Heads Up

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On Investing (ISSN 1523-5327) is published quarterly. This publication is mailed at Standard A postal rates. ♦ If you prefer not to receive On Investing, please call 888-484-5340.
♦ POSTMASTER: Send address changes to On Investing, Charles Schwab & Co., Inc., P.O. Box 982600, El Paso, TX, 79998-2600. On Investing does not assume any liability resulting from actions taken based on the information included in this magazine. Mention of a company or security does not constitute endorsement. Some contributors to On Investing may have active positions in securities or companies discussed in this issue. MAG105672Q420-00
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Walt Bettinger
President & CEO

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Do Hold Back

It might be time to revisit your W-4.
Putting Your HSA to Work

Health savings accounts are for more than just routine medical expenses.

Health savings accounts (HSAs) are particularly prized for their triple tax advantages: Contributions are tax-deductible, earnings are tax-free, and withdrawals are tax-free when used for qualified medical expenses. However, roughly 95% of HSA holders keep their accounts entirely in cash, according to the Employee Benefit Research Institute. Account holders who don’t invest their HSA contributions could be missing an opportunity to earn tax-free returns.

“We generally recommend keeping two to three years’ worth of routine medical expenses in cash,” says Rob Williams, vice president of financial planning at the Schwab Center for Financial Research. But any funds in excess of that could be invested for potential growth—for two reasons:

1. Given the likelihood that health care costs will be even higher in the future, it may be wise to do all that you can to get ahead of them. Indeed, a 65-year-old couple retiring today can expect to need as much as $363,000 in state taxes in California or New Jersey.1
2. If you use HSA funds for things other than health care expenses after age 65, you’ll pay only ordinary income tax with no other penalty—putting the funds on par with withdrawals from 401(k)s and IRAs, with the added advantage that HSAs aren’t subject to required minimum distributions. (Nonqualified withdrawals made prior to age 65 are subject to ordinary income tax plus a 20% early-withdrawal penalty.)

To contribute to an HSA, you must participate in an eligible high-deductible health care plan. You can contribute up to $3,550 in 2020 ($7,100 for families), plus an additional $1,000 in catch-up contributions if you’re 55 or older. Once you have sufficient funds in the account—most require you to maintain a minimum cash balance—you can start to invest additional funds based on your risk tolerance, your time horizon, and the choices offered by your HSA administrator.

While HSA contributions are exempt from federal income tax, they are not exempt from state taxes in California or New Jersey.1

1While HSA contributions are exempt from federal income tax, they are not exempt from state taxes in California or New Jersey. | 2Paul Fronstin and Jack VanDerhei, “Savings Medicare Beneficiaries Need for Health Expenses in 2019: Some Couples Could Need as Much as $363,000,” EBRI, 05/16/2019.

“Before you commit to investing in your HSA, you need to ensure you’re comfortable investing an amount that’s enough to cover your potential needs,” says Williams. The amount of income you’ll be able to withdraw in retirement depends on many factors, including the amount you’re going to need and your projected life expectancy. You can use the IRS Tax Withholding Estimator (irs.gov/w4app) to help you calculate whether you should increase or decrease your withholding based on changes in income or other factors.

Where specific advice is necessary or appropriate, Schwab recommends consultation with a qualified tax advisor, CPA, financial planner, or investment manager. (1120-9DWZ2)

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There’s a New ETF in Town

A new breed of exchange-traded fund offers less transparency—in ways good and bad.

The Securities and Exchange Commission recently approved a new kind of exchange-traded fund: the semi-transparent ETF.

Unlike transparent ETFs, whose managers are required to report their holdings daily, semi-transparent ETFs must disclose their holdings only monthly or quarterly—which allows fund managers to roll out actively managed strategies without fear of copycats or predatory traders following their every move.

“Some active managers have avoided traditional ETFs because they believe the requirement for daily disclosure would allow others to steal their secret sauce,” says Emily Doak, CFA and managing director of ETF research at Charles Schwab Investment Advisory.

“This new breed of ETF allows fund managers to offer the kinds of proprietary strategies formerly reserved for active mutual funds.”

That said, less frequent disclosure of holdings could involve trade-offs. Because they often shield their holdings using proxy portfolios that resemble but aren’t identical to the fund’s actual holdings, semi-transparent ETFs may be harder to value than regular ETFs.

This could cause their shares to trade with wider bid-ask spreads, particularly during periods of heightened market volatility.

“The bottom line is, it’s too soon to know how semi-transparent ETFs will stack up against their traditional peers and each other,” Emily says, “so I suggest approaching them with an abundance of caution until they have a track record to back them up.”

See page 38 for important information. ◆ Investors should consider carefully information contained in the prospectus or, if available, the summary prospectus, including investment objectives, risks, charges, and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read it carefully before investing. ◆ Active semi-transparent ETFs operate differently from other ETFs. Unlike other ETFs, an active semi-transparent ETF does not publicly disclose its entire portfolio composition each business day, which may affect the price at which shares of the ETF trade in the secondary market. Active semi-transparent ETFs have limited public trading history. There can be no assurance that an active trading market will develop, be maintained, or operate as intended. There is a risk that the market price of an active semi-transparent ETF may vary significantly from the ETF’s net asset value and that its shares may trade at a wider bid/ask spread and, therefore, cost investors more to trade than shares of other ETFs. These risks are heightened during periods of market disruption or volatility. ◆ Schwab receives remuneration from active semi-transparent ETFs or their sponsors for platform support and technology, shareholder communications, reporting, and similar administrative services for active semi-transparent ETFs available at Schwab. This fee will vary, but typically is an asset-based fee of 0.10% per annum of the assets held at Schwab. (1120-0CE3)
or millions of Americans struggling financially in the wake of COVID-19, legislation that allows early, penalty-free withdrawals from certain retirement accounts in 2020 may feel like a lifeline. However, those eligible for a coronavirus-related distribution should approach the decision with caution.

“The new rules are well intentioned,” says Rob Williams, vice president of financial planning at the Schwab Center for Financial Research, “but early withdrawal penalties were put in place to help preserve your savings for their true purpose: funding retirement. Tapping the money early may help in the short term but could have the opposite effect in the long term.”

Of course, there may be times when withdrawing retirement funds early is the right—and possibly only—course of action. Even so, here are three tips to consider as you weigh your options:

1. Exhaust the alternatives: Your retirement savings may be a tempting target, but other options might make more sense in the long run. For example, borrowing against the equity in your home or your brokerage assets could provide the short-term cash flow you need without undermining your long-term goals.

2. Keep your withdrawal to a minimum: The legislation allows you to withdraw up to $100,000 across eligible accounts—but just because you can withdraw that amount doesn’t mean you should. After all, every dollar you withdraw now is a dollar you’re taking from your future self (not to mention any gains it might produce if you were to leave it invested).

3. Pay it back ASAP: If you do decide to take a withdrawal, make a plan for getting your retirement savings back on track as quickly as possible, particularly since you won’t owe taxes on those funds if you pay them back within three years.

If you’re thinking of taking a coronavirus-related distribution, be aware that the provision is set to expire at the end of 2020, unless Congress votes to extend it. Also be sure to check with your employer’s plan administrator before taking a withdrawal, as employers are not required to amend their plans to provide for such distributions and/or loans. And finally: “Speaking with a financial advisor before taking action is always a good idea,” Rob says.

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Dear Readers,
As we’ve all hunkered down this year due to the pandemic, have you noticed that more and more of us are getting into baking? Even though we can’t as easily get together to share a meal with family and friends, we can still share recipes as a way to connect.

With that in mind, I thought I’d share a recipe that has special meaning for me: my family’s pumpkin chiffon pie, which we make every year during the holidays.

And as I was rereading the recipe, I got to thinking about how baking and investing are alike. Here are six lessons I’ve learned from making this pie that could just as easily apply to your portfolio.

1. A good recipe removes the mystery
Isn’t making chiffon pie complicated? Not really—so long as you follow the directions (see next page). A good basic recipe will tell you the essential ingredients, how to mix them together, and the time involved. In a way, an investment plan is like a recipe for building your portfolio. Your basic ingredients are stocks, bonds, and cash. The measurement for each ingredient is kind of like asset allocation. And the baking time is like your time horizon. Once you have a handle on those key things, you just need to take it step by step.

2. Quality ingredients are essential
As with baking, you’ll have better success with investing if you start with good ingredients. Whether you prefer exchange-traded funds (ETFs), mutual funds, or individual stocks, don’t skimp on quality. That means doing your research on companies, fees, and ratings before you buy. Also, know that you don’t always need a lot of money to get the quality ingredients you want. With the introduction of new services like fractional shares, for example, you can even buy a “slice” of a very expensive stock if you want to add that to your mix.

A Recipe for Success
Investing—like baking—takes quality ingredients, planning, and patience.

BY CARRIE SCHWAB-POMERantz

Illustration by Bex Glendinning
The recipe has been in my family for years. As far as I can tell, it started with my grandmother (though it may have come from my great-grandmother) and now my son makes it, too.

And as we’ve each taken our turn, this humble recipe has provided an opportunity to connect, tell stories, and share lessons. Whether you’re baking or investing, patience, planning, and a little practice are the best ways to ensure you don’t wind up with something half-baked. It takes time to master—but the results are well worth the wait.

Carrie Schwab-Pomerantz (@carrieschwab), CFP®, is president of Charles Schwab Foundation and senior vice president of Schwab Community Services at Charles Schwab & Co., Inc.

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Graham cracker crust (recipe below).

1. Mix the following ingredients in the top of a double boiler:
   - 1 envelope gelatin
   - ½ cup sugar
   - ½ tsp. salt
   - ½ tsp. cinnamon
   - ½ tsp. nutmeg
   - ½ tsp. ginger

2. In a separate bowl, beat lightly together:
   - 3 egg yolks
   - ¼ cup milk

3. Add wet ingredients to dry ingredients in the top of double boiler and stir. Then add:
   - 1 ¼ cup canned pumpkin
   - ¼ cup ground walnuts

4. Put top of double boiler directly over medium heat until mixture is warm, then place over bottom of double boiler and cook, stirring constantly, until gelatin is dissolved and mixture is thickened (about 10 minutes). Pour mixture into shallow dish and chill until firm.

5. In a separate bowl, beat 3 egg whites until very stiff, then beat in:
   - ½ cup sugar (gradually)
   - 2 tsp. vanilla (1 tsp. at a time)

6. Fold egg white mixture into chilled pumpkin custard, then pour into 9” deep-dish graham cracker crust. Refrigerate.

7. Take pie out of refrigerator an hour before serving so it will slice easily. Best served with homemade whipped cream.

Graham cracker crust

1. Mix together:
   - 11 graham cracker sheets, coarsely crushed
   - ½ cup powdered sugar

2. Melt ½ cup butter and stir into graham cracker mixture.

3. Pour three-fourths of mixture into bottom of 9” deep-dish pie plate and pat down with fingers, covering entire bottom of dish.

4. Use remaining mixture to line sides and rim of dish, using a warm, dry teaspoon to pat and make firm.

Carrie’s tips

- This recipe makes one pie.
- Don’t use a store-bought crust—homemade is so much better. For best results, make a day in advance and avoid crushing the crackers too finely.
- Be sure to chill the pumpkin custard before mixing in the egg whites.
- Don’t be too critical when your kids make the pie!
hanks to decades-long trends that have lowered costs for trading and increased access to the markets, it’s now easier than ever to become an investor.

Some of the latest innovations include commission-free online stock trading and the introduction of fractional shares, which allow investors to buy smaller, more affordable “slices” of otherwise prohibitively priced stocks.

While these developments are indeed wonderful, they don’t change a fundamental aspect of investing—namely, that investing is all about balancing the potential for making money with the possibility of losing it.

Whether you’re a new investor or an experienced one, have a little bit of money or a lot, managing risk is key to success. With that in mind, here are four risk-management principles to get you started—and to stick with throughout your investing career.

**1. Align your risk with your goals**

What are you investing for and how are you going to achieve it? To create a successful plan, you first need to identify what your goal is: a comfortable retirement, the down payment on a
house, a trip you hope to take in the next few years?

Once you know your goals, ask yourself how quickly you want to achieve each and how much risk you’re willing to take—financially and psychologically—to get there. Could you afford to lose much of the money you’re investing? How would you react? If the answers are “no” and “poorly,” it doesn’t mean you shouldn’t invest; it just means you should invest in ways more in line with your risk tolerance and time horizon.

If you’re saving for something you’ll want or need soon—such as a down payment on a new house—you’ll probably want to invest in something relatively stable, like a money-market fund or U.S. Treasuries. If you’re saving for a retirement that’s still decades away, you may be comfortable with a larger portion of your savings in stocks—which have historically come with more risk but also delivered higher returns—since you’ll have much longer to potentially recover from a downturn.

Diversify

Diversification means spreading out your investments—both across different asset classes (such as stocks and bonds) and within them (such as U.S. stocks and international stocks).

Each asset class plays a unique role in your portfolio. Stocks provide the potential for growth and could make up the majority of your portfolio when you’re young and have many decades to benefit from compound growth. Bonds, on the other hand, can help preserve your capital, which becomes all the more critical as you approach retirement. What’s more, asset classes don’t always move in tandem, so when one is doing poorly, another may be doing well. Holding a healthy mix of assets can help reduce the impact of any single investment on your portfolio’s performance.

After a long bull run, equities could account for a much larger chunk of your overall portfolio than you’d planned—leaving you exposed to unwanted risk.

That said, diversification still matters even if you’re investing solely in stocks. A portfolio of 20 equities in a variety of industries, for example, is generally far less risky than a portfolio of just two.

Rebalance

Achieving long-term investing success isn’t just a matter of creating a portfolio with the right mix of investments for your goals and time frame. As the markets rise and fall, the investments in your portfolio will grow and shrink in value—so much so that, over time, your portfolio could become either less or more aggressive than you’d intended. After a long bull run, equities could account for a much larger chunk of your overall portfolio than you’d planned—leaving you exposed to unwanted risk.

This is what makes rebalancing so important. By regularly selling positions that have become overweight in relation to the rest of your portfolio and moving the proceeds to positions that have become underweight, you can bring your portfolio back to its original target allocation. It’s a good idea to do this at least once a year, and more frequently if markets are making big moves.

Again, even if you invest only in a handful of individual stocks, don’t let any single name or type of stock represent too big a portion of your overall portfolio. Ask yourself what would happen financially and psychologically if your biggest position significantly declined or got wiped out altogether. If that scenario is troubling even to contemplate, then your position probably needs to be trimmed back.

Watch out for leverage

Leverage is a strategy that uses borrowed money to increase an investment’s potential return—often through products like leveraged exchange-traded funds, futures contracts, margin loans, or options. While such products can amplify returns, they can also disproportionately magnify risk, making it especially easy to get into financial trouble. Indeed, some of the saddest stories involve investors who suffered catastrophic losses because leverage worked against them.

Ultimately, if you don’t understand leverage, it’s best to steer clear of it altogether. Even relatively sophisticated investors should proceed with caution, lest their desire for outsized gains deliver outsized losses instead.

Go slow

Investing is a lifelong endeavor replete with plenty of trial and error. You can learn as you go, and explore different approaches as your interests and goals change. The important thing is to diversify, rebalance regularly, and take a cautious approach to riskier practices in order to get where you’re going without undue turbulence.

Mark Riepe, CFA®, is senior vice president of the Schwab Center for Financial Research.

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(1120-OWL6) ADP11115601-01 (08/20) 00249632
What Lies Beneath

Uncovering the complexities of commodity ETFs.
By Emily Doak

Just because an investment drops in value doesn’t mean it’s a bargain. That’s a lesson many investors learned the hard way back in April when they scooped up shares of a popular oil exchange-traded fund (ETF) after the spot price of crude dropped below zero.

Contrary to some investors’ expectations, the ETF continued to struggle for several days after the price of oil recovered. So where did investors go wrong? What they thought was a fund that tracked the spot price of West Texas Intermediate crude—the U.S. benchmark for oil—was in fact a fund that tracked the benchmark’s futures contracts, which can produce very different returns.

With any fund, but especially those that track commodities, it’s important to understand the fund’s strategy before you buy. Here are three questions to ask when researching commodity ETFs for your portfolio.

Does it hold physical assets or futures?

Some precious-metal ETFs actually purchase the physical commodities—such as bars of gold or silver—and warehouse them in secure vaults. These ETFs tend to closely track the spot price of the commodity in question because the metals can be retrieved and sold on the spot market at any time. However, most commodities—including livestock, oil, and wheat—are too costly or cumbersome for an ETF to transport and store. Instead, ETFs typically invest in these commodities via futures contracts, which are agreements to buy a commodity on a future date for a specified price, with the intention of selling the contract before it expires rather than taking possession of the commodity in question.

As a result, ETF managers must regularly sell expiring contracts and purchase new ones with later expiration dates—with two potential consequences:

• When contracts approaching expiration have higher prices than those with expiration dates further out, ETFs are effectively selling high and buying low with every contract rollover—a condition known as contango. This happens when the current demand for a commodity is higher than investors expect it to be in the future, relative to its supply.

• Conversely, when contracts approaching expiration have lower prices than those with expiration dates further out, ETFs are effectively selling low and buying high with every contract rollover—a condition known as back-dated. This happens when the current demand for a commodity is lower than investors expect it to be in the future, relative to its supply.

While contango obviously isn’t ideal, fund managers often invest in futures contracts of various durations to help mitigate its effects.

• A fund’s prospectus will tell you whether the ETF relies on physical assets or futures contracts. Log in to schwab.com, search its ticker symbol, and click the Prospectus link.

How volatile is it?

Commodity ETFs are notoriously volatile because of the supply-and-demand characteristics of their underlying holdings, which can be dramatically impacted by certain events. Unseasonably cold or wet weather, for example, can be catastrophic to some agricultural commodities, while OPEC—(to say nothing of COVID-19)—can unduly influence oil prices.

One solution to this potential problem is to consider ETFs that track a broadly diversified commodity index. That said, the degree of diversification will vary by index. For example, 61.7% of the S&P GSCI Commodity Index is allocated to the more-volatile energy sector,1 while the Bloomberg Commodity Index’s allocation is roughly a third of that, at 25.6%.2

• To search for commodity ETFs, log in to schwab.com/ETFsresearch, select Fund Category under the Basic Criteria menu, and then select Commodities.

• Check a commodity ETF’s volatility characteristics by logging in to schwab.com, searching its ticker symbol, and clicking Risk & Tax.

Know your fund

Investing in commodity ETFs can be a low-cost way to add diversification and inflation protection to your long-term portfolio. However, if you’re looking to make shorter-term tactical moves, be sure you understand how the ETF you’re considering is constructed, since a fund’s volatility, in particular, can have an outsized impact on your short-term prospects.

S&P GSCI methodology, as of 05/2020 | Bloomberg Commodity Index fact sheet, as of 04/30/2020

See page 38 for important information. ● Investors should consider carefully information contained in the prospectus if it is available, the summary prospectus, including investment objectives, risks, charges, and expenses. Please read it carefully before investing. ● Commodity-related products carry a high level of risk and are not suitable for all investors. Commodity-related products include very high-volatility, illiquid, and can be significantly affected by underlying commodity prices, world events, import controls, worldwide competition, government regulations, economic conditions. ● This information does not constitute and is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. Where specific advice is necessary or appropriate, Schwab recommends consultation with a qualified tax advisor, CPA, financial planner, or investment manager. (1125-0CVB)

Preferential Treatment

Preferred securities may offer attractive yields—but don’t discount their risks.

By Collin Martin

It’s been a tough year for income-focused investors, as the economic fallout from COVID-19 has helped push yields to historic lows.

When the pickings are so slim, preferred securities could prove an attractive alternative. They offer higher yields than investment-grade corporate bonds, though they tend to come with more risk.

Let’s take a look at how preferreds work and why you should understand their finer points before adding them to your portfolio.

What are preferred securities?

Preferreds are corporate issuances that blend the characteristics of bonds and stocks:

• Like bonds, preferreds make scheduled coupon payments and have par values (typically $25) that are paid back at maturity. They’re usually issued with maturities of 30 years or more—indeed, some never mature—but are generally callable within 10 or 15 years, meaning the issuer can redeem the shares for a fixed value before maturity. Many shares also carry a credit rating from a recognized rating agency.

• Like stocks, preferreds tend to be more volatile than bonds, and a company can suspend dividend payments on certain types of preferreds without triggering default, just as they can with dividends on common shares. (Note that some preferreds are structured as debt and pay interest rather than dividends, meaning they could, in fact, trigger a default.) Additionally, they’re lower than traditional bonds on an issuer’s priority of payments—but more
senior in the payment hierarchy than common stock (hence the “preferred” moniker)—meaning, in the event the issuer is unable to meet all of its liabilities, preferred shareholders will be paid after traditional bondholders but before common stock shareholders.

Because they’re lower in the payment hierarchy, preferreds carry higher credit risk than some corporate bonds and thus offer higher yields to compensate for that risk. That said, if you can find preferreds from an investment-grade issuer, they’re generally less risky than junk bonds but may offer similar yields.

Should you consider preferreds now?

Low interest rates make preferreds particularly attractive now, but their unique attributes could subject them to additional risk in today’s market for two reasons:

1. The Fed could restrict dividends
   The Federal Reserve has been flexing its regulatory authority amid the pandemic. As part of its annual stress tests, in June the Fed instructed large banks to suspend stock buybacks and to keep common stock dividends flat in the third quarter to ensure firms had enough capital to keep lending during the pandemic. Preferred dividend payments weren’t affected by the Fed’s actions this summer, but if the economic picture worsens, banks might need to halt capital distributions—limiting common stock dividends first, then preferred dividends if the Fed deems it necessary.

   Suspending dividends not only eliminates a predictable income source for investors but can also severely erode a preferred security’s value. For example, during the Great Recession one preferred security suspended dividends for a staggering 18 months, and its share price fell more than 50% as a result.

2. Your securities could be called
   With interest rates near rock bottom for many fixed income securities, investors have bid up prices on higher-yielding preferreds. This raises concerns for investors in callable preferreds, which allow issuers to repurchase the securities at par value prior to their maturity date. If you buy a callable security at a premium, be aware that the issuer could buy it back at par, potentially forcing you to realize a loss by buying high and selling low.

How should investors proceed?

There are three moves investors can make to help mitigate these risks:

- Opt for quality: There’s no telling how the next year will shake out, but issuers of higher-rated securities are generally in a better financial position to satisfy their liabilities. You could also invest via an actively managed preferred fund, whose managers may be able to weed out riskier securities.

- Diversify: If the Fed clamps down on bank common stock dividends, preferreds could be next. One way to get ahead of this is by adding preferreds from sectors the Fed doesn’t regulate—such as communications, real estate, and utilities—to your portfolio. Many preferred funds will hold a mix of issuers from multiple sectors.

- Pay attention to prices: If a preferred security is trading above its typical par value of $25, investigate how soon it could be called. Should interest rates stay low for an extended period of time, issuers may choose to call their higher-interest shares early in order to issue newer shares at lower rates. Investing in preferreds via a diversified fund can help reduce this risk.

Consult a Schwab fixed income specialist if you need help assessing the prospects of a preferred security by calling 866-893-6699.

Preferreds can be a good way to supplement a fixed income portfolio, especially during times of low interest rates. Just be sure your allocation matches your risk tolerance. We generally recommend fixed income investors limit their exposure to riskier assets—including preferreds—to no more than 20% of their overall portfolio.
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Betting on a Breakdown

The ins and outs of short selling. By Lee Bohl

**Fundamental analysis:** Analyzing a company’s financials can help determine if its stock may be a candidate for a pullback. For example, a company’s earnings per share (EPS) and sales growth tend to move in the same direction as its share price; hence, when looking for short-sale candidates, traders may consider companies with negative EPS and sales growth trajectories.

**Technical analysis:** Patterns in a stock’s price movement can also help you determine if it’s on the cusp of a downtrend. One potential sign of a seller’s market is a stock that’s been falling through a series of lower lows while trading at higher volumes. Another is a stock that’s rebounded to the upper range of its trading pattern but appears to be losing steam.

**Thematic:** This approach involves betting against companies whose business models or technologies are deemed outdated (think Blockbuster Video), which can be more of a long game but can pay off should your prediction prove correct.

**Entering a trade:** As with any trade, you should identify your entry and exit points, and a potential stop order before you begin (see “A simple plan,” below). You’ll want to enter a stop order to help limit your losses in the event the trade moves against you. In general, two kinds of stop orders may prove useful:

- **Buy-stop orders** trigger an order to buy back the shares if the stock price rises to or above the stop price.
- **Trailing buy-stops** specify a stop price that follows, or “trails,” the lowest price of a stock by a percentage or dollar amount that you set. If the stock rises above its lowest price by the trail or more, it triggers a buy market order, at which point the stock is purchased at the best available price. If the price drops, the stop resets at a lower price.

Moreover, neither of these methods guarantees that the order will execute at or near the price you designate—and in fact could lock in losses if the price gaps up.

**Understanding the risks:** Short selling comes with numerous risks—but these are the big two:

- **Potentially limitless losses:** When you place a standard trade, your downside is limited to 100% of the money you invested. But when you’re shorting a stock, its price can keep rising—which means there’s theoretically no limit to the amount you’d have to pay to replace the shares you borrowed.
- **Margin calls:** If the value of the collateral in your margin account drops below the minimum equity requirement—usually 30% to 55% of the value of the borrowed shares, depending on the firm and the particular securities you own—your brokerage may require that you immediately deposit more cash or securities to cover the shortfall.

For example, so long as your 100 shares of stock XYZ remain at $80 per share, you’ll need $2,480 in your margin account, assuming a 30% equity requirement ($8,000 x .30). However, if the stock suddenly rises to $100 per share, you’ll need $3,000 ($10,000 x .30)—requiring an immediate infusion of $600 to your account, which you may or may not have.

If you fail to meet the margin call, your brokerage firm may close out open positions to bring your account back to the minimum requirement.

**Proceed with caution:** At its most basic, short selling involves rooting against individual companies or the market, and some investors may be opposed to that on principle. However, if you have a firm conviction that a stock price or index is heading lower, shorting can be a profitable way to act on that instinct—so long as you’re aware of the inherent risks.

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**Stop order:** $84, for a maximum loss of $4 per share.

**Exit:** At or below $74

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**Stop order:** $84

**Enter order:** Below $80

**Exit:** At or below $74

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**Stop order:** $84

**Enter order:** Below $80

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Lee Bohl, CMT, is a trading services senior manager at Charles Schwab & Co., Inc.

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To view this video series, visit schwab.com/trading-up-close.
Five unexpected expenses that can derail your retirement—and how to get ahead of them.
You’re living off your savings, unexpected expenses can undo years of diligent planning.

“Even with Medicare, health care can cost you a pretty penny in retirement. ‘But many retirees don’t fully appreciate just how much, in part because they believe Medicare covers more than it actually does,’” says David Jamison, a CERTIFIED FINANCIAL PLANNER™ professional with Schwab’s Centralized Planning Team.

Medicare is federal health insurance for those aged 65 or older. It’s divided into four parts:

- Part A, which covers hospital stays, and Part B, which covers doctor visits. Many other expenses and services you might consider, such as dental, hearing, and vision care, as well as copays and prescription drugs—are covered only through supplemental plans, which cost extra.

For complete coverage, you may need multiple plans. For example, you can sign up for Medicare’s stand-alone prescription drug program, known as Part D, as well as purchase a private Medigap policy to help cover deductibles, coinsurance, and copays. You could also consider enrolling in a Medicare Advantage plan, which bundles parts A and B, as well as dental, hearing, and vision care.

Another approach would be to buy a private Medicare Advantage plan, which bundles parts A and B, as well as dental, hearing, and vision care. It’s important to understand that each approach comes with trade-offs. Medigap plans, for instance, may mean fewer out-of-pocket expenses but generally have higher premiums. Medicare Advantage, on the other hand, may have lower premiums but could involve more out-of-pocket expenses. All told, Schwab suggests that retirees budget between $450 and $600 per month in particular categories of health care costs, including plan premiums and out-of-pocket expenses. If your current budget won’t support that level of spending, consider stepping up now to ramp up your savings.

To help meet the rising costs of health care in retirement, it may make sense to contribute to a health savings account (HSA) while you’re working, if eligible. Rob says. Contributions to HSAs are federally tax-deductible, earnings are tax-free, and withdrawals for qualified medical expenses, which include Medicare premiums and out-of-pocket costs but not Medigap and Medicare Advantage premiums. (For more, see “Putting Your HSA to Work,” page 6.)

Uncovered health care

Long-term care

The U.S. Department of Health and Human Services estimates that close to 70% of today’s 65-year-olds will require some kind of long-term care, for an average of about three years—and the costs can be exorbitant.

For example, the national average cost of a middle-income home aide in 2019 was $52,624, whereas a private room in a nursing home facility was $102,280.1 Americans are becoming more aware of these potential expenses the more they still don’t really plan for them—or even know where to start,” David says.

Some retirees may be able to reduce long-term care expenses by helping their families for help, but those who can’t or don’t want to rely on their loved ones generally cover these expenses in one of two ways:

- **Out of pocket:** One approach is to pay out of pocket and if when the need arises, in which case you’ll need significant savings to cover such costs. The benefit of this approach is that you pay for only what you need, which may be attractive to wealthier individuals who don’t want to pay for insurance they may not use.

- **Long-term care insurance:** For most people, coming up with an extra hundred thousand dollars or more isn’t realistic—in which case, long-term care insurance may allow them to get the quality care they need without having to liquidate their assets to pay for it. David says it’s generally best to purchase a policy in your 50s or early 60s, which changes each month but generally approximates the rate paid by certificates of deposit and savings accounts. If your loan’s rate is below the AFR or the IRS imposes that the loan wasn’t really a loan at all, it may be treated as a gift for tax purposes (and subject to the $15,000 annual gift tax exclusion).

For example, the IRS sets a minimum rate for such loans, called the applicable federal rate (AFR), which changes each month but generally approximates the rate paid by certificates of deposit and savings accounts. If your loan’s rate is below the AFR or the IRS imposes that the loan wasn’t really a loan at all, it may be treated as a gift for tax purposes (and subject to the $15,000 annual gift tax exclusion).

For more help estimating retirement costs, see “Putting Your HSA to Work,” page 6.)

A child in crisis

It’s natural to want to step in when your child needs financial help. But the older your child is, the more difficult it can be to get help and recover from such an unanticipated expenditure. In fact, half of all parents financially helping an adult child say it’s putting their retirement savings at risk.2 “When an adult child falls on hard times, retired parents often feel obligated to help, even when their savings aren’t planning for the added expense,” David says.

Before offering your support, think about how much help you’re able to provide—and for how long. “Are you willing to withdraw a large lump sum from your savings, for example, or would you be more comfortable covering your expenses over a longer time frame while they get back on their feet?” Rob asks.

If you do decide to dip into your retirement funds, be sure to talk to a financial advisor about your situation before you make a decision. “You need to have a clear, honest conversation with your child about the terms of the arrangement—including whether the money will be a gift or a loan—and be clear about the extent to which you’re willing to help,” says David.

“Boundaries and clear communication are really important in a situation like this,” David says. “Your child may see the money as a gift while you expect to be paid back, which can cause conflict down the line.” If you both agree to a loan, however, make sure you understand the rules surrounding intrafamily loans before you finalize the terms—the details are complex and can create unexpected tax consequences.

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Between the COVID-19 pandemic, natural disasters, and social unrest, 2020 has seen its fair share of upheaval—and generous Americans with the means to help have stepped up their charitable giving in response. One study of 32 community foundations reported an 80% increase in donations from March to May, compared with the same period in 2019.1 Despite a growing desire to help, however, many donors and even some seasoned philanthropists

Five steps for maximizing your charitable impact.
Donating direct
Donating an appreciated asset directly to a charity or donor-advised fund (DAF)—as opposed to selling the asset and donating the proceeds—can allow you to give more and pay less in taxes.

<p>| Option 1: Sell asset and donate the proceeds | Option 2: Donate asset directly to charity or DAF |</p>
<table>
<thead>
<tr>
<th>Current fair market value of stock</th>
<th>Amount donated to charity</th>
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<tbody>
<tr>
<td>$100,000</td>
<td>$100,000</td>
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<tr>
<td>Long-term capital gains tax</td>
<td>Amount donated to charity</td>
</tr>
<tr>
<td>$14,250</td>
<td>$0</td>
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<tr>
<td>Deduction for those who itemize*</td>
<td>Deduction for those who itemize*</td>
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<td>$85,750</td>
<td>$85,750</td>
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<td>$100,000</td>
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The example is hypothetical and provided for illustrative purposes only. Assumes investor has held stock for at least a year and a day (24 months), and a long-term capital gains rate of 15%. (Assumes a 32% federal income tax rate and does not reflect state or local taxes, or a potential Medicare net investment income tax. Note that the tax rate of a charitable deduction may be subject to reduction for taxpayers whose adjusted gross income (AGI) is above certain thresholds. In addition, deductions for contributions of appreciated property to public charities generally are limited to 50% of the donor’s AGI. Donor contributions may be carried forward for up to five tax years.)

With COVID-19, for example, do you want to support the global fight against the virus, or would you rather help closer to home? “Kim asks. “Of course, it doesn’t have to be either-or. The point is to figure out what you care about most so you can start to identify the organizations that match your goals.”

Step 1: Pinpoint your priorities
To get started, it can help to reflect on what you hope to achieve with your support:

- What causes, communities, and concerns are most important and relevant to you?
- Do you want to focus locally, nationally, globally, or all combination thereof?
- Which, if any, areas of need overlap with your philanthropic mission, and give most effectively?

Step 2: Choose your charities
Once you’ve settled on which causes to support, you may still need to choose from hundreds or even thousands of organizations focused in those areas. “Different charities will approach the problem in different ways,” Kim says. “Do some research. You can identify groups that are helping to implement the kind of changes you’d like to see.”

Step 3: Consider your contribution options
Next, think about the kind of support you want to offer. Will you contribute money or your time and skills? According to the Corporation for National and Community Service, more than half of all Americans donate money in 2018, and nearly a third volunteered. If you want to provide financial support, talk it out with your family. Nearly any noncash asset—such as publicly traded stock, real estate, art, or even private business interests—could be appropriate charitable donations. That’s because donating appreciated noncash assets that you’ve held more than one year directly to a charity can potentially eliminate the capital gains tax you might otherwise have owed on a sale of the assets (see “Donating direct,” below left).

However, some charities may not be positioned to manage such noncash donations—especially during an emergency—in which case a donor-advised fund can be a valuable tool for giving. With a donor-advised fund, you contribute cash or noncash assets to the account, allow the donor-advised fund sponsor to manage the sale of the assets, where applicable, then make grants to the charities of your choice, either as a one-time or recurring donation.

“Especially now, long-term support is critical,” Kim notes. “Many charities are reeling from both financial strain and overwhelming demand—and set ting up recurring grants and signing up for ongoing volunteer shifts can help organizations maintain their services and reliably fill critical positions.”

Step 4: Plan your giving
When you choose your giving strategy, consider how you want to give your 2021 filing.

This is particularly critical as fewer people are expected to itemize their deductions—including charitable donations—now that the standard deduction has been doubled as a result of the Tax Cuts and Jobs Act of 2017. One way to take full advantage of the benefits of charitable giving is to bunch several years’ worth of giving into a single year. For example, if you typically donate $3,000 a year and have $5,000 in other deductions, your total deductions would be less than the standard deduction of $12,400 in 2020, meaning you wouldn’t want to itemize them. If you were to consolidate two years’ worth of charitable gifts into a single tax year, however, you might be able to take the standard deduction and $5,000 in other deductions, pushing you past the standard deduction and allowing you to deduct the full value of your gifts. You could then spread your giving over three years, taking the standard deduction for your 2021 filing.

Kim notes that donor-advised funds are particularly well-suited to this purpose. “Donor-advised funds allow the donor to contribute a lump sum in the current year—and potentially include the gift among her or his itemized deductions—without having to decide right away which charities to support,” she says. “Instead, donors can take their time researching the causes they care about and strategically request grants to qualified organizations at any point in the future—not just in the year of the donation.”

Donors who plan to take the standard deduction may be able to take advantage of a temporary provision introduced by the Coronavirus Aid, Relief, and Economic Security (CARES) Act that allows individuals to claim an above-the-line deduction of up to $300 for cash contributions to operating charities (excluding donor-advised funds, private foundations, and so-called supporting organizations). This may be a great option for donors who bunched two or more years of giving in 2019.

Step 5: Just get started
It’s easy to get bogged down in the details as you identify your goals and vet potential donation recipients, but it’s important to remind yourself that there’s no such thing as the “right” charity.

“Don’t let perfection be the enemy of good,” Kim says. “Amid all this uncer tainty, you may be able to do anything you want if you have the opportunity to make a valuable and appreciated.”

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Debt

Investors—and with good reason.

If the rapid growth of U.S. borrowing keeps you up at night, you’re not alone. Even before COVID-19, investors had reason to be concerned about the federal debt, which, after a brief period of decline in the 1990s, has been on a steady upward march for most of the 21st century.

Indeed, the federal debt as a percentage of gross domestic product (GDP) reached 100% in the years following the 2008–2009 financial crisis, and this year’s historic pandemic-relief spending has pushed that number much higher than ‘Awash in debt,’ below. As of mid-2020, the federal debt stood at 136% of GDP.

Emboldened by historically low interest rates, U.S. companies, too, have been on a borrowing binge for the better part of a decade. Unfortunately, many businesses saw their profits evaporate due to this year’s pandemic, which ushered in a wave of corporate defaults (see “Going for broke,” page 32). As of mid-year 2020, defaults were rising at the fastest pace since the financial crisis, which could ripple through the broader economy if layoffs continue, suppliers go unpaid, and local and state tax revenues continue to shrink.

“Longer term, we might also see significant ramifications associated with running up the federal debt—including stunted economic output,” says Liz Ann Sonders, Schwab’s chief investment strategist.

Let’s look at why federal and corporate debt matters—and how you might adjust your portfolio in response.

Federal debt

In the near term, the soaring federal debt isn’t a major concern for two reasons:

1. The Federal Reserve has dramatically lowered the cost of borrowing by reducing the federal funds rate to a range of 0% to 0.25%, down from 2.25% just a year earlier. The fed funds rate influences interest rates on everything from credit cards to U.S. Treasuries, and the lower the rate the less the government has to pay its bondholders in interest.

2. At least for the time being, the Fed has guaranteed a market for U.S. Treasuries, thereby reducing the yield the government needs to offer to entice outside buyers.

Once the economy recovers, however, the Fed will likely look to raise rates to help stave off inflation. It will also need to pull back on its purchases of Treasuries, which may require the government to pay higher yields to attract traditional big buyers like China. Over the long run, those higher interest payments will eat up more of the federal budget, potentially leading the government to cut back on infrastructure investments and other capital expenditures—which in recent years have contributed about a fifth of U.S. GDP.

“All else being equal, net interest payments over the next 10 years will crowd out government spending elsewhere. And when the government invests less in the economy, growth trends to suffer,” Liz Ann says.

Corporate debt

When the economy is growing, borrowing typically helps businesses expand their production capacity or workforce to meet increasing or anticipated demand. However, many businesses today are turning to the debt markets simply to stay afloat.

Unfortunately, many companies today aren’t issuing bonds to build new plants or hire new employees—they’re doing so to shore up cash reserves, which can help them weather future economic uncertainty,” says Collin Martin, managing director and fixed income strategist at the Schwab Center for Financial Research. “As a result, their future growth could be constrained as debt payments crowd out more productive investments, just as with the federal government. It might even make them riskier as they pile on debt in the face of declining profits and weaker economic prospects.”

So far, moves by the Fed to backstop that debt by purchasing corporate bonds have helped sustain demand and provided fresh capital—which has eased investors’ fears and helped to explain why stock prices have continued to rise even as other economic indicators have tanked.

However, there’s a limit to the amount of corporate bonds even the Fed can buy. For example, relatively few individual sub-investment-grade corporate bonds are eligible for purchase by the Fed due to its self-imposed ratings limitations. “Ultimately, the Fed can’t save everyone,” Collin says.

Awash in debt

This year’s historic pandemic-relief spending caused the already-elevated federal debt to jump by more than 25%.

Let’s review the key drivers of federal and corporate debt in the past decade:

- Federal debt: From 2000 to 2020, the federal debt jumped from 2% of GDP to 140% of GDP, with about half the increase in that period due to the pandemic.
- Corporate debt: The ratio of corporate debt to GDP more than doubled from 2000 to 2020, reaching 60% of GDP.

Despite the Fed’s support for the credit markets, that support can’t keep every company afloat; nor will it last forever. For now, a conservative approach may make sense for many investors. In particular:

- **Bonds:** With corporate debt balances at record levels and bankruptcies on the rise, there’s greater risk that defaults will increase in frequency. Despite the Fed’s support for the credit markets, that support can’t keep every company afloat; nor will it last forever. For now, a conservative approach may make sense for many investors. In particular:

- **Stocks:** Although the stock market has seen a broad rally since the pandemic started, the market outlook of mainstay asset classes such as stocks and bonds. With that in mind, here are some moves that could help fortify three key areas of your portfolio:

1. **Stocks:** Diversify your holdings in a variety of industries and sectors. Consider buying stocks of companies that have a strong balance sheet and are generating significant cash flow. Look for companies that have a history of paying dividends or are likely to increase their dividends in the future.

2. **Bonds:** Consider holding a mix of U.S. government and high-quality corporate bonds. This diversification can help to protect your portfolio from the effects of rising interest rates or economic downturns.

3. **Cash:** Keep some cash reserves on hand for potential opportunistic investments. This can help you take advantage of market fluctuations or unexpected opportunities.

In conclusion, the rapid growth of U.S. borrowing and federal and corporate debt should be a concern for investors. While the short-term effects of the pandemic may have been exacerbated, the long-term implications of high debt levels should not be ignored. Investors should carefully consider the risks and rewards associated with higher debt levels and take steps to adjust their portfolios accordingly.
Avoid overexposure to junk-rated corporate and municipal bonds, as well as those on the lowest rungs of the investment-grade scale. Focus instead on more defensive issuers with lower debt balances or revenue streams that can weather the ups and downs of the recovery.

Limit the average duration of your bond funds. While not an immediate concern, keeping the average duration of bond funds in your portfolio below market benchmarks can help you manage the effects of interest rate risk, or the chances that your holdings will lose value should rates rise. For example, the Bloomberg Barclays Aggregate Bond Index, which is typically used as a proxy for the overall U.S. bond market, has a duration of about 6, so we would suggest keeping the average duration of your U.S. bond funds at 4 or 5.

Cash savings: The Fed has pledged to keep short-term rates near zero for the foreseeable future. That means yields on cash or short-term investments like certificates of deposit and money market funds are likely going to remain quite low. As a result:

- If you’re still working, consider limiting your cash savings to emergency funds that can cover three to six months’ worth of expenses and investing the rest in a diversified mix of assets.
- If you’re a retiree, consider limiting your short-term cash reserves to what you’re going to need for the next two to three years, and investing the rest in higher-income options such as annuities, bonds, and dividend-paying stocks.

Stocks: The early days of the pandemic led to significantly elevated volatility and the fastest 30% stock market decline in history. Thanks in part to the Fed’s aforementioned relief efforts, stocks’ recovery was nearly as swift. Even so, the speed with which a full market cycle of decline and recovery unfolded serves as a reminder that what’s gone up might well go down again. Thus, rather than trying to anticipate market moves, consider:

- Rebalancing your portfolio more frequently, especially after big swings (as opposed to the typical calendar-based portfolio maintenance that brings your asset allocations back in line with your long-term targets).
- Focusing on quality. In the wake of a recession, investors often focus on sectors that look primed for a rebound. However, Liz Ann says it might be better to focus on so-called quality stocks. “You want to look for industry leaders with strong balance sheets, positive cash flows, and management teams that will see them through this crisis,” she says.
- Reducing your expectations for long-term stock returns and increasing your savings to make up for the difference. For example, Schwab estimates the annual return for U.S. large-cap stocks over the next decade will be 7.1%—compared with 10.1% for the five decades prior.

Take control

Investors are right to be concerned about historically elevated debt levels and their effect on the economy. “You may have to put more away if you were counting on a repeat performance from the markets to help you reach your long-term goals,” Liz Ann says. “But with some planning, you can reposition your portfolio to help weather uncertainty.”

Going for broke

As the rate of corporate borrowing has risen, so too has the rate of corporate defaults.

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<tr>
<th>High-yield corporate default rate</th>
<th>Nonfinancial corporate debt as a percentage of GDP</th>
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<tr>
<td>Q1 2008 15%</td>
<td>43.0%</td>
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<td>Q3 2020 8.4%</td>
<td>56.7%</td>
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Charles R. Schwab
Founder & Chairman

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