LENOX ADVISORS, INC

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LENOX ADVISORS, A LEADER IN INDIVIDUAL SOLUTIONS AT NFP.

Overdiversification could actually hinder your investment goals

Diversify, diversify, diversify. If you know only a little about investing, you've almost certainly heard — perhaps more times than you'd care to — about the importance of building a diversified portfolio. But is it possible to overdiversify or spread your investment dollars too thin across asset types and industry sectors? In a word: Yes. But because diversification is a complicated concept and can be difficult to get right, you need a nuanced perspective.

WHY WE DO IT

Diversification is designed to reduce the impact of losses that you might experience when specific securities or asset classes, particular market sectors, or even the general market are struggling. While some investments or asset classes lag, others may perform well — or not as badly. Thus, diversification helps reduce overall portfolio risk and volatility.

But while diversification helps manage risk, it can never keep your portfolio fully protected from losses. For example, in times of financial crisis many investments or asset classes (including in some periods, both stocks *and* bonds) can move in tandem and punish even well-diversified portfolios. The bottom line: When you invest, there's always a risk you'll lose a significant portion of your original investment.

AN OVERLOOKED RISK

Although the risks of underdiversification are relatively clear, the risks of having too much diversification may initially be harder to see. But there are a couple of reasons why owning too many investments or investment types can work against your portfolio.

First, the more investments you have in your portfolio, the harder it can be to keep track of all of them. It's more challenging to monitor each investment's performance and understand when something fundamental has changed with individual stocks or mutual funds. Consequently, you may not know when it's prudent to rebalance your portfolio or change your investment

strategy to remain on target toward long-term financial goals.

Another potential risk of overdiversification is holding overlapping securities. The more individual investments you own, the greater the likelihood that you may not be as diversified as you think. For example, there's a good chance that two small-company growth mutual funds own some of the same stocks. If you own both funds, you not only duplicate investment costs, you also get greater exposure to certain stocks than you probably intended. Bigger positions can seem like an advantage if those stocks are doing well — but not if they stumble and make your portfolio more volatile.

Also consider multiple studies that have shown that, with a certain higher level of diversification, investment portfolios tend to produce consistently mediocre returns. This happens because, when you have a large number of holdings, the returns of the successful ones become diluted by the average-to-poor returns of the portfolio's remaining investments. Meanwhile, you may be paying fees that aren't justified by diluted returns.

OPTIMAL NUMBER AND TYPE

To review, a portfolio of two stocks is less risky than a single-stock portfolio because performance problems with one security can be offset by the other security's higher returns. But the opposite is also true. If a single stock performs well, a second stock can limit overall portfolio returns. The challenge for investors is to limit risk while encouraging returns.

What, aside from becoming an investment expert, can you do to assemble a balanced portfolio? Your Lenox advisor can help identify the goals that are most important to you — for example, reaching a certain amount by the time you retire while reducing tax exposure — and build a portfolio that targets these goals.

So you've dipped into savings …

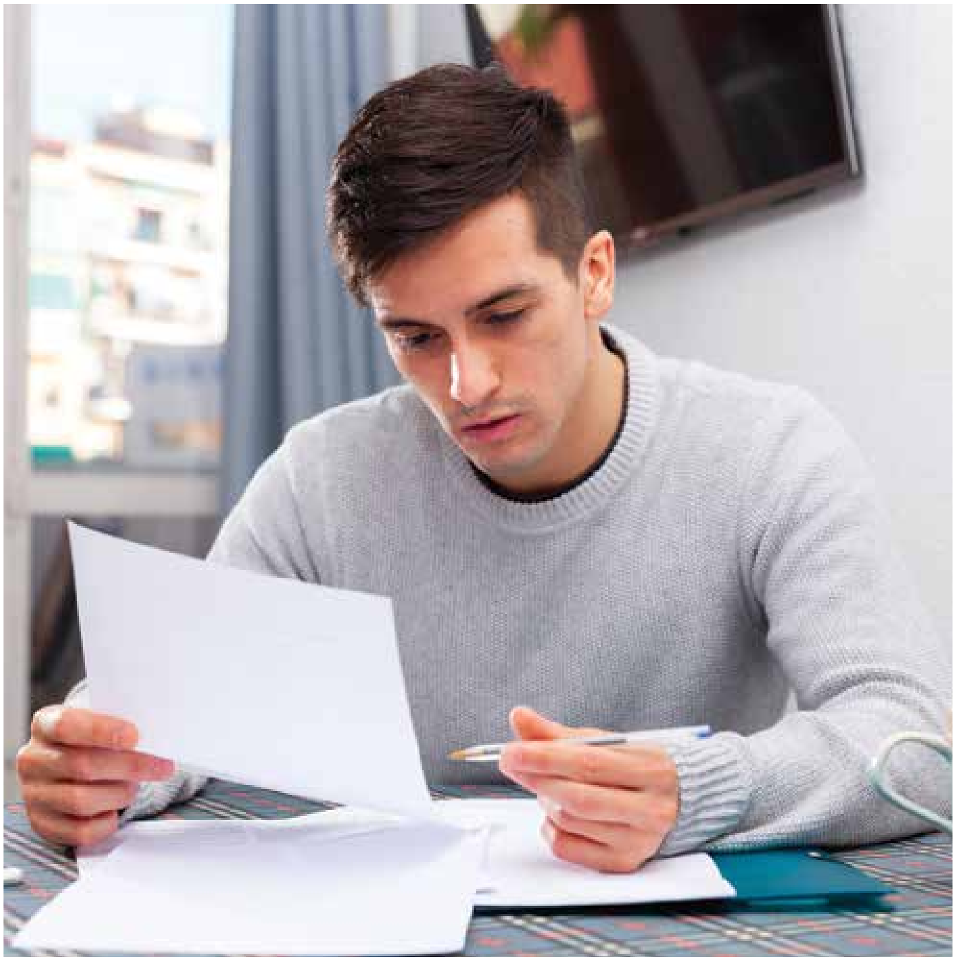
What to do next with your retirement account

Tapping an IRA, 401(k) plan or other tax-deferred account to pay current expenses can derail your retirement savings plan. Therefore, it should be viewed as a last resort. Unfortunately, many people reached that point in 2020 or earlier this year due to COVID-19's financial impact. If you withdrew or plan to withdraw tax-deferred savings as a result of financial hardship, you may need a strategy for getting your retirement plan back on track.

ELIMINATING PENALTIES

To ease some of the pain, last year's CARES Act eliminated early withdrawal penalties for people affected by COVID-19 who withdrew up to $100,000 in retirement savings in 2020. The act also provided that account owners can avoid income taxes on the amount withdrawn by returning it to the account within three years.

Retirement plan owners unable or unwilling to return the funds have the option of reporting the distribution, and paying applicable taxes, ratably over three years. And the Consolidated Appropriations Act, signed into law at the end of 2020, extended similar relief to certain non-COVID-19-related disasters, applicable to eligible distributions made on or after the date of the qualified disaster and before June 25, 2021.



SERIOUS CONSEQUENCES

To get an idea of how early withdrawals can affect your retirement plan, consider this hypothetical example. At the beginning of 2020, Pete is 35 years old and has a $200,000 balance in his employer's 401(k) plan. He contributes $1,000 per month to the plan and expects to retire in 30 years. If his account earned an average return of 7% per year, his balance would be approximately $2.7 million at retirement.

In April 2020, Pete's wife, Alicia, is laid off as a result of the pandemic. In July 2020, Pete takes a $75,000 distribution from his 401(k) plan to help cover the family's expenses while Alicia looks for work. He also stops contributing to his plan until July 2021. How does a $75,000 distribution and a year-long suspension of contributions affect Pete's anticipated retirement balance? The combined action reduces it to $2.1 million — $600,000 less than his original projected balance.

MAKE UP THE LOSS

As you can see, taking an early distribution (even if it's penalty free) from a tax-deferred account and suspending contributions can really set you back. So, what can you do to make up for the loss in expected retirement benefits? Ideally, you would return the distribution to the account within three years to avoid taxes, plus contribute some extra to make up for any contributions and earnings you missed during the period of financial hardship. If that's not possible, think about increasing your monthly contributions by an amount that will enable you to achieve your original savings goal.

In Pete's case, for example, if he's unable to return the $75,000 distribution, he might still significantly reduce the tax by increasing monthly contributions from $1,000 to approximately $1,600 when they resume in July 2021. Increasing contributions also allows him to return $38,400 of the distribution within three years and avoid taxes on that amount. The remaining $36,600 could be included in taxable income at a rate of $12,200 per year. Pete won't quite be back on track with his original goals, but if he keeps up the increased contributions, he can get there.

IRS REFUNDS

If financial hardship forced you to take an early retirement plan distribution, you're not necessarily doomed to a financially insecure retirement. Consider recontributing some or all of the distributed funds within three years or increasing your contributions to make up for lost time. Be sure to amend your tax return if you report distributions as taxable income and later return them to the account within the three-year period. The IRS will refund you. Contact your Lenox advisor for advice on saving for retirement and minimizing taxes for your unique situation.

3 tips for making retirement less taxing

Recent retirees often are surprised by the size of their tax bills. As they soon learn, income taxes during retirement can be significant. However, with some planning, it's possible to soften the blow. Here are three tips to consider implementing.

1. CREATE A BUCKET LIST

This isn't the kind of bucket list that includes scaling mountains and writing a novel. Instead, you should estimate your cash flow needs in retirement and take inventory of your income sources, segregating them into one of three "buckets":

- Taxable — such as mutual funds, brokerage accounts and rental property income,
- Tax-deferred — including traditional IRAs and 401(k) plans, and
- Nontaxable — for example, Roth IRAs and Roth 401(k)s.

As you withdraw funds in retirement, carefully select from these buckets to maximize tax-efficiency. Some people tap their nontaxable and taxable buckets first to avoid paying taxes on withdrawals from tax-deferred accounts. But this approach can backfire by triggering hefty required minimum distributions (RMDs) once you reach age 72 (see tip number three).

To avoid this result, consider withdrawing tax-deferred funds until you reach the upper end of the 12% tax bracket ($81,050 for joint filers in 2021). This strategy generates modest current taxes while drawing down your tax-deferred accounts to minimize future RMDs. The next funding tier might come from brokerage accounts, which typically generate long-term capital gains taxed federally at between 15% and 23.8%. To maximize tax-free growth, withdrawals from nontaxable accounts should be delayed as long as possible.

A WINDOW OF OPPORTUNITY

If you have significant balances in one or more traditional IRAs, the window between retirement and age 70 or 72 can be an ideal time to convert some or all of these into Roth IRAs. Most or all of the amounts converted will be taxable as ordinary income. But completing the conversion while you're in a lower tax bracket will keep taxes to a minimum.

To ensure that the conversion itself doesn't push you into a higher tax bracket, you may need to do it in annual phases. For example, you could convert a portion of your IRA balance each year. Once the process is complete, you'll essentially have converted taxable assets into nontaxable assets and reduced, or even eliminated, the need for future RMDs.

2. DELAY SOCIAL SECURITY

You can begin receiving Social Security benefits as early as age 62 or as late as age 70, but unless you need the money sooner, it's generally best to wait. For one thing, the longer you put it off, the higher your monthly benefit will be, giving you a substantial benefit as long as you or your spouse live long enough to offset the initial lost income. In addition, as much as 85% of your Social Security income is taxable, depending on your income level. So, for many people it makes sense to postpone the start of Social Security benefits until their taxable income is lower because they've stopped working.

On the other hand, you may expect your taxable income to increase in the future because, for example, you'll need to take sizable RMDs from traditional IRAs or 401(k)s. In that case, it's important to consider the impact of those RMDs on Social Security taxation when determining the right time to start receiving Social Security benefits.

3. MANAGE RMDS

Under current federal law, you're required to begin distributions from traditional IRAs and employer-sponsored retirement accounts when you reach age 72. The RMD for a given year is calculated by dividing your account balance by the "distribution period." Generally, this means your life expectancy under the government's Uniform Lifetime Table. But if your spouse is more than 10 years younger than you, the distribution period is your joint and survivor life expectancy.

Because RMDs usually consist of ordinary income, they can generate significant taxes. But if you retire before age 70, you can use the period between retirement and the onset of Social Security benefits and RMDs (when you'll likely be in a lower tax bracket). By taking distributions from traditional IRAs or 401(k)s during that time in amounts that won't push you into a higher bracket, you can minimize taxes on those distributions *and* lower future RMDs.

Other strategies involve:

Employer-sponsored plans. You may be able to defer RMDs from your 401(k) plan. Some plans permit participants to postpone RMDs so long as they continue working (even part time) for the company that sponsors the plan.

Qualified charitable distributions (QCDs). If you're charitably inclined, and at least age 72, you can kill two birds with one stone: A QCD allows you to transfer up to $100,000 per year tax-free directly from a traditional IRA to a qualified charity. There are several potential benefits: You can satisfy your charitable goals, reduce your IRA balance without tax consequences and, if you're age 72 or older, QCDs can be applied toward some or all of your annual RMDs.

Roth IRAs. Another effective strategy is to execute a Roth IRA conversion, recognizing current taxable income while you're in a lower tax bracket. Roth IRAs aren't subject to RMDs (see "A window of opportunity" on page 5).

GET THE TIMING RIGHT

Minimizing taxes in retirement is a delicate balancing act, requiring careful timing of distributions from various income sources. Work with your Lenox advisor to develop a plan that addresses your goals and considers your situation — ideally before you retire.

Are you responsible for your parents' nursing home expenses?

Given the steep cost of nursing homes, planning for long-term care is critical — for you as well as your parents. One important question to consider is whether you could be financially responsible for your parents' nursing home bills if they can't afford to pay them. The answer is: It's possible, but not likely.

FILIAL RESPONSIBILITY LAWS

More than half of the states have "filial responsibility" laws, under which adult children are responsible for their parents' medical bills if their parents are unable to pay. These laws are rarely enforced, for several reasons. For one thing, nursing home expenses usually are covered by Medicare or Medicaid. Also, most filial responsibility laws require a court to consider the children's ability to pay before imposing liability.

In rare cases, however, an adult child may be held responsible for his or her parents' nursing home bills. This might be the case, for example, if a parent doesn't yet qualify for Medicare and has just enough financial resources to be disqualified from Medicaid.

It's also possible for Medicaid eligibility to be delayed by several months — or even years — if the applicant made certain gifts or other asset transfers within a five-year "look-back" period. Nursing homes may be able to seek payment from the adult children of a patient who has made such disqualifying asset transfers to them during the look-back period.

ESTATE RECOVERY PROCESS

Even if you're not directly responsible for your parents' nursing home bills, you may end up contributing to their care indirectly through Medicaid's estate recovery process. This allows Medicaid to recoup funds it spent on your parents' care from their estates after they die, thus reducing the amount of your inheritance.

So if your parents are receiving, or will soon receive, nursing home care and have limited funds, consult an attorney. Your legal advisor can help you determine whether you're potentially responsible for their bills. An attorney can also look into whether your parents' assets are exposed to the Medicaid estate recovery process and whether strategies are available to limit your liability.