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Your Bonds and Rising Interest Rates

Bonds can be an appropriate option for investors who want to focus part of their portfolios on generating an income stream. Adding to the appeal of bonds is the fact that they help investors diversify* and manage the risks in their investment portfolios since bond and stock prices do not always move in the same direction.

However, bonds are not without risks. One of the primary risks is interest rate risk — the risk that a change in interest rates will change the value of an investment. When market interest rates rise, prices of fixed-rate bonds fall (and vice versa). Why? Their interest rates become less attractive to investors than the higher rates of newly issued bonds of similar quality. So how can you gauge how much a bond's price might fall after rates rise?

Bond Duration

One way investment managers measure interest rate risk is by looking at a bond's duration. Duration is the average time it takes for a bond's future cash flows to cover its cost. By multiplying the bond's duration by the projected interest rate change, a manager can estimate the effect on a bond's price. A bond with five-year duration, for instance, will see its price decrease by about 5% if interest rates rise by 1%. Likewise, the bond's price will increase by about 5% if interest rates fall by 1%.

Bond Funds

For bond funds, the relationship between interest rate changes and the fund's value is more complicated. A bond fund's duration is the average duration of all the bonds in the fund, and this duration may provide an indication of how the fund might be affected by a rate change.

Owners of bond funds rely on the funds' investment managers to employ strategies that can mitigate various risks, including interest rate risk. One way bond fund managers attempt to minimize the impact

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Economic and Market Update

By Kate Braddock, CFA

After ending the second quarter flat, stocks have seen a resurgence of volatility. August saw a 6% decline in the stock market, driven by fears of slowing growth in China, questions about when and how much the Fed could raise rates, and a drastic drop in oil prices.

We believe the U.S. economy is fine. Unemployment is at 5.1%, versus a 50-year average of 6.1%. We continue to add approximately 225,000 jobs a month. In 2011, when we saw the last correction, unemployment was at 9.1%. Second quarter GDP came in at 3.7%. Housing statistics continue to show healthy gains, and consumer confidence is strong.

Emerging markets are affected most by slowing growth in China, a potential increase in rates at the Federal Reserve, and the significant decline in oil prices. Emerging markets are commodity driven economies. The effects of recent events have yet to be measured in full. We do know, however, that there will be a negative drag on emerging markets currencies and growth.

Ups and downs are part of market cycles and should not alter our long-term allocation and goals.

Helping Grandchildren Pay for College

A college education is expensive. If you have grandchildren, you may want to help them with their higher education costs. Here are two tax-friendly options you might consider.

Giving Outright

Every year, you can give cash and other assets worth up to $14,000 — per recipient — without any federal gift-tax consequences by using what's known as the "gift-tax annual exclusion." (The $14,000 figure may be adjusted for inflation in future years.) Your spouse can do the same. Combined, both you and your spouse could give $28,000 to one grandchild. By making annual gifts to your grandchildren, you remove the gifted assets from your estate.

Grandparents who want to give even more on a gift-tax-free basis might consider paying tuition on behalf of their grandchildren. If the payments are made directly to the school, they are not considered taxable gifts and are not counted toward the $14,000/$28,000 limit.

Section 529 Plans

529 savings plans allow investment earnings to accumulate on a tax-deferred basis. Earnings won't be subject to federal income taxes when withdrawn to cover the beneficiary's qualified educational expenses. You can choose from a variety of states' plans, since many 529 plans are open to non-residents. In addition, certain states offer their residents tax incentives for investing in an in-state plan. (Consult your tax advisor for specifics.)

The Cost of College

It's no secret that it costs a lot of money to send a child off to college. Though scholarships, loans, and grants can lessen the financial burden for parents, a college education is still expensive.

2014-2015	Tuition and Fees	Room and Board
Private, Non-profit Four-Year	$31,231	$11,188
Public Four-Year	$9,139	$9,804

Source: The College Board, *Trends in College Pricing 2014*

Avoid Family Strife — Discuss Beneficiary Designations

Few things can split a family down the middle more than disputes over who gets what from a recently deceased family member. You can help avoid strife in your family by keeping your will and your beneficiary designations updated and discussing with loved ones how you want your assets distributed.

Ensuring Your Property Is Distributed Correctly

An up-to-date will is an important first step in ensuring that the property you want your loved ones to receive actually passes to them. However, a will alone can't control how all property is distributed. Life insurance policies, retirement plan accounts, and certain other assets may allow you to designate a beneficiary. Here are some specifics.

Retirement plan accounts. If you are married, you are generally required to name your spouse as the primary beneficiary of your qualified plan account unless your spouse signs the required type of consent waiving his or her rights to your plan assets. Just be sure to update your beneficiary designation whenever there has been a major life event, such as marriage, divorce, or the death of a named beneficiary. For example, if you name your spouse as beneficiary of your retirement plan and later divorce that spouse, he or she may still be entitled to receive your retirement plan assets when you die if you fail to change your beneficiary designation.

Life insurance proceeds. When you first buy a life insurance policy, you name a beneficiary or beneficiaries to receive the proceeds upon your death. The proceeds of your life insurance policies will generally be paid to the beneficiary or beneficiaries designated in your policy, even if you purport to name someone else as beneficiary of the policy in your will.

Other assets. Other assets also may pass through beneficiary designations. For example, you may be able to designate a beneficiary to exercise any stock options you may have within a certain time after your death. And if you bought company stock through an employee stock purchase plan, you may be able to designate a beneficiary for that stock.

A regular review of your will and your beneficiary designations can help maintain family peace and harmony.

Year-end Tax Planning

The last quarter of the year is always a good time to look for opportunities to reduce your income-tax burden. Consider the following strategies.

Maximize Contributions to Your Retirement Plan

The IRS allows pretax salary deferrals of up to $18,000 to a 401(k) or 403(b) plan for 2015, plus an additional $6,000 of catch-up contributions for participants age 50 or older. (Your plan may set lower limits.) If you haven't already contributed the maximum amount allowed, consider boosting your deferrals before year-end.

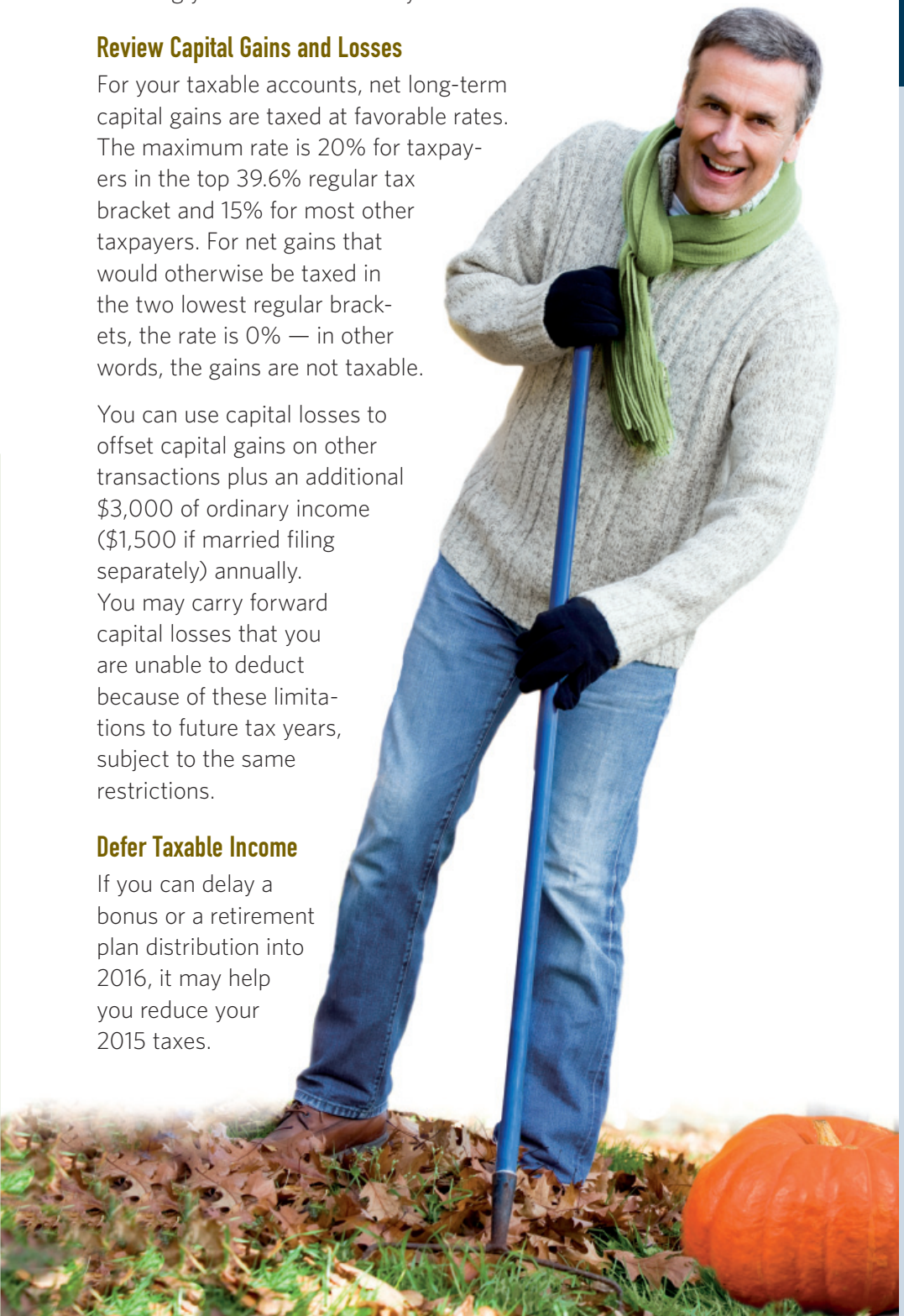
Review Capital Gains and Losses

For your taxable accounts, net long-term capital gains are taxed at favorable rates. The maximum rate is 20% for taxpayers in the top 39.6% regular tax bracket and 15% for most other taxpayers. For net gains that would otherwise be taxed in the two lowest regular brackets, the rate is 0% — in other words, the gains are not taxable.

You can use capital losses to offset capital gains on other transactions plus an additional $3,000 of ordinary income ($1,500 if married filing separately) annually. You may carry forward capital losses that you are unable to deduct because of these limitations to future tax years, subject to the same restrictions.

Defer Taxable Income

If you can delay a bonus or a retirement plan distribution into 2016, it may help you reduce your 2015 taxes.



Tax-savvy Retirement Withdrawals

Does it make sense to prioritize withdrawals from one type of retirement account over another as your tax situation changes from year to year? It may.

For example, taxable distributions from traditional 401(k) plans and individual retirement accounts (IRAs) are included in your gross income. Thus, such distributions could potentially place you in a higher marginal tax bracket. However, qualified distributions from Roth 401(k) accounts and Roth IRAs are not taxed and therefore have no impact on your current tax bracket.

> "Pay attention to your tax situation before making a decision about which accounts to withdraw from."

Investments you hold in taxable accounts are potentially eligible for the discounted long-term capital gains rates when sold. Additionally, your dividend income may qualify for a favorable tax rate. You also can use capital losses to offset capital gains on other transactions plus an additional $3,000 of ordinary income ($1,500 if married filing separately) annually.

Pay attention to your tax situation before making a decision about which accounts to withdraw from.

Your Bonds and Rising Interest Rates *(Continued from page 1)*

of changing interest rates on their fund holdings is to adjust the fund's sensitivity to interest rates. Depending on the fund manager's rate outlook, the manager may opt to invest a larger or smaller share of the fund's portfolio in bonds with shorter or longer maturities. This is known as moving in or out on the yield curve. In normal economic environments, yields tend to rise as maturities lengthen, compensating owners of bonds with long maturities for taking greater risk.

Look at the Big Picture

All investments, including bonds, will fluctuate in value over time. Bonds, though, can be a good addition to your portfolio by providing a fixed income component to your asset allocation.

** Diversification does not ensure a profit or protect against loss in a declining market.*

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