403b NEWS

A quarterly newsletter for Retirement Plan Participants

Investing in Style

Style-conscious investors may have an edge when it comes to making decisions about the investments in their retirement accounts. Does that mean wearing designer clothes and driving a sports car will make you a better investor? Of course not. But paying attention to the investing styles that fund and portfolio managers follow can be helpful.

Passive Investing

This investing style is based on the theory that it's difficult to "beat the market" so investors might as well "buy the market." Passive fund managers aim to mirror the performance of a specified market index (such as the S&P 500, an index of 500 stocks issued by large U.S. companies).[1] Since it's impossible to invest in an index directly, a passive fund generally holds the same securities in the same proportions as the index the fund follows. The fund manager switches investments only when the underlying index changes. Limited trading means that index funds have relatively low expenses. However, passively managed funds generally don't outperform the indexes they follow because market indexes don't have expenses, whereas index funds and portfolios do. And when the market is down, there's not much passive fund managers can do to avoid losses.

Active Investing

Active fund managers, on the other hand, strive to outperform a market index by buying and selling investments. They might take different approaches in pursuit of that goal.

Some fund managers follow a growth style investing strategy, favoring the stocks of established companies that typically deliver above-average growth in earnings and profits. These companies are typically large, stable firms that reinvest their earnings, a sign they intend to keep growing. Some fund managers prefer a value style. The goal is to look for undervalued stocks that managers feel may be poised for a comeback. Value stock prices may be low for a number of reasons: a company's earnings may have fallen short of estimates, the stock may be temporarily out of favor, or the entire industry or sector may be troubled.

Some focus on company size, which is known as market capitalization, or "market cap." It refers to the total dollar value of a company's outstanding stock at a specific point in time. The dollar ranges to determine market cap aren't set in stone, but there are general definitions (see Investing by Company Size, below).

Note that actively managed funds typically have higher expenses and fees than passively managed funds. And, if the manager makes poor investment choices, the fund's performance may suffer relative to its benchmark index.

Out of Fashion

Sometimes, the manager or management team of an actively managed fund or portfolio will add investments that don't fit with the fund's objectives or investment style. This is called "style drift." It can happen for a number of reasons. One reason is disappointing returns. The manager of a small-cap stock fund may add some large-cap stocks to the fund to try to boost performance, for example. Style drift also can occur when the fundamentals of a fund's underlying investments change. A small company might grow into a mid-sized company, for example. Or a value stock might turn into a growth stock.

Does Style Drift Matter?

If one of your investments "drifts" from its stated style substantially, it could create overlap or duplication without your knowing it. In turn, that could change your portfolio's exposure to investment risk and its potential return. It's important to be aware of changes in the investments you hold. If the changes aren't compatible with your investment strategy, you may want to make some adjustments.

Go Ahead and Mix It Up

Understanding the different investing styles can help you select investments that diversify your retirement account.[2] Although mixing fashion styles might be a no-no, mixing investment styles can be a good thing.

Investing by Company Size

Market cap is a measure of a company's size. It's determined by multiplying the company's stock price by the total number of outstanding shares. Although definitions can vary, here are some very general guidelines.

- **Mega cap** -- Market cap of at least $200 billion; typically, industry leaders
- **Large cap** -- Market cap of $10 billion to $200 billion; well-known companies; considered relatively stable
- **Midcap** -- Market cap of $2 billion to $10 billion; more volatile than large caps
- **Small cap** -- Market cap of $300 million to $2 billion; generally, new or young companies

Historically, large-cap stocks have sustained relatively slower growth with lower risk, while small caps offer relatively higher growth potential and higher risk, although past performance is no guarantee of future results.

[1] An index is a measure of the value of a hypothetical portfolio of securities that is representative of the market (or market segment) it tracks. Indexes are unmanaged; no securities are bought or sold in an attempt to increase the value of the index. An investor cannot invest directly in an index.

[2] Diversification does not ensure a profit or protect against loss in a declining market.

Planning the Withdrawal of Your Retirement Assets

An efficient withdrawal strategy may be able to improve the overall performance and longevity of a retirement portfolio. Certain tactics for drawing cash from retirement assets may have more favorable tax implications for the investor. It is also possible to manage portfolio rebalancing in order to minimize transaction costs. Other factors that have a significant impact on withdrawal strategy include IRS required minimum distribution rules and large holdings of company stock in a qualified retirement plan.

You've worked long and hard to accumulate the assets that you are using to help finance your retirement. Now, it's time to start drawing down those assets. Exactly how you liquidate your assets will affect your tax and impact how long those assets last, so it pays to plan a withdrawal strategy that is efficient and maximizes the benefits of different types of investments.

The first step in planning your withdrawal strategy is to make a precise inventory of all the assets you have in your portfolio, paying particular attention to distinguish between taxable accounts, such as ordinary bank or brokerage accounts, and tax-deferred accounts such as 401(k), 403(b), and 457 plans, and IRAs. From this inventory, you can estimate how much cash you will receive from dividends, interest payments, redemptions, and distributions in the coming year. You can also assess how much you will need to hold in reserve in order to meet the associated federal and state tax obligations.

If your total net cash flow from the assets in your taxable accounts is strong enough to meet your budgeted cash needs for the year, you may consider yourself to be fortunate. You need not weigh the transaction costs of different asset sale strategies or consider the added income tax effects of withdrawing assets from employer-sponsored plans and IRAs. But if you do need to liquidate assets in order to meet your cash flow targets, then you should consider the pluses and minuses of each withdrawal strategy as outlined in the following savings withdrawal hierarchy.

As you consider these options, keep in mind that no single order can be right for every person and every situation. Among the additional issues you should consider when designing your withdrawal strategy are the management of portfolio risk, your tax bracket, and the cost basis of the investments. With that in mind, below is a high-level summary of guidelines for creating an appropriate strategy. Remember, this is a conceptual ranking. Your circumstances may require a different sequence, so be sure to obtain relevant financial advice before taking any action. Note, too, that estate tax considerations might have an impact on withdrawal priorities.

•Meet the rules for Required Minimum Distributions (RMDs). Owners of traditional IRAs and participants in 401(k), 403(b), and 457 plans must follow IRS schedules for the size and timing of their RMDs (see below). Those who fail to do so face a penalty tax equal to half of any required distribution that has not been taken by the applicable deadline.

•Sell losing positions in taxable accounts. If you have an investment that is worth less now than when you bought it, you may be able to create a tax deduction by selling that investment. This deduction can be used to offset any investment gains you realize. It can also be used to offset up to $3,000 in ordinary income ($1,500 for married individuals who file separate tax returns). Losses in excess of the limits can usually be carried forward for use in future years.

•Liquidate assets in taxable accounts that will generate neither capital gains nor losses. As you consider which assets to sell, keep your target asset allocation in mind. You may be able sell assets from a class that is currently overweighted in your portfolio. By focusing on reducing the overweighted class to restore balance, you can minimize net transaction costs.

•Realize gains from taxable accounts or withdraw assets from tax-deferred accounts to which nondeductible contributions have been made, such as after-tax contributions to a 401(k) plan. Which accounts to tap first within this category will depend on a number of factors, such as the cost basis relative to market value of the accounts to be liquidated and the tax characteristics of the assets in the taxable account. When liquidating taxable account assets, liquidate the holdings with long-term capital gains before those with short-term gains, and liquidate assets with the least unrealized gain first.

•Take additional distributions from tax-favored accounts. RMD rules, state tax treatment, and other features and characteristics of the different IRAs and employer-sponsored plans may make some accounts better candidates for earlier withdrawals. For instance, withdrawals from a traditional IRA would usually precede withdrawals from a Roth IRA.

Required Minimum Distributions (RMDs)

For traditional IRAs and employer-sponsored retirement savings plans, individuals must begin taking required minimum distributions no later than April 1 following the year in which they turn 70½. RMDs from a 401(k) can be delayed until actual retirement if the plan participant continues to be employed by the plan sponsor and he or she does not own more than 5% of the company. The size of an RMD is determined by the account owner's age. An account owner with a spousal beneficiary who is more than 10 years younger can base required minimum distributions on their joint life expectancy.

Estimating the Required Minimum Distribution

This is the most broadly applicable required minimum distribution table -- the Uniform Lifetime Table for unmarried owners, married owners whose spouses are not more than 10 years younger, and married owners whose spouses are not the sole beneficiaries of their accounts. Other tables apply in other situations.

Age	**70**	**75**	**80**	**85**	**90**	**95**	**100**	**105**
Actuarially projected life expectancy (in years)	27.4	22.9	18.7	14.8	11.4	8.6	6.3	4.5
RMD (% of assets)	3.6%	4.4%	5.3%	6.8%	8.8%	11.6%	15.9%	22.2%

Source: The Internal Revenue Service

A Potential Tax Benefit for Company Stock Held in a Retirement Plan

For individuals who hold company stock in their 401(k) or other qualified retirement plan, the IRS offers certain tax advantages when withdrawing company stock from the plan. Rather than paying ordinary income tax on the entire amount of the withdrawal, you may elect to pay it on the original cost basis of the stock, assuming it was paid for in pre-tax dollars, then pay capital gains tax, usually at a lower rate, on the net unrealized appreciation when you eventually sell the shares.

Keep in mind that the IRS has exacting requirements for exploiting all of the tax management strategies discussed above and that tax laws are always subject to change. You should review your cash management plans with your tax and investment advisors before taking any specific action.