WIN MAKE GIVE

benkinney TRAINING

WEALTH SERIES

2.0

PART NINE

Financial Instruments

FINANCIAL INSTRUMENTS

"Someone is sitting in the shade today because someone planted a tree a long time ago."

- Warren Buffett -

IMPORTANT

Nothing in this course constitutes investment advice, performance data or any recommendation that any security, portfolio of securities, investment product, transaction or investment strategy is suitable for any specific person.

We cannot assess anything about your personal circumstances, your finances, or your goals and objectives, all of which are unique to you, so any opinions or information contained on this course are just that – an opinion or information.

You should not use my advice to make financial decisions and I highly recommend you seek professional advice from someone who is authorized to provide investment advice.

Win Make Give Series

Part Nine - Financial Instruments

Congrats on listening to the first eight lessons, downloading the workbooks, and doing all the homework! I know many of you may be experiencing a roller coaster of emotions. You may worry that you haven't saved enough for retirement or are upset that you've spent your money unwisely. Take a breath and recognize how far you've come. The fact that you have done all the steps up to this point is HUGE and essential in understanding how to build wealth.

Previously, we covered the benefits of diversifying your investment strategy using the Buckets of Wealth Model. One of those buckets is financial instruments, which consists of stocks, index funds, bonds, 401(k), IRAs, HSAs, and 529 Plans. I use some of these tools in my wealth plan, and others I do not. Remember, your wealth plan needs to be personalized to you, so it's up to you to choose the best strategy for your desired lifestyle.

In this lesson, we cover many of the most common financial instruments available. You'll find the details and benefits you may receive from including them in your wealth plan outlined in this workbook.

As you continue your wealth-building journey, I encourage you to read *The Psychology of Money* by Morgan Housel. And, if understanding more about compounding interest in retirement accounts and index funds excites you, I highly recommend *The Simple Path to Wealth* by JL Collins.

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Financial Instruments - Stocks

You've probably heard this popular definition of what a stock is:

A stock is a share in the ownership of a company. Stock represents a claim on the company's assets and earnings. As you acquire more stock, your ownership stake in the company becomes greater (Desjardins Group).

Unfortunately, this definition needs to be corrected. The term ownership as it relates to stockholders is somewhat of a misnomer because shareholders have a stake in the business but don't own business assets. However, corporations are a special type of organization because the law treats them as legal persons (investopedia.com).

In other words, corporations file taxes, can borrow money, can own property, can be sued, etc. The idea that a corporation is a "person" means that the corporation owns its own assets (investopedia.com). As an example, a corporate office is full of desks and chairs, and those furnishings belong to the corporation, not the shareholders.

This distinction is important because corporate property is legally separated from the property of shareholders, limiting the liability of both the corporation and the shareholder. A judge may order all of its assets solid if the corporation goes bankrupt, but your personal assets are not at risk.

What shareholders own are shares issued by the corporation, and the corporation owns the assets. If you own 33% of the shares of a company, it is incorrect to assert that you own one-third of that company; it is instead correct to state that you own 100% of one-third of the company's shares.

Shareholders cannot do as they please with a corporation or its assets. A shareholder can't walk out with a chair because the corporation owns that chair. This is known as the "separation of ownership and control."

Financial Instruments - Bonds

A bond is a fixed-income investment in which an investor loans money to an entity (typically corporate or governmental) that borrows the funds for a defined period of time at a variable or fixed interest rate (wellsfargo.com). Bonds are used by companies, municipalities, states, and sovereign governments to raise money and finance a variety of projects and activities. Owners of bonds are debtholders, or creditors, of the issued bond (top.ddot.dc.gov).

THERE ARE THREE MAIN CATEGORIES OF BONDS:

1. Corporate bonds are issued by companies.
2. Municipal bonds are issued by states and municipalities.
3. U.S. Treasury bonds (more than 10 years to maturity), and notes (1-10 years to maturity)

TAX FREE MUNICIPAL BONDS:

If you're looking for a safe investment that is likely to deliver slow yet steady returns over the long haul and where you don't have to pay federal or local taxes, a tax-free municipal bond might be a good option. Local (city or state) municipal bonds do not incur local taxes.

HOW TO SAVE TAXES WHILE INVESTING IN BONDS:

Taxes are likely to diminish bond return, but there are a couple of alternatives such as investing in a tax-free municipal bond where there is neither a capital gain nor a capital loss, the bondholder is not subject to any alternative minimum tax, and when holding bonds in a tax-advantaged account, such as a Roth IRA or a 529 plan.

Financial Instruments - Bonds

The total return of a bond can come from multiple sources:

1. Interest earned on the bond.

2. Reinvestment of the returns every 6 to 12 months. The *reinvestment rate* is the most important because of the power of compound interest.

The only kinds of bonds where the reinvestment rate is not a factor are zero-coupon bonds, where one payment is made at maturity.

Example: You buy a 30-year, $1,000 bond that pays 6 percent on a semiannual (twice per year) basis of 6% of $1,000 = $60/2 = $30 a payout). If you spend the $30 at the end of 30 years, then your total annual rate of return is **6 percent simple interest**.

Now, suppose that you choose to immediately reinvest that $30 at the same coupon rate (6% return, twice per year). Over the course of the same 30 years, that reinvested money grows at an annual rate of **6 percent compounded and now earns you $5,891.60.**

Financial Instruments - Mutual Funds

Mutual funds come in variety of options. There are index funds, stock funds, bond funds, money market funds, and more. Each may have a different investment objective and strategy, along with unique risks, volatility, fees, and expenses.

Types of Mutual Funds:

GROWTH FUNDS: Growth fund managers add stocks to the fund portfolio that show a high probability of capital appreciation.

AGGRESSIVE GROWTH FUNDS: Aggressive growth funds are similar to growth funds, except that they invest in higher risk companies that show high growth potential.

INTERNATIONAL STOCK AND BOND FUNDS: International funds invest in companies outside the U.S. They may invest in securities issued by companies located in several countries within a particular region of the world, like Europe or Asia, or they may focus on a single country, such as Japan.

INDEX FUNDS: An index fund invests in securities within a particular benchmark index and according to the specific composition of that index. For instance, a typical index fund available to investors that mirrors the S&P 500 Index.

Which type of mutual fund fits best with my investing strategy and lifestyle, and why?

Financial Instruments - 401(k) & 403(b)

Since its inception in 1978, the 401(k) plan has become America's most popular employer-sponsored retirement plan (investopedia.com). Many employers use their 401(k) plans to distribute company stock to employees, and few other plans can match the relative flexibility that 401(k)s offer.

WHAT IS A 401(k) PLAN?

A 401(k) plan is an arrangement that allows an employee to defer a percentage of their paycheck to a 401(k) account. The amount deferred is usually taxable to the employee once it is withdrawn or distributed. If the plan permits, an employee can make 401(k) contributions on an after-tax basis (these accounts are known as Roth (401k), and these amounts are generally tax-free when withdrawn.

CONTRIBUTION LIMITS

For 2023, the maximum contribution that an employee can defer to a 401(k) plan is $22,500. Employees aged 50 (by the end of the year) and older can also make additional catch-up contributions of up to $7,500. The maximum allowable employer/employee joint contribution limit remains at $66,000.

THE DIFFERENCE BETWEEN A 401(k) & A 403(b) RETIREMENT PLAN

The basic difference is that a 403(b) is used by nonprofit companies, religious groups, school districts, and governmental organizations. The law allows these organizations to be exempt from certain administrative processes that apply to 401(k) plans. In other words, administrative costs for a 403(b) are lower.

IRA

IRA stands for **Individual Retirement Account**, and it's basically a savings account with big tax breaks, making it an ideal way to sock away cash for your retirement. Many people mistakenly think an IRA itself is an investment, but it's just the basket in which you keep stocks, bonds, mutual funds, and other assets (money.cnn.com).

There are several different types of IRAs, including Traditional, Roth, SEP, SDIRA, and SIMPLE. An IRA differs from other types of retirement accounts such as, 401(k)s, as typically, those types of accounts are provided by your employer. The most common type of IRAs are accounts that you open on your own.

Each IRA has eligibility restrictions based on your income or employment status. SEP and SIMPLE IRAs can only be opened by self-employed individuals and small business owners. All types of IRAs have caps on annual contributions, and penalties are incurred if you withdraw your money before the designated retirement age.

Roth IRA, Traditional IRA, and SDIRA Annual Contribution Limits
In 2023, the maximum contribution is $6,500. Individuals over 50 can play catch-up and contribute an additional $1,000.

Roth IRA

A Roth IRA is an Individual Retirement Account to which you contribute after-tax dollars.

When you contribute to a Roth IRA, that money is post-tax dollars, and contributions and earnings grow tax-free. In short, you are paying taxes now to not pay taxes upon withdrawal. If you are 59½ and have had the account for a certain time frame (typically five years), withdrawals will be tax and penalty-free. Unlike a Traditional IRA, there are no mandatory withdrawals required when you reach a certain age.

Eligibility to open a Roth IRA, as well as your contribution amount, is determined by your Modified Adjusted Gross Income. While there is no age limit to open a Roth IRA or contribute to it, that money must come from taxable income. A Roth IRA can also be passed on to heirs, and their withdrawals will continue to be tax-free.

Traditional IRA

A Traditional IRA is an Individual Retirement Account to which you can contribute pre-tax or after-tax dollars.

When you contribute to a Traditional IRA, that money is made with pre-tax or after-tax dollars and may be tax-deductible, giving you immediate tax benefits. Contributions grow tax-deferred. However, withdrawals may be subject to ordinary income tax.

At age 72, you must start taking annual Required Minimum Distributions (RMDs), and you can make penalty-free withdrawals beginning at age 59½. Eligibility to open a Traditional IRA is not limited by income, but there are limits for tax-deductible contributions.

Simplified Employee Pension IRA (SEP)

A SEP IRA, or Simplified Employee Pension (SEP), is a retirement savings plan established by employers, including self-employed individuals (independent contractors, sole proprietorships, or partnerships) **for the benefit of their employees**.

Employers may make tax-deductible contributions on behalf of eligible employees (including the business owner) to their SEP IRAs and the employer is allowed a tax deduction for plan contributions that do not exceed the statutory limit.

SEP IRA contributions are made to each eligible employee's SEP IRA on a discretionary basis. That means that the employer can choose to contribute (or not) each year. However, if the employer does contribute, even if they just contribute for themselves, they must contribute the same percentage of compensation to all employees eligible for the plan, up to the contribution limit.

Employees do not pay taxes on SEP plan contributions. However, distributions of these amounts plus any earnings are subject to income taxes. Catch-up contributions are not available for 50 years or older. Minimum distributions are required at age 73. You can make penalty-free withdrawals at 59½.

An employee (including the business owner) who is eligible to participate in his or her employer's SEP plan must establish a traditional IRA to which the employer will deposit SEP contributions. Some financial institutions require the traditional IRA to be labeled as a SEP IRA before they will allow the account to receive contributions (investopedia.com).

SEP IRA Annual Contribution Limits
SEP IRA are nearly 10 times the amount of a Roth or Traditional IRA. Contributions cannot exceed 25 percent of compensation, and the limit in 2023 is $66,000.

Self-Directed IRA (SDIRA)

A self-directed individual retirement account (SDIRA) is a type of retirement account where the investor makes all the investment decisions. The self-directed IRA provides the investor greater opportunity for asset diversification outside traditional stocks, bonds, and mutual funds. All securities and investments are held in an account administered by a custodian or trustee.

Like a Traditional or Roth IRA, a SDIRA is used to save for retirement and is structured to facilitate withdrawals at a specified age. Designed for do-it-yourself investors, SDIRAs differ from Traditional and Roth IRAs by the assets they hold as they allow the owner to invest in a wider array of securities.

Managed by the plan owner, a SDIRA can function as an extensive investment portfolio as its options are much broader than basic eligible securities offered by brokerage firms for Traditional and Roth IRAs. As such, it requires more initiative and due diligence by the plan owner.

Annual contributions are the same as Roth or Traditional IRAs; withdrawals are subject to income tax. Annual distributions begin at age 72 and are based on the account balance and life expectancy. Penalty-free withdrawals begin at age 59½.

NOTE: SDIRA investors have much broader investment options. SDIRAs can include nearly any type of investment, accommodating private placements, private securities, real estate, limited partnerships, precious metals, commodities, crowdfunding investments, and more. Life insurance is not permitted in a SDIRA.

Roth IRA Conversions

When you convert from a Traditional IRA to a Roth IRA, a process also known as creating a “backdoor” Roth IRA, you generally pay income tax on the contributions. The taxable amount that is converted is added to your income taxes, and your regular income rate is applied to your total income. If the amount is large enough, it may raise your tax bracket for the year in which you do the conversion.

If you anticipate your income dropping significantly in a certain year (and increasing in following years), you could plan a conversion for the low-income year. Since your income is lower, you may be in a lower tax bracket when you convert. Similarly, if the government announced tax-rate increases to go into effect in the following year, a conversion in the current year would save income tax.

Converting to a Roth IRA guarantees that you will owe no additional income tax on the converted funds and any earnings before you withdraw them during retirement. The balance in your portfolio is what you can tap into during retirement, and you won’t have to calculate an after-tax balance.

NOTE: If the money in your Traditional IRA is after-tax money (you did not take a deduction on the money you contributed), you may not owe tax when you convert to a Roth IRA. Tax-savvy investors want to pay as little income tax as possible. Converting to a Roth IRA allows you to make smart tax moves that save money in the long run.

529 Plans

A 529 plan is a tax-advantaged savings plan designed to encourage saving for future educational costs (sec.gov). Legally known as "qualified tuition plans," a 529 plan is sponsored by states, state agencies, or educational institutions and are authorized by Section 529 of the Internal Revenue Code (investor.gov). There are two types of plans, prepaid tuition plans or education savings plans, and all 50 states sponsor at least one type of plan. There's no limit to the number of 529 accounts that can be opened for one beneficiary.

Minimum contribution requirements vary per state and some states offer generous income tax deductions. Earnings grow tax-free and are not taxed when the money is taken out to pay for qualified educational expenses.

If assets in a 529 are used for something other than qualified education expenses, you'll have to pay both federal income taxes and a 10% penalty on the earnings. An interesting side note is that if the beneficiary gets a full scholarship to college, the penalty for taking the cash is waived (schwab.com).

About two-thirds of the states offering 529 plans allow anyone (parent, grandparent, relative, friend) who is a resident of that state take a state income tax deduction. The remaining states let you deduct contributions only if you're the account owner. In these cases, you may want to open an account for a grandchild to qualify for the deduction, even if the parents already have an account for them (kiplinger.com).

NOTE: In 2023, a contribution of $17,000 a year or less qualifies for the annual federal gift tax exclusion (equitable.com). You can also gift as much as $85,000 ($170,000 for joint gifts), and avoid the federal gift tax provided that the contribution is spread out over five years.

HSA Plans for Retirement

A HSA (health savings account) is a type of savings account that lets you set aside money on a pre-tax basis to pay for qualified medical expenses (healthcare.gov). In order to be eligible to open an HSA, the individual must be covered by a high deductible health plan and have no other health coverage (irs.gov).

One of the highest and most unpredictable retirement costs is paying for healthcare. An HSA can benefit retirees as funds in the account can be used for medical expenses (copays, prescriptions, vision and dental care, deductibles, etc.). If funds are used for healthcare costs, withdrawals are not taxed, and funds grow in your account tax-free. If funds are used for non-medical expenses, the amount may be subject to income tax and a 20 percent penalty. Once the account owner turns 65 or Medicare eligible, only income tax is assessed for non-qualified withdrawals (investopedia.com).

One drawback is that to qualify for an HSA, you must purchase an HDHP, or high-deductible health plan. Since these health plans have a higher annual deductible than traditional plans, you may pay more out-of-pocket medical expenses than with a traditional healthcare plan.

However, if you remain relatively healthy during your working years and don't incur many medical expenses, an HSA could build up a significant balance to help pay for any future medical expenses..

HSA Annual Contribution Limits
In 2023, the maximum contribution is $3,850 for an individual and $7,300 for a family. If you are age 55 or older, you can make an additional $1,000 contribution.

Financial Instruments - Reflection

What retirement programs does your company currently offer and how are you going to build that into your retirement plan?

Based on your current situation, how much do you think you could invest into your retirement or into your kids college fund or into the stock market?

If you are doing all the financial instruments, what do you think you could contribute monthly or annually?

TIP: Download the Acorns app on your phone and explore IRA options.

Financial Instruments - Reflection

How much cash do you want in reserves?

What types of financial instruments will you add to your wealth plan?

DISCUSSION QUESTIONS

What companies do we believe in enough that we would want to own stock shares?

Which financial instruments will we pursue to add to our wealth plan and retirement lifestyle (and why)?

What expenses can I cut (even for the short term) to invest into a bond?

TIP: Download the Robinhood app on your phone and explore its offerings of stocks, ETFs, and IRAs.

FINANCIAL INSTRUMENTS

"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."

- Robert G. Allen -

Part Nine Homework Question

Warren Buffett says, "The stock market is a device for transferring money from the ________ to the ________."

Save these answers and submit them in the questionnaire at the end of the course for a chance to win a $10,000 grand prize!

Preparation for Part Ten

- [ ] Get ready to listen to our in-depth interview with a special guest.

- [ ] If you haven't already, please join the discussion on the [Win Make Give Facebook group](). Post your thoughts, comments, and takeaways from the first six lessons.