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Now's A Time To Recall Financial Planning Basics

Just a few years ago, almost everyone knew at least one person who had made a fortune in the stock market. Today, many of us have lost a fortune. For those who are wondering what went wrong, here's a refresher course in financial planning basics.

Diversification. In the late 1990's, many investors thought diversification meant buying three computer stocks and two Internet stocks. Others assumed they were being prudent because they owned a dozen mutual funds. But true diversification means buying a range of investments in markets that do not move in lockstep with each other. Through most of the 1990s, growth stocks were the spectacular performers; in recent years value stocks have been successful. A balanced portfolio will have both. It will also include bonds. But just starting out with the right mix isn't enough; you also need to rebalance your portfolio regularly, trimming positions that have done well and adding to others that may be poised to rebound.

Planning. Establishing clear life goals and a long-term strategy is the essence of sound financial planning. A solid plan lays out the amount you must save annually, assuming an expected average rate of return, to reach your financial targets. It prepares you for future expenses, such as a child's college education, and unexpected setbacks, such as premature death or disability.

Saving. Money doesn't grow on trees, but it does grow provided you invest it. The more you put aside and the longer you allow it to compound, the better off you'll be. The rule of 72 is the easiest way to see how this works*. Simply divide 72 by your rate of return to get the number of years it will take for your money to double. For example, with an 8% return, your investment will double in nine years and quadruple in 18. A steady, automatic withdrawal from your paycheck is probably the most effective way to save. That way, you don't miss the money, because you never see it, and you're able to load up on assets when they're doing poorly and reap the benefits when they go up.

Retirement contributions. The government rewards savers by offering tax benefits to retirement accounts such as 401(k)s, 403(b)s, and IRAs. In most cases, you contribute pre-tax dollars and the money grows tax-deferred, meaning you don't owe taxes on gains until you withdraw the money. With Roth IRAs, you contribute money that has already been taxed but your withdrawals are tax-free. Either way, the boost from Uncle Sam is so generous that it's worth stuffing as much as possible into retirement accounts before allocating to regular savings and taxable accounts.

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Converting Your IRA To A Roth May Make Sense

After some of the worst market declines in history, should you convert your traditional IRA to a Roth? Pay taxes now on the conversion balances—while avoiding the 10% early withdrawal penalty—and never pay taxes on them (or investment income they generate) again!

In order to qualify for a conversion in 2009, your modified adjusted gross income (MAGI) must be $100,000 or less. If you do not qualify now, prepare for 2010, when this income limit is permanently repealed.

A conversion is most advantageous if you can afford to pay the taxes from a non-IRA source. Please contact Chad, David, or Wade to see if a conversion makes sense for you now or down the road.

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Creating A Comfortable Financial Independence Plan

Everyone needs a financial blueprint for life after work. Operating without one is a little like closing your eyes as you barrel down the freeway. It's essential to know where you're going and how you expect to get there. But a financial independence plan will help you achieve your goals only if you incorporate it into your financial life, and that won't happen unless the plan feels comfortable. And that comes from understanding its component parts and how they're connected. Consider these elements:

Cash flow analysis. Your plan needs to project where your money will come from and where it will go during the rest of your life (and your spouse's life, too, if you're married). What will come in during retirement, from Social Security, a company pension, annuities, and from drawing down your savings? And how will that match the needs of the lifestyle you want? Several unpredictable variables complicate these calculations. Inflation affects how far your money goes, and investment returns, based in turn on economic and market cycles and your choices, determine how much you have to spend. Taxes will also play a role.

Investment choices. Three factors affect what should be in your investment portfolio. Your goals: What kind of return do you need, both while you're working and during retirement, to support your lifestyle? Your risk tolerance: How much volatility in portfolio returns are you willing to accept to meet your goals? Taking greater risks may provide higher potential long-term returns, but not if you panic and sell when the market takes a turn for the worse. And your time horizon: How long do you have to save for retirement, what is your tax bracket, and how many years do you need your savings to last?

Contingency plans. Job losses, expensive illnesses, or the unexpected death of you or your spouse could put your plan off track. There could also be unforeseen expenses involving your children or parents, and the need for nursing home care during retirement could quickly drain your savings. Having a cash cushion along with life, disability, and long-term care insurance can prepare you to handle potential setbacks. Not planning for lifestyle changes is a major mistake and will put your financial future in jeopardy.

Estate planning. This is crucial even if estate taxes aren't likely to be an issue. You need a will, periodically updated, and a letter of instruction that tells heirs where to find information about financial accounts, life insurance, safe deposit boxes, and the like. It's also important to designate beneficiaries for 401(k)s, IRAs, and other financial accounts that reflect your wishes and take into account potential tax liability.

It can be complicated to weave together all of these elements. But we have the tools, expertise, and experience to help you create a financial plan that feels comfortable. ●

To Consolidate Your IRAs Or Not To Consolidate

Although this dilemma isn't as life altering as Hamlet's, it could still have a signi-ficant impact on your financial affairs. Here are several reasons to consider one path or the other.

When not to consolidate. While it's generally possible to consolidate multiple traditional or Roth IRAs—that is, merging traditional IRAs with other traditional IRAs, or Roths with other Roths—you can't put a traditional IRA with a Roth, and you can't join an IRA with employer retirement plans such as 401(k)s or 403(b)s.

One reason not to consolidate accounts is that it may mean forfeiting favorable tax treatment. For example, although the law was recently revised to permit a non-spouse to roll over inherited retirement plan assets, those funds must remain in a separate inherited IRA. (You can, however, merge an IRA left by your spouse into your own account.) Or you may have assets in a "conduit IRA," a special kind of account that holds money from a previous employer's retirement plan until you can move it to a plan at your new job. To preserve the advantages of a 401(k) or 403(b)—for example, being able to tap the account at age 55 if you retire early, or getting better tax treatment for company stock—you must avoid mixing a conduit IRA with other accounts.

You may also not want to consolidate if the IRAs have been separated to accomplish specific planning goals involving beneficiary designations or to set up specific streams of income.

When to consolidate. If none of those reasons apply, bringing together two or more accounts may provide several benefits. Almost all of the advantages involve the fact that it's much easier to manage one account than to keep track of several. Consider the following:

- Making changes in your

Estate Rules Cast Doubt On Survivor Policies

Survivorship life insurance has traditionally had one key benefit for married couples: When the second spouse dies, proceeds from a policy can help heirs pay estate taxes. But now, with the future of the estate tax in flux, does survivorship insurance still make sense?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually reduces the federal estate tax before eliminating it in 2010. But unless Congress extends the repeal or makes it permanent, the estate tax will return in 2011, affecting anyone whose estate is worth more than $1 million. So the ultimate end of the tax as a prime motivation for buying survivorship insurance is hardly a sure thing.

Because you can't know for sure when you'll die or exactly what the estate laws will look like then, having a second-to-die policy may still be a good idea, particularly if your wealth is concentrated in illiquid assets, such as real estate or a business. Without an insurance death benefit to cover estate taxes, your heirs could be forced to sell such property at fire sale prices.

Even if you don't expect your estate to be taxed, survivorship insurance could still be useful. For example, although your heirs won't owe estate tax if you die in 2010, they could be subject to higher capital gains taxes in the future. Suppose you leave your children $1 million of stock in your former employer. Currently, they would be taxed only on the amount those shares appreciate after they take possession. Under EGTRRA, however, after 2009 your heirs will inherit your cost-basis (what you paid for the stock), and owe tax on gains that may have occurred long before they inherited it. If, for example, you paid only $250,000 for the shares, your heirs would owe capital gains tax on an additional $750,000. At the 20% long-term capital gains rate that is currently scheduled to apply after 2010, that's an extra $150,000 in taxes. A survivorship death benefit could help pay those taxes.

Note that the basis of property inherited after 2009 may generally be increased by $1.3 million by non-spouse beneficiaries and by $3 million for property passing to a surviving spouse. But the lower cost-basis remains a concern for affluent families.

If you're likely to leave behind a large retirement account balance, a survivorship policy could also offset income taxes due on withdrawals by your heirs, which will be taxed at ordinary income tax rates (up to 35%). Plus, state taxes might also be owed.

Beyond taxes, second-to-die insurance can simplify your estate plan. You could split the death benefit among loved ones, for example, and leave the rest of your other assets to charity. Also, if you own a business, proceeds could provide cash for family members who don't want a stake in the company after you're gone.

In some cases, a survivorship policy may be easier to get than other kinds of life insurance—for example, if one spouse is in ill health and other-wise wouldn't qualify for coverage. Moreover, second-to-die coverage is generally less expensive than carrying two individual policies because there is no death benefit after the first spouse's death. It can be an economical way to ensure ongoing care for a dependent with special needs after both you and your spouse die.

If you're considering survivorship insurance, look for options such as split coverage. This feature allows a couple to separate the insurance into individual policies in case of divorce or if the estate tax is repealed. The cost is minimal. Some insurers charge nothing and you may be able to divide a policy without proving insurability.

You should also seek a policy that waives a surrender charge in years when there is no estate tax, giving yourself an escape hatch if you no longer need the policy. But read the fine print. Some carriers waive the charge only if you end your coverage completely, while others will also eliminate the fee if you reduce the policy amount.

Keep in mind that many traditional universal-life policies now come with a guarantee. If you pay the premiums on time and don't borrow against the policy, your beneficiaries get the full benefit, even if there's no cash value.

Also, you must determine whether a survivorship policy is right for you by examining you and your spouse's life expectancy. And if you are worried about estate tax repeal, consider a low-load policy where you could exit with less financial loss. ●

investment strategy—say, moving to a more conservative mix of assets as you approach retirement—is significantly more complex and time-consuming if it involves several accounts.

- If you have many accounts, you may tend to ignore those that are small or aren't performing well.
- If your IRAs are at several institutions, each one may charge you an annual maintenance fee. You'll also have more paperwork, with multiple monthly statements and end-of-year tax forms.
- When it's time to begin distributions from a traditional IRA—the year after you turn 70½—the amount of the required withdrawal is based on the total value of all IRAs. Neglect to include one in your calculations and you'll face punishing tax penalties. (Exemption: The rule for taking required distributions is temporarily waived for the 2009 tax year.)
- Before consolidating IRAs, consider rolling over your 401(k) plan to an IRA so that you can "stretch" the IRA over a beneficiary's life expectancy. If a 401(k) participant dies before doing this, beneficiaries are generally required to take a full distribution and pay income taxes on it within five years.

We can help you decide if you should consolidate your IRAs and consider how those assets fit into your overall financial plan. ●

Gold Decouples From Oil, Sparking Buzz

One measure financial analysts use to gauge the health of the economy is the ratio of gold prices to oil prices. This ratio may also help predict where gold prices are headed. Of course, gold's value is ultimately unpredictable, and recent trends could be reversed. Still, the connections between these two commodities could have important implications, particularly in today's volatile investing environment.

Gold is attractive in times of crisis, because of its intrinsic value. Unlike stocks or bonds, which could end up worthless if a company fails, gold should always have a market, and many investment portfolios devote a small percentage of assets to the precious metal. Today, the case for gold is stronger than usual, in light of the Federal Reserve's intervention in the U.S. economy. Analysts say the cost of paying for the Wall Street bailout and buying up troubled mortgages will be paid in inflated dollars, possibly weakening the dollar and strengthening the value of gold.

It's important to note that gold already has had a strong run-up in price. From March 2007 to March 2008, the price of gold soared from $660 an ounce to more than $1,000 an ounce. Since then, as economic troubles grew, gold prices retreated and have fluctuated between $730 and $980.

Prices of gold and oil tend to rise and fall together, in part because major purchases of oil once were paid for with gold, and even today much surplus oil revenue gets invested in gold. So, rising oil prices tend to boost demand for gold and its price. Also, higher oil prices encourage inflation, and that also increases demand for gold, a time-tested hedge against inflation.

In recent months, however, oil prices have declined while gold prices have risen, a situation that analysts refer to as "decoupling." If oil prices were going up and gold prices falling, it would signal a surging economy and potential inflation. But between July 2008, when oil prices peaked, and October, when the price of a barrel of crude had fallen nearly by half, the oil-to-gold ratio climbed from 5.8 to 10.15, signaling the approach of recessionary conditions. For investors, this may also forecast a continued rise in the price of gold because a flagging economy usually pushes up the demand for gold.

Indeed, Morningstar Inc. predicted in early October that gold prices could reach $1,250 an ounce within a year. Citing gold's decoupling from oil prices, Morningstar asserted "bullion has significant room for further appreciation on its own as an asset class in times of financial crisis." Still, Morningstar recommended using gold only as a hedge against inflation and keeping "a small portion" of a portfolio in gold.

If you'd like to review the possible role of gold in your portfolio, please give us a call. ●

Financial Planning Basics

(Continued from page 1)

Tax planning. Hidden within hundreds of pages of tax laws are a broad range of special breaks for taxpayers. Shifting income from one year to another, selling assets that have lost money to balance out gains from top performers, and making contributions to educational savings accounts are just three possibilities. Review your tax situation with a financial professional at the beginning of the year and again in December.

Insurance. Planning for the unexpected is the key when determining insurance needs. You should have enough life insurance to meet heirs' long-term needs. Your health insurance should include coverage of catastrophic accidents or illnesses. Disability insurance is relatively inexpensive, but could make a big difference if you need it. And you should seriously consider long-term care insurance if you don't think your retirement income will be sufficient to pay for nursing home care.

Estate planning. Having the right estate plan will ensure that your wishes are respected. If you have substantial assets, developing a well-thought-out estate plan can minimize taxes even while you are alive and maximize the amount you are able to leave to loved ones and your favorite charities. Even if you don't have enough in your estate to be liable for federal or state estate taxes, having a valid will can save your heirs a lot of trouble and money.

In the dying days of the 20th century, there was talk about how the old financial rules no longer applied. "It's different this time," everyone said. But it wasn't all that different, and millions of investors lost ground and time on the road to their financial goals. It's never fun to start over, but it does give you one more chance to do everything right. Taking care of these basics should prepare you well, and we are happy to help. ●

***The Rule of 72 is hypothetical and there can be no assurance that any investment will double within the specified timeframe.**

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