Building a Strong Foundation for Your Financial Plan

Having a well-built plan can allow you to optimize opportunities as they emerge

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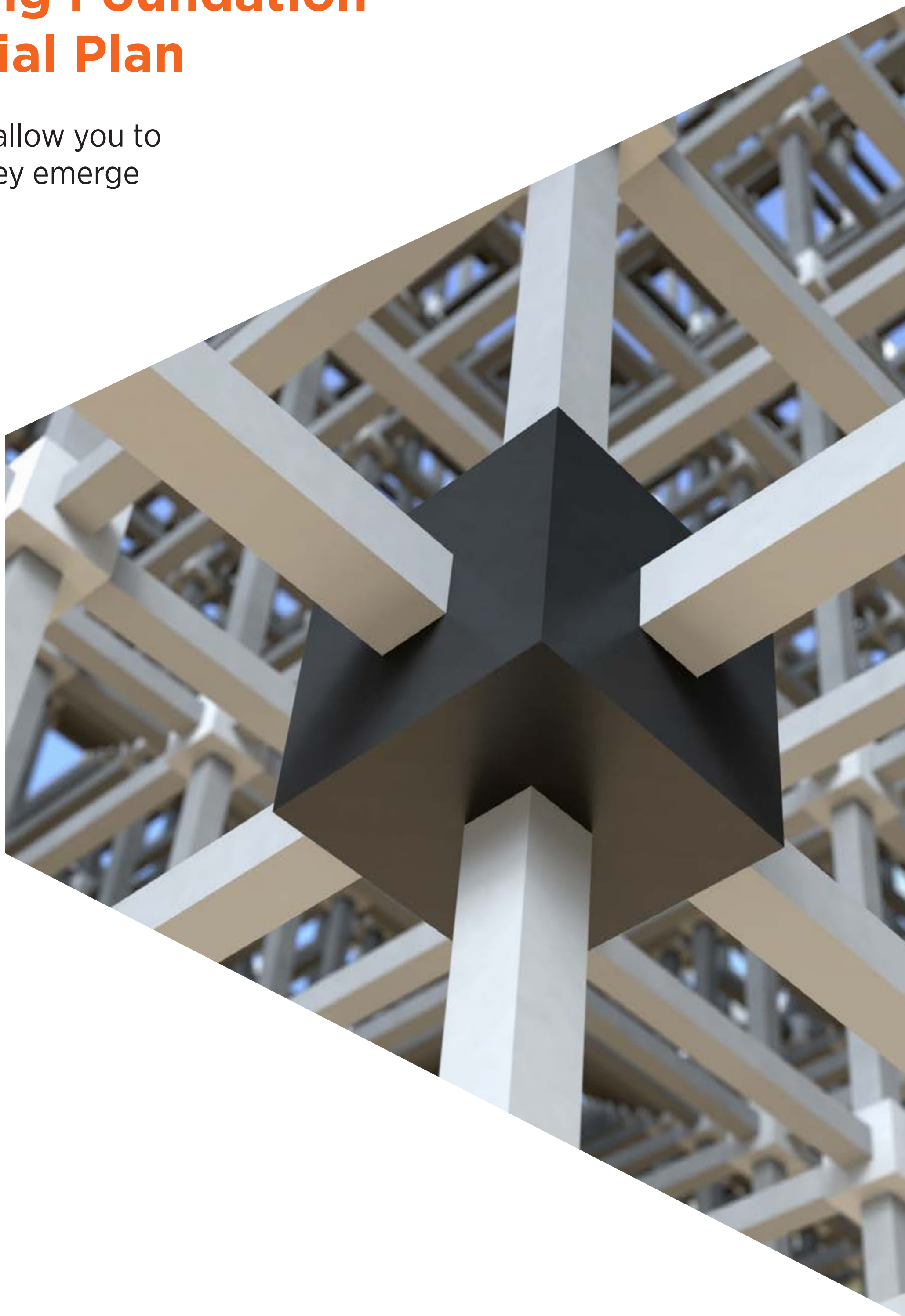

Key points

- Financial planning is a process, and one that should be built from a solid foundation
- With the right plan in place, you can help provide stability and protection for your loved ones now and in the years ahead
- Even though you may feel that you have a solid plan in place that doesn't require any changes, it's important to explore the opportunities that arise in various economic conditions

Financial planning is a long-term process, so it's important to begin by building a strong foundation upon which the rest of your plan can grow. The foundation of your plan is designed to provide financial stability and protection.

Building a stable foundation

One of the very basic stabilization measures is to be sure that you have an emergency reserve of cash that can cover three to six months of your living expenses. In the event that someone in your household loses his or her job, even temporarily, this reserve of cash can help maintain the budget and make liquidating assets from your investments unnecessary. Another liquidity option that may be worth considering is to use the equity in your home to obtain a reverse mortgage or home equity line of credit. Both options would provide you with cash when needed, with the opportunity to pay back the funds at some point in the future.

Working hand-in-hand with building an emergency cash reserve is having a good understanding of your actual living expenses. It's important to establish a budget and then periodically review it to be sure you know exactly how much cash you should have on hand to meet those monthly expenses. Having a budget can also greatly improve the accuracy of your retirement plan projections so that you have an idea of how sustainable your spending goals will be during your retirement years.

Keep your documents updated

In addition to a budget review, it's important to look at your estate planning documents—such as your will, durable power of attorney, health care proxy, and living will. If you become incapacitated, what will happen to your assets and who will step into your shoes to make your financial decisions? These documents can help ensure that your wishes are carried out as you intend, and they should be reviewed and updated at least every five years, or more often as life changes dictate. Events such as a marriage, divorce, birth, or death should trigger document reviews.

You should also conduct a periodic review of any life insurance policies you and your spouse own, particularly during times when the health of your family is a concern. Do you know how much life insurance you have, and is it adequate to protect your family in the event of a worst-case scenario? You should be certain the beneficiary designations on your policies—and on all of your accounts—are in keeping with your current situation, and make any updates as needed.

Take advantage of relief programs

Finally, stay informed of new opportunities that may arise from legislation passed by the government. Historically, the government has created financial breaks during times of economic crises that taxpayers could take advantage of. For instance, debt payments may be placed on hold or extensions may be awarded. Certain penalty-free distributions from retirement accounts may be possible to assist with cash flow. There may be additional income tax credits available to small businesses in order to help keep their operations sustainable. Staying in contact with your

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financial advisors can provide you with information on measures that federal and state authorities are enacting in response to unsettling times.

Growing toward your financial goals

Once established, a strong financial plan will look toward the future and integrate growth strategies to help you achieve your long-term financial goals. An important first step is to determine your appetite for investment risk. Understanding your risk tolerance can assist you and your investment advisor in developing your portfolio. Identifying and maintaining the optimal allocations to equity, fixed income, and cash can help protect your portfolio in times of economic disturbances, and better position you to achieve your financial goals.

When designing an investment portfolio, identifying both short- and long-term goals can be very important. You will likely have a different risk appetite for those investments intended to meet your short-term goals, such as buying a house or funding a wedding, as opposed to long-term goals, like retirement. Evaluating the risk of your portfolio based on the timeframe of the goal is a common way to approach allocation decisions.

Understanding tax diversification

There are different types of investment accounts with varying tax treatments. Taxable investment accounts are funded with after-tax dollars, and returns can generate taxable income in the form of dividends, interest, and capital gains. Allocation to tax-free investments, such as municipal bonds, can help limit the tax burden in these types of accounts. Tax-deferred accounts, such as IRAs and 401(k)s, provide the benefit of tax-deferred growth, which does not generate taxable income to the account owner until the assets are ultimately distributed. Tax-free accounts, such as Roth IRAs, provide the advantage of tax-free distributions, but are funded with after-tax dollars. Tax-deferred and tax-free accounts typically restrict distributions by penalizing early withdrawals, making them generally more suitable for long-term investment goals. The more tax diversification you have, the more flexibility you might be afforded in retirement.

Savings strategies to enhance your plan

There are several savings strategies that you may consider implementing to help enhance your financial planning efforts.

Contribute to an IRA or Roth IRA

Taxpayers have until the following April 15 to contribute to their IRA for the tax year. As previously described, an IRA helps you save on a tax-deferred basis, or on a tax-free basis with a Roth. These tax-advantaged accounts can be extremely helpful tools to supplement your Social Security or pension income during retirement. Further, contributions to a traditional IRA can offer you a current benefit in the form of an income tax deduction during the tax year of the contribution.

Establish or contribute to a 529 college savings plan

A 529 plan allows you to save on a tax-free basis for college education expenses, and in some instances, for K-12 schooling, provided that you use the funds in the account for a qualified expense (tuition, room, board, etc.). This is a popular savings strategy for parents or grandparents who want to save on a tax-advantaged basis for their children or grandchildren's future education. Similar to an IRA, contributions to a 529 plan may also allow you to receive an income tax deduction (state tax benefit only) in the year of the contribution.

Review your health savings account

A health savings account (HSA) allows for tax-advantaged savings for medical costs. Any funds withdrawn from the account will be tax free if used for a qualified medical expense. In addition, once you hit age 65, the funds in the HSA can be used for any purpose without penalty (income tax would be owed if not used for a qualified medical expense, however). Note that you must be covered under a high deductible health plan in order to establish and fund an HSA.

If you have an HSA you may be able to direct the funds in that account toward investments as opposed to leaving it in cash earning very little interest. Many employers offer this option, however, employees may not be aware they can actually invest those funds in the account.

Optimization strategies

Even though you may feel that you have a solid plan in place that doesn't require any changes, it's important to explore the opportunities that arise in various economic conditions. The following are a few strategies that you may want to consider implementing to optimize the effectiveness of your plan. Many of these strategies require you to keep your long-term goals in mind, and perhaps make a financial sacrifice today that may benefit you in the future.

Roth IRA conversion

The potential for higher tax rates in the future emphasizes the importance of a tax-free source of income. For this reason, a Roth IRA can be an effective planning tool. By preserving the Roth IRA for as long as possible, you are providing the opportunity for maximum growth to an account that can be 100% income-tax-free.

Given the long-term benefits that Roth IRAs can provide in planning, conversions from traditional IRAs to Roth IRAs should be evaluated in the scope of your overall income tax and estate planning. Although there is an upfront tax paid when the

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conversion takes place, when the market environment is down it could make this tax less burdensome than in the past and the conversion more beneficial in the long run. This strategy opens up the Roth IRA for those who are ineligible to directly contribute to the account due to the income limitations.

The benefit of a Roth IRA is that it is essentially an income-tax-free vehicle. While assets in a traditional IRA benefit from tax-deferred growth, future distributions are taxed at ordinary income rates. Alternatively, Roth IRA accounts not only grow on a tax-free basis while in the account, but distributions are also income-tax-free in the future. Furthermore, there are no required minimum distributions from Roth accounts unless they are inherited accounts.

Converting to a Roth IRA is a taxable event where the tax is based on the fair market value of the traditional IRA at the time of conversion. However, if the traditional IRA is undervalued, then the resulting conversion tax would be lower as well. Additionally, once converted, any rebound of value inside the Roth IRA would be income-tax-free.

As with all tax strategies, there are many variables that factor into the decision to make the conversion, such as the expected future tax rate and investment growth, the age of the account holder, and aggregation rules. A detailed analysis of the various factors is highly recommended.

Review your portfolio: Rebalance your "new" asset allocation

With movements in the stock market, your target asset allocation may be thrown into flux. During a bull market, your equity allocation will almost certainly outperform your bond allocation, which may send your portfolio into a more aggressive stance than you initially felt comfortable with. Conversely, when the stock market declines, your equity positions are most likely underweighted from your target equity allocation. Investors with an original 60% stock and 40% bond mix might someday find themselves in a 40% stock and 60% bond mix based on market fluctuation.

During turbulent times it may be appropriate to review where your current allocation is versus your target allocation and make the necessary changes.

Tax-loss harvesting opportunities

During challenging market conditions, if your portfolio is experiencing a loss, you might consider harvesting that loss now. This way, if you have any existing gains, or when there are gains on your investments in the future, you can use your harvested loss against those future gains.

The IRS offers taxpayers a way to ease the pain of a losing stock investment: sell the security to offset capital gains incurred on redeemed "winning" securities (short- and long-term losses against short- and long-term gains, respectively). You can, in general, stay invested in the market or even same type of company, but still harvest any losses (e.g., sell Home Depot, then realize the loss and buy Lowe's, or opt into an index fund to maintain equity exposure). However, there is a caveat. If you buy back the same or substantially the same stock 30 days before or 30 days after, you will trigger the "wash sale rule" established by the IRS and the loss will be disallowed.

You can also harvest losses for individual bonds, which may be particularly important going forward as bond prices typically decline when interest rates rise. Either way, it's important to be alert to portfolio pain points and opportunities to turn around a loss to your tax advantage.

Be charitable

If you are charitably inclined, especially during a time when many charities could be struggling, there are certain income tax benefits that you may claim by gifting cash or securities to the charity. In addition, any property that you gift to charity will be excluded from your estate and escape estate taxation (as well as any appreciation from that property). There are trust strategies that can be implemented, such as charitable remainder or charitable lead trusts, that will not only provide you and the charity with a benefit but could also benefit your family members in the form of income or remainder assets from the trust.

Overall, financial planning is a process, and one that should be built from a solid foundation. Once that foundation has been built, it should stabilize the rest of the planning process, which consists of growth and the use of opportunistic strategies. Both short-term and long-term goals need to be identified and reviewed on a continual basis to make sure that the plan is on track to achieve your objectives. As circumstances surrounding your family and wealth change, so should your plan.

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Matthew holds a bachelor's degree in finance from Canisius College and earned the CERTIFIED FINANCIAL PLANNER™ designation in 2011, and the CHARTERED FINANCIAL CONSULTANT® designation in 2015 from The American College. Matthew has also received the ACCREDITED ESTATE PLANNER® designation from the National Association of Estate Planners and Councils in 2019. Matthew is an active member of the Financial Planning Association of Western New York and the Western New York Estate Planning Council.

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Brad serves on the Investment Committee for Outward Bound in Baltimore, and the Investment and Finance Committees for Irvine Nature Center. He is an active member of the Financial Planning Association and the Baltimore Estate Planning Council. In addition, Brad volunteers as a mentor with the Big Brothers Big Sisters of the Greater Chesapeake.
