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### **Vanguard Goes Ultra Short**

Last week, Vanguard announced that it will be launching a new fixed-income fund in February: The actively managed Ultra-Short-Term Bond. The fund will have a weighted maturity of 0 to 2 years and be managed by two veterans from its Fixed Income Group, Gregory Nassour and David Van Ommeren.

The portfolio will hold at least 65% of assets in high-quality bonds, but is permitted to invest up to 30% in “medium-quality” bonds, according to the preliminary prospectus. The fund managers will also be able to put 5% of the portfolio into non-investment-grade bonds.

Vanguard has argued for some time that the risks of investing in short-term or even intermediate-term bond funds are mitigated by the value in rising monthly distributions—especially when they are reinvested. However, the demand from risk-averse income investors over the last few years for “safer” fixed-income or alternative fund products has been high, and this new fund is Vanguard’s attempt to meet that demand. Ultra-Short-Term Bond’s launch should offer Vanguard investors a low-risk way to deal with the rise of interest rates likely on the horizon sometime next year (funds with lower average maturities and durations typically feel less of an impact from changes in interest rates).

Ultra-short bonds can also be an appealing option for investors who are taking income distributions out of their holdings rather than reinvesting. Price moves will likely be small and once interest rates rise, these type of bond funds could see yields rise at a decent rate.

Vanguard already offers an ultra-short municipal bond fund, Short-Term Tax-Exempt. The new fund will serve as its complement on the taxable, investment-grade side of the ledger.

Ultra-Short-Term Bond’s Investor shares will carry a 0.20% expense ratio with a minimum initial investment of \$3,000, while its Admiral shares will charge 0.12% and require a \$50,000 initial investment.

### **IRS Clarifies Key Rollover Question**

This fall, in a decision friendly to taxpayers, the IRS released unequivocal guidance that finally cleared up a murky area of retirement investing tax law: 401(k) investors are now expressly permitted to split distributions consisting of both tax-free and taxable earnings between a Roth IRA and a traditional IRA.

Prior to the clarification, IRA investors had no official guidance on how to deal with rollover distributions from 401(k) plans if that money included after-tax contributions. An IRS notice from 2009 did not expressly forbid splitting pre- and after-tax rollovers into separate vehicles, but doing so required a number of transactions and caused confusion among tax professionals as to the legality of doing so.

It may seem like an obscure ruling, but for people switching jobs mid-

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career who want to move their retirement savings from their previous employer's plan into a more customizable IRA, it's a very common concern. Take Mike, who got a new job cross country and wants to do a rollover, as his previous employer's plan had only limited investment options. Mike's 401(k) account contains \$100,000, of which \$80,000 came from pretax salary deferrals and compounded earnings, and \$20,000 was from after-tax contributions. He could certainly roll the entire amount tax-free into an IRA, though future earnings on pre- and after-tax money would be subject to taxes when distributed. This is not ideal, because Mike would need to file IRS Form 8606 to prorate the nontaxable and taxable distribution amounts, or else have to pay income taxes on them.

In this simple example, it makes more sense for Mike to send his pretax money to a traditional IRA (paying income taxes when he takes distributions in retirement) and convert his after-tax money into a Roth IRA (getting tax-free distributions later), something he is now explicitly permitted to do.

The IRS ruling, *Notice 2014-54*, also applies to rollovers from 403(b) and 457 plans.

One important note: Allocating after-tax money to Roth IRAs is permissible only when an entire retirement account (with both pre- and after-tax dollars) is rolled over at once. Partial rollovers are still subject to the pro rata rule, which requires any withdrawal to have a proportionate balance of taxable and non-taxable dollars.

The new rule officially goes into effect on Jan. 1, 2015, though investors were free to use this strategy as of Sept. 18, 2014, when it was approved.

Despite this clarification from the IRS, the rules and regulations of tax-deferred investing can be complex and overwhelming. We recommend consulting with a trusted financial adviser to maximize your tax savings when investing for retirement.

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