401(K) investing: Positive asset allocation

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Your Personal Finance

Successful investment pros are the people you should imitate when figuring out how to manage your 401(K). And the pros agree: ninety percent of successful investing has to do with asset allocation.

Asset allocation refers to the way you divide your money among the investment options in your 401K, like stocks or bonds. A major research study found that investment mix accounted for over 90 percent of the variation in total return among the investors surveyed.

Most surprising was what didn't seem to make much difference. When the investors bought or sold, and whether they chose stocks or bonds that did better or worse than the pack, had little impact on the overall success of their portfolios.

Allocation above selection

If you had bought Intel stock in the spring of 1994, (Intel is a computer chip maker), you'd have more than doubled your money by the end of 1995. So how could picking a big winner like that not be more important than asset allocation? Simple. Research shows that it is more important that you know to invest in stock in general over investing in any one particular stock.

But you can't always make those brilliant calls in advance. In the long run, even the pros generally earn a little less for their shareholders than the market's overall performance. So, unless your money manager is psychic, use asset allocation to strengthen your portfolio. The key is to divide your money between stock funds and bond funds in the right balance for your financial needs and goals and your own investment personality.

Take your own measure

When you're deciding on asset allocation for your 401K, the very first person you need to consult is you. Only you can assess how much risk you can tolerate, how soon you might need the money, and how likely it is that something could unexpectedly put a snag in your financial plans. The longer you plan to keep your money in the 401K plan, the more of it you can afford to put at risk in stock funds. But if an emergency should rise it could mean having to withdraw money at the bottom of a sour market.

So look at your overall financial situation. Is your job secure? Do you have other emergency resources? Is your retirement more than a decade away? If you answer no to any of these questions, then take less risk in your 401K.

Diversification

The first law of investing says that reward is commensurate with risk. If this were always true, then making the most with your 401K money would be simple. Just go with high-risk stock funds. But there are two good reasons not to allocate all your money to the most aggressive stock funds in your plan. One reason is if you can't tolerate that level of risk. The other is the loophole: it's something called the diversification effect. It says that you can get nearly as strong a return with far less risk by spreading your money around among the investment options in your plan. Often, gains in one fund offset losses in another, producing a better trade-off between risk and reward than putting all your money in any one fund alone.

Your money and moxie

Your goal in deciding on asset allocation for your 401K is to arrive at a mix that gives you the highest return without exceeding your tolerance for risk.

Constructing a portfolio is not simply a matter of studying numbers and making a choice, even though the numbers are a good starting point. Your financial advisor can calculate the expected returns and risk levels on different portfolios to find the one whose numbers promise the best match for your financial goals and your risk tolerance. But remember that these projections are educated guesses based on past performance and can give you only a general idea of what to expect. You must be the judge of how your 401K options fit your plans and needs.

Charles Ross is host of the syndicated radio program, "Your Personal Finance," and author of Your Common Sense Guide to Personal Financial Planning.

Should you rent your vacation home?

If you're thinking about renting out your vacation home, don't forget to check in with Uncle Sam.

The North Carolina Association of CPAs points out that the tax rules governing vacation home rentals are complex, particularly if you're planning to mix personal use with rental use. While the lure of rental property tax deductions may be enticing, before signing any rental agreements, take the time to understand fully the tax ramifications and the impact they will have on your personal use. Here are some important questions CPAs recommend you address:

• Do you want the freedom to use your home whenever you want?

If you want to use your vacation home whenever you please, you'll have a tough time getting the tax benefits of a rental property. Those benefits vary significantly, depending on the number of days the home is rented and the extent of personal use. Keep in mind that personal use includes a stay by a family member unless he or she uses the unit as his or her main home and pays the fair market rental price.

When your vacation home is used primarily for personal use by you and your family, your tax write-offs are limited to your mortgage interest and property taxes, just as they are with your primary residence. The trade-off is that you get to use your vacation home with no strings attached.

• Do you want to rent your house out only on a limited basis?

Tax law does provide you with a means to earn some tax-free income on a vacation home deemed to be a personal residence. If you rent out the house for less than 15 days a year, then you do not have to pay taxes on the rental income. What's more, allowable deductions, such as mortgage interest and real estate taxes, may still be taken. This unique exemption provides a valuable loophole for those with vacation homes near annual events where rents soar for short periods. In fact, when the Olympics come to Atlanta this summer, thousands of individuals with vacation homes (and primary residences) in Georgia are expected to take advantage of this opportunity to earn tax-free rental income.

• Are you willing to limit your use of the home?

You'll reap the greatest tax advantage if you don't make personal use of your vacation home for more than 14 days a year, or more than 10 percent of the number of days the home is rented, whichever is greater. As such, you may deduct expenses for repair and maintenance, utilities, insurance coverage and cleaning services.

You also may claim depreciation on, and thereby deduct a portion of, the home's cost each year. Keep in mind, however, that even if you use the home for one day, you must allocate your expenses between personal-use and rental days, and calculate your deduction accordingly. Regardless of how many days you use your home, mortgage interest (on primary and secondary residences) and property taxes remain fully deductible under the current tax law. Keep in mind that the more frequently you use your vacation home, the fewer the tax benefits.

If your personal use of the property exceeds the above limit, the rules on deducting expenses are more restrictive. Your rental expenses also must be deducted in a certain order: first, mortgage interest and real estate taxes allowable to the rental period; second, operating expenses like repairs, maintenance and utilities; and, finally, depreciation. But keep in mind that you cannot use your vacation home to produce a tax loss to shelter income such as compensation, interest or dividends.

However, any excess losses may be carried forward to future years. However, there is one exception by which, if your rental deductions produce a tax loss, you may be entitled to write off up to $25,000 of those losses against your salary and other income. To qualify, you need to meet three requirements: 1) you must limit your personal use to 14 days a year or less; 2) you must actively manage the property; and 3) your adjusted gross income (AGI) must be below $100,000. (The $25,000 amount is phased out as your AGI increases from $100,000 to $150,000.)

• Do you need rental income?

Realistically assess your financial situation to determine the extent to which you can afford the expenses of maintaining your vacation home. If you anticipate incurring substantial maintenance expenses, such as repairing faulty or old wiring, you may want to rent your house out as much as possible to qualify for the biggest tax benefits.

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Group charges 'Net scams children

THE ASSOCIATED PRESS

WASHINGTON – A private group wants the government to investigate a Milwaukee company's Internet web site it says lures children to advertisements and marketing surveys, by posing as educational.

The Federal Trade Commission said Monday it would look into the Center for Media Education's complaint against the KidsCom web site, operated by SpectraCom Inc. of Milwaukee.

SpectraCom officials insist their web site does not exploit children.

The company does, at one spot on the site, occasionally gather information from children about their likes and dislikes, using "standard marketing techniques" that site developer Jorian Clarke compared to asking people questions in shopping malls.

The information, without the children's names, is passed on to the company that paid for the survey, Clarke said. The area on the site that asks these questions is optional, and includes a line encouraging children to get parents' permission, she said.

Most of the site is educational or games, Clarke asserted.

But the media education center believes the site "was set up by a marketing firm with the sole purpose of monitoring children's on-line behavior, collecting personal data and aggressively promoting products," said president Kathryn Montgomery.

The media watchdog group last month released a report alleging that several firms, including SpectraCom, have designed web sites – places on the Internet where companies or individuals can be reached – "to capture the loyalty and spending power" of children.

The FTC does not regulate ads for children over the Internet. But its jurisdiction over deceptive market practices does extend to the computer network. The agency plans a conference next month on the issue of privacy in cyberspace, with one day devoted to children's issues.

On SpectraCom's web site, children also are asked to fill out questionnaires that include favorite TV show, commercials, musical groups and interests. They are offered points for their responses that can be used to "buy" items including video games and cookies.

The company says it asks those questions to match children worldwide with electronic pen pals. And those questions are in a separate area from the occasional marketing surveys it also conducts, Clarke said.

She said the site is meant to be entertaining and educational and that developers try hard to get parents involved, she said.

The media center, a nonprofit organization, received most financing for its web-site project from the Carnegie Corporation in New York.