# FINANCIAL DESIGN STUDIO

DESIGNED FOR LIFE



Left to Right: Michelle Smalenberger, Steve Smalenberger, Rob Stoll, Trevore Meyer

## Financial L.O.V.E. Skill

With Valentine's Day this month, we want to share the acronym **L.O.V.E.** This is one thing that can make you successful in your financial plan.

**L**earning
**O**rganization
**V**ery
**E**arly

As a parent you may agree that you are trying to get your kids to understand this skill. This is not only important in your finances. When you are organized, things have a place and you learn to allocate those items to where they should go, rather than being cluttered or taking up extra space. There are many things that, once organized, can get allocated well.

Those things can include time, money, your plans financially, or for a day like Valentine's. You've spent the time deciding what to do.

It's also interesting that when we organize something we feel more confident and comfortable. We know where things are. Just like you've planned the time together with your loved one(s), you likely feel better about the time you're going to spend with them if you have organized or planned ahead.

So one of the things we can do ourselves and even teach our kids is this skill of learning organization very early. When you do this you're actually loving them just like the fun plans you have this month!

# Mind Your Index!

Written By: Rob Stoll, CFP®, CFA

Index investing has become all the rage over the last 10 years. And with good reason. Index funds have much lower expenses and are more tax-efficient compared to actively managed funds. But can too much of a good thing be bad for your portfolio? Possibly! While index funds are designed to take away the stock-picking guesswork, you still need to understand exactly what you're investing in.

## Active vs. Passive Investing

Actively managed funds (mainly mutual funds) have long dominated the marketplace. These funds are run by teams of "stock pickers" whose objective is to pick stocks that beat their benchmark index. For example, a manager that invests in large companies (i.e "large-cap stocks") is usually trying to beat a large-cap index like the S&P 500.

Having spent nearly 20 years of my career as a stock-picking analyst for an actively managed fund, I can tell you it's a tough business. A lot of money is invested by these fund managers to do detailed research on companies, which is why actively managed funds cost more than passive funds.


Passively managed funds – also known as "index funds" – have a different investment objective. Their goal is to simply match the performance of an index for the lowest cost possible. Unlike actively managed funds, they're not trying to beat the index. They just want to match it.

Over the last decade actively managed funds have had a harder time beating their benchmarks. Investors have concluded that it makes little sense to pay upwards of 1.00% for an actively managed fund that lags an index like the S&P 500 when they have the option of investing in a passively managed fund that "should" match the index for a fraction of the cost.

## Are you really diversified?

While passive index investing may seem to be an easy way for people to invest, you still need to understand what you're investing in. Many mutual funds and exchange traded funds (ETFs) have what's called a "reference index" that they're trying to replicate. These indexes can be popular, name brand indexes such as the S&P 500, or they can be a customized index created by the fund manager itself.

What's important to pay attention to is to make sure your investments are truly diversified. Every now and then we'll see a situation where someone owns 10 different ETFs and thinks they're diversified. But when we look under the hood at the reference indexes of those ETFs, we find they're all referencing very similar indexes, if not the same ones! Meaning, they might own 10 different ETFs, but the same stocks are owned in each fund.

## Indexes May Be Riskier Than They Appear

Another thing to pay close attention to when you're investing passively is to make sure that the index your fund is trying to replicate isn't riskier than it appears on the surface. This is a bigger issue with passive bond ETFs and mutual funds, as we'll see.

The most popular U.S. bond index is called the Bloomberg Barclays U.S. Aggregate Bond Index. Popular index funds that reference this index are often called "Total Bond Market" funds because they encompass all bonds trading in the U.S.

The issue with investing in a "total market" bond fund like this is that the riskiness of the underlying index has increased in recent years. We can see one example of this by looking at the Duration of the U.S. Aggregate Bond Index mentioned above.

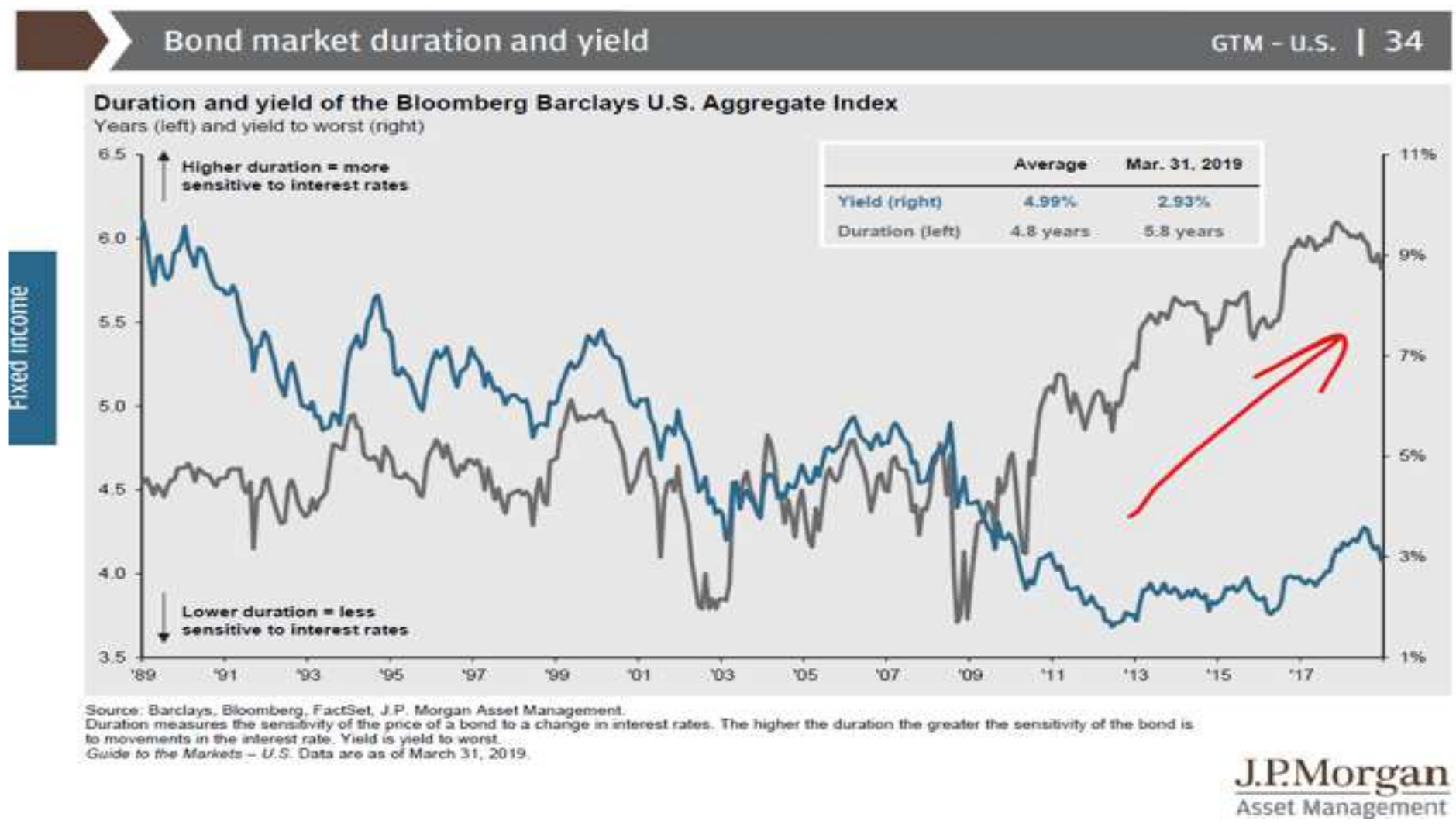
Duration is a complicated measure but at its core it measures the life of a bond's expected cash flows (in years.) Those cash flows come in the form of interest payments and price movements. The higher the duration, the more sensitive the bond is to moves in interest rates. The lower the duration, the less it will move around as interest rates change.

Below is a chart of the Duration of the U.S. Aggregate Bond Index. What you see (red arrow) is that the duration of the index has increased meaningfully since 2009 as interest rates have dropped. The index's duration averaged ~4.5 from the late 80's to about 2008. But since then it has increased to almost 6.0. What that means is that the interest rate risk in this index has increased by 33%!

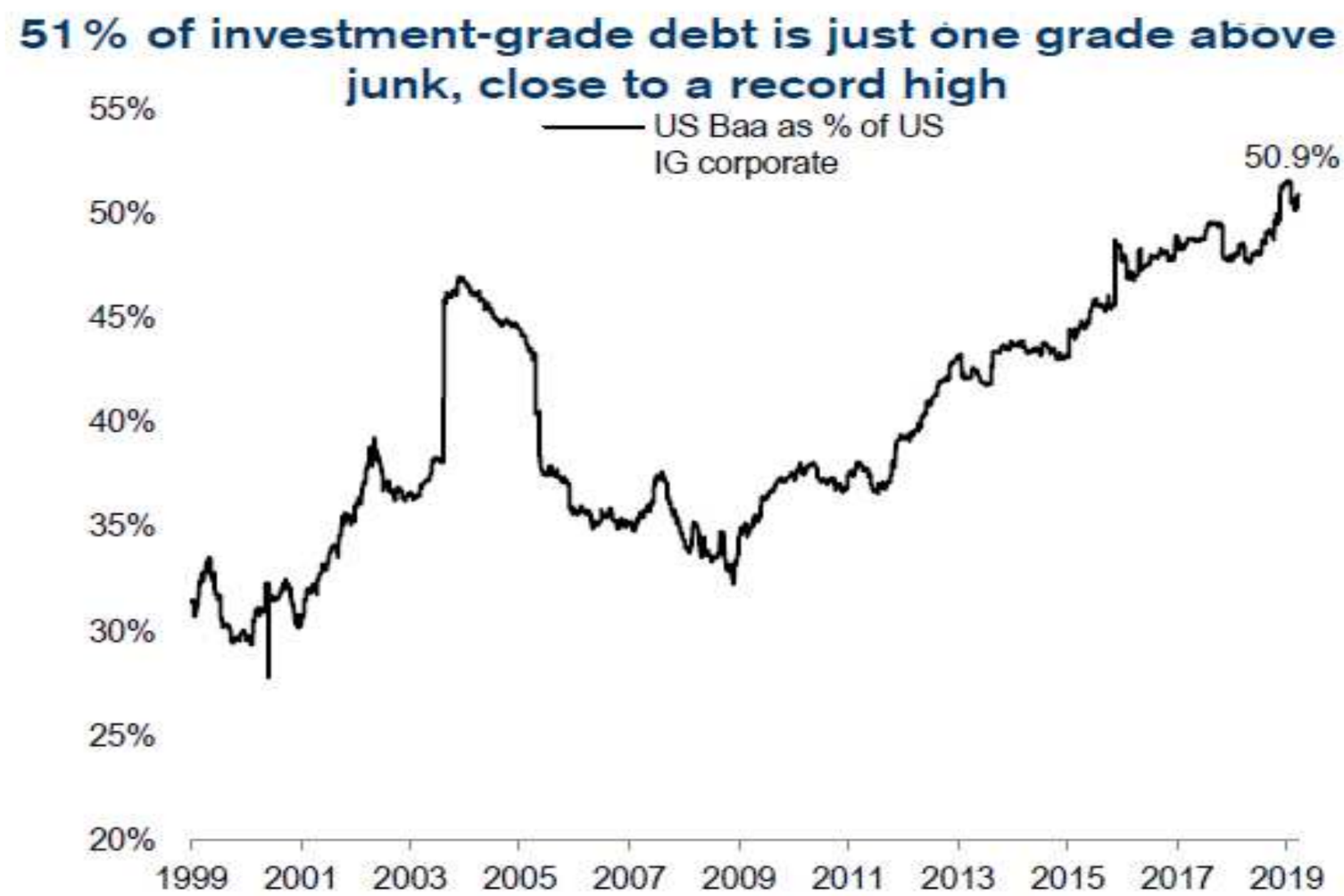
If you own a passively managed fund that references this index, you're unwittingly taking much more interest rate risk than you were 10 years ago.

Another good example is looking at the credit quality of Corporate Bond indexes. Investors who don't like junk bonds will invest in what's called "investment-grade" corporate bonds. Those are the bonds of high-quality companies and presumably safer than their "junk" counterparts.

But look at what has happened to the quality of the investment-grade corporate bond index since 2009. Over half of the index is now made up of bonds that sit only one grade level above junk. If they get downgraded just one notch, they go from an investment-grade bond to a junk bond.



Much like we saw in the Duration example above, investors in these bond index funds have seen the riskiness of the index increase a lot in the last 10 years. How many investors in these funds are aware of this?




**Create a Balanced Investment "Diet"**

Passive index investing has a lot of great things going for it. But it's important to keep things in balance. Eating a diet comprised solely of kale and carrots isn't healthy. You need other nutrients as well. Investing is similar.

Passive funds are a great foundation for your portfolio given their low costs and tax-efficiency. But you want to make sure the passive fund is the best way for you to get diversified exposure to different asset classes. Sometimes, an actively managed fund will do a better job of giving you exposure to an asset class (such as bonds) than a run-of-the-mill index fund.

The lesson in all of this is that it's important to dig down and know what you're investing in. Proponents of passive investing make it sound as easy as picking a few index funds and calling it a day. This is lulling many investors to sleep in thinking they're diversified when they're not. When selecting funds for our client portfolios, we pay close attention to what each fund invests in, and what it does not. That way, we make sure our client portfolios are truly diversified to reach their long-term goals.

***Ebb & Flow of the Market***

| | January 2020 | July 2019 | January 2019 |
|---|---|---|---|
| S&P 500 Index | 3225.52 | 2980.28 | 2704.10 |
| MSCI EAFE Index | 1993.72 | 1897.12 | 1831.09 |
| MSCI Emerging Markets | 1062.34 | 1037.01 | 1049.93 |
| Gold ($/oz) | $1,586.14 | $1,412.60 | $1,319.76 |
| Bloomberg Commodities | 74.84 | 78.96 | 80.97 |
| U.S. 10yr Gov't Bond Yield | 1.52% | 2.02% | 2.64% |
| Fed Funds Rate | 1.75% | 2.25% | 2.50% |

# When Should I Refinance My Mortgage? And other mortgage reminders.

Getting the right mortgage is one of the bigger financial decisions your family will ever have to make. So if you are thinking about refinancing your mortgage, let me give you a couple of tips for what you should be looking for:


**1. Shorten The Term Of Your Mortgage**
The first tip is to look at shortening the term of your mortgage. So, if you originally took out a 30 year mortgage, and you've already paid off five years of it, while you're going to refinance, look and see if you could afford getting into a 15, 20, or 25 year mortgage.

Most companies are pretty flexible with the terms, so I'd recommend looking at that because that could help save you a lot of interest.

**2. Lower Your Mortgage Interest Points**
My second recommendation would be to look at points you would pay on a mortgage refinance. Usually you can pay a little bit more upfront to get a lower rate. But the thing you want to be careful of is to make sure you'll be living in the house long enough that it makes sense to pay those points up front and you get the interest benefit as you pay off the mortgage in the future.

**3. How Does Retirement Affect Your Mortgage?**
The third recommendation I would add for you is to think about your other goals. So in your forties or fifties for example, you'll think about retiring at 65. Just remember that if you take out a 30 year mortgage, that mortgage won't be paid off until you are into retirement. If you do that, just make sure you have a plan to pay off that mortgage more aggressively so that you are not carrying that mortgage long into retirement.

**4. When Should I Refinance My Mortgage?**
And the last thing I'd mention and probably the biggest question we get is when should I refinance? Our basic recommendation is to look at the current rate you are getting now and compare that to what you could get. When you look at those options relative to what you have today keep in mind to look at the total interest you would pay over the remainder of the mortgage and compare it to what you are paying now. The decision is then based on a combination of all these factors.

So if you have any questions about your current mortgage, feel free to reach out to us. We will run various scenarios for you so that you and your family are confident your current or future mortgage is the best one for you.

# Can I Change My Tax Outcome AFTER Year-End?

Written By: Steve Smalenberger, EA

It's that time of year again that is affectionately referred to as "Tax Season." Whether you are scheduling a time with your CPA or firing up a tax software on your computer, you may be wondering what results you'll find when the return is complete. Will you have a refund or a balance due? If you owe… how much? At this point, what if anything can be done to impact your return?

There are a few options available depending upon whether you are self-employed or not. For now, let's address what can be done after year-end by the general public who do not have their own business.

The Internal Revenue Service allows taxpayers who have earned income, which is essentially wages from a paycheck, to make a contribution(s) any time throughout the year even up to April 15th of the following year. These contributions can be made into an Individual Retirement Agreement better known as an IRA.

Depending upon your income level, the money deposited could be recognized either as a tax-deductible contribution or a non-deductible contribution. Here is a table from the IRS which provides a summary.

| Traditional IRA deduction income limits for 2019 | Maximum contribution $6,000 | Over 50 Catch Up Contribution $1,000 | |
|---|---|---|---|
| Filing Status for Deductibility | Full deduction If modified AGI is... | Partial deduction if modified AGI is... | No deduction if modified AGI is... |
| Married filing jointly and you are covered by retirement plan at work | $103,000 | $103,000 but less than $123,000 | $123,000 or more |
| Married filing jointly and your spouse is covered by a retirement plan at work | $193,000 or less | More than $193,000 but less than $203,000 | $203,000 |
| Single or head of household | $64,000 or less | More than $64,000 but less than $74,000 | |
| Married filing separately and you or your spouse is covered by a retirement plan at work | Not available | Less than $10,000 | More than $10,000 |

If tax-deductible, the money that goes into this type of account reduces both your Adjusted Gross Income (AGI) and your Taxable Income, ultimately lowering your tax due!

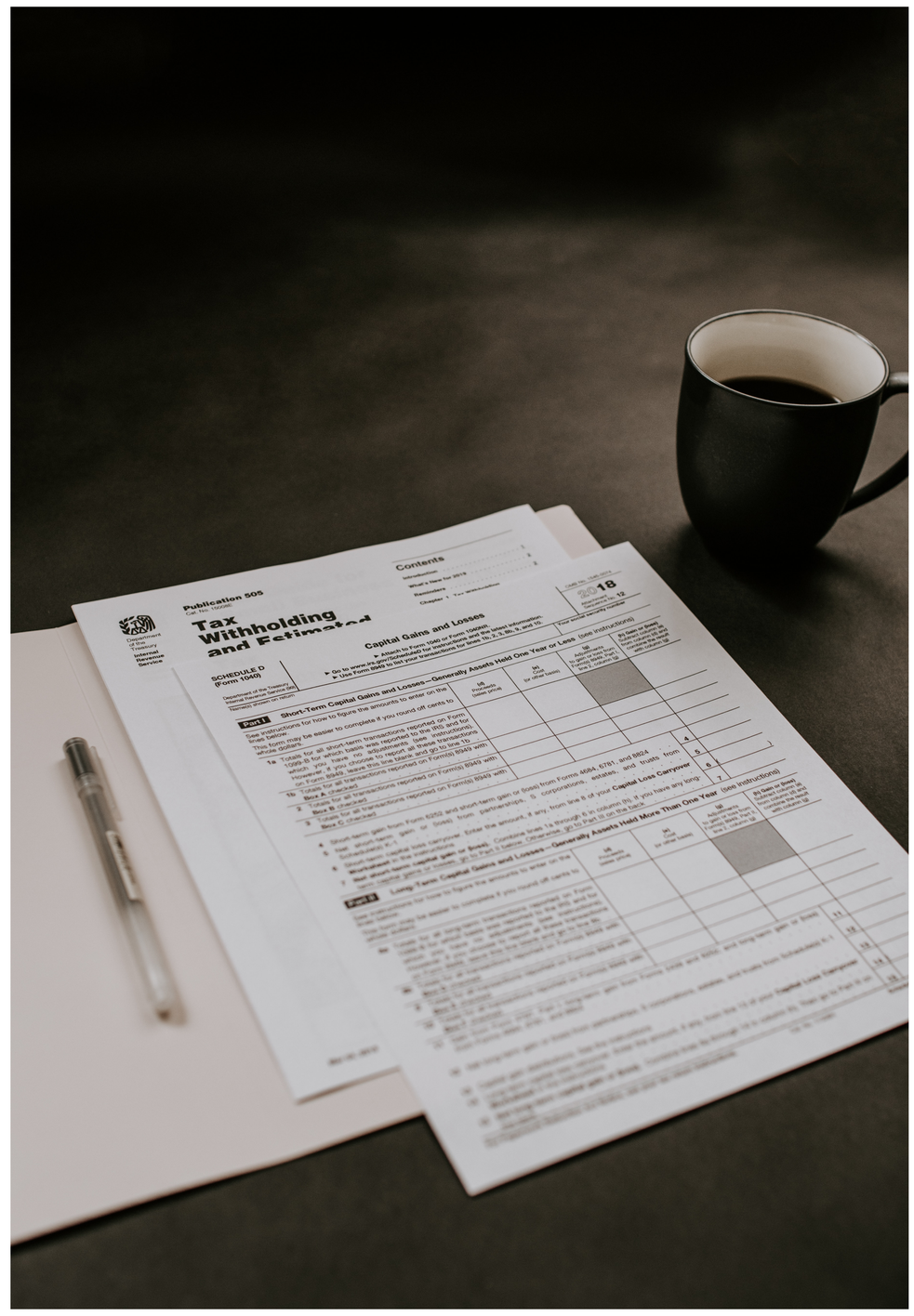
If your income for the year, however, exceeds the limits as seen above, a contribution can still be made but you will not receive the benefit of a tax deduction. The amount that can be contributed each year is limited by one of two factors: your earned income or your age.

For the 2019 Tax Year, those under age 50 could make a maximum contribution of up to $6,000. And those over 50 are allowed an additional $1,000 "catch-up" which brings their total maximum contribution up to $7,000 for the year.

Like most areas of tax or finance, there are many rules and sometimes even exceptions. To add another layer of complexity, there is even something called a "Spousal Contribution" which allows a working spouse to make contributions on behalf of their non-working spouse into an IRA owned by that person.

In the meantime, if you are facing sticker shock of a tax balance due wondering what potentially can be done to reduce it or are considering ways to save money for retirement in a tax-efficient manner, a contribution to a Traditional IRA may be something for you to consider. And if you don't want to be in the same position next year, let's talk now about how we can help you plan ahead.

# Prepare for your tax returns using F.O.R.M.S.




It's tax season and everyone's thinking of everything they need to get ready for their accountant. I want to help you with an easy system to remember all the things you need to pull together. Here's an acronym to walk you through the list!

**Financial Forms:**
This you may receive in the mail or from your employer. Examples may be a W-2 or 1099.

**Ordinary Day Process:**
You should be able to explain how your business receives revenue and pays expenses.

**Reports:**
These are business reports like a profit and loss statement or a balance sheet. This could be through a software like Quickbooks or Excel.

**Mileage:**
This may be necessary to track for business or personal reasons. Tracking this throughout the year or compiling your log and miles before meeting with your accountant is necessary. You could use an app, notebook, or spreadsheet to track this.

**Summary Statements:**
This means to have your bank account or investment account statements compiled in a way that information can be found quickly if there is a transaction in question. A summary is a written list of anything that changed this year for your family. Examples of things that change are new children, new marriage, or you moved. You don't get a document in the mail that reminds you to tell your accountant of your new child born last year. But it's important as there could be items that affect your taxes due to this change.

If you can be prepared to meet with your accountant this upcoming tax season they will be excited to work with you because you have your information in order. Run through this checklist one last time before you meet with your accountant so you're ready when that time comes.

## Save the Date: May 30, 2020

Saturday, May 30th we are hosting another event where your whole family can come! We will have things for your kids as well as for you. Mark it on your calendars now so you don't miss the fun!

WHO: The Whole Family
WHEN: 10:30am - 12:30pm (Lunch provided)
WHERE: Our office
21660 W. Field Parkway, Suite 118
Deer Park, IL 60010

More details will be shared as the date gets closer. We would love for you to join us, so please save this date!

## Frequently Asked Questions (FAQs)

***Are you a Fiduciary?***
Yes, we are! This means we have a **duty** to act in **your** best interest. A person acting in a **fiduciary** capacity is held to a high standard of honesty and full disclosure in regard to the client and must not obtain a personal benefit at the expense of the client.

***You're Fee-Only: What does that mean?***
We have chosen to be a fee-only advisory firm. This means we do not accept any fees or compensation based on product sales. While we know our clients need products like insurance we do not receive any benefit from any source when you buy a product.

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