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Introduction

Asset allocation combines the theoretical with the practical: principles of diversification support the use of fact-finding tools, financial planning models and customer preference. This book explores the purpose, the methods and the application of asset allocation. It demonstrates that asset allocation is a sensible and flexible device which provides a clear path to meeting the financial needs of a customer.

On the following pages the reasoning behind asset allocation, its goals and method is explained. Each asset category is defined, and common products used within each category are described. The course concludes with practical application of asset allocation in some everyday situations.

It is recommended that the reader refer to any customer profiling and asset allocation tools he or she is using as this course is read and completed.
Chapter One: Asset Allocation Introduced

Asset allocation is a term which is commonly used today. The phrase *asset allocation* is seen in magazines, newspapers, fund brochures and bank posters, and heard in investment seminars and sales meetings. Asset allocation seems to be the catch phrase of the moment in the financial services industry.

Is the popularity of the phrase a fair representation of the soundness of the underlying concepts of asset allocation? Yes, if asset allocation is used to mean the placement of portfolio assets in an optimal mix of liquid, fixed and growth products with appropriate risk levels for the individual. Asset allocation in this sense is the cornerstone of a sound investment strategy and when done properly, has a positive impact on return. On the other hand, if asset allocation is used to identify a program or account within a specific mutual fund, variable annuity or variable life product, the principles of asset allocation may not be fully exercised.

This chapter will discuss what lies behind asset allocation theory and will provide tools to determine whether a particular asset allocation instrument is a suitable method for the practical application of this theory.

**Asset Allocation Theory**

Asset allocation is based on the theory of diversification. Sophisticated mathematical models have proven that what is true in the chicken house is true in the stock and bond markets -- to get the best return and limit risk, don’t put all your eggs in one basket, nor your money into only one stock or bond. By diversifying among different securities, the overall return on your money is statistically likely to be higher over time than if all the money were placed in one corporation’s stock. Why? Because should that stock be negatively impacted because of poor company management, competition, bad weather, labor strikes, a downturn in interest rates or governmental regulation, to name a few possibilities, the entire portfolio’s return is negatively impacted. However, if part of the portfolio were placed in this stock, Stock A, and the other in a different company’s stock, Stock B, perhaps in an entirely different industry, the factors which impact Stock A are not likely to impact Stock B in the same manner. For example, if the company which issued Stock A manufactured farm equipment and the company which issued Stock B made umbrellas, a long stretch of bad weather would harm Stock A’s return, but be a boon for Stock B.
**Types of Risk**
A portfolio is subject to several kinds of risk. Diversification can reduce the impact of various types of risk on a portfolio. But all portfolios contain some risk. The type of risk and the degree to which it occurs varies based on the types and mix of products within the portfolio.

Investment risks include *Financial or Default Risk, Market Risk, Interest Rate Risk, Purchasing Power Risk,* and *Political or Economic Risk.* Some products have risks which are unique to that product, such as the risk of damage to a collectible used as an investment.

**Financial or Default Risk**
Financial risk is the risk that the underlying corporation or issuing entity will be financially unable to meet the obligations of the product. In the case of stocks, the financial risks include the risk that the corporation will be unable to pay dividends and/or will reduce or eliminate dividend payments. Financial difficulties within the corporation can also cause the value of the stock to fall, just as financial strength can drive share values up.

The financial or default risk of a bond is the risk that the issuing entity, whether a corporation, a state or local government, or the federal government, will be unable to meet the obligations of the bond issue. The relative risk of default of a bond is based on the creditworthiness of the issuer. Therefore, the risk of default of a bond issued by the US government is considered to be virtually nonexistent whereas the risk of default of a small, undercapitalized corporation, or a large corporation newly reorganized to avoid bankruptcy can be considered to be quite high.

**Bond Rating Agencies**
Bond rating agencies perform credit analysis and assign ratings to bond issues. The three best known agencies are Moody’s Investor Services and Standard & Poor’s Corporation and Fitch Investors Service.

The focus of the evaluation of rating agencies is the relative ability of the issuer to meet the specific obligations of the bond. Moody’s and S&P assign letter ratings to the different risk levels, or grades. The higher the rating, the lower the risk of default. The different rating agencies use different descriptions for the letter grades assigned, but the industry has general terms applied to the different bond grades, as shown in the table following:
<table>
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<th>General Industry Description</th>
<th>Moody’s</th>
<th>S&amp;P</th>
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<tr>
<td>Investment Grade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prime</td>
<td>Aaa</td>
<td>AAA</td>
</tr>
<tr>
<td>High Quality</td>
<td>Aa</td>
<td>AA</td>
</tr>
<tr>
<td>Upper Medium Grade</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Medium Grade</td>
<td>Baa</td>
<td>BBB</td>
</tr>
<tr>
<td>Below Investment Grade</td>
<td></td>
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<tr>
<td>Moderately Speculative</td>
<td>Ba</td>
<td>BB</td>
</tr>
<tr>
<td>Speculative</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>Highly Speculative</td>
<td>Caa</td>
<td>CCC</td>
</tr>
<tr>
<td>Lowest Quality</td>
<td>C</td>
<td>C,D</td>
</tr>
</tbody>
</table>

**Exhibit 1.1 Bond Grades**

**Market Risk**

Market risk refers to the risk of price fluctuation of a particular security, securities of a particular industry group, e.g. all airlines or all pharmaceutical companies, or for the entire securities market. Financial difficulties within an industry can impact price, as can competition, weather, regulation, public perception, etc. Some professionals refer to components of market risk as *event risk* rather than market risk to emphasize the inability to predict the occurrence or impact of a massive oil spill, a series of airplane accidents, the discovery of (another) cancer causing element found in a popular food item, etc.

**Interest Rate Risk**

Interest rate risk is primarily related to debt securities, such as bonds and notes. However, interest rate changes can impact other products, such as equity securities. When interest rates change, equities may be affected due to the relative attractiveness of competing products. For example, if rates in long-term, prime bonds or certificates of deposit have been relatively low, a certain portion of risk averse investors who had been invested in bonds or certificates of deposit may accept additional risk for the expected additional return found in high quality stock mutual funds. Once bond rates rise, these investors may return to the long-term bonds or certificates of deposit with which they feel more comfortable.

**Interest Rate Changes and Bond Prices**

Prices of debt securities, like bonds, are impacted by changes in interest rates. When interest rates move up or down, generally a bond’s price moves in the opposite direction. For example, if a bond with a fixed rate of 7% were purchased, and rates fell to 5%, the price of the bond will rise, because investors
will be willing to pay more for the 7% rate. If rates rise, the bond’s price will fall because investors will pay less for the 5% rate. The price of a bond is only important to the investor who does not plan to hold the bond to maturity. At maturity, the face amount of a bond will be paid to the bondholder.

**Interest Rate Changes and Bond Term and Quality**

The longer the term of the bond, or the greater the number of years to the bond’s maturity, the more sensitive the bond price to interest rate changes. Since there is a greater number of years for the bond to be impacted by the rate change, the relative impact on price is greater. In addition, the higher the bond quality, the greater the relative impact of interest rates on the bond’s price. Since high quality bonds have low default risk, the high quality bond’s price is based primarily on its interest rate. Low quality, or junk bond prices are impacted by the acceptance of default risk by the investor. Therefore, if interest rates change, the impact on a high quality bond will be relatively greater than the impact on a low quality, or junk bond. Sensitivity to rate changes is also impacted by the options of a bond, such as whether the bond is callable, and whether the rate paid, or the coupon, is a fixed rate or a floating rate based on an index.

**Purchasing Power Risk**

Purchasing power risk is the risk that a product will not increase in value to keep pace or beat inflation. Inflation results in the reduced purchasing power of currency. If a product returns 5% and the inflation rate is 6% during the same period, the product will be generating returns which will not offset the effects of inflation on purchasing power. Products with a fixed rate generally will have greater purchasing power risk than those with a variable rate. Equities are generally considered as a hedge against inflation, since common stock prices have, over time, moved upward as inflation indices, such as the Consumer Price Index, have risen.

**Political or Economic Risk**

Political and economic risks stem from changes in the regulatory environment, the stability of a country’s currency, inflation rates, interest rates and the overall stability of the political environment within that country. For example, if a bond were purchased from a company within a developing country, and some sort of political upheaval took place, that bond’s price may plummet, or the assets behind it may even be seized or frozen.

**Pre-Payment Risk**

Pre-payment risk is associated with mortgage securities. Mortgage securities can provide a higher rate of return than many other government issued securities, but carry the risk that the mortgagees may pay off their mortgages early, e.g. in a decreasing rate environment. This risk is known as pre-payment risk. When mortgages are paid off early, which can mean either before the terms of the
mortgage agreement or before the expected pay off date, principal is returned to the investors and the interest payments cease.

**Exchange Rate Risk**
Exchange rate risk is a risk found primarily in securities issued outside the US. Exchange rate risk is the risk that the currency in a foreign country will decrease in value relative to other currencies, such as the dollar. If so, the securities issued from that country will be worth less to investors from countries with stronger currency, or currency which is relatively higher in value. Not only will the security’s price be worth less if the currency decreases, but the relative value of the coupon payments, dividends, reinvested income and capital gains will decrease as well to the foreign investor.

**Asset Allocation and Maximizing a Portfolio’s Return**
Asset allocation goes one step beyond the risk reduction principles of diversification. Asset allocation addresses the question of how much of a portfolio should be invested in what type of investments in order to maximize return while utilizing the principles of diversification to minimize risk. Asset allocation also provides guidelines to help determine what specific types of products within a type or class of investment is suitable for a particular individual.

**Asset Allocation Theory Used in the Real World**
To determine and apply an optimal portfolio mix, asset allocation principles dictate that the following steps be taken:

I. **Identify the individual’s risk tolerance and investment experience.**

II. **Identify the current product mix held, along with the purpose of the money held, savings goals and time frame of those goals.**

III. **Identify the optimal portfolio mix, using an asset allocation modeling tool. Compare the current portfolio mix with the optimal mix.**

IV. **Re-allocate assets to conform to the optimal mix.**

V. **Review asset allocation mix at least semi-annually.**

Various tools based on asset allocation theory exist. Most begin with a customer profiling process, because to ascertain an optimal asset mix and its allocation, one must know the customer.

**Goals of an Asset Allocation Plan**
The goals of an asset allocation plan are to:
1. Include products which have the appropriate features and characteristics to meet the needs of the portfolio holder.
2. Maximize return by placing assets in products which match the risk tolerance of the customer.
3. Place the appropriate amount of assets in the liquid class to meet short term and emergency needs.
4. Reduce volatility in the portfolio by placing non-liquid assets in the appropriate mix of fixed and growth products.

**Asset Classes and Use of an Asset**

Before discussing the components of these five steps, a discussion of asset classes is necessary. Asset allocation divides a portfolio into different asset classes. When an inventory of current products held is performed, these products are identified by class type. When an optimal mix is developed, the assets may be re-allocated among these classes.

Typically, the asset classes used are 1) liquid, 2) fixed income, and 3) growth. These classes may be referred to respectively as cash, fixed and equity or other similar names. The idea is that a portion of a portfolio should be liquid: cash, or easily converted to cash. Another portion should be in fixed products. The third part of a portfolio should be in growth products, like equities.

The liquid portion of the portfolio is used for short-term needs and emergencies. It may contain products with guaranteed return and principal, or products with variable returns and no guarantees. Typically, liquid assets are products with the lowest returns in the portfolio over time. Fixed products generally refer to products with a guaranteed or stable return and/or guaranteed or stable principal, and often can generate income. These products are typically subject to interest rate risk and default risk. The growth products typically are not guaranteed in any way, and their predominant risk exposure is to market risk.

Products don’t always easily fit into one particular class. For example, is a CD liquid? It is easily converted to cash. Should the early withdrawal penalty on a CD keep it from being classified as a liquid asset? How about the fact that you can draw regular interest income from a CD? Is it better placed in the fixed category? Because of issues such as this, various asset allocation tools categorize products differently. Some categorize CDs as liquid, along with US savings bonds. Others put these two products in the fixed category. No classification of products is perfect. The user should view tools which suggest products for each class as a guideline, and use the purpose of the product for a particular individual as the reason for placing it in any particular class.

For example, if an individual has sufficient liquid assets in money market accounts or mutual funds, his one year CD is not likely to be used as a liquid
asset. In his portfolio, his one year CD should be classified as a fixed asset. Another individual may have only a small checking account and several one year CDs. She considers some of her CDs as emergency funds. These CDs should be categorized as liquid assets, because this is their intended use.

**Risk Tolerance**

We tend to think of certain products as having virtually no risk, such as certificates of deposit (CDs) held within Federal Deposit Insurance limits. However, risk exists in every product. The CD can contain purchasing power risk, for example. It is important to recognize that even safe products contain risk when discussing the most appropriate products for a customer. The customer may not recognize the risks involved in what are considered low-risk or safe products. Therefore, it is never appropriate to label a savings or investment product as risk-free or no-risk.

---

**Exhibit 1.2 Examples of Products Within Asset Classes**

The specific product selected for a customer within the liquid, growth or fixed class is impacted by the amount of risk and the types of risk the individual is willing to accept. Certain types of risk are generally acceptable to a customer, while others are not. Risk of principal and fluctuating returns may not be acceptable, for example to a retiree on a fixed income. The customer may instead require guarantees of principal and return, and be willing to accept purchasing power risk. In such a scenario, the products selected for each of the asset classes can vary significantly.
categories may be as much as possible FDIC insured, US treasury backed, or maybe even a product issued by a highly rated insurance company. Another customer may be more willing to accept the risk of losing principal and return fluctuations, and less willing to accept purchasing power risk. This person would use securities rather than guaranteed products in the liquid, growth and fixed classes in her portfolio.

**Investment Experience**

Risk tolerance and investment experience are often related. For example, if an individual made a first time foray into mutual funds, and had a bad experience, he or she is unlikely to want to make the venture again.

Investment experience is also a *reflection* of risk tolerance. If an individual indicates during the profiling process she is willing to accept day-to-day fluctuation in principal, yet her existing and previous investments are and have been solely in fixed CDs, the representative assisting the customer will want to ask a few more probing questions to ensure a complete understanding of her true risk tolerance. Actual investment experience should always be used to ensure the accuracy of answers given to risk tolerance related questions.

**Investment Horizon**

Besides classing products by use, asset allocation tools incorporate the individual’s investment horizon for portfolio assets. What is the length of time until the money invested will be used? This period of time is known as the investment horizon. For the purposes of this manual, a short-term investment horizon is 5 years or less, and a long-term horizon is anything over 5 years. If money is being saved for ten-year old Becky’s college education, the investment horizon is eight years, when Becky will be eighteen and attending college. Generally, the more aggressive the product, i.e., the more risks associated with the product, the longer the investment horizon should be to ride the ups and downs of return.

**Savings Goals and Investment Horizon**

The use of the product is considered to determine if an asset in an individual’s portfolio is long-term or short-term. Again, using CDs as an example, is a six-month CD short-term or long-term? In terms of its maturity date, it is short term. But what if the CD is not liquidated but is rolled over every six months for ten years? Clearly, in this case, a short-term product is being used for a long-term purpose.

The savings goals and investment time frames of goals help pinpoint the asset class of existing products, and identify which asset classes should be used in the optimal mix. For example, if a customer is in retirement and using investment income to live on, his savings goal is often income, while retaining principal.
This person’s asset allocation mix, depending on the characteristics of his risk tolerance, may have little money in the equity or growth asset class. His goals are immediate income, not future growth. On the other hand, a well-to-do individual in her thirties, saving for the college education of her children and for her own retirement, may have little money in the fixed asset class and much more in the equities or growth class. Her savings goals and time frames are growth oriented and in the somewhat distant future.

**Optimal Portfolio Mix**

Once the data related to risk tolerance, investment experience, current products held, savings goals and time frames is collected, the asset allocation mix can be derived. Many tools, from worksheets to detailed computer models, are available to determine an optimal asset allocation mix.

How should an asset allocation tool be selected? Below are a few questions to consider when determining the viability of an asset allocation tool:

- Is the model or tool based on well-accepted principles of financial planning?
- Can the model be used for a very aggressive customer as well as a very conservative one?
- Are sufficient questions asked to ensure that the customer’s true financial picture is completed?
- Do the results of the model provide more than one option with similar risks within a class? Or are the results heavily skewed toward one type of product, e.g. only mutual funds or only life insurance?
- Is the tool easy to understand? Can the customer understand its recommendations?
- Are reasonable rates of return used, if illustrations are part of the model? Are sufficient disclosures used?
- Does the tool allow tailoring for the individual’s customer’s needs, or are many assumptions made for the customer?

An asset allocation tool or model should be flexible, recommend more than one product to meet the needs of the customer, take into account the risk tolerance and investment experience of the customer, require sufficiently detailed financial information to make a recommendation, be easy to understand, and allow for personal decision making by the customer. If illustrations are used as part of the process, they should use reasonable rates of returns and all required accompanying disclosures should be provided to the customer.

**Asset Allocation Programs**

As mentioned at the beginning of this chapter, asset allocation is sometimes used to refer to a specific program offered within a product, or by a product provider.
Many mutual funds and variable annuities offer asset allocation programs, or an asset allocation fund or sub-account.

In an asset allocation program offered by a mutual fund or variable annuity, normally a bond, equity and money market fund or sub-account are used as the asset allocation vehicles. Periodically, perhaps once a quarter, the asset allocation committee will meet and determine the best percentage allocation for a portfolio to diversify against market and interest rate risks. For example, the asset allocation mix could be 60% in the equity fund, 35% in the fixed income or bond fund, and 5% in cash or the money market fund. If a client had signed up for the asset allocation program with the fund, the fund would automatically allocate the investments in the appropriate funds to meet the suggested asset allocation mix. The asset allocation may not be changed every time the committee meets. Or the asset allocation committee may meet as needed and may make a change when market conditions indicate, rather than on a calendar quarter.

It is important to note that a potential negative of such a program within a mutual fund is that moving shares from fund to fund within a mutual fund involves liquidating shares, and therefore causes potential capital gains, and subsequent taxation. If this is a concern, some funds have a history of relatively few asset allocation movements, e.g. annually or semi-annually. Variable annuities are tax-deferred, so the moving of units from sub-account to sub-account is not a taxable transaction. Another alternative for a client interested in this type of asset allocation program is the use of a single fund or sub-account, similar to a balanced fund, which is managed as an asset allocation fund.

The methods of determining the asset allocation mix vary from fund to fund or company to company. Some companies use sophisticated computer programs; others rely on the analytical skills of the managers.

An asset allocation program or fund should not be confused with an overall asset allocation strategy for a particular client. These programs can be used in conjunction with the overall optimum asset allocation plan for a client, and may be found to be a suitable component of a portfolio through the customer profiling process. They are not a one-size fits all answer, and do not replace the important fact finding process and ongoing consultation with the customer that an effective asset allocation plan demands.

**Tax Rules Affecting Stocks and Mutual Funds**

Capital gains can result from a shareholder selling shares or from a fund selling assets within the fund. Capital losses may be used to offset capital gains.

Capital gains and losses may be either long-term or short-term. A short-term gain or loss is one which occurs when property held for one year or less is sold. A long-term gain or loss arises from property held over a year.
The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the capital gains tax rates. Long-term capital gains that occurred prior to May 6, 2003, were taxed at a maximum rate of 20%. Under the provisions of the 2003 Act, such capital gains were taxed at a maximum of 15%. For those in a 10% or 15% tax bracket, these capital gains were taxed at a maximum rate of 5% through 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended the 15% capital gains rate for those in a tax bracket of 25% or above through 2010, and applied a capital gains rate of 0% for those in the tax brackets of 10% and 15% from 2008 through 2010. The maximum tax rate was increased to 20% in 2013, due to provisions in the American Taxpayer Relief Act of 2012, but not many taxpayers are impacted by the highest rate.

Effective in 2013, a “net investment tax” applies to capital gains included in income. The IRS issued a final guidance on the application of this tax on November 26, 2013. The net investment tax applies at a rate of 3.8% for taxpayers with income above threshold amounts. These threshold amounts are set by statutory law and not subject to adjustment for inflation:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Threshold Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly</td>
<td>$250,000</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$125,000</td>
</tr>
<tr>
<td>Single</td>
<td>$200,000</td>
</tr>
<tr>
<td>Head of household with qualifying person</td>
<td>$200,000</td>
</tr>
<tr>
<td>Qualifying widow(er) with dependent child</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Short-term capital gains from a fund’s assets are treated as dividends for income tax purposes. Therefore, they are generally taxed as ordinary income. However, under the provisions of the 2003 Act, some of the ordinary income may include dividends (called qualified dividends) that qualify for preferential tax treatment, with a maximum tax rate of 15% and a minimum tax rate of 0%. The Tax Reform, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010) extended the 0% to 15% tax treatment of qualified dividends through 2012. The American Taxpayer Relief Act of 2012 (ATRA 2012) made this 0% to 15% tax rates permanent for qualified dividends paid to:

• individual taxpayers with taxable income below $400,000; and
• joint taxpayers with taxable income below $450,000.

These dividends, other than those subject to the permanent 0% to 15% rate, are now subject to a maximum tax rate of 20%. Each mutual fund company will report to its shareholders the type of distributions that it has made and the corresponding tax information on a 1099-DIV.
Maximum Long-Term Capital Gains and Qualified Dividends Rates

<table>
<thead>
<tr>
<th>Rate</th>
<th>Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>If taxable income falls in the 10% or 15% marginal tax brackets</td>
</tr>
<tr>
<td>15%</td>
<td>If taxable income falls in the 25%, 28%, 33%, or 35% marginal tax brackets</td>
</tr>
<tr>
<td>20%</td>
<td>If taxable income falls in the 39.6% marginal tax bracket</td>
</tr>
<tr>
<td>28%</td>
<td>On collectibles</td>
</tr>
<tr>
<td>28%</td>
<td>On qualified small business stock after exclusions</td>
</tr>
</tbody>
</table>

Note that the 20% maximum tax rate for higher income individuals effectively becomes 23.8% due to the net investment tax. (See IRS Publication 550 for more information on qualified dividends, qualified small business stocks and other capital gains issues.)

Qualified Dividends

Qualified dividends are ordinary dividends subject to the same 0%, 15% or 20% maximum tax rate that applies to net capital gain. They should be shown in box 1b of the Form 1099-DIV you receive.

The maximum rate of tax on qualified dividends is:
0% on any amount that otherwise would be taxed at a 10% or 15% rate.
15% on any amount that otherwise would be taxed at rates greater than 15% but less than 39.6%
20% on any amount that otherwise would be taxed at a 39.6% rate.

To qualify for the maximum rate, all of the following requirements must be met.

- The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
- The dividends are not of the type listed later under Dividends that are not qualified dividends.
- You meet the holding period.

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it. See the examples later.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the previous paragraph applies.

Example
You bought 10,000 shares of ABC Mutual Fund common stock on July 9, 2013. ABC Mutual Fund paid a cash dividend of 10 cents a share. The ex-dividend date was July 16, 2015. The ABC Mutual Fund advises you that the portion of the dividend eligible to be
treated as qualified dividends equals 2 cents per share. Your Form 1099-DIV from ABC Mutual Fund shows total ordinary dividends of $1,000 and qualified dividends of $200. However, you sold the 10,000 shares on August 12, 2015. You have no qualified dividends from ABC Mutual Fund because you held the ABC Mutual Fund stock for less than 61 days.

**Up Next**
The next three chapters will discuss the three asset classes and the products which are placed within them. Each product discussed is summarized in an *Asset Allocation Key*, which provides product characteristics, risks and uses at a glance.
Chapter One: Study Questions

Select the letter which best represents the correct answer.

1. Diversification can:
a) increase the return of an investment portfolio
b) reduce volatility in an investment portfolio
c) both a and b

Match the definition to the type of risk by placing the correct letter next to the risk type.

_____2. market risk
_____3. interest rate risk
_____4. purchasing power risk
_____5. default or financial risk

a. the risk that a product will not increase in value to keep pace with or beat inflation.
b. the risk of price fluctuation due to competition, weather, industry financial difficulties, etc.
c. the risk that a change in interest rates will affect a security’s price.
d. the risk that the issuing entity of a security will be financially unable to meet its obligations.

6. Which of the following is not a goal of an asset allocation plan?
a) Place assets in products which yield a high return.
b) Maximize return by placing assets in products which match the risk tolerance of the customer.
c) Place the appropriate amount of assets in the liquid class to meet short term and emergency needs.
d) Reduce volatility in the portfolio by placing non-liquid assets in the appropriate mix of fixed and growth products.

7. True or False
Short-term products should never be used to fulfill long-term savings needs.______

8. Risk tolerance is often related to ___________________ _____________

9. True or False
Investing in an asset allocation mutual fund cannot take the place of the important fact finding process and ongoing consultation with the customer an effective asset allocation plan demands.______
10. The products in the fixed asset class are typically subject to _________ and ______ - ______ risks. The predominant risk of products within the growth asset class is ________________ risk.
Chapter Two: The Liquid Asset Class

A portion of a portfolio should be placed in liquid products. *Liquid* products or assets are those which are cash, or can be easily converted to cash. Liquid assets include short-term certificates of deposit, checking and savings accounts, money market accounts and money market funds. Besides the commonality of easy conversion to cash, these products also share the characteristics of relatively low market and default risks, and relatively low return.

**How Much Of A Portfolio Should Be In Liquid Assets?**

Ideally, the maximum amount of a portfolio placed in liquid assets is the amount needed to cover emergencies and short term spending needs. Any amount over this ideal amount can be placed in the other asset categories to earn higher returns and meet income or growth needs.

The specific amount to be placed in this category, like all other asset categories, is impacted by the relative conservatism, age, income level, and experience of the individual. For example, the determination of the amount needed for emergencies varies based on the perception of the individual, on the likelihood of an emergency, his age, his current circumstances (employed, unemployed, retired), the income he needs to live on, and his experience. Experts have traditionally suggested that an amount equivalent to three months of living expenses should be set aside for emergencies. In today’s more volatile, less secure job environment, some experts are now suggesting an amount equal to six months of income as a more realistic figure. Which amount is better? It depends on the individual and his or her situation.

For the older or retired client, the prospect of a health-related emergency may impact her ideal liquid asset amount, along with short-term plans to travel, and other retirement related expenditures. If this client has a history of health problems, or has a spouse with one, the amount this individual needs in liquid assets may be significantly higher than the amount a healthy retiree with no history of health problems will need. The key is to be realistic. The individual should be encouraged to think about fixed expenses, probable home repairs, medical expenses, short-term recreation plans, stability of employment, and debts in making this decision.

**Determining Liquidity Amounts with an Asset Allocation Model**

Assume that after a complete customer profile and asset allocation model is completed, the optimal mix derived is 10% in liquid assets, 60% in fixed assets and 30% in growth assets. This model assumes that the individual’s actual liquidity needs will equal 10% of his or her entire portfolio, and that the individual has assets enough after meeting liquidity requirements to allocate to the other categories the amounts of 60% and 30%, respectively. The weakness in this assumption is that liquidity needs actually should be determined independently. Then the remaining assets should be allocated based on the asset allocation.
mix. In other words, realistic liquid asset amounts should not be sacrificed in order to meet an asset allocation model. Determine the liquid asset needs first, then use the suggested percentages from the asset allocation model to allocate the remaining assets to meet the needs of growth and income. If the model portfolio percentages cannot be immediately met, establish a plan to meet them over time.

For example, Client A has total invested assets of $50,000. His ideal asset allocation investment portfolio, based on profiling, is 10% liquid, 31% fixed and 59% growth. However, the customer does not feel that $5,000 is enough to cover his liquidity needs, but rather, due to his expense levels, $10,000 is needed. The remaining $40,000 can be split between the fixed and growth categories to closely match the percentages recommended, and as more assets are added to the portfolio, the growth and fixed categories can be added to in order to meet the optimal asset allocation model over time. On the other hand, another customer, Client B who has the same recommended portfolio mix, has $300,000 in invested assets and feels $30,000 is plenty for her liquidity needs. She can immediately meet her optimal model asset allocation percentages.

In summary, it is important that a customer not have to take an annuity surrender charge penalty or liquidate mutual fund shares at the bottom of the market in order to pay for a refrigerator to be repaired. The customer must have sufficient liquid assets to meet short-term and emergency expenditures.

How Much Is Too Much?
On the other side of determining the appropriate amount of liquid assets is the overly conservative customer, who places too much in the liquid asset category. This customer will profit by understanding the amount of potential return and utility he is losing by keeping unnecessary amounts in liquid vehicles.

Liquid Asset Vehicles
Liquidity needs are traditionally met in two ways: placing money in products such as savings and checking accounts or money market accounts, or placing money in short-term products such as short-term CDs or Treasury bills and notes.

Short Term Certificates of Deposit
Short-term CDs are CDs with a maturity of five years or less. Short-term CDs are typically issued in thirty, sixty, 180, 270 day maturities, as well as one, two, three, four and five year periods. The minimum deposit to open varies from as little as $50 to as much as $10,000 or more. At the end of the CD period, the customer may liquidate the account or roll the CD over. Rolling a CD means to reinvest in another CD, either of the same or different maturity period.

The issuers of CDs have created new varieties in an effort to compete with mutual funds and other products into which a more sophisticated public is now investing. CDs today may offer variable rates, rates tied to indices such as ninety day Treasuries, and may allow a limited number of withdrawals, besides the ability to withdraw interest.
Risk Characteristics
Certificates of deposit are issued by banks and savings institutions. They are typically backed by the Federal Deposit Insurance Corporation (FDIC), up to $250,000 per account registration. (For the purposes of this manual, we will assume bank accounts are purchased from institutions covered by FDIC insurance.) Certificates of deposit insured by the FDIC are considered to have a very low risk of loss of principal, or default risk because the insurance funds used by the FDIC are backed by the full faith and credit of the US government.

CDs may be fixed or variable rate. Even variable rate CDs have low volatility when general market interest rates change.

The major risk which may be present in a CD investment, is purchasing power risk. CDs may not keep up with the rate of inflation over time.

Uses of Short-Term CDs
Short-term CDs may be used as a liquid investment to meet emergency expenses, planned recreation or other short-term savings needs. Or, they may be used by an individual with a long-term investment horizon, but who does not have the confidence that rates will be stable, or that rates will go down, over his investment period. Investing in a short-term CD mitigates the risk that rates may go up during the term of the CD. When a longer term CD is purchased and rates go up, the holder must either forego higher returns or pay an early withdrawal penalty in order to get out of the longer term CD. The purchaser of a short-term CD for long-term purposes sacrifices some potential return for this conservative strategy.

In the past, banks and particularly thrifts or savings and loans offered a rate on short-term CDs that was consistently and substantially lower than the rate for longer term CDs. These institutions had fifteen and thirty year fixed mortgages they held and the long term CDs were good liability matches for these mortgages. This changed when CD rates were forced

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### Federal Deposit Insurance Corporation Insurance

- Single Accounts (Owned by One Person) $250,000 per owner
- Joint Accounts (Owned by Two or More Persons) $250,000 per co-owner
- Certain Retirement Accounts (Includes IRAs) $250,000 per owner
- Revocable Trust Accounts $250,000 per owner per unique beneficiary
- Corporation, Partnership and Unincorporated Association Accounts $250,000 per corporation, partnership or unincorporated association
- Irrevocable Trust Accounts $250,000 for the noncontingent interest of each unique beneficiary
- Employee Benefit Plan Accounts $250,000 for the noncontingent interest of each plan participant
- Government Accounts $250,000 per official custodian

[more coverage available subject to specific conditions]

[https://www.fdic.gov/deposit/deposits/brochures/deposit_insurance_at_a_glance-english.html](https://www.fdic.gov/deposit/deposits/brochures/deposit_insurance_at_a_glance-english.html)
higher than the fixed loans the savings and loans held, loan competition grew more fierce and a healthy secondary mortgage market emerged. The banks were not always interested in the long-term commitment of a relatively high rate, long-term CD. Rather, they began to offer rates on shorter term CDs that sometimes were and are within a few basis points of longer term CDs. This is another reason people may use a short term CD for a long-term purpose. The return benefit for locking in a long rate may not be viewed as sufficient for bearing the risk that rates may go up while the long-term CD is held.

CDs may be used to generate income for the owner. Many CDs allow interest to be paid out monthly, quarterly, semi-annually or annually. This can be an important feature for the purchaser on a fixed income, who uses CD interest to meet living expenses.

**Investment Horizon**

By definition, liquid assets are short-term assets. It is possible, however, that short-term CDs could be part of a longer-term investment horizon, if the CD is rolled over to a new CD or CDs.

**Tax Considerations**

Earnings on CDs are generally taxed as ordinary income. If a CD is jointly owned, the interest earned is considered to be owned by both persons for federal income tax purposes, unless local laws state otherwise.

**Advantages of Short-Term CDs as a Liquid Asset**

- FDIC backing
- Availability of fixed, known returns
- Variety of maturities available
- Often, small minimum balance requirements
- Ability to draw interest income

**Disadvantages of Short-Term CDs as Liquid Asset**

- Relatively low returns
- Penalty for early withdrawal, often loss of interest earned
- Money cannot typically be added to a CD

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**Checking Accounts**

Checking accounts may be interest-bearing or non-interest bearing accounts. If they are interest bearing, they normally require a certain minimum balance, commonly $1000, and
pay a relatively low rate of return, often two to four basis points lower than money market funds.

Checking accounts often charge fees. In an interest bearing account, a fee may be charged if the balance drop below a certain point, or checks are written in numbers exceeding the monthly maximum amount. Non-interest bearing checks also usually include fees. The current trend is toward increasing fees, including for the use of Automatic Teller Machines (ATMs) used to withdraw cash from an account. Fees can significantly erode return on an interest bearing checking account.

**Risk Characteristics**

Like other bank deposit accounts, checking accounts can be backed by the FDIC. Therefore, as long as they are within the coverage limits of FDIC insurance, the risk of principal is considered to be virtually nonexistent.

Checking accounts either earn little or no return, so their greatest risk, like that of CDs, is purchasing power risk.

**Uses of Checking Accounts**

The only use of a checking account in an investment portfolio is obviously to hold liquid assets. Because other vehicles within the liquid asset product group can provide higher returns, only a limited amount of cash should be held in a checking account.

Checking accounts can include many features which may be of use to a customer: check guarantee, overdraft protection, the use of a low fee debit or credit card perhaps even with a frequent shopper bonus. Everyone needs a checking account, but as part of an investment portfolio, its use is solely as a place to hold liquid assets. All the bells and whistles may add functionality to a checking account, but little or no return. To maximize returns in the portfolio, the checking account selected should provide the needed services with the lowest possible fees and highest possible interest, if any. The customer should be encouraged to keep enough in the account to avoid fees, and place other liquid assets in instruments such as CDs, savings accounts or money market funds.

**Investment Horizon**

A checking account can scarcely be considered an investment. It is a holding vehicle for liquid assets. It has no investment horizon.

**Tax Considerations**

Interest from a checking account is treated as ordinary income in the tax year it is received.

**Advantages of Checking Accounts**

- Immediate access to cash
- FDIC backing
- Money can be added at any time
- Extra services, such as a check guarantee card
Disadvantages of Checking Accounts

- Low or no return
- Potential Fees

<table>
<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checking Accounts</td>
</tr>
<tr>
<td>Liquidity: High</td>
</tr>
<tr>
<td>Investment Horizon: Immediate</td>
</tr>
<tr>
<td>Tax Advantaged: No</td>
</tr>
<tr>
<td>Uses: Holding vehicle for liquid assets</td>
</tr>
<tr>
<td>Primary Risks: Purchasing Power</td>
</tr>
<tr>
<td>Return: Fixed or Variable</td>
</tr>
<tr>
<td>Income: Completely Liquid</td>
</tr>
<tr>
<td>Asset Class: Liquid</td>
</tr>
</tbody>
</table>

Savings Accounts

Savings accounts differ from certificates of deposit in that there is no specified period in which moneys must be held in a savings account. Savings accounts are different from CDs because if money other than interest is withdrawn prior to maturity from a CD, a penalty is applied. Savings accounts are completely liquid, and money may be added or withdrawn at any time to a savings account. There may be fees associated with savings accounts if a certain minimum balance is not met, or if a certain number of withdrawals are made, especially through an ATM.

For years the typical savings account, the *passbook* account paid a rate of 5%. But when rates tumbled in the 80’s, the 5½% rate was done away with. Today, savings accounts earn a fixed rate, but the actual percentage varies from bank to bank.

Risk Characteristics

Like other bank accounts, FDIC guarantees equate to no loss of principal risk. Low returns cause the presence of purchasing power risk, however.

Uses of Savings Accounts

Savings accounts can be used to hold money which will be needed in the near term and which does not need to be held in a checking account. CDs typically pay higher rates than a savings account. If a choice had to be made between the use of a CD or a savings account, the CD’s return would make it a better option, as long as immediate access to the cash is not needed and therefore the application of the early withdrawal CD penalty is unlikely.

Investment Horizon

Savings accounts allow immediate access, so the investment horizon can be virtually any time frame. Like checking accounts, return is quite low. The length of time any money is kept in a savings account that could be invested in higher returning products should be minimal.
Tax Considerations
Savings accounts are taxed in the same way as certificates of deposit. Interest earned is taxed as ordinary income.

Advantages of Savings Accounts
• FDIC guarantee
• Immediate access to cash

Disadvantages of Savings Accounts
• Low return
• Potential fees

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Money Market Funds and Money Market Accounts
Money market funds are securities products, offered through mutual fund companies. They typically invest in short-term liquid vehicles and short-term commercial instruments like CDs, bankers’ acceptances, commercial paper, and short-term municipal securities. Money market funds have minimums ranging from $50 to $5000, and may offer limited check writing privileges. Money market funds do not charge a sales load.

A money market account (MMA) is offered through a bank or savings institution. It is a deposit account which can be backed by FDIC insurance. Financial institutions advertise market rates of interest on the accounts, although these accounts may pay returns of around two percent or more below those of money market funds.

MMAs usually require a minimum balance of $1000 which must be maintained to avoid a service charge. There are a restricted number of withdrawals allowed, per federal regulation, on this type of bank account. Although this account has many features of a money market fund, it is not a securities product.

Risk Characteristics
Money market accounts are FDIC insured. Therefore, loss of principal through default is protected within FDIC limits. They pay a variable rate, so there is a risk of principal fluctuation due to market and interest rate risks. Their return may be low enough to invite purchasing power risk as well.

Money market funds are not guaranteed in terms of principal or return. Money market funds are managed with the objective of keeping the value of each share at $1.00, thereby
resulting in stable principal, but there is no guarantee that each $1.00 placed in a money market fund will be worth $1.00 while it remains in the fund. Despite this risk, money market funds are considered stable, conservative products, because the likelihood is very low that share values will go below $1.00 and therefore principal would be lost. The securities regulators are imposing stricter standards on the assets permitted in a money market fund. These stricter policies should only increase the stability of money market fund share values.

As with other liquid bank investments, purchasing power risk is inherent in money market accounts. Money market funds are not as subject to this type of risk, since they more directly reflect current market security returns, which tend to go up with inflation. However, as a short-term security, there is still purchasing power risk present.

**Uses of Money Market Funds and Money Market Accounts**

Money market accounts and money market funds are liquid accounts. The money market fund may be more flexible in its withdrawal terms, since its withdrawals are not regulated in the same way as the money market accounts. But if only a few withdrawals will be made monthly, and if checks may be drawn on the money market fund, both accounts are equal in liquidity. If checks may not be drawn on the money market fund, there may be a delay of a week or so, including mailing time, in receiving a withdrawal because the fund will have to process the withdrawal request and mail the check to the owner(s). Some funds have direct deposit programs, where withdrawals can be wired to a bank account if appropriate paperwork is completed.

**Dollar Cost Averaging**

Money market funds may be used as part of a dollar cost averaging program. Dollar cost averaging is a strategy used to reduce the impact of market fluctuations on the value of a portfolio. It involves investing a fixed amount of money on a regular basis, e.g. monthly or quarterly, into a mutual fund (or mutual funds). When prices are high, the investment purchases fewer shares, and when prices are low, the investment purchases more shares. This method often results in the average price per share being lower than if all shares were purchased at once or at random over the same period that dollar cost averaging is used. It is not a fail-safe method of reducing share price. If a stock goes into a long period of declining share value, for example, dollar cost averaging will not provide a hedge against loss. However, if a stock follows the historical up and downs of the market, over a four to six year period, dollar cost averaging can provide a method of purchasing shares at a lower price per share than the average price per share during the same period.

Dollar cost averaging is not for the client who does not intend to hold shares. It is a strategy for a *buy and hold* customer who will ride the markets ups and downs to take advantage of the benefits of dollar cost averaging.

**Types of Money Market Funds**

Money market funds come in a variety of forms and can meet different needs and risk tolerances. There are tax-exempt, international, and US Treasury money market funds, to name a few. Each invests in slightly different short-term vehicles. Tax-exempt money market funds, whose dividends are exempt from federal income taxation, invest in municipal...
bond securities. US Treasury money market funds invest in US Treasury securities, and international money market funds place money in short term securities issued around the world. Each of these money market funds can have slightly different levels of risk.

**Investment Horizon**

Liquid products may be used on either a short-term or long-term basis, as was stated within the discussion on CDs. MMAs or money market funds may be used to hold cash that will be used in a short period of time, such as the proceeds from selling a house which will be used shortly to purchase a new home. The liquidity feature is important when money may be needed on short notice. Or, money may be held in a money market account or fund for years, held there to pay for an emergency which, perhaps, never occurs.

**Tax Considerations**

Money market accounts are taxed like other bank deposit accounts and earnings are taxed as ordinary income.

Typically, money market funds have two types of earnings which can be taxed: taxable dividends and tax-exempt dividends. Tax-exempt dividends are those resulting from a municipal security. If a fund’s assets are at least 50% invested in federally tax exempt securities, the dividends resulting from these securities are federally income tax-exempt to the shareholder. The mutual fund will report the amount of tax-exempt dividends earned to each shareholder. Taxable dividends are all other dividends resulting from interest, dividends and short-term capital gains on a fund’s holdings. These are taxed as ordinary income or as qualified dividends in the tax year in which they are earned.

**Advantages of Money Market Accounts**

- FDIC insured, therefore principal is guaranteed within FDIC limits.
- Includes check writing privileges
- Immediate access to cash

**Disadvantages of Money Market Account**

- Relatively low returns, returns not necessarily guaranteed
- Possibility of fees eroding return
- Limits on the number of check written and withdrawals made
- Exposure to purchasing power risk

**Advantages of Money Market Funds**

- Market returns
- May have check writing privileges
- Immediate or near immediate access to cash
- Stable principal

**Disadvantages of Money Market Funds**

- Principal not guaranteed
- Return not guaranteed
- May have limited or no check writing privileges
**ASSET ALLOCATION KEY**

**Money Market Accounts**

- Liquidity: High
- Investment Horizon: Immediate
- Tax Advantage: No
- Uses: Holding vehicle for liquid assets, short term savings goals, emergencies

**Primary Risks:** Purchasing Power, Principal fluctuation
**Return:** Variable

**Income:** Completely Liquid
**Asset Class:** Liquid

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**ASSET ALLOCATION KEY**

**Money Market Funds**

- Liquidity: High
- Investment Horizon: Immediate
- Tax Advantage: Yes, if Tax-Exempt Fund
- Uses: Holding vehicle for liquid assets

**Primary Risks:** Market and Interest Rate
**Return:** Variable

**Income:** Completely Liquid
**Asset Class:** Liquid

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**Treasury Bills and Notes**

Treasury bills and notes are debt securities issued by the US Treasury. Purchasing one of these securities effectively lends money to the federal government. The Treasury promises to repay the debt by paying a specified amount or amounts on a specified date or specified dates.

**Treasury Bills**

Treasury bills have a maturity of one year or less. Typically they are issued with 4, 13, 26 or 52 week maturities. Treasury bills, or T-Bills, do not pay interest. Rather, they are issued at a discount, then at maturity pay face value. T-Bills are issued in multiples of $100, and are often purchased in $1,000, $10,000, $15,000, $100,000, $500,000 and $1 million amounts.

The Treasury auctions 4, 13 and 26 T-Bills weekly, normally on Mondays. 52-week T-Bills are auctioned every four weeks. The term *auction* is used because purchasers submit *bids* for the bills. The Treasury accepts the best (highest) bids submitted by a specific time on the auction date. Since each week a set dollar amount of bills are auctioned, if a bid is too low it may not be accepted.

Another form of T-Bill, the Cash Management Bill, is issued with variable terms, with a maturity of a only a matter of days. These are not auctioned by the Treasury.

Individual purchasers often submit a *non-competitive bid* for the bills. The price for a bill when a non-competitive bid is submitted is the average of the competitive bids accepted for a particular auction.
New issues of T-Bills may be purchased electronically through Treasury Direct, www.treasurydirect.gov, and from brokerage houses, from the federal reserve, and from some large banks who act as dealers. After issue, T-Bills are traded on the OTC. Commission on the trade is in the form of a mark-up which is reflected in the yield quoted on the bill.

Exhibit 2.1

<table>
<thead>
<tr>
<th>Bond Yield Calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Yield</strong></td>
</tr>
</tbody>
</table>
| The current yield calculation for a bond is the \( \text{annual interest} / \text{current bond price} \). For example, if $75 of interest is received and the bond’s current price is $1000, the current yield would be 7.5%: \( \frac{75}{1000} \).

| **Yield to Maturity**    |
| The yield to maturity reflects the impact of receiving interest payments over the life of the bond, followed by the receipt of the face value of the bond at maturity. The yield to maturity on a bond is different from the current yield if a bond is selling at a discount or premium. Assume five years after issue, a ten year $1000 bond with a 7.5% rate is now selling for $960. The yield to maturity for this now five year bond is 8.5%. This figure comes from a “bond yield table.” Bond yield tables (or more often today, computerized yield to maturity calculations) take into account the time value of money, the number of years to maturity, and the redemption of face value at maturity. Note that in this example that because rates in the market had risen since the bond was purchased, the bond is selling at a discount to yield the market rate of 8.5%.

Yield of Treasury Bills

The formula for calculating the yield on T-Bills which mature in 52 weeks is

\[ \text{The Face Value of the Bond} - \text{The Price of the Bond} / \text{The Price of the Bond} \]

For example, if the price of a $10,000 T-Bill is $9500, the calculation is

\[ \frac{10,000 - 9500}{9500}, \text{ or } 500/9500 = 5.26\% \]

If a T-Bill matures in less than 52 weeks, the calculation is:

\[ \text{The Face Value of the Bond} - \text{The Price of the Bond} / \text{The Price of the Bond divided by The Days To Maturity / 365 (the number of days in a year)} \]

If a $10,000 T-Bill matures in 26 weeks and has a price of $9800, the calculation is:

\[ \frac{200}{9800} \text{ divided by } 182/365 = \frac{0.0204}{499} = 4.09\% \]

Treasury Notes

Treasury notes are issued in multiples of $100 and often are purchased in denominations of $1000, $5000, $10,000, $100,000 and $1 million. They have maturity dates of 2, 3, 5, 7 and 10 years.

Unlike T-Bills which do not pay interest, Treasury notes pay a fixed amount of interest semi-annually.

Auctions are held for Treasury notes. Notes are bid for like bills, and can be purchased directly through treasurydirect.gov, or through a commercial bank or brokerage house. T-Notes can also be sold through treasurydirect.gov.
Risk Characteristics
Treasury notes and bills are issued by the US Treasury and backed by the full faith and credit of the federal government. The risk of default and therefore the likelihood of the inability to fulfill the terms of an issue is considered nearly nonexistent.

T-notes and bills, as debt securities are subject to interest rate risk, as described in Chapter One. If a T-bill or note is held to maturity, the impact of interest rates on price is not of much importance. The purchaser will be paid the face amount at maturity, not the price of notes or bills on the secondary market.

Short-term government securities have at times been at or below the inflation rate. Therefore, purchasing power risk can be present in these securities.

Uses of T-Bills and T-Notes
T-Bills are used to hold funds which may be used for emergencies or short-term savings needs. Or, they may be used as an alternative to a longer term product for a purchaser without confidence in the longer-term rate market. Short-term T-Notes may also be used for these purposes, and have the added feature of semi-annual interest income. As mentioned earlier, income is often an important feature for the purchaser on a fixed income, as is the negligible risk of principal found in US Treasury securities.

Investment Horizon
T-Bills and T-Notes are used in the liquid asset category as short-term, guaranteed products, which can be converted to cash in the secondary market or redeemed by the Treasury at maturity. T-Notes may also be placed in the fixed category, discussed in the next chapter.

Tax Considerations
Generally, interest from T-Notes is exempt from local and state income taxation. Ordinary income resulting from T-Bills is also generally exempt at the state and local levels. Gains and losses resulting from the sale or exchange of a T-Bill or note are taxed as long term capital gains or losses when they are the result of holding the security for over one year. Gains and losses are treated as ordinary income or loss if the security is held for shorter periods.

Advantages of T-Bills and Notes
• Principal is returned at maturity
• T-Notes provide regular income
• Return is guaranteed by the US Treasury if held to maturity

Disadvantages of T-Bills and Notes
• If sold prior to maturity, subject to interest rate risk

| ASSET ALLOCATION KEY |
| T-BILLS AND SHORT TERM T-NOTES |
| --- | --- |
| Liquidity: High | Primary Risks: Interest Rate |
| Investment Horizon: T-Bills- one year or less. T-Notes - over one year to ten | Return: Fixed or Variable |
| Income: T-Notes - Yes | }
years
Tax Advantaged: May be at the state and local level

Asset Class: Liquid or Fixed
Uses: Short-term savings goals, emergencies
Chapter Two: Study Questions

1. Define liquid assets:

Which risks are primary risks of the following products? Place the letters of applicable risks in the blank next to the product names below. More than one risk may apply.

a. market risk  
b. interest rate risk  
c. default or financial risk  
d. purchasing power risk

2. FDIC insured short-term CDs. ______
3. FDIC insured checking accounts ______
4. Money market funds ______
5. FDIC insured money market accounts ______
6. T-Bills ______

Match the investment horizon with the following products. Place the letter of the applicable time period next to the product names below.

a. no investment horizon  
b. 3 mos. to 5 years  
c. one year or less  
d. over one year to ten years

7. T-Notes ______
8. Short-Term CDs ______
9. T-Bills ______
10. Checking accounts ______
Chapter Three: The Fixed Asset Class

The fixed asset category is often seen as an asset class with fewer risks than those in the equity class. Actually, it is a class with different risks than the equity class. The fixed class contains many products which have the predominant risks of interest rate and default. The equity class contains products whose predominant risk is market risk. Asset allocation calls for placing assets in products with different predominant risks, because they will behave differently over time as various circumstances arise, take aim and fire at the returns in the portfolio. For example, if interest rates fall, some of the products in the fixed asset class will respond by increasing in price. If interest rates increase, some of the products in the fixed asset class will respond by also offering higher rates. Interest changes also impact equities, but more indirectly. They are foremost impacted by market risk, as will be discussed in the next chapter.

Products commonly included in the fixed asset class are fixed annuities, US Savings Bonds, Long-Term CDs, Life Insurance Guaranteed Cash Values, Treasury, Municipal and Corporate Bonds, Bond Mutual Funds, and Variable Annuity, Variable Life and Variable Universal Life Bond Sub-Accounts. The unifying characteristic of all these products is that they offer stable or fixed returns, and may provide income.

US Savings Bonds

US Savings Bonds are securities issued by the US Treasury. Three types of savings bonds are currently available, Series EE, Series HH and Series I. Series EE and I savings bonds accrue interest which is paid at maturity or when the bonds are liquidated. Series HH bonds pay income semi-annually.

Series EE and I Savings Bonds

Series EE and I bonds can be purchased in denominations from $25 to $10,000. Electronic EE and I bonds can be purchased in any amount above $25, up to $10,000. A purchaser can buy an EE bond for $76.42, for example, or for $6,234.55. The purchase price of Electronic EE and I bonds is equal to the face amount. Both Series EE and I bonds earn a rate based upon 5-year treasury securities.

Series EE and I bonds have a final maturity date of thirty years from issue. From time of purchase through final maturity, interest accrues. Upon final maturity, no further interest accrues.
Some employers offer Electronic Series EE and I bonds through a Payroll Savings Plan. Electronic EE and I bonds can be purchased directly through treasurydirect.gov. Paper Series EE and I bonds can be redeemed at most financial institutions, or by mail to the Federal Reserve in Minneapolis, MN. Electronic Series EE and I bonds are purchased and sold through treasurydirect.gov. Series EE and I bonds can be redeemed any time after twelve months from issue. No paper EE bonds are issued anymore, but paper I bonds may be purchased with a tax refund. When bonds are purchased as gifts, the purchaser registers them in a manner that allows the purchaser to redeem them.

Interest is earned monthly and compounded semiannually. If the bond is cashed in prior to five years from issue, three months of interest is lost.

**Series HH Bonds**

Series HH bonds were issued in denominations of $500, $1000, $5000 and $10,000. They were purchased in exchange for Series E bonds, which were the predecessors of Series EE bonds, or in exchange for Series EE bonds. The major advantage in doing so was to defer taxation of accrued interest of a Series E or EE bond. They were issued last in 2004, with a 20 year maturity date. Series HH bonds pay interest semiannually. It is paid electronically to a designated bank, savings, or other financial institution account.

**Risk Characteristics**

As issues of the US Treasury, savings bonds are backed by the full faith and credit of the US Government. Therefore, default risk is considered to be zero, and principal and accrued interest is guaranteed. Since they are redeemed by the US Treasury, and not sold on the secondary market, there is no market risk. Returns are variable on Series E and I bonds, and could be low enough to expose the owner to purchasing power risk.

**Uses of Savings Bonds**

Savings bonds can be used as a conservative savings program through the Payroll Savings Plan, or by purchase through treasurydirect.gov. Under the Payroll Savings Plan, money is deducted, after tax, from salary and converted to Series EE or I bonds in denominations of $25 or greater. Because money is deducted from salary, the Payroll Savings Plan offers a kind of forced savings program for the willing participant.

Both Series EE and I bonds can be used to pay for college tuition. A tax-break may be available when the bonds are used for this purpose, under specific conditions. Basically, if a bond owner has an adjusted gross income under a specified amount, interest on these bonds cashed may be excluded from federal income tax. The bond owner must be at least age 24 by the first day of the month
is which the bonds were purchased and the bond owner must be paying for educational expenses for himself, or his spouse or dependents. Educational expenses do not include room, board, nor books.

In 2015 purchasers may buy up to $20,000 in Electronic EE and I savings bonds, and up to $5,000 paper I bonds through a tax refund. The adjusted gross income of a single bond owner must be under $92,200 in 2015 under this program. A married couple filing jointly qualifies if adjusted gross income is under $145,750. Married couples filing separately do not qualify for this exclusion.

**Investment Horizon**

Series EE and I bonds may be redeemed anytime from twelve months to thirty years or later from purchase. They are generally used as long-term savings tools. Series HH bonds have a maturity of twenty years.

**Tax Considerations**

Interest on Series EE and I bonds is not taxable until the earlier of the date it is redeemed or the bond’s final maturity date. The interest is taxable at final maturity whether the bond is redeemed or not. A bond owner may elect to pay taxes on the accrued interest annually.

Series HH interest is taxable as income when paid.

**Advantages of Savings Bonds**

- Backed by the full faith and credit of the US government.
- Series EE and I interest is tax-deferred until bonds are redeemed, final maturity.
- Series HH bonds is taxable for the tax year in which it is received.
- Interest may be excluded from federal income tax to pay for college tuition, under certain circumstances
- Regular savings plan is available through some employers

**Disadvantages of Savings Bonds**

- Relatively low returns and susceptibility to purchasing power risk
- Loss of accrued interest if bonds are redeemed between interest add dates

<table>
<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Savings Bonds</strong></td>
</tr>
<tr>
<td>Liquidity: High</td>
</tr>
<tr>
<td>Investment Horizon: Twelve months to thirty years, twenty years in HH bonds.</td>
</tr>
<tr>
<td>Primary Risks: Purchasing Power</td>
</tr>
<tr>
<td>Return: EE and I bonds, Variable, HH bonds; Fixed</td>
</tr>
<tr>
<td>Tax Advantaged: Yes</td>
</tr>
<tr>
<td>Uses: Long term savings goals</td>
</tr>
<tr>
<td>Income: HH Bonds - Yes</td>
</tr>
<tr>
<td>Asset Class: Liquid or Fixed</td>
</tr>
</tbody>
</table>
Treasury Notes and Bonds

Treasury notes and bonds pay interest semi-annually and are issued in multiples of $100. Like savings bonds, they are backed by the full faith and credit of the US government. Upon maturity, the face amount of the bond is paid to the bondholder.

Treasuries may be purchased in electronic form only, through a broker a bank, or through treasurydirect.gov. They are redeemed at maturity by the US Treasury, and traded on the secondary market prior to maturity. As mentioned in the last chapter, Treasury notes have maturities of over one year up to ten years. Treasury bonds are issued with maturities of thirty years.

Risk Characteristics

Because these securities are issued by the federal government, they are considered as having nearly zero risk of default. As debt instruments, they are subject to interest rate risk. Interest rate risk is of particular significance with debt instruments issued by the US Government because it is the major risk of these instruments. Since risk determines price, and interest rate risk is the central risk in Treasury debt securities, a change in interest rate has a higher impact on the price of these securities than debt securities not issued by the US Treasury. Non-government bonds have other risks supporting their prices. As mentioned in the previous chapter, interest rate risk is of import if the Treasury security is not held until maturity, and is traded in the secondary market.

Treasury security returns have tended to follow the curve of inflation rates, with longer term Treasuries normally outpacing inflation, and shorter term Treasury securities being almost identical to the inflation rate in many years. Therefore, purchasing power risk is higher in short-term government securities than in longer term issues.

There is a type of Treasury security that has a return that is tied to the inflation rate, and so provides more protection against inflation rate risk than other types. These securities are known as Treasury Inflation-Protected Securities, or TIPS. TIPS are offered as 5-year, 10-year and 30-year securities, and pay interest every six months. They are considered best suited as retirement investments, so that taxation is governed by IRA rules. Non-IRA TIPS are taxed on both the interest paid out and the inflation adjustment on an annual basis. Traditional IRAs earn interest on a tax-deferred basis, and require taxes to be paid on the gain as withdrawals are made from the IRA.
Uses of Treasury Notes and Bonds

Treasury notes and bonds are often used by persons looking for fixed income and stable return. They are used by persons in retirement, and those nearing retirement, who have a high desire to conserve principal. They are also used by persons with a low tolerance for principal fluctuation who are saving for long-term goals, such as a college education or retirement, and as part of a well-allocated, diversified portfolio.

Investment Horizon

Treasury notes and bonds pay face amount upon maturity. In order to receive this stated return, the bond must be held to maturity. T-notes are issued in maturities of over one year to ten years. T-bonds have been issued in many different maturities, and are issued in maturities of thirty years today. Since T-notes and bonds are sold in the secondary market, the investment horizon could be virtually of any length. But because of interest rate risk, unless the Treasury security matures in the short-term, T-notes and bonds should be considered a long-term investment for the individual interested in a known return.

Tax Considerations

As mentioned in the last chapter, interest income from T-Notes is generally exempt from state and local income taxation. This is also true of T-Bond income. Short-term gains and losses are also treated as ordinary income.

Advantages of T-Notes and T-Bonds

• Risk of default considered to be negligible
• Interest income paid semi-annually
• Principal returned if held to maturity

Disadvantages of T-Notes and T-Bonds

• Interest rate changes can cause relatively significant changes in price.
• Subject to interest rate risk if sold in the secondary market.

<table>
<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Notes and Bonds</td>
</tr>
<tr>
<td>Liquidity: High</td>
</tr>
<tr>
<td>Investment Horizon: Over one year to thirty years.</td>
</tr>
<tr>
<td>Tax Advantaged: May be at the state and local levels</td>
</tr>
<tr>
<td>Uses: Long term savings goals, income</td>
</tr>
<tr>
<td>Primary Risks: Interest Rate Return: Fixed</td>
</tr>
<tr>
<td>Income: Yes</td>
</tr>
<tr>
<td>Asset Class: Fixed (Short Term T-Notes could be Liquid)</td>
</tr>
</tbody>
</table>
Long-Term Certificates of Deposit

Short-term CDs were discussed in the last chapter. Long-term CDs have all the same characteristics, except are issued in maturities of over five years.

Life Insurance Guaranteed Cash Values

Certain life insurance products provide guaranteed cash values. These values can be withdrawn, or can be accessed through policy loans. Policy loans can provide a tax benefit to the policy owner.

Policy types which provide guaranteed cash values are adjustable life policies, and all types of whole life, excluding variable life.

Policy Loans

By state statute or regulation, all life policies with cash values must allow policy loans. The amount of the loan cannot exceed the surrender value (taking into account interest on the loan) of the contract. If the loan is not repaid before the death of the insured, it will be deducted from the death proceeds paid by the insurance company to the policy beneficiaries.

Interest is charged on a policy loan as reimbursement to the insurance company for the gain the insurance company would have made on the money borrowed from the policy. Interest not paid by the policyowner while the loan is in force is paid by additional loans from the cash value, usually on an annual basis.

Policy loans are not treated as a distribution from the policy for tax purposes. Therefore, loans are not taxable to the owner, as a distribution could be. This tax treatment causes policy loans to be a popular feature, particularly when rates for other types of loans are higher than those of policy loans.

Distributions of Cash Value

The cash value of a policy may be distributed. Some policies allow partial distributions as well as full surrenders. If a full surrender is taken, the policy coverage ceases. The surrender value of a life policy, called the net surrender value, is equal to the total cash value in the policy, less any surrender charges and outstanding policy loans, plus any paid up additions accumulated dividends, and prepaid premium. A paid up addition is a dividend option in a participating policy, which is a policy wherein policyholders participate in the experience of the life insurance company, and can earn dividends if experience is favorable. Paid up additions purchase additional insurance coverage.

When cash values are withdrawn from whole life and adjustable life, the face amount of the policy, the amount paid at the insured’s death, generally is decreased proportionately. This is in contrast to the effect of a policy loan, which does not impact face value.
Distributions may be taxable to the policyowner. For policies issued in 1985 or later, distributions made within the first fifteen years of policy issue, which also cause a reduction in death benefit, are taxed as though gain is received first. Policy gain is taxable as income in the tax year received. If distributions are made later than fifteen years from issue, or from policies issued prior to 1985, the distribution is taxed under the cost-recovery first rule. Under this rule, the policyowner’s cost, or total premiums paid, in the policy is considered to be distributed first. Cost basis in the policy is not taxable when withdrawn, since it was made with after-tax dollars.

**Risk Characteristics of Life Insurance Guaranteed Cash Values**

Guaranteed life insurance cash values are guaranteed by the general assets of the insurance company. The risk of default of contractual obligations by an insurance company is generally low, although the late 1980’s and early 1990’s saw several insurance companies collapse, and others fall into financial trouble. Much of this financial instability was due to large investment in *junk bonds*, real estate and mortgages by the insurance company. Since then, many states have instituted specific standards regarding the amounts of various investments, including junk bonds, in which an insurance company should invest based on regulations developed by the National Association of Insurance Commissioners (NAIC).

**Life Insurance Rating Agencies**

Insurance companies are rated by a variety of rating agencies, such as A.M. Best, Standard & Poors Insurance Rating Services, Moody’s Investor Service, and Fitch Ratings. These ratings can give the customer the ability to use a third-party (someone outside of the insurance company and its agents) to help determine if the insurance company the customer is considering is a healthy one.

**A.M. Best Company, Best’s Insurance Reports**

Best’s Insurance Reports rate insurance companies on their ability to meet policyholder and contractual obligations. Company ratings range from a high of “A++” down to “F.”

**Standard & Poor’s Insurance Rating Services**

Standard & Poor’s rates the insurer’s claims paying ability. They rate subscribing companies (companies which pay a fee for the rating) from “AAA” to “D.” Non-subscriber ratings are from “BBBy” to “Bq.”

**Moody’s Investor Service Insurance Financial Strength Ratings**

Moody’s assigns ratings based on the overall financial strength of an insurance company, and therefore, the company’s ability to meet obligations to its policyholders. Moody’s highest rating is “Aaa” and its lowest “C.”
Fitch Ratings
Fitch assigns Insurer Financial Strength (IFS) ratings to insurers. These ratings represent an evaluation of the financial strength of an insurance organization. The rating is assigned based on the ability of the insurer to meet policyholder obligations on a timely basis as well as the expected recoveries received by claimants if the insurance company suspends payments due to the insurer’s failure or due to regulatory intervention. Long-term IFS ratings range from AAA, exceptionally strong to C, distressed.

Uses of Life Insurance Guaranteed Cash Values
Life insurance cash values may be used for emergencies or for specific savings goals such as purchase of a home or paying for college. When life insurance is used for an emergency or to fulfill a savings goal, a policy loan is normally recommended. The tax consequences may be more favorable through a loan than through a distribution, and the face amount of the policy remains intact when a loan is used.

Although other savings vehicles may return more than life insurance cash values, saving through life insurance cash values does have some advantages other savings instruments do not. Earnings grow tax-deferred within life insurance, premium payments can be a forced savings program for those who may not have the discipline to save otherwise, and of course, life insurance provides a death benefit for beneficiaries.

Investment Horizon
Life insurance is a long-term investment. In a level premium policy, one which requires level premiums throughout the life of the policy, cash values do not show much growth in the early years of the policy, since many of the loads and expenses of the policy are charged against the premium in the first years after purchase. Life insurance policies are meant to be held until death or until they mature.

Tax Considerations
As mentioned earlier, distributions may be taxable as income when received. Or, if they are from policies issued prior to 1985, or 15 years from issue, distributions are taxed under the cost recovery first rule.

Policy loans are not taxable as income when received, since they are not treated as distributions for tax purposes.

Death benefits from life insurance policies are received income tax free to beneficiaries.
Advantages of Life Insurance Guaranteed Cash Values

• Tax-favored treatment of policy loans
• Tax-favored treatment of distributions, under certain conditions
• Forced savings program through premium payments
• Death benefit creates instant estate and is payable income tax free to beneficiaries

Disadvantages of Life Insurance Guaranteed Cash Values

• Life insurance can be an expensive way to save
• If premiums paid are not sufficient to keep the policy in force, the policy will lapse and the death benefit will be lost
• Distributions normally cause a proportionate reduction in death benefit
• Distributions may be taxable

ASSET ALLOCATION KEY

<table>
<thead>
<tr>
<th>Life Insurance Guaranteed Cash Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity: Through loans, high. Total surrender, high. Partial distributions may not be allowed.</td>
</tr>
<tr>
<td>Investment Horizon: Over ten years</td>
</tr>
<tr>
<td>Tax Advantaged: Yes</td>
</tr>
<tr>
<td>Uses: Emergencies, long-term savings goals</td>
</tr>
<tr>
<td>Primary Risks: Default</td>
</tr>
<tr>
<td>Return: Fixed</td>
</tr>
<tr>
<td>Income: No</td>
</tr>
<tr>
<td>Asset Class: Fixed (Could be liquid if held over ten years)</td>
</tr>
</tbody>
</table>

Corporate Bonds

Corporate bonds are debt instruments issued by corporations. Several types of corporate bonds are available, some secured by collateral, others not. Bonds are issued by all types of corporations - there are more corporate bonds listed on the exchanges than there are equities.

Corporate bonds often pay interest semiannually, but some pay quarterly or annually.

An underwriting group or syndicate brokers the initial offering of a bond issue. The underwriters are securities brokerage firms and investment banking firms. Subsequent to the initial sale, bonds are traded on the exchanges and the OTC.

Each time a bond is purchased or sold, a commission is paid, and the yield on the bond is effectively reduced to the purchaser or seller

Unsecured Corporate Bonds

Unsecured bonds are bonds which are not backed by collateral, but are backed by the corporation issuing the bond. Unsecured bonds are known as debentures.
Debenture bondholders are general creditors should the corporation fail financially.

*Subordinated debentures* are another type of unsecured bond. Subordinated debenture bondholders, as the name indicates, are behind debenture holders and other creditors’ claims on the issuing corporation. Subordinate debentures as a class pay higher interest rates than debentures and secured bonds. They also may be convertible to common stock to make them a more attractive buy. Debentures and subordinated debentures which may be converted to common stock are called *convertible debentures*.

Debentures may be bonds or notes and, although unsecured, may include provisions which can reduce the level of risk the purchaser carries. For example, the indenture can include a provision that the debenture be of a specific size, and no further debenture series may be issued until the first issue is paid. Or, a specific amount of working capital may be required to be maintained equal to the amount of outstanding debentures.

**Secured Corporate Bonds**

There are numbers of ways bond issues can be secured with collateral. The most common secured bond types are mortgage bonds, collateral trust bonds and equipment trust certificates.

**Mortgage Bonds**

A corporation may place a mortgage lien on property it holds as security for a bond issue. The mortgage may be a first mortgage or a combination of a first mortgage on a portion of the secured corporate property and second or even third mortgages on other corporate property.

**Collateral Trust Bonds**

Collateral trust bonds are backed by specific corporate assets, such as securities. Through the bond indenture, if the issue goes into default, the corporate trustee of the issue is given the authority to sell the collateral to pay off the bond debt.

**Equipment Trust Certificates**

Equipment Trust Certificates are issued primarily by corporations in the transportation industry: users of railroad cars, trucks, air transport planes or oil tankers. Basically, the corporation orders equipment, such as railroad cars, from a manufacturer. The manufacturer gives legal title to a trustee. The trustee leases the equipment to the corporation and sells the equipment trust certificates, or *guaranteed loan certificates*, as they are called in the airline industry. Proceeds from the sale of the equipment trust certificates are used to pay the manufacturer. The rental payments from the corporation are used to pay off the
equipment trust certificates debt. If the corporation is unable to make the lease payments, the trustee leases the equipment to a different corporation.

Equipment trust certificates are considered relatively low-risk, because the equipment is usable by many different corporations in the same industry.

**Risk Characteristics**

The two principle types of risk corporate bonds are subject to are interest rate risk and default risk. Changes in interest rates will affect the price of the bond if it is traded in the secondary market.

Default risk of the bond varies greatly based on the financial strength of the corporation issuing the security. Several companies rate the financial strength of corporations, as mentioned in the first chapter of this course under the discussion of default risk.

Fixed coupon corporate bonds may not be a hedge against inflation. If the stated rate is, or becomes, lower than the inflation rate, purchasing power is not protected by the bond’s return.

**Uses of Corporate Bonds**

Corporate bonds may be used as income generating vehicles, and as short or long term savings vehicles. Because they commonly contain more risk than do Treasury securities, the return on corporate bonds is often higher than on these instruments.

**Investment Horizon**

Corporate bonds may be found in virtually any maturity. They are typically considered long-term investments.

**Tax Considerations**

Interest income from a bond is taxed as ordinary income, as are short-term gains. Long term gains and losses are taxed as capital gains and capital losses.

**Advantages of Corporate Bonds**

- Generate income
- Generally have returns higher than Treasury bills, notes or bonds
- Are issued by many companies, so can be selected with characteristics to offset risks of other securities held in a portfolio

**Disadvantages of Corporate Bonds**

- Exposure to default risk
- If not held to maturity, interest rate risk is inherent to this security.
- Fixed coupons may be exposed to purchasing power risk.
Municipal Bonds
Municipal bonds are issued by municipalities and states for projects such as roads, schools and buildings. A primary advantage of municipal bonds is that the interest generated from the bonds is generally exempt from federal income tax. It is important to note that although interest income from municipal bonds is federally tax exempt, capital gains earned by municipal bond transactions are not exempt from federal taxation.

Municipal bonds are generally issued in $5000 denominations. Interest payments are generally paid semi-annually. The return on the bond may be fixed or variable.

Risk Characteristics of Municipal Bonds
There are several general types of municipal bond issues. To understand the risks related to a municipal bond, it is important to know the differences in the terms of an issue. Of particular significance is the method of revenue backing the issue’s obligations.

General Obligation Bonds
General obligation bonds are backed by the full faith, credit and taxing authority of the issuing municipality. Therefore, revenue from any taxable source of the municipality can be used to pay any obligations of the bonds. General obligation bonds are generally considered to have the lowest default risk of municipal bonds backed by the tax authority of a municipality.

Special Tax Bonds
Special tax bonds are secured by a specific tax or taxes of a municipality. The default risk of a special tax bond is based on the ability of the tax to generate the revenue needed to support the bond issue.

Revenue Bonds
Revenue bonds are backed by the revenue produced by the project being funded. For example, a highway may be built by the issue of a revenue bond and secured by tolls to be collected once the highway is complete. The risk of default in a
revenue bond varies depending upon the specific terms and revenue generating methods of the issues.

**Housing Authority Bonds**
Housing authority bonds are backed by the full faith and credit of the US government. They are issued to build low-rent housing projects. A federal agency, the Housing Assistance Administration, pledges an annual contribution to these projects. Because housing authority bonds are backed by the US government, they are considered high quality bonds with no default risk.

**Industrial Revenue Bonds**
Industrial revenue bonds are issued by a municipality on behalf of a corporation or business. The business will lease the facility built, and the income from the lease is used to meet the issue’s payment obligations. The default risk of these bonds is dependent on the viability of the business use of the property and the ability of the business to generate sufficient payments to meet the issue’s obligations.

**Insured Municipal Bonds**
Insurance can be purchased on municipal bonds by the issuer to protect bond purchasers from the risk of default. Since the risk of default is reduced, bond rating agencies will assign a higher credit rating to an insured municipal bond issue than for the same issue had it been uninsured. Since the insurance costs the issuer money, the interest rate of the bond issue will generally be lower than if the issue were uninsured. However, yields on insured issues are generally competitive with other high quality municipal bond issues. Some professionals question the necessity of insurance for municipal bonds, since only the highest quality bonds are able to obtain insurance.

Besides the differing default risks of municipal bonds, they are subject to interest rate risk as well. They are sold in the secondary market through municipal bond dealers, securities brokers and commercial banks. Their price is greatly impacted by the default risk and current interest rates.

**Uses of Municipal Bonds**
Municipal bonds are used to generate tax-exempt income, often for those in retirement. If a municipal bond is issued within a state with income tax, the bond is typically *double-tax exempt*, meaning the interest income is exempt from both state and federal taxation. Some issues are triple tax-exempt, and interest is exempt from local, state and federal tax.

**Investment Horizon**
Municipal bonds are long-term investments. To avoid interest rate risk, they must be held to maturity.
**Tax Considerations**

As mentioned, interest from municipal bonds is generally exempt from federal income tax. Income from municipal bonds is also often exempt from state taxation in the state in which they are issued.

**Private Activity Bonds**

There are certain types of municipal bonds which are not exempt from federal income tax. Interest on *private activity* or private purpose bonds may not be exempt. Bonds which fall into this category are used to fund industrial development or other private activity and are bonds issued after August 7, 1986. Determination of whether a bond is or is not exempt from federal income tax depends on a number of complex factors. Special law firms render opinions regarding the taxability of a municipal bond issue. If a bond purchased by a fund is considered to be a private activity bond, the fund will provide shareholders the tax information necessary for the shareholders to properly report income from such bonds.

Private activity bond interest is generally considered a tax-preferred item in the calculation of alternative minimum tax for individuals and corporations.

**Advantages of Municipal Bonds**

- Available in a wide variety of issues and maturities
- Interest is federally tax exempt, and may be exempt on the state and local levels as well
- Generate regular income
- Principal returned at maturity

**Disadvantages of Municipal Bonds**

- Subject to both default and interest rate risks
- May be too expensive for an individual to purchase, since they are often issued in denominations of $5000

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<table>
<thead>
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<th>ASSET ALLOCATION KEY</th>
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<tr>
<td>savings goals, income</td>
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**Preferred Stock**

Preferred stock is placed in the fixed asset class rather than the equity class because it acts like a debt instrument in that it pays a fixed dividend. Preferred
stock is *preferred* in comparison to common stock because owners of preferred stock are paid before owners of common stock in the event a corporation is dissolved or goes into bankruptcy.

Preferred stock pays a dividend annually. The dividend is either a fixed amount, a fixed percentage of the stock’s face value, or a floating rate tied to an index. Because preferred stock pays a dividend, it is like a bond. However, a preferred stock dividend is unlike a bond dividend in that it must be earned and declared annually by the corporation’s board of directors. If a bond does not pay its stated interest income, it is considered in default. If a preferred stock does not pay a dividend, the issue is not in default, but the market may view the non-payment as evidence of a corporation’s financial difficulty.

Preferred stock may have *cumulative* or *non-cumulative* dividends. A cumulative dividend provision in a preferred stock issue means that any preferred stock dividends not paid will accumulate for payment at a later date. Dividends of cumulative preferred stock must be paid before any common stock dividends are paid.

A preferred stock with a dividend based on a fixed rate has a price which is more sensitive to interest rate changes than a dividend subject to a floating rate. Some preferred stocks pay variable dividends based on indices such as Treasury issues.

**Convertible Preferred Stock**

Convertible preferred stock can be converted to common stock at a certain price and/or as a certain number of common stock shares. The price where the value of the preferred stock is equal to the price of the common stock is known as the *parity price*. Once the convertible preferred stock reaches or goes beyond the parity price of the common stock, the preferred stock will in some ways begin to behave like common stock: its price will increase as the common stock’s price does. But because it has a stated dividend, when the common stock’s price falls, the preferred stock will generally not fall below a certain level. The preferred stock has an inherent value because of the stated dividend.

**Risk Characteristics of Preferred Stock**

Because of the stated dividend of preferred stock, it is subject to interest rate risk and default risk. Although it pays a stated dividend, there is no guarantee the dividend will be paid. It must be paid prior to any dividends paid on common stock, but it still may not be paid. Similarly to companies which rate bond issues, Moody’s and Standard & Poor’s along with large brokerage firms, also rate or have research available on preferred stock issues. The customer can use these services to help determine default risk of a preferred stock issue.
Interest rates impact the market price of the preferred stock. Its price changes inversely with the direction of interest rates.

Preferred stock may also be illiquid. It is often purchased by large institutional investors. Large investors can affect the availability of the stock and potentially limit the market for a particular issue. An individual investor may have a hard time liquidating some issues of preferred stock.

**Uses of Preferred Stock**

Preferred stock is for those who are looking for income. Preferred stock can offer high dividend yields.

**Investment Horizon**

Preferred stock is typically a long-term investment for the purpose of income generation.

**Tax Considerations**

Dividends and short-term gains are treated as ordinary income and taxed as such in the year received. However, preferred stock dividends may qualify for preferential tax treatment as qualified dividends. The tax treatment of qualified dividends was discussed in Chapter One. Long term gains or losses are currently taxed as capital gains or capital losses.

**Advantages of Preferred Stock**

- Income
- Potential for high yields
- Will pay dividends prior to those paid on common stocks

**Disadvantages of Preferred Stock**

- No guarantee of principal
- Exposure to default and interest rate risks
- Possible low liquidity on some issues

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Bond Mutual Funds
A mutual fund is an investment company which offers shares of pooled securities to the public. Mutual fund companies may offer shares from two types of funds, open-end and closed-end.

Open-End Funds
Open-end funds offer new shares continuously to the public, and buys shares back on demand.

Closed-End Funds
Closed-end funds have a fixed number of shares to offer. Once issued, closed end shares are traded on the market rather than redeemed by the mutual fund company.

Mutual Fund Values
Mutual fund shares are valued based on the market price of the underlying assets and liabilities of the fund. The value of each share is known as the Net Asset Value (NAV) and represents fund assets, including receivables, less liabilities. The NAV is the price received if shares are liquidated. The Public Offering Price (POP) is the purchase price of shares, and includes any sales charges or loads which are charged at purchase.

Mutual Fund Returns
The return of a mutual fund is expressed through calculations of yield and total return.

Yield
The yield of a fund is basically the amount of annual income received per share, expressed as a percentage of the current or average share price. As a simple example, if the current share price of a fund is $10.00, and $1.00 of income was earned per share over the past twelve months, the yield would be 10% ($1.00 / $10.00). The actual yield calculation required for mutual funds (the SEC Yield) is much more complex than this example. It includes incorporating risk premiums, special accounting for foreign security distributions, and other complicated computations.

Total Return
The total return of a fund is a calculation which incorporates the change in share price over a period of time and assumes distributions are reinvested as they are received. It is expressed as a percentage of the share price excluding loads or including loads.
**Fund Objectives and Investment Policies**

Each mutual fund must adhere to the fund objective as stated in the fund’s prospectus. Generally, the objectives found in a prospectus include *capital appreciation* or *growth*, *current income*, *total return*, and *stability of principal* or *preservation of capital*. Along with the fund objective, the prospectus details the investment policies of the fund. The investment policy includes the type of securities which will be invested in, and whether options, futures or derivatives will be used. In some cases a specific minimum or maximum investment percentage allowable for particular types of securities is identified.

The earnings generated from the assets in a mutual fund are passed through to the shareholders. If interest is earned on bonds, for example, it is paid out as dividends to the shareholders. If a security is sold and a capital gain generated, it is generally passed on to the shareholders as a capital gain. The mutual fund company provides reporting to each shareholder each year regarding earnings from dividends and capital gains.

Investing in mutual funds has several advantages. These include professional management, diversification, liquidity, flexible income options, and a variety of funds available with differing objectives.

**Professional Management**

Mutual funds are managed by professionals. Fund managers have a thorough understanding of the markets in which they buy and sell securities. They are schooled in investment theories, financial and accounting issues. They understand the ways in which securities act in market upswings and downturns, when interest rates change and when the economy is strong and when it is weak.

**Diversification**

Diversification is the buying of more than one security in order to spread risk over several securities. Diversification is discussed in detail in Chapter One. The idea behind diversification is that if different securities are owned, when one security goes down, another security will go up, or at least may not go down as much as the first security. The entire portfolio will have less volatile returns than if one security were held. Mutual funds include many securities in a fund, providing diversification levels that the average individual would not be able to afford on his own.

**Variety of Objectives**

Mutual funds include a wide variety of objectives. An individual can find a mutual fund with the objective desired, for example income, at a risk level that the individual feels comfortable with - from low risk to aggressive.
Liquidity
Open-end mutual funds are easily redeemed by the mutual fund company.

Variety of Income Options
If income is desired from a mutual fund, the shareholder can receive dividend distributions, regular systematic withdrawals, or can liquidate shares whenever desired. Income may be sent to the customer as a check, or in some cases may be wired directly to a bank account.

Mutual funds can be invested in for the same purposes as if an individual security were purchased, yet have the added advantages listed above. Included in the fixed asset class are municipal bond, government bond, corporate bond and international bond funds.

Municipal Bond Funds
Municipal bonds funds are funds comprised of municipal bonds. They may be single state municipal bond funds, national municipal bond funds, or insured single state or national municipal bond funds.

Single State Municipal Bond Funds
A primary advantage of a single state municipal bond fund for a purchaser who pays taxes in the state of issue is that most states exempt the interest from municipal bond funds from that state’s income taxation. Therefore, the purchaser receives the benefit of both federal and state income tax exemption from the fund’s interest income. The yield on municipal bonds issued in states with high income tax tend to be lower than those of states where state income tax is not a consideration. Single state funds may hold a small percentage of municipal bonds from outside the state. The mutual fund company will normally generate a statement at the end of each year for the holders which indicates the percentage of the income generated from the fund from the various state holdings in the fund to enable the proper reporting of taxable income.

National Municipal Bond Funds
National municipal bond funds invest in municipal bonds issued across the US. A national fund can provide more diversification than a single state issue, since there is a larger pool of securities from which to choose.

Insured Municipal Bond Funds
Both single state and national municipal bond funds are available with portfolios comprised of insured municipal funds. These funds tend to be competitive in yield with other high quality municipal bond funds, but provide the purchaser with a hedge against default risk. Of course, interest rate risk is still a concern, as with all bond funds.
UITs
Closed-end mutual funds include Unit Investment Trusts or UITs. Unit Investment Trusts are pools of investments, often municipal bonds. Rather than shares, the purchaser receives units of ownership. The portfolio of a UIT does not change over time. It is fixed upon the formation of the trust. The purchaser knows the portfolio composition, including the quality and maturity of the issues from the outset.

The income from a UIT is passed to the unit holder, like all mutual funds. If a bond in the portfolio is sold, the unit holder receives a pro-rated amount of the principal. Income is paid on a monthly, quarterly, semi-annual or annual basis.

Unit Investment Trusts come in short-term (five years or less), intermediate-term (six to fifteen years) and long-term (fifteen years and over) issues. At the end of the period, the UIT is no longer because all principal will have been paid to the unit holders.

Risks of Municipal Bond Funds
Risks of municipal bond funds are similar to those of municipal bonds: interest rate and default. However, they are generally managed to reduce the effects of that risk on return through diversification and careful selection. A careful look at the prospectus of the fund will indicate whether it is managed toward stability of share values, to maximize return, or to return income. The risks of the fund are also specifically defined in the prospectus.

Uses of Municipal Bond Funds
Like individual municipal bonds, municipal bond funds are used generally to generate tax-exempt income.

Investment Horizon
Municipal bond funds may be titled short-term, intermediate term or long term. Short-term funds may be composed of short-term municipal securities. These tend to have less interest rate volatility than longer-term issues. However, unless the fund is a money market fund, or nearly one, it will still often have enough share price volatility to be considered a long-term fund. Municipal bond funds are at the short end of the long-term scale however, at five to eight years.

Tax Considerations
Dividends resulting from interest income from municipal bonds is federally tax-exempt. However, dividends and earnings resulting from capital gains are not. As mentioned, the fund will issue a statement annually which will provide the amount of capital gain and dividend income from the fund. It will also provide a list of the income by state of issue, so that the income can be reported accurately on the state level.
**Advantages of Municipal Bond Funds**

- Highly liquid, whereas an individual municipal bond may not be
- The minimum to open a mutual fund may be lower than the purchase price of an individual municipal bond
- Tax-exempt dividends
- Diversification and professional management
- Income

**Disadvantages of Municipal Bond Funds**

- No guarantee of principal or return
- Subject to default and interest rate risk
## ASSET ALLOCATION KEY

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<th>Municipality Bond Mutual Funds</th>
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<tr>
<td><strong>Income:</strong> Yes</td>
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<tr>
<td><strong>Asset Class:</strong> Fixed</td>
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</tbody>
</table>

### Government Bond Mutual Funds

Government bond funds invest primarily in bonds and other securities issued by the US government or government agencies. Issuing departments or agencies of the US government include the US Treasury, the Federal Home Loan Bank, the Federal National Mortgage Association (Fanny Mae), the Government National Mortgage Association (Ginnie Mae), the World Bank or International Bank for Reconstruction and Development, the Federal Intermediate Credit Banks, the District Banks for Cooperatives, the Federal Land Banks and the Inter-American Development Bank.

As discussed previously, the risk of default on government issued securities is considered to be zero. Government securities are considered the *safest* investment in terms of default risk. Some securities found in government funds are from government agencies, not directly from the US Treasury. These securities may or may not be backed by the full faith and credit of the federal government. As bonds and bond-like securities, government issued securities are still subject to interest rate, market and purchasing power risks. Depending upon the structure of the security, these risks may be minimal to very high.

The objective of government funds is generally current income with relatively low fluctuation in net asset value. However, the objective and share volatility varies from fund to fund. Some funds are 100% invested in treasury securities; others use options, futures, CMOs and CMO derivatives. The relative risks and volatility in these different funds will obviously be quite different.

### US Government Funds

US Government funds typically have the objective of current income, and many include the objective of capital preservation as well. Typically, US Government funds which seek current income only will allow investment in options and futures to a greater degree than those funds including the objective of capital preservation.
Government funds may be comprised largely of short-term, intermediate or long-term bonds, or may have portfolios of securities with a variety of maturities. Typically, if a fund is invested for a specific maturity, the fund name will indicate so, e.g. the ABC Short-Term US Government Fund (short-term indicates maturities of five years or so). The average maturity of the portfolio impacts the return and volatility of the fund. A short-term government fund’s volatility is generally lower than the return and volatility of a long-term government fund. However, a fund’s entire portfolio composition and the impact of the interest rate environment on all portfolio assets means that name alone cannot be used to anticipate volatility related to interest rate risk.

**Ginnie Mae, or GNMA Funds**

GNMA funds are funds largely comprised of pass-through securities. Ginnie-Mae pass-through, or participation, securities are pools of mortgages wherein the investor (in this case the mutual fund) owns an interest. The principal and interest payments made on the mortgages are passed through to those with a share in the pool.

Mortgage securities can provide a higher rate of return than many other government issued securities, but carry the risk that the mortgagees may pay off their mortgages early, e.g. in a decreasing rate environment. This risk is known as pre-payment risk. When mortgages are paid off early, which can mean either before the terms of the mortgage agreement or before the expected pay off date, principal is returned to the investors and the interest payments cease. New mortgages purchased in the lower rate environment will pay lower interest to the pool participants.

**Adjustable Rate Mortgage Funds**

Adjustable rate mortgage funds (ARM funds) invest in adjustable rate mortgage securities. These funds may or may not limit these mortgages to those issued by the US government; by prospectus the funds may invest in private mortgage-related securities.

ARM funds were often positioned as a low-risk alternative to money-market funds when first introduced in the mid-1980’s and early ‘90’s. Many funds intended stable net asset values along with higher yields than money market funds. However, the decrease in interest rates in the early 1990’s made apparent the relative volatility possible in an ARM fund, along with the subsequent downturn in return. Some fund managers purchased higher yielding CMOs and mortgage security derivatives to increase yields. As rates continued to fall, these strategies resulted in further decreased returns in funds so managed. From this experience, ARM funds were shown to have the potential to be much more volatile than money market funds, especially those funds with a significant portion of assets in derivatives. However, ARM funds with small exposure to these riskier securities can provide the potential of higher returns to those
investors who are willing to accept prepayment risk along with greater interest rate risk than found in a traditional money market fund.

**US Government Treasury Funds**

US Treasury funds hold assets comprised solely or primarily of debt issued by the US Treasury. These funds too may be short-term, intermediate or long-term. The long-term funds have the greatest volatility, and show the greatest return when interest rates fall. Because Treasury funds either limit or do without mortgage-backed securities, the risks related to prepayment as found in a Ginnie Mae fund are not normally found in a Treasury fund. And since government backed securities are considered to have no risk of default, the major risk found in a Treasury fund is interest rate risk.

**Risk Characteristics**

Government funds vary widely in risk levels. The prospectus should be read to determine the levels and types of risk of any particular fund. Generally, the risks are the same as those for individual government securities, with interest rate risk being the central risk affecting the portfolio’s return.

**Uses of Government Bond Funds**

Government bond funds are often used for income and for long-term savings goals.

**Investment Horizon**

Some funds are of a more short-term nature, but five to eight years is still the suggested time frame for even short-term mutual funds. Few, if any, government bond funds would be considered aggressive, unless they are comprised of government security derivatives (see the glossary). If the fund were aggressive, an investment horizon of eight to ten years would be suggested.

**Tax Considerations**

Dividends and short-term capital gains are taxed as income when earned for federal tax purposes and long-term capital gains are taxed as capital gains.

**Advantages of Government Bond Funds**

- Negligible default risk
- Wide variety of funds with differing objectives
- Income
- Diversification and professional management
- Highly liquid

**Disadvantages of Government Bond Funds**

- No guarantee of return or principal
Corporate Bond Funds

Corporate Bond Funds, as the name suggests, invest mainly in corporate bonds. A number of different types of corporate bond funds are available.

High Yield Corporate Bond Funds

High yield corporate bond funds are the most aggressive of the corporate bond fund types. They are generally invested in corporate bonds issued by financially troubled companies. The bonds have a higher coupon rate than those of more financially stable corporations. The risk of default in high yield funds is reflected in the potential for higher returns. Whether the return is ample enough for the default risk is up to the fund managers to determine. The funds often allow, by prospectus, a percentage of the fund assets to be in common or preferred stock as well. Some funds also invest in futures and options. Again the overall portfolio composition affects the overall risk of the fund.

Corporate Bond Funds - High Quality

High quality corporate bond funds generally invest in investment grade corporate debt along with treasuries and government agency securities. The risk of default in a high quality corporate bond fund is low, but the funds retain the interest rate risk of all bond funds. Like government funds, corporate bond funds can be found with portfolios comprised of short term, intermediate term or long-term bonds. The average maturity of the portfolio will impact the relative interest rate risk of a fund since short term bonds are generally less sensitive to interest rate risk than long-term bonds.

Corporate Bond Funds - General

Corporate bond funds which are not comprised of high-yield or high-quality bonds have a wide variety of objectives. Generally, corporate bond funds invest primarily in investment-grade domestic corporate debt. Other investments can include US government securities, stock, foreign securities and small percentages of less than investment grade bonds. Generally, the risk levels and return of a corporate bond fund should fall somewhere between high quality and high yield corporate bond funds. However, the return, interest rate and default risks are dependent on the specific portfolio of the corporate bond fund.
**World Bond Funds**

World bond funds include funds which invest solely in bonds from outside the US (also known as International bond funds) and those which also include US corporate bonds in their portfolios (also known as Global bond funds). The risks of the political and economic environment varies from country to country or region to region in the world markets.

Issues such as trade agreements and embargoes, multi-nation treaties, such as NAFTA and GATT, and wars or uprisings can all have an impact on the default risk of a world bond fund. Some countries are very stable, such as many western European nations, and others have highly volatile economies and political environments, such as some eastern European nations.

World bond fund portfolios may also be short-term, intermediate and long-term. Since the world market can be much more volatile than US investments, however, a short-term world bond fund will generally consist of bonds with greater risk than a short-term domestic (US government or US corporate) bond fund.

World bond funds are generally considered aggressive funds. However, some funds invest in a great deal of US bonds, only venturing into foreign markets when the risk and return trade off is ascertained to be a prudent risk by the fund manager. These funds may be considered low risk within the world bond fund arena. Others are highly speculative, entering newly emerging foreign markets with highly volatile political and economic environments.

**Convertible Bond Funds**

Convertible bonds may be converted to common stock for a specified price. Generally, these funds are intended to offer levels of return and risk which fall between corporate stock funds and corporate bond funds. When compared to purchasing common stock from the same issuer, a convertible bond will typically provide less potential for growth, but generally will not have as much downside risk as the common stock. The reason the bond will not provide the same opportunity for growth as the common stock is that the convertible bond will be more expensive than the purchase of common stock outright. The purchaser is paying for the reduced risk of a bond. The relative risk of a corporate bond is lower than that of the corporation’s common stock because of the guarantees of the issue: that a certain coupon rate is paid and at maturity, the bond will have a certain value.

Convertible bonds have specific features which make them different from a typical corporate bond fund. Convertible bonds are typically *callable* under certain circumstances, such as when the price of the corporation’s common stock is greater than the established call price of the bond.
Convertible bond funds may have the objective of current income, total return, capital preservation, or all three. Convertible funds often invest in both convertible bonds and convertible preferred stock. The composition from fund to fund varies from extremely high quality securities to low quality, and the ratio of bonds to equities and other securities held differs, so relative risk and return varies by fund.

**Risk Characteristics of Corporate Bond Funds**

Corporate bond funds run the gamut from relative low risk to aggressive. The risk characteristics of the fund depend on the default risk of the issues in the fund’s portfolio, their maturities, the interest rate market, and whether tools such as futures or options are used in the portfolio.

**Uses of Corporate Bond Funds**

Corporate bond funds are commonly used for long-term savings goals and for income. There are a wide variety of funds, some with income as the primary goal, others with total return.

**Tax Considerations**

Dividends and short-term gains from corporate bond funds are treated as ordinary income. Again long-term gains or losses are treated as capital gains or capital losses for federal tax purposes.

**Advantages of Corporate Bond Funds**

- Liquidity
- Wide variety of funds with varying objectives
- Diversification and professional management
- Income

**Disadvantages of Corporate Bond Funds**

- Exposure to default and interest rate risk
- No guarantee of return or principal

**ASSET ALLOCATION KEY**

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Fixed Annuities

Fixed annuities are tax-deferred contracts issued by insurance companies. The earnings of contributions grow tax-deferred until they are withdrawn. Fixed annuities generally pay a rate guaranteed for continuous one-year periods.

Fixed annuities do not provide a death benefit in the same manner as life insurance contracts do. However, the accumulated value of an annuity is paid to a beneficiary upon the death of the annuitant or owner of the annuity contract.

Fixed annuities have some unique features. For example, many annuities today include a waiver of surrender charges for withdrawals made in conjunction with certain stays in a hospital or long-term care facility. Fixed annuities also may offer a bail-out option wherein a customer can liquidate the contract without penalty if the rate falls below a certain level.

_Surrender charges_ are assessed for certain withdrawals made from annuities within a certain time frame. The time frame, or _surrender period_, is generally from five to seven years. Generally, withdrawals of earnings or up to 10% of accumulated value do not incur charges, and so are known as _penalty free_ withdrawals. Annuities also can provide regular income through systematic withdrawals. Systematic withdrawals can often be made monthly, quarterly, semi-annually and annually, and normally must stay within the penalty-free amount in order to avoid applicable surrender charges.

Fixed annuities can also be converted to an irrevocable income annuity. This conversion is called _annuitization_. The amount accumulated in the annuity is used to purchase a guaranteed income stream of various specifications. The income could be paid for the life of the annuitant, for a specific period of time, say five, ten or twenty years, or a combination of period certain and life. Payments may be made based on a single life expectancy, or on joint life expectancies.

Besides annuitizing an annuity contract, annuity income contracts can be purchased directly. Annuity income contracts which begin paying income within twelve months of purchase are known as _immediate annuities_.

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Tax Advantaged: No  
Income: Yes  
Uses: Long term savings goals, income  
Asset Class: Fixed
**Risk Characteristics**

Since annuities are life insurance products, the standards of the NAIC and state regulation also cover them. The ratings issued by rating agencies can be used to determine the strength of a company issuing an annuity contract just as they can be for those issuing any kind of life insurance product.

Fixed annuities offer a guaranteed minimum rate, which may be governed by state regulation. Current interest rates are also guaranteed, typically for one-year periods. Above the guaranteed rate, fixed annuities are exposed to interest rate risk. Many companies try to manage the assets backing the annuities so that rates do not vary greatly from year to year, but there is no guarantee, unless an annuity contract specifically states differently, that an annuity will pay any more than the guaranteed minimum rate after its first year of issue.

Some policies also guarantee that principal will be returned upon full surrender, even if surrender charges apply which would have invaded principal.

Annuities, although not considered high return products, generally outpace the inflation rate. The assets backing the annuities commonly have returns which help the annuity to pay rates above the inflation rate.

**Uses**

Fixed annuities may be used for long-term savings goals, most commonly retirement. If withdrawals are made from annuities prior to age 59 ½, an additional tax of 10% is levied on the interest portion of the withdrawal. So, it is to the advantage of the owner to keep the annuity until after they turn 59 ½ to avoid this tax.

As mentioned, annuities may be used as an income generating vehicle, either through systematic withdrawals, or through annuitization. Because annuity withdrawals are generally taxed as though interest in the contract is distributed first, systematic withdrawals may distribute all interest in the contract. Therefore, the tax deferral aspect of the contract is no longer in place if regular withdrawals are made.

Tax-deferral is one of the most important, if not the most important, uses of the annuity. Taxable investments generate a statement 1099, and income must be reported and tax paid on the income annually. Because earnings are not taxed each year they are earned, a 10%, 15%, 25%, 28%, 33%, 35% or 39.6% tax does not erode the earnings of the annuity. The effect of this taxation is to reduce the effective rate of return on the investment. For example, a product earning a taxable rate of 5% purchased by an investor in a 25% tax bracket is equivalent to an after-tax rate of only 3.75%. This after-tax yield is derived by multiplying the taxable rate by one minus the tax bracket, in this case 5% x (1-.25).
For an individual looking to reduce current income tax while accumulating assets for retirement (or other savings goal with an investment time frame which ends after age 59 ½) who is looking for return guarantees, low default risk, in some cases guarantee of principal upon surrender, and flexible distribution options, the annuity can be a great savings or distribution vehicle.

**Investment Horizon**

Fixed annuities may be used as long-term savings products and as income generating products. Because the surrender schedule on most annuities is at least five years, the surrender schedule itself lends itself to holding the annuity for a period of at least five years. The annuity is considered a long-term, retirement vehicle by the IRS. If withdrawals from an annuity are made prior to age 59 ½, an additional income tax of 10% is levied on the interest withdrawn from the annuity.

**Tax Considerations**

Besides the additional tax on earnings withdrawn prior to age 59 ½, the annuity has some other special tax rules. Earnings in an annuity grow tax deferred until withdrawn. This is often the most important reason an annuity is purchased. When a withdrawal is made from annuity contributions made after August 14, 1982 it is taxed as though income is distributed prior to principal. The cost recovery first rule applied to some life insurance distributions does not apply to these annuity distributions. Annuity contributions and earnings on these contributions made prior to August 14, 1982 are taxed under the cost recovery first rules when distributed.

Annuity income payments, or annuitization payments, have different taxation rules applied. As noted, earnings are taxed as withdrawn from deferred contracts, but once a contract is annuitized, or if a contract is an immediate annuity, different tax rules apply. Annuity payments are taxed as part principal, part interest. The IRS has specific rules regarding the calculation of the taxable and non-taxable portions of an annuity payment. The IRS calculation determines the exclusion ratio, the ratio used to calculate the portion of each payment which is non-taxable. Since the period certain IRS calculation is the simplest, it will be illustrated to provide a general explanation of the calculation of the exclusion ratio.

The exclusion ratio is the ratio of the investment in the contract to the expected return in the contract, and is the ratio of each payment which is not taxable, or is excluded from taxation.

\[
\text{Exclusion Ratio} = \frac{\text{Investment in the Contract}}{\text{Expected Return in the Contract}}
\]
Exclusion Ratio  \times  Annuity Payment = Non-Taxable Amount of Payment

Assume a ten year period certain annuity, purchased with $50,000 and paying $500.00 a month for ten years.

\[
Exclusion \ Ratio = \frac{\$50,000 \text{ Investment in the Contract}}{\text{Expected Return} \times (\$500 \times 12 \text{ mos.} \times 10 \text{ yr.})} = 83.33\% \text{ exclusion ratio}
\]

\[
\frac{\$50,000}{\$60,000} = 83.33\% \times \$500 \text{ payment} = \$416.65, \text{ the non-taxable portion of each payment.}
\]

**Advantages of Fixed Annuities**
- Tax-deferred
- Flexible withdrawal and income provisions
- Guaranteed minimum rate
- Fixed return typically for contiguous one year periods

**Disadvantages of Fixed Annuities**
- Possibility of default
- Typically no rate guarantee above minimum rate guarantee after the first year
- Regular withdrawals can nullify tax-deferral advantage
- Currently, interest is considered to be withdrawn before principal
- Withdrawals prior to age 59 ½ are subject to an additional tax
- Surrender charges may be applicable to withdrawals or surrenders

**ASSET ALLOCATION KEY**

<table>
<thead>
<tr>
<th>Fixed Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity: High, but surrender penalties and additional taxation may apply to certain withdrawals.</td>
</tr>
<tr>
<td>Investment Horizon: Over five years</td>
</tr>
<tr>
<td>Tax Advantaged: Yes</td>
</tr>
<tr>
<td>Uses: Long term savings goals, income</td>
</tr>
</tbody>
</table>
**Variable Annuities - Bond Sub-Accounts**

A *variable annuity* is a contract between the annuity owner and an insurance company. It is a tax-deferred product which allows the purchaser to allocate his contributions to one or more sub-accounts. A *sub-account* is a pool of securities invested to meet a specified objective. A variable annuity also includes the option to receive annuity income payments at a specified date in the future.

The variable annuity is so-named because the return on the annuity is variable. Returns vary based on the performance of the sub-accounts selected by the purchaser. Fixed annuities, as we have discussed, pay a fixed rate of interest, established by the insurance company.

Variable annuities are regulated as both an insurance product and a securities product. To sell a variable annuity, both an insurance and Series 6 securities license is required. States may require either a life insurance license or a special variable annuity insurance license to sell variable annuities.

Variable annuities are regulated as a security because the variable annuity policyowner bears investment risk: the policyowner chooses where his purchases are allocated among the sub-accounts. Fixed annuities, on the other hand, are not considered securities because the insurance company assumes the investment risk. The insurance company takes the risk that it will be able to meet the obligations of a fixed annuity contract - the initial rate guarantee, the minimum rate guarantee, and any other guarantees of the contract. Even though a variable annuity may include guarantees which equate to an insurance company risk, the preponderance of risk is assumed by the policyholder.

Like fixed annuities, variable annuities include an option to annuitize the contract. Variable annuity income options are more flexible than fixed annuity income options. If a variable annuity is annuitized using a variable income option, the variable annuity company may allow additions to be made to the contract, and they will allow the owner to transfer units remaining in the contract to be moved to another sub-account within the annuity.

Income from a variable annuity can often be taken as regular, systematic withdrawals as an alternative to, or prior to, annuitization payments. These payments can be started and stopped as necessary and can also generally be received on a monthly, quarterly or annual basis.

Variable annuities offer several advantages as a long-term investment vehicle. The two foremost advantages are tax-deferral and the opportunity to choose among many different investment options. Other advantages include guaranteed death benefits and flexible annuity income options.
As investment goals change, or market conditions warrant, account values may be redistributed within the variable annuity sub-accounts. An added advantage is that when moneys are moved from one sub-account to another, no current tax ramifications occur. This is different than transfers from mutual fund to mutual fund, even within the same fund family. Transfers among mutual funds, other than those within a qualified retirement plan or IRA, may cause current income and capital gains taxation.

**The Separate Account of a Variable Annuity**

The separate account is used by the insurer to hold the sub-account assets of the variable annuity. Separate accounts are also used for holding assets of variable life and variable universal life, discussed later. Under federal securities law, the separate account is considered a separate legal entity from the insurance company issuing the variable annuity. The separate account must be registered as an investment company under the Investment Company Act of 1940. This is the same act which governs the registration of investment companies issuing mutual funds and sets forth the requirements relating to promotion, reporting requirements, pricing of securities for sale to the public and allocation of investments within a portfolio.

The separate account may be managed by a firm outside of the insurance company. It is not uncommon for a variable product to have more than one separate account affiliated with the product, and for each separate account to be managed by a different group of advisors. Typically, the separate account managers, if from outside the insurance company, are from mutual fund companies or institutional investment firms.

**The Sub-Account**

The sub-accounts within the separate account are pools of securities, such as stocks, bonds and money market instruments. Each sub-account is managed according to an objective such as growth, aggressive growth, high yield bond or growth and income. The objective, the types of securities invested in, and the risks of the sub-account as an investment are described in the variable annuity prospectus.

The return of a variable annuity is based on the value of the sub-accounts. The total value of a variable annuity’s sub-account is calculated by multiplying the number of accumulation units held by an annuity owner by the value of each unit in the sub-account. For example, if Mr. Smith owns 2025 units of the ABC Annuity Special Growth Account, and each unit is worth $1.45, his account value is $2,936.25 (2025 x $1.45). The value of the separate account is calculated at the end of each trading day each day the New York stock exchange is open.
Guaranteed Death Benefits

Many variable annuities include a guaranteed death benefit. Although the provisions vary, typically the minimum death benefit guarantee is a guarantee of the greater of the value of the contract at time of death or all premiums paid, less withdrawals. Some variable annuities also include a stepped-up death benefit, wherein the contract values are frozen every certain number of years for the purposes of calculating the death benefit. The death benefit guarantee in this case is typically the greater of the stepped-up value, the current value at the time of death, or the total of all premiums paid. A guaranteed death benefit is very attractive to those concerned about the value of the assets left to beneficiaries.

Bond Sub-Accounts

The variety and characteristics of bond sub-accounts are virtually the same as those described for bond mutual funds. There are government bond sub-accounts, corporate bond sub-accounts and world bond sub-accounts. Because variable products are already tax-deferred, there are no municipal bond sub-accounts within them.

Fixed Account Description

Many variable annuities include a fixed account option in addition to the sub-account options. A fixed account is not a sub-account within the variable annuity separate account. It is not registered under the Securities Act of 1933 or under the Investment Company Act of 1940. Rather, it is an account which is part of the general assets of the insurance company.

The fixed account offers a guaranteed rate for a specified time period and a minimum guaranteed rate. The fixed account guarantees are an obligation of the issuing insurance company.

Often exchanges or transfers from the fixed account are limited when compared to the frequency of transfers allowed from the sub-accounts. Since the insurance company guarantees rates of return for specified periods of time, withdrawals may be limited to ensure there are sufficient invested assets to meet rate guarantees. In addition, since the fixed account is an obligation of the issuing company, reserves must be set aside to meet all contract obligations, and withdrawal privileges impact the amount of reserves required.

Some variable annuity contracts incorporate a Market Value Adjustment or MVA for withdrawals from the fixed account. If current, new money rates are lower than the rate the fixed account is paying at surrender or withdrawal, the annuity will be given a positive cash value adjustment, resulting in a higher surrender value than if no MVA was calculated. If current, new money rates are higher than the rate the fixed annuity is paying at surrender or withdrawal, a negative adjustment to cash value will be made, resulting in a lower surrender value than
if the MVA was not calculated. The idea behind an MVA is that the insurance company will have to pay less to replace moneys surrendered in a decreasing rate environment, so the policy is given a positive MVA. In an increasing rate environment, the cost of new money is higher for the insurance company, so there is a negative MVA applied to the surrendered policy.

Risk Characteristics of Variable Annuity Bond Sub-Accounts

Because bond sub-accounts are similar in composition to many bond mutual funds, the same risk characteristics apply. Their return is impacted by the default risk, interest rate market, bond maturities, and other types of securities used in the portfolio. Unlike fixed annuities, however, the values in the sub-accounts are not exposed to default risk of the insurance company. The sub-accounts are part of the separate account, which is not part of the general assets of the insurance company. Therefore, if the insurance company did fall into financial trouble, the assets in any separate accounts would not be accessible by creditors. These assets belong to the unit holders within the variable products offered by the insurance company.

The fixed account of a variable annuity, however, is part of the general assets of the insurance company. Therefore, if the insurance company did get into financial difficulty, creditors have claim to the assets.

The fixed account has generally the same risk characteristics as a fixed annuity: default risk along with a guaranteed minimum return as long as the insurance company meets its obligations, which as discussed is highly likely given the standards in place today.

Uses of Variable Annuity Bond Sub-Accounts

The tax-deferral aspect of the variable annuity makes investing in bond sub-accounts different from mutual funds. For one thing, the return on the sub-accounts is not eroded by annual income taxation. Also, transfers among sub-accounts are not taxable transactions, as they are when mutual fund transfers occur.

On the other hand, income is not typically the purpose of purchasing a variable annuity bond sub-account as it might be for purchasing bond mutual funds. This is because withdrawals prior to age 59 ½ are subject to the same additional 10% tax as was discussed under the topic of fixed annuities. Tax-deferral is nullified by regular withdrawals as well. However, if the contract is annuitized, favorable tax rules still apply and, as mentioned, variable annuitization options offer more flexibility than do fixed annuitization options. Often, a variable annuity is held for several years before it is annuitized, although the more aggressive individual may purchase an immediate variable annuity.
Variable annuities, then, are often used for saving for retirement, as fixed annuities are. Because of the variety of sub-account options, they can provide more opportunity for growth than can the fixed annuity.

**Investment Horizon**
Because variable annuities also typically have a surrender charge period of at least five years, they are considered long-term investments based on the surrender period alone. Add to that the volatility of sub-accounts, and the tax treatment of withdrawals prior to 59 ½, and the variable annuity is definitely a long-term investment.

**Tax Considerations**
Variable annuities are taxed very similarly to fixed annuities. Earnings grow tax-deferred until withdrawn, withdrawals of interest made prior to age 59 ½ are subject to an additional 10% tax, and contributions made after August 14, 1982 are taxed as though income is distributed prior to principal when withdrawn. Annuity contributions and earnings on these contributions made prior to August 14, 1982, are taxed under the cost recovery first rules when distributed.

Variable annuitization payments are taxed under slightly different rules than are fixed annuitization payments. The expected return of the variable income annuity is unknown. Therefore, the exclusion ratio used is \( \frac{\text{Investment in the Contract}}{\text{Number of Years Annuity Payments Will Be Made}} \). If a life annuity is chosen, the number of years is determined by using IRS life expectancy tables. For a period certain, the certain number of years is used.
Using a 10 year period certain annuity to illustrate the calculation of the non-taxable portion of a variable annuity:

\[
\text{\$50,000 Investment in the Contract} \\
\text{10 Years of Annuity Payments} \\
= \text{\$5000 annual excludable amount}
\]

Each year, \$5000 in payments are excludable from taxation.

If a variable annuity income option includes a refund component, the calculation is more complex.

Since variable annuity income payments fluctuate, it is possible that the annual amount received could be less than the calculated excluded amount. If the income payments received are less than the excludable amount, the amount of the excludable amount not received may be carried over the remaining years of the annuity. For example, using the 10-year certain example above, if only \$4000 in income payments were received in the fifth year, the \$1000 excludable portion not received would be carried over the remaining five years. The excludable portion would then be \$5200 annually rather than \$5000 for the duration of the annuity.

**Advantages of Variable Annuity Bond Sub-Accounts**

- Earnings grow tax deferred until withdrawn
- Variety of sub-account options
- Diversification and professional management
- Transfers among sub-accounts are not taxable transactions
- Availability of Guaranteed Death Benefits
- Flexible income options

**Disadvantages of Variable Annuity Bond Sub-Accounts**

- Neither return nor principal guaranteed
- Exposure to default and interest risk
- Surrender charges and market value adjustment may be applicable
- Additional tax due on earnings withdrawn prior to age 59 \(\frac{1}{2}\)
- Currently, withdrawals are taxed as though interest is received first
Variable Life and Variable Universal Life Bond Sub-Accounts

Variable Life (VL) and Variable Universal Life (VUL) are life insurance products which do not include guaranteed cash values. Rather, cash values are based on the return premiums, less expenses, earned in sub-accounts selected by the policyowner. (See the discussion of sub-accounts under variable annuity bond sub-accounts.) These policies offer a wide variety of sub-account types, just as variable annuities do. The fixed asset class includes the cash values of VL and VUL bond sub-accounts.

**Variable Life**

Variable life is a type of whole life insurance policy. Like ordinary whole life, it provides a guaranteed minimum face amount and level premiums. Unlike ordinary life, it generally offers no guaranteed cash values unless a guaranteed return rider of some kind is paid for, and return of cash value is based on sub-account performance. The death benefit from the policy is also variable, but incorporates a guaranteed minimum.

**Variable Universal Life**

Variable universal life is a form of universal life policy which incorporates the use of sub-account investing. Universal life policies allow flexible premium modes and amounts, adjustment in the death benefit, more than one death...
benefit option, and more flexible withdrawal options than whole life policies typically allow.

Although we are discussing the cash values of the VUL as an asset, in order to understand the difference between Variable Life and Variable Universal Life, one must look at the death benefit options of these products.

**Death Benefit Options of VUL and VL**

Variable Universal Life, like universal life, offers two death benefit options, Option A (or I) and Option B (or II). Under Option A, the death benefit remains level over the life of the policy. As cash values increase, the pure insurance reduces, resulting in a level benefit (within regulated limits to avoid being classified as a modified endowment contract - see discussion in the following paragraph). Under Option B, the death benefit varies directly with changes in cash value. The pure insurance level remains constant over the life of the policy, so as cash values change, the death benefit changes. Universal life policies are structured this way because the pure insurance portion of the policy is divided from the cash value. Whole life policies do not separate pure insurance from cash value.

Variable Life also offers two death benefit options, the corridor percentage approach and the net single premium approach. The corridor percentage approach is based on current tax law which requires that there is a certain percentage relationship between cash value and death benefit. If this relationship is not met, the policy is treated as a modified endowment contract, and the policy loses some beneficial tax treatment. Distributions from modified endowment contracts are treated for tax purposes like annuity distributions - interest is considered to be distributed first and is taxable. As discussed earlier, life insurance cash values are taxed under the cost recovery first rule, unless made within the first fifteen years from purchase and accompanied by a reduction in death benefit. Under the cost recovery rule, investment in the contract is considered to be recovered first, and therefore is not taxable.

Under the net single premium approach, the variable life death benefit is periodically adjusted to reflect the amount of death benefit which could be purchased with a single premium equivalent to the amount of available cash value.

**Withdrawal Options**

Variable universal life policies often offer more flexible withdrawal options than whole life policies. Many whole life policies do not allow partial withdrawals. They may instead allow policy loans or full surrenders only. Universal life policies normally allow partial withdrawals.
Risk Characteristics of Variable Life and Variable Universal Life Bond Sub-Accounts
Like variable annuity sub-accounts, VL and VUL bond sub-accounts are subject to interest rate and default risks related to the assets in the sub-accounts. However, the assets in the sub-accounts are part of the separate account, and are not subject to creditor claims in the same manner as the insurance company’s general account could be.

Uses of Variable Life and Variable Universal Life Bond Sub-Accounts Cash Values
Policy loans may be taken from VL and VUL, so cash values can be used for emergencies, or long-term goals like purchase of a home, college tuition, or for retirement. The sub-accounts provide the owner with the opportunity for growth in cash values beyond the guaranteed returns of ordinary life. But, this opportunity carries with it the risk of loss in cash values as well. So, VL and VUL, like mutual funds, should be used by those willing to accept fluctuation in value and risk of loss of principal. Unlike mutual funds, however, VL and VUL offer tax-deferred growth and a death benefit.

Investment Horizon
All cash value life insurance should be looked at as a long-term vehicle. The early years of a policy often do not show large cash value growth, and there may be surrender charges applied to distributions. The added risks in sub-account investing in a VL or VUL policy make a long-term horizon even more important.

Tax Considerations
Withdrawals and policy loans from a VL and VUL policy are treated the same way for tax purposes as those from ordinary life, discussed earlier under the topic Life Insurance Guaranteed Cash Values.

Advantages of Variable Life Bond Sub-Account Cash Values
- Significant opportunity for growth
- Wide variety of sub-account investment options
- Earnings grow tax-deferred
- Death benefit paid income tax free to beneficiaries
- Lack of default risk related to the insurance company

Disadvantages of Variable Life Bond Sub-Account Cash Values
- Risk of principal (premiums paid)
- Fluctuating returns
- Variable death benefit
- Cash values not guaranteed
- Sub-account return exposed to interest rate and default risk in the underlying securities
<table>
<thead>
<tr>
<th>Asset Allocation Key</th>
<th>Variable Life and Variable Universal Life Bond - Sub Account Cash Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity:</td>
<td>Through loans, high. Total surrender, high. Partial distributions may not be allowed.</td>
</tr>
<tr>
<td>Investment Horizon:</td>
<td>Over ten years</td>
</tr>
<tr>
<td>Tax Advantaged:</td>
<td>Yes</td>
</tr>
<tr>
<td>Uses:</td>
<td>Emergencies, long-term savings goals</td>
</tr>
<tr>
<td>Primary Risks:</td>
<td>Default and interest rate risks of the underlying securities</td>
</tr>
<tr>
<td>Return:</td>
<td>Variable</td>
</tr>
<tr>
<td>Income:</td>
<td>No</td>
</tr>
<tr>
<td>Asset Class:</td>
<td>Fixed (Could be liquid if held over ten years)</td>
</tr>
</tbody>
</table>
Chapter Three: Study Questions

1. What risks are primary in the fixed asset class?

2. What are the common characteristics among fixed products?

3. Which of the following products are backed by the full faith and credit of the US Treasury?
   a) US Savings Bonds
   b) FDIC insured CDs
   c) Corporate Bonds
   d) Treasury Bonds
   e) Fixed Annuities
   f) Municipal Bonds

4. Which of the following products are federally income tax-advantaged?
   a) US Savings Bonds
   b) FDIC insured CDs
   c) Corporate Bonds
   d) Treasury Bonds
   e) Fixed Annuities
   f) Municipal Bonds

5. Which of the following products are highly liquid?
   a) US Savings Bonds
   b) FDIC insured CDs
   c) Corporate Bonds
   d) Treasury Bonds
   e) Corporate Bond Mutual Funds
   f) Preferred Stock

6. Advantages of life insurance policy loans compared to surrenders are:
7. Which of the following statements regarding a life insurance company’s separate account are true? More than one answer may apply.
   a) The separate account is a separate legal entity from the life insurance company.
   b) The separate account is regulated under the Investment Company Act of 1940.
   c) The separate account’s assets are not accessible by a life insurance company’s creditors.

8. True or False
   Both dividends and long-term capital gains from municipal bonds are exempt from federal income taxation. ______

9. True or False
   VUL policies are more likely to allow partial withdrawals than are VL policies. ______

10. True or False
    The fixed account of a variable product is part of the insurance company’s separate account. ______
Chapter Four: The Growth Class

The products within the fixed and liquid classes do not have the potential for the level of positive return which growth products, as a whole, possess. So why don’t people place all their assets in growth products? Because potential return is not their only goal, nor their only concern. Portfolio owners are concerned about short-term expenses, guarantees, income, volatility and diversification as well as return. The properly allocated portfolio will have assets in all three categories in order to meet these needs and concerns.

The growth asset class may be the largest in scope. It includes common stock, stock mutual funds, and stock variable annuity, variable universal life and variable universal life sub-accounts. It also can include real estate, collectibles and precious metals. This asset class generally provides the highest return potential over time along with various levels of market risk.

Common Stock
Common stocks are issued by many types of corporations and have different characteristics and risks based on the issue terms and the underlying corporation’s line of business.

Common stockholders share in the performance of the issuing corporation. If a company is doing well, its common stock will reflect its healthy performance. If it is doing poorly, the common stock will also reflect this condition in lower prices.

Growth Stocks
Growth stocks are stocks issued by companies who are considered to have a propensity for substantial expansion. Growth companies retain earnings in order to expand their business and generally are younger companies, or companies in an industry with strong and increasing demand.

In the realm of growth stocks, there are companies which are considered to issue aggressive growth stock because of the possibility for rapid high growth along with high risk of financial setbacks or out and out failure. Companies on the leading edge of various technologies without other diversified lines of business fit into the aggressive category.
**Blue-Chip Stocks**

Blue-Chip stocks, like the high-valued chips in the game of poker, are common stocks from companies who have proven themselves over time to be of high value. These companies are dominant market players with consistent above-average growth. A blue-chip company typically has a long record of dividend payments.

**Income Stocks**

Income stocks pay a relatively high dividend on a consistent basis. Companies with income stock are typically strong financially and do not need to re-invest income to finance growth.

**Cyclical Stocks**

Some companies are in an industry or a line of business which is cyclical in nature. Cyclical industries include consumer goods such as appliances, houses and automobiles. These industries depend on consumers having disposable income. In times of economic health, companies offering these products do well, and in slow economic times, these companies often experience slow growth or even financial difficulties.

**Defensive Stocks**

Other companies provide products or services which do not fluctuate greatly with the economy. Items such as groceries and utilities fall into this category. In an economic downturn, these stocks do not generally lose as much in value as the general market. Conversely, in an economic upswing, these stocks do not enjoy the growth of stocks more dependent upon a healthy economy. These stocks are known as defensive stocks because they help keep returns level over time in a diversified portfolio.

**International Stocks**

Corporations outside the US issue stock which is traded on foreign stock exchanges. Foreign or international securities can offer diversification opportunities not found in the US. Industries which are mature in the US may be at the beginning of the growth curve in other countries. Fast-food, entertainment, and supermarkets offered growth decades ago in North America, but are industries in their infancy in many overseas countries.

**Risks of International Stocks**

Risks in international investing include political, economic and exchange rate risk along with the risks associated with common stocks. Foreign securities may also be less liquid than domestic securities.
**Political Risks**
Foreign governments vary from being very stable to being close to anarchy. The biggest risk in a foreign country is that business assets will be seized by the government, or that assets will be frozen.

**Economic Risks**
Economic climate in a country has an impact on its securities just as the domestic economy has an impact on many of the securities issued in the US.

**Exchange Rate Risk**
The value of the currency of the country in which the international stock is issued relative to the dollar affects the value of the stock. The stock’s performance for a US investor may be enhanced or reduced by the difference in the value of the dollar.

**Liquidity Risk**
Stocks issued from some world markets may be low in liquidity. The reason for this may be inactive stock markets, or may be due to the difference in capitalization in some overseas countries. In some countries, stocks are held for long periods by institutional investors. Since turnover is low, a stock may not be actively traded.

**Uses of International Stocks**
International stock is used for long-term savings. Generally, international stocks are a more aggressive investment than domestic common stocks. The risk of loss is generally higher, but the return may be higher as well. International stock may be used to take advantage of growth opportunities in overseas countries that are not available in the US.

International stocks are also used to reduce overall return volatility in a portfolio. Issues within the US which may negatively impact the US stock market may have no negative impact in a foreign market, or perhaps even a positive one. By owning stocks in these differing markets, an investor may enhance the portfolio’s overall return.

**Risks of Common Stocks**

**Fluctuation of Price**
As a security, common stocks offer no guarantee of principal. The shares may go up and down in price.

**Financial Risk**
The financial strength or weakness of the underlying company affects share price and dividend payment.
Market Risk
New competition, technological change, changes in demographics, and business cycles can all impact a company’s business.

Uses of Common Stocks
Common stocks are used primarily for long-term growth. In the case of some stocks such as blue chips, they may also be used for income. Because of the lack of guarantees of any kind, they are more aggressive vehicles than many of the fixed asset products used for income or long-term savings. For the individual willing to accept price fluctuation and possible loss of principal and who has a long-term investment horizon, common stocks provide an excellent savings vehicle. They are used to save for retirement, college education, purchase of a home, or fulfill other plans.

As with other individual securities, it is difficult for one individual to put together a well-diversified stock portfolio for these purposes. There are many, many equity mutual funds available as an alternative.

Investment Horizon of Common Stocks
The less aggressive stocks may be invested in for five years or more. More aggressive stocks, such as small cap, have an investment horizon closer to ten years or more. By holding stocks for longer periods of time, historically the holder has experienced positive returns. If stocks were held for a short period of time, it is more likely that the market for stocks may experience a downturn without a subsequent compensating upturn. Holding a common stock for the short-term increases the risk that principal will be lost and return may be poor.

Tax Considerations
Dividends and short-term capital gains resulting from stocks are currently taxed as income in the year received. Gains or losses as a result of holding stock for over a year are considered long-term, and are taxed as capital gains or losses.

Advantages of Common Stock
• Relatively high opportunity for growth
• Income from dividends available on some issues
• Wide variety of issues available
• Many stocks are highly liquid

Disadvantages of Common Stock
• No guarantee of principal nor returns
• Exposure to market and default risk
• Some stocks may be illiquid
• Diversification expensive for an individual investor
**Equity Mutual Funds**

Equity mutual funds are funds largely comprised of common stocks. The universe of equity funds is even more diverse in objective and portfolio composition than that of bond mutual funds.

*Aggressive Growth Funds*

The primary objective of an aggressive growth fund is capital appreciation. Portfolios normally hold large amounts of stocks from small and midsize companies, with good, as defined by the fund managers, potential for growth. Options and futures may also be heavily utilized in aggressive growth funds.

As the name implies, aggressive growth funds generally provide excellent opportunity for growth, but can also be highly volatile. This fund type is for the long-term investor able to ride out potentially extreme fluctuations in return. Historically, these fund types are more volatile than other growth funds in the short term.

*Growth Funds*

The objective of a growth fund is growth of capital, or capital appreciation. The portfolio mix in growth funds range from stocks from a wide variety of large corporations to funds which invest in stocks from established corporations in certain sectors of the marketplace, such as technology or health care.

Growth funds are less volatile, generally, than aggressive growth funds due to their more conservative, higher quality stock portfolios. Those with portfolios with a high concentration in a particular sector are subject to more market risk than those with a more diversified portfolio.

*Small Cap or Small Company Funds*

Small Cap stock funds invest in stocks of small to midsize companies. Generally, the objective of these funds is capital appreciation. Small company funds may seek appreciation through a values approach - the fund managers seek out securities which they determine are undervalued in price given their potential
for growth. Or a growth approach may be used which picks stocks from companies which show strong earnings and revenue growth.

The amount of diversification in a small cap fund impacts its subjectivity to market risk -- some small cap funds are heavily invested in certain sectors. Recently, technology firms have been one such sector. Sector swings will impact these funds more greatly than more diversified small cap funds.

Small cap funds vary in overall risk and portfolio quality, so may be appropriate for the moderate to aggressive investor, with a long-term investment horizon to ride out the market’s potential volatility.

*Growth and Income Funds*

The objective of growth and income funds is current income and capital appreciation. Generally, portfolios are comprised of high dividend stocks and convertibles. Portfolios may also include some small-cap stocks and bonds.

Growth and income funds are generally considered less risky than growth funds, because of their emphasis on stocks from large, established corporations with histories of healthy returns and dividend payments. Since these funds are equity funds, their short-term volatility makes them suitable for the long-term investor.

*Equity Income Funds*

Equity income funds are generally considered the most conservative of the equity funds. Generally, an equity income fund’s objective is current income and capital appreciation. Portfolios generally consist of high quality, high-dividend stock and convertibles, as well as bonds.

Equity income funds generally return lower yields than a corporate bond fund, but over the long-term have the potential for greater total return than a corporate bond fund due to the capital appreciation of the stocks within the portfolio. Short-term volatility is an issue, as with all equity funds.

*World Stock Funds*

World stock funds include both funds which invest solely in stocks issued by companies outside the US (also known as International stock funds) and those which invest in stocks from companies both inside and outside the US (also known as Global stock funds). The risks are similar to those of world bond funds: exchange rate risk, political and economic risks are all applicable.

*Sector Funds*

Sector funds are funds which invest in stocks within certain sectors, such as financial, retail, services, utilities, etc. Depending on the sector invested in, the fund may have the objective of capital appreciation or current income. For
example, utility funds have the objective of current income, while precious metals funds have the objective of capital appreciation.

Sector funds are generally used as hedging instruments in a portfolio, hedges against purchasing power risk, against interest rate risks, or against general market risks. Sector funds tend to be volatile, since their exposure to sector swings is high. But, when used in a diversified portfolio, can actually reduce overall risk in an individual’s portfolio return. Sector funds are meant to be part of a diversified investment portfolio, for the long term investor.

**Balanced Funds**

Balanced funds are both bond and equity funds. A balanced fund’s portfolio includes a mixture of preferred stocks, common stocks, and bonds. The objective of a balanced fund is generally to achieve long-term growth or capital appreciation and earn current income while conserving principal. Balanced funds generally have less opportunity for growth than an equity fund, but have the advantage of less volatility due to the bonds and preferred stocks in the portfolio.

Through the diversification of their portfolios, default risk, market risk, interest rate risk and purchasing power risk can all potentially be reduced through a balanced fund. However, as with all general fund categories, each individual fund considered a balanced fund is different. Some balanced funds emphasize capital appreciation through the investment in a high percentage of growth stocks. Others seek current income and invest in conservative, high quality bonds and income-oriented stock. The investment emphasis in the portfolio will impact the types and degree of risks in the fund.

**Risks Characteristics of Equity Mutual Funds**

The applicable risks of equity mutual funds were discussed as each type was explored, above. Generally, equity funds are exposed to market risk. They have no guarantee of principal or return. They all have price fluctuation.

**Uses of Equity Mutual Funds**

Equity mutual funds are used for savings goals, as well as for income. Like individual common stocks, equity mutual funds are used to save for college expenses, for retirement or any other savings goal. Income, often for retirement purposes, is generated from a mutual fund through dividend distributions or through systematic withdrawals.

Most funds which offer systematic withdrawal programs are able to generate hypotheticals which illustrate historical returns assuming the desired withdrawal amount. The historical results shown on a hypothetical are not a guarantee of future performance; however, a hypothetical illustration can help
the client understand the way in which a systematic withdrawal program works. It is important that the client completely understand that systematic withdrawals can exceed or fall within current returns, and that the fund value does not remain constant during the withdrawal period. Receiving systematic withdrawal income is not the same as receiving coupon payments from an individual bond, nor like receiving interest from a fixed rate CD: the value within the fund will fluctuate.

If a client desiring income has a profile indicating he or she is willing to accept some fluctuation in principal in exchange for a yield or return potential higher than that available in a more conservative instrument, such as a CD or fixed annuity, an equity mutual fund may be a suitable income producing vehicle. The key elements of importance for the client to understand regarding a mutual fund purchased for income are:

• Account values will fluctuate; they may lose all or a portion of what was invested.
• The yield and return on the fund is not guaranteed.
• Generally, the return on the investment is a reflection of the risks the client is assuming.
• If income is taken via distribution of dividends, the amount of the check will vary based on the yield of the account and the number of days in the period for which the check is payable.

Investment Horizon of Equity Mutual Funds

Equity mutual funds vary greatly in exposure to risk. Small cap stock funds are likely to be subject to high price fluctuations. Blue chips typically much less so. All equity funds are long term; the more aggressive should be held for ten years or more, the less requiring holding periods of at least five years.

Tax Considerations

Taxable earnings from equity mutual funds come in the form or dividends and capital gains.

Dividends

Dividends from fund assets which are distributed to shareholders are taxed as ordinary income to shareholders. Interest income is also considered dividend income and therefore is taxed as ordinary income. Whether a shareholder opts to receive dividend distributions or to reinvest them, dividend distributions are generally taxable.

Capital Gains

Capital gains can result from a shareholder selling shares or from a fund selling assets within the fund. Capital losses may be used to offset capital gains.
Capital gains and losses may be either long-term or short-term. A short-term gain or loss is one which occurs when property held for one year or less is sold. A long-term gain or loss arises from property held over a year.

Short-term capital gains from a fund’s assets are treated as dividends for income tax purposes. Therefore, they are currently taxed as ordinary income.

**Advantages of Equity Mutual Funds**
- Wide variety of funds available
- Potential for high return
- Flexible income options
- Diversification and professional management

**Disadvantages of Equity Mutual Funds**
- No guarantee of principal or return
- Exposure to market and financial risks
- Subject to price fluctuation

<table>
<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
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<tbody>
<tr>
<td><strong>Equity Mutual Funds</strong></td>
</tr>
<tr>
<td>Liquidity: High</td>
</tr>
<tr>
<td>Primary Risks: Market and Financial</td>
</tr>
<tr>
<td>Investment Horizon: Five - ten years or more</td>
</tr>
<tr>
<td>Return: Variable</td>
</tr>
<tr>
<td>Tax Advantaged: Yes, for corporations</td>
</tr>
<tr>
<td>Income: Yes</td>
</tr>
<tr>
<td>Uses: Long-term savings goals, income</td>
</tr>
<tr>
<td>Asset Class: Growth</td>
</tr>
</tbody>
</table>

**Variable Products Equity Sub-Accounts**

As discussed in the prior chapter, variable annuities, variable life and variable universal life offer sub-account options. These products not only include bond sub-accounts, but many varieties of equity sub-accounts as well. Since these sub-account assets are like those of equity mutual fund accounts, their risks and uses are similar.

As discussed in the last chapter, these products offer tax-deferral, which can be a big advantage to an individual who desires to reduce taxable income. For example, transfers among sub-accounts within a variable product are not taxable transactions, as transfers among mutual funds can be. Life insurance products also offer tax-free policy loans as well as a death benefit.

If life insurance protection is needed, variable universal life or variable life can be a viable option for those who want to maximize cash value growth. A variable annuity can be a good option for the individual looking for reduction in current
taxable income, with savings goals which extend past the surrender period and age 59 ½, and who would like the opportunity for growth sub-account savings can provide.

**Collectibles**

The growth class can include collectibles for the right individual. Collectibles include just about anything, from bottle caps to rare coins. For the purposes of discussing collectibles’ fit in the growth asset category, we will concentrate on collectibles with an active, mature market. These include coins, stamps and artwork.

Collectibles, if used for more than a hobby, are generally for the high net worth individual. The expense of procuring rare coins, stamps or art-work in order to assemble a collection of worth generally precludes those without large amounts to invest from using collectibles as an investment. However, it is possible that an individual of otherwise modest means may have a valuable collection. A collection may have been begun by a grandparent or great-grandparent and handed down and added to by subsequent generations, for example.

Collectibles may be invested in directly, or through a broker. If purchased directly, the collected item must be stored, cared for and insured using the assets of the collector. If through a broker, the trustee of the assets will care for and insure the items.

Often, brokered collectible trusts require large investments, as much as $1 million. A few individual investors may be involved in such a trust, but often, universities, various trusts, museums or pension plans are the participants in a collectibles trust.

The greatest advantage of collectibles is the opportunity for growth in amounts far exceeding the inflation rate. Certain pieces of artwork, stamps or coins may multiply in value many times over time.

**Risk Characteristics of Collectibles**

Obviously, a great risk in collectibles is market risk. Will what is popular today be what is popular tomorrow, or will it grow in popularity over time? Collectibles have no guarantees, so return and principal can be completely lost.

Collectibles have risks unique among the investments discussed in this course. Risk of damage, for example, and forgery or theft. Unscrupulous dealers may misrepresent the value and quality of a collectible as well, which is more difficult (although not impossible) to do in the efficient, regulated marketplace of stocks, bonds and the like.
Uses of Collectibles

Profit
When used as an investment, collections are assembled to make a profit. The collector in it for profit must have a deep understanding of the article being collected, the market value of the collection, its liquidity and demand.

Gifting
Collectibles may also be given as gifts. A gift occurs when property is transferred during the lifetime of the donor for less than full consideration in money or money's worth. Current income taxation and estate planning often play a part in an individual's reasons for gifting. By gifting property generating significant current income, an individual may reduce their income taxation. By gifting property today that is rapidly increasing in value, an individual may reduce the applicable estate taxes which would have been due on that property if transferred at death.

The amount of a gift is based on the fair market value of the property on the date the gift is made. Fair market value is the price for which the property would be bought or sold if neither the buyer or seller were under any compulsion to buy or sell and both buyer and seller had reasonable knowledge of any relevant facts.

A donor, the person making the gift, may generally gift up to $14,000 per donee, the person receiving the gift, annually without payment of gift tax. This is known as the annual exclusion. A married couple may make a split gift and jointly gift $28,000 per donee if they are married at the time of making the gift and the spouses jointly consent to making the gift. (Joint consent is considered to have been given when both spouses sign an IRS Gift Tax Form.)

The annual exclusion is applied solely to gifts of present interest, meaning generally that the donee has immediate use of the property. The IRS Code defines this issue in Section 2503. A gift of future interest is generally one where the use, possession or enjoyment of the property is at some future date. Gifts of future interest are still subject to gift taxation, but the tax not be offset by the annual exclusion.

Generally, gifts made between spouses are not subject to gift tax due to the unlimited marital deduction allowed. To qualify for the marital deduction the following requirements must be met:
1. The couple must be legally married at the time the gift is made.
2. The donor spouse must be a US Citizen.

From 2001 through 2010, lifetime gifts of up to $1,000,000 above the annual exclusion amount were also excluded from gift taxation. Under TRA 2010, the
annual exclusion amount for lifetime gifts was $5,000,000, and this amount was adjusted for inflation in 2012 to $5,120,000. The American Taxpayer Relief Act of 2012 made the $5,120,000 lifetime exemption permanent, subject to adjustments for inflation. In 2013, the lifetime gift exemption was $5,250,000. In 2014, the lifetime gift exemption was $5,340,000. In 2015, the lifetime gift exemption is $5,430,000. This lifetime gift exemption is reduced by the exemption amounts used in previous years.

**Investment Horizon of Collectibles**

Collectibles can be held for years, or traded regularly. If not a dealer, many individuals will hold onto collectibles for many years. They may be sold for purposes such as retirement income. Others hold them to pass onto beneficiaries.

**Tax Considerations**

Besides the tax considerations surrounding gifting a collectible discussed above, collectibles are subject to capital gains taxation. If a collectible is bought as an investment and is held over a year and then sold, the gain (or loss) on the transaction is taxed as a capital gain (or capital loss). While the collectible is held, no tax is due on its gain, so it is a tax-deferred investment.

**Advantages of Collectibles**

• Opportunity for large increases in value
• Prices influenced by different risks and factors than financial products

**Disadvantages of Collectibles**

• Can be highly risky. Have no guarantee of principal nor return
• Exposure to market risks, as well as risks of damage, theft or forgery
• Must be highly knowledgeable in the collectible to have the best chance of making a profit

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<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
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<tbody>
<tr>
<td><strong>Collectibles</strong></td>
</tr>
<tr>
<td>Liquidity: Varies.</td>
</tr>
<tr>
<td>Mature collectibles</td>
</tr>
<tr>
<td>have moderate to high liquidity.</td>
</tr>
<tr>
<td>Investment Horizon: Ten years or more</td>
</tr>
<tr>
<td>Tax Advantaged: Gain is deferred until object is sold</td>
</tr>
<tr>
<td>Uses: Long-term savings goals, gifts</td>
</tr>
<tr>
<td>Primary Risks: High levels of market risk</td>
</tr>
<tr>
<td>Return: Variable</td>
</tr>
<tr>
<td>Income: Yes</td>
</tr>
<tr>
<td>Asset Class: Growth</td>
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</table>
Real Estate Investment Trusts

Real estate can be used in many ways to generate a profit or enhance a portfolio’s growth. One avenue of real estate investing are Real Estate Investment Trusts or REITs.

A real estate investment trust (REIT) is a trust which purchases or finances real estate and passes most of its taxable net income to shareholders of the trust. Its objective is typically long-term income and long-term capital gains. Shares of the trust are traded on the NYSE and NYSE MKT LLC stock exchanges and on the OTC.

The two most common types of REITs are the equity real estate investment trust and the mortgage real estate investment trust. Another variety is the combination real estate investment trust, which includes some elements of the other two types.

Equity REITs

Equity REITs own real estate property within the trust. The trust passes on income generated from the property, such as rents, to shareholders, as well as any capital gains resulting from the sale of trust property. The income comes in the form of income dividends and capital gain dividends.

Mortgage REITs

A mortgage REIT owns mortgages and real estate loans. It passes income from the interest on the loans to shareholders.

Combination REITs

A combination REIT owns some property and makes loans with a portion of the trust funds. Income from both sources is passed to the shareholders.

Risk Characteristics of REITs

The risks of the real estate market can all impact a REITs return -- those of interest rate risk, default risk on the part of lessees or mortgagees. Market risk is another risk in real estate. It is the risk that a particular area or sector in the real estate market experiences low demand and falling prices, for example.

There are no guarantees of principal or return in a REIT. And just as real estate can be volatile in price, so can REIT shares.

REITs vary greatly in terms of risk level. The exact purposes of the trust, the properties invested in, the expected length of time assets will be held, all affect risk levels. The customer must review the REIT considered for purchase carefully before investing. Unsuspecting REIT shareholders have purchased REITs which finance short-term construction projects, which have a high risk of
loss, without understanding the true risks of the REITs. These shareholders were unpleasantly surprised when they lost large sums of money in these REITs.

**Uses of REITS**

REITs are used as an income producing vehicle for the person who can tolerate price and dividend fluctuations, as well as potential loss of principal.

**Investment Horizon**

Although REITs, like mutual funds, are highly liquid, they are a long-term investment. Real estate does not necessarily appreciate rapidly, and it can be subject to market downturns.

**Tax Considerations**

Most dividends from a REIT are taxable as income to the shareholder. Occasionally, dividends are paid which reflect a return of capital, so are not taxable. REITs may also issue dividends representing capital gains distributions, which of course are taxed as long-term capital gains to the shareholder.

**Advantages of REITs**

- High income potential
- High liquidity

**Disadvantages of REITs**

- Subject to interest rate, default and market risks
- No guarantee of principal or return
- May be a much more volatile investment than a purchaser realizes.

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<th>ASSET ALLOCATION KEY</th>
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<tbody>
<tr>
<td><strong>REITs</strong></td>
</tr>
<tr>
<td>Liquidity: High</td>
</tr>
<tr>
<td>Investment Horizon: Ten years or more</td>
</tr>
<tr>
<td>Tax Advantaged: No</td>
</tr>
<tr>
<td>Uses: Long-term income and return</td>
</tr>
<tr>
<td>Return: Variable</td>
</tr>
<tr>
<td>Income: Yes</td>
</tr>
<tr>
<td>Asset Class: Growth</td>
</tr>
</tbody>
</table>
Gold
Gold can be invested in through the purchase of coins, bullion, mutual funds, stocks and futures. Generally, the purpose of investing in gold or other precious metals is as a hedge against inflation. The price of gold tends to rise when stocks, bonds and cash fall or weaken in value. When the economy weakens, the demand for precious metals increases, attributable, some experts say, to the number of people who believe precious metals will hold an intrinsic value should the US economy, or any nation’s economy, collapse.

Regardless of why precious metals go up during shaky economic times, they have historically done so. Therefore, more and more investors are placing a portion of their portfolio in gold to reduce the downside risk of the portfolio’s return.

Gold Vehicles

Bullion
Bars or ingots of gold bullion are purchased and held by the purchaser or in a financial institution or special bonded facility.

Bullion Coins
Bullion coins are available in various weights, from one-tenth of an ounce to a full ounce in the case of South African coins. Some countries issue gold coins with varying gold content. Bullion coins are actively traded with a mature gold coin market.

Gold Stocks
Gold mining companies around the world issue common stocks, or depository receipts. These stocks and receipts can yield high dividends. The value of these securities tend to rise and fall with gold prices over time.

Gold Mutual Funds
Gold mutual funds invest in securities of gold mining and production companies. Like investing directly in precious metals, these funds are typically invested in as a portfolio hedge.

Gold Futures
A future is a contract between a buyer and seller to buy a specified amount of a commodity at a specified price on a specified date. Gold futures are generally traded as income producing securities, or to hedge an actual gold sales transaction.
**Risk Characteristics of Gold Investing**

The gold market can be very volatile. Prices can rise and fall dramatically in short periods of time. If actual gold bullion or coins are purchased, they are subject to risks like those mentioned under collectibles: theft and misrepresentation of value.

**Uses of Gold**

Gold is used as a portfolio hedge. Historically, it has gone up in value when financial markets are weak, so it is used to protect a portfolio’s return when stocks and bonds are both performing poorly.

**Investment Horizon**

Since its intended use is to protect a portfolio’s return over time, gold is a long-term investment. Gold has to be held during periods when it is not yielding high returns in order that it is available when it may be one of the only positive returning items within a portfolio.

**Advantages of Gold**

- Historically has been a hedge against inflation
- Potential for long-term growth
- Liquid market

**Disadvantages of Gold**

- Exposure to high market risk and volatile price swings
- No guarantee of returns or principal.

<table>
<thead>
<tr>
<th>ASSET ALLOCATION KEY</th>
<th>Gold</th>
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<tbody>
<tr>
<td>Liquidity: High</td>
<td></td>
</tr>
<tr>
<td>Investment Horizon: Ten years or more</td>
<td></td>
</tr>
<tr>
<td>Tax Advantaged: No</td>
<td></td>
</tr>
<tr>
<td>Uses: Long-term return, inflation hedge</td>
<td></td>
</tr>
<tr>
<td>Primary Risks: Market Return: Variable Income: No (except mutual funds) Asset Class: Growth</td>
<td></td>
</tr>
</tbody>
</table>

**Chapter Four: Study Questions**

1. The fixed asset class generally provides the __________ _________ over time.

2. Since stocks tend to provide the highest return over time, why don’t people place all their assets in stocks or stock funds?
3. Income can be generated through a systematic withdrawal program from an equity mutual fund. What key elements of a systematic withdrawal program should a person who is more familiar with receiving income from a CD or fixed annuity understand?

4. Which of the following products are federally income tax advantaged to an individual? More than one answer may apply.
   a) Common stock  
b) Equity mutual funds  
c) Variable annuity  
d) Variable life  
e) Collectibles  
f) REITs  
g) Gold

5. The primary objective of a REIT is generally:

6. Which of the following products have high liquidity, without qualification or at all times?
   a) Common stock  
b) Equity mutual funds  
c) Variable annuities  
d) Variable life  
e) Collectibles  
f) REITs  
g) Gold coins

7. List three growth products which could be used for income:

Chapter Five: Asset Allocation Applications

Melba Kairdfor
Melba Kairdfor is a widow in her late sixties. Her total net worth is $200,000. Her assets include a condo, valued at $90,000, a bank checking account with about a $10,000 balance, a $10,000 Treasury Note paying 5% interest semi-
annually, a 1 year, $20,000 CD nearing maturity from which Melba draws monthly interest, a money market bank account with a $5000 balance, a 5 year CD with a balance of $15,000 and a $50,000 fixed annuity, purchased three years ago and currently paying 3.75%. Melba has not taken any withdrawals from the annuity.

Melba has monthly income from her social security, a retirement plan and her CD interest of about $1200. Her condo is paid for, and she frequently travels. Her monthly expenses are about $700, including the presents she likes to give her grandchildren. She spends about five thousand dollars a year on travel.

Melba considers herself an investor with a moderate tolerance for risk. When her husband was alive, they had some mutual funds. But since Melba’s husband had handled these investments, she now places her money largely in the bank accounts she is more familiar with.

Melba’s portfolio is currently allocated as follows:

<table>
<thead>
<tr>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 Checking Account</td>
<td>$10,000 Treasury Note</td>
<td>$0</td>
</tr>
<tr>
<td>$20,000 1 Year CD</td>
<td>$15,000 5 Year CD</td>
<td></td>
</tr>
<tr>
<td>$5,000 MMA</td>
<td>$50,000 Fixed Annuity</td>
<td></td>
</tr>
<tr>
<td>$35,000 or 35%</td>
<td>$75,000 or 75%</td>
<td>$0 or 0%</td>
</tr>
</tbody>
</table>

Upon further discussion with Melba, her financial representative discovers that Melba has excellent health insurance, and her children have purchased a living benefit insurance policy as well as a long-term care policy which will pay for many of the expenses she could incur if health problems occur and she needs nursing home, hospice or at-home care. Her liquid assets will be needed to meet deductibles of the health plans, but major health or medical expenses will be met through this insurance.

After an asset allocation tool is used, it is found that given Melba’s risk tolerance, net worth and income, her model asset allocation should be

<table>
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<tr>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>24%</td>
<td>51%</td>
<td>25%</td>
</tr>
</tbody>
</table>

With her $110,000 in assets to invest, she could move $11,000 from her liquid assets and $26,000 from her fixed assets to the growth category to conform to this asset allocation model. Melba feels that is moving a little too fast, so she instead takes the following recommendations:

- With the income from her CD and Treasury Note, she opens a balanced mutual fund and will contribute to it as she receives her interest.
• If she feels comfortable with the mutual fund, she will place one-half of her one year CD into the mutual fund when it matures.
• If Melba places these CD proceeds into the fund, her portfolio will be allocated 25% cash, 75% fixed and 10% growth. When her five year CD matures, she will consider placing a portion of that into the balanced fund, or another moderately risked mutual fund, to increase the growth portion of her portfolio.

How do these changes meet the goals of an asset allocation plan listed in the first chapter?

1. *Maximize return by placing assets in products which match the risk tolerance of the customer.*
   Her risk tolerance is greater than the risk level her original portfolio contained. Her new portfolio has the potential for much greater returns and reflects her risk tolerance.
2. *Place the appropriate amount of assets in the liquid class to meet short term and emergency needs.*
   She has enough liquid assets to meet her living expenses and emergencies.
3. *Reduce volatility in the portfolio by placing non-liquid assets in the appropriate mix of fixed and growth products.*
   Although she is still heavily invested in the fixed category, over time a portion of her assets are likely to be moved into the growth category.

**John and Mary Hoapwel**

John and Mary Hoapwel, each 39, are married with two children, aged 8 and 10. John earns $45,000 a year and Mary, working part-time, brings in $20,000. They recently paid off most of their debt and have built up a money market fund of $30,000. They have a $150,000 mortgage on their $200,000 home. John contributes about $400 a month to a 401(k) plan, with half going to a stable asset fund and the other to an equity fund. Their total monthly expenses are about $2800. They take a family vacation each year and spend about $2000.

They are covered by John’s employer’s medical plan, and they own term insurance policies of $200,000 on one another. They have about $500 a month to invest, and are concerned about saving for their children’s’ college education and about their own retirement.

The Hoapwels consider themselves aggressive investors. They just have never had much money to invest up until now. Their current portfolio is allocated as:

<table>
<thead>
<tr>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000 Money Market Fund</td>
<td>$5000 Stable Asset Fund 401(k)</td>
<td>$5400 Equity Fund 401(k)</td>
</tr>
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</table>
Through the use of an asset allocation tool, it is found that their model portfolio would be:

<table>
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<tr>
<th></th>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>10%</td>
<td>15%</td>
<td>75%</td>
</tr>
</tbody>
</table>

As we discussed in Chapter Two regarding liquidity, some people do not have enough assets to meet their model portfolio without sacrificing reasonable liquidity needs. The Hoapwels are in this situation. To meet three months of living expenses, an amount they feel is reasonable, they need at least $7400. Taking into account insurance deductibles and their family vacation, they want at least $10,000 in their liquid asset category. This leaves them $20,000 to allocate among fixed and growth assets, besides their 401(k) assets.

The Hoapwels decide to split the $20,000 into two growth equity mutual funds -- one with an aggressive objective and the other with a more moderate portfolio. With the $500 they have to invest monthly, they will contribute $400 to college funds for their children, using for now the aggressive mutual fund registered in custodian accounts for the children through the Uniform Transfers to Minors Act (see the Glossary). They will place the other $100 a month in a corporate bond mutual fund. For now, they will leave their 401(k) allocated the way it is, because the stable asset fund has a good return for a fixed investment.

Their $500 is being invested 80% growth and 20% fixed. They will review their portfolio regularly with the help of their financial representative and reallocate assets based on the performance of their overall portfolio over time.

How do the Hoapwels decisions match the goals of an asset allocation plan?

1. Include products which have the appropriate features and characteristics to meet the needs of the portfolio holder.
   The Hoapwels were looking for retirement and college savings vehicles. The mutual funds are suitable vehicles for these goals.

2. Maximize return by placing assets in products which match the risk tolerance of the customer.
   By selecting an aggressive growth mutual fund, a growth mutual fund and a corporate bond fund, the Hoapwels are using products which reflect both their risk tolerance and their asset allocation goals.

3. Place the appropriate amount of assets in the liquid class to meet short term and emergency needs.
   The Hoapwels did not invest money in the growth or fixed classes that needed to be in the liquid class.

4. Reduce volatility in the portfolio by placing non-liquid assets in the appropriate mix of fixed and growth products.
   They diversified their assets among asset classes. They did not allow their aggressive risk tolerance to keep them from putting some money in the
fixed category. Over time, this should reduce the volatility of their portfolio’s return.

**Asset Allocation Revisited**

Asset allocation is a process, not a one-time event. Markets change, goals change, people age and different needs arise. The financial representative assisting people in developing an asset allocation plan can provide a great service by carefully reviewing all the aspects of an individual’s financial picture, giving well thought out recommendations, listening carefully to the customer, and revisiting the portfolio regularly.

This course was designed to assist the financial representative in doing a great service for his or her customers: help them design a suitable asset allocation plan. By keeping in mind the basic goals of such a plan, and the characteristics of the many products available to meet these goals, the financial representative can be assured of gaining and keeping many satisfied customers.
Chapter Five: Study Questions

Sue and Marty Newleewed are a young married couple, both in their late 20’s. Both have high paying jobs. Sue earns $55,000 at a computer consulting firm, and Marty $50,000 at a marketing company. They are in a 28% marginal tax bracket.

Before marriage, Sue was diligent at saving. She purchased a $125,000 home and stayed out of debt. She has $10,000 in a balanced fund which she uses as an IRA, since her company does not have a retirement plan. She also has one growth mutual fund with a value of $25,000 and a $100,000 whole life policy with cash values of about $3000. She has a money market fund with a balance of $5000. Her only bank account is her checking account, in which she keeps a minimum of $1000.

Marty confesses to being a spender. He recently paid off a Mercedes and has three different growth mutual funds, recommended by his friends. The total value in these mutual funds is $13,000. He also has about $3000 in a money market fund. He keeps no minimum balance in his checking account. His company has a 401(k) plan. He contributes $250 a month to the plan’s equity account. It has a value of about $6400. He has term life insurance through his work, which provides a death benefit equal to his annual salary ($50,000). Both Sue and Marty are covered under Marty’s company health plan.

The Newleeweds want to save for an addition to the home Sue purchased, because they anticipate having children within the next five years. They plan that Sue will leave her position at the consulting firm and work from home once the children arrive. Since her income will become more variable at this time, they want to save as much as possible right now, both for the remodel and toward retirement. They feel this will be the best time for them to save heavily, while they are in what they consider secure employment.

Their after tax income monthly is $5200. Expenses are about $3000 a month, including their house payment and college debt which will be paid off in two years. They feel they have plenty to save, although Marty says money tends to somehow slip through his fingers.

The risk tolerance of the Newleeweds is moderate. They have placed money mostly in growth stocks because they just had not taken a lot of time to think about a more balanced portfolio.

1. Inventory the Newleeweds’ assets by category:

<table>
<thead>
<tr>
<th></th>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
</thead>
</table>

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2. Assume their financial representative provides them with an asset allocation model portfolio based on their asset information, risk tolerance and experience. It provides suggested ratios of 10% liquid, 40% fixed and 50% growth. Given their total investment assets listed in number one, what amounts should be in each category, according to this model?

Liquid: $__________  Fixed: $__________  Growth: $__________

3. What recommendations or things to consider would you offer to the Newleeweds. Consider their tax situation, investment horizon, risk tolerance, special circumstances, and model asset allocation plan. General suggestions are sufficient since exact dollar amounts could not be determined without further discussion with the Newleeweds.

Regarding Liquid Assets:

Regarding Fixed Assets:

Regarding Growth Assets:
Glossary

**Accumulation Unit**: A standard of measurement used in each sub-account to determine the value of the sub-account.

**Annuitant**: Party on the annuity contract who is normally the measuring life.

**Annuitization**: Making an irrevocable option to receive periodic payments.

**Annuity Unit**: A standard of measurement used in the calculation of variable annuity income payments.

**Cash surrender value**: The amount distributed to a policyowner upon distribution of a life insurance policy or annuity.

**CMO**: Collateralized Mortgage Obligations. A CMO is a security backed by a pool of pass-throughs, actual loans, or stripped mortgage backed securities. A CMO is structured so that the underlying mortgages are placed into several classes, or tranches of bonds with varying stated maturities.

**Death benefit**: The amount contractually specified to be paid out at the death of the insured on a life insurance policy.

**Deferred annuity**: Annuity in which earnings are not taxable until withdrawn.

**Exchange rate risk**: The risk that the currency in a foreign country will decrease in value relative to other currencies, such as the dollar.

**Face amount**: The amount listed on the front page, or face page, of an insurance policy, to be paid as the death benefit. The actual death benefit may differ from the face amount due to policy loans, or increases in coverage allowed under the contract.

**Financial risk**: The risk that the underlying corporation or issuing entity of a security will be financially unable to meet the obligations of the security.

**Fixed annuity**: Annuity which pays a fixed interest for a specified period of time, and which has a minimum guaranteed interest rate.
**Fixed assets:** Products that they offer stable or fixed returns, and may provide income. Examples include bonds, fixed annuities, and CDs. Fixed assets are typically subject to interest rate and default risks.

**Fixed income annuity:** Annuity or immediate income option which guarantees the periodic payment amount and payment period length.

**General account:** The investment portfolio of a life insurance company.

**Growth assets:** Products which have a high potential of increasing in value over time. Examples include stocks, stock mutual funds and sub-accounts, REITs, collectibles and gold. Growth asset’s predominant risk is market risk.

**Guaranteed cash value:** The amount which is guaranteed at surrender of a life insurance policy. It is based on guaranteed values disclosed in the life insurance policy.

**Immediate annuity:** An annuity which pays income within twelve months of purchase in exchange for a lump sum. This contract type is irrevocable.

**Interest rate risk:** The risk that a securities price will be affected by a change in interest rates.

** Loads:** Sales charge assessed on purchases of mutual fund shares

**LIFO:** Last in, first out. Annuities issued after August 13, 1982 are considered to distribute income first, principal last.

**Liquid products:** Those which are cash, or can be easily converted to cash.

**Market risk:** The risk of price fluctuation of a particular security or securities of a particular industry group due to financial difficulties, competition, weather, regulation, public perception, etc. within an industry.

**Market Value Adjustment:** Adjustment made in fixed account value based on the change in interest rates since contributions were made to the fixed account if the fixed account is withdrawn from. An increase in interest rates causes a negative market value adjustment. A decrease in interest rates causes a positive market value adjustment.

**Nursing home waiver:** Feature of an annuity contract wherein if a specified party is confined to a nursing home, hospital, long term care facility or other qualified facility, partial or full surrender of the annuity contract values may be made
without applicable surrender charges. Particular provisions of a nursing home waiver vary.

**NYSE**: New York Stock Exchange. The NYSE is the largest stock exchange in the US. Most of the largest US corporations trade on the NYSE.

**Ordinary life insurance**: Also known as whole life and straight life. A type of life insurance policy which generally requires level premium payments from purchase of the policy until death, or until the policy matures, typically at age 100.

**OTC**: The over-the-counter market. The over-the-counter (OTC) market is not an exchange at a fixed location. Rather it is a method of trading stocks not listed on an exchange. The OTC is a negotiated market, wherein the purchasers and sellers use no intermediary.

**Penalty-free withdrawal**: Annuity feature wherein the owner may make a specified withdrawal amount, normally annually, without normally applicable surrender charges applied.

**Political and economic risk**: The risk that a security will change in value due to changes in the regulatory environment, the stability of a country’s currency, inflation rates, interest rates and the overall stability of the political environment within that country.

**Purchasing power risk**: The risk that a product will not increase in value to keep pace or beat inflation.

**Separate account**: An investment account used by life insurance companies to hold assets backing variable product sub-accounts. It is considered a separate legal entity from the life insurance company.

**Single premium annuity**: Annuity which accepts the opening contribution only.

**State guaranty association**: Association governed by individual state regulations. Insurance companies which are members of a state guaranty association are liable for contractual obligations to policyholders if another member is unable to meet them.

**Surrender Charge**: Another term for deferred or back-end sales load. Percentage charge assessed on certain withdrawals from annuities and life insurance policies which are within the surrender charge period. The surrender charge period begins from the date of contribution, or from the opening date of the contract and continues for a specified period of time.
**Tax-Deferral:** Deferral of taxes until a certain event, such as withdrawal of earnings or pre-tax accumulations, occurs.

**Total Return:** The total return of a fund is a calculation which incorporates the change in share price over a period of time and assumes distributions are reinvested as they are received. It is expressed as a percentage of the share price excluding loads or including loads.

**UGMA:** Uniform Gift to Minors Act. Act whose provisions allow irrevocable transfers of property to a minor through a custodian.

**UTMA:** Uniform Transfer to Minors Act. Act whose provisions allow irrevocable transfers of property to a minor through a custodian. UTMA provisions allow transfer of property types not allowed by UGMA provisions.

**Variable annuity:** Annuity which allows the purchaser to allocate their contributions to a variety of sub-accounts which generally provide variable, rather than fixed, return to a customer.

**Variable income annuity:** Annuitzation or immediate income option which guarantees the number of units paid in each periodic payment. Since unit values may fluctuate, the variable income payments may also fluctuate.

**Whole life policy:** See ordinary life insurance.

**Yield of a Mutual Fund:** The yield of a fund is basically the amount of annual income received per share, expressed as a percentage of the current or average share price. As a simple example, if the current share price of a fund is $10.00, and $1.00 of income was earned per share over the past twelve months, the yield would be 10% ($1.00 / $10.00) The actual yield calculation required for mutual funds (the SEC Yield) is much more complex than this example. It includes incorporating risk premiums, special accounting for foreign security distributions, and other complicated computations.
Answers to Study Questions

Chapter One
1. c
2. c
3. a
4. b
5. d
6. a
7. False
8. investment experience
9. True
10. default, interest-rate, market

Chapter Two
1. Those which are cash, or can be easily converted to cash.
2. d
3. d
4. a
5. b,d
6. b,d
7. d
8. b
9. c
10. a

Chapter Three
1. interest rate, default
2. stable or fixed returns, may provide income
3. a,b,d
4. a, e, f
5. a, b, d, e
6. loans are not taxable distributions, the death benefit is not decreased unless the loan is not paid back prior to the death of the insured.
7. a,b,and c
8. False
9. True
10. False

Chapter Four
1. return levels
2. Because of other needs besides return: saving for short-term expenditures, desirability of known or stable returns, life insurance protection, tax-deferral or other tax advantages, to name some examples.
3. Account values in an equity mutual fund will fluctuate; they may lose all or a portion of what was invested. The yield and the return on the fund is not guaranteed.
4. c,d,e
5. to produce long-term income and long-term capital gains
6. b, f, g
7. equity mutual funds, variable annuities, REITs

Chapter Five

<table>
<thead>
<tr>
<th>Liquid</th>
<th>Fixed</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5000 MMF</td>
<td>$3000 cash value insurance</td>
<td>$25,000 mf</td>
</tr>
<tr>
<td>$1000 Checking</td>
<td></td>
<td>$13,000 mfs</td>
</tr>
<tr>
<td>$3000 MMF</td>
<td></td>
<td>$6400 401(k)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$10,000 IRA</td>
</tr>
<tr>
<td><strong>Total: $9000</strong></td>
<td><strong>Total: $3000</strong></td>
<td><strong>Total: $54,400</strong></td>
</tr>
<tr>
<td>Percent: 13.5%</td>
<td>Percent: 4.5%</td>
<td>Percent: 82%</td>
</tr>
</tbody>
</table>

Total Invested Assets $66,400

2. Liquid: $6640  
   Fixed: $26,560  
   Growth: $33,200

3. Liquid Assets:  
   Given expenses of $3000 a month, at least $9000 (an amount equal to three months of expenses) should remain in liquid assets. Money market funds are suitable investments, given their risk tolerance. Sue may want to reduce the amount she leaves in the checking account. She can earn a better return in the money market fund.

Fixed Assets: To meet the asset allocation model, they need $23,000 more of their current assets in this category. They can move some money out of the growth category, and use savings in the first few years of their asset allocation savings program to build this category. Vehicle options include corporate bond mutual funds, or variable product sub-accounts.

Any money placed in a variable product should be money they plan to leave for the long-term. Since they have a remodel coming shortly, they should place an amount in a corporate bond fund which, including additions, will grow to meet
their remodeling needs. As will be described under growth assets, they may decide to take the money from a growth mutual fund, but since they have ample assets, they can put money away for the remodel in both the fixed and growth categories, and make the final decision later.

Since Marty does not have as much life insurance as he needs given his now married status, a VUL or VL policy could be used. Since he is a spender, these policies will provide him with a forced savings vehicle. Sue may be able to convert her whole life policy to a variable policy as well, if her insurance company has such a program.

Growth Assets:
Review the four growth mutual funds they hold to determine which have the best return or returns over time. Consolidate the funds. From these funds they should plan to take assets for the remodel, if the timing for this need does not coincide with a stock market downturn. Should it, they could take money from the corporate bond fund they are opening.

Marty could increase the amount he is placing in his 401(k). Since this money comes out of his salary, it is another forced savings vehicle for him. Since retirement is far off, the choice of the equity account in the 401(k) plan is suitable.

Comments: Although the Newleeweds are young and could probably afford more risk than their moderate risk tolerance will allow, unless they fully agree and feel comfortable with a more aggressive strategy, it should not be undertaken. In the semi-annual review of their portfolio, they may over time decide to construct a more aggressive portfolio than the asset allocation model suggested.