James V Sadrianna, PA
James Sadrianna, CPA
CPA
7441 Haddington Cove
Lakewood Ranch, FL 34202
407-810-8595
james@jamesvsadriannapa.net
jamesvsadriannapa.com

James V Sadrianna PA - March 2021 Newsletter

Table of Contents

National Consumer Protection Week: Beware of Pandemic Scams 3

There's Still Time to Contribute to an IRA for 2020 5

Pandemic Relief Measures and Your Tax Return 7

Get a Fresh Start on Your Finances in 2021 9

GameStop, Reddit, and Market Mania: What You Need to Know 10

Understanding Risk 13

Six Keys to More Successful Investing 16

Handling Market Volatility 19

National Consumer Protection Week: Beware of Pandemic Scams

This past year, scam artists have taken advantage of people's concerns over the coronavirus pandemic to defraud them of money. According to the Federal Trade Commission (FTC), consumers reported losing more than $3.3 billion to fraud in 2020, up from $1.8 billion in 2019.[1]

This week is National Consumer Protection Week, the perfect time to take steps to protect yourself from the increase in fraud, identity theft and other scams. Here are some of the latest ones to watch out for.

Unemployment benefit scams

According to the U.S. Department of Labor, there has been a surge in identity theft related to unemployment insurance claims. In fact, over $5 billion in potentially fraudulent unemployment claims were paid between March and October of 2020.[2]

Typically, these types of scams involve a fraudster trying to use your personal information to claim unemployment benefits. If you receive an unexpected prepaid card for unemployment benefits, see an unexpected deposit from your state in your bank account, or receive a Form 1099-G for 2020 unemployment compensation that you did not apply for, report it to your state unemployment insurance office as soon as possible.

Economic impact payment scams

Scammers have come up with a number of schemes related to the economic impact payments sent to taxpayers by the federal government. It is important to note that at this time, all first and second economic impact payments have already been sent out. A third economic impact payment may be sent out to taxpayers by mid-March.

The IRS is warning taxpayers to be aware of scammers who:

- Use words such as "stimulus check" or "stimulus payment" instead of the official term, "economic impact payment"
- Ask you to "sign up" for your economic impact payment check
- Contact you by phone, email, text or social media for verification of personal and/or banking information to receive or speed up your economic impact payment

In most cases, the IRS will deposit economic impact payments directly into accounts that taxpayers previously provided on their tax returns. If the IRS does not have a taxpayer's direct-deposit information, a check or prepaid debit card will be mailed to the taxpayer's address on file with the IRS. For more information visit irs.gov.

Fraudulent products and vaccine scams

This past year, the Federal Trade Commission has warned about scam artists attempting to sell fraudulent products that claim to treat, prevent or diagnose COVID-19.

National Consumer Protection Week is a coordinated campaign by federal and state government and nonprofit partner organizations to help people understand their consumer rights and make well-informed decisions about money. For more information, visit ftc.gov.

With the arrival of new COVID-19 vaccines, the FTC is warning consumers to also be wary of possible vaccine scams. The FTC is urging consumers to contact their state or local health department in order to find out how, when and where to get a COVID-19 vaccine. In addition, the FTC warned consumers to avoid scammers who:

- Offer to put your name on a vaccine list or get early access to a vaccine for a fee
- Call, text or email you about the vaccine and ask for financial information

Protecting yourself from scams

Fortunately, there are some things you can do to protect yourself from scams, including those related to the coronavirus pandemic:

- Don't click on suspicious or unfamiliar links in emails, text messages or instant messaging services — visit government websites directly for important information
- Don't answer a phone call if you don't recognize the phone number — instead, let it go to voicemail and check later to verify the caller
- Keep device and security software up-to-date, maintain strong passwords and use multi-factor authentication
- Never share personal or financial information via email, text message or over the phone
- If you see a scam, be sure to report it to the FTC at ftc.gov, the Treasury Inspector General for Tax Administration (TIGTA) at tigta.gov and your local police department

[1] Federal Trade Commission, February 2021

[2] U.S. Department of Labor, February 2021

Making a last-minute contribution to an IRA may help you reduce your 2020 tax bill. If you qualify, your traditional IRA contribution may be tax deductible. And if you had low to moderate income and meet eligibility requirements, you may also be able to claim the Saver's Credit for 2020 based on your contributions to a traditional or Roth IRA. Claiming this nonrefundable tax credit may help reduce your tax bill and give you an incentive to save for retirement. For more information, visit [irs.gov.](irs.gov)

There's Still Time to Contribute to an IRA for 2020

Even though tax filing season is well under way, there's still time to make a regular IRA contribution for 2020. You have until your tax return due date (not including extensions) to contribute up to $6,000 for 2020 ($7,000 if you were age 50 or older on or before December 31, 2020). For most taxpayers, the contribution deadline for 2020 is April 15, 2021.

You can contribute to a traditional IRA, a Roth IRA, or both, as long as your total contributions don't exceed the annual limit (or, if less, 100% of your earned income). You may also be able to contribute to an IRA for your spouse for 2020, even if your spouse didn't have any 2020 income.

Traditional IRA

You can contribute to a traditional IRA for 2020 if you had taxable compensation. However, if you or your spouse was covered by an employer-sponsored retirement plan in 2020, then your ability to deduct your contributions may be limited or eliminated, depending on your filing status and modified adjusted gross income (MAGI). (See table below.) Even if you can't make a deductible contribution to a traditional IRA, you can always make a nondeductible (after-tax) contribution, regardless of your income level. However, if you're eligible to contribute to a Roth IRA, in most cases you'll be better off making nondeductible contributions to a Roth, rather than making them to a traditional IRA.

2020 income phaseout ranges for determining deductibility of traditional IRA contributions:		
1. Covered by an employer-sponsored plan and filing as:	Your IRA deduction is reduced if your MAGI is:	Your IRA deduction is eliminated if your MAGI is:
Single/Head of household	$65,000 to $75,000	$75,000 or more
Married filing jointly	$104,000 to $124,000	$124,000 or more
Married filing separately	$0 to $10,000	$10,000 or more
2. Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan	$196,000 to $206,000	$206,000 or more

Roth IRA

You can contribute to a Roth IRA if your MAGI is within certain limits. For 2020, if you file your federal tax return as single or head of household, you can make a full Roth contribution if your income is less than $124,000. Your maximum contribution is phased out if your income is between $124,000 and $139,000, and you can't contribute at all if your income is $139,000 or more. Similarly, if you're married and file a joint federal tax return, you can make a full Roth contribution if your income is less than $196,000. Your contribution is phased out if your income is between $196,000 and $206,000, and you can't contribute at all if your income is $206,000 or more. If you're married filing separately, your contribution phases out with any income over $0, and you can't contribute at all if your income is $10,000 or more.

2020 income phaseout ranges for determining eligibility to contribute to a Roth IRA:		
	Your ability to contribute to a Roth IRA is reduced if your MAGI is:	Your ability to contribute to a Roth IRA is eliminated if your MAGI is:
Single/Head of household	$124,000 to $139,000	$139,000 or more
Married filing jointly	$196,000 to $206,000	$206,000 or more
Married filing separately	$0 to $10,000	$10,000 or more

Even if you can't make an annual contribution to a Roth IRA because of the income limits, there's an easy workaround. You can make a nondeductible contribution to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA. Keep in mind, however, that you'll need to aggregate all traditional IRAs and SEP/SIMPLE IRAs you own — other than IRAs you've inherited — when you calculate the taxable portion

You have until your tax return due date (not including extensions) to contribute up to $6,000 for 2020 ($7,000 if you were age 50 or older on December 31, 2020) to all IRAs combined. For most taxpayers, the contribution deadline for 2020 is April 15, 2021.

of your conversion. (This is sometimes called a "back-door" Roth IRA.)

If you make a contribution — no matter how small — to a Roth IRA for 2020 by your tax return due date and it is your first Roth IRA contribution, your five-year holding period for taking qualified tax-free distributions from all your Roth IRAs (other than inherited accounts) will start on January 1, 2020.

__Last year was unpredictable, and your financial situation may have been far from normal.__

Pandemic Relief Measures and Your Tax Return

Two emergency relief bills passed in 2020 in response to the COVID-19 pandemic will make this an unusual tax season for many taxpayers. The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed in March, and a second relief package was attached to the Consolidated Appropriations Act, 2021, in December.

The federal government relied on the tax system to deliver financial lifelines to struggling households, boost consumer spending, and help speed the economic recovery.

The following provisions may affect many households when they file their personal tax returns for 2020. You might consult a tax professional who can further explain the relevant changes and recommend strategies to help reduce your tax liability for 2021.

Recovery Rebate Credit

Most U.S. households received two Economic Impact Payments (EIPs) from the federal government in 2020. They are not taxable because technically they are advances on a refundable credit against 2020 income taxes.

The CARES Act provided a Recovery Rebate Credit of $1,200 ($2,400 for married joint filers) plus $500 for each qualifying child under age 17. The second bill provided another $600 per eligible family member.

Any individual who has a Social Security number and is not a dependent generally qualifies for the payments, up to certain income limits. The amounts are reduced for those with adjusted gross incomes (AGIs) exceeding $75,000 ($150,000 for joint filers and $112,500 for heads of household) and phase out completely at AGIs of $99,000 ($198,000 for joint filers and $112,500 for heads of household).

In order for the money to be delivered quickly, eligibility was based on 2019 income tax returns (or 2018 if a 2019 return had not been filed). Eligible taxpayers who did not receive two full payments, possibly due to errors or processing delays, may claim the money as a Recovery Rebate Credit on their 2020 tax return. Households that reported a lower AGI in 2020 (or added a dependent) might be eligible for additional funds. To calculate the credit, filers will need to know the amounts of any payments they already received. The credit amount will increase the refund or decrease the tax owed, dollar for dollar.

Taxpayers who received two full payments don't need to fill out any additional information on their tax returns. The IRS will begin accepting 2020 tax returns on February 12, 2021; filing electronically usually results in a faster refund.

Coronavirus-related distributions

Another measure in the CARES Act allowed IRA owners and employer-plan participants who were adversely affected by COVID-19 to withdraw up to $100,000 of their vested account balance in 2020 without having to pay the 10% tax penalty (25% for SIMPLE IRAs) that normally applies prior to age 59½.

Still, withdrawals from tax-deferred retirement accounts are typically taxed as ordinary income in the year of the distribution. To help manage the tax liability, qualified individuals can choose to spread the income from a coronavirus-related distribution (CRD) equally over three years or report it in full for the 2020 tax year, with up to three years to reinvest the money in an eligible employer plan or an IRA.

Taxpayers who elect to report income over three years and then recontribute amounts greater than the amount reported in a given year may "carry forward" the excess contributions to next year's tax return. Taxpayers who recontribute amounts after paying taxes on reported CRD income can file amended returns to recoup the payments.

Qualified individuals whose plans did not adopt CRD provisions may choose to categorize other types of distributions — including those normally considered required minimum distributions — as CRDs on their tax returns (up to the $100,000 limit).

Other notable changes

The special rules for charitable gift deductions enacted for 2020 have been extended through 2021. For those who itemize deductions, the limit on the charitable gift deduction increased to 100% of AGI for direct cash gifts to public charities. For nonitemizers, a new $300 charitable deduction for 2020 and 2021 direct cash gifts to public charities is available. For joint filers, this deduction increases to $600 for 2021 cash gifts to charitable organizations.

The floor for deducting medical expenses has been permanently lowered to 7.5% of AGI. (It was scheduled to increase to 10% in 2021.) And starting in 2021, there is no deduction for qualified tuition and related expenses. Instead, the modified adjusted gross income (MAGI) phaseout range for the Lifetime Learning credit was increased to be the same as the phaseout range for the American Opportunity credit ($80,000 to $90,000 for single filers; $160,000 to 180,000 for joint filers).

A temporary provision that allows taxpayers to exclude discharged debt for a qualified principal residence from gross income was extended through 2025, though the limit has been reduced from $2 million to $750,000. Also through 2025, employers can pay up to $5,250 annually toward employees' student loans as a tax-free employee benefit.

Yes, unemployment aid is taxable

The number of unemployed workers spiked above 22 million in March 2020, and more than 9 million people were still out of work at the end of the year.[1] Both relief bills expanded unemployment benefits and provided them to many workers who normally are not eligible (including the self-employed, independent contractors, and part-time workers).

Unemployment benefits, which sustained many families impacted by the pandemic, are considered taxable income, and many recipients may not have correctly withheld taxes from their 2020 payments. Avoiding a surprise tax bill typically requires opting into a 10% withholding rate and, in some cases, paying additional quarterly taxes during the year.

Last year was unpredictable, and your financial situation may have been far from normal. You should file your 2020 tax return by the April 15 deadline, even if you are worried that it's going to show a balance due. Being up-to-date on filing is generally required to pursue a payment agreement with the IRS. If you owe $50,000 or less, you may even be able to apply online for a short-term extension (up to 120 days) or a longer payment agreement. Paying as much as you can afford can help limit penalties and interest that accrue on unpaid amounts.

1) U.S. Bureau of Labor Statistics, 2021

Get a Fresh Start on Your Finances in 2021

There's no doubt about it — last year was tumultuous. The coronavirus pandemic, a contentious election, and widespread protests were just some of the events that impacted our nation in 2020. Fortunately, the arrival of new vaccines has brought hope for a brighter 2021. If you are looking forward to a fresh start this year, why not begin with your personal finances? Here are some tips to help you get started.

Examine your budget

One way to start the year off right financially is to examine your budget. First, identify your income and expenses. Next, add each of them up and compare the two totals to make sure you are spending less than you earn. Hopefully you've been able to stay the course during the pandemic and your budget is still on track. If you find that your expenses outweigh your income, you'll need to make some adjustments. For example, if you've experienced a loss or reduction in income during the pandemic, you may need to cut back on certain discretionary spending (e.g., online shopping, take-out) or look for ways to lower your fixed costs, which may require more significant changes.

Once you have a solid budget in place, it's important to stick with it. And while straying from your budget from time to time is normal, there are some ways to help make working within your budget a bit easier:

- Make budgeting a part of your daily routine
- Build occasional rewards into your budget
- Evaluate your budget on a regular basis and make changes when necessary
- Use budgeting software/apps to help analyze saving and spending patterns

Rethink your financial goals

While the pandemic may have sidelined or stalled some of your financial goals, now is a good time to regain your focus. Take a look at the financial goals you set for yourself last year. Perhaps you wanted to increase your emergency fund or save money for a down payment on a home. Maybe you wanted to invest more money towards your retirement. Were you able to accomplish your goals despite any setbacks brought about by the pandemic? Do you have any new goals you would like to achieve in 2021? Finally, if your personal or financial circumstances changed, will you need to reprioritize your goals?

Make sure your investment portfolio is still on target

Despite the pandemic, the U.S. stock market ended 2020 at an all-time high. But that doesn't necessarily mean your investment portfolio is still targeting your financial goals. When evaluating your investment portfolio, you'll want to ask yourself the following questions:

- Do I still have the same time horizon for investing as I did last year or prior to the pandemic?
- Has my tolerance for risk changed?
- Do I currently have an increased need for liquidity?
- Does any investment now represent too large (or too small) a part of my portfolio?

Pay down your debt

Reducing debt is part of any healthy financial plan. Whether you have student loan debt, an auto loan, and/or credit card balances, you'll want to try to pay it down as quickly as possible. Start by tracking all of your balances and being mindful of interest rates and hidden fees. Next, optimize your repayments by paying off any high-interest debt first and/or taking advantage of debt consolidation/refinancing programs.

If the financial impact of the pandemic has made it difficult for you to pay down your debt, you may want to contact your lenders to see if they offer financial assistance. Many lenders may be willing to work with you by waiving interest and certain fees or allowing you to delay, adjust, or even skip some payments.

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

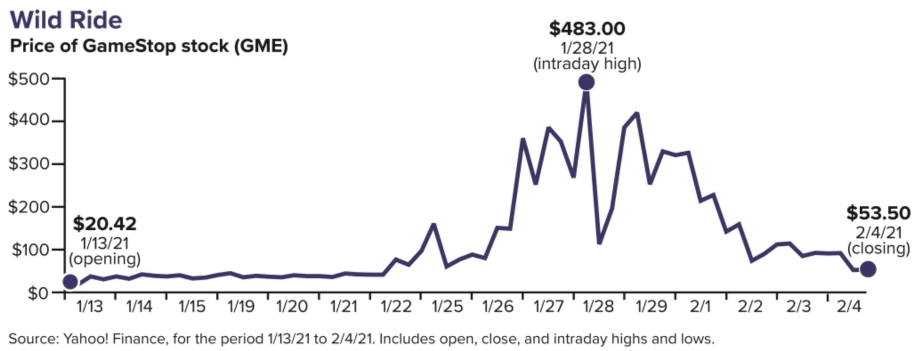
GameStop, Reddit, and Market Mania: What You Need to Know

Over the course of 11 trading days from January 13 to January 28, 2021, the stock of GameStop, a struggling brick-and-mortar video game retailer, skyrocketed by more than 2,200% — creating a mix of excitement and concern throughout the financial world, as well as among many people who pay little attention to the stock market.[1] Other stocks of small, struggling companies made similar though less dramatic moves.

At the heart of this story are two very different sets of investors: professional managers of multibillion-dollar hedge funds and a small army of individual investors connected through social media.

At the heart of this story are two very different sets of investors: (1) professional managers of multibillion-dollar hedge funds, who took large, risky positions betting that GameStop stock would drop in price; and (2) a small army of individual investors, connected through social news aggregator Reddit and other social media sites, who worked together to buy large numbers of shares in order to drive the stock price up.

As the stock price rose, fund managers were forced to buy more and more shares at ever-increasing prices to "cover their bets," while individual investors continued to buy shares in hopes of continuing the momentum. The opposing forces created a feeding frenzy that sent the stock to dizzying heights far beyond the fundamental value of the company.[2] The stock price peaked on January 28 and lost almost 90% of its peak value over the next five trading days.[3]



If you are confused, concerned, intrigued — or a combination of all three — here are answers to some questions you may have about the recent market volatility triggered by "meme" stocks, an Internet term for stocks heavily promoted through social media.

1. What is a hedge fund, and what were the hedge funds doing?

A hedge fund is an investment company that uses pooled funds to take an aggressive approach in an effort to outperform the market. These funds are typically open to a limited number of accredited investors and may require a high minimum investment. Hedge funds use various high-risk strategies, including buying stock with borrowed money or borrowing stock to sell, called buying or borrowing on margin. This enables the fund to increase potential profits but also increases potential losses. (Individual investors can use these high-risk techniques, but the investor must meet certain financial requirements in order to establish a margin account and accept the increased risk.)

In this case, certain hedge funds borrowed shares of GameStop and other struggling companies on margin from a brokerage firm and sold the shares at the market price, with the expectation that the share prices would drop significantly by the time they had to return the shares to the lender. The funds could then buy shares at the lower price, return the shares, and pocket the difference, minus fees and interest. When GameStop share prices began to rise quickly against expectations, the "short sellers" began to buy shares at market prices in order to protect against future losses. These purchases helped drive share prices even higher — supply and demand — which led to more purchases and even higher prices. This created a situation known as a short squeeze.[4]

To understand the level of risk faced by the short sellers, consider this: An investor who actually owns shares of a company can lose no more than 100% of the investment, but there is essentially no limit to the potential losses for a short seller, because there is no limit to how high a stock price might go. This is why short sellers were willing to buy at ever-increasing prices, accepting large losses rather than risking even

larger losses. In addition, they were forced to add additional funds and/or other securities to their accounts to meet margin requirements; investors must keep a certain percentage of the borrowed funds as collateral, and the higher the stock prices went, the more collateral was required in the margin accounts.[5]

2. What is Reddit, and what were the Reddit investors doing?

Reddit is an online community with more than a million forums called subreddits in which members share information on a particular topic. Members of a subreddit dedicated to investing coalesced around a strategy to buy GameStop stock in order to push the price up and squeeze the hedge funds. The potential for this strategy was first suggested on the forum in April 2020, but it exploded on Reddit and other social media sites in January 2021, after a change in the GameStop board of directors that encouraged bullish investors coupled with an announcement from a well-known short seller predicting that the stock price would quickly drop.[6]

While some investors genuinely believed that GameStop was undervalued, the movement developed into a crusade to beat the hedge funds in what amateur investors perceived to be a "game" of manipulating stock values, as well as a more pragmatic belief that there was money to be made by buying GameStop low and selling high. The fact that many young investors were gamers who felt an affinity for GameStop added to the sense of purpose.[7]

The strategy worked more powerfully than the amateur investors expected, and some who bought the stock in the early stages of the rally and sold when it was flying high earned large profits. However, those who joined the excitement later faced large losses as the stock plummeted. Once some hedge funds had accepted losses and begun to close their short positions, there was no longer demand for shares at inflated prices.[8]

3. Why did brokerage firms limit trading activity for certain stocks?

At various points during the peak trading activity, some brokerage firms stopped the trading of GameStop and other heavily shorted and heavily traded stocks. They also placed restrictions on certain stocks, limiting trading to very small lots and/or raising margin requirements. In a typical situation, an investor must maintain a 50% margin, meaning the investor can borrow shares or funds equal to the shares or funds in his or her account. Restrictions varied in response to the recent trading, but at least one brokerage firm raised margin requirements on certain stocks to 100% for long positions (purchasing stocks to hold) and 300% for short positions.[9]

The stoppages and restrictions elicited accusations of unfairness from investors and some members of Congress, who believed the brokerage firms were protecting the hedge funds. In fact, the moves were dictated in large part by clearinghouses that process trades from the brokers. These clearinghouses require that brokers keep a certain level of funding (collateral) on deposit in order to cover both sides of any given trade. As trading and values increased, clearinghouses asked for larger deposits. By halting and/or restricting trading of highly volatile stocks, brokers were able to reduce the required collateral, which enabled them to meet the new deposit requirements in a timely manner.[10]

The restrictions also helped protect investors from being overextended and suffering outsized losses amid extreme volatility. And to an extent, they protected the broader stock market. The New York Stock Exchange (NYSE) regularly suspends trading of individual stocks when price swings exceed certain limits. On February 2, when the price of GameStop was plunging, the NYSE suspended trading five times throughout the day, with each suspension lasting less than 12 minutes. Although GameStop remained in the spotlight, more than 20 other stocks also had trading suspended throughout that day.[11]

4. What happens next?

It may take months or years before the full effects of the recent activity play out in the financial markets, but one clear takeaway is that social media, combined with accessible low-cost trading platforms, allows like-minded groups of retail investors to exert power that matches large-scale institutional investors. More than 10 million new brokerage accounts were opened in 2020, and many new investors are trading securities online and through smartphone apps.[12]

Some hedge fund managers have already stated that they will rethink their focus on short selling.[13] And new services aimed at providing tools for professional investors to track investing discussions on social media platforms have quickly risen and may become a staple of investment research.[14]

Although the larger stock market remained resilient throughout the episode, extreme volatility is always a concern, and the Securities and Exchange Commission issued a statement saying, "The Commission is closely monitoring and evaluating the extreme price volatility...[which] has the potential to expose investors to rapid and severe losses and undermine market confidence. As always, the Commission will work to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation."[15]

What about GameStop and other companies involved in the volatility? The huge price swings had little or

nothing to do with the actual value of the companies, and they will need to make fundamental business changes to address the underlying weakness that caused them to be targeted for short sales in the first place. The changes on the GameStop board that helped spark the rally, adding leaders with online expertise, may help the company compete in the marketplace, but that remains to be seen.[16]

As an investor, the lesson for you might be to tune out market mania over "hot stocks," especially when there is little to back up the sudden interest other than speculation. The wisest course is often to build a portfolio that is appropriate for your risk tolerance, time frame, and personal situation and let your portfolio pursue growth over the long term. This strategy may not be as exciting as the wild ups and downs of stocks in the spotlight, but it's more likely to help you reach your long-term goals.

The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve higher risk.

Margin accounts can be very risky and are not appropriate for everyone. Before opening a margin account, you should fully understand that: you can lose more money than you have invested; you may have to deposit additional cash or securities in your account on short notice to cover market losses; you may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

1, 3) Yahoo! Finance, for the period January 13, 2021, to February 4, 2021

2, 4–5) Kiplinger, January 30, 2021

6–7) Bloomberg, January 25, 2021

8) *The New York Times,* February 3, 2021

9) CNBC, January 28, 2021

10) *The Wall Street Journal,* January 29, 2021

11) New York Stock Exchange, 2021

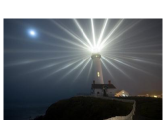
12) *The Wall Street Journal,* December 30, 2020

13) *Barron's,* January 29, 2021

14) MarketWatch, February 1, 2021

15) Securities and Exchange Commission, January 29, 2021

16) *The New York Times,* February 1, 2021



Understanding Risk

Few terms in personal finance are as important, or used as frequently, as "risk." Nevertheless, few terms are as imprecisely defined. Generally, when financial advisors or the media talk about investment risk, their focus is on the historical price volatility of the asset or investment under discussion.

Advisors label as aggressive or risky an investment that has been prone to wild price gyrations in the past. The presumed uncertainty and unpredictability of this investment's future performance is perceived as risk. Assets characterized by prices that historically have moved within a narrower range of peaks and valleys are considered more conservative. Unfortunately, this explanation is seldom offered, so it is often not clear that the volatility yardstick is being used to measure risk.

Before exploring risk in more formal terms, a few observations are worthwhile. On a practical level, we can say that risk is the chance that your investment will provide lower returns than expected or even a loss of your entire investment. You probably also are concerned about the chance of not meeting your investment goals. After all, you are investing now so you can do something later (for example, pay for college or retire comfortably). Every investment carries some degree of risk, including the possible loss of principal, and there can be no guarantee that any investment strategy will be successful. That's why it makes sense to understand the kinds of risk as well as the extent of risk that you choose to take, and to learn ways to manage it.

What you probably already know about risk

Even though you might never have thought about the subject, you're probably already familiar with many kinds of risk from life experiences. For example, it makes sense that a scandal or lawsuit that involves a particular company will likely cause a drop in the price of that company's stock, at least temporarily. If one car company hits a home run with a new model, that might be bad news for competing automakers. In contrast, an overall economic slowdown and stock market decline might hurt most companies and their stock prices, not just in one industry.

However, there are many different types of risk to be aware of. Volatility is a good place to begin as we examine the elements of risk in more detail.

What makes volatility risky?

Suppose that you had invested $10,000 in each of two mutual funds 20 years ago, and that both funds produced average annual returns of 10 percent. Imagine further that one of these hypothetical funds, Steady Freddy, returned exactly 10 percent every single year. The annual return of the second fund, Jekyll & Hyde, alternated — 5 percent one year, 15 percent the next, 5 percent again in the third year, and so on. What would these two investments be worth at the end of the 20 years?

It seems obvious that if the average annual returns of two investments are identical, their final values will be, too. But this is a case where intuition is wrong. If you plot the 20-year investment returns in this example on a graph, you'll see that Steady Freddy's final value is over $2,000 more than that from the variable returns of Jekyll & Hyde. The shortfall gets much worse if you widen the annual variations (e.g., plus-or-minus 15 percent, instead of plus-or-minus 5 percent). This example illustrates one of the effects of investment price volatility: Short-term fluctuations in returns are a drag on long-term growth.

Note: *This is a hypothetical example and does not reflect the performance of any specific investment. This example assumes the reinvestment of all earnings and does not consider taxes or transaction costs.*

Although past performance is no guarantee of future results, historically the negative effect of short-term price fluctuations has been reduced by holding investments over longer periods. But counting on a longer holding period means that some additional planning is called for. You should not invest funds that will soon be needed into a volatile investment. Otherwise, you might be forced to sell the investment to raise cash at a time when the investment is at a loss.

Other types of risk

Here are a few of the many different types of risk:

- Market risk: This refers to the possibility that an investment will lose value because of a general decline in financial markets, due to one or more economic, political, or other factors.
- Inflation risk: Sometimes known as purchasing power risk, this refers to the possibility that prices will rise in the economy as a whole, so your ability to purchase goods and services would decline. For instance, your investment might yield a 6 percent return, but if the inflation rate rises to double digits, the invested dollars that you got back would buy less than the same dollars today. Inflation risk is often overlooked by fixed income investors who shun the volatility of the stock market completely.
- Interest rate risk: This relates to increases or decreases in prevailing interest rates and the resulting price fluctuation of an investment, particularly bonds. There is an inverse relationship between bond prices and interest rates. As interest rates rise, the price of bonds falls; as interest rates fall, bond prices tend to rise. If you need to sell your bond before it matures and your principal is returned, you run the risk of loss of principal if interest rates are higher than when you purchased the bond.
- Reinvestment rate risk: This refers to the possibility that funds might have to be reinvested at a lower rate of return than that offered by the original investment. For example, a five-year, 3.75 percent bond might mature at a time when an equivalent new bond pays just 3 percent. Such differences can in turn affect the yield of a bond fund.
- Default risk (credit risk): This refers to the risk that a bond issuer will not be able to pay its bondholders interest or repay principal.
- Liquidity risk: This refers to how easily your investments can be converted to cash. Occasionally (and more precisely), the foregoing definition is modified to mean how easily your investments can be converted to cash without significant loss of principal.
- Political risk: This refers to the possibility that new legislation or changes in foreign governments will adversely affect companies you invest in or financial markets overseas.
- Currency risk (for those making international investments): This refers to the possibility that the fluctuating rates of exchange between U.S. and foreign currencies will negatively affect the value of your foreign investment, as measured in U.S. dollars.

The relationship between risk and reward

In general, the more risk you're willing to take on (whatever type and however defined), the higher your potential returns, as well as potential losses. This proposition is probably familiar and makes sense to most of us. It is simply a fact of life — no sensible person would make a higher-risk, rather than lower-risk, investment without the prospect of receiving a higher return. That is the tradeoff. Your goal is to maximize returns without taking on an inappropriate level or type of risk.

Understanding your own tolerance for risk

The concept of risk tolerance is twofold. First, it refers to your personal desire to assume risk and your comfort level with doing so. This assumes that risk is relative to your own personality and feelings about taking chances. If you find that you can't sleep at night because you're worrying about your investments, you may have assumed too much risk. Second, your risk tolerance is affected by your financial ability to cope with the possibility of loss, which is influenced by your age, stage in life, how soon you'll need the money, your investment objectives, and your financial goals. If you're investing for retirement and you're 35 years old, you may be able to endure more risk than someone who is 10 years into retirement, because you have a longer time frame before you will need the money. With 30 years to build a nest egg, your investments have more time to ride out short-term fluctuations in hopes of a greater long-term return.

Reducing risk through diversification

Don't put all your eggs in one basket. You can potentially help offset the risk of any one investment by spreading your money among several asset classes. Diversification strategies take advantage of the fact that forces in the markets do not normally influence all types or classes of investment assets at the same time or in the same way (though there are often short-term exceptions). Swings in overall portfolio return can potentially be moderated by diversifying your investments among assets that are not highly correlated — i.e., assets whose values may behave very differently from one another. In a slowing economy, for example, stock prices might be going down or sideways, but if interest rates are falling at the same time, the price of bonds likely would rise. Diversification cannot guarantee a profit or ensure against a potential loss, but it can help you manage the level and types of risk you face.

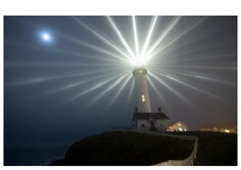
In addition to diversifying among asset classes, you can diversify within an asset class. For example, the stocks of large, well-established companies may behave somewhat differently than stocks of small companies that are growing rapidly but that also may be more volatile. A bond investor can diversify among Treasury securities, more risky corporate securities, and municipal bonds, to name a few. Diversifying within an asset class helps reduce the impact on your portfolio of any one particular type of stock, bond, or mutual fund.

Evaluating risk: where to find information about investments

You should become fully informed about an investment product before making a decision. There are numerous sources of information. In addition to the information available from the company offering an investment — for example, the prospectus of a mutual fund — you can find information in third-party business and financial publications and websites, as well as annual and other periodic financial reports. The Securities and Exchange Commission (SEC) also can supply information.

Third-party business and financial publications can provide credit ratings, news stories, and financial information about a company. For mutual funds, third-party sources provide information such as ratings, financial analysis, and comparative performance relative to peers.

Note: *Before investing in a mutual fund, carefully consider its investment objectives, risks, fees and expenses, which can be found in the prospectus available from the fund; read it and consider it carefully before investing.*



Six Keys to More Successful Investing

A successful investor maximizes gain and minimizes loss. Though there can be no guarantee that any investment strategy will be successful and all investing involves risk, including the possible loss of principal, here are six basic principles that may help you invest more successfully.

Long-term compounding can help your nest egg grow

It's the "rolling snowball" effect. Put simply, compounding pays you earnings on your reinvested earnings. The longer you leave your money at work for you, the more exciting the numbers get. For example, imagine an investment of $10,000 at an annual rate of return of 8 percent. In 20 years, assuming no withdrawals, your $10,000 investment would grow to $46,610. In 25 years, it would grow to $68,485, a 47 percent gain over the 20-year figure. After 30 years, your account would total $100,627. (Of course, this is a hypothetical example that does not reflect the performance of any specific investment.)

This simple example also assumes that no taxes are paid along the way, so all money stays invested. That would be the case in a tax-deferred individual retirement account or qualified retirement plan. The compounded earnings of deferred tax dollars are the main reason experts recommend fully funding all tax-advantaged retirement accounts and plans available to you.

While you should review your portfolio on a regular basis, the point is that money left alone in an investment offers the potential of a significant return over time. With time on your side, you don't have to go for investment "home runs" in order to be successful.

Endure short-term pain for long-term gain

Riding out market volatility sounds simple, doesn't it? But what if you've invested $10,000 in the stock market and the price of the stock drops like a stone one day? On paper, you've lost a bundle, offsetting the value of compounding you're trying to achieve. It's tough to stand pat.

There's no denying it — the financial marketplace can be volatile. Still, it's important to remember two things. First, the longer you stay with a diversified portfolio of investments, the more likely you are to reduce your risk and improve your opportunities for gain. Though past performance doesn't guarantee future results, the long-term direction of the stock market has historically been up. Take your time horizon into account when establishing your investment game plan. For assets you'll use soon, you may not have the time to wait out the market and should consider investments designed to protect your principal. Conversely, think long-term for goals that are many years away.

Second, during any given period of market or economic turmoil, some asset categories and some individual investments historically have been less volatile than others. Bond price swings, for example, have generally been less dramatic than stock prices. Though diversification alone cannot guarantee a profit or ensure against the possibility of loss, you can minimize your risk

somewhat by diversifying your holdings among various classes of assets, as well as different types of assets within each class.

Spread your wealth through asset allocation

Asset allocation is the process by which you spread your dollars over several categories of investments, usually referred to as asset classes. The three most common asset classes are stocks, bonds, and cash or cash alternatives such as money market funds. You'll also see the term "asset classes" used to refer to subcategories, such as aggressive growth stocks, long-term growth stocks, international stocks, government bonds (U.S., state, and local), high-quality corporate bonds, low-quality corporate bonds, and tax-free municipal bonds. A basic asset allocation would likely include at least stocks, bonds (or mutual funds of stocks and bonds), and cash or cash alternatives.

There are two main reasons why asset allocation is important. First, the mix of asset classes you own is a large factor — some say the biggest factor by far — in determining your overall investment portfolio performance. In other words, the basic decision about how to divide your money between stocks, bonds, and cash can be more important than your subsequent choice of specific investments.

Second, by dividing your investment dollars among asset classes that do not respond to the same market forces in the same way at the same time, you can help minimize the effects of market volatility while maximizing your chances of return in the long term. Ideally, if your investments in one class are performing poorly, assets in another class may be doing better. Any gains in the latter can help offset the losses in the former and help minimize their overall impact on your portfolio.

Consider your time horizon in your investment choices

In choosing an asset allocation, you'll need to consider how quickly you might need to convert an investment into cash without loss of principal (your initial investment). Generally speaking, the sooner you'll need your money, the wiser it is to keep it in investments whose prices remain relatively stable. You want to avoid a situation, for example, where you need to use money quickly that is tied up in an investment whose price is currently down.

Therefore, your investment choices should take into account how soon you're planning to use your money. If you'll need the money within the next one to three years, you may want to consider keeping it in a money market fund or other cash alternative whose aim is to protect your initial investment. Your rate of return may be lower than that possible with more volatile investments such as stocks, but you'll breathe easier knowing that the principal you invested is relatively safe and quickly available, without concern over market conditions on a given day. Conversely, if you have a long time horizon — for example, if you're investing for a retirement that's many years away — you may be able to invest a greater percentage of your assets in something that might have more dramatic price changes but that might also have greater potential for long-term growth.

Note: *Before investing in a mutual fund, consider its investment objectives, risks, charges, and expenses, all of which are outlined in the prospectus, available from the fund. Consider the information carefully before investing. Remember that an investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporate or any other government agency. Although the fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in the fund.*

Dollar cost averaging: investing consistently and often

Dollar cost averaging is a method of accumulating shares of an investment by purchasing a fixed dollar amount at regularly scheduled intervals over an extended time. When the price is high, your fixed-dollar investment buys less; when prices are low, the same dollar investment will buy more shares. A regular, fixed-dollar investment should result in a lower average price per share than you would get buying a fixed number of shares at each investment interval. A workplace savings plan, such as a 401(k) plan that deducts the same amount from each paycheck and invests it through the plan, is one of the most well-known examples of dollar cost averaging in action.

Remember that, just as with any investment strategy, dollar cost averaging can't guarantee you a profit or protect you against a loss if the market is declining. To maximize the potential effects of dollar cost averaging, you should also assess your ability to keep investing even when the market is down.

An alternative to dollar cost averaging would be trying to "time the market," in an effort to predict how the price of the shares will fluctuate in the months ahead so you can make your full investment at the absolute lowest point. However, market timing is generally unprofitable guesswork. The discipline of regular investing is a much more manageable strategy, and it has the added benefit of automating the process.

Buy and hold, don't buy and forget

Unless you plan to rely on luck, your portfolio's long-term success will depend on periodically reviewing it. Maybe economic conditions have changed the prospects for a particular investment or an entire asset class. Also, your circumstances change over time, and your asset allocation will need to reflect those changes. For example, as you get closer to retirement, you might decide to increase your allocation to less volatile investments, or those that can provide a steady stream of income.

Another reason for periodic portfolio review: your various investments will likely appreciate at different rates, which will alter your asset allocation without any action on your part. For example, if you initially decided on an 80 percent to 20 percent mix of stock investments to bond investments, you might find that after several years the total value of your portfolio has become divided 88 percent to 12 percent (conversely, if stocks haven't done well, you might have a 70-30 ratio of stocks to bonds in this hypothetical example). You need to review your portfolio periodically to see if you need to return to your original allocation.

To rebalance your portfolio, you would buy more of the asset class that's lower than desired, possibly using some of the proceeds of the asset class that is now larger than you intended. Or you could retain your existing allocation but shift future investments into an asset class that you want to build up over time. But if you don't review your holdings periodically, you won't know whether a change is needed. Many people choose a specific date each year to do an annual review.

Handling Market Volatility

Conventional wisdom says that what goes up, must come down. But even if you view market volatility as a normal occurrence, it can be tough to handle when it's your money at stake.

Though there's no foolproof way to handle the ups and downs of the stock market, the following common sense tips can help.

Don't put your eggs all in one basket

Diversifying your investment portfolio is one of the key ways you can handle market volatility. Because asset classes often perform differently under different market conditions, spreading your assets across a variety of different investments such as stocks, bonds, and cash alternatives (e.g., money market funds and other short-term instruments), has the potential to help manage your overall risk. Ideally, a decline in one type of asset will be balanced out by a gain in another, though diversification can't guarantee a profit or eliminate the possibility of market loss.

One way to diversify your portfolio is through asset allocation. Asset allocation involves identifying the asset classes that are appropriate for you and allocating a certain percentage of your investment dollars to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives). A worksheet or an interactive tool can suggest a model or sample allocation based on your investment objectives, risk tolerance level, and investment time horizon, but your strategy should be tailored to your unique circumstances.

Focus on the forest, not on the trees

As the markets go up and down, it's easy to become too focused on day-to-day returns. Instead, keep your eyes on your long-term investing goals and your overall portfolio. Although only you can decide how much investment risk you can handle, if you still have years to invest, don't overestimate the effect of short-term price fluctuations on your portfolio.

Look before you leap

When the market goes down and investment losses pile up, you may be tempted to pull out of the stock market altogether and look for less volatile investments. The small returns that typically accompany low-risk investments may seem downright attractive when more risky investments are posting negative returns.

But before you leap into a different investment strategy, make sure you're doing it for the right reasons. How you choose to invest your money should be consistent with your goals and time horizon.

For instance, putting a larger percentage of your investment dollars into vehicles that offer safety of principal and liquidity (the

opportunity to easily access your funds) may be the right strategy for you if your investment goals are short-term or if a long-term goal such as retirement has now become an immediate goal. But if you still have years to invest, keep in mind that although past performance is no guarantee of future results, stocks have historically outperformed stable value investments over time. If you move most or all of your investment dollars into conservative investments, you've not only locked in any losses you might have, but you've also sacrificed the potential for higher returns.

Look for the silver lining

A down market, like every cloud, has a silver lining. The silver lining of a down market is the opportunity you have to buy shares of stock at lower prices.

One of the ways you can do this is by using dollar cost averaging. With dollar cost averaging, you don't try to "time the market" by buying shares at the moment when the price is lowest. In fact, you don't worry about price at all. Instead, you invest the same amount of money at regular intervals over time. When the price is higher, your investment dollars buy fewer shares of stock, but when the price is lower, the same dollar amount will buy you more shares. Although dollar cost averaging can't guarantee you a profit or protect against a loss, over time a regular fixed dollar investment may result in an average price per share that's lower than the average market price, assuming you invest through all types of markets. A workplace savings plan, such as a 401(k) plan in which the same amount is deducted from each paycheck and invested through the plan, is one of the most well-known examples of dollar cost averaging in action. Please remember that since dollar cost averaging involves continuous investment in securities regardless of fluctuating price levels of such securities, you should consider your financial ability to make ongoing purchases.

Don't count your chickens before they hatch

As the market recovers from a down cycle, elation quickly sets in. If the upswing lasts long enough, it's easy to believe that investing in the stock market is a sure thing. But, of course, it never is. As many investors have learned the hard way, becoming overly optimistic about investing during the good times can be as detrimental as worrying too much during the bad times. The right approach during all kinds of markets is to be realistic. Have a plan, stick with it, and strike a comfortable balance between risk and return.

Don't stick your head in the sand

While focusing too much on short-term gains or losses is unwise, so is ignoring your investments. You should check up on your portfolio at least once a year, more frequently if the market is particularly volatile or when there have been significant changes in your life. You may need to rebalance your portfolio to bring it back in line with your investment goals and risk tolerance, or redesign it so that it better suits your current needs. Don't hesitate to get expert help if you need it when deciding which investment options are right for you.

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James V Sadrianna, PA
James Sadrianna, CPA
CPA
7441 Haddington Cove
Lakewood Ranch, FL 34202
407-810-8595
james@jamesvsadriannapa.net
jamesvsadriannapa.com