

# Financial Focus

A Publication of Fortune Wealth Management, LLC

## Investors Are Human, Too



In 1981, the Nobel Prize-winning economist Robert Shiller published a groundbreaking study that contradicted a prevailing theory that markets are always efficient. If they

were, stock prices would generally mirror the growth in earnings and dividends. Shiller's research showed that stock prices fluctuate more often than changes in companies' intrinsic valuations (such as dividend yield) would suggest.<sup>1</sup>

Shiller concluded that asset prices sometimes move erratically in the short term simply because investor behavior can be influenced by emotions such as greed and fear. Many investors would agree that it's sometimes difficult to stay calm and act rationally, especially when unexpected events upset the financial markets.

Researchers in the field of behavioral finance have studied how cognitive biases in human thinking can affect investor behavior. Understanding the influence of human nature might help you overcome these common psychological traps.

### Herd mentality

Individuals may be convinced by their peers to follow trends, even if it's not in their own best interests. Shiller proposed that human psychology is the reason that "bubbles" form in asset markets. Investor enthusiasm ("irrational exuberance") and a herd mentality can create excessive demand for "hot" investments. Investors often chase returns and drive up prices until they become very expensive relative to long-term values.

Past performance, however, does not guarantee future results, and bubbles eventually burst. Investors who follow the crowd can harm long-term portfolio returns by fleeing the stock market after it falls and/or waiting too long (until prices have already risen) to reinvest.

### Availability bias

This mental shortcut leads people to base judgments on examples that immediately come to mind, rather than examining alternatives. It may cause you to misperceive the likelihood or frequency of events, in the same way that watching a movie about sharks can make it seem more dangerous to swim in the ocean.

### Confirmation bias

People also have a tendency to search out and remember information that confirms, rather than challenges, their current beliefs. If you have a good feeling about a certain investment, you may be likely to ignore critical facts and focus on data that supports your opinion.

### Overconfidence

Individuals often overestimate their skills, knowledge, and ability to predict probable outcomes. When it comes to investing, overconfidence may cause you to trade excessively and/or downplay potential risks.

### Loss aversion

Research shows that investors tend to dislike losses much more than they enjoy gains, so it can actually be painful to deal with financial losses.<sup>2</sup> Consequently, you might avoid selling an investment that would realize a loss even though the sale may be an appropriate course of action. The intense fear of losing money may even be paralyzing.

It's important to slow down the process and try to consider all relevant factors and possible outcomes when making financial decisions. Having a long-term perspective and sticking with a thoughtfully crafted investing strategy may also help you avoid expensive, emotion-driven mistakes.

**Note:** All investments are subject to market fluctuation, risk, and loss of principal. When sold, investments may be worth more or less than their original cost.

<sup>1</sup> *The Economist*, "What's Wrong with Finance?" May 1, 2015

<sup>2</sup> *The Wall Street Journal*, "Why an Economist Plays Powerball," January 12, 2016

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Investors Are Human, Too

Nearing Retirement? Time to Get Focused

Understanding the Net Investment Income Tax

Can I make charitable contributions from my IRA in 2016?



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*A financial professional can help you estimate how much your retirement accounts may provide on a monthly basis. Your employer may also offer tools to help. Keep in mind, however, that neither working with a financial professional nor using employer-sponsored tools can guarantee financial success.*

## Nearing Retirement? Time to Get Focused

If you're within 10 years of retirement, you've probably spent some time thinking about this major life change. The transition to retirement can seem a bit daunting, even overwhelming. If you find yourself wondering where to begin, the following points may help you focus.

### Reassess your living expenses

A step you will probably take several times between now and retirement--and maybe several more times thereafter--is thinking about how your living expenses could or should change. For example, while commuting and dry cleaning costs may decrease, other budget items such as travel and health care may rise. Try to estimate what your monthly expense budget will look like in the first few years after you stop working. And then continue to reassess this budget as your vision of retirement becomes reality.

### Consider all your income sources

Next, review all your possible sources of income. Chances are you have an employer-sponsored retirement plan and maybe an IRA or two. Try to estimate how much they could provide on a monthly basis. If you are married, be sure to include your spouse's retirement accounts as well. If your employer provides a traditional pension plan, contact the plan administrator for an estimate of your monthly benefit amount.

Do you have rental income? Be sure to include that in your calculations. Is there a chance you may continue working in some capacity? Often retirees find that they are able to consult, turn a hobby into an income source, or work part-time. Such income can provide a valuable cushion that helps retirees postpone tapping their investment accounts, giving them more time to potentially grow.

Finally, don't forget Social Security. You can get an estimate of your retirement benefit at the Social Security Administration's website, [ssa.gov](http://ssa.gov). You can also sign up for a *my* Social Security account to view your online Social Security Statement, which contains a detailed record of your earnings and estimates of retirement, survivor, and disability benefits.

### Manage taxes

As you think about your income strategy, also consider ways to help minimize taxes in retirement. Would it be better to tap taxable or tax-deferred accounts first? Would part-time work result in taxable Social Security benefits? What about state and local taxes? A qualified tax professional can help you develop an appropriate strategy.

### Pay off debt, power up your savings

Once you have an idea of what your possible expenses and income look like, it's time to bring your attention back to the here and now. Draw up a plan to pay off debt and power up your retirement savings before you retire.

- **Why pay off debt?** Entering retirement debt-free--including paying off your mortgage--will put you in a position to modify your monthly expenses in retirement if the need arises. On the other hand, entering retirement with mortgage, loan, and credit card balances will put you at the mercy of those monthly payments. You'll have less of an opportunity to scale back your spending if necessary.
- **Why power up your savings?** In these final few years before retirement, you're likely to be earning the highest salary of your career. Why not save and invest as much as you can in your employer-sponsored retirement savings plan and/or your IRAs? Aim for the maximum allowable contributions. And remember, if you're 50 or older, you can take advantage of catch-up contributions, which allow you to contribute an additional \$6,000 to your employer-sponsored plan and an extra \$1,000 to your IRA in 2016.

### Account for health care

Finally, health care should get special attention as you plan the transition to retirement. As you age, the portion of your budget consumed by health-related costs will likely increase. Although Medicare will cover a portion of your medical costs, you'll still have deductibles, copayments, and coinsurance. Unless you're prepared to pay for these costs out of pocket, you may want to purchase a supplemental insurance policy.

In 2015, the Employee Benefit Research Institute reported that the average 65-year-old married couple would need \$213,000 in savings to have at least a 75% chance of meeting their insurance premiums and out-of-pocket health care costs in retirement. And that doesn't include the cost of long-term care, which Medicare does not cover and can vary substantially depending on where you live. For this reason, you might consider a long-term care insurance policy.

These are just some of the factors to consider as you prepare to transition into retirement. Breaking the bigger picture into smaller categories may help the process seem a little less daunting.



# Understanding the Net Investment Income Tax



**The 3.8% net investment income tax, sometimes referred to as the Medicare surtax on net investment income, originated in revenue provisions included in the Affordable Care Act of 2010. Unlike payroll tax revenues, funds collected from this surtax are deposited into the general fund of the U.S. Treasury; they are not applied to the Medicare Trust Fund.**

It's been around since 2013, but many are still struggling to come to grips with the net investment income tax. The 3.8% tax, which is sometimes referred to as the Medicare surtax on net investment income, affected approximately 3.1 million federal income tax returns for 2013 (the only year for which data is available) to the tune of almost \$11.7 billion.<sup>1</sup> Here's what you need to know.

## What is it?

The net investment income tax is a 3.8% "extra" tax that applies to certain investment income in addition to any other income tax due. Whether you're subject to the tax depends on two general factors: the amount of your modified adjusted gross income for the year, and how much net investment income you have.

**Note:** *Nonresident aliens are not subject to the net investment income tax.*

## What income thresholds apply?

Modified adjusted gross income (MAGI) is basically adjusted gross income--the amount that shows up on line 37 of your IRS Form 1040--with certain amounts excluded from income added back in.

The net investment income tax applies only if your modified adjusted gross income exceeds the following thresholds:

Filing Status	MAGI
Married filing jointly or qualifying widow(er)	\$250,000
Married filing separately	\$125,000
Single or head of household	\$200,000

## What is net investment income?

Investment income generally includes interest, dividends, capital gains, rental and royalty income, income from nonqualified annuities, and income from passive business activities and businesses engaged in the trade of financial instruments or commodities. Investment income does not include wages, unemployment compensation, Social Security benefits, tax-exempt interest, self-employment income, or distributions from most qualified retirement plans and IRAs.

**Note:** *Even though items like wages and retirement plan distributions aren't included in net investment income, they are obviously a factor in calculating MAGI. So higher levels of non-investment income can still make a difference in whether the net investment income tax applies.*

Gain from the sale of a personal residence would generally be included in determining investment income. However, investment income does not include any amount of gain that is excluded from gross income for regular income tax purposes. Qualifying individuals are generally able to exclude the first \$250,000--or \$500,000 for married couples filing jointly--of gain on the sale of a principal residence; any of the gain that's excluded for regular income tax purposes would not be included in determining investment income.

To calculate *net* investment income, you reduce your gross investment income by any deductible expenses that can be allocated to the income. So, for example, associated investment interest expense, investment and brokerage fees, expenses associated with rental and royalty income, and state and local income taxes can all be factored in.

## How is the tax calculated?

You know your modified adjusted gross income. You know your net investment income. To calculate the net investment income tax, first subtract the threshold figure (shown above) for your filing status from your MAGI. Then compare the result with your net investment income. Multiply the lower of the two figures by 3.8%.

For example, assume you and your spouse file a joint federal income tax return and have \$270,000 in MAGI and \$50,000 in net investment income. Your MAGI is \$20,000 over the \$250,000 threshold for married couples filing jointly. You would owe \$760 (3.8% multiplied by \$20,000), because the tax is based on the lesser of net investment income or MAGI exceeding the threshold.

## How is it reported?

If you're subject to the net investment income tax, you must complete IRS Form 8960, Net Investment Income Tax--Individuals, Estates, and Trusts, and attach it to your federal income tax return (you must file IRS Form 1040). The instructions for IRS Form 8960 provide an overview of the rules that apply and can be a good source of additional information. If you think you may be affected by the net investment income tax, though, it's a good idea to consider discussing your individual situation with a tax professional.

<sup>1</sup> IRS Statistics of Income Bulletin, Spring 2015



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### **Can I make charitable contributions from my IRA in 2016?**

Yes, if you qualify. The law authorizing qualified charitable distributions, or QCDs, has recently been made

permanent by the Protecting Americans from Tax Hikes (PATH) Act of 2015.

You simply instruct your IRA trustee to make a distribution directly from your IRA (other than a SEP or SIMPLE) to a qualified charity. You must be 70½ or older, and the distribution must be one that would otherwise be taxable to you. You can exclude up to \$100,000 of QCDs from your gross income in 2016. And if you file a joint return, your spouse (if 70½ or older) can exclude an additional \$100,000 of QCDs. But you can't also deduct these QCDs as a charitable contribution on your federal income tax return--that would be double dipping.

QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA in 2016, just as if you had received an actual distribution from the plan. However, distributions (including RMDs) that you actually receive from your IRA and subsequently transfer to a charity cannot qualify as QCDs.

For example, assume that your RMD for 2016 is \$25,000. In June 2016, you make a \$15,000 QCD to Qualified Charity A. You exclude the \$15,000 QCD from your 2016 gross income. Your \$15,000 QCD satisfies \$15,000 of your \$25,000 RMD. You'll need to withdraw another \$10,000 (or make an additional QCD) by December 31, 2016, to avoid a penalty.

You could instead take a distribution from your IRA and then donate the proceeds to a charity yourself, but this would be a bit more cumbersome and possibly more expensive. You'd include the distribution in gross income and then take a corresponding income tax deduction for the charitable contribution. But the additional tax from the distribution may be more than the charitable deduction due to IRS limits. QCDs avoid all this by providing an exclusion from income for the amount paid directly from your IRA to the charity--you don't report the IRA distribution in your gross income, and you don't take a deduction for the QCD. The exclusion from gross income for QCDs also provides a tax-effective way for taxpayers who don't itemize deductions to make charitable contributions.