Doerschler & Associates

Wealth Management Financial News

Jill Ingersoll, AIF, CPFA
Carl Doerschler, AIF, CPFA, CMFC
54870 N. Main Street
Mattawan, MI 49071
269-744-2004
269-744-4180

Doerschler & Associates
WEALTH MANAGEMENT

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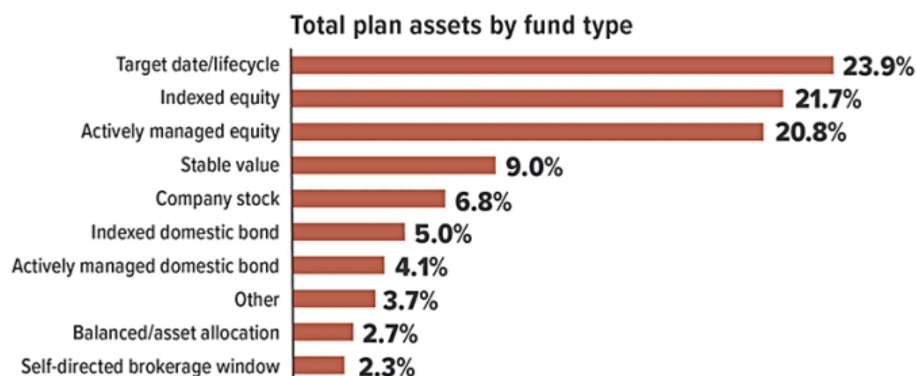
Average number of investment funds offered in 401(k) and profit-sharing plans in 2020

Source: Plan Sponsor Council of America, 2021

How Are 401(k) Plan Participants Investing Their Money?

Created in 1996, National 401(k) Day has historically been celebrated on the Friday following Labor Day to shine a spotlight on this important employee benefit. Since the late 1990s, plans have evolved substantially, and most participants can now choose from a diverse variety of investments. The chart below shows how 401(k) and profit-sharing funds were invested in 2020.



Source: Plan Sponsor Council of America, 2021

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Passive, Active, or Both?

Index funds, which try to match the performance of a particular market index, have drawn increasing interest from investors, but traditional actively managed funds still hold more assets (see chart). There is ongoing discussion in the financial media about which approach is most effective, but there may be good reasons to hold both in a well-diversified portfolio. Here are some pros and cons to consider.

A Simple Approach

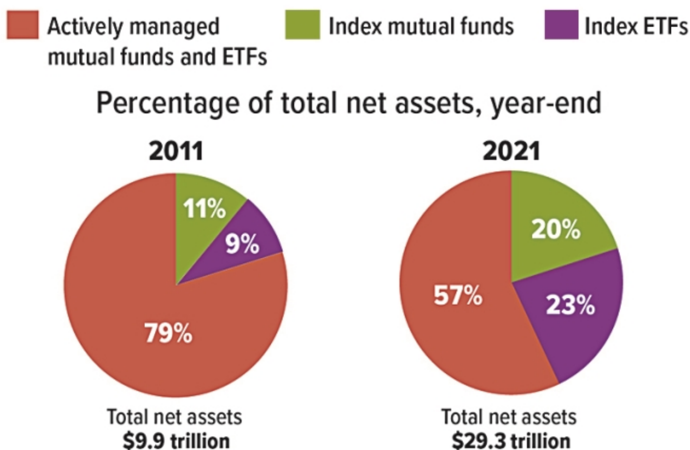
Index funds typically hold the same securities in the same proportions as the index the fund is tracking (or in some cases a representative selection of securities). After assembling the fund, the fund manager generally makes adjustments only as necessary to track the index, so these funds are called *passively managed.*

The primary appeal is cost-efficient simplicity. Because index funds have less managerial involvement, fees are often lower than they are for actively managed funds. Index funds may also buy and sell assets less frequently, and lower turnover can help reduce capital gains distributions, which could be important when funds are held in taxable accounts.

However, this simplicity can also be a negative. Many well-known indexes commonly tracked by index funds are broad based and weighted by market capitalization, a company's value based on the number of outstanding shares multiplied by share prices. Some are price-weighted, meaning the price per share determines the weighting of the security. In either case, index investing may place heavy emphasis on a relatively small number of large companies in the index. And an index fund holds securities in the index regardless of the potential performance of an individual company.

A Decade of Growth

Index funds more than doubled their share of the fund market from 2011 to 2021.



Source: Investment Company Institute, 2022 (totals may not equal 100% due to rounding)

Hands-On Strategies

Active fund managers strive to outperform benchmarks by hand-picking securities based on research and a defined investment strategy. Thus, actively managed funds offer the potential to outperform the broader market, although historically most of them have not.

According to investment analyst Morningstar, 45% of active funds outperformed the average comparable index fund in 2021, a slight drop from 49% in 2020. Both of these years were relatively successful for active funds, possibly because active managers were able to respond to rapidly changing market conditions during and after the pandemic. Over the 10-year period ending in December 2021, only 26% of active funds outperformed the average of their passive counterparts. However, performance varied widely for different underlying investments.[1]

An actively managed fund may be more diversified than an index fund holding stocks in the same asset category, because the manager can choose to weight the securities to meet the fund's objective rather than following the market-capitalization or price-weighted structure of an index. Diversification is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

Active managers also have more flexibility and may use a variety of trading strategies to help manage risks. For these reasons, some actively managed funds might offer defensive benefits when markets are falling, and they may be able to take advantage of specific market movements that might not be captured in an index fund.

Passive and active funds each have potential strengths and weaknesses, and there is no guarantee that any investing strategy will be successful. But holding both types of funds in your portfolio may provide a helpful balance.

The return and principal value of mutual funds and exchange-traded funds (ETFs) fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in an index. Past performance does not guarantee future results. Actual results will vary.

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1) Morningstar, February 2022

Pooled Income Fund: A Charitable Gift That Provides Income to You

A pooled income fund is a trust with both charitable and noncharitable beneficiaries. It is established and run by a public charity, not by you. The charity "pools" the irrevocable contributions of many people, invests the money, and then distributes to you (or your designated beneficiary) a periodic income payment (usually quarterly or annually) for life, prorated to match your contribution to the fund. When you die or your designated beneficiary dies, your remaining share in the fund passes to the charity.

Charitable Deduction

If you itemize deductions, you receive an immediate federal income tax charitable deduction for the present value of the remainder interest that will pass to charity. Your deduction is limited to 50% or 30% of your adjusted gross income (AGI), depending on the type of property contributed. Amounts disallowed because of the AGI limitations can be carried over for up to five years, subject to the AGI limitations in the carryover years. The transfer of the remainder interest to charity would also qualify for the federal gift tax or estate tax charitable deduction.

The amount of the income tax deduction is generally based on the fair market value of the property contributed to the pooled income fund, the beneficiary or beneficiaries' age(s), and the fund's highest rate of return in the last three taxable years.

Noncharitable Income Interest

Trust payments can last for the life or lives of one or more noncharitable beneficiaries. For example, you could name yourself, yourself and your spouse, or even someone else as the noncharitable beneficiary.

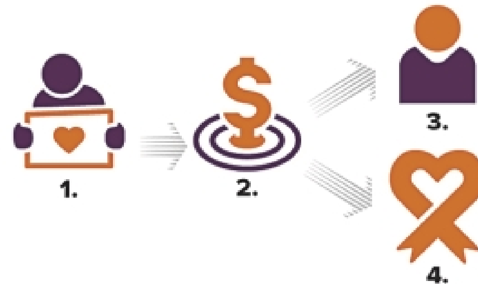
If you retain a noncharitable interest, the pooled income fund interest will be included in your gross estate for federal estate tax purposes. If your spouse receives the noncharitable interest as your survivor, that interest should qualify for the estate tax marital deduction (and the balance should qualify for the estate tax charitable deduction).

If you transfer a noncharitable interest to someone else while you are alive, you may have made a gift or generation-skipping transfer (GST) to that person of the income interest. (A GST is a transfer to a person two or more generations younger than you.) A portion of the gift may qualify for the annual gift tax exclusion, but not for the GST tax annual exclusion. A transfer to your spouse would generally qualify for the gift tax marital deduction. You may also have a federal gift and estate tax applicable exclusion amount or a GST tax exemption to shelter any transfer from tax.

Donors generally have limited choices in investment strategy. The amount of income received by the noncharitable beneficiary is not guaranteed; it may increase or decrease depending on the performance of the fund. If the investments in the fund perform poorly and the actual income earned by the fund declines, the charity is prohibited from invading the principal to increase the payment to the noncharitable beneficiary.

Income distributed to the noncharitable beneficiary is usually taxable at ordinary income tax rates. It may also be subject to the 3.8% net investment income tax.

How a Pooled Income Fund (PIF) Works



1. You donate to PIF (charitable tax deduction)
2. Charity pools donations and invests them
3. PIF pays share of fund's income annually to beneficiary
4. Charity keeps what's left after beneficiary dies

Other Considerations

One of the biggest advantages of choosing a pooled income fund over a charitable remainder unitrust or charitable remainder annuity trust is that you avoid the hassle and cost of establishing your own trust. Another advantage is that if the property you are donating to charity is relatively small, a pooled income fund makes the most of your assets by commingling them with the property of others. The fund can then use the increased assets to diversify among investments, thus helping reduce your investment risk. Also, the large size of the fund (compared to your own charitable trust) may translate into lower operating costs and more experienced management. By contrast, it may not be economically feasible for you to establish a charitable trust with a small investment. Even if you do, it may be impossible for the trustee to spread this money over a variety of investments. (Diversification does not guarantee a profit or protect against investment loss.)

In general, you can donate any type of property to a pooled income fund that the charity is willing to accept. A noncash donation will generally cause the 30% AGI limitation to apply to your charitable deduction. A fund cannot accept or hold tax-exempt securities.

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Building Financial Resilience

Inflation, roller-coaster markets, global events, and life circumstances can test anyone's fortitude. You may not feel ready to handle these pressure-filled times and might worry about the potential effects on your financial well-being. Fortunately, you can take steps to build the resilience you need to help handle the turbulence and hopefully emerge even stronger.

Focus on the Foundation

Developing a new budget or reviewing an existing one may help reduce stress by reminding you that you still have control over many aspects of your personal finances. A budget outlines your income and expenses and shows how much money is coming in compared to how much money is going out. If you find that you are spending more than you realized, you can make adjustments.

An important companion to a budget is an emergency fund. When an unexpected expense comes up, you can use your emergency reserves to cover it, instead of dipping into long-term savings or racking up costly credit-card debt that could throw your budget off track at a time you can least afford it. Consider starting an emergency fund and build it up over time.

Stress-Test Your Portfolio

When you're investing for retirement or another financial goal, assessing the potential impact of various scenarios may help you prepare for unexpected events. This may be done using computer simulations to analyze how your portfolio might perform. Doing this at regular intervals may help take some of the emotion out of decision-making during stressful times, helping you address gaps and opportunities.

There is no assurance that a simulation will be accurate. Because of the many variables involved, you should not rely on simulations without realizing their limitations. All investing involves risk, and there is no assurance that any financial strategy will be successful.

It's better to look ahead and prepare, than to look back and regret.

Jackie Joyner-Kersee

Source: BrainyQuote.com

Prepare for the Future

Of course, you're never going to be prepared for every financial scenario. But developing a written financial strategy and reviewing it periodically may help you thoughtfully navigate life's twists and turns. It documents and organizes the pieces of your financial picture, helping you stay focused on the future as you weather the current storms.

Building financial resilience is an ongoing process, and it's never too late to start. Becoming better positioned for downturns can help you feel more confident that you can handle whatever challenges come your way.

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