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summaries

SIGMA INVESTMENT COUNSELORS

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THE IMPORTANCE OF ALLOCATING YOUR INVESTMENTS STRATEGICALLY

As we grow older and our investments begin to snowball into the assets that will fund our retirements, the growing shadow of Uncle Sam looms over, waiting to take his piece of the cake we spent years saving to enjoy. While there will almost always be some taxes taken out on gains, there are strategies that can be put in place to maximize the amount of growth that you can realize without paying taxes on those gains. There are three tax designations: taxable, tax-deferred, or tax free. A taxable account is taxed under the capital gains tax rules immediately when the gains are realized, as well as dividends and interest payments being taxed when earned. In a tax deferred account, like a traditional 401k or IRA, you can make as many trades as you want and won't realize income until you withdraw any money. This is when you will realize the gains and have to pay taxes on them. Finally, the most appealing, is a tax free account. Perhaps the most popular tax free account, a Roth IRA, allows you to contribute after-tax dollars to grow and be withdrawn tax free. Assigning investments to the correct account can help you minimize taxes when you are ready to retire.

Over time, stocks give a better return than fixed income due to the relationship between risk and reward. In simple terms, higher risk usually provides higher reward. For this reason, when investors are younger, it is important to invest in equities when they have the most time to grow. As mentioned earlier, a Roth IRA is tax free account that allows deposits to grow and be withdrawn tax free. When you make your contributions to a Roth IRA, the government sees those dollars as after-tax dollars, meaning that everything you deposit is 100% yours and in most situations there will be no more tax implications. To take advantage of the tax status and the higher return stocks have provided over time, it is advantageous to have your Roth IRA at 100% equities. If someone who maxed out their Roth IRA from ages 21 to 60 allocated towards 100% equities and got a 10% return, their

$251,000 investment would be worth almost $3,000,000. On the other hand, it is important to put fixed income into traditional retirement accounts to shelter the interest payments from the higher ordinary income tax rates. Throughout the life of the bond, the gains from the equites will far outgain the interest payments of the bonds, causing you to pay more taxes if the gains are realized in a taxable account.

Given an average allocation of 70% towards equities across taxable, tax-deferred, and tax free accounts, an investor that does not prioritize asset allocation will realize less gains due to how their money will grow. That same investor will also pay more in taxes over the life of their investments. Another important part of asset location is to realize the different immediate tax advantages that certain accounts may have. In tax-deferred accounts, the government has decided that they are going to take out their portion of the gains when you make distributions. For this reason, they allow you to take tax deductions which vary based on your income level. Depending on how much you contribute and the tax bracket you are in, contributions to your 401k has the potential to make your tax bill much more manageable come tax season.

You may be thinking, how would this affect me and why would I not just worry about making my deposits and having all of my assets in one account? The answer to this is that you are preparing for your future and saving yourself a lot of money in the future by following this strategy. When it comes time for retirement, there will be trips to plan, projects to fund, or finally buying the vacation home you have been dreaming about. By prioritizing asset location, you will be able to fund those projects and save yourself money on the tax bill when you decide to make withdrawals.

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