report showing a long-term decline in the share of American men ages 25-54 who are participating in the labor force (see first chart), to the point where the U.S. now has one of the lowest male labor force participation rates in the world (see second chart).

What's going on? The traditional explanation is that many men are lazy, and prefer living on disability insurance and food stamps rather than actually getting off the couch and earning a living. But the study debunked this view, showing that the number of people receiving Social Security Disability Insurance has gone up by just 2 percentage points since 1967, compared to a 7.5 percentage-point decline in prime-age male labor force participation rates over the same period. Other government programs, such as Temporary Assistance for Needy Families (TANF) and the Supplemental Nutrition Assistance Program (SNAP) have become increasingly hard to access for those out of work—and especially those without children.

Instead, the report cites a reduction in the U.S. economy's demand for lower-skilled and less-educated men, whose participation rate has fallen the farthest, who are mired in jobs paying lower wages in an economy that is increasingly focused on technology, automation, and globalization. Another potential factor, compared with other developed economies, is the fact that the US spends just 0.1% of GDP on things like job search assistance and job training—far less than the 0.6% OECD average. Also, the US provides fewer subsidies for child care, has a higher tax wedge on secondary earners, and is the only advanced economy not to provide paid leave.

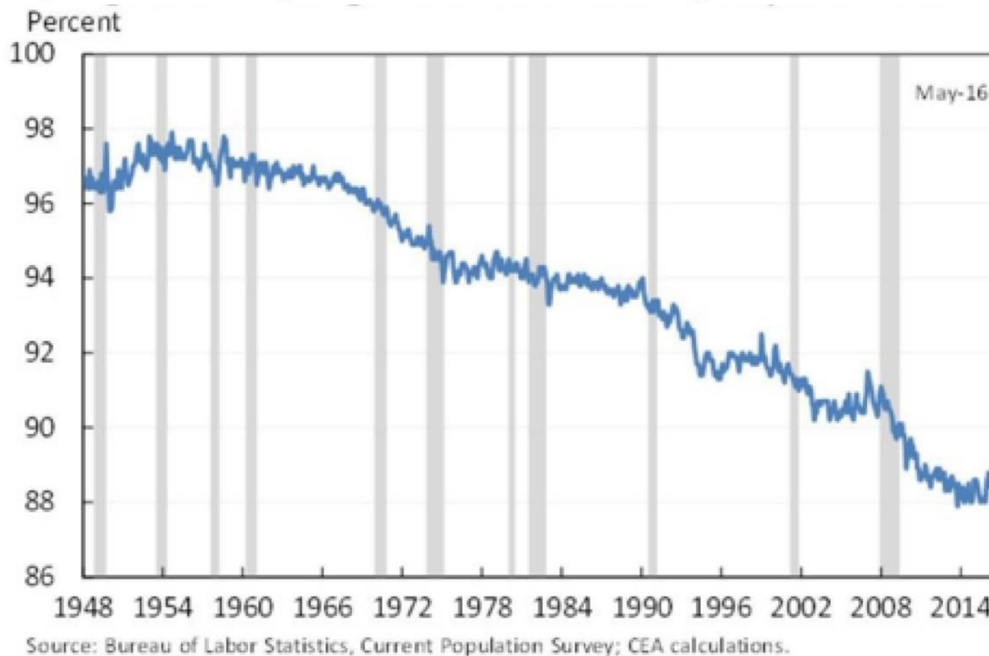
One factor might come as a surprise: the Council of Economic Advisors speculated that the steep rise of mass incarceration since the 1970s in the US could be a contributing factor, even though prisoners are not counted in the statistics. People with a criminal record, even for drug possession or other victimless crimes, face substantially lower demand for their labor after they are released from prison.

In many States, the formerly-incarcerated are legally barred from a significant number of jobs by occupational licensing rules or other restrictions. Indeed, the American Bar Association has counted over 1,000 mandatory license exclusions for individuals with records of misdemeanors and nearly 3,000 exclusions for felony records. And there is evidence that, even in the absence of legal restrictions, employers are less likely to hire someone with a criminal record.

Whatever the causes, the chart suggests that the U.S. unemployment rate we see updated each month is at best misleading, because it doesn't factor in the fact that fewer American men are participating in the labor force, and therefore represent an uncounted number of unemployed who quite possibly would like to have jobs, but know, due to lack of skills, training, education or a clean legal resume, that they are unlikely to find one.

Can anything be done? The report offers some possible remediations, including increased investment in public infrastructure (creating low-skill construction jobs); reforming community college and training systems to better match job demand; providing better search assistance as part of the unemployment insurance program; reducing the U.S. tax system penalty on secondary earners; expanding the Earned Income Tax Credit for individuals without qualifying children; investing in education and reforming the criminal justice and immigration systems.

Figure 1: Prime-Age Male Labor Force Participation Rate in the U.S.



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Who Pays for College? Are They Getting Their Money's Worth?

According to the Student Loan Marketing Association (more commonly known as Sallie Mae Bank), the average tuition, room and board at a private college comes to $43,921. Public tuition for in-state students at state colleges amounted to $19,548, with out-of-state students paying an average of $34,031.

How are parents and students finding the cash to afford this expense?

Sallie Mae breaks it down as follows: 34% from scholarships and grants that don't have to be paid back, coming from the college itself or the state or federal government, often based on need and academic performance.

Parents typically pay 29% of the total bill (an average of $7,000) out of savings or income, and other family members (think: grandparents) are paying another 5%.

The students themselves are paying for 12% of the cost, on average.

The rest, roughly 20% of the total, is made up of loans. The federal government's low-interest loan program offers up to $5,500 a year for freshmen, $6.500 during the sophomore year, and $7,500 for the junior and senior years. If that doesn't cover the remaining cost, then students and parents will borrow from private lenders. The average breakdown is students borrowing 13% of their total tuition costs and parents borrowing the other 7%.

Is the cost worth it? The Federal Reserve Bank of New York recently published a report on the labor market for college graduates. The conclusion is that younger workers have experienced much higher unemployment rates than their college graduate peers—the figures currently are 9.5% unemployment for all young workers, vs. just 4.2% for recent college graduates. Overall, the unemployment rate for people who have graduated with a 4-year degree is 2.6%, and even during the height of the Great Recession, it never went over 5%.

And income is higher as well. The average worker with a bachelor's degree earns $43,000, vs. $25,000 for people with a high school diploma only. The highest average incomes are reported for people with pharmacy degrees ($110,000 mid-career average), computer engineering ($100,000), electrical engineering ($95,000), chemical engineering ($94,000), mechanical engineering ($91,000) and aerospace engineering ($90,000).

Lowest average mid-career incomes: social services ($40,000), early childhood education ($40,000), elementary education ($42,000), special education ($43,000) and general education ($44,000).

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Among the lowest unemployment rates: miscellaneous education (1.0%), agriculture (1.8%), construction services (1.8%) and nursing (2.0%).

Yes, there are some themes here, and of course people in every career can fall above or below these averages. Nor does everybody who graduates with a particular degree end up in a career that tracks that degree. The point is that despite the cost, a college degree does seem to provide significantly better odds of getting a job, and getting paid more for the job you do get.

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