

Q&A's

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IRA

Would it be better to contribute to my Roth or traditional IRA this year? I have \$5,000 which I could contribute.

Assuming you meet the income requirements for 2011 (single filer with less than \$120,000 of income or joint filers with less than \$179,000), and do not need/want a tax deduction, the Roth IRA may be your best choice. Your Roth contribution will generate tax-free growth and income for your future withdrawals. The traditional IRA is tax-deferred until you withdraw funds. You can contribute \$5,000 of earned income to either IRA this year; \$6,000 if you are 50 years or older. With future tax increases on the horizon, you may be better off to pay the tax on the contribution now and enjoy a tax-free future. Check with your tax advisor for details on your tax situation.

I have enough set aside this year to buy an IRA but I am uncertain which to get – a regular IRA or a Roth IRA. I have never had an IRA before. What do you suggest? (Edwin, TX)

I do recommend you invest in an IRA as soon as you have earned income and can afford a contribution. This is a great opportunity to take control of your retirement lifestyle. A Roth IRA will provide tax-free withdrawals in the future but no current year tax deduction for your contribution. Your contribution is made from after-tax income. A traditional IRA might provide a current year tax deduction but the withdrawals will be taxed.

If you qualify (income limits), a Roth IRA will be a better choice, especially for younger people. There are income and retirement plan participation restrictions for IRA contributions. See Chapter 12 in the book *Investing for Retirement – Surviving a Financial Tsunami*, for more details or check the IRS web site for *Publication 590, Individual Retirement Arrangements (IRAs)*.

I know there is a limit on the amount I can contribute to my IRA each year, but is there a limit on the number of IRA's I can open?

It sounds like you are considering opening certificate of deposit type IRAs. While there is no limit on the number of accounts, you can become overwhelmed trying to administer multiple IRAs. I suggest you open only one certificate of deposit IRA each year. Better yet, for more investment choices open an IRA at a brokerage firm or mutual fund company. With a brokerage IRA you can be very conservative using CD's and take advantage of more choices that offer growth and diversification using mutual funds, ETFs, or a combination of investments.

I am 47 years old and have \$175,000 in my IRA at a discount broker. I am concerned that the stock market will take years to recover and may even tank again. I am considering selling all my equity mutual funds and stocks and putting everything into insured CDs. What is your opinion?
(ML)

I wish I could predict the future but I can't. However, I can say that a 47 year old with 20 years until retirement, should save for retirement with an investment objective directed toward growth. The stock market will "tank" several times in the next 20 years before you retire. The key to successful investing is to have your savings/investments in an asset allocation that fits your risk tolerance. If you take on more risk (stocks) than your risk tolerance (e.g. your comfort zone) allows, you will panic at market lows and lock in your losses. You may also ignore warning signs at market tops and continue to add more to your stock allocation, instead of taking some money off the table.

Take a risk tolerance evaluation to understand your ability to accept risk. Understanding your risk tolerance and developing an investment plan to match, is critical to your success as an investor. If you are a conservative investor, put your investments into index funds or ETFs and CD's with 1 year maturities or less. Most 47 year olds should have some portion of their retirement savings in diversified growth oriented investments. If you are a saver and not an investor, place your retirement assets in a CD ladder out to 5 years. (See Asset Allocation for more information.)

When is the best time to contribute to an IRA - before the end of the year or at tax filing?

The best time is as soon as you have the opportunity – in early January of each year. If you wait until tax filing, the following April, you have lost the opportunity for 15 months of earnings on your contribution. You don't have to wait until you have the full contribution available, most mutual funds will take periodic investments.

Investing

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Why does it seem that every time I buy into something [an investment], I get it at its high and it goes down? (KA, TX)

This is one of the most important questions I have been asked. On its surface it seems fairly simple, but the reality of the situation is beyond casual. Ask yourself, “Why do you feel confident when you buy a stock or mutual fund?” You feel comfortable about your decision. The stock market and economy are moving along and “all seems right.” This ‘feeling’ will usually occur near market tops – only we can’t see that the market is about to top. Now consider the other side of the cycle. Ask yourself, “I sell a security near its low point only to see it eventually recover its loss. Why did I sell at that time?” You felt uncomfortable – uncertain and fearful for the future of your investment.

These 2 competing emotions, fear and greed, are normal human emotions. We will never eliminate them, but we can recognize them and try to control our responses to them. You can’t make money in the market by buying high and selling low. The only way to be a successful investor is to develop an investment plan that you can live with in all phases of the market cycle. For more information on this critical understanding to becoming a successful investor, read Sections One and Three in the book: *Investing for Retirement – Surviving a Financial Tsunami*.

I currently have a large portion of my retirement funds in the Vanguard Wellington mutual fund. Is there an alternative for constructing a portfolio with the same asset allocations using less expensive ETFs? (LK, San Antonio)

When you say “less expensive,” I assume you are referring to the cost to purchase and sell the Wellington fund. These transaction costs, at a discount brokerage, may range from \$40 to \$70 per buy/sell transaction. There are no transaction costs when you purchase directly from Vanguard. The expense ratio of this managed fund is a very reasonable .35%.

The Wellington fund is a balanced fund with 65% in large-cap stocks and 35% in high quality investment-grade bonds. You could duplicate the asset allocation using ETFs from Vanguard:

Vanguard Intermediate-Term Bond ETF (Symbol: BIV, expense ratio: .14%)

Vanguard Large-Cap ETF (Symbol: V V, expense ratio: .13%)

You can also construct a similar low cost portfolio using ETFs from Fidelity and Charles Schwab.

I am a federal employee with less than a year until my retirement. I currently have my TSP [401(k) plan] invested with 75% in the C fund [S&P 500 index fund] and the rest in the G fund [US Government securities]. What allocation do you recommend for my TSP when I retire?

You did not say, but I assume you have at least a moderate risk tolerance since you have 75% of your TSP in a stock fund and are this close to retirement. You should change your asset allocation to 45% C fund and 55% G fund. Additionally, be sure you have at least 5% of your total retirement assets set aside in readily available cash equivalents. You do not need to wait until you retire to make this change. Your asset allocation should already be set to emphasize more stability than the 75% commitment to stocks will provide.

I am considering buying a high yield bond fund for a better return in my IRA. I am 42 years old and can take some risk. What fund would you recommend? (WS, NJ)

I don't recommend any high-yield bond fund. Keep in mind that they are also known as junk bond funds. With the prospect of higher inflation and interest rates in the future, fixed-income funds, including high-yield funds, will decline in price. A 42 year old can afford to take some risk in his/her investments, but it should be for the potential for greater return – greater potential than afforded in a bond fund. With another 20 to 25 years before retirement, you should use a mix of equity index funds or ETFs to achieve solid long-term returns. However, if you must include high-yield funds in your asset mix, you should limit them to no more than 25% of your total portfolio. As you approach retirement, the high-yield funds should be replaced with intermediate-term investment-grade bond funds or ETFs. The Fidelity Capital & Income Fund is currently one of the higher rated high yield funds.

I am a recently divorced 40-something year old woman. I need to make up for lost time in accumulating my retirement savings. What type of stocks and bonds should I have in my portfolio? Should I use a discount broker?

With 20 or more years of employment before retirement, you have time to accumulate a reasonable retirement portfolio by initially using an asset allocation that emphasizes growth. A reasonable investment mix at your age would be 75% equities, 25% fixed-income. As you move closer to retirement, say 7 or 8 years out, begin to shift toward a more conservative allocation until you have about 35% in equities at retirement. This is an arbitrary percentage and should be adjusted to accommodate your risk tolerance. Read Chapter 6 in *Investing for Retirement – Surviving a Financial Tsunami* for more details on understanding your risk tolerance.

You should put 30% into a large-cap index fund such as the Vanguard 500 Index Fund or Vanguard Large Cap Index ETF; 20% into a mid or small-cap index fund - Vanguard Mid Cap Value Index ETF; and 25% in an international fund - Vanguard Total International Stock Index fund. The fixed-income portion of your portfolio should be invested in the Vanguard Inflation-Protected Securities Fund or the iShares Barclays TIPS Bond ETF (Treasury Inflation-Protected Securities). You may also achieve this mix with similar investments offered through Schwab, Fidelity and other brokerage or mutual fund companies – be sure to check the expense ratios and compare to these recommendations.

Are bonds really a safe investment? Advisors seem to recommend them as part of a portfolio for safety. (Ken, TX)

That depends entirely upon the issuer of the bond - will the bond be paid off at maturity? Investment-grade bonds provide a greater level of principal protection and a stream of income. The ratings for top quality bonds from the US government and corporations, range from AAA to A. I would avoid the lower investment-grade rating, BBB, and anything less – known as junk bonds. Bonds can and will fluctuate in market price as interest rates move up and down. Bond funds provide more price stability than equities and are an important part of any retirement savings portfolio.

You mention equities and fixed-income a lot, but to which asset class does real estate belong? Seems like RE could sometimes offer more potential. What do you think about including RE in my portfolio?

Real estate is in an asset class by itself. It has its own behaviors and purposes. In addition to providing us a place to live, real estate can add another dimension to our investment portfolios. Unless you enjoy the activities associated with direct ownership of income producing real estate, the best vehicle for adding real estate potential to your portfolio is a real estate investment trust (REIT). REIT's provide diversification of real estate ownership, liquidity, and come with professional management. As long as REITs pay out 90% of their earnings to the owners, the earnings are not taxed at the company level and pass through to the shareholder. REITs are classified as either equity REITs (own real estate and distribute the resulting income and gains) or Mortgage REITs (own real estate mortgages). Quality REITs can be useful in portfolios where income is an objective.

Should I increase the percentage [contribution] of my 401(k) the closer I get to retirement? (DL)

You will benefit more from increased contributions earlier rather than later. The sooner you put money to work the more time it has to work for you. Don't look at your 401(k) as reducing your lifestyle, rather, see it as enhancing your future lifestyle. The sooner you can adjust to increased contribution levels, the easier it will be to let future wage increases add to and compound your savings.

Misc.

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Why do you recommend using ETFs instead of mutual funds for retirement accounts?

I don't recommend one over the other. Ask yourself how you want to use the investment. Is it for long-term growth or immediate income? Both ETFs and mutual funds can match most investment goals and objectives. However, mutual funds can be setup to provide you with an automatic monthly income withdrawal. ETFs would have to be sold in order to tap some of your investment principal.

I have almost all of my retirement savings in a 401(k) and a traditional IRA. How can I minimize the taxes when I make withdrawals from them during retirement? (JB)

This is really a tax question that should be addressed to your accountant. However, the basics of tax implications for withdrawals are:

The money withdrawn from your 401(k) is fully taxable at your tax rate in the year you withdraw the money. Remember, you did not pay taxes on those funds when you contributed to the 401(k) or the years they were earning dividends or interest.

The withdrawal from your traditional IRA is a little more complicated. You have a cost basis on the IRA – the amount of deposits which you did not deduct from your taxes in the year of the deposit. You will be able to partially reduce the taxable amount by the ratio of non-deductable contributions to the value of the IRA.

After consulting your tax advisor, you might also consider converting some or all of your traditional IRA into a ROTH IRA. You'll pay taxes on the amount converted (less the non-deductable/value ratio), but you will save future taxes on the earnings from that point on. When you convert some or all of your traditional IRA you will increase your taxable income – be sure you understand the tax and Social Security/Medicare implications. See Chapter 12 in the book *Investing for Retirement – Surviving a Financial Tsunami*, for more specifics.

Mutual funds & ETFs

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What keeps the price of ETFs from being manipulated by the buyers and sellers on a stock exchange?

An Exchange Traded Fund (ETF) is a fund that owns a portfolio of securities. The shares of the ETF trade on a stock exchange like a stock. The trades take place frequently and are based on what another investor is willing to pay for a share of the ETF – just like a share of stock. In a traditional mutual fund, the shares are sold or repurchased daily based on the value of the fund’s assets, divided by the number of shares outstanding – it is not subject to the whims of another investor.

Because ETFs are frequently traded throughout the day, and the assets owned by the ETF are publically known, it is easy for large investors and institutions (known as Authorized Participants) to determine almost instantaneously, when an ETF is selling above or below the underlying value of its assets. When its’ price gets away from the true value of the underlying securities, a large investor will come in and create or redeem ETF shares (called creation units) that match the exact security composition of the ETF. This activity will help keep the ETF close to its asset value.

“Other” Investments

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How much gold should I hold in my portfolio? (KW)

Lately, this has become a popular question. Gold is a commodity not a financial investment. It can be bought and sold like an investment, but its fundamental characteristic is that of a commodity. Its’ trading velocity is emotion driven. The price of gold is also driven by the relative value of the US Dollar. As long as gold is quoted in dollars, the price will be influenced by the fluctuation in the dollar – as the dollar falls, the price of gold will rise. Today the media is full of advertisements and infomercials touting the virtues of owning gold, but a look at its past will reveal something very different. If you apply the Rule of 72 - an investment earning 7.2% will double every 10 years - you can easily see the fallacy of owning and holding gold for the long-term. For example, in 1980, gold traded at \$500 an ounce. Using the Rule of 72, by 1990 if gold increased 7.2% a year it should have been \$1000, by 2000 it should have reached \$2000 and in 2010 it should be selling for \$4000 an ounce. That revelation clearly shows that owning gold in a portfolio long-term is a bad idea. Maybe you are fast enough to “trade” gold, but most people, including the investment pros, are not. In the recent financial Tsunami, as stocks plunged and then began to recover, gold moved lower, then up to \$1200 an ounce, back to \$1050 and recently moved above \$1500. I am still waiting for \$4000 an ounce gold. Someday it will be there, but in the meantime, investors can earn some real returns with a proper mix of equities and fixed-income investments.

For investors who insist on owning gold, check out the gold ETF - SPDR Gold Shares (GLD), and limit your investment to no more than 5% of your portfolio.

I want to include gold in my IRA. Which type of ownership (coins, bullion, or funds) is best and what percentage would you recommend?

As I previously mentioned, I would limit gold ownership to no more than 5% of your portfolio. As with any investment, it is important to minimize the transactional costs of ownership. That is, what does it cost to buy, sell and store the gold. Buying coins is the most expensive method – you buy at retail and sell back at wholesale. Owning the bullion will add the expense of storage to your costs. I would suggest you use a gold or precious metals fund or the SPDR Gold Shares ETF (GLD). This ETF will provide you liquidity and inexpensive transaction costs.