



# Destination Financial Freedom

Getting you there

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## ETFs, Index Funds and Riding the Market

Exchange Traded Funds (ETFs) and index funds have become very popular the past few years. The purpose of these securities is to mimic specific areas or industries in the market. Generally, these securities are known for their low expenses and tax efficiencies. But are they appropriate in your portfolio?

### Index Funds

Investing in Index Funds is an inexpensive and easy way to passively manage portfolios. The Vanguard 500 Index fund that tracks the S&P 500 has an expense ratio of 0.18% compared to actively managed funds that can range anywhere from 0.75% to over 2.0%. Because of this dramatic difference, some financial advisors and planners only recommend Index Funds. In fact, several financial publications have also been promoting this method of investing.

In addition to low costs, Index Funds are sometimes recommended to control taxes. Unlike Index Funds, actively managed funds trade and hold securities. When the fund sells a security for a profit a capital gain has been created. These capital gains are required to be distributed to shareholders (generally at the end of the year). Because Index Funds do not actively trade securities, these capital gain distributions can be reduced, which in turn helps shareholders control their taxes. However, like with stocks, when an investor sells an Index Fund there may be a capital gain if the investor sells it for more than what they bought it for.

### Exchange Traded Funds

ETFs are traded on an exchange like stock and are priced throughout the day unlike a mutual fund that that is only priced once at the end of each day. There are no front-end or back-end loads (a percentage charge at the beginning or end of the investment) with ETFs allowing them to be less costly to own. ETFs can also be sold at any time and do not carry early redemption fees like most mutual funds that are sold before the 90 day holding period passes. Barron's states that some of the most popular ETFs that are based on trading volume

include the Nasdaq 100 Index (QQQ), the S&P 500 (SPY). Two that follow individual industry sectors are State Street Technical SPDRs (XLK) and Vanguard Materials VIPERs (VAW). Ameritrade has a great ETF educational website that tracks the ETF market daily ([www.ameritrade.com](http://www.ameritrade.com), click on 'Exchange Traded Funds' on the right side of the page).

### Marathon's Take

ETFs and Index Funds can be a very powerful tool in the right scenario. For investors who do not have the time or investment knowledge to monitor their investments, these securities may be very attractive. Because there are so many different types, investors can build a completely diverse portfolio based solely on these securities. For instance there are small cap, mid cap, large cap, fixed income, real estate and different industries to choose from. All of which may offer instant, broad diversification within their specific asset class.

Keep in mind that these investments automatically require that investors to settle for what the market has to offer; no more, no less. The risk of underperforming the market is removed at the price of possibly beating the market.

There is no opportunity to earn above the market's performance

At Marathon, we monitor mutual funds by following their performance, management styles, managers and operations. We subscribe to several research databases and publications in order to continually examine and conduct cross searches on securities. We believe that through our dedicated efforts it is possible to identify funds that may perform better than the market. Of course, beating the market may come at a slightly higher expense ratio, but the overall performance is well worth the cost. We also believe that no one can predict the market, including ourselves. Therefore, we do not guarantee that our recommendations will outperform the market. Instead, we offer our experience and knowledge to provide you with an integrated individual approach to what you are trying to accomplish.



## Increasing the Bottom Line for Self Employed

There are many reasons why lots of small businesses don't survive the first few years. Planning and managing a business takes more than just a good idea to become profitable and successful. In order to make the business truly viable, integrating the business plan with other life goals such as time management, lifestyle, college savings and retirement is recommended. Here are a few financial ideas that are often overlooked during the daily operational chaos.

### Retirement Planning

Generally during the first few years of running a business, retirement contributions are disregarded due to the overwhelming efforts to produce adequate profits. Typically there isn't room for the added expense of funding retirement accounts. This can result in tremendous losses for more than one reason. First, the sooner you start saving for retirement the less you will have to save in the long-run. For example, at 35 years old, saving \$4,000 while self-employed can increase a retirement account by more than \$320,000 at the age of 67 (assuming a 10% annual return). In order to replace this same amount starting at the age of 45, \$10,375 must be saved annually for 5 years. The earlier investor had a total out of pocket expense of \$20,000 compared to total contributions of nearly \$52,000 at the later age (more than 2 ½ times more)! Considering there are no guarantees regarding the future of social security benefits, today's workers are solely responsible for funding their retirement accounts in the most efficient and effective way possible.

Second, if money is deposited into a qualified plan or an Individual Retirement Account (IRA), contributions are tax deductible which means a smaller tax bill. Basically, this is the government's way of providing taxpayers with an incentive to save for retirement. The benefit is that taxpayers do not have to pay taxes on any of the money deposited into these types of accounts. In qualified contribution plans business owners can contribute up to \$40,000 and not pay taxes on it, which in the 25% marginal tax bracket would save \$10,000 in taxes in one year! Yes, that \$40,000 would have to come out of your pocket and not be spent on current consumption, however, imagine what these

For going expenses now, will cost a lot **MORE** in the future

contributions could render after twenty years of compounding. This technique can also move you down into lower tax brackets; for instance from the 25% tax bracket into the 15% bracket.

Employees who have a small side business of their own can open their own business retirement plan. If they earn \$9,000 in the small business they can contribute the \$9,000 to a retirement plan and not have to pay a dime in extra income taxes. Even if the employee has a retirement account with their full-time employer, they can still have a plan for the side business and contribute to that as well.

### Tax Planning

There are plenty of ways to lower your tax bill if you plan ahead. Start by classifying as many employees as contractors in order to avoid payroll taxes such as FICA, Medicare and unemployment. Retirement contributions can also be avoided for contractors. Before implementing or making any changes, keep in mind that there are specific guidelines as to when you can or cannot classify an employee as a contractor.

Next, stay current with estimated quarterly tax payments in order to save money on late payment penalties. The rule is to pay the lesser of the estimated figures on a quarterly basis:

- 100% of previous year's tax liability (110% if earnings are over \$150,000), or
- 90% of estimated current year's tax liability

For quarterly payments, divide the lesser of the above by four.

There are several other methods depending upon the situation that can help reduce your tax load. Some ideas include buying depreciable office space instead of renting (you can also sublease out what you don't use), or obtaining an above the line deduction of 100% of the cost of health insurance premiums if you are a sole owner of an S-Corporation or self-employed, and considering an installment sale if an owner is selling their business.

Business owners might increase their chance of operating a successful business by implementing some if not all of these ideas. If you would like to learn about any of these processes and how they may work for you, please give me a call or talk to your accountant.

***If you would like to receive this publication via e-mail and not in paper form, please notify me at [amahlen@marathoninvestments.com](mailto:amahlen@marathoninvestments.com). Also please let me know if you have any thoughts or suggestions on any financial topics for future newsletters.***