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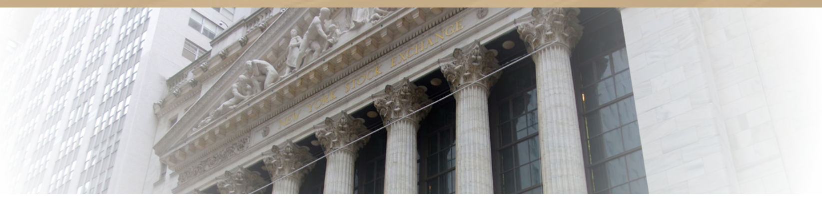
An Index Overview



Part 1: Indexes–Defined

Since nearly every media outlet on the planet reported the news, you probably already know that the Dow Jones Industrial Average topped 35,000 for the first time on May 10, 2021. But when a popular index like the Dow is on a tear, up or down, what does it really mean to you and your investments?

Great question. In this multi-part series, we're going to cover some of the ins and outs of indexes and the index funds that track them.

What Is An Index?

Let's set the stage with some definitions.

> ***An index tracks the returns generated by a basket of securities that an indexer has put together to represent ("proxy") a particular swath of the market.***

Some of the familiar names among today's index providers include the **S&P Dow Jones**, **MSCI**, **FTSE Russell** and **Wilshire**. It's perhaps interesting to note that some of the current index providers started out as separate entities — such as the S&P and the Dow, and FTSE and Russell — only to consolidate over time. In any case, here are some of the world's most familiar indexes (with "familiar" defined by your location):

- S&P 500, Nasdaq Composite, and Dow (U.S.)
- S&P/TSX Composite Index (Canada)
- FTSE 100 (U.K.)
- MSCI EAFE (Europe, Australasia and the Far East)
- Nikkei and TOPIX (Japan/Tokyo)
- CSI 300 (China)
- HSI (Hong Kong)
- KOSPI (Korea)
- ASX 200 (Australia)

Why Do We Have Indexes?

Early on, indexes were designed to offer a rough idea of how a market segment and its underlying economy were faring. They also helped investors compare their own investment performance to that market. So, for example, if you had invested in a handful of U.S. stocks, how did your particular picks perform compared to an index meant to track the average returns of U.S. stocks? Had you "beat the market"?

Then, in 1976, Vanguard founder John Bogle launched the first publicly available mutual fund specifically designed to simply copy-cat an index. The thought was, instead of spending time, money and energy trying to outperform a market's average, why not just earn the returns that market has to offer (reduced by relatively modest fund expenses)? The now familiar Vanguard 500 Index Fund was born . . . along with index fund investing in general.

There are some practical challenges that prevent an index from perfectly replicating the market it's meant to represent. We'll discuss these in future segments. But for now, the point is that indexes have served investors across the decades for two primary purposes:

Benchmarking: A well-built index should provide an approximate benchmark against which to compare your own investment performance . . . ***if*** you ensure it's a relatively fair, apples-to-apples comparison, and ***if*** you remain aware of some of the ways the comparison still may not be perfectly appropriate.

Investing: Index funds that replicate indexes allow you to indirectly invest in the same holdings that an index contains, with the intent of earning what the index earns, net of fees.

Indexes Are NOT Predictive

There is also at least one way indexes should NOT be used, even though they often are:

> ***Index milestones such as "Dow 35,000" do NOT foretell whether it's a good or bad time to buy, hold or sell your own investments.***

Indexes don't tell us whether the markets they are tracking or the components they are using to do so are over- or underpriced, or otherwise ripe for buying or selling. Attempting to use current index values as a way to time your entry into or exit from a market does not, and should not replace understanding how to best reflect your unique investment goals and risk tolerances in an evidence-based investment strategy.

In fact, market-timing of any sort is expected to detract from your ability to build wealth as a long-term investor, which calls for two key disciplines:

1. Building a cost-effective, globally diversified portfolio that exposes you to the expected returns you'd like to receive while minimizing the risks involved
2. Sticking with that portfolio over the long run, regardless of arbitrary milestones that an index or other market measures may achieve along the way

As one **commentator** observed the day after the Dow first broke 20,000 (January 2017): "Sensationalism of events like these has the ability to trigger our animal spirits or our worst fears if we don't have a long-term investment plan to keep them in check."

Until next time, no regrets!

David Bromelkamp

President and CEO

Headlines

- Dave Bromelkamp, Eric Hutchens, Suzanne Tudor, Derek Van Calligan and Saul Bauman presented the webinar "Purchasing a Second Home? 19 Things to Know" on September 30. In case you missed it, the webinar recording will be coming to our website soon.
- Allodium was pleased to welcome six new clients during the third quarter of 2021.
- Our office will be closed December 24, January 17 and February 21 for company holidays.

Note: To find out more about Allodium's breaking news, please visit our website: www.allodium.com.

Events

December 21, 2021

Dave Bromelkamp will be a panelist for the Financial Planning Association's December Virtual Meeting and Networking Social. The topic will be *ESG As a Tool for Values and Purpose in Your Practice.*

January 25, 2022

Join us for the annual Allodium Investment Forum webinar. Dave Bromelkamp, Eric Hutchens, Suzanne Tudor, Derek Van Calligan and Saul Bauman will help us understand the positives and negatives of cryptocurrencies. To register, contact Ilona Avraamides at iavraamides@allodium.com.

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@allodium.com to arrange a friendly, no-obligation introduction.

FINANCIAL PLANNING TIP

Financial Planning for Non-US Citizens

More than 40 million people living in the U.S. were born in another country.[1] If you are a non-citizen or know someone who is, read on for some information on taxes, retirement planning, and estate planning.

Income Taxes

Everyone who earns income in the U.S. must pay taxes on that income. The terms "resident" and "non-resident" alien are IRS classifications for tax purposes. Resident aliens legally have a green card or have been in the country for a requisite number of days over a three-year period. Resident aliens follow the same rules as U.S. citizens for filing income tax returns. Income earned elsewhere in the world is subject to U.S. income tax the same way as a U.S. citizen.

Non-resident aliens are in the U.S. temporarily on a short-term visa. Non-resident aliens must pay taxes on income earned in the U.S. However, they do not owe U.S. income tax on income earned elsewhere in the world. This distinction offers tax planning opportunities for non-resident aliens.

Social Security and Medicare Benefits

Resident aliens pay FICA (Social Security and Medicare tax) on earned income. They are eligible for Social Security benefits if they have earned income for at least 40 quarters (10 years) subject to special rules that, among other things, prohibit the counting of any quarter when the person receives means-tested public benefits. They are also eligible for Medicare if they have paid FICA taxes for 40 quarters, are age 65 or older, have lived in the U.S. for at least five years, or have been married to a U.S. citizen for at least one year. They can also qualify on the work record of a U.S. citizen spouse.

Non-resident aliens are exempt from FICA taxes on their U.S. income and, in most cases, are not eligible for Social Security and Medicare benefits.

Qualified Retirement Accounts

Both resident and non-resident aliens can contribute to 401(k) plans, IRAs, or Roth IRAs if they have earned income in the U.S. Both receive the same tax deductions and tax deferrals as U.S. citizens and the same employer matches and profit-sharing awards. Both must file a U.S. tax return when they withdraw the money and pay U.S. income taxes. This is an important consideration for non-resident aliens who may not be living in the U.S. when they retire.

Estate and Gift Tax

Estate tax laws differ for resident aliens from U.S. citizens. The general rationale behind this is to keep a foreign-born spouse from inheriting U.S. assets and leaving the country to avoid the estate tax. The first difference is the lifetime estate and gift tax exemption which is $11.7 million in 2021. For a resident alien to be eligible for the exemption, he or she must meet the requirements to be a U.S. domiciliary. A domiciliary must have proof of a physical presence in the U.S. and a present intention to remain indefinitely. This is similar to a U.S. citizen proving residence when they move to a different state. Non-resident aliens and those who cannot prove domicile have only a $60,000 lifetime exemption for estate and gift taxes.

A second difference is gifts made from one spouse to the other. For U.S. citizens, annual gifts between spouses are unlimited and not subject to gift tax. For non-U.S. citizen spouses, there is an annual exclusion gift limit of $159,000 in 2021.

The third area of difference is the unlimited marital deduction at death. U.S. citizens can leave an unlimited amount of assets to their surviving spouses with no estate tax. Resident alien spouses of U.S. citizens are not eligible for the marital deduction. Qualified Domestic Trusts (QDOTs), life insurance and/or life insurance trusts (ILITs) are some ways to leave assets to a resident alien spouse and potentially reduce or avoid estate taxes.

1. Budiman, A. (August 20, 2020). Key findings about U.S. immigrants. Pew Research Center. https://www.pewresearch.org/fact-tank/2020/08/20/key-findings-about-u-s-immigrants/

Steward is published quarterly by Allodium Investment Consultants. Please contact iavraamides@allodium.com if you have any comments about this publication or wish to be added to or removed from our mailing list.