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CLIENT NEWSLETTER

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RISING RATES: SHORT-TERM PAIN FOR LONG-TERM GAIN?

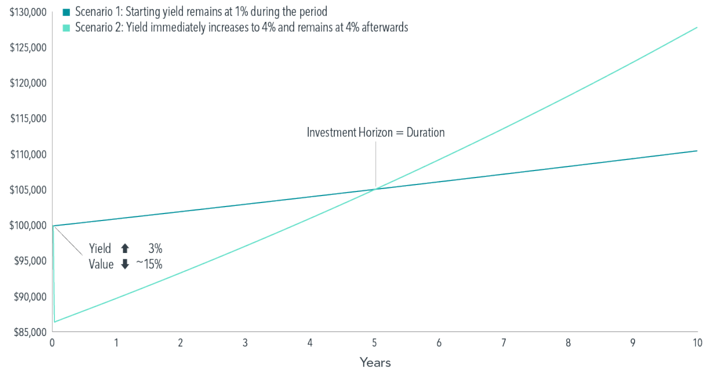
Investors have likely noticed the improved opportunity set in fixed income due to higher yields. And yet some investors may be hesitant to take advantage of higher yields because of concerns about future increases in yields. Some may even be considering reducing their bond exposure after this year's negative returns for fixed income.[1] The good news? If yields do keep rising, investors seeking higher expected returns may still be better off maintaining the duration of their fixed income allocation.

Rising yields impact fixed income portfolios in several ways. On the one hand, longer-duration portfolios may experience larger immediate losses from increased yields relative to shorter-duration portfolios. On the other hand, higher yields may lead to higher expected returns. Investors can think of this tradeoff as a pit stop in a Formula 1 race. The pit stop immediately causes the driver to fall back. However, fresh tires may help the driver win the race if there are enough laps left to catch the leader.

Exhibit 1 illustrates this using two scenarios for a $100,000 fixed income allocation with a five-year duration. Scenario 1 experiences a constant yield of 1% during the period. Scenario 2 is faced with a sudden spike in yield from 1% to 4% on Day 1 and sees its value immediately drop to a little over $86,000. However, the higher-yield environment accelerates Scenario 2's recovery: With a 4% yield rather than the previous rate of 1%, Scenario 2's portfolio value overtakes Scenario 1's within five years—the time horizon determined by the duration of Scenario 2.

Exhibit 1. Recovery Race

Growth of $100,000 fixed income allocation with a five-year duration



For illustrative purposes only.

When faced with uncertainty, investors should focus on the things they can control. Research tells us that trying to outguess the market by holding on to cash, or shortening duration, with the expectation of future yield increases may not help you achieve your long-term goals.[2] Markets quickly incorporate new information about higher interest rates and inflation.[3] Investors who maintain appropriate asset allocations, even after increases in bond yields, may have a more rewarding investment experience in the long run.

—Thomas Meinke and Wes Crill,
Dimensional Fund Advisors

Footnotes

[1] The Bloomberg Global Aggregate Bond Index (hedged to USD) returned –12.1% from January 1, 2022, through September 30, 2022.

[2] Doug Longo, "Bonds Deliver Positive Returns in July 2022," Insights (blog), Dimensional Fund Advisors, August 12, 2022.

[3] Wes Crill, "Light at the End of the Inflation Tunnel," Insights (blog), Dimensional Fund Advisors, June 10, 2022; "Markets Appeared to Be Ahead of the Fed," Insights (blog), Dimensional, June 16, 2022.

ROTH IRAS FOR YOUNGER GENERATIONS

Roth IRAs are still a fairly new type of retirement account that have benefits that go unused by many. Roth IRAs can play an important role in long-term financial planning, especially for younger generations.

Eligibility

There is no age limit on when people can open and contribute to a Roth IRA. They just need earned income. If you have a babysitting job at the age of 15 and make $2,500, you can contribute $2,500 for the year.

Contribution Limits

In 2022, an individual can contribute up to $6,000. If they are over age 50, they are allowed a "catch-up" of $1,000. If the individual makes over $144,000 or a married couple earns over $214,000, then no Roth IRA contributions are allowed for that year.

Withdrawal Exceptions

A concern we often hear is that younger people need access to funds for college, a first home purchase, a wedding, their firstborn, etc. There are exceptions that make a Roth IRA a valuable option:

- A person can remove Roth IRA contributions at any time for any reason (but may have to pay taxes and penalties on withdrawal of earnings).
- First-time home buyers can remove up to $10,000 from their Roth IRA. If the account has been open for five years or more, they can remove earnings penalty-free.
- Each parent is allowed to take $5,000 in the first 12 months after having or adopting a child. (This is one of the few exceptions allowing an individual to put the money back in.)
- An individual may use funds from a Roth IRA to pay for higher-education expenses. They will avoid the 10% penalty but may still have income tax on the earnings.

Cash Flows

Often, younger people do not have the extra cash to fund a Roth IRA. One way to contribute is via leftover money in a college savings account, like a 529 plan.

Depending on the account, there may be a penalty incurred. But younger people in lower tax brackets may find it worthwhile to take the penalty now instead of waiting until they are in a higher bracket or no longer eligible to contribute to a Roth IRA.

Tax Advantages

Many tax advantages are often overlooked when it comes to Roth IRAs. The tax benefits are:

- The Roth IRA grows tax-free, so you do not have to pay income tax or capital gains tax during retirement.
- Most younger people make less than the salary limit, which allows them to contribute before they start earning more and can no longer contribute. Even then, the funds still grow tax-free until their retirement.
- With Roth IRAs, there is no required minimum distribution (RMD) at age 72 like traditional IRAs have.

Tax Disadvantages

The one disadvantage compared to other retirement accounts is an individual does not get the tax deduction they would get for their contributions to a traditional IRA or traditional 401(k).

Roth 401(k) vs. Roth IRAs

A question we hear a lot is "Can we contribute to both a Roth 401(k) and Roth IRA?" Yes, you absolutely can.

The limit for the Roth 401(k) is $20,500 (2022), and after the age of 50, there is a catch-up of $6,500. The Roth 401(k) may be limited in investment options but still grows tax-free. Roth 401(k)s do have an RMD requirement beginning at age 72, but an individual can roll a Roth 401(k) into a Roth IRA to avoid the RMD.

A common misconception is an employer match will go to a Roth 401(k). An employer can only put a matching contribution into a traditional 401(k). You will still get the match for your contributions to your Roth 401(k), but the match will go into a separate traditional 401(k) account.

From a planning perspective, this allows the individual to have multiple buckets to choose from during retirement to minimize their taxes.

Conclusion

Roth IRAs can be especially beneficial for younger generations who can contribute to a Roth IRA and let their investments grow tax-free until they retire or need it to begin their careers.

—Charles Thomas, MBA

WHY A ROTH CONVERSION CAN INCREASE YOUR MEDICARE PREMIUMS

Roth conversions can be a great way to create tax-free income in retirement. However, if you've signed up for Medicare or plan to within a couple of years, take notice: Your Roth conversion could increase your Part B and D premiums—sometimes significantly. Read this article to understand why.

Why Complete a Roth Conversion?

With a Roth conversion, you convert a traditional IRA into a Roth IRA to enjoy tax-free distributions in retirement. What's more, you do not have to take required minimum distributions (RMDs) with Roth IRAs. These advantages can increase retirees' tax flexibility in retirement.

Many people use down markets like we have experienced this year to leverage conversions. That's because you pay income taxes at the time of your conversion. So, if your portfolio value has dropped, the taxes you pay drop too.

But Roth conversions come with a couple of caveats. First, you should avoid making withdrawals for five years or face a 10% penalty. You also want to have the cash to pay the income taxes you owe. That way, you avoid using other retirement accounts to cover your tax payment, potentially incurring more taxes and penalties.

Finally, conversions could increase your Social Security taxes and certain Medicare premiums. (Read more about Social Security taxes in the Money article "This Roth IRA Move Can Create a Massive Tax Headache."[1])

How Roth Conversions Affect Medicare Premiums

Many people have made Roth conversions and been shocked by an increase in their Medicare premiums a couple of years later. This is because of a little-known charge called the income-related monthly adjustment amount, or IRMAA.

IRMAA essentially means people with higher incomes pay higher premiums for Medicare Parts B and D. It works like this:

- Medicare Parts B and D have a regular premium that everyone pays.
- Medicare adjusts the premium upward based on the modified adjusted gross income (MAGI) on your tax returns two years prior.
- So if your Roth conversion bumps your MAGI above a certain amount (currently $91,000 for individuals and $182,000 for married couples filing jointly[2]), you can expect an increase in your Medicare premiums two years out.

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- Medicare will generally remove IRMAA within a year or two—unless you do more Roth conversions or something else to raise your MAGI.

The premium increase can be substantial too. For example, your monthly Part B premium in 2022 is $170.10. But IRMAA can increase that premium up to $578.30—*per month*![3]

If you opt for Part D drug coverage, you pay a monthly premium as detailed in the plan you select. However, Medicare can tack on an IRMAA increase so that you're paying the plan premium plus up to $77.90 per month.

What Should You Do?

Roth conversions aren't as cut-and-dried as they often appear, especially if you receive Medicare. However, you may have strategies to help reduce your MAGI, such as spreading out conversions, making charitable contributions, or completing tax loss harvesting.

Consider talking with us before you do any Roth conversions. We can help you decide the timing and amount based on your overall financial picture and goals.

Footnotes

[1] https://money.com/roth-ira-conversion-taxes-social-security/

[2] https://www.medicare.gov/basics/costs/medicare-costs

[3] https://www.medicare.gov/basics/costs/medicare-costs