

SPECTRUM

A newsletter for the friends and clients of First Republic Private Wealth Management

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Sustainable and Responsible Investing: Aligning Your Values With Your Portfolio

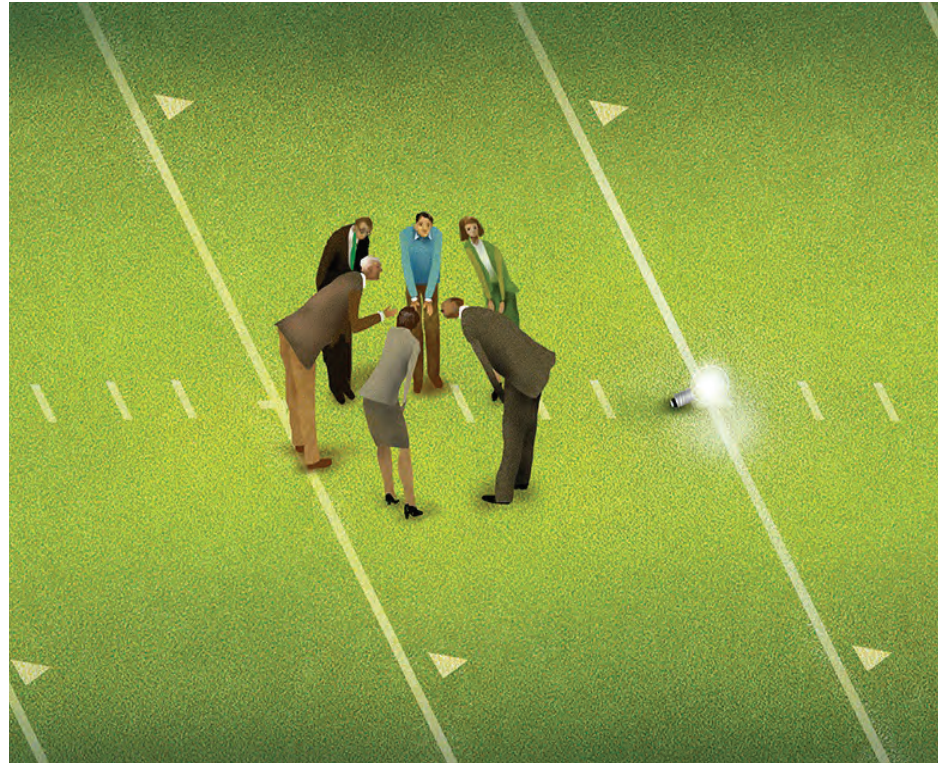
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2018 Year-End Tax Checklist

Joseph M. Dionisio, CFP®, Financial Planner,
First Republic Investment Management

The Tax Cuts and Jobs Act of 2017 (TCJA), signed into law on December 22, 2017, largely became effective in 2018. The law has changed many fundamental tax planning items in the process.

Although some aspects of the Act limit the benefits of year-end planning, other areas provide opportunities. It is now appropriate to review your existing year-end planning and turn your focus to some of the tax provisions that may affect you. Though this piece highlights important considerations, we recommend reaching out to your tax advisors to review the full impact of this Act on your current and future tax situation.

The following is our 2018 checklist to help plan and organize the different aspects of your year-end finances.

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Joseph M. Dionisio, CFP®, Financial Planner,
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Consider
with your tax
advisor either
accelerating
income in the
current year or
deferring income
to the following
year.

2018 YEAR-END TAX CHECKLIST

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RETIREMENT

- Consider maximizing your 401(k), 403(b) or other company plan contributions. If you are 50 years and older, catch-up contributions are allowed.
- Maximize your IRA contributions.
- Consider converting traditional IRAs to Roth IRAs, especially if you are in a low tax bracket and can pay the taxes with other funds available.
- If you are 70 ½, make sure you take your required minimum distribution.
- If you are self-employed, consider opening and funding a SEP IRA.
- Check beneficiary designations on all retirement plans.
- Consider making a 2018 charitable donation directly from your IRA using a qualified charitable distribution (QCD) if you are 70½ and older.

GIFTING

- Consider using your annual gift tax exclusion amount (\$15,000 per donee) for cash gifts.
- Consider using your annual gift tax exclusion to fund 529 plans.
- Consider using appreciated assets to fund your charitable gift.
- Evaluate which charitable vehicle is right for you: donor advised fund, private foundation, charitable trust, etc.
- Consider using all or a portion of your lifetime federal estate, gift and GST exemption amount of \$11,180,000 by creating and funding an irrevocable trust.
- Before gifting any asset, know the cost basis and the tax consequences to the donee.
- Revisit your gifting strategies and your estate planning documents.

INCOME TAXES

- Work with your tax advisor to prepare an income tax projection for 2018 and 2019.
- Consider “bunching” your deductions.
- Consider with your tax advisor either accelerating income in the current year or deferring income to the following year.
- Check your withholding to avoid interest and penalties.
- Consider working with your tax advisor to determine if you will be subject to Alternative Minimum Tax (AMT) this year and to evaluate ways to minimize exposure.
- Consider ways to minimize the 3.8% Net Investment Income Tax (NIIT) by reducing modified adjusted gross income (MAGI) and net investment income.

INSURANCE

- Review your current insurance policies.
- If you have a material change in life, revisit the amount of coverage.

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Sustainable and Responsible Investing: Aligning Your Values With Your Portfolio

The traditional model of philanthropy created a wall of separation between the drive to make money and the desire to do good in the world; one would invest first and foremost for return, make as much money as possible, and *then* gift to charity.

Today, however, there are many opportunities to invest in companies that are advancing social and environmental causes while simultaneously seeking to generate competitive market returns. Asset growth is on the rise; total U.S.-domiciled assets under management (AUM) using sustainable, responsible and impact investing strategies grew from \$8.7 trillion at the start of 2016 to \$12.0 trillion at the start of 2018, a 38% increase, according to the U.S. SIF Forum for Sustainable and Responsible Investing. This represents 26%—or 1 in 4 dollars—of total U.S. assets under professional management.

AN INTRODUCTION TO THREE MODELS: SRI, ESG AND IMPACT INVESTING

Socially Responsible Investing (SRI) and Environmental, Social and Governance (ESG) investing are two values-driven models that firms have employed for years. With SRI, an exclusionary screening approach is applied to avoid investing in companies that sell items that might conflict with personal, moral or ethical values (think alcohol, tobacco, weapons and genetically modified foods).

On the other hand, ESG investing utilizes a positive screening approach, identifying best-in-class companies with strong environmental, social and governance policies. The largest ESG ratings agency, MSCI, covers over 8,500 publicly traded companies and issues an ESG score rating of AAA to CCC (similar to a bond rating). These reports evaluate companies on a range of ESG issues including carbon footprint, water management, product lifecycle, packaging, employee welfare, diversity, data privacy and security, and female board representation, to name a few.

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The Tax Challenge with Highly Appreciated Real Estate

Owning real estate as an investment presents both benefits and unique challenges. For the fortunate investor who owns real estate that has appreciated significantly in value, minimizing the impact of income and estate taxes is a common concern. The exit strategy for a highly appreciated investment real estate property requires careful planning.

THE INCOME TAX IMPACT OF SELLING APPRECIATED REAL ESTATE

Generally, when an investment that has been held for longer than a year is sold, the gain will be subject to federal capital gains taxes at rates up to 20 percent, depending on the taxpayer's income level. The gain may also be subject to an additional 3.8 percent net investment income tax.¹ One benefit of investing in real estate is the ability to depreciate your property over time. Depreciation is an accounting calculation that allows one to deduct the cost of the asset over its useful life.² Annual depreciation is a deduction that can offset rental income. Depreciation is important in calculating the potential income tax due on the sale of a property; previously allowed depreciation reduces the tax basis³ and is later "recaptured" and taxed at a higher federal rate of 25 percent when the property is sold.

Example:

Real estate investor Jane purchased an apartment building 28 years ago for \$500,000 and has made no major improvements. She plans to sell to a buyer who will purchase the property for \$4 million. Her federal tax owed would be approximately \$958,000.

- Net sale price of \$4,000,000 minus original basis of \$500,000 = \$3,500,000 taxed at 23.8 percent (\$833,000)
- Full depreciation = \$500,000 taxed at 25 percent (\$125,000)

The simplified example above only illustrates the federal tax liability. However,

depending on the location of the property, additional state income taxes may be due. The table below illustrates the wide range of combined federal and state tax rates by state. Many real estate investors with highly appreciated property and very low basis may be unwilling to trigger capital gains taxes. The potential capital gains tax liability is even larger for investors in high-income tax states such as California and New York.

Highest marginal capital gains rate*	California	Massachusetts	Florida
Top federal long-term capital gains rate	20.0%	20.0%	20.0%
Net investment income tax	3.8%	3.8%	3.8%
Top state income tax rate	13.3%	5.1%	0.0%

*Table excludes depreciation recapture

§1031 EXCHANGE

Real estate investors commonly seek to exit their current properties in order to diversify, increase their cash flow, or because they no longer want to manage the property. Individuals with properties that have substantially appreciated in value can expect to incur significant capital gains taxes if the properties are sold. After the capital gains taxes are paid, the remaining proceeds available to reinvest may be considerably less. An alternative approach would be to take advantage of Internal Revenue Code Section 1031, which allows an individual to exchange one investment property for another like-kind investment property without triggering capital gains recognition. Notably, a §1031 exchange does not eliminate the capital gains tax; instead, the exchange defers capital gains recognition and the cost basis from the original property carries over to the new property or properties.

Several nuances and requirements are involved in qualifying for a §1031 exchange, including the timing during which the exchange must be completed, the types of property that qualify and what is considered like-kind property. Taxable gain may also be triggered if the investor receives any cash or debt relief during the exchange transaction. Investors contemplating a §1031 exchange are strongly advised to work with a team of experienced professionals to prepare for and execute the transaction.

Example:

A California real estate investor owns an investment property with a value of \$4 million and \$0 basis.

- **Sale:** After paying federal and state capital gains taxes of \$1.49 million, the remaining \$2.51 million is re-invested.
- **§1031 exchange:** No taxable gain is recognized and the investor subsequently owns one or more properties with a combined value of \$4 million and \$0 basis.

THE ESTATE TAX IMPACT OF OWNING APPRECIATED REAL ESTATE

Each U.S. citizen is allowed to transfer up to a certain dollar amount tax-free to his or her heirs during his or her lifetime or at death. Any amount over the threshold is taxed at a federal rate of 40 percent. The current lifetime gift and estate tax exemption is \$11.18 million per person or \$22.36 million per married

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The exit strategy for a highly appreciated investment real estate property requires careful planning.





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Health Care Costs in Retirement: What You Need to Know

Determining how much money you will need in retirement for medical expenses and long-term care is challenging, as you can't know exactly what your future health care needs will be. However, understanding the various types of health care costs and the potential strategies for minimizing those costs can help you prepare more effectively and reduce your long-term financial risks.

Here's a look at four health care costs to be prepared for:

1. MEDICARE

Medicare, the federal health insurance program that most Americans are eligible for starting at age 65, currently consists of four parts: Part A (hospital insurance), Part B (medical insurance), Part C (private health insurance plans, known as Medicare Advantage) and Part D (prescription drugs). Medicare does not cover hearing care, vision care or costs associated with long-term care, though you can buy additional insurance coverage that does. (See sections below.)

There is no premium cost for Part A, while Part B's premium varies depending on the covered person's income. Both Part A and Part B (often referred to as "Traditional Medicare") have co-payments and annual deductibles, but no annual out-of-pocket limit on how much the covered person pays toward their medical costs. That's why, in order to cover the often-high out-of-pocket costs of traditional Medicare, some seniors elect to get retiree insurance from a previous employer. An additional option is to purchase Medigap – or "supplemental" – insurance coverage or Medicare Advantage.

2. MEDIGAP

Medigap policies are designed to help cover some or most of traditional Medicare's out-of-pocket costs, including co-payments, co-insurance and deductibles. Policies are sold by private insurers and feature 10 different Medigap plan options. Seniors who don't purchase Medigap coverage when they first join Medicare risk facing much higher premiums later on or being denied Medigap coverage altogether. Medicare requires that during certain periods, its participants have the right to a guaranteed Medigap policy. This means that a Medigap policy must be issued regardless of the applicant's

health condition. Outside of designated periods, insurance companies can use medical underwriting. If the applicant has health issues, a Medigap policy may be denied. By carefully planning – and comparison shopping – for Medigap policies, individuals may save hundreds of dollars a year.

Keep in mind that Medigap policies do not cover prescription drugs, so a stand-alone Medicare Part D plan may be purchased. In general, seniors will not need (and cannot purchase) a Medigap policy if they get Medicare Advantage.

3. MEDICARE ADVANTAGE

Seniors on traditional Medicare can opt to receive their Part A and Part B benefits by getting a comprehensive health plan, known as Part C, or Medicare Advantage, through a private insurer. These plans generally include prescription drug coverage. Seniors with a Medicare Advantage plan continue to pay their Part B premium while also generally paying an extra premium for the additional coverage they receive through the private insurance. Medicare Advantage plans usually have deductibles and co-pays, but unlike original Medicare, they limit out-of-pocket costs. That means that when the insured person reaches the annual out-of-pocket limit, the plan pays 100 percent of his or her medical bills for the rest of the year.

4. LONG-TERM CARE INSURANCE

At some point, many Americans need temporary or ongoing care to help them with daily self-care activities, either in their home or in a professional care facility. According to the U.S. Department of Health and Human Services, 70 percent of Americans over the age of 65 will need some form of long-term care services. A 2017 survey by Genworth Financial estimates that the median rate for a private room in a nursing home is \$8,121 per month, while assisted-living centers charge an estimated median rate of \$3,750 per month, and an in-home health aide costs \$4,099 per month.

Traditional Medicare, Medigap and Medicare Advantage plans do not cover such in-home or facility care, so it's crucial to plan separately for these potentially very significant costs.

People with very limited income and financial resources may qualify for government-paid Medicaid coverage to help pay for care either in their home or in an assisted-living center or nursing home. Those who do not qualify for Medicaid assistance, however, must either cover these costs using their own assets or through long-term care insurance. Since the cost of long-term care can deplete someone's life savings, people with significant discretionary income who are looking to leave assets to their loved ones should consider purchasing long-term care insurance. It makes sense to evaluate long-term care coverage options sooner than later, as premiums tend to rise with age and some people may be denied coverage altogether if they wait too long.

5. THINKING REALISTICALLY

Many people don't like thinking about their future health and long-term care needs, much less planning for them. And, while understandable, even if you've lived a very healthy life so far, there's certainly no guarantee you won't incur significant health care costs later in life. For these reasons, it's important to think realistically about the future, take steps now to protect your assets, and plan for these vital—and potentially very high—costs.

Understanding the various types of health care costs and the potential strategies for minimizing those costs can help you prepare more effectively and reduce your long-term financial risks.



2018 YEAR-END TAX CHECKLIST

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If you plan to purchase a mutual fund toward year-end, check to see if the fund is making a sizable capital gains distribution.

- Check the beneficiary designation forms for all insurance coverage.
- Request an in-force ledger for all permanent life insurance policies.
- Consider transferring your life insurance into an irrevocable life insurance trust (ILIT).
- If your life insurance is owned by an ILIT, make sure you are providing Crummey letters to the beneficiaries.

INVESTMENTS

- Review asset allocation for rebalancing.
- Check to make sure your investments are in line with your risk tolerance and investment objectives.
- Consider selling some losers to offset gains. You can deduct up to \$3,000 of capital losses against ordinary income and carry forward excess capital losses to future years.
- If you plan to purchase a mutual fund toward year-end, check to see if the fund is making a sizable capital gains distribution.

Now is an opportune time to consider additional year-end strategies that could benefit you and your family while planning for 2019. For additional insights, please reach out to your local First Republic wealth professional.

THE TAX CHALLENGE WITH HIGHLY APPRECIATED REAL ESTATE

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couple. (Note: The lifetime exemption is currently scheduled to return back to previous amounts at the end of 2025)

With a few exceptions, most assets held inside the estate will receive a basis adjustment to the fair market value at the date of death. If the value is higher, the basis will “step-up”; if the value is lower, the basis will “step-down.” The graphic below illustrates that certain types of assets benefit more from a step-up in basis.

For estates that fall under the estate tax exemption, the basis step-up can provide valuable income tax savings for heirs. However, for larger estates well over the estate exemption, the taxpayer must weigh the benefit of the cost basis step-up versus the additional estate tax burden caused by including the asset in the estate. Generally, the estate tax liability is due 9 months after the date of death. Estates that have a large portion of illiquid assets, such as real estate or business interests, may find it challenging to raise the cash needed to pay the estate tax liability in the short time frame.

Example:⁴

Real estate investor Joe owns an apartment building with \$0 adjusted basis and no debt. At his date of death, the property’s basis is adjusted to a fair market value of \$4 million. If his heirs immediately sell the property, there may be minimal to zero capital gains taxes due. However, assuming that Joe’s estate exceeds his federal estate tax exemption, the federal estate tax liability

associated with the apartment building may be \$1.6 million (\$4 million taxed at 40 percent rate).

Additional state-level estate taxes must be considered as well. A handful of states are decoupled from the federal estate tax laws; these states have their own state estate tax rates and exemption limits that are often not aligned with the federal estate tax system. Currently, 12 states (Connecticut, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont and Washington), along with the District of Columbia, levy an additional estate tax. Investors should understand the state tax laws when purchasing real estate outside their state of residency. For example, a California resident who owns real property in Oregon could potentially face Oregon state estate tax if the value of the Oregon real property exceeds Oregon's \$1 million estate exemption.

GIFT AND WEALTH TRANSFER: START PLANNING NOW

For estates over the lifetime exemption now or in the future, it's worth exploring whether or not it is more beneficial to gift wealth today and allow the asset to appreciate outside of the estate.

There are many strategies available for those interested in maximizing wealth for their heirs or charity. One example is to structure gifts to certain irrevocable trusts in a way that provides the flexibility to "swap" a low-basis asset for high-basis asset. The goal would be to bring the previously gifted low-basis asset back into the estate in the future for the basis step-up and transfer the high-basis asset outside of the estate.

Planning ahead early to mitigate tax erosion is critical for investors considering an exit strategy or transferring wealth to the next generation, or for individuals inheriting wealth. The approach you take should be customized to fit your particular situation.

Although it is essential to plan around the estate tax and income tax challenges for real estate investors, keep in mind that taxes are only one piece in the overall planning strategy. Income and estate taxes at both the federal and state level will likely continue to change over the long term. We recommend that you periodically revisit your estate plan and partner with trusted advisors who maintain a comprehensive understanding of your financial, estate, and tax plan, unique family dynamics and philanthropic wishes.

¹ Net investment income tax of 3.8% is applied to the lesser of net investment income or the excess over the modified adjusted gross income (MAGI). The thresholds are as follows: \$200,000 for single, \$250,000 for married filing jointly or \$125,000 for married filing separately. Net investment income may include interest, dividends, capital gains, passive business income or passive rental income.

² Residential rental property is depreciated over 27.5 years and commercial property is depreciated over 39 years.

³ Typically, the basis includes the original purchase price, certain expenses associated with acquiring the asset and improvements to the property.

⁴ Numbers were calculated using NumberCruncher version 2018.01 and are intended to be estimates only.

With a few exceptions, most assets held inside the estate will receive a basis adjustment to the fair market value at the date of death.



SUSTAINABLE AND RESPONSIBLE INVESTING: ALIGNING YOUR VALUES WITH YOUR PORTFOLIO

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Compared to impact investing, SRI and ESG approaches provide a wider range of investment options.

Impact investment is a newer and, some may say, more direct values-driven model with the primary objective of solving a social or environmental issue while concurrently generating a positive return. For example, an impact investor might choose to devote his or her funds directly to an alternative energy enterprise (wind or solar), an energy efficiency project, or natural and organic food production. Impact investing could also mean investing in affordable housing, medical or educational facilities in low-income areas, or in resource management via municipal water infrastructure bonds.

EXPLORING INVESTMENT OPTIONS

Impact investing has traditionally been accessible through two asset types: private equity and/or bonds. Private equity affords the opportunity to invest directly in mission-focused social enterprises and small businesses as opposed to large public companies encompassing multiple departments, services or products. With private equity, impact investors are able to commit their capital to companies that are specifically focused on making a difference. However, private investments are often subject to investment minimums and lock-up periods should be taken into consideration.

Bonds create an avenue to invest in a larger company or entity in specific projects that are earmarked for impact. For instance, the World Bank coined the term Green Bonds in 2008 when it began issuing debt earmarked for projects to mitigate climate change. To that end, Green Bonds include everything from investments in energy efficiency, water management and green building to technologies in waste management and agriculture for the purpose of reducing greenhouse gas emissions. By the same token, investors have the ability to access bond issuances by large public companies such as banks and REITs (Real Estate Investment Trusts) that have earmarked corporate debt issuances for solar energy or energy efficiency projects.

Compared to impact investing, SRI and ESG approaches provide a wider range of investment options. With hundreds of publicly traded mutual funds and ETFs, these funds are available to investors of all sizes. ESG advocates argue that ESG data provides an additional layer of risk analysis for portfolio management, which could lead to long-term performance.

NOTABLE TRENDS IN THE ESG SPACE

For years, environmentalists have been calling for action from the private sector to address the global issue of climate change. In 2018, companies have started responding, in particular due to increased engagement from investors. There has been a significant rise in both shareholder filing and support for environmental issues, with over 150 proposals filed this year requesting sustainability reporting, 2-degree scenario analysis, or other climate change related topics, according to corporate governance firm Institutional Shareholder Services (ISS).¹ Climate change has evolved from just a “care for our planet” issue to a material financial risk for investors.

Also of note in 2018 is the issue of gender equality in the workplace and, more specifically, the corporate boardroom. Studies have demonstrated high correlations between female board representation and financial performance

If you have any questions, comments or suggestions for Spectrum, please contact us at privatewealthmanagement@firstrepublic.com

indicators such as return on sales and return on equity, according to Catalyst Inc., a global women’s organization.² Women accounted for roughly one-third of new board seats in 2018, with the number growing, reports a data analysis by ISS.³ And in October 2018, California became the first state to require at least one female on the board of all publicly listed companies with headquarters in the state by the end of 2019.

CREATING A PORTFOLIO THAT REFLECTS YOUR VALUES

Any investor seeking a direct connection with how their capital is making a difference in the world is a great candidate for sustainable and responsible investing. Women and millennials in particular are currently driving demand for values-driven investments, but high net worth individuals, family foundations, donor-advised fund investors and institutional endowments are also participating.

If you’re interested in sustainable and responsible investing, it’s important to work with a wealth manager who is knowledgeable about the field and can construct a portfolio that aligns with your values and focuses on optimizing your financial return. As with more traditional investments, you still need to consider the typical factors that impact your asset allocation mix, such as timeline for the funds, risk profile and your overall goals and objectives.

Your wealth manager can help incorporate one or more of the investment styles below. For more information, reach out to your local First Republic wealth professional.

	Description	Examples	Investment Vehicles
Socially Responsible Investing (SRI)	Mitigates exposure to industries or businesses that don’t align with your values	Restrictive screening for: Tobacco, Alcohol, Fossil Fuels, Weapons or Firearms, Gambling, Factory-Farming/ Organisms (GMOs)	<ul style="list-style-type: none"> – Separately Managed Accounts (SMAs) provide customized restrictive screening. – SRI mutual funds or ETFs provide basic standard restrictive screens.
Environmental, Social & Governance (ESG) Investing	Integrates performance metrics for companies in regard to their environmental, social and governance policies and procedures	Low Carbon Emissions, Water & Resource Management, Toxic Waste Disposal, Employee Benefits & Diversity, Supply Chain Labor Standards, Data Privacy & Security, Business Ethics, Board Diversity	<ul style="list-style-type: none"> – First Republic’s ESG Investment Strategy has a track record dating back to 2012. – SMAs provide customized ESG strategies with minimum ESG thresholds or specific factor tilts. – ESG mutual funds or ETFs provide basic ESG tilts or minimum ESG thresholds for investing.
Impact Investing	Focuses on resolving a specific environmental or social challenge	Alternative Energy (Solar, Wind, Hydro), Natural Resources, Affordable Housing, Microfinance/ Business Development, Educational & Healthcare Facilities	<ul style="list-style-type: none"> – Private Equity funds provide focused impact solutions. – Thematic mutual funds or ETFs focus on specific issues of interest. – Fixed Income markets provide access to specific projects via Green Bonds.

¹ISS Institutional Shareholder Services

²<https://www.catalyst.org/knowledge/bottom-line-corporate-performance-and-womens-representation-boards>

³<https://www.rgrdlaw.com/news-item-Board-Diversity-Developments-09192008.html> and <https://www.issgovernance.com/library/board-diversity-review/>





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spec'trum, n.

A broad range of related ideas or objects, the individual features of which tend to overlap so as to form a continuous series or sequence.

—*Random House Unabridged Dictionary*

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