Investing Considerations

WORTH KNOWING®

Investing Considerations

Investing often raises a lot of questions. How to invest for various needs or goals, when to change investments, when to add funds, and how to ultimately use the funds are common concerns among investors. We will broadly cover these general investing topics plus touch on some additional items that investors may want to research further.

Risk Tolerance

All investments are a trade-off between risk and return, but not all investors can bear the same amount of risk. Risk tolerance is a general measure of how much loss investors can endure within their investment portfolio since greater risk translates to more volatility. All investors should understand their own ability and willingness to tolerate swings in the value of their investments and align their portfolios accordingly.

For the purposes of this paper, we will consider bonds as conservative investments and equities as risky investments. If a retiree regularly withdraws funds to pay bills and is relying on their investments staying relatively steady to support expenses but has 100% of their savings invested in equities, that portfolio is not in line with the individual's risk tolerance. This investor should aim for little volatility in the value of their investments, which can be achieved with a higher proportion of bonds.

Once investors understand their risk tolerance and have their investments in sync, they should review both periodically. As the stock market moves, portfolios should be monitored and rebalanced as needed to ensure they remain appropriately aligned. Changes in risk tolerance are typically in response to life events that impact one's financial situation, such as marriage, divorce, having children, job changes, retirement, or the death of a spouse or partner. Risk tolerance is personal and should be linked to investors' personal situations and needs rather than to outside influences like market movements.

Time Horizon

One factor that informs risk tolerance is time horizon. Time horizon refers to how soon investors will need to use their invested funds, ranging from short-term (less than two years), to mid-term (two to five years), to long-term (more than five years).

For retirement accounts, a long-term time horizon is common because the funds should grow during the investor's working years and last throughout retirement. For non-retirement accounts, the time horizon may differ depending on the purpose of the funds.

When selecting riskier investments, it is generally recommended to stick with a mid- or long-term time horizon so that there is time to weather market ups and downs. Investing with a shorter time horizon can cause problems if the investments decrease in value immediately before they are intended for use. Being successful with short-term investing also requires market timing, and as mentioned below, this is difficult to accomplish.

Market Timing

For the average investor, access to financial and world news is plentiful. Some hear this information and wonder whether they should change their investments based on the latest headline or market movement. Making changes like this is a form of market timing, which is generally not advised.

Moving money in and out of the market or switching between investments based on short-term news or predictions is the opposite of a buy-and-hold strategy,

MORE >>

where investors buy investments and keep them for a long period, regardless of market volatility. Historically, timing the market has proved tough and can be costly.

Markets and asset prices, particularly equities, can move quickly, and once the average investor reads a headline, the news is likely already being priced in by the market. Furthermore, market drops can result in emotional decision-making as investors try to stem their losses, which often occur at the worst time. We recommend establishing a long-term investment plan and sticking to it.

Contributions

Investors should also have a strategy around contributions to their investment accounts. One method is to contribute and invest the same amount at regular intervals. This is called dollar-cost averaging. Establishing a contribution plan can help avoid emotional decisions and market timing. If investors make consistent, periodic purchases, they may also be able to take advantage of price drops, which can lower their average cost of investing over time.

Alternatively, investors can make ad hoc contributions into their investment accounts. A drawback of this strategy is that it requires investors to actively monitor how much they have in additional funds and then take steps to make the contributions. The upside of this strategy is that it can allow for easily pausing contributions if an unexpected expense occurs.

Taxes

Investing has tax consequences, and it is important to understand how and when investments will be taxed. Retirement accounts are subject to specific tax treatment for contributions and withdrawals. Traditional types of retirement accounts are tax-deferred, meaning the contributions are tax-free and the owner pays taxes only upon withdrawal of funds. Alternatively, Roth retirement accounts can provide tax-free withdrawals, but the investor pays taxes on the initial contributions.

Taxable accounts are subject to taxes in the year taxable activity is realized. Taxable activity refers to any income such as dividends or interest produced by the investments as well as any gains or losses from investments that are sold in that year. If the investment was held for less than one year before selling, any gains would be subject to short-term capital gains tax, which is based on the investor's federal income tax bracket. Unless produced from a tax-exempt investment, any interest and dividends from investments would also be taxed at the investor's federal income tax bracket. Gains from investments held for more than one year before selling are taxed at a lower rate, called the long-term capital gains rate. In 2022, that rate is either 0%, 15%, or 20%, depending on the investor's income.

Contributing to a combination of tax-deferred, taxable, and tax-free accounts can often help reduce an investor's overall tax bill now and in the future.

Withdrawal Strategy

There is rightfully a major emphasis on accumulating assets for future needs, such as retirement. However, developing a strategy for spending assets is also crucial.

If investors have several account types, they may be able to withdraw from multiple accounts to minimize taxes while meeting their income needs. If multiple accounts exist of the same type, it may make sense to consolidate them for ease of monitoring and tracking any potential distribution requirements. Building up a cash reserve is also advisable for investors who are preparing to shift from earned income to investments for meeting their day-to-day financial needs.

Summary

As we've highlighted, investors have many factors to consider as they manage their investments. Some of these items stay fairly consistent over time, while others, like retirement account rules and taxes, change with new legislation. Investors should stay informed and research any proposed legislative changes they hear about. It is important to leverage the expertise of advisors and tax professionals when addressing questions about managing investments and planning for individual needs, both in the near term and looking to the horizon.