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Is market volatility keeping you up at night?

The stock market volatility during the past year has left even seasoned investors feeling queasy. If the up-and-down market is making you uncertain about your investments, steel your resolve against reacting rashly by understanding volatility and implementing strategies to better shield your investment portfolio from it.

Interpreting the VIX

When the stock market begins to gyrate, inevitably a hot topic of conversation in the financial media is the Volatility Index (VIX). The VIX was introduced in 1993 by the Chicago Board Options Exchange (CBOE). According to the CBOE, the VIX ". . . is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices." More commonly, it's referred to as the "investor fear gauge."

VIX readings below 20 generally indicate a relatively complacent mood among investors, while levels above 30 are associated with heightened fear. In October 2008, soon after the collapse of investment bank Lehman Brothers, the VIX soared to around 80.

Ideally, the VIX would provide advance notice of when the stock market is headed for trouble and when it's about to stage a recovery. However, there seems to be little consistency to extreme VIX readings. Each market cycle has its own particular dynamics, and perhaps the most you can glean from the VIX is a general sense of investors' level of anxiety at any given time.

Planning for volatility

Despite the VIX's limitations as a predictive tool, experienced investors recognize that market volatility is part of investing and plan accordingly.

Here are steps you can take to help fortify your investment portfolio against volatility:

Acknowledge that periodic bouts of extreme volatility will occur. You can't predict what the market will do in the future. However, you can see what it's done in the past and use that information to your advantage. How you should react to significant market declines will depend on your risk tolerance, investment time horizon and financial goals.

Diversify your portfolio. Diversification can't prevent losses or guarantee profits. But spreading your equity investments among various sectors of the market and allocating a portion of your portfolio to bonds, cash and possibly other asset classes can mitigate losses when the stock market heads south. Remember, the best time to think about diversification is *before* the market plunges.

Avoid market timing. Studies show that most investors who attempt to time the market end up boosting their allocations to stocks ahead of market downturns and lightening up near important bottoms — just the opposite of what would be ideal.

Consider dollar-cost averaging. Using this technique, you invest a set dollar amount every week, month or quarter, regardless of how the market is doing. Consequently, you end up buying more shares when prices are low and fewer when prices are high. Again, profits aren't guaranteed, and you need to consider your ability to continue to invest amid declining prices. But this method gives you a disciplined, steady way to build your portfolio.

3 facts about the VIX and volatility

1. The Volatility Index (VIX) isn't the only "fear gauge"; there are two lesser-known ones: The Nasdaq Volatility Index (VXN) tracks sentiment based on options on the Nasdaq-100 Index®, and the DJIA Volatility Index (VXD) fulfills a similar function for the Dow Jones Industrial Average℠.

2. Although the VIX wasn't in existence on Black Monday (Oct. 19, 1987), when the U.S. stock market plunged by more than 20% in a single day, the Chicago Board Options Exchange later calculated that volatility spiked to an all-time high of 172.79 on the following day.

3. The next-highest VIX reading was during the 2008 crisis — an intraday spike to almost 90 on Oct. 24, 2008. None of the other notable VIX peaks in 1997, 1998, 2001, 2002 and 2010 rose past 50.

Living with market volatility

For investors, market volatility, like death and taxes, is an unavoidable fact of life. Even though you can't sidestep volatility, through planning you can hopefully tame it to a level you can live with. Before taking action, consult with your advisor to determine which strategies make sense for your specific circumstances. ■

Turn rental real estate activity losses into tax benefits

But you must qualify as a "real estate professional"

THREE

Pat owns a few rental properties but, unfortunately, they're hemorrhaging money thanks to the soft economy. He would like to deduct his losses, but the passive activity loss (PAL) rules are restrictive. In Pat's case, it's worth his while to determine whether he falls under the IRS definition of a "real estate professional." If he qualifies, he can enjoy tax benefits by converting passive losses into nonpassive losses. Before taking action, Pat turns to his tax advisor to ask a few questions.

What does "passive" activity mean?

The PAL rules prohibit taxpayers from currently deducting net losses generated by "passive" business activities — such as certain limited partnerships (for example, one that holds real estate) — from wages, interest, dividends or other "nonpassive" income. Disallowed losses may be carried forward and deducted against passive income in later years or recovered when the taxpayer disposes of the passive activity.

A passive activity is a trade or business in which you don't "materially participate." "Participation" generally is any work done by an individual with respect to the activity that the individual owns an interest in. "Participation" doesn't include work that isn't customarily done by an owner if one of the principal purposes for performing the work is to avoid the PAL rules.

"Material" means "regular, continuous and substantial," but that definition doesn't provide much guidance. Fortunately, IRS regulations establish several objective tests you can apply to determine whether an activity qualifies.

Your participation in an activity is material if any *one* of the following is true during a tax year:

- You participate in the activity for at least 500 hours.
- Your participation constitutes substantially all of the participation in the activity by all persons (including nonowners) — in other words, it's a one-person operation.
- You participate in the activity for at least 100 hours and no other person (including nonowners) participates more than you.
- You participate in the activity for at least 100 hours and your total participation in "100-hour" activities totals more than 500 hours.
- You materially participated in the activity for any five of the preceding 10 tax years (or any three previous tax years for a personal service activity).

Even if you don't satisfy one of these tests, you can meet the material participation requirement if, based on all the facts and circumstances, you participate in an activity on a regular, continuous and substantial basis.

There's an added catch when it comes to real estate, however: The PAL rules treat income from rental real estate as passive, no matter how many hours you devote to it, unless you qualify as a "real estate professional."

How do you qualify as a "professional"?

Because you may be able to avoid the PAL limitations and deduct rental real estate losses from *non*passive income if you're a real estate professional, it's important to determine whether you qualify. To do so, you must spend more than half of your working hours and more than 750 hours during the year on real estate businesses in which you materially participate.

Activities you perform as an employee don't count toward these participation requirements unless you own at least 5% of the business. Eligible businesses include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage.

Unlike the material participation requirements, you and your spouse can't combine your hours; one of you must individually qualify as a real estate professional.

Even if you're a real estate professional, you must still materially participate in a rental activity before you can deduct losses against nonpassive income. This can be a problem if you're involved with several properties.

Suppose, for example, that you own 10 rental buildings and devote 80 hours per year per building to managing them, for a total of 800 hours per year. You also have two full-time employees who help manage the buildings.

Assuming the 800 hours you spent in the last year constitute more than half of your working time, you would qualify as a real estate professional. But because you spent less than 100 hours on each building, you don't meet the material participation requirements.

You can get around this restriction — and convert your rental losses from passive to nonpassive — by electing on your tax return to treat all of your rental properties as a single activity.

> The PAL rules treat income from rental real estate as passive, no matter how many hours you devote to it, unless you qualify as a "real estate professional."

Questions answered

After consulting with his advisor, Pat learned that in fact he does qualify as a real estate professional and can treat his rental real estate losses as nonpassive losses, thus deducting the losses from his wages or other nonpassive income. If your rental property is losing money and you'd benefit from taking the loss currently, ask whether you, too, can turn your losses into tax savings. ■

6 wealth management strategies in a low interest rate environment

FIVE

The Federal Reserve has stated that it expects to keep interest rates "exceptionally low" at least through late 2014. That's music to the ears of borrowers but bad news for savers, who are saddled with historically low rates on savings accounts, certificates of deposit (CDs), money market funds and U.S. Treasuries.

What strategies should you consider in this environment?

Strategies to consider

Here are six possibilities, roughly in order of increasing risk:

1. Online savings accounts. You can boost your income modestly, but safely, by opening an online savings account. The annual interest rate for a traditional, brick-and-mortar bank's checking and savings accounts generally is 0%

to a paltry 0.10%. In contrast, an online savings account might pay as much as 1% or more.

Higher rates and the $250,000-per-depositor FDIC protection offered by most online banks make this a painless and virtually risk-free way to make your money work harder. But if you'll be leaving one or more accounts at your traditional bank, consider any possible fee increases or interest rate reductions it may impose because of your lower balance there.

2. Longer-term CDs. If you're willing to deposit your money in a three-year CD, you can earn about 1.5% as of this writing, and close to 2% for a five-year CD. However, be sure you know the penalty for early withdrawal. In many cases, this penalty is modest enough not to be an obstacle if you're hesitant to "lock up" your money.

At one online bank, for example, the penalty for early withdrawal on any CD is 60 days of interest. For an account paying 2% annually, such a penalty amounts to 0.33% of your principal (just $3.30 per $1,000). If interest rates increased significantly after you bought such a CD, you could withdraw the money before your term was up and reinvest it at the higher rate.

3. Short-term bond funds. A short-term investment-grade bond fund at one well-known fund family paid 1.74% annually and had a 10-year average annual return of 4.11% as of this writing — well above the lesser rates offered by money market funds. Understand, though, that such a fund is subject to both interest-rate and credit risks.

If interest rates rise, bond fund prices generally fall — though the damage typically is more muted in funds that hold securities with shorter maturities. Credit risk can be a factor if the economy takes a turn for the worse. In that case, a flight to quality can hurt debt perceived as risky, which sometimes includes corporate bonds with investment-grade credit ratings.

4. GNMA funds. These funds invest in Government National Mortgage Association (also referred to as "Ginnie Mae") securities, which are mortgage-backed securities that carry the full faith and credit of the U.S. government and typically offer higher yields than U.S. Treasuries. As of this writing, a number of these funds are paying in excess of 3% annually.

Be aware that the government guarantee applies only to the securities purchased by a GNMA fund, not to your investment in it. Therefore, money invested in a GNMA fund can fluctuate in value due to movements in interest rates, among other factors.

5. High-yield bonds. Also known as junk bonds, high-yield bonds are lower-quality corporate debt. There's no doubt that yields in this asset class can be tantalizing. Even during good economic times, junk-bond yields normally are several percentage points higher than those of comparable U.S. Treasuries.

Look out, though, if investors begin to worry about whether corporate profits can support those debt payments. Junk-bond prices can quickly fall. A good time to invest in this asset class generally is when economic activity is strengthening.

6. Dividend-paying stocks. There are several reasons to consider this category. Corporate balance sheets generally are in solid shape, and the valuations of the shares of many large, dividend-paying companies have fallen near multidecade lows.

Additionally, many of these firms have a long history of boosting their dividends annually, increasing shareholders' income. There's also the potential for capital appreciation. That said, the prices of even high-quality stock can drop, so be forewarned.

Priorities, first

Before reaching for higher yields, it's important to be clear about your priorities. Your advisor can provide assistance in helping you find a mix of investments that suits your risk tolerance and income needs. ■

Rules to give by

When making charitable gifts, follow substantiation requirements

It can be incredibly satisfying to make charitable gifts: You're helping a cause that's near and dear to you while enjoying tax deductions.

However, that feeling of goodwill quickly can fade if you fail to follow the substantiation rules and lose your deductions as a result. To be sure, the requirements aren't difficult to meet. But you'll need to pay attention to the details before filing your income tax return.

For **cash gifts of $250 or less**, the IRS requires a canceled check, a receipt from the charity or some other reliable documentation that lists the charity's name as well as the donation date and amount.

Cash gifts of more than $250 require a "contemporaneous" written acknowledgment from the charity; that is, you must receive the acknowledgment on or before the *earlier* of 1) your tax return due date for the tax year you make the donation, or 2) the date you file your return. It must include the contribution date and amount and describe any goods or services you received from the charity in exchange for your contribution.

If you're donating **noncash gifts worth $250 or less**, the IRS requires a receipt that lists the charity's name, the date and location of the contribution, and a description of the donated property. For **noncash gifts worth more than $250**, you must have a contemporaneous written acknowledgment from the charity similar to the one needed for cash donations, but it must also include a description of the property.

Noncash gifts of $500 or greater require, in addition to the previously discussed substantiation, written records that document the date you acquired the property, how you acquired the property (such as a gift, inheritance or purchase) and your adjusted basis in the property. If your **noncash gifts exceed $5,000**, an independent appraisal may be required. Contact your tax advisor for more information.

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By working with our experienced team of advisors, you will benefit from the independent and objective perspective necessary to make your financial vision a reality.

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J.L. serves as a research analyst and portfolio manager for the firm. In addition to assisting clients with the many facets of financial planning, he is also responsible for the rebalancing of client portfolios and analysis of securities and separate account managers.

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