KANAWHA
CAPITAL MANAGEMENT
First Quarter 2019

This Quarter's Highlights

- Build a Budget to Save
- Start With an Emergency Fund and Company Retirement Plan
- Individual Retirement Accounts (IRAs) and Brokerage Accounts
- The Benefit of Time and Compounding of Returns
- Longer Time Horizons and the Risk-Return Tradeoff
- Income Protection

Kanawha Currents

Planning Basics for Young Workers

Younger workers who are in the asset *accumulation* phase of life often have financial objectives and face risks that are different from those of older cohorts. Individuals and families in their 20s, 30s, and 40s should have financial plans that are focused on maximizing saving and investment. And unlike retirees who may seek to balance growth, income, and preservation of capital, younger investors have longer time horizons that generally allow them to accept more investment risk in exchange for potentially higher returns. On the other hand, they are likely to be more sensitive to risk factors that could unexpectedly compromise their significant earnings potential. Planning strategies for young professionals should be geared towards saving, growth, and income protection.

Build a Budget to Save

A prudent financial plan designed to accrue savings and build wealth begins with a budget that accurately determines income and expenses. A budgeting exercise encourages individuals to prioritize how they are choosing to spend their money. Ideally, this improves accountability and leads to a "pay yourself first" discipline.

Opportunities to Save

Pay increases offer an excellent opportunity for individuals to save without feeling deprived of any foregone dollars. It takes less sacrifice to choose not to spend your pay increase than it does to reduce expenses. Bonus payments also present an opportunity to save. One may choose to reward oneself with a portion of a bonus while saving the remainder of it.

Start With an Emergency Fund and Company Retirement Plan

Young workers with a willingness and ability to save should start with an *emergency fund* and, if available, their company retirement plan. A widely accepted rule of thumb is to save the equivalent of three to six months' worth of normal expenses in an emergency fund. Money saved in this account should be used for unexpected costs that are not part of one's normal operating budget.

A company retirement plan can offer a convenient and tax-efficient way for young professionals to save. Salary deferrals are automatically deducted from gross pay and deposited directly into the employee's account. Many employers also match a portion of their employees' salary deferrals. For example, a company may match 100% of deferrals up to 3% and 50% of deferrals up to 6%. In this scenario, if we assume a salary of $60,000 and deferrals of $3,600, the company match would equal $2,700. This would represent a 75% immediate return on the employee's savings.

Traditional 401(k) versus Roth 401(k)

Company retirement accounts are granted certain tax benefits by law to encourage workers to save for retirement. Inside of these accounts, investment income such as capital gains, stock dividends, and bond interest is not subject to income taxes in the year it is received. This tax-deferred growth allows retirement accounts to potentially accumulate faster over time. Both a traditional 40l(k) and Roth 40l(k) benefit from the tax-deferral of current investment income. The primary difference between a traditional 40l(k) and a Roth 40l(k) is whether an additional tax benefit is granted at the time of contribution or distribution. A traditional 40l(k) allows participants to lower their taxable income through employee salary deferrals. Each dollar that is contributed (up to a maximum amount) is made pre-tax. A Roth 401(k), on the other hand, receives an additional tax benefit at distribution. Since there is no tax deduction on Roth 40l(k) salary deferrals, employees generally benefit from tax-free withdrawals on the back-end as long as the owner is at least 59½ (and any other plan rules are satisfied).

Individual Retirement Accounts (IRAs) and Brokerage Accounts

Beyond emergency funds and employer retirement plans, young savers should also consider investing in Individual Retirement Accounts (IRAs) and brokerage accounts. Like a 401(k), savers can choose between a traditional IRA and a Roth IRA. Note that income limitations may reduce or eliminate Roth IRA contributions and traditional IRA contributions (if you or your spouse are an active participant in an employer retirement plan). For 2019, individuals may be able to contribute up to $6,000 per year ($7,000 if age 50 and older) to IRAs. See the back page for IRA income phaseout limitations. Additionally, personal brokerage accounts offer the flexibility to invest without income restrictions and annual contribution limits. And while they lack the inherent tax benefits of retirement accounts, individuals can choose to invest in low turnover funds and individual securities to potentially mitigate tax costs. Younger savers may consider low-cost funds that provide market exposure and diversification with a minimum investment. Similar to company retirement plans, automatic deposits can be set up to fund these accounts on a regular basis.

The Benefit of Time and Compounding of Returns

In addition to having the discipline to save money, perhaps the most valuable financial lesson that young people can learn is the concept of compound returns. The ending value of a dollar invested is the product of a series of returns on that dollar over some duration of time. Said another way, a saver is getting interest on their initial principal *plus* on any accumulated interest. The period of time, or number of years invested, is arguably the most important independent variable in determining the ending value of a portfolio.

The benefit of time and the power of compounding can be illustrated with a hypothetical savings scenario. An individual who saves $250 per month and earns a 5% compound annual growth rate would grow their funds to $38,821 over 10 years, $102,758 over 20 years, $208,064 over 30 years, and $381,505 over 40 years (see Figure 1). Note that investment gains make up less than a quarter of the ending value after 10 years but they account for more than two-thirds of the ending value after 40 years. The longer the time period is, the greater the compounding benefits that can be accrued. As such, younger workers clearly have the most to gain from compounding. Conversely, they should also be aware that they have the greatest opportunity cost - they have the most to lose if they do not save and fail to take advantage of time being on their side.

Figure 1: $250 Invested per Month at 5% CAGR

Time	Saving	Investment Growth	Ending Value
10 Years	$30,000	$8,820	$ 38,820
20 Years	$60,000	$42,758	$102,758
30 Years	$90,000	$118,064	$208,064
40 Years	$120,000	$261,505	$381,505

Longer Time Horizons and the Risk-Return Tradeoff

Longer time horizons have an additional benefit beyond compounding of returns. More time also gives investors the ability to absorb higher levels of investment risk. This is significant because there is a positive relationship between risk and return; the higher level of risk an investor is willing to accept, the greater the expected return should be. Having a higher “risk budget” allows younger investors to focus more on growth which should enhance their odds of building wealth over time.

Investment Risk

The higher the level of risk an investor is willing to accept, the greater the expected rate of return should be. The risk of a stock or fund is often measured by the degree to which its price fluctuates. But the primary concern among investors is downward price movement or the risk of principal loss. Declines in stock prices serve as the "cost" investors must accept in exchange for returns that may exceed a normal rate of inflation. Investors must ask themselves how much of this cost they are willing to tolerate. Fortunately, younger investors are afforded more time to wait for stock prices to recover from their downdrafts.

Income Protection

Another form of risk young professionals should be sensitive to is the potential for lost income due to an unexpected death or disability. The most significant asset for younger workers is often their earnings *potential*. Therefore, they should consider protecting this asset through life and disability insurance. Since the cost of most forms of life insurance tends to rise with age, younger individuals should consider buying this protection sooner rather than later. This is especially true for those who are starting families and have a spouse or children who may be depending on their income for years to come. Disability insurance provides workers with income protection due to unforeseen accidents or illnesses. Individuals should research these policies carefully to make sure they understand the costs, potential benefits, and what may qualify as a valid claim. In many cases, such insurance is available through one’s employer.

Starting a Family - A Simple Financial Checklist

- ✓ Execute appropriate legal documents which may include basic wills, trusts, powers of attorney, medical directives, guardianships for children, etc.
- ✓ Determine appropriate titling for investment accounts, house, and other assets
- ✓ Life insurance
- ✓ Disability insurance
- ✓ Medical insurance
- ✓ Property and casualty insurance (home, auto, personal liability)
- ✓ Education savings plans
- ✓ Update beneficiary designations on retirement accounts and life insurance policies

Conclusion

Younger professionals often work hard and earn a reasonable income. Unfortunately, many fail to develop strong savings habits due to a lack of planning. Setting goals and creating a budget can help one prioritize how they want to spend their money. Implementing an automatic deposit strategy to fund an emergency savings account and a company or individual retirement account can serve as a practical step towards long-term wealth creation. Understanding the value of time on compounding of returns should motivate younger individuals to begin saving early. Longer time-horizons also give younger investors greater ability to recover from short-term investment losses. This allows them to focus more on growth investments which can potentially improve their expected returns. While saving and growing assets are essential to building wealth, young professionals should also be sensitive to protecting their most important asset, their earnings potential. Depending on their circumstances, income protection may be one of the most important components of a well-rounded financial plan.

2019 Important Financial Information

2019 Tax Rate Schedule	
Taxable Income	Marginal Rate
Single	
$0 to $9,700	10%
$9,701 to $39,475	12%
$39,476 to $84,200	22%
$84,201 to $160,725	24%
$160,726 to $204,100	32%
$204,101 to $510,300	35%
$510,301 +	37%
Married Filing Jointly & Surviving Spouse	
$0 to $19,400	10%
$19,401 to $78,950	12%
$78,951 to $168,400	22%
$168,401 to $321,450	24%
$321,451 to $408,200	32%
$408,201 to $612,350	35%
$612,351 +	37%
Head of Household	
$0 to $13,850	10%
$13,851 to $52,850	12%
$52,851 to $84,200	22%
$84,201 to $160,700	24%
$160,701 to $204,100	32%
$204,101 + $510,300	35%
$510,301 +	37%
Married Filing Separately	
$0 to $9,700	10%
$9,701 to $39,475	12%
$39,476 to $84,200	22%
$84,201 to $160,725	24%
$160,726 to $204,100	32%
$204,101 to $306,175	35%
$306,176 +	37%
Estates and Trusts	
$0 to $2,600	10%
$2,601 to $9,300	24%
$9,301 to $12,750	35%
$12,751 +	37%

Capital Gains Tax Rates			
Short-Term Capital Gain Rates (held 1 year or less)			Same as ordinary income
Long-Term Capital Gains (held > 1 year) and Qualified Dividends			
Single	Married Filing Jointly	Head of Household	Rate
Up to $39,375	Up to 78,750	Up to $52,750	0%
$39,376 to $434,550	$78,751 to $488,850	$52,751 to $461,700	15%
$434,551 +	$488,851 +	$461,701 +	20%
Unrecaptured gains on Section 1250 property			25%
Collectibles			28%

Income Tax Deductions and Exemptions	
Standard Deduction	
Single	$12,200
Married filing jointly	$24,400
Head of household	$18,350
Over age 65 or blind additional standard deduction	
Married or surviving spouse	$1,300
Single or not a surviving spouse	$1,650
Personal exemption	None

Retirement Plan Contribution Limits	
401(k), 403(b), 457 plans elective deferrals	$19,000
Catch-up contributions for 50 and older	$6,000
Defined contribution plans	$56,000
Defined benefit plans	$225,000
SIMPLE plans elective deferrals	$13,000
Catch-up contributions for 50 and older	$3,000
Traditional and Roth IRA	$6,000
Catch-up contributions for 50 and older	$1,000
Traditional IRA deductibility for active participants	Phaseout Limits:
Single	$64,000 to $74,000
Joint	$103,000 to $123,000
Spousal IRA if one spouse is covered by a plan	$193,000 to $203,000
Married filing separately	$0 to $10,000
Roth IRA income phaseout	
Single and Head of Household	$122,000 to $137,000
Joint	$193,000 to $203,000
Married filing separately	$0 to $10,000

Estate and Gift Tax	
Annual gift tax exlusion	$15,000
Estate and gift tax exclusion	$11,400,000
Maximum estate tax rate	40%

Health Savings Account (HSA) Contribution Limits = $3,500 for Self Only, $7,000 for Family
Catch-up contributions of $1,000 for age 55 and older

Medicare Surtaxes
0.9% on wages that exceed $200,000 (Single) or $250,000 (Married FJ)
3.8% on net investment income that falls above MAGI of $200,000 (Single) or $250,000 (Married FJ)

Medicare			
Part A Hospitalization			
First 60 days inpatient deductible		$1,364 for each benefit period	
Days 61 - 90		$341 per day, for each benefit period	
Days 91 +		$682 per day, up to 60 days over lifetime, then full amount per day	
Part B Premium: Those participants who enroll in Medicare Part B for the first time in 2019, whose MAGI from 2017 exceeded certain thresholds, or who don't get Social Security benefits may be subject to the premiums below.			
MAGI Single (for *2017*)	MAGI Joint (for *2017*)	Part B Monthly Premium	Part D *Addition* to Plan Premium
$85,000 or less	$170,000 or less	$135.50	$0
$85,001 to $107,000	$170,001 to $214,000	$189.60	$12.40
$107,001 to $133,500	$214,001 to $267,000	$270.90	$31.90
$133,501 to $160,000	$267,001 to $320,000	$352.20	$51.40
$160,001 to $500,000	$321,001 to $750,000	$433.40	$70.90
$500,001 +	$750,001 +	$460.50	$77.40
Part B Deductible	$185		
Coinsurance	20% of Medicare-approved amount for most services		

Source: irs.gov, Rev. Proc. 2018-57, IR-2018-211, Centers for Medicare & Medicaid Services.
The data contained on this sheet is for informational purposes only and should not be interpreted as tax or investment advice.
Consult your tax professional for specific advice about your personal situation.