Heritage Perspective

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Holiday Gifts from the IRS

When we were children, we were taught that it is better to give than to receive. While this adage is true in most instances, in cases where the Internal Revenue Service is on the other side of the transaction, most of

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us have a fairly strong preference for receiving rather than giving. Although it may surprise you, there are things you can do to allow for a few gifts from your dear friends at the IRS during this season of giving.

At Thanksgiving time, you should embrace the harvest theme by "harvesting" some tax losses from your investment portfolio. In case you are not familiar with how tax harvesting works, here is an example: Let's say you own 15 mutual funds in your portfolio, 12 of which have been profitable and three of which have lost money. You can "harvest" losses by selling the three funds that are down, and replacing them with three new funds that have similar objectives to the funds that were sold. Selling the three funds allows you to generate capital losses that can be used to offset current or future capital gains, and since you are replacing the funds that were sold with similar funds, this strategy does not cause a significant change in the composition of your portfolio.

Charitable contributions offer another opportunity to benefit from the munificence of the IRS during the holiday season. For most taxpayers, some or all of the donation to a qualified charity is deductible from taxable income. In essence, a charitable donation is two gifts: one from you to the charity, and the other from the IRS to you.

The IRS is also surprisingly generous when it comes to company retirement plans. If your employer offers an employer-sponsored retirement plan such as a 401(K) or 403(b), your retirement contributions to this plan are usually tax-deductible. In addition, many employers, perhaps inspired by the virtue of the IRS, add to the IRS's gift by matching a portion of your retirement plan contributions out of their own pocket. As the end of the year approaches, you should take a few

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Heritage Investment Group would like to thank all of our clients for their continued support. If you have any friends or family members who could benefit from our disciplined investment process, we would welcome the opportunity to speak with them. Please contact us at (954)785-5400.

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minutes to ensure that you have contributed as much as possible to your company retirement plan. Once the clock strikes midnight on New Year's Eve, you can no longer make 401(k) contributions for 2014.

Being on the receiving end of the IRS's gift giving is certainly satisfying, however, you also need to be careful not to end-up on their naughty list. For example, if you do sell any securities to take advantage of the tax-loss harvesting strategy mentioned above, you must wait at least 30 days to re-purchase any of the same securities you have sold. This is why the harvesting strategy involves purchasing similar, but not identical, securities to replace those that were sold. If you do repurchase identical securities within the 30-day window, you trigger the "wash sale rule," which negates the tax advantages of the sale. So be good for goodness' sake.

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Also, if you are older than 70 1/2 years of age before December 31, you typically must withdraw a certain percentage of your 401(k), individual retirement accounts, and other retirement plans each calendar year in order to fulfill your IRS-mandated required minimum distributions (RMDs). Failure to take these required distributions can result in penalties of 50% of the required withdrawal amount that was not taken. This is even worse than coal in your Christmas stocking.

As with most magnanimous uncles, Uncle Sam's gifts often come with exceptions and strings attached. Your ability to personally benefit from the generosity of the Internal Revenue Service will depend upon your own individual tax situation, so you should consult with your tax advisor before accepting any of these holiday gifts. From all of us at Heritage Investment Group, we wish all of you a wonderful holiday season, and all the best for the new year.

This article was originally written by Heritage for the November 2014 edition of The Light, a local magazine serving Broward County, Florida.

Investment Decisions and Flawed Memory

If it is true that you can improve your performance by learning from the past, then the weak link in this process is our memory, according to the findings of recent neuroscientific research. A poor memory may distort our recollection of our past financial decisions and outcomes, making it likely we will not be able to learn the proper lessons from them.

Neuroscience experiments have identified two memory flaws. First, we often do not properly store information. Second, the stored information is often distorted by common cognitive biases when it is recalled. Investors should heed these research findings if they want to avoid repeating past mistakes.

Too much information

Research has shown that our brains simply do not have the capacity to hold in long-term memory every detail of every event we have experienced. Much detail can be held in short term memory, but after a while only a general outline – including perhaps a few specific details – of events and facts remain in our memory. Then, when we recall those memories, our brains reconstruct them based on what it has stored. But it also fills them in with information from our current set of beliefs and knowledge, a process that often distorts the memory of the actual event.

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Transience, a phenomenon where information is gradually lost the longer it is stored in memory, may explain why stock market participants who have experienced long periods of calm markets are shocked when a crisis period ensues: The vividness of their memories of previous crisis periods has faded. They may panic and sell their investments because they do not fully remember how quickly markets recovered after past crises.

Blocking the bad

Researchers also say we often block salient information with other information, making it difficult or impossible to retrieve. For instance, it is more common

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> *“Investors can overcome these memory flaws by using written portfolio allocations and keeping investment diaries.”*

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to remember pleasant experiences than unpleasant ones. For investors, that can mean recalling our winners but not fully remembering our losing decisions.

However, highly traumatic memories seem to persist in our memory more than others. The Great Depression generation, for instance, never got over the stressful memories they had of the 1930s, and were generally more risk averse when investing than were subsequent generations.

Overcome your limits

Investors can overcome these memory flaws by using written portfolio allocations and keeping investment diaries. A written portfolio allocation documents your risks, rules and limits for investing. Frequent consultation with it can prevent you from making short-term investment decisions that conflict with your long-term goals.

An investment diary should include all of your reasons for making decisions to buy or sell. It can help you learn from past mistakes, avoid the bias of hindsight and correct any overconfidence. You should note in your diary all of the reasons for a trade and then the outcomes. Such a record will allow you to keep score in an honest way, and may help you determine whether your wins are due to skill or just plain luck.

To paraphrase Nietzsche, “When pride and memory collide, memory yields.” Documenting your investment plan and keeping score in an honest way will help you to overcome the influence of pride, and it might just make you a better investor.

The Curve Ball

Market expectations about interest rates change because of news. This makes it very difficult to build a coherent investment strategy around a forecast.

In an article this summer[1], Bloomberg News noted that the rally in the US Treasury market in 2014 was stronger than every economist surveyed by its journalists had predicted. US 10-year yields were around 2.3% at the end of August, down from just over 3% at the end of 2013. Yields fall as prices rise, so those who heeded economists' forecasts and backed out of bonds missed part of this capital return.

But this isn't just a US story. Japan's 10-year government bond yield hit its lowest levels in 16 months this summer as well, and European bond yields tumbled to record lows.

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Why did many economists get their interest rate calls wrong? There could be a variety of reasons. Economic growth and inflation may have been below their assumptions. Geopolitical strains may have dampened risk appetites. Central banks may have adjusted their timetables for withdrawing monetary stimulus. The important point is that unless you have a way of forecasting news, you are unlikely to enjoy consistent success in basing your fixed income strategy on anticipating changes in interest rates.

Luckily, there is another way of managing fixed income; one that doesn't require predicting interest rates. It involves diversifying globally and using the information in the market at any one time to work out which parts of the market to invest in.

The benefits of diversification come from the fact that interest rate cycles can vary across economies, reflecting differences in expectations for inflation, economic growth and other indicators. For example, while benchmark rates in many economies remain at record lows, New Zealand raised its cash rate four times since March of this year. Elsewhere, while markets suspect the Bank of England may raise rates, the European Central Bank has recently announced further stimulus to ward off deflation.

The non-correlated nature of interest rate movements implies that spreading fixed income risk globally can reduce volatility in an overall portfolio. This is the argument for global diversification – not betting everything on a single market.

The second part of this non-forecasting approach is to vary maturities in a fixed-income portfolio based upon the state of the yield curve today. The yield curve is a graph that compares the yields of similar sorts of bonds of different maturities. A normally sloped yield curve is upward sloping – reflecting the additional return investors require for committing their capital for longer periods. This is called "term risk." Sometimes, yield curves can flatten or invert. This is when there is little or no premium on offer for tying up your money for longer periods.

So if the yield curve is upward sloping, it may pay to take more of this term risk because you are being compensated for it with higher yields. Conversely, if the curve is flat or inverted, there is little or no compensation for taking on the term risk, so you should stay in shorter-dated bonds.

This approach uses no forecasting, market timing, or assumptions about the direction of interest rates. It uses today's yield curve to work out where to allocate term risk in a portfolio. And treating bonds as a global asset class provides a larger set of yield curves to choose from – more opportunity, more diversification.

Of course, everyone has an opinion about the interest rate outlook, and that's fine. The problems arise when we base long-term investment decisions on expectations for interest rates, only to see them confounded by the curve ball of new information.

[1] *"Treasury Market Rally Stronger than Every Economist Predicted," Bloomberg, August 30, 2014.*