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The "Urban Legends" of Financial Planning

We've all heard them. The story about the little dog exploded in the microwave by a well-intentioned, but stupid owner. The $5,000 IRS tax credit for descendents of slaves. Coke and aspirin taken together produce a high. The terrorist plot to blow up suburban shopping malls on Halloween.

Every profession has its share of urban legends. Financial planning has its share, but unfortunately they aren't elevated to the status of legend yet. Urban legends make for good story telling and media articles. They often have a basis in fact, but it's their staying power or propagating power that makes them so intriguing-and so misleading. Someday, we're going to write a book about the ones in our profession, but for starters, here are five "urban legends" of financial planning. They all have a truth to them, but they become legends when they turn into universal maxims applicable to everyone.

1. Retirees need a lot of liquidity

They don't, especially when compared to working parents with a big mortgage, an insecure job, the potential loss of their health insurance or the financial risk of becoming disabled. Most retirees simply don't have those risks because they have Social Security, Medicare, and often a paid off home, secure pension, and no job to lose. They do have other risks, especially of outliving their assets, which we'll write about in the future.

Nevertheless, many retirees have a tendency as they near retirement to "circle the wagons" by wanting to put most everything into cash or short-term investments. Our answer to that is, "Are you going to die tomorrow?" According to the new IRS tables, a couple age 65 has a joint life expectancy of another 26 years, which means that someone from that relationship may live much longer than that.

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Are Higher Interest Rates A Danger To The Financial Markets?

We've received a number of questions from clients about the prospect of higher interest rates. And with Federal Reserve Chairman Alan Greenspan's hints about an increase on June 28 when the Federal Reserve Board meets, the prospects of a 0.25% rate increase or higher are likely.

We don't see this as bad news, or the end of the low interest rate era. In the long run, an increase in short-term rates may help the financial markets by keeping the economy from overheating and inflation starting back. Already, inflation is at a 1.8% annual rate, up from 1.1% in December, according to Ed Harris, Chief Economist of Lehman Brothers. (He obviously hasn't been to a gas pump in Oregon lately!)

The Fed can only control short-term interest rates. The prices of long-term bonds and mortgages (and ultimately their interest rates) are based upon supply and demand. Since long-term bond traders and mortgage lenders fear inflation more than anything else, they demand higher interest rates (and thus pay less for a bond) when they perceive inflation to be high. They are much less likely to be spooked about inflation when they see the Fed taking positive steps to control prices.

Higher interest rates compete against stocks, but generally are not a significant factor at this point because they are still generally lower than the dividend or expected earnings growth of many larger companies. Value stocks usually do better in this

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Leaving a Legacy With IRAs And Other Retirement Plans

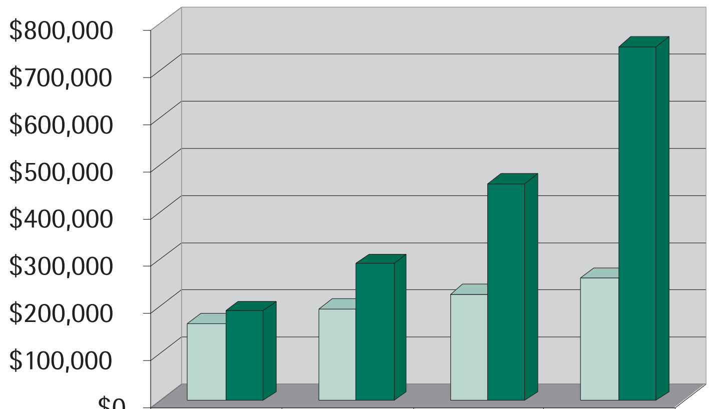
Most people realize how efficient IRAs and other tax-deductible retirement plans are for saving taxes and accumulating money for retirement. Unfortunately, this money is fully taxable as ordinary income when it is withdrawn because it has never been taxed before.

But what most people do not realize is just how unique these plans can be as an inheritance for your heirs and/or for your favorite charities. One of the things that makes then unique is that they pass by way of a beneficiary designation. This makes them easy to change. It also means that your will or living trust has no control over them, unless your estate or living trust is a named beneficiary.

The other unique thing is that your spouse can receive the retirement plan assets through a tax-free rollover until funds are withdrawn. Your heirs, however, must pay income taxes on what they receive from an inherited retirement plan. This could be very huge tax bill, putting your heirs in a much higher tax bracket than normal. That's the bad news.

The good news is that the law permits your heirs to stretch an inherited retirement plan over his or her life expectancy. Taxes are paid only on the amount withdrawn each year. The balance continues to grow tax deferred. A 35 year old, for example would only have to withdraw 1/47.5 of the account value the year after your death. The end result is that your beneficiaries receive far more over their lifetimes than they would have if they had taken a lump sum, paid the taxes, and invested it in a taxable environment. The table below shows the hypothetical results on a $100,000 IRA inheritance at different ages. The results would be substantially better with a stretch-out Roth IRA.

Total After-Tax Distributions on $100,000 IRA to Beneficiaries of Different Ages



	Age 55 28.7 LE	Age 45 37.9 LE	Age 35 47.5 LE	Age 25 57.2 LE
Lump Sum	$162,928	$194,334	$227,094	$260,195
Stretch Out	$190,928	$290,231	$461,223	$753,003

Life expectancy is based on the IRS 2002 tables, however the beneficiary could live longer or less than that. The Lump Sum assumes an ordinary income tax rate of 35 % in the first year, leaving $65,000 of principal earning a hypothetical 7% gross return, reduced by a 25% tax rate (assuming a mixture of ordinary income and capital gains). The after-tax starting principal amount is distributed at life expectancy. The Stretch-Out assumes an annual tax rate of 30% ordinary income in all years until life expectancy. Estate taxes are not taken into consideration, nor are inflation and changes in tax brackets.

This strategy works well if your heirs agree to follow your intentions. All too often, however, the new car salesman, the vacation home realtor, the electronics store, immediate family members or distant relatives can be very persuasive in persuading your heirs to spend their inheritance now, instead of stretching it out.

If you think that may happen, and you would also like to leave a charitable legacy to one or more organizations that have made a difference in your life, you may want to name one or more charities as partial or full beneficiaries of your retirement plan. **These retirement plan proceeds are the perfect assets for charitable bequests because the charity can receive the proceeds tax-free.** This frees you to give other assets to your heirs (perhaps with strings attached), which most likely would not be taxed as heavily as the retirement plan. Also what you give to charity reduces the size of your estate, and your potential estate taxes.

This is just a very brief overview of the planning opportunities, and there are more details you need to know to make these strategies work. We would welcome the opportunity to discuss them with you in more detail, including the concept of naming your own family foundation or donor-advised fund as the charity.

Estate and Gift Tax Correction

Last issue we provided an update on important financial planning numbers for 2004. In an effort to fit space requirements we implied that both the estate and gift tax exemptions for 2004 were both $1.5 million. However, they are **not** the same. Even as the estate tax exemption increases, the gift tax remains at $1 million. Both amounts return to $1 million in 2011 if the sunset provisions of the 2001 law are not repealed. **Meanwhile, without proper planning, Oregon residents dying in 2004 with estates over $850,000 may be subject to $64,400 in Oregon estate taxes.** We encourage you to update your estate plans accordingly!

The "Urban Legends" of Financial Planning . . . continued from page 1

2. One should keep six months of income in liquid reserves

This is similar to the legend above. It all depends upon your circumstances. If you have an insecure job and little other assets or fringe benefits, it may apply. However, if you have good disability insurance, a line of credit, accounts receivable, a secure practice or business, some semi liquid investments, and a reasonable debt load, that guideline probably isn't for you. After inflation and taxes in this low interest rate environment, you're going broke safely. Put your money to work.

3. The Percentage of equities in one's portfolio should be 100 minus your age

We know of very few 50 year-olds with a 50/50 mix of equities and fixed income, and 60 year-olds with a 40/60 blend. Having run thousands of simulations many different ways, we can say that portfolios with a higher percentage of equities generally have a higher probability of lasting longer than one's life expectancy. In many cases, bonds are more volatile than a broadly diversified stock portfolio or index. If you adjusted your portfolio over the past three years to more bonds, you would have been selling equities at a loss and buying bonds high.

4. Index funds are the only way to go

Sometimes they are, sometimes they are not. But you should get very nervous when any single investment strategy is touted as a panacea. When Ron got into this business 23 years ago, even **average** equity funds out performed the broad market indexes. This trend changed in the mid 1990s, when the large companies such as Microsoft, Cisco, GE, Intel, etc. that dominated the broad market indexes and their weightings were also stellar performers. Most actively managed funds didn't perform as well as index funds. But they also didn't load up on the high flyers that later on had the flight path of a rock in the ensuing bear market.

Over the past three to five years, many actively managed funds are actually doing better than similar index mutual funds, even within that large fund family that is well know for indexed funds. But the indexing drumbeat continues. Some of the allure is the simplicity of index funds, some of it is the publicity and enthusiasm of indexing advocates, and a good part of it is the allure of cost savings. **When all else is equal, by all means, pick the lower cost alternative. But in the end, it is the net result after costs that really matter.**

Things are not always equal. Some asset classes, such as large companies, lend themselves quite well to an indexed approach. Others, such as high yield bonds, international, and small companies, tend to do better where an active hands-on manager can make a huge difference. Asset classes regularly rotate in and out of favor. **With a passive "put in an index fund and forget about it" approach, you may keep up with a certain index. But you may also be exposing yourself to more risk and less upside than with a less dogmatic—but more flexible—approach.**

5. Your retirement income needs will be about 60% of your pre-retirement earnings

This was probably started by a financial writer or some academic who never had any actual experience counseling people into retirement, and certainly no experience as a retiree. Over our combined 32 years in practice we have yet to see a client immediately start spending 40% less than he or she did the day before retirement. If anything, the costs are actually higher, especially in the early years. How much you need varies from client to client, and we will address that in a future article.

These "urban legends" are dangerous because they are often stated as absolutes. People take them too seriously. In reality, every person and situation is different. If you have a question about some broad generalizations, please talk to us about them. Perhaps we can add yours to our growing collection of so-called myths. And remember, there is no substitute for financial advice customized to your unique situation.

THE KELEMEN-WAY ADVANTAGE

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants and jointly serve their clients as a team with 32 years of combined experience. Their fee-based practice focuses on wealth planning and management for professionals, business owners, and retirees. Together, they have developed *The Planning Vision Process®* and several other unique processes. They are both advisory associates of The H Group, Inc., one of the largest independent fee-based registered investment advisory firms in the Northwest with 18 professionals and over $300 million under active management. They are also registered with Financial Network Investment Corporation, (unaffiliated with the H Group, Inc.) a national broker-dealer with offices throughout the United States, Member SIPC.

About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP®**, is a contributing author of the definitive book on retirement planning: *Ways and Means: Practical Answers from America's Foremost Financial Advisors and Retirement Planning Attorneys.* His other contributory book, *Strictly Business—Planning Strategies for Privately Owned Businesses*, is now available from Ron or Quantum Press. He is Vice President of the Willamette Valley Estate Planning Council, active in mentoring and in several local charities, and is frequently quoted in national the press.

About Mary Way, CFP®, CPA

Mary Way, CFP®, CPA is a professional team member on Ron's team for over nine years. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She is active in Salem Rotary, the Financial Planning Section of the Oregon Society of CPAs, The Oregon Financial Planning Association, and The Willamette Valley Estate Planning Council.

Team Update

Even though we don't prepare tax returns, tax season is always a busy time for us. Clients fund their retirement plans and accountants request additional information. We also spent some time getting used to our new computer upgrades with additional servers and security, and spent a significant amount of time preparing for newly mandated compliance procedures. You may soon see this in the form of additional disclosures and paperwork.

Lani Moore is busier than ever with grandchildren and attending her son Caleb's Sprague High School award winning choir concerts. With a couple of landscaping courses under her belt she has been busy after hours with spring gardening.

Debbie Renggli and husband Bob drove down to San Francisco to take daughter Gretchen home for the summer. After mother-daughter visits to Portland and Seattle, she has decided to transfer to the University of Portland. But the big news is their cute new puppy, Lulu, a cavalier spaniel, who just graduated from obedience school and is the center of the Renggli household.

Mary and husband Steve spent a week in Kauai, Hawaii in late April, followed by a long Memorial Day weekend in Newport. Her stepson, Stephen graduated from West Salem High and will attend Linn Benton Community College. But the highlight of the past quarter has been her three-day mini medical internship, sponsored by the local medical society. She job shadowed six doctors from a variety of specialties and gained valuable perspectives that will help us better serve our many doctor clients. We are all proud of her for not fainting at the sight of blood.

Ron's broken ankle has healed fairly well, and he hopes to resume running by August. He helped organize the Estate Planning Council speakers for the Leave A Legacy's public forum and made a presentation on estate planning with IRAs. He attended his usual Strategic Coach session in Chicago and a securities compliance meeting in Los Angeles. Ron was also quoted in the *Sunday Wall Street Journal* twice, *Financial Advisor, Morningstar Advisor,* and *Scopes* (a magazine for doctors in Washington State). He chaperoned a group of high school students on a four-day raft trip on the Deschutes River in June. Daughter Skyler graduated and will attend Boston University in the Honors Program with her older sister, Shanti.

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kind of environment. Looking over market returns and interest rates over the past 20 years, it is obvious that we have had many up markets during either rising and/or higher interest rates at the same time. Many market commentators think that the stock market already discounted the potential Fed rate increase into the price of stocks in April.

Beyond interest rates, oil prices are a concern, because they can be a drag on the economy-which might help keep interest rates low. Oil as a percentage of our GDP is less than it was 20 years ago because so much of our economy is now service based. However, it is still a significant cost of the transportation industry. **No single investment is ideal for all of the possible things that can happen. That's why a carefully diversified portfolio is so important in a changing world.**

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The Kelemen-Way Financial Perspective

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New Portfolio Asset Classes Introduced

For the past year, we have spent considerable time researching ways to diversify our clients' holdings with the goal of reducing long-term volatility. We are pleased to announce that for our fee-based asset management accounts through the H Group, Inc., we can now add three more permanent asset classes to individual client portfolios. These asset classes include a small portion of real estate, foreign bonds, and a fund that tries to replicate a broad commodity index. We would over-weight and under-weight these just as we do with the other asset classes.

These three asset classes have very little correlation with the stock and bond markets often "zigging" when the traditional financial markets are "zagging." Short-term volatility is slightly increased, but there is less volatility three years and beyond.

Although there has been considerable research published about this diversification strategy in the professional journals during the past year or so, we may be among the earlier firms in the country to actually make it available to our clients. This strategy may not be for everybody, but it appears to work better for equity-leaning portfolios with longer time horizons. If you are interested in adding these asset classes to your portfolio, we would welcome the opportunity to discuss it further with you.