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Independent Wealth Management Solutions™

THE KELEMEN, WAY & SHEPPARD
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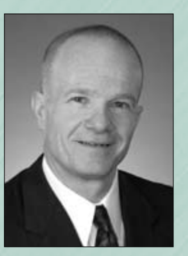

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# Do Life Cycle Funds Miss Their Target?

For a growing number of people, the lure of life cycle funds and/or target funds is just too hard to resist. The number and sheer asset size of these funds are growing as more people use them for retirement and education investing. According to Morningstar, there are 1,236 life cycle funds with about $205 billion in assets under management. **Their attraction is their simplicity: put your money into a fund based on when you'll need it our how risk adverse you think you are and forget about it. The mutual fund company supposedly does the rest.**

Life cycle or target funds are like a "fund of funds" of six to 12 offerings from the same fund family. Each fund is composed of a portfolio of different funds, chosen and allocated as a group to attain different mixes of equities, bonds, and cash. In the case of target funds, the mix is determined by the investors' target retirement year. As time goes by, the mix of the fund shifts, decreasing the exposure to stocks and increasing the weightings of bonds and cash. For life cycle funds, the mix is determined by your risk tolerance.

We recommend them in limited circumstances, especially where the account size is small or there aren't a lot of other options. This usually is the case for 529 college savings plans and some employer-sponsored 401-k plans. We recommend target-date funds for 529 college savings plans because of their narrow goal: usually four years of college, in contrast to a lifetime of retirement fund income. That's a lot longer time horizon.

But they have their problems and limitations.

## Too-Narrowly Constructed

A white paper released in 2007 by JP Morgan Chase & CO, says that target date funds may miss their mark because they are too narrowly constructed and make incorrect assumptions about participant behavior. The managers of target date funds may not be accounting properly for participant withdrawals, inadequate contributions and account loans. In other words, too much "one-size-fits-all." It also claims that the asset mixes are too heavily weighted in favor of equities.

## The Wrong allocation?

Yet other observers (including us) question the heavy bond allocations of many of these funds, especially at and during retirement. Many of them have a "circle the wagons" mentality, not recognizing that retirement can be a 30-year proposition. It may benefit the employer (for liability purposes) to have retiring employees invested in very low risk choices, but it doesn't necessarily benefit the retiree facing a need for lifetime income. The average life expectancy for a 65-year old is another 20 years. Of a couple reaching age 65 together, there is a 50% chance that one of them could live to age 90 or higher. Bonds just don't cut it over that length of time, especially when inflation is factored in.

## Not Enough Diversification

We have helped clients with the allocation of their employer-sponsored retirement plans. It has been our experience that many of these plans and the target funds within them lack the variety of other important asset classes, such as commodities, real estate, emerging markets, small and mid cap companies, and certain kinds of bonds. And they generally don't provide clear choices between growth and value styles among the equity funds. They are just too plain vanilla in a world where other flavors are also important. And even if a fund family has a number of offerings to round out a modern portfolio, the odds are very low that the sponsoring mutual fund family will be the best manager for each asset class.

**Continued on page 2.**

# 2008 Brings Tax Problems—and Opportunities

This year promises to be a good-news, bad-news year for tax payers.

### First the good news.

- **0% Tax on Capital Gains and Qualifying Dividends.** Yes, you read the heading correctly. All you need to do is reduce your <u>taxable</u> income so that you are in the 10% or 15% tax bracket.

| 2008 15% TAX BRACKET THRESHOLDS | |
|---|---|
| Filing status | 15% Bracket |
| Married, filing jointly & qualifying widow(er)s | <$65,100 |
| Single & married filing separately | <$32,550 |
| Head of household | <$43,650 |

- For many of our readers that may be a problem, but there may be some opportunities, particularly if you are close to that number, are working a partial year, plan to make a large charitable contribution, or have a business and the ability to time your income. We'd be happy to explore the possibilities with you and your tax professional.
- **Alternative Minimum Tax (AMT).** In the waning hours of Congress, AMT relief was extended to cover 2007, but <u>not</u> 2008. We don't know what the 2008 exemption amounts will be, but for 2007 they were $66,250 for those filing married or as surviving spouse, and $44,350 for those single or head of household. Worse, you will need to wait for the IRS to change its software and print new forms. Blame Congress—not the IRS.
- **Income Taxes.** The other tidbit of good news is that this year it takes over $357,700 of taxable income to be in the top 35% Federal bracket. (If you can fog a mirror, you are in the top 9% bracket for the State of Oregon.)
- **Qualifying Long-Term Care Premiums.** The amount that can be deducted as a medical expense has been increased. The amounts vary by age. For those 51-60 the amount is $1,150; for those 61-70, the amount is now $3,080.

### Bad News--Expiring Tax Breaks:

- **The sales tax deduction, tuition deduction,** and the **direct donation to charity** from the IRAs of those over age 70 ½ were not renewed.
- **The "Kiddie Tax"** is expanded to include all children under age 19 and full-time students under age 23. This means that any unearned investment income over 1,800 will be taxed at the same rate as the child's parents.
- **No AMT relief** (yet) for 2008.

When you meet with your tax professional this year to review your 2007 taxes, be sure to start thinking strategy for your 2008 taxes. As always, we are pleased to cooperate with your tax professional and to offer general suggestions from our perspective.

We all know that Ron collects elephants. Is this A) The latest in head attire for bald guys? B) A blessing in a South Indian Temple? C) Ron's joining the circus? Or D) This elephant collects Ron's? *See the Team Update on page 4 for the correct answer.*

## Do Life Cycle Funds Miss Their Target? . . . continued from page 1

### Rigidity

Many of them march on to their own beat, oblivious to what is going on in the real world. They can force you to buy, hold, or sell at the wrong time (and without taking tax issues into account, either.) Take bonds, for example. They were one of the worst performing asset classes in the late 1990s. You would have completely missed out on the booming equity market then. Or, conversely, if you were younger in the early 2000's, your target fund could have forced a larger portion of equities when bonds were booming. If your target date was 2007, you would have missed out on the booming equity market for the past five years and participated big time in a tough bond market in 2005 and 2006.

**The point here is that investing is dynamic. While it is good to have a core asset allocation, it needs to be tweaked and adjusted as the environment changes. And any portfolio clearly needs to take your own situation into consideration, such as spending needs, other resources, and contributions.**

### Fees

Fees can also be a problem. It might be better to use an asset allocation fund (which is basically one unified but highly diversified portfolio) than to have a fund-of-funds with an extra layer of fees.

### Performance

Finally, there is the issue of performance. We conducted our own internal study, comparing target and life cycle funds against other similar portfolios—including our own. For the most part, the target and life cycle funds were not competitive, due mostly to the "plain vanilla" choices, their static nature, and handicap of using only the in-house proprietary managers.

### The Bottom Line

For the investor that doesn't have enough in an account to properly construct a portfolio, who doesn't have a lot of choices, or who doesn't have the time, desire, or resources to manage the account, target date funds and life cycle funds can be a reasonable alternative. And they are certainly better than investing the entire account in a single asset class or fund. They can make sense for a 529 college savings plan because, unlike retirement, the costs and duration of expenses are fairly predictable. **If you must use one, we recommend that you consider your risk tolerance and time horizon, then select a life cycle or asset allocation fund over a target date fund. And if you decide to use a target date fund, pay attention to its allocation in light of your goals and the financial markets. Then be prepared to make changes if necessary.**

# New Retirement Planning Numbers For 2008

Happy New Year! You can now save even more for retirement and get an increased income tax deduction for doing so. So, now is the time to start taking advantage of COLAs for retirement plan contributions. And if you are already retired, the IRS has good and bad news for you, too.

There are a few changes in the retirement plan area, and most of them are small. I'll address the ones that are most applicable and of interest to our readers.

**2008 PENSION PLAN LIMITS** *(Changes highlighted in bold)*

| | 2007 | 2008 |
|---|---|---|
| Maximum annual benefit under a defined-benefit plan | $180,000 | **$185,000** |
| Maximum annual contribution for defined-contribution plans (i.e. 401-k, profit sharing, SEP IRA, etc.) | $45,000 | **$46,000** |
| Annual compensation limit used for determining retirement plan contributions | $225,000 | **$230,000** |
| Maximum annual contribution to 401(k), 403(b), and 457 plans | $15,500 | $15,500 |
| Catch-up contribution for those age 50 and over | $5,000 | $5,000 |
| Maximum annual SIMPLE employee deferral | $10,500 | $10,500 |

So, if you are 50 or older, you could potentially sock away up to $51,000 in a defined-contribution type of plan. Now is the time to talk to your payroll administrator to start setting your 2008 amounts aside on a monthly basis. That extra $1,000 per year may not seem like much, but over the next 10 years at an assumed 7.5% growth rate, it turns into $14,147. Over the next 20, it grows to $43,304.

And given the changes in the financial markets in 2007, this would also be a good time to re-balance the allocations of your asset classes.

**2008 IRA CHANGES** *(Changes highlighted in bold)*

| | 2007 | 2008 |
|---|---|---|
| Maximum annual IRA contribution (Roth & regular) | $4,000 | **$5,000** |
| Catch-up IRA contribution for those 50 and over | $1,000 | $1,000 |
| Income limit for full deductibility of single taxpayers | $52,000 | **$53,000** |
| Income limit for full deductibility of married couples | $156,000 | **$159,000** |
| AGI limitation for maximum Roth IRA contribution (singles) | $99,000 | **$101,000** |
| AGI Limitation for maximum Roth IRA contribution (couples) | $156,000 | **$159,000** |

The limitation for Roth conversions is not adjusted for inflation and remains at $100,000. However, that limitation is lifted in 2010. **Therefore, if you can afford it, make an IRA contribution, whether it is deductible or not—especially if it is non-deductible.** Your Roth can be a source of tax-free income in later years.

**Continued on page 4.**

## The Results Are In!

Thanks to all of you who completed our client survey during October and November. We had a 62% response rate, which is off the charts for any survey in any industry.

The survey, conducted by Business Health PTY, LTD, measured client satisfaction in nine key performance indicators (KPI's). We were compared against a large number of similar firms nationwide that also used Business Health to conduct a survey. In all nine KPI's, we scored well above the benchmark and placed in the top quartile. **Based on their scoring system, we scored a perfect 36 out of 36. We are particularly pleased that our highest scores were for professionalism and support staff.** And a whopping 95% of you said you would be willing to refer us to others, which many of you have already done.

The many positive comments were gratifying to read. However we especially appreciated the constructive suggestions and other comments. We will focus on those areas in the coming months. Meanwhile, why wait for our next survey? We truly value your feedback at any time!

## The Team Advantage

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants. Together with Alex Sheppard they jointly serve their clients as a team with over 37 years of combined experience. They are all members of The National Association of Financial Advisors (NAPFA), and as such work on a fee only basis and do not accept any third party compensation or finders fees. Their practice focuses on wealth planning and management for professionals, business owners, and retirees. They are advisory associates of The H Group, Inc., one of the largest independent fee-only registered investment advisory firms in the Northwest with 18 professionals and over $500 million under active management.

### About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP®** is a contributing author of three financial planning reference books. *Medical Economics* listed him as one of the 150 best financial advisors for doctors. He is President-Elect of Salem Rotary, active in mentoring and in several local charities, and is frequently quoted in the national press and professional journals.

### About Mary Way, CPA, CFP®

**Mary Way, CPA, CFP®** celebrated her 13th anniversary as a member of the practice. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She sits on the Investment Policy Committee of The H Group, Inc. and is Secretary of the board of the Willamette Valley Estate Planning Council. She is active in Salem Rotary and the Financial Planning Section of the Oregon Society of CPAs.

### About Alex Sheppard, MBA

**Alex Sheppard, MBA** joined the practice in March 2005, and has passed his CFP® comprehensive exam. He has a variety of experience in financial services, including four years as an analyst with a major mutual fund company. He is active in the Salem Area Chamber of Commerce and serves on the board of South Salem Rotary and the Willamette Chapter of The American Red Cross.

## TEAM UPDATE

As we reviewed the year at our year-end team retreat in December, we realized just how great a year it really turned out to be. It was a year of stability and building upon the foundation we laid in 2006 when we converted to a fee-only practice.

**Lani** was busy with all of our year-end communications and organizing. She and Jim spent a week of November helping daughter Holly's family fix up and move into their home in Yreka, California. In early December they gathered the entire family, (including 9 grandchildren under the age of 5) to welcome son Eli back from a two-year church mission.

**Debbie** spent much of the past two months with the paperwork involved in moving accounts to Fidelity, our new preferred custodian. As empty nesters, she and Bob spent quiet holidays with friends and relatives in Oregon and Washington.

**Alex** was very involved helping to put on "Education Day" for the Chamber of Commerce's Leadership Salem program. He and wife Virginia spent the Christmas and New Year holidays with Virginia's family in Caracas, Venezuela. At least they got some sun and warm weather!

**Mary** took courses in estate planning. She and Steve enjoyed their first Christmas in their new Silverton home surrounded by new friends in the community. They made an overnight getaway to Skamania Lodge on the Columbia River just before Christmas. But all of this was overshadowed by the loss of their beloved German Shepherd, Lucy, who had to be put down at age 13 ½. Since we are all "dog people" in this office, it has been hard on us too.

**Ron** conducted a two-hour course for the Salem Area Chamber of Commerce on business planning. He and Kathy spent three weeks in November independently touring southern India for their 30th wedding anniversary. It came close to being the trip of a lifetime, but it was so nice to return to the good old US of A! Daughter Skyler returned home safely from Kenya just before the rioting broke out. *(The correct answer to the photo on page 2 is **B** –Ron getting blessed by an elephant inside the largest Hindu temple in the world in Maduari India.)*

# Happy New Year!

The financial markets had some real ups and downs in 2007, but in the end it turned out to be an okay-to-good year for the vast majority of our clients. Who would have thought? Just like last year, we start 2008 off with plenty of reasons to be pessimistic. And like 2007 we will continue to evaluate the fundamentals and invest accordingly. We would much rather make investment decisions when people are cautious and pessimistic than during euphoric bubbles. We wish you all the best for a happy New Year, and we will do what we can to make it prosperous for you as well.

THE H GROUP, INC. Independent Wealth Management Solutions

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## New Retirement Planning Numbers For 2008. . . continued from page 3

### Social Security and Medicare

If you're still working, the bad news is that you must now pay taxes of 6.2% on the $102,000 of income, up from $97,500. Self-employed and employers pay another 6.2%. There is no limit on the 1.45% Medicare taxes. But if you're on the receiving end the maximum monthly Social Security benefit is now $2,185, up from $2,116.

**Thinking of part-time work and taking Social Security? Think twice!** If you are under full retirement age of 66, you will give up $1 in benefits for every $2 in earnings over $13,560 per year. During the year you reach full retirement age you will lose $1 for every $3 above the limit of $36,120. This applies only to earnings for the months prior to attaining full retirement age. And remember, you will take a big hit by starting benefits before age 66.

Medicare premiums have increased, pretty much wiping out the increase in Social Security benefits. And as a result of the Medicare Modernization Act, high-income Medicare recipients started paying higher Part B premiums in 2007. These income levels are adjusted for inflation. Premiums range from $96.40 for couples with a Modified Adjusted Gross Income of $164,000 or less all the way to $238.40 for those couples with a MAGI of more than $410,000. A detailed table can be found at the Centers for Medicare and Medicaid Services website at http://www.cms.hhs.gov.

**What's ahead?** Short of winning the lottery or receiving an inheritance, all that will be there at retirement is what you send on ahead in the form of investments and what the working generation sends in the form of Social Security and Medicare taxes. Given current demographics and budget deficits, it just makes sense to send even more ahead in 2008.

### *Thought for the month*

What one thing will really make 2008 a very good year for you?