Wealth Management

INVESTMENTS, ADVICE & TRUST SERVICES

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When Interest Rates Rise

Interest rates have been at historic lows for several years now. So it should come as no surprise to investors that, eventually, rates will begin to rise. While some areas of the economy benefit from rising interest rates, fixed income investments typically don't fare well.

Interest rates and bond prices generally move in opposite directions. A rise in market interest rates typically means a decline in the prices of fixed rate bonds. If, like many investors, you have chosen bonds to reduce your portfolio's volatility, rising interest rates may present a reason to revisit your fixed income exposure.

Determine Your Exposure

The first step in determining whether changes to your portfolio are warranted is to review the fixed income investments you currently own. Reviewing the types of bonds you're holding and their durations can help you assess your portfolio's vulnerability in a rising interest-rate environment.

Duration is a measure of a bond's sensitivity to interest-rate movements and can help investors compare bonds with different coupon rates and maturities. The higher a bond's duration, the greater the bond's sensitivity to rate changes. Several variables, including time to maturity, enter into the calculation of duration.

Longer Term, Greater Losses

When interest rates are rising, the prices of long-term bonds are generally affected most. Their extended maturity dates generally make them less desirable to investors. Investors who want to sell older bonds generally will have to sell them at a discount to their face value.

Replacing bonds that have maturity dates that are far in the future with shorter maturity bonds may offer some protection when rates are rising. However, keep in mind that these bonds generally pay less interest than longer term bonds.

Fewer Bonds

You may want to consider adding stocks, cash, or other asset classes to a portfolio

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Don't Fear the VIX

Often referred to as the "fear gauge" or "fear index," the Chicago Board Options Exchange Volatility Index® — the VIX — measures the stock market's expectation of near-term volatility. It typically acts as an indicator for investor sentiment.

Take Measure

The VIX is based on S&P 500 stock index options prices and generally has moved in the opposite direction of the S&P 500, an important benchmark for large-cap stocks. The VIX tends to rise when investors anticipate increased volatility and higher risk. As investors' concerns abate, the VIX generally declines.

Information, Please

The VIX is not an indicator of stock market movement over the long term, so investors with a long investing time horizon typically won't be affected by the VIX's movements. The CBOE website (*www.cboe.com*) includes historical VIX data for investors who are interested.

Dividend Stocks: Right for Your Retirement Portfolio?

Retirees who are looking to remain at least partially invested in the stock market may want to consider stocks that have a long history of paying dividends to shareholders. Dividend-paying stocks combine the potential for appreciation with an income stream and can be found across a broad range of sectors and industries.

Dividend-paying stocks often come from large, well-established companies with many years of steady payments. Although companies sometimes reduce dividends during a difficult economy, typically, dividends have outpaced inflation over the long term. Even when share prices decline, dividends have the potential to provide retirees with a reliable stream of income.

Holding dividend-paying stocks can complement your other strategies for generating retirement income.

Dividends' Tax Benefits

Unlike bond interest that's taxed as ordinary income, qualifying dividends are taxed at the long-term capital gains rate. For most investors, that means dividends are taxed at the 15% rate. The rate falls to 0% for individuals in the 10% or 15% tax brackets and rises to 20% for individuals in the 39.6% tax bracket.

To qualify for the favorable rate, dividends generally must have been paid by a U.S. corporation or qualified foreign corporation. Stockholders also must meet a designated holding period for owning their shares.

Saving for a Child's Future

Giving money to children or grandchildren is a planning strategy that benefits donors and beneficiaries. You can make annual gifts of up to $14,000* each to an unlimited number of recipients, free of gift and generation-skipping transfer tax, without using any of the lifetime gift exemption. But consider your options for holding gifted assets carefully.

Custodial Accounts

Custodial accounts established under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) allow you to set aside money for any activities that benefit your child. But custodial accounts may not be your best option. Your child will be able to access the funds at a young age — often 18 or 21, depending on state law — and may not have the maturity to use the funds wisely.

Crummey Trust

With a Crummey trust, you specify how the money in the trust should be used and when the beneficiary can receive the assets. If desired, the trust can continue for the beneficiary's entire lifetime. However, to avoid forfeiting the gift-tax annual exclusion, you must notify the beneficiary when you make an annual gift to the trust and give the beneficiary a limited amount of time (e.g., 30 days) to withdraw those funds. A Crummey trust allows more control over the funds, since a beneficiary may be reluctant to go against a donor's wishes.

** For 2014*

IRA Rollovers: What *Are* the Rules?

Individual retirement account (IRA) owners have long had the ability to roll over funds from one IRA to another IRA without tax consequences, provided the rollover is accomplished within 60 days. During the 60-day window, the individual has unrestricted use of the rollover funds. The tax law allows one IRA rollover per year.

New Interpretation

In the past, the IRS applied the one-per-year rollover rule to each of a taxpayer's IRAs individually rather than to all of the taxpayer's IRAs collectively. However, in a recent case, the U.S. Tax Court determined that the rule should be applied to a taxpayer's combined IRAs. In other words, a taxpayer can't make a non-taxable rollover from one IRA to another if the taxpayer already made a roll-over from *any* IRA in the preceding one-year period. Shortly afterward, the IRS announced that it would follow the Tax Court's decision.

If the one-per-year rule is violated, the extra rollover amount is generally taxable and also may be subject to the 10% early distribution penalty.

Avoiding Problems

Individuals with multiple IRAs should keep in mind that the once-per-year rule does not apply to direct, trustee-to-trustee transfers between IRAs. Since transfers aren't considered distributions or rollover contributions, there are no limits on the number of direct IRA-to-IRA transfers you can make during the year.

Changes Grandfathered

The IRS is in the process of revising its IRA publication (Publication 590) to reflect the Tax Court's interpretation of the rule. Taxpayers who receive distributions in 2014 don't have to worry, though. The rule won't apply to rollovers involving IRA distributions that occur before January 1, 2015.

Simple Giving

A donor-advised fund can be an effective vehicle for supporting philanthropic causes that are important to you while receiving a tax break for your contributions.

You set up a donor-advised fund by making an irrevocable contribution to a sponsoring organization for distribution to qualified charities at some future time. You typically can recommend which charities will receive donations, although the sponsoring organization has the final say in the disbursement.

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Generally, you'll be able to claim an income-tax deduction in the year you set up the fund. You'll also avoid capital gains taxes on any appreciated securities you contribute. The value of your estate will be reduced by your contributions to the fund, potentially saving future estate taxes.

If you're interested in creating a lasting legacy, you may want to ask the sponsoring organization if the fund will continue after your death.

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that is heavily weighted in bonds when interest rates are on the rise. Reducing fixed income holdings might help you avoid substantial losses if interest rates rise dramatically.

Or Different Bonds

This also may be a good time to review the types of fixed investments you hold in your portfolio. For example, convertible bonds are a fixed income investment you might want to consider. Although they tend to pay lower interest rates than standard bonds, convertibles give investors the option of converting bonds into common stock if the company does well. Non-investment-grade corporate bonds (also known as "junk" bonds) typically pay higher interest rates but also present a higher risk of default. Investors need to be cautious.

Help from Laddering

Constructing a bond ladder may offer some protection against rising rates. Laddering involves buying bonds with maturities that are spread out over several years. If rates rise, investors can reinvest the proceeds from maturing bonds at the higher rates.

Professional Assistance

Fixed income investments provide a hedge against stock market volatility and are an important component of a well-diversified portfolio. Interest-rate risk should be evaluated within the context of your portfolio's overall risk.

In a changing market environment, the insights and assistance of an experienced investment manager can be invaluable. Please contact us to discuss your portfolio and its exposure to interest-rate risk.

This publication involves sophisticated tax and financial planning concepts. Before applying anything you read to your situation, you should consult with your professional advisor.