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Correlation and Portfolio Performance

Different types of investments are subject to different types of risk. On days when you notice that stock prices have fallen, for example, it would not be unusual to see a rally in the bond market.

Asset allocation refers to how an investor's portfolio is divided among asset classes, which tend to perform differently under different market conditions. An appropriate mix of investments typically depends on the investor's age, risk tolerance, and financial goals.

The concept of correlation often plays a role in constructing a well-diversified portfolio that strikes a balance between risk and return.

Math that matters

In the financial world, correlation is a statistical measure of how two securities perform relative to each other. Securities that are positively correlated will have prices that tend to move in the same direction. Securities that are negatively correlated will have prices that move in the opposite direction.

A correlation coefficient, which is calculated using historical returns, measures the degree of correlation between two investments. A correlation of +1 represents a perfectly positive correlation, which means the investments always move together, in the same direction, and at a consistent scale. A correlation of -1 means they have a perfectly negative correlation and will always move opposite one another. A correlation of zero means that the two investments are not correlated; the relationship between them is random.

In reality, perfectly positive correlation is rare, because distinct investments can be affected differently by the same conditions, even if they are similar securities in the same sector.

Correlations can change

While some types of securities exhibit general trends of correlation over time, it's not uncommon for correlations to vary over shorter periods. In times of market volatility, for example, asset prices were more likely to be driven by common market shocks than by their respective underlying fundamentals.

During the flight to quality sparked by the financial crisis of 2008, riskier assets across a number of different classes exhibited unusually high correlation. As a result, correlations among some major asset classes have been more elevated than they were before the crisis. There has also been a rise in correlation between different financial markets in the global economy.[1] For example, the correlation coefficient for U.S. stocks (represented by the S&P Composite Total Return index) and foreign stocks (represented by the MSCI EAFE GTR index) increased from 0.75 over the last 25 years to 0.89 over the last 10 years.[2]

Over the long run, a combination of investments that are loosely correlated may provide greater diversification, help manage portfolio risk, and smooth out investment returns. Tighter relationships among asset classes over the last decade may be a good reason for some investors to reassess their portfolio allocations. However, it's important to keep in mind that correlations may continue to fluctuate over time because of changing economic and market environments.

The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Past performance is no guarantee of future results. All investing involves risk, including the possible loss of principal. Asset allocation and diversification strategies do not guarantee a profit or protect against investment loss; they are methods used to help manage investment risk.

Investing internationally carries additional risks such as differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country. This may result in greater share price volatility. When sold, investments may be worth more or less than their original cost.

[1] International Monetary Fund, 2015

[2] Thomson Reuters, 2015, for the period 12/31/1989 to 12/31/2014

Taxes, Retirement, and Timing Social Security

This hypothetical example is for illustrative purposes only, and its results are not representative of any specific investment or mix of investments. Actual rates of return and results will vary. The example assumes that earnings are taxed as ordinary income and does not reflect possible lower maximum tax rates on capital gains and dividends, as well as the tax treatment of investment losses, which would make the return more favorable. Investment fees and expenses have not been deducted. If they had been, the results would have been lower. You should consider your personal investment horizon and income tax brackets, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. Investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

The advantages of tax deferral are often emphasized when it comes to saving for retirement. So it might seem like a good idea to hold off on taking taxable distributions from retirement plans for as long as possible. (Note: Required minimum distributions from non-Roth IRAs and qualified retirement plans must generally start at age 70½.) But sometimes it may make more sense to take taxable distributions from retirement plans in the early years of retirement while deferring the start of Social Security retirement benefits.

Some basics

Up to 50% of your Social Security benefits are taxable if your modified adjusted gross income (MAGI) plus one-half of your Social Security benefits falls within the following ranges: $32,000 to $44,000 for married filing jointly; and $25,000 to $34,000 for single, head of household, or married filing separately (if you've lived apart all year). Up to 85% of your Social Security benefits are taxable if your MAGI plus one-half of your Social Security benefits exceeds those ranges or if you are married filing separately and lived with your spouse at any time during the year. For this purpose, MAGI means adjusted gross income increased by certain items, such as tax-exempt interest, that are otherwise excluded or deducted from your income for regular income tax purposes.

Social Security retirement benefits are reduced if started prior to your full retirement age (FRA) and increased if started after your FRA (up to age 70). FRA ranges from 66 to 67, depending on your year of birth.

Distributions from non-Roth IRAs and qualified retirement plans are generally fully taxable unless nondeductible contributions have been made.

Accelerate income, defer Social Security

It can sometimes make sense to delay the start of Social Security benefits to a later age (up to age 70) and take taxable withdrawals from retirement accounts in the early years of retirement to make up for the delayed Social Security benefits.

If you delay the start of Social Security benefits, your monthly benefits will be higher. And because you've taken taxable distributions from your retirement plans in the early years of retirement, it's possible that your required minimum distributions will be smaller in the later years of retirement when you're also receiving more income from Social Security. And smaller taxable withdrawals will result in a lower MAGI, which could mean the amount of Social Security benefits subject to federal income tax is reduced.

Whether this strategy works to your advantage depends on a number of factors, including your income level, the size of the taxable withdrawals from your retirement savings plans, and how many years you ultimately receive Social Security retirement benefits.

Example

Mary, a single individual, wants to retire at age 62. She can receive Social Security retirement benefits of $18,000 per year starting at age 62 or $31,680 per year starting at age 70 (before cost-of-living adjustments). She has traditional IRA assets of $300,000 that will be fully taxable when distributed. She has other income that is taxable (disregarding Social Security benefits and the IRA) of $27,000 per year. Assume she can earn a 6% annual rate of return on her investments (compounded monthly) and that Social Security benefits receive annual 2.4% cost-of-living increases. Assume tax is calculated using the 2015 tax rates and brackets, personal exemption, and standard deduction.

Option 1. One option is for Mary to start taking Social Security benefits of $18,000 per year at age 62 and take monthly distributions from the IRA that total about $21,852 annually.

Option 2. Alternatively, Mary could delay Social Security benefits to age 70, when her benefits would start at $38,299 per year after cost-of-living increases. To make up for the Social Security benefits she's not receiving from ages 62 to 69, during each of those years she withdraws about $40,769 to $44,094 from the traditional IRA--an amount approximately equal to the lost Social Security benefits plus the amount that would have been withdrawn from the traditional IRA under the age 62 scenario (plus a little extra to make the after-tax incomes under the two scenarios closer for those years). When Social Security retirement benefits start at age 70, she reduces monthly distributions from the IRA to about $4,348 annually.

Mary's after-tax income in each scenario is approximately the same during the first 8 years. Starting at age 70, however, Mary's after-tax income is higher in the second scenario, and the total cumulative benefit increases significantly with the total number of years Social Security benefits are received.*

Prepaid Funeral Arrangements Can Have Grave Consequences

Possible long-term care benefit

Irrevocable funeral trusts may also help you qualify for long-term care benefits through Medicaid. These trusts may be funded with assets that would otherwise be countable resources for Medicaid. Trust assets, including life insurance death benefits, are not countable resources when trying to qualify for long-term care benefits through Medicaid. And you can fund the funeral trust right before applying for benefits--there's no "look-back" period for these transfers. The legal expense to create an irrevocable funeral trust (IFT) is typically paid by the insurance company, which acts as the Trustee. There is typically no expense to the insured party to create the IFT other than the one-time cost of the insurance. Almost all states impose a limit on the amount of money that can be placed in a funeral trust. Not all funeral trusts are considered to be Medicaid-exempt assets. Consult with your estate planning attorney for help with your individual circumstances.

An important part of estate planning involves consideration of funeral or memorial arrangements, including paying for some or all of the costs in advance. Planning ahead not only spares your survivors from the stress of making these decisions, but prepaying for your services relieves your survivors from the burden of worrying about money during an otherwise difficult time.

Prepaid agreement

One way to prepay your funeral is by entering into a pre-need agreement with a funeral home of your choice. The funeral home may agree to "lock in" costs for future funeral or burial services at an agreed-upon price. This is often done through a trust or other arrangement that you can fund with cash, bonds, or life insurance. At your death, the funds are disbursed to pay for your funeral according to the terms of the agreement.

But before entering into a prepaid arrangement, you may want to get answers to the following questions:

- What happens to the funds you've prepaid? How are they held? Do they earn interest? Are they safe?
- What happens if the funeral home goes out of business? What protections, if any, do you have that your funds will be available when needed?
- Can you cancel the agreement and, if so, are you able to receive a refund?
- If you move, can your funds be transferred to another funeral home? Will the same terms apply? Is there a fee or cost to transfer your funds to another funeral home?

The Funeral Rule

There are some legal protections available to consumers of funeral home services. The Funeral Rule, enforced by the Federal Trade Commission (FTC), requires funeral providers to give consumers accurate, itemized price information and other disclosures about funeral goods and services. The Rule also prohibits funeral providers from misrepresenting service-related requirements and from engaging in unfair or deceptive practices.

The key feature of the Funeral Rule is the General Price List, which entitles consumers to receive itemized prices for the various goods and services offered, allowing them to comparison shop and to purchase goods and services on an itemized basis, and not solely as part of a package. For more information on shopping for funeral services, the Funeral Rule, and prepaying for some or all of the expenses involved, visit the FTC consumer website www.consumer.ftc.gov.

State law protections

The Funeral Rule generally governs funeral providers. It does not offer specific remedies or causes of action for consumers who are victims of funeral providers that do not comply with the Rule. Laws in individual states regulate funeral providers and help ensure that advance payments are available when they're needed. However, protections vary widely from state to state, sometimes providing a window of opportunity for unscrupulous operators.

What can you do?

Before entering into a prepaid agreement, here are some steps you can take to safeguard your funds and ensure you'll get the services you've payed for:

- Find out what kind of consumer protection your state provides and whether it regulates the payment methods.
- Be sure that your funds or insurance policy are held in a trust at a reputable bank or other financial institution that you can check on to be sure your money or policy is safe. You may even be entitled to an annual statement.
- If you're funding some or all of the pre-need arrangements with life insurance purchased through the funeral services provider, be sure the policy is permanent insurance, such as whole life, and not term insurance (if you outlive the term of the policy, there will be no insurance proceeds to pay for your funeral).
- The agreement should address what happens to any excess funds that may be available after paying for your services. Some pre-need contracts allow you to designate how excess funds are to be disposed (e.g., surviving family members, your church or other charity).
- Along those same lines, if you cancel the contract, you may be entitled to a partial or full refund, although some states allow the funeral provider to retain a portion of the funds, often depending on how long the contract has been in existence.

Ultimately, be sure to tell your family about the plans you've made and where you'll keep important documents, such as your last will and testament and any documentation you've retained concerning your pre-need funeral arrangements.

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What should I consider as a ride-sharing service passenger?

Despite the surface appeal of ride-sharing services, there are some important factors to bear in mind before hopping into a stranger's car to get to your destination of choice. Doing some homework up front will help ensure that you'll have a positive and safe ride-sharing experience.

Safety. You'll want to research how your ride-sharing service screens drivers. What background checks do they run before hiring a driver? Is it a one-and-done process, or are drivers regularly screened to account for changes to their criminal histories or driving records? Similarly, most ride-sharing services require drivers to use vehicles that are reasonably new. This makes it more likely that the vehicle will be in good working condition.

Cost. It may seem obvious, but you'll want to pay close attention to how much a ride-sharing trip will cost. Rates will vary depending on the service you use, the length of your trip, and even how much demand there is for rides at the time. Fares are usually quoted on the service's mobile app, providing you with that information prior to booking the trip. In some cases, using a ride-sharing service might be more cost-effective than using another mode of transportation, but you should be aware that certain holidays, rush hours, and special events can drive up prices dramatically. Moreover, transactions typically occur via a ride-sharing service's app, so fares are charged automatically to your credit card. That could be a convenient way to collect the fare, but there are risks associated with keeping your credit card information on file. Other payment options may also be available.

Insurance. You may wonder how insurance would come into play if you are injured in an accident while you are a paying passenger. Consider looking into the specifics of the company's insurance policies, especially if you use a particular service frequently. If you have a personal auto policy, it may provide coverage above and beyond the ride-sharing service's policy. You can also reach out to your state insurance department to find out about insurance requirements for ride-sharing services and how they might affect you as a passenger.

How can I protect my Social Security number from identity theft?

Your Social Security number is one of your most important personal identifiers. If identity thieves obtain your Social Security number, they can access your bank account, file false tax returns, and wreak havoc on your credit report. Here are some steps you can take to help safeguard your number.

Never carry your card with you. You should never carry your Social Security card with you unless it's absolutely necessary. The same goes for other forms of identification that may display your Social Security number (e.g., Medicare card)

Do not give out your number over the phone or via email/Internet. Oftentimes, identity thieves will pose as legitimate government organizations or financial institutions and contact you to request personal information, including your Social Security number. Avoid giving out your Social Security number to anyone over the phone or via email/Internet unless you initiate the contact with an organization or institution that you trust.

Be careful about sharing your number. Just because someone asks for your Social Security number doesn't mean you have to share it. Always ask why it is needed, how it will be used, and what the consequences will be if you refuse to provide it.

If you think someone has misused your Social Security number, contact the Social Security Administration (SSA) immediately to report the problem. The SSA can review your earnings record with you to make sure their records are correct. You can also visit the SSA website at www.ssa.gov to check your earnings record online.

Unfortunately, the SSA cannot directly resolve any identity theft problems created by the misuse of your Social Security number. If you discover that someone is illegally using your number, be sure to contact the appropriate law-enforcement authorities. In addition, consider filing a complaint with the Federal Trade Commission and submitting IRS Form 14039, Identity Theft Affidavit, with the Internal Revenue Service. Visit www.ftc.gov and www.irs.gov for more information.