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The 1% Difference

Last year, New York City school children went door to door collecting pennies. By asking for only 1% of a dollar, they were able to raise \$1 million for charity.

Sometimes the small actions we take yield big results. Take a look at three examples of how adjusting your finances by just 1% can make a real difference over time.

Boost your retirement contribution

Making contributions to an employer sponsored retirement account via payroll deductions can be a convenient way to save for retirement. But because these contributions come out of your salary automatically, you can easily lose track of how much you're contributing, and end up with less than you should have—or could have—for retirement.



If you're not already saving the maximum amount allowed, why not commit to steadily increasing your contributions by 1% (or more) each year? For example, if you're earning \$100,000 per year, and you're currently contributing 10% of your salary to your retirement account at work, you'll have approximately \$1,181,340 by the time you retire in 30 years, assuming an average return of 8%. But if you increase your contribution by 1% (to 11% of your salary), your retirement account could be worth approximately \$1,299,484—10% more—by the time you retire.*

Review investment expenses

When you're focused on returns, it's easy to overlook the costs associated with investing. However, it's important to periodically review investment expenses and their impact on returns. These vary widely, but even a 1% difference can be significant over time. For example, the

following table shows what a \$200,000 investment might be worth in the future, assuming an annual return of 8% before expenses are taken into account. (Note that taxes and inflation are not considered.)*

| | Annual Expense of 1.50% (net 6.5%) | Annual Expense of 2.50% (net 5.5%) | The 1% difference |
|-----------------------|---|---|--------------------------|
| After 10 years | \$375,428 | \$341,629 | \$33,799 |
| After 20 years | \$740,729 | \$583,551 | \$121,178 |
| After 30 years | \$1,322,873 | \$996,790 | \$326,083 |

Of course, there are other things to be concerned about when investing. For example, you may want to consider potential ways to generate higher returns through your asset allocation and investment management choices, taking into account your investment objectives, risk tolerance, and time horizon.

Refinance higher-cost loans

Concerns about the economy have led to rate cuts by the Federal Reserve. With some interest rates falling to their lowest levels in two years, now might be a good time to think about refinancing a higher-cost loan or mortgage. As the following examples show, interest rates don't need to fall far for you to save money. Here's what you could potentially save by reducing your interest rate by just 1%:

- Refinancing a 48-month, \$25,000 car loan to reduce the rate from 6.99% to 5.99% could save you approximately \$553 in interest over the life of the loan

- Refinancing a 25-year, \$400,000 mortgage to reduce the rate from 6.75% to 5.75% could save you approximately \$74,166 in interest over the life of the loan

* This is a hypothetical example, and does not reflect the performance of any specific investment.

How Well Are You Navigating the Efficient Frontier?

Investing isn't just about achieving the highest return possible; it's also about the tradeoff between return and risk. Modern portfolio theory (MPT) is based on a key assumption: No rational investor wants to take more risk than is necessary to achieve the desired return. The concept was outlined by Harry Markowitz in a pioneering 1952 *Journal of Finance* study titled "Portfolio Selection," which argued that you can manage the type and level of risk you take by combining investments that tend to behave very differently from one another.

In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goals.

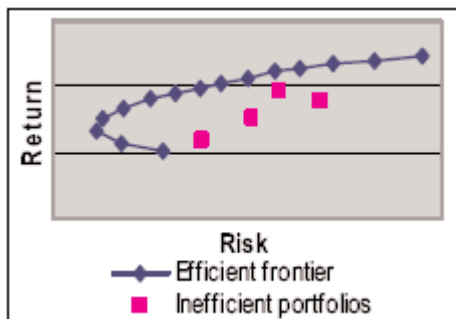
Different strokes for different folks

Modern portfolio theory tries to create portfolios that maximize return for a given level of risk—or alternatively, that minimize risk for a given level of return. MPT compares a portfolio's standard deviation—how much its return may vary from its statistical mean return over time—to its returns. An efficient portfolio navigates the risk/reward tradeoff by combining investments based on their level of risk, their expected return, and their correlation with other investments in the portfolio. MPT argues that a portfolio that doesn't do so isn't optimized—in other words, it takes too much risk for the return it provides.

Efficiency is in the eye of the beholder

Even with a limited number of securities, the ways to combine them into a portfolio are practically limitless. For any group of assets, there may be multiple efficient portfolios, each of which combines those assets differently. Collectively, they represent what economists and financial professionals call "the efficient frontier." On a chart, the efficient frontier is a line that represents all optimized portfolios for a given group of assets. That line is actually a series of points; each represents a portfolio that provides the best return for whatever risk you are comfortable taking.

The efficient frontier represents all of the combinations of a given group of assets that combine risk and return most efficiently, expressing that tradeoff in graphic form. In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal. Each GPS user may choose a different destination, but in each case, the GPS suggests the most effective way to get there.



So what is risk anyway?

Risk has traditionally been measured by volatility; an asset whose price varies dramatically is considered riskier than one that is more stable. However, some experts have begun to question whether a portfolio can be better optimized by focusing on downside risk, arguing that such an approach more closely matches the way investors tend to think.

Unlike MPT, this so-called "post-modern portfolio theory" concentrates not on how an investment's return deviates from its statistical mean—its ups and downs—but on how often its returns fall below an individual investor's minimum acceptable return, how far below that figure they fall, and the potential worst-case scenario possible for that investment. Outlined in *Managing Downside Risk in Financial Markets* by Frank Sortino and Stephen Satchell of the Pension Research Institute, this approach attempts to combine portfolio theory with behavioral finance, hoping to more closely reflect the human decision-making process.

Depending on how risk is measured—by volatility or by downside risk alone—the efficient frontier may look very different, even for the same group of assets.

The balance is up to you

Whichever approach is taken, the efficient frontier still doesn't tell you which assets are right for you, or in what combination. Only you can decide where you want your portfolio to be along the efficient frontier, and what type and level of risk you're willing to take.

Though past performance is no guarantee of future results, it can help serve as a guide when developing an appropriate asset allocation. Using data about past and anticipated returns of various assets as well as estimates of their volatility or downside risk, your financial professional can position your portfolio at the point along the efficient frontier that makes sense for you.

Will You Pay Taxes on Your Social Security Benefits?

Did you know that you might have to pay federal income tax on your Social Security benefits? If Social Security was the only income you had during the year, then your benefits generally won't be taxable. However, if you or your spouse worked and had any earned income during the year, or if you had other substantial income (such as investment income), then a portion of your Social Security benefits may be taxable.

Gather information

Your benefits are taxable if one-half of your Social Security benefit plus your other income (called your "combined income") exceeds a certain amount (called the "base amount"). To determine if your benefit is taxable, you need to know three things: (1) how much you received from Social Security during the year, (2) your combined income, and (3) the base amount for your filing status.



Find out how much you received from Social Security

Each January, the Social Security Administration (SSA) will send you a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits you received during the previous year. You'll need to use this information to figure out whether any of your benefit will be taxable.

Calculate your total income

Once you know how much you've received from Social Security, it's time to calculate your combined income. This figure includes the following:

- One-half of Social Security benefits received
- Other income including wage income, and taxable interest and dividends
- Tax-exempt interest income
- Income that's normally excludable— interest from qualified savings bonds, employer-provided adoption assistance, foreign earned income or foreign housing, and income earned by bona fide residents of American Samoa and Puerto Rico

The IRS has a worksheet you can use to calculate your combined income and determine whether or not your Social Security benefits are taxable. You can find this worksheet and more information about the taxation of Social Security benefits in IRS Publication 915, Social Security and Equivalent Railroad Retirement Benefits.

Compare your combined income against the base amount for your filing status

Once you've calculated your combined income, you must compare that against the base amount for your federal income tax filing status. If your total income is less than the base amount, then your Social Security benefits won't be taxable. If your combined income is more than the base amount, then part of your benefits will be taxable. Base amounts aren't indexed for inflation, so they're the same year after year.

Your base amount is:

- \$25,000 if you file as single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for the entire tax year
- \$32,000 if you file as married filing jointly
- \$0 if you file as married filing separately and you lived with your spouse at any time during the tax year

For example, let's say your combined income for the year was \$30,000 and you file your taxes jointly with your spouse. Because your combined income is less than the base amount for your filing status, \$32,000, your benefits won't be taxable.

How much of your benefit is taxable?

Even if your combined income exceeds the base amount for your filing status, you won't have to pay taxes on the entire amount of benefits

you've received. Generally, up to 50% of your benefits will be taxable, but if your combined income is more than \$34,000 (\$44,000 if you are married filing jointly), or if your tax filing status is married filing separately and you lived with your spouse at any time during the tax year, up to 85% of your benefit will be taxable. Again, see IRS Publication 915 for worksheets you can use to figure your taxable benefits.

Keep in mind that taxation of Social Security benefits can be complicated. Different rules apply to certain U.S. citizens and nonresident aliens living abroad and in other situations. If you have any questions, consult your tax professional.

Did you know?

Social Security benefits were not subject to federal income taxation until 1984. They became taxable as a result of the 1983 Amendments to the Social Security Act.



Tax withholding

You can have federal income taxes (but not state income taxes) withheld from your benefits if you so choose. Complete IRS Form W-4V and select the percentage that you want withheld (7%, 10%, 15%, or 25%), then return it to your local Social Security office.

ASK THE EXPERTS

What are the benefits of donor-advised funds?

If you plan to make significant charitable gifts over a long period of time, a donor advised fund (DAF) can be an attractive alternative to a private foundation. While private foundations are separate charitable entities operated by their donors, a DAF is merely an account set up with a host organization, such as a community foundation or educational institution. You make contributions to the account, and the organization makes grants to qualifying charities in your name. Although the organization legally owns your contributions and has ultimate control over grants, you can advise the organization on how to



invest your contributions and how grants should be made. Donor-advised funds have become popular recently because they require less money, time, legal assistance, and administration than private foundations. DAFs also enjoy greater tax advantages. Generally, you can open a DAF with a smaller initial contribution than would be required with a private foundation (as little as \$10,000). And because DAFs are qualified public charities, you generally get an immediate income tax deduction for your contributions (subject to the usual limitations).

Additionally, while private foundations are required to distribute a minimum of 5% of their assets each year, DAFs currently have no such minimum distribution requirement. You can let your account build up tax free for many years, deferring distributions until a later date. Further, DAFs are not subject to excise tax as private foundations are.

Finally, DAFs don't need to fulfill many of the reporting and filing requirements that are imposed on private foundations. And because the host organization handles any legal, administrative, and filing requirements (including tax returns), you're completely freed from these responsibilities.

How do I establish a donor-advised fund?



The first thing you should do is select an organization that offers donor-advised funds (DAFs). DAFs are offered by community foundations, financial service firms, educational institutions, cultural organizations, and public charities. Where you choose to establish your account depends on whether the charitable goals of the offering organization are compatible with your own.

Once you have selected a fund, be sure to obtain and carefully review the program's policies and guidelines before you open an account.

To open an account, you will need to complete and sign an application, also known as a letter of understanding. Many DAF accounts can be opened online. Typically, there is no charge to open the account, although you may be charged an administration fee each year thereafter.

You will then need to name your account. You can name it after yourself or your family, in memory of someone, or for a charitable purpose. If you prefer, you can name your account in a way that protects your anonymity.

You will also need to make the required minimum initial contribution. Typically, the minimum amount for subsequent contributions is lower than for the initial contribution. You can contribute cash, stocks, bonds, real estate, life insurance, business interests, and other types of assets, but once made, contributions are irrevocable. If you wish, you can also name someone who will continue donating to your fund after your death.

Finally, you can designate someone to advise the fund for you if you don't plan to advise the fund yourself.

Once your account is open and funded, you can recommend grants at anytime.

For more information or to discuss the content of this newsletter, please contact:

Jeffrey Arsenault, CPA/PFS, CFP, MST
Partner & Senior Wealth Advisor
(978) 687-5869
jarsenault@newwealthadvisors.net

New Wealth Advisors, LLC
1 Highwood Office Park
Tewksbury, MA 01876
www.newwealthadvisors.net

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