Coast Guard HR Flag Voice 153

PLANNING FOR YOUR FUTURE -- THE TIME IS NOW (PART 3)

Fundamentals of Building your Investment Plan (cont.)

Time And Growth of Money

Time and return are both vital factors in accumulating wealth. **The longer the period of time that you have your money invested and/or the greater your investment return, the less you will need to save to reach your goal.**

Obstacles To Your Investment Plan

The two biggest enemies of any investment plan are taxes and inflation. You need to understand how these two factors can influence your future wealth. The bottom line to all investors is what's left after taxes, referred to as the after-tax return. The investment return can be taxed under one of two types of income tax; capital gains or ordinary income.

Long-term capital gain is a favorable tax rate, currently 20%, that is applied to the investment gain which occurs from the sale of a "capital" asset, such as stocks, bonds, and other investment securities which were held for more than twelve months. If the gains were realized from the sale of a capital asset that was held for 12 months or less, it would be considered a short-term capital gain and taxed at your marginal tax rate. The marginal tax rate (i.e. 15%, 28%, 31%, 36%, 39.6%) is also applied to gains that are considered ordinary income. The ordinary income rate that you are taxed under is dependent on the amount of adjusted gross income that you receive for the tax year and your filing status. Ordinary income is considered to be earnings such as your salary, self-employment earnings, dividends, and interest. Please refer to last years tax return to determine your income tax rate. Also note that the recent tax cut will lower the tax rates over the next few years.

The second, and most overlooked, obstacle in a financial plan is the effect of inflation. The constant grinding of inflation will erode the purchasing power of your income by continually increasing the cost of products and services that you have come to rely on. As a result of these increases over time, you will need to make more money in the future in order to maintain your current standard of living. If you don't plan for it, inflation can have a large negative impact on any of your long term investment goals.

To account for taxes and inflation you will need to generate greater returns in order to reach your goal.

Protecting Your Plan From Taxes

Because of the impact that taxes can have on an investment plan, protecting your earnings from taxes should always be a goal when investing. Fortunately, there are several ways in which you can achieve that goal. Purchasing individual investments which are already provided favorable tax treatment (e.g. municipal bonds) or placing investments which are not given favorable tax treatment into a tax advantaged account are ways of achieving your protection from taxes goal.

Tax-deferred accounts are very effective tools in reducing your annual tax liability. Deferring your tax liability translates into more money staying in your investment and generating greater returns over time. There are various types of tax-deferred investment accounts to choose from, accounts such as IRA's, Company Retirement Accounts (e.g. Thrift Savings Plan (TSP), 401(k), 403(b)), annuities, and permanent life insurance plans. In addition to the tax-deferral, some accounts may allow you to contribute part or all of your money on a pre-tax basis. Pre-tax contributions will allow you to remove the amount of the contribution from your gross income in the year the contribution was made. Therefore, your year end taxes will be immediately reduced while the future earnings on the investment will be deferred. Investment accounts which may allow you to make contributions on a pre-tax basis include TSP, Traditional IRA, 401(k), and 403(b). Although other accounts, such as annuities and permanent life insurance, may not allow you to make pre-tax contributions, you will still have the advantage of tax-deferred earnings.

Note: Both active duty and reserve members have just received authorization for TSP in the FY01 National Defense Authorization Act. It is likely service members will be able to start contributing on or about 1 October 2001 pending DoD working out the implementation details. This allows a member to contribute up to 5% of basic pay and up to 100% of all special and incentive pays for an annual contribution limited to $10,500.

One account which is a must to look at as a very effective retirement account is the Roth IRA. The Roth IRA allows annual contributions of up to $2,000 on an after-tax basis with earnings accruing tax-deferred. **The big advantage of this account is that all the money that you receive in retirement is tax-free!** This is the very best tax-deferred savings vehicle. If you are entitled to contribute to a Roth IRA (which is the majority of Coast Guard people as only high incomes are prohibited), it is advised that you first place the maximum into the Roth before contributing any significant money to the TSP. The money you contribute to the TSP will be taxed when you eventually withdraw during your retirement years.

Before placing an investment within any of the various tax advantaged accounts, be sure that you understand all of the rules and restrictions that will apply to you. All accounts will have their own rules. Be aware that tax-deferred accounts may be more restrictive than a taxable account in the way you can receive your money or you may have penalties applied to certain withdrawals.

Fundamental Investment Strategies

Devising the most ingenious investment strategy ever conceived should not be your goal. Rather, your task is to create a basic investment plan that suits you and stick with it. Investing regularly, automating your savings program and diversifying among various investments are some of the keys to a successful investment strategy.

Many investors look to the stock market for its favorable long-term returns by investing in mutual funds and/or individual stocks. But with the markets daily fluctuations, most investors are unsure of when they should put their money into the investment(s). **Rather than trying to time the market, which very few are able to do with any success, many investors use a method called dollar cost averaging.** Dollar cost averaging allows the investor to make purchases of the same investment at regular intervals (e.g., $100 paid every two weeks, monthly, quarterly, etc.). When the selected investment price declines, the $100 will purchase a greater number of shares. When the investment price increases, the $100 will purchase a fewer number of shares.

Over time if you systematically purchase shares of the same investment at different prices, your average cost per share will be less than the average price per share. For active duty military members, you have the opportunity to put this strategy on auto pilot by taking advantage of the allotment system. Your allotment can be directed every month to purchase shares of mutual funds, bonds, or various other investments. If you are not eligible for allotment service you can have payments made electronically from your bank account to the investment or investment institution.

How you are diversified among various assets will determine how much risk your portfolio may have as well as what your potential returns may be. Asset Allocation is the strategy which seeks to minimize your investment risk while obtaining your desired rate of return by spreading your contributions over different investment asset types. **The decision on how you invest your money among the three primary investment categories (stocks, bonds, cash) will have a far greater impact on your overall portfolio return than any other more specific decisions that you may make about your portfolio** (assuming that you follow the basic investing principles in your other decisions). Diversifying your money between these various types of assets will allow you to smooth out some of the volatility in your investment portfolio while obtaining your desired rate of return.

Diversification should be based on your time horizon, risk tolerance, and desired return. Many of the financial planning software programs or web sites can provide you with a percentage of allocation based on your various factors.

Making Your Investment Transactions

Buying and selling investments can be done directly with the institution which offers the investment or through a brokerage firm.

Mutual Fund companies will allow you to directly purchase any of the individual mutual funds which are offered within their family of funds. To purchase a mutual fund directly from the fund company you will need to contact the company and have them send you an application with information on the investment(s) that you are interested in purchasing. Once you establish an account, you can purchase or sell your mutual fund(s) without incurring any commissions. Even though you do not incur any commission at the time of the purchase or sale, your individual mutual fund will still have various other charges which will be assessed during the period of time that you hold the fund. Please refer to the mutual fund prospectus before investing in order to obtain all the specific fund information.

Establishing an account with a brokerage company will allow you the opportunity to purchase a wider array of investments, everything from mutual funds to individual stocks and bonds. In addition you can also receive several services, such as research material, monthly account statements, check writing, etc. There are three general types of brokerage companies: Full Service, Discount, and Deep Discount. The types of services you receive and expenses that you incur will depend on the type of brokerage company. A full service broker will provide you with investment advice, many services, and will have higher fees (you pay for what you get). A deep discount broker will provide you with no investment advice (except what they may have on their web site), limited number of services, and very low fees. You need to decide what type of services you would like to receive and then shop around to get information from many different brokerage companies.

Putting Your Plan Into Action

Gathering information and educating yourself on various planning considerations, individual investments, and strategies is crucial to developing a sound investment plan. But at some point, you need to take the plunge and put your plan into action. Taking too much time before implementing your plan because you are waiting for the perfect investments or perfect time to invest could result in you not reaching your goal.

Remember that successful investing is not a matter of picking the best investments or figuring out the best time to buy or sell your investments, rather it is simply to start investing - and the time to start is now.

Next: If tragedy should strike -- information for the military member

Regards, FL Ames

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