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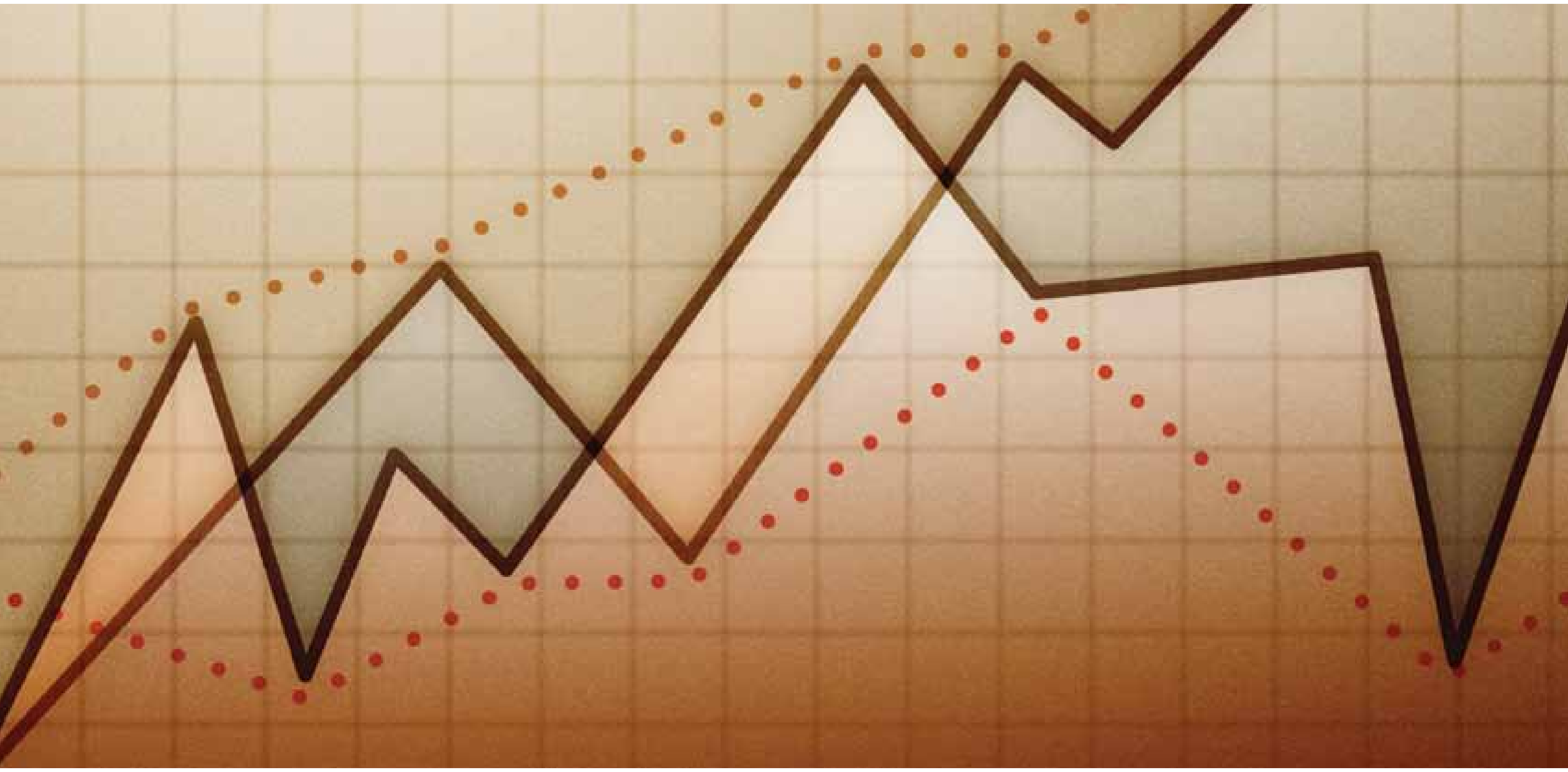
WEALTH MANAGEMENT ADVISOR



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Bond credit ratings 101

Despite unfavorable press, ratings are still meaningful

Credit rating agencies have been criticized for not providing adequate warning about risky securities. Despite their recent high-profile failings, credit ratings remain a useful tool for bond investors, as long as their limitations are understood.

3 credit rating agencies

Three major credit rating agencies — Moody's, Standard & Poor's and Fitch — issue ratings on the creditworthiness of companies and public entities that issue debt, as well as ratings on the debt itself. Ratings represent an agency's opinion of a bond issuer's ability to make scheduled interest payments and to repay principal at maturity. However, a high rating is only a guide — not a guarantee of creditworthiness.

The agencies issue ratings in a letter format. For example, the ratings from Standard & Poor's and Fitch range from AAA for the highest-quality bonds to D for bonds in default, meaning the issuer has stopped making interest payments. The agencies also use plus and minus signs to indicate stronger or weaker ratings within certain groups. Moody's uses a different but similar scale, with Aaa as the highest rating.

Ratings, yields and risk

There typically is an inverse relationship between a bond's credit rating and its yield. Riskier, lower-rated bonds tend to offer higher yields than comparable higher-rated bonds. The higher yield compensates investors for the added risk they take in buying a lower-rated bond.

Bonds in any of the four highest-rated groups (AAA, AA, A and BBB) are considered investment grade. All bonds below investment grade are classified as high yield, speculative or "junk" bonds — all terms with roughly the same meaning.

Because many institutions can't own bonds below investment grade, the investment-grade bond market is more liquid than the high-yield market. This leaves more opportunity to find bargains in the high-yield market. And when a bond is upgraded from high-yield to investment-grade status, it typically means a significant boost in price.

Lower-rated bonds may offer better return potential, but their risks are real. When an issuer defaults on a bond, not only does it stop paying interest, but it also may not be able to pay back your principal.

In an analysis by Standard & Poor's covering the 15 years from 1995 through 2009, the average default rate of U.S. corporate bonds in all investment-grade categories was only 4.62%. Compare that to the 32.41% average default rate for high-yield corporate bonds. In the lowest-rated high-yield groups, including CCC, CC and C, the average default rate was a whopping 62.30%.

What about municipal bonds?

Credit rating agencies also rate municipal bonds — debt issued by state and local governments, as well as their agencies and authorities. These bonds generally are exempt from federal income taxes. Because of their tax-exempt status and perceived low risk, municipal bonds typically offer lower yields than comparable corporate bonds.

Municipal bonds have long been viewed as a relatively stable area of the fixed-income markets. But given the recent budgetary problems states and municipalities face, it's wise to approach the municipal-bond market with added caution these days. Even though actual defaults from municipal-bond issuers are still relatively rare, that could change if the U.S. economy weakens again.

This doesn't mean you should avoid municipal bonds, which, because of their federal tax-free status, can be useful investments. For the foreseeable future, however, take special care when investing in this market and be sufficiently skeptical of high municipal-bond ratings.

Delayed downgrades

In an ideal world, credit ratings would change along with an issuer's financial condition. In the real world, though, rating agencies don't always respond promptly, especially when it comes to downgrading or lowering a company's credit rating.

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When a company's credit rating is downgraded, it might be forced to pay higher interest rates on its bank loans or even repay the loans on an accelerated schedule. So rating agencies often drag their feet about issuing downgrades.

To cite one infamous example, defunct energy trader Enron carried an investment-grade rating until just four days before the company filed for bankruptcy in December 2001. More recently, the rating agencies were slow to recognize the risk in derivative securities held by Bear Stearns and Lehman Brothers — both of which collapsed in the 2008 financial crisis.

That's why, if you're buying an individual bond, it's important to research an issuer as carefully as you would if you were buying a stock. Additionally, even in a portfolio of highly rated bonds, diversifying across multiple issuers — some advisors say a minimum of 10 — as well as a variety of market sectors is likely a good idea.

Using bond credit ratings successfully

Bond ratings can be useful in your investment research, as long as you use them as one analytical tool among many. The key is keeping their limitations in perspective and incorporating the same principles of sound investing that you would apply to stocks — such as diversification — to dampen risk. ■

What to consider when naming retirement plan beneficiaries

You create a retirement plan to help prepare for your golden years. For example, you may want to ensure you have enough for you and your spouse to buy a vacation home in Arizona or a sailboat in Florida. At the same time, you need to think about what will happen to your remaining retirement funds after you're gone. To address this concern, you must choose retirement plan beneficiaries.

Income and estate tax ramifications

Income and estate tax ramifications are among the most important factors to consider when choosing your retirement plan beneficiaries. Let's first take a closer look at the income tax consequences. Unlike most inherited assets (such as stocks and real estate), funds that beneficiaries withdraw from traditional 401(k) plans, traditional IRAs and most other retirement plans are 100% taxable unless you used nondeductible contributions to fund the account.

The important elements to consider are how long the beneficiary will be able to defer distributions, how large any required minimum distributions (RMDs) will be, and his or her income tax bracket.

Except in the case of a spouse beneficiary, annual RMDs usually are required to begin shortly after the plan owner's death. An employer-sponsored plan, however, may require the beneficiary to take a lump sum distribution of the plan's balance, though recent tax law changes let most beneficiaries roll the funds into an IRA, which will then be treated as an inherited IRA.

Just how big will those RMDs be? That depends on the account's size and the beneficiary's age. Younger beneficiaries will face smaller RMDs, which brings greater opportunity for tax-deferred growth as the account is drawn down at a slower rate. And a younger beneficiary is more likely to be in a lower tax bracket, at least for the early years of RMDs.

So it might make tax-sense to name your children as beneficiaries. In some situations, grandchildren as beneficiaries may be the ultimate in income tax planning, at least within the limits of the generation-skipping transfer tax exemption.

But many people prefer to name a spouse as beneficiary. Spouses have the advantage of being able to treat inherited IRAs as their own and delay RMDs until turning age 70½.

Another reason many people opt to name their spouses as beneficiaries is the estate tax ramifications. Naming anyone else can increase taxes on your estate. A number of factors — such as the dollar value of the account's assets and size of your total estate — will determine whether naming a nonspouse will result in any estate tax liability.

Because transfers to your spouse (provided he or she is a U.S. citizen) qualify for the marital deduction and are subtracted in arriving at your taxable estate, naming your spouse as beneficiary can allow you to steer clear of estate taxes on the plan's assets when you die. This, in effect, makes the assets "neutral" when considering the impact on your estate taxes.

One caveat, however: The assets will boost the size of your spouse's estate. And that could raise estate taxes on his or her assets.

Other beneficiary options

Naming a person as your retirement plan beneficiary isn't your only option.

Take a trust, for example. Naming a trust as beneficiary can allow a married person with a taxable estate to give as much as possible to heirs while still permitting a spouse to have access to the funds if needed. Single parents may also look to a trust to protect retirement plan assets for the benefit of children or other young beneficiaries.

There are, however, specific tax rules governing trusts as plan beneficiaries that must be adhered to in order to ensure that RMDs are based on the ages of beneficiaries who receive them. Otherwise, the RMDs will be determined as though your estate were the named beneficiary, and everything must be distributed within five years after the year of death.

A charity is another choice. In this case, neither your estate nor the charity will owe income tax on the retirement plan assets. Moreover, your estate may qualify for a charitable deduction for estate tax purposes.

Naming *both* a charity and individuals as beneficiaries, however, could limit the tax-deferral opportunities of the noncharitable beneficiaries. You can avoid this problem by splitting your accounts so that the charitable beneficiaries and the noncharitable beneficiaries don't have interests in the same account.

Learn the consequences

When discussing your retirement plan with your tax advisor, seek his or her advice on naming your plan's beneficiaries. It's important to know the income and estate tax ramifications of your decision. ■

Should you invest in emerging markets?

The robust economic growth in emerging markets such as China, India and Latin America continues to make headlines, particularly in comparison with the tepid growth in most developed markets. You may be wondering if you should follow the trail of many individual investors around the world and increase your exposure to emerging markets. The answer is: It depends on your situation.

Looking at performance

Individual investors eyeing emerging markets may have plenty of company. According to *Pensions & Investments*, a publication for institutional investors, pension funds are considering boosting their holdings in emerging markets because of their superior performance compared with their developed-market counterparts following the recent bear market.

The combination of emerging markets' solid economic growth and more-muted exposure to the global financial crisis resulted in stronger relative performance for equities in those regions since stock prices bottomed early in 2009. For a longer-term perspective, during the decade ending December 2009, the U.S.-focused S&P 500 lost about 9% while the MSCI Emerging Markets Index rose by 154%. Of course, past performance is no guarantee of future results.

Diversification with a caveat

Besides the potential for higher returns, diversification may be another benefit of emerging market stocks. The goal of diversification is to decrease volatility and boost overall returns by owning investments that have a low correlation with each other — in other words, they tend to react to economic and financial events differently.

On this score, the record of emerging market stocks is mixed. Along with developed markets, emerging markets sustained large losses during the 2008 financial meltdown — but emerging markets bounced back fairly well afterward. So, emerging markets provided some valuable diversification benefits, but not as much as was hoped for by those who believed that emerging markets might "decouple" from developed markets.

Here's something else worth considering: If you don't invest in emerging markets, you'll lack exposure to a significant and rapidly growing segment of the world economy.

Near the end of 2009, emerging markets represented about 12% of the MSCI All Country World Index, which tracks stocks in both developed and developing countries. That figure was up sharply from about 5% at the beginning of the decade. Moreover, emerging economies accounted for about 35% of the global economy late in 2009. As emerging markets gain in economic importance, this figure may continue to increase.

However, despite the opportunities, there are specific risks associated with investing internationally. You need to keep in mind changes in currency rates and foreign taxation as well as differences in auditing and other financial standards. Many emerging markets are in countries with authoritarian governments — for example, China and Russia — or relatively unstable regimes, increasing uncertainty about investments there.

Additionally, securities laws in most emerging markets are relatively undeveloped, which may result in less transparency in the way companies interact with shareholders. Last, emerging market stocks tend to attract considerable short-term investment capital (the so-called "hot money"), which — when combined with their generally lower trading volume — tends to make them more volatile than equities in developed markets.

Adding emerging market exposure

A number of mutual funds and exchange-traded funds invest in emerging market stocks, and both vehicles can give you a relatively diversified stake in this asset class. It's important to "look under the hood" before you invest.

Check costs, performance and the holdings of your various investment candidates. For example, some funds hold almost entirely large- and mid-cap stocks, with virtually no exposure to small-caps. That may or may not suit your style, but it's important to know in advance.

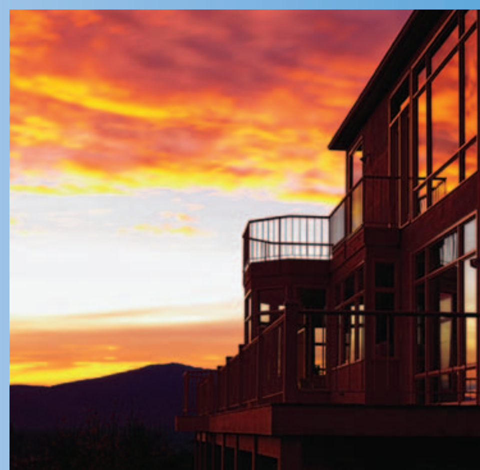
Many emerging market funds may also have a large concentration in certain industries, such as financial stocks or mining stocks. It can be difficult to find a truly well-diversified fund, especially among funds that focus on one country or region.

Make a smart investment decision

Before adding any emerging market stocks (or funds) to your portfolio, review your investment objectives and current holdings with your financial advisor. Looking at your bigger picture will be helpful as you decide if it makes sense to increase — or initiate — your stake in emerging markets. ■

Tax breaks associated with owning a vacation home

When Howard bought a vacation home, he knew it would provide happy memories for his family. But he didn't realize the extent to which it might also provide tax savings. To understand the tax breaks, Howard asked his tax advisor about how the IRS treats income and expenses associated with a vacation (or second) home.



So long as the home includes sleeping accommodations, a bathroom and a kitchen, and the dwelling is used for personal purposes, the IRS considers it a vacation home. The home could be a house, condominium or even a yacht.

If you (or your immediate family) occupy the home for more than 14 days or 10% of the days you rent the property — whichever is greater — the IRS will classify the home as a personal residence. In this situation, you can deduct the personal portion of mortgage interest, property taxes and casualty losses as itemized deductions. (You can generally deduct interest up to $1 million in combined acquisition debt on your main residence and a second residence. In addition, you can also deduct property taxes on any number of residences.) The rental portion of your expenses is deductible up to the amount of rental income. If your rental expenses are greater than your rental, you may not deduct the loss against other income.

What happens if you (or immediate family) use the home for more than 14 days and rent it for less than 15 days during the year? In this situation, the IRS will consider the property a "pure" personal residence, and you don't have to report the rental income. But any expenses associated with the rental aren't deductible.

The IRS will classify your home as a rental property if you (or your immediate family) use the home for 14 days or less, or under 10% of the days you rent the property, whichever is greater. In this instance, while the personal portion of mortgage interest isn't deductible, you may report as an itemized deduction the personal portion of property taxes. You must report the rental income and may deduct all rental expenses, including depreciation, subject to the passive activity loss rules.

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