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Welcome to August. Another school year around the corner.

I often get questions about funding college.

*529 plans are funded with after-tax dollars for post secondary education. Distributions will be tax-free (this means you don't pay tax on the earnings generated by the contributions), provided the distributions are for qualified education expenses incurred in the year of distribution.

*Educations Savings Accounts (ESA) are funded with after-tax dollars for K-12 AND post secondary education. Distributions are treated the same as the 529 distributions.

Excellent websites for information on this are www.finaid.org and savingforcollege.com.

As always your questions and comments about College Funding or any other topic are most welcomed.

Have a great August.

Bill
PS: I will be away on business travel from 8/5 through 8/16. Emails and phone calls will be monitored, responses may be delayed. Thank you.

August 2016

Investors Are Human, Too

Four Reasons Why People Spend Too Much

Understanding the Net Investment Income Tax

Should I pay off my student loans early or contribute to my workplace 401(k)?

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.¹

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.² 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.

1 *The Economist*, "What's Wrong with Finance?" May 1, 2015

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

Four Reasons Why People Spend Too Much



You may be more likely to overspend on a particular purchase compared to other possible expenditures. According to research conducted by the Consumer Reports National Research Center, adults in the United States reported that they would spend money on the following throughout the year:

- 54%--electronics
- 33%--appliances
- 27%--a car
- 23%--home remodeling

Source: Consumer Reports, November 2014

You understand the basic financial concepts of budgeting, saving, and monitoring your money. But this doesn't necessarily mean that you're in control of your spending. The following reasons might help explain why you sometimes break your budget.

1. Failing to think about the future

It can be difficult to adequately predict future expenses, but thinking about the future is a key component of financial responsibility. If you have a tendency to focus on the "here and now" without taking the future into account, then you might find that this leads you to overspend.

Maybe you feel that you're acting responsibly simply because you've started an emergency savings account. You might feel that it will help you cover future expenses, but in reality it may create a false sense of security that leads you to spend more than you can afford at a given moment in time.

Remember that the purpose of your emergency savings account is to be a safety net in times of financial crisis. If you're constantly tapping it for unnecessary purchases, you aren't using it correctly.

Change this behavior by keeping the big picture in perspective. Create room in your budget that allows you to spend discretionary money and use your emergency savings only for true emergencies. By having a carefully thought-out plan in place, you'll be less likely to overspend without realizing it.

2. Rewarding yourself

Are you a savvy shopper who rarely splurges, or do you spend too frequently because you want to reward yourself? If you fall in the latter category, your sense of willpower may be to blame. People who see willpower as a limited resource often trick themselves into thinking that they deserve a reward when they are able to demonstrate a degree of willpower. As a result, they may develop the unhealthy habit of overspending on random, unnecessary purchases in order to fulfill the desire for a reward.

This doesn't mean that you're never allowed to reward yourself--you just might need to think of other ways that won't lead to spending too much money. Develop healthier habits by rewarding yourself in ways that don't cost money, such as spending time outdoors, reading, or meditating. Both your body and your wallet will thank you.

If you do decide to splurge on a reward from time to time, do yourself a favor and plan your purchase. Figure out how much it will cost ahead of time so you can save accordingly instead of tapping your savings. Make sure that your reward, whether it's small or big, has a purpose and is meaningful to you. Try scaling back. For example, instead of dining out every weekend, limit this expense to once or twice a month. Chances are that you'll enjoy going out more than you did before, and you'll feel good about the money you save from dining out less frequently.

3. Mixing mood with money

Your emotional state can be an integral part of your ability to make sensible financial decisions. When you're unhappy, you might not be thinking clearly, and saving is probably not your first priority. Boredom or stress also makes it easy to overspend because shopping serves as a fast and easy distraction from your feelings. This narrow focus on short-term happiness might be a reason why you're spending more than normal.

Waiting to spend when you're happy and thinking more positively could help shift your focus back to your long-term financial goals. Avoid temptations and stay clear of stores if you feel that you'll spend needlessly after having an emotionally challenging day. Staying on track financially (and emotionally) will benefit you in the long run.

4. Getting caught up in home equity habits

Do you tend to spend more money when the value of your assets--particularly your property--increases? You might think that appreciating assets add to your spending power, thus making you feel both wealthier and more financially secure. You may be tempted to tap into your home equity, but make sure you're using it wisely.

Instead of thinking of your home as a piggy bank, remember it's where you live. Be smart with your home equity loan or line of credit--don't borrow more than what is absolutely necessary. For example, you may need to borrow to pay for emergency home repairs or health expenses, but you want to avoid borrowing to pay for gratuitous luxuries that could put you and your family's financial security at risk. After all, the lender could foreclose if you fail to repay the debt, and there may be closing costs and other charges associated with the loan.

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.¹ 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.

¹ IRS Statistics of Income Bulletin, Spring 2015

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Should I pay off my student loans early or contribute to my workplace 401(k)?

For young adults with college debt, deciding whether to pay off student loans early or contribute to a 401(k) can be tough. It's a financial tug-of-war between digging out from debt today and saving for the future, both of which are very important goals. Unfortunately, this dilemma affects many people in the workplace today. According to a student debt [report](#) by The Institute for College Access and Success, nearly 70% of college grads in the class of 2014 had student debt, and their average debt was nearly \$29,000. This equates to a monthly payment of \$294, assuming a 4% interest rate and a standard 10-year repayment term.

Let's assume you have a \$300 monthly student loan payment. You have to pay it each month--that's non-negotiable. But should you pay more toward your loans each month to pay them off faster? Or should you contribute any extra funds to your 401(k)? The answer boils down to how your money can best be put to work for you.

The first question you should ask is whether your employer offers a 401(k) match. If yes, you

shouldn't leave this free money on the table. For example, let's assume your employer matches \$1 for every dollar you save in your 401(k), up to 6% of your pay. If you make \$50,000 a year, 6% of your pay is \$3,000. So at a minimum, you should consider contributing \$3,000 per year to your 401(k)--or \$250 per month--to get the full \$3,000 match. That's potentially a 100% return on your investment.

Even if your employer doesn't offer a 401(k) match, it can still be a good idea to contribute to your 401(k). When you make extra payments on a specific debt, you are essentially earning a return equal to the interest rate on that debt. If the interest rate on your student loans is relatively low, the potential long-term returns earned on your 401(k) may outweigh the benefits of shaving a year or two off your student loans. In addition, young adults have time on their side when saving for retirement, so the long-term growth potential of even small investment amounts can make contributing to your 401(k) a smart financial move.

All investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.



Have you heard about the newest employee perk?

What's one of the most cutting-edge employee benefits right now? Company-provided student loan assistance for employees who are paying back student loans.

With a record amount of student loan debt attached to the incoming workforce (visit [finaid.org](#) to see a student debt clock that now tops \$1.3 trillion), companies that rely on a college-educated workforce--and want to attract and retain the best workers--are starting to offer student loan assistance to meet this immediate financial concern of many employees.

How do these programs work? Generally, an employer will contribute a certain amount each month toward an employee's student loans, typically from \$100 to \$250 per month, up to a lifetime cap (for example, \$10,000). Programs may restrict participation to employees who have been with the company for a minimum period of time, and may require employees to remain at the company for a certain period of time after they receive loan repayment benefits.

But participants beware: Unlike matching 401(k) contributions that companies may give to employees, money given to help repay

student loans is considered taxable income. Yet for college graduates facing thousands of dollars of debt and years of loan repayment, this employee benefit can be an attractive perk. Along with the actual financial help, borrowers may get a psychological boost from knowing that they have a plan in place to successfully pay off their loans and that their employer is invested in the outcome.

Even with the early hype, company student loan repayment programs are still a relatively uncommon employee benefit. According to a 2015 employee benefit survey by the Society for Human Resource Management, these plans were offered by only 3% of the more than 450 companies surveyed. Essentially, a handful of large employers that hire a large number of college grads are at the forefront of this trend.

Industry observers expect a lot of pent-up demand for this employee benefit as millennials' student debt burdens continue to garner widespread attention and employee retention efforts intensify as the economy improves. A company's contribution probably won't cover 100% of a young employee's student debt, but it might make a meaningful and welcome dent.