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March 2018

Weighing the risks of bond funds

Most portfolio allocations call for a mix of stocks (equities) and bonds (fixed income). The underlying theory is that stocks may deliver substantial results over the long term, whereas bonds contribute interest income and lower volatility.

As we've seen in recent years, stocks can be extremely risky but have recovered from periodic setbacks. Bonds offer low yields in today's environment. Therefore, one main reason for holding bonds is to dampen overall portfolio swings, holding down losses when stocks sag. This may help keep investors in the stock market and allow them to benefit in the next cyclical move to the upside.

Although bonds have not been as volatile as stocks, they do have risks. Understanding the possible perils may help you adjust your portfolio so that any fixed-income holdings are aligned with your risk tolerance.

Safety in numbers

Today, many people invest in the bond market via funds. Individual bonds may be difficult for non-professionals to analyze, and the trading prices for small transactions in the fixed-income market might be relatively high.

When you invest through a fund, experienced portfolio managers make the buy and sell decisions. Often, these managers are supported by a research team. In addition, a bond fund may hold dozens or even hundreds of different issues, reducing investors' exposure to weakness in any one bond. Trading prices can be more favorable for bond funds than those for individual investors.

Investing in bond funds can reduce your fixed-income risk, but there still are possible pitfalls to consider.

Credit risk

Buying a bond is essentially making a loan. Your greatest risk is that the borrower will fail to make scheduled interest payments or fail to return the loan amount at maturity. In times of overall economic weakness or specific issuer problems, perceived credit risk may increase. Then, the price of some or even most of the bonds held by a fund might drop, reducing the value of investors' shares. In the case of an actual default, the price decline can be severe.

Interest rate risk

Rising interest rates generally push down bond prices, even without significant credit risk. That's because higher interest rates mean that lower-yielding bonds are less attractive. Prices will drop to bring yields in line.

In this issue

Down payments up

The median down payment for single family homes and condos purchased with financing in the third quarter of 2017 was $20,000, up from $14,400 a year earlier.

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Example: Mark Tucker invests $10,000 in bonds issued by ABC Corp., which is in excellent financial condition. The bonds yield 3%, so Mark will collect $300 (3% of $10,000) in interest each year until the bond pays back his $10,000 at maturity.

What if interest rates rise to 4%? Investors can then receive $400 a year on a similar $10,000 investment. In this scenario, no one will pay Mark $10,000 for bonds yielding $300 a year. If he wants to sell his bonds, he might have to drop the price to $7,500.

A buyer acquiring bonds yielding $300 a year for $7,500 would be getting a 4% return, the going rate in this example. As you can see, a 33.3% increase in interest rates (3% to 4%) leads to a 25% drop ($10,000 to $7,500) in bond values. This is a simplified illustration, but it demonstrates the concept that rising yields will devalue existing bonds.

Reducing the risks

The aforementioned risks can be mitigated by an adept selection of bond funds. To reduce credit risk, look for funds holding bonds from creditworthy issuers.

For instance, bonds issued by the U.S. Treasury have scant risk of default. Corporate bonds are rated by private agencies and those from financially sound companies are considered "investment grade." Standard & Poor's, one such agency, gives AAA, AA, A, or BBB ratings to companies considered to have low credit risk.

Bonds with lower ratings or no ratings at all are judged to have more credit risk. The term "junk bonds" may be applied to such issues, although they also may be known as "high yield" bonds because they must offer relatively robust payouts to attract investors. Online, you can see the ratings of the bonds held by various funds. A fund with average credit quality of AA, for example, would generally have little credit risk.

As for interest rate risk, that's largely determined by whether the bonds in the fund are long- or short-term. In the previous example, suppose Mark buys bonds that mature in one year. An interest rate rise might not drive down the bond price very much. In a year, Mark can redeem his 3% bonds and reinvest in 4% bonds, assuming interest rates hold steady.

Conversely, suppose Mark's bonds won't mature for 20 years. A buyer would receive his or her $300 annual payout for decades, locking in that scant return. That prospect could reduce the bonds' market value a great deal. For risk reduction, Mark should look for funds with relatively short maturity bonds.

Revealing rates

The bottom line is that high-quality short maturity bonds typically have less risk than lower quality long-term bonds. Bond funds holding lower quality or longer-term bonds will have higher yields. Thus, looking at a bond fund's yield is a key indicator of the risks involved.

As of this writing, U.S. Treasury bonds maturing in the two- to five-year range yield around 2%. Therefore, any bond fund with yields significantly higher than 2% might be taking on meaningful credit risk, interest rate risk, or both. Lower-yielding funds may be relatively safe from share price deterioration.

Two five-year tests for Roth IRAs

The pros and cons of Roth IRAs, which were introduced 20 years ago, are well understood. All money flowing into Roth IRAs is after-tax, so there is no upfront tax benefit.

As a tradeoff, all qualified Roth IRA distributions can be tax-free, including the parts of the distributions that are payouts of investment earnings.

To be a qualified distribution, the distribution must meet two basic requirements. First, the distribution must be made on or after the date the account owner reaches age 59½, be made because the account owner is disabled, be made to a beneficiary or to the account owner's estate after his or her death, or be used to buy or rebuild a first home.

Second, the distribution must be made after the five-year period beginning with the first tax year for which a contribution was made to a Roth IRA set up for the owner's benefit.

Note that the calculation of a Roth IRA's five-year period is very generous. It always begins on January 1 of the calendar year.

Example 1: Heidi Walker, age 58, opens her first Roth IRA and makes a contribution to it on March 29, 2018. Heidi designates this as a contribution for 2017, which can be made until April 17, 2018.

Under the five-year rule, Heidi's five-year period starts on January 1, 2017. As of January 1, 2022, Heidi's Roth IRA distributions are tax-free, qualified distributions because they will have been made after she turned 59½ and after the five-year period has ended. The five-year period is determined based on the first contribution to the Roth IRA; the starting date of the five-year period is not reset for the subsequent contributions.

Note that if Heidi opens her first Roth IRA late in 2018, even in December, the first contribution will be a 2018 Roth IRA contribution and Heidi will reach the five-year mark on January 1, 2023.

Conversion factors

Other than making regular contributions, Roth IRAs may be funded by converting a traditional IRA to a Roth IRA and paying tax on any pre-tax dollars moved

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to the Roth side. For such conversions, a separate five-year rule applies. There generally is a five-year waiting period before a Roth IRA owner who is under age 59½ can withdraw the dollars contributed to the Roth IRA in the conversion that were includible in income in the conversion, without owing a 10% early withdrawal penalty.

Similar to the five-year rule for qualified distributions, the five-year period for conversions begins on the first day of the year of the conversion. However, unlike the five-year rule for qualified distributions, the five-year rule for conversions applies separately to each Roth IRA conversion.

Example 2: In 2018, Jim Bradley, age 41, leaves his job and rolls $60,000 from his 401(k) account to a traditional IRA, maintaining the tax deferral. If Jim decides to withdraw $20,000 next year, at age 42, he would owe income tax on that $20,000 plus a 10% ($2,000) penalty for an early withdrawal.

Instead, in 2019, Jim converts $20,000 from his traditional IRA to a Roth IRA and includes the entire amount converted in income. However, if Jim withdraws that $20,000 in 2019, he also will owe the 10% penalty because he does not meet the five-year rule for conversions; the rationale is that the IRS doesn't want people to avoid the early withdrawal penalty on traditional IRA distributions by making a Roth conversion.

The good news is that, in this example, Jim will have started the five-year clock with his 2019 Roth IRA conversion. Therefore, he can avoid the 10% early withdrawal penalty on the conversion contribution after January 1, 2024, even though he will only be age 47 then. Jim will owe income tax on any withdrawn earnings, though, until he reaches age 59½ or he meets one of the other qualified distribution criteria.

Note that various exceptions may allow Jim to avoid the 10% penalty before the end of the five-year period. Altogether, the taxation of any Roth IRA distributions made before five years have passed and before age 59½ can be complex. If you have a Roth IRA, our office can explain the likely tax consequences of any distribution you are considering. Generally, it is better to wait until the age 59½ and five-year tests are passed before making Roth IRA withdrawals, to avoid taxes.

Trusted advice

Roth IRA distributions

- Roth IRA distributions after age 59½ (and five years after you set up and make a contribution to your first Roth IRA) qualify for complete tax-free treatment.
- Distributions that do not qualify for this tax-free treatment may be subject to income tax, a 10% early withdrawal penalty, or both.
- Ordering rules apply to non-qualified distributions.
    - First come regular contributions, rollover contributions from other Roth IRAs, and rollover contributions from a designated Roth account.
    - Next come conversion contributions, on a first-in, first-out basis. The taxable portion comes before the nontaxable portion.
    - Earnings on contributions are the last dollars to come out.

How small companies can address harassment issues

Politicians, journalists, and other celebrities are not the only ones vulnerable to charges of sexual harassment. As a business owner, you could be in the spotlight if allegations of improper behavior arise, especially if they are brought by one or more employees. Even if your own conduct has been beyond reproach, harassment among staff members might damage your company's workplace morale, public image, and profitability.

This issue is not going away. Here are some ideas on how to minimize problems and deal with any that might surface.

Get serious

A plan for addressing sexual harassment at your firm is not something you should assign to just anyone. Get involved personally or delegate the task to a reliable person with proven ability to accomplish vital matters. The higher in your company the responsibility lies, the greater the importance of preventing problems will appear to all of your people.

Get a lawyer

You shouldn't believe that your knowledge of the company and good old common sense will enable you to deal with any incidents. The legalities and public perceptions can be complex. One way to start facing potential perils from sexual harassment is to get in touch with an attorney who is knowledgeable about local law in your state and perhaps your city.

It's likely that such an attorney will advise you to create and disseminate a formal policy, expressing your company's abhorrence of sexual harassment. The policy can spell out what actions will not be tolerated by employees at any level of the firm. Make it clear that any problems can be brought to you or to someone in a senior position without fear of retaliation. At the same time, the policy should assert that anyone accused of

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stepping out of line won't be prejudged until all the facts are revealed.

Get ready to follow through

Accept the fact that some harassment claims will arise at some point. Therefore, you should have a plan in place to investigate the dispute, perhaps a procedure suggested by your attorney.

You'll probably begin by hearing both sides. This might be done separately, so the parties won't fear intimidation. Get statements from third parties if they have witnessed the activities in question.

Keep records that thoroughly document what has been said and what has been done about it. The complaint might be dismissed, the person accused might be told to undergo counseling, or the guilty party could be fired. Again, it's a good idea to touch base with your lawyer before announcing any resolution of the complaint.

Set an example

Perhaps the best way to indicate that sexual harassment won't be condoned at your company is to walk the walk as well as talk the talk. Refrain from saying or doing anything that might be misconstrued, no matter how innocent it might seem to you. If you're married, and if you have children, think about how any

questionable actions might be perceived by your spouse or your kids.

Demonstrate to all your employees that your place of business is somewhere that they can do their jobs without feeling uncomfortable.

Tax calendar

MARCH 2018

March 15

Partnerships. File a 2017 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), "Partner's Share of Income, Deductions, Credits, etc.," or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004.

S corporations. File a 2017 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), "Shareholder's Share of Income, Deductions, Credits, etc.," or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe in tax.

S corporation election. File Form 2553, "Election by a Small Business Corporation," to choose to be treated as an S corporation beginning with calendar year 2018. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2019.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

APRIL 2018

April 17

Individuals. File a 2017 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, "Application for Automatic Extension of Time to File U.S. Individual Income Tax Return." Then file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2018 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2018 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of $2,000 or more in 2017 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2016 or 2017 to household employees. Also, report any income tax you withheld for your household employees.

Corporations. File a 2017 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe in taxes.

Corporations. Deposit the first installment of estimated income tax for 2018.

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