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How To Diversify With Investment Real Estate

The potential benefit of diversifying your investments is straightforward. By holding many different kinds of assets, you reduce the risk of being hurt by a plunge in the worth of any one of them. While there are no guarantees, especially when markets decline, this often has proven to be a sound approach to investing.

But how do you diversify if most of your holdings are stocks? One popular option is to invest in real estate.

That doesn't mean your personal residence. Although your home may appreciate over time, and if you profit when you finally sell it some or all of your gain may be exempt from taxes, it is better not

to think of it as an investment. But other kinds of properties can help you diversify your portfolio.

Typically, real estate values don't move in synch with stocks and bonds. And whereas those financial assets may serve as "leading indicators," helping predict the way the economy is going, real estate values often increase and fall after, not before, other economic trends. Also, the market for real estate can vary significantly based on geography and other factors. When the market in one part of the country is hot, another could be ice cold.

So how can you invest in real estate? Consider these three common approaches:

1. Be a landlord. You might own an apartment building or a home in a resort area. Once you've made the down payment to purchase a property, you'll have both regular expenses—including property taxes and mortgage interest—and rental income. The goal, of course, is for your income to be greater than your expenses.

This arrangement also offers tax benefits, including the ability to offset the tax on rental income with deductions for expenses, including an



annual depreciation allowance. In some cases, you may be able to deduct a loss. But special tax rules may apply to passive activities in which you're not actively participating in the rental activity. And

if you rent out a vacation home that you also use personally sometimes, you'll need to be careful to stay within personal-use guidelines.

For larger or more complicated properties, you may need to enlist the services of a management firm. That's an additional expense and it may undercut your profits. But it can relieve you of some of the headaches of meeting your tenants' demands. It's important to consider all of the potential trade-offs before you become a landlord.

2. Be an indirect investor. Instead of diving headfirst into investment real estate by owning properties directly,

Lessons From The SSG Conference

After 12 years with Shareholders Service Group—the primary custodian for Knopinski & Fauver and TNL Asset Management clients—I finally attended SSG's annual conference last month.

Note to self: Don't miss another one!

Not only did I get to meet many of the fantastic folks at SSG that help us provide a high level of service to our clients, I also walked away with a few somewhat new perspectives.

First, advisors and clients alike better get used to using more technology to make better decisions. These "fin tech" tools aren't so much about making better investment decisions or being more tax efficient—though there are plenty that help with such decisions—as they are about presenting information to clients in an easy-to-understand, concise, and impactful way. For example, there are several programs that enable advisors to present managed assets along with non-managed assets (often referred to as "held-away" assets) in consolidated reports that are updated with the push of a button. This has been a desire of mine since I started TNLAM 12 years ago and hope to offer this to clients soon.

Second, few advisors offer the individual security approach that we do. In a room full of 200-plus advisors, only a handful of arms went up when the presenter asked "Who buys individual stocks and bonds for clients?" It's a rare offering that I'm proud to offer that distinguishes our firm.

Third, the robos are coming and customer service will be the differentiator that makes us better. But this one, we already knew...

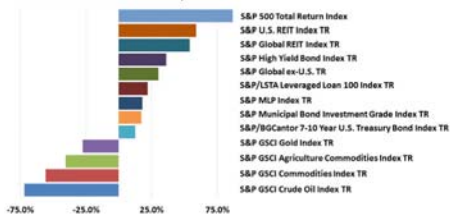
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Market Data Bank: 1st Quarter 2017 ^ψ



ECONOMY AND STOCKS STRONG
In the first quarter of 2017, stocks posted a total return of 6.1%. That followed a return of 3.8% in the fourth quarter of 2016, 3.9% in the third quarter and 2.5% in the quarter before that. Politics captivated the nation but, at the same time, better than expected economic data has propelled stock prices higher.

Indexes Tracking Asset Classes
Five Years Ended March 31, 2017

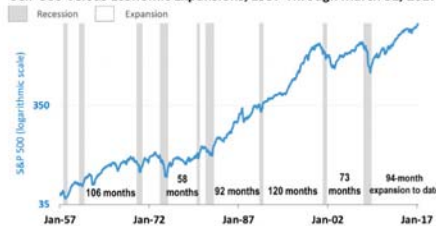


INDEXES TRACKING ASSET CLASSES
For the five years ended March 31, 2017, U.S. large-cap stocks were tops among the broad array of 13 asset classes shown here. Keep in mind, being diversified means your portfolio never will perform as well as the leading asset class, but also means you never will perform as poorly as the worst asset class.

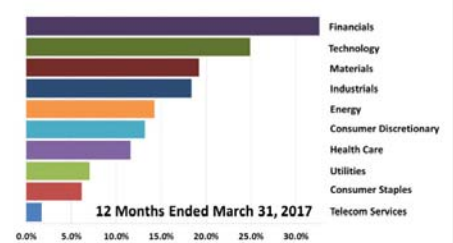


A GREAT FIVE YEARS
Since the near-collapse of the world financial system in 2008, stocks have staged a history-making comeback. In just five years, America's largest publicly-held companies nearly doubled in value. The chance of a bear market — a drop of at least 20% — increases as the eight-year bull market grows older.

S&P 500 Versus Economic Expansions, 1957 Through March 31, 2017



THIS EXPANSION VERSUS OTHERS
At 94 months, the current expansion and bull market are getting on in years, but this compares to the 120-month expansion in the 1990s, the 92-month expansion in the '80s, and the 106-month cycle in the '60s. This very well could turn out to be the longest expansion since the end of World War II.



FINANCIAL STOCKS LEAD
For the 12 months ended March 31, 2017, financial stocks were No. 1. Investors welcomed the possibility of rising rates and, post-election, were enthusiastic about a possible rollback of rules imposed on financial companies by the Dodd-Frank Act of 2010.

S&P 500 vs. 17X Actual And Estimated Earnings



S&P 500 INDEX VS. EARNINGS^ψ
Estimated earnings on the average share in the S&P 500, as of March 31, 2017, was \$130.80 in 2017 and \$146.67 in 2018. Stock prices have climbed in tandem with earnings, both actual and projected. Though they are perhaps slightly rich, the valuation on stocks is reasonable and nothing like the bubble of 2000.

Past performance of investments is not a very reliable indicator of future performance. ± Indices and ETFs representing asset classes are unmanaged and not recommendations for any specific investment. Foreign investing involves currency and political risk and foreign-country instability. Bonds offer a fixed rate of return while stocks fluctuate. Leading economic indicators from the Conference Board. S&P 500 earnings bottom-up operating earnings per share for 2015 (actual), 2016 (estimated) and 2017 (estimated) as of March 31, 2017: for 2017, \$130.80; for 2018, \$146.67. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through April 7, 2017; and actual operating earnings data through 2016.

Timely Tax Angles To Dividends

Not all payouts to shareholders are “qualified dividends,” but those that are get favorable treatment in which they’re normally taxed at less than your rate for ordinary income.

But the tax rules for qualified dividends may go out the window if proposed tax reforms are enacted. The big question is whether you would fare worse under the new rules—or better.

Under current law, most dividends issued by domestic companies are qualified when paid out to shareholders and the owners of mutual funds. In some cases,

qualified dividends also may come from foreign corporations, if their shares include publicly traded American Depositary Receipts (ADRs) or shares that are otherwise readily available on an established U.S. securities market.

The maximum tax rate on qualified dividends is only 15% for most investors. If you’re in the top ordinary income tax bracket of 39.6%, the tax rate is 20%. Even better, though, investors in the two lowest ordinary income brackets of 10% and 15% benefit from a maximum 0% rate on qualified dividends.

To qualify for these reduced tax rates, shareholders of common stock and mutual funds must own the shares for more than 60 days, including the ex-dividend date (the annual date on which dividends are paid out). The holding period is 90 days for preferred stock. This can affect the timing of transactions if the ex-dividend date is approaching.

Other dividends, including most dividends issued by foreign corporations, are taxed at ordinary income rates. Therefore, if you received \$1,000 in foreign dividends in 2016 and you’re in the top tax bracket of 39.6%, you must

Top Results For Social Security Benefits

What's the payoff for working most of your life and paying Social Security tax into the system? When your time to retire finally comes, you'll be eligible to receive Social Security benefits based on your work history and when you choose to begin receiving benefits. If you're married, you may have additional options for Social Security, even if one spouse has worked little or not at all.

A particular couple's optimal strategy depends on your age, the age of your spouse, and your health status, among other factors.

Your basic options for receiving benefits are to start early, begin benefits at your full retirement age (FRA), or to delay benefits until later.

- You can begin receiving Social Security retirement benefits as early as age 62, but if you do, you'll lock in smaller benefits than you would have gotten if you'd waited longer. If you retire at age 62, your benefit will be about 25% lower than if you waited until FRA.
- If you wait until FRA (also called "normal retirement age") to apply for benefits, there's no reduction. Your FRA depends on the year in which you were born. For most post-World War II Baby Boomers, the age is 66. However, FRA

pay \$396 in tax on the dividends on your 2016 tax return. But even then, you may be eligible for a foreign credit or deduction that can offset tax paid on foreign dividends dollar for dollar.



increases gradually and tops out at age 67 for those born after 1960.

- Finally, if you postpone your benefits until after FRA, you'll receive an increased monthly payment. For each year you wait, you'll get about 8% more, until you reach age 70. (Waiting past 70 doesn't increase your benefit amount.)

These basic rules apply to individuals. If you're married, you can claim benefits based on your own work record or you can get 50% of the benefit your spouse is entitled to, if that's higher.

Because Social Security benefits are guaranteed for life, starting early with a smaller benefit still could deliver significant income over your remaining years. Yet you may collect more overall if you start later or if you live for a long time. According to the Social Security Administration (SSA) the average life expectancy of someone at age 65 is now 84.3 years for a male and 86.6 years for a female.

What should a married couple do? Every situation is somewhat different, but consider these three common scenarios:

So how does potential tax reform figure in the mix? Under campaign proposals from President Trump, the favorable tax rates for qualified dividends would be repealed, but investors would benefit from overall tax cuts. The seven-bracket structure would be scaled back to just three tax brackets with a top tax rate of 33%. It's not yet clear what changes will be enacted, however, or how particular taxpayers might fare.

The best approach is to continue to monitor developments. We will pass along vital information. ●

Scenario 1. Adam and Eve are close in age and income. Because they're both in good health and enjoy their jobs, they plan on working past FRA. They also have enough savings, plus their work income, to sustain them easily until age 70. Currently, Adam has a life expectancy of age 88, while Eve's is age 90. If they elect early benefits at age 62, they would be entitled to an estimated lifetime benefit of almost \$1.25 million. But if they

wait until age 70 to apply for benefits and then live as long as expected, they could receive close to \$125,000 more.

Scenario 2. In our next example, Romeo and Juliet have shorter life

expectancies due to health issues. Currently, Romeo has a life expectancy of age 78 and Juliet has a life expectancy of age 76. If they claim benefits at FRA, it's estimated that the couple will receive almost \$100,000 more than if they delayed benefits until age 70, based on their life expectancies.

Scenario 3. Jack and Jill are both in their early sixties. Jill is in better health than Jack. If they start benefits at age 62, let's say Jack would get \$1,500 a month and Jill \$750 per month. Those amounts would rise to \$2,000 monthly for Jack and \$1,000 for Jill if they claim benefits at FRA. However, by delaying benefits until age 70, Jack will receive about \$2,650 a month. What's more, if Jill outlives Jack as expected, she is entitled to benefits based on 50% of Jack's higher monthly amount. Depending on how long Jill lives, her total benefits easily could increase by \$50,000 or even more.

One of these scenarios might be similar to your situation, but you'll need to factor in your own variables—including how long you want to or need to work, as well as other financial and personal considerations and your health status—as you consider the best times for you and your spouse to begin receiving Social Security benefits. ●



4 Cornerstones Of Diversification

How can you balance the quest for investment rewards against the potential risks? Part of this involves your personal comfort level and your investing timetable. Invest too conservatively early in your career or too aggressively late in life and you might fall short of your objectives.

But diversification is the chief tool of this balancing act. It can help you reduce the risks of your portfolio while still pursuing rewards by spreading out your investments over several kinds of assets—an approach that also may lessen the impact of the ups and downs of volatile markets. (Of course, diversification doesn't ensure a profit or guarantee protection against a loss, especially in a declining market.)

There are numerous ways to diversify within a portfolio, but you can build a basic framework on these four cornerstones:

1. Domestic stocks: Typically, this is the most aggressive part of a portfolio, likely providing the greatest potential for reward. Historically, stock market investments have outpaced most

other kinds of holdings. Nevertheless, the market is volatile and periodically experiences downward spirals, so to take advantage of the potential long-term outperformance of stocks you have to stick to your plan over the long haul. It's the value of stocks when you decide to sell, not what they may be worth during the time you hold them that truly counts.

2. Domestic bonds: Bonds can serve as a counterweight to stocks because the prices of the two kinds of investments sometimes move in opposite directions. Again, there are no guarantees that this will happen or that

holding both kinds of assets will have the desired effect. If safety is a primary concern, you might increase your investment in U.S. Treasury bonds or high-quality corporate bonds, which tend to offer less volatility, though with somewhat lower returns. In other cases, you might opt for high-yield bonds with their higher returns and greater exposure to risk.

3. Short-term investments: Conservative investments such as money market funds and certificates of deposit (CDs) generally offer stability and help preserve your principal. Most CDs are backed by the Federal Deposit Insurance Corporation within generous limits. A main attraction of money market funds, which aren't federally insured, is their liquidity, but you do risk losing principal.

4. International investments: Foreign holdings in stocks and bonds can round out a portfolio. With international stocks, both your potential returns and possible risks may be higher than they would be with domestic stocks. International bonds, too, offer the opportunity for more reward at a greater risk. ●



Investment Real Estate

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you could buy shares in a real estate investment trust (REIT). A REIT is a corporate entity that invests in real estate properties much like the way mutual funds invest in stocks. Professional managers handle the portfolio. If it meets specified requirements, a REIT will be eligible for favorable tax treatment.

Although there are several types of REITs, the most common is the "equity REIT." It holds physical real estate properties—typically, shopping malls, hotels, hospitals, offices or timberland—that generate rental income. Some equity REITs focus on properties in just one geographic area. The properties usually are purchased as

part of a portfolio of investments instead of being developed for resale.

3. Be a flipper. Landlords and REIT owners frequently invest for the long haul. But some investors use a shorter-term approach by trying to "flip" investment properties. In other words, they buy a property, renovate it, and try to resell it quickly at a profit. You've probably heard commercials on TV and radio extolling the virtues of the methods used by "experts."

But the risks here are even greater than for other investments in property

or REITs. Flipping requires know-how and capital to get started. And, as with other real estate investments, you're subject to the vagaries of the



marketplace and could be left holding the bag on properties that just won't sell. This is not for the faint-of-heart and generally is not recommended for casual investors.

Real estate often offers the potential for sizable rewards along with corresponding risks. If you decide to add this component to your portfolio, lean heavily on your financial advisors to help steer the course. ●