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Crisis Investing: Keeping Your Head

When a crisis creates uncertainty, markets often become volatile, especially when the scope of the disaster isn't clear. A crisis is like Janus, the Roman god with faces that looked forward and back. For some investors, it may represent a threat; for others, it may spell opportunity. Not every crisis requires a reaction; sticking to a long-term plan is still the best strategy for most people.

Here are some examples of factors that investors sometimes overlook when considering which face of Janus to focus on during a crisis.

Watch the global supply chain

Companies and economies increasingly operate in a global context. The more heavily an industry or company relies on global partners, the more it might be affected by crisis conditions. Think not only about companies that are affected directly by turmoil, but about other companies that rely on them.

For example, China has become in many ways the world's factory floor, and many information technology services are now outsourced to India. How would a crisis in either country affect global supply chains or communications infrastructure? Might competitors not affected by the crisis pick up at least some of the slack? How might a particular industry be hit by shortages of parts or raw materials? Is a large multinational so geographically spread out that a crisis in one part of the world may have little impact on its overall operations? Oil is perhaps the most obvious example of how a crisis can affect global supply chains. A perceived threat to supplies can affect prices of other assets.

Consider currency fluctuations

Currency fluctuations are another factor to consider. Crises in one part of the world can affect that region's currency. That in turn can affect companies located elsewhere. The 2010 panic over potential default by several eurozone countries strengthened the dollar, and though that may sound like good news, a stronger dollar can hurt U.S. exports.

Currency issues are also important because of what's called the "carry trade." This happens when investors use money from a country where interest rates are relatively low--the Japanese yen and the U.S. dollar have been prime examples in recent years--to invest elsewhere at a better rate of return. However, if the cheaper currency suddenly increases in value, the carry trade can reverse as investors put their capital back into the so-called funding currency. That can affect assets denominated in other currencies. For example, the yen soared as investors anticipated that money would be repatriated to deal with Japan's earthquake/tsunami/nuclear disaster. Some investments denominated in other currencies suffered when investors sold them to invest in yen.

Think both long term and short term

Nothing lasts forever. A crisis could create opportunities that eventually peter out, or challenges that later seem trivial. Or it could have little short-term impact but mean profound change over a period of years. When considering whether a crisis represents a challenge or an opportunity, think both short term and long term.

A crisis with potentially long-term opportunities or harmful consequences may mean you may be able to take more time with a decision. If the window of opportunity is smaller or the potential devastation more short term, remember that there are alternatives to an all-or-nothing approach. For example, you could take a small position and see how your investment thesis plays out before committing more. Even if the window of opportunity slams shut, new opportunities often emerge during even the worst of times; missing one now doesn't mean you won't find others later. If you're worried about a potential downturn, you could use other investments to hedge your exposure while retaining a long-term stake, or take profits to protect part of your holdings but leave some money invested in case the crisis is short-lived.

Note: *Any investment approach involves some type of risk, including the possible loss of principal, and there's no guarantee any strategy or technique will be successful.*

Tax Advantages of Homeownership

Mortgage interest deduction threatened?

Recent discussions relating to reducing the budget deficit have cast a spotlight on itemized deductions, including the mortgage interest deduction. Could the mortgage interest deduction ultimately be eliminated? That seems unlikely, but elimination or reduction of the deduction has remained part of the ongoing debate, and was included among the recommendations contained in the National Commission on Fiscal Responsibility and Reform's December 2010 report.

According to the U.S. Census Bureau, the estimated homeownership rate in the United States at the end of 2010 was 66.5% (Source: U.S. Census Bureau, Housing and Household Economic Statistics Division).

Although tax considerations probably aren't the motivating force behind most home purchases, the tax advantages associated with homeownership are significant enough that they may factor into the decision process. Here's a quick review of federal tax benefits available.

The mortgage interest deduction

If you itemize deductions on Schedule A of Form 1040, you're generally able to deduct the interest you pay on debt resulting from a loan used to buy, build, or improve your principal residence, provided that the loan is secured by your home (the ability to deduct mortgage interest also generally applies to second homes, though special rules apply if you rent the home out for part of the year). Interest you pay on up to $1 million in mortgage debt ($500,000 if you're married and file a separate federal income tax return) can qualify for the deduction (different rules may apply if you incurred the debt prior to October 14, 1987).

Interest on qualifying home equity debt (basically, debt on a loan secured by equity in your main or second home that is not used to buy, build, or improve your home) of up to $100,000 ($50,000 for married individuals filing separately) is generally deductible regardless of how the loan proceeds are used. Note, however, that if you're subject to the alternative minimum tax (AMT), the AMT calculation doesn't allow a deduction for interest on debt that's not used to buy, build, or improve your home.

Qualified mortgage insurance premium payments made prior to 2012 can be deducted in the same manner as qualified mortgage interest, provided the mortgage insurance contract is issued after 2006. The deduction is, however, phased out for those with adjusted gross incomes exceeding $100,000 ($50,000 for married couples filing separate federal income tax returns).

Deduction for real estate property taxes

If you itemize deductions, you can also generally deduct the real estate taxes that you pay on your property in the year that you pay them to the taxing authority. If you pay your real estate taxes through an escrow account, you can only deduct the real estate taxes actually paid by your lender from the escrow account during the year. For purposes of calculating the AMT, however, no deduction for state and local taxes, including any real estate tax, is allowed.

Energy tax credit

Though not as generous as it has been the last two years, a credit is available to individuals who make energy-efficient improvements to their homes. You may be entitled to a 10% credit for the purchase of qualified energy-efficient improvements, including a roof, windows, skylights, exterior doors, and insulation materials. Specific credit amounts may also be available for the purchase of specified energy-efficient property: $50 for an advanced main air circulating fan; $150 for a qualified furnace or hot water boiler; and $300 for other items, including qualified electric heat pump water heaters and central air conditioning units.

There's a lifetime credit cap of $500 ($200 for windows), however. So, if you've claimed the credit in the past--in one or more tax years after 2005--you're only entitled to the difference between the current cap and the total amount that you've claimed in the past. That includes any credit that you claimed in 2009 and 2010, when the aggregate limit on the credit was $1,500.

Capital gain exclusion

If you sell your principal residence at a gain, you may be able to exclude some or all of the gain from federal income tax. Generally speaking, capital gain (or loss) on the sale of your principal residence equals the sale price of the home less your adjusted basis in the property. Your adjusted basis is the cost of the property (i.e., what you paid for it), plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.

If you meet all requirements, you can exclude from federal income tax up to $250,000 ($500,000 if you're married and file a joint federal income tax return) of any capital gain that results from the sale of your principal residence. In general, this exclusion can be used only once every two years. To qualify for the exclusion, you must have owned and used the home as your principal residence for a total of two out of the five years before the sale. If you fail the two-out-of-five-year test, you might still be able to exclude part of your gain if your home sale is due to a change in place of employment, health reasons, or certain other unforeseen circumstances.

It's important to note that special rules apply in a number of circumstances, including situations in which you maintained a home office for tax purposes or otherwise used your home for business purposes. Special rules may also apply if you are a member of the uniformed services.

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Getting an Early Start on Saving for Retirement

It's obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off your retirement savings. For example, if you retire at age 70 instead of age 65, and save an additional $22,000 per year at a hypothetical 6% rate of return, you can potentially add $124,016 to your retirement fund (and any existing savings will have five more years of potential growth). (This is a hypothetical example and not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Many people assume they can hold off saving for retirement and make up the difference later. But this can be a costly mistake. Waiting too long to start saving can make it very difficult to catch up, and only a few years can make a big difference in how much you'll accumulate. This doesn't mean there's no hope if you haven't set aside anything for retirement yet. It just makes it all the more important that you implement a plan today.

Start saving now

Start saving as much as you can, as soon as you can. The earlier you start, the longer compounding can work for you. For example, a 20 year old who saves $200 a month until age 65 and earns exactly 6% on saved funds annually would have accumulated around $550,000. But a 40 year old contributing the same amount each month at the same earnings rate would have accumulated only $138,600 by age 65.

Contribute $200/month to age 65 at different hypothetical earnings rates

	Start at age 20	Start at age 30	Start at age 40	Start at age 50
2%	$174,931	$121,510	$77,764	$41,943
4%	$301,894	$182,746	$102,826	$49,218
6%	$551,199	$284,942	$138,599	$58,164
8%	$1,054,908	$458,776	$190,205	$69,208

(This is a hypothetical example and is not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Take advantage of employer plans

Chances are your employer offers a 401(k), 403(b), or similar retirement savings plan. You can contribute up to $16,500 to a 401(k) plan in 2011. And if you're 50 years old or older, you can make additional "catch-up" contributions of up to $5,500, for a total of $22,000 in 2011.

Since pretax contributions are excluded from your paycheck, you'll enjoy an immediate tax savings when you contribute to one of these plans. For example, if your effective income tax rate is 30%, a $22,000 annual pretax contribution will only "cost" you $15,400 once the tax benefit is factored in. Of course, you'll have to pay income tax when you start receiving distributions from the plan, but it's possible you'll be in a lower tax bracket at that time (note that distributions made prior to age 59½ may be subject to a 10% additional penalty tax unless an exception applies). Your employer's plan may also allow you to make Roth contributions. There's no immediate tax benefit (contributions are made with after-tax dollars), but qualified distributions are entirely free from federal (and most states') income tax.

Even if you can't contribute the maximum allowed, you should at least try to contribute as much as necessary to get any matching contributions that your employer offers. This is essentially "free money." However, you may need to work up to six years before you're fully vested in (that is, before you fully own) any employer matching contributions.

Don't forget IRAs

You can contribute up to $5,000 to an IRA in 2011. You can also make catch-up contributions to an IRA if you're 50 or older--up to an additional $1,000 in 2011.

Your contributions to a traditional IRA may be deductible if neither you nor your spouse are covered by an employer retirement plan, or (if either of you are covered) your income falls within specified limits. Like pretax 401(k) contributions, deductible IRA contributions can result in an immediate tax savings, and as with 401(k) plans, withdrawals made prior to age 59½ may be subject to an additional 10% penalty tax unless an exception applies.

But even if you can't make deductible contributions to a traditional IRA, you can generally make nondeductible (after-tax) contributions. There are no up-front tax benefits, but your contributions will be tax free when withdrawn, and any earnings will grow tax deferred until distributed.

If your income is within prescribed limits, you can also make after-tax contributions to a Roth IRA. In this case, even the earnings are tax-free if your distribution is "qualified." Distributions are qualified if you satisfy a five-year holding requirement, and the distribution is made after you reach age 59½, become disabled, or die, or the funds are used to purchase your first home (up to $10,000 lifetime).

Make saving a priority

Saving even a little money can really add up if you do it consistently. Consider ways to free up more money to save for retirement--by reducing discretionary spending, for example. And, put retirement ahead of competing goals, even important goals like saving for your child's education.

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Am I eligible for a veteran's pension?

Honorably discharged veterans who have limited incomes and nonservice related health problems may be eligible for a pension from the Department of Veterans Affairs.

To be eligible for this pension, you must be age 65 or older, or you must be permanently and totally disabled; you must have limited income and assets; and you must have served a minimum of 90 days of active duty with at least one day of active duty during wartime. If you entered active duty after September 7, 1980, you must have served at least 24 months, or the full period for which you were called to active duty.

Your countable income must be below an annual pension limit set by law. This pension limit is higher based on whether you have a spouse and/or dependents. You can reduce your countable income by deducting unreimbursed medical expenses that exceed 5% of the appropriate annual pension limit.

While there's no stated limitation on your net worth in order to qualify for pension benefits, the VA states that net worth can't be excessive. Generally, you may not be eligible for benefits if your net worth is large enough to live on for a reasonable period of time.

Your benefits are calculated by totaling all of your countable income reduced by eligible unreimbursed medical expenses. This figure is subtracted from the appropriate annual pension limit to determine your total annual pension, which is then paid monthly. For example, assume the appropriate annual pension limit is $11,830; you have unreimbursed medical expenses of $1,500 and countable annual income of $8,500. Your countable income ($8,500) is reduced by your unreimbursed medical expenses that exceed 5% of the appropriate annual pension limit ($1,500 - $592 = $908). Your countable income ($8,500 - $908 = $7,592) is then subtracted from the appropriate annual pension limit ($11,830 - $7,592), resulting in an annual pension of $4,238, or $353 per month. Your monthly benefit may be increased if you're eligible for Aid and Attendance or housebound benefits. For additional information, visit the United States Department of Veterans Affairs website at www.va.gov.

What is Aid and Attendance?

Aid and Attendance (A&A) is a monthly benefit paid to qualifying veterans and their surviving spouses who need the aid of another person to help them with activities of routine daily living. It is a benefit paid in addition to the monthly veteran's pension. To be eligible, the honorably discharged veteran or the surviving spouse must:

- Need another person to assist with activities of daily living, such as bathing, feeding, dressing, or taking care of needs of nature; or
- Be disabled to the extent that he or she must remain in bed apart from any prescribed course of convalescence or treatment; or
- Be a patient in a nursing home or assisted living facility due to mental or physical incapacity; or
- Be blind

Eligibility for A&A is not dependent on a service-connected disability; however, the benefit may not be paid unless the claimant is eligible for the veteran's pension, or in the case of a surviving spouse, the veteran's death pension.

The tax-free applicable monthly benefit amount can be as much as $1,644 for a veteran, $1,056 for a surviving spouse, and $1,949 for a married veteran.

Housebound benefits are similar to A&A benefits, although a claimant can't receive both housebound and A&A benefits. To receive housebound benefits, the claimant must be eligible for pension benefits (VA death pension for a surviving spouse) and benefits are paid in addition to the monthly pension. Housebound benefits are paid to a veteran (or surviving spouse) who is 100% disabled due to a single disability and, due to that disability, is confined to his or her home or immediate premises, or if not so confined, the claimant is 100% disabled due to a single permanent disability and has another disability or disabilities that are at least 60% disabling.

Determining eligibility for these benefits depends on a number of factors. For more information including how and where to apply for these benefits, visit the United States Department of Veterans Affairs website at www.va.gov.

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