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THE KELEMEN-WAY FINANCIAL PERSPECTIVE

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Can We Save Social Security?

This marks the start of the 14th year of this newsletter. Initially they were monthly, then bimonthly, and now quarterly. So that's a lot of newsletters, and even more articles. And throughout all of them, we have made a conscious effort to stick to financial planning matters important to our clients and stay away from politics. Unfortunately, Social Security has become politicized, so no matter what we say, you may interpret it as political or partisan. But with so many clients wanting our honest opinions about the reform proposals, here are our thoughts, distilled from a thick stack of articles and research papers we have accumulated in recent months.

Before we get into our answers about President Bush's privatization proposal, please understand that we are predisposed to an "ownership" economic system where citizens own things, are held accountable for their choices, and can enjoy the results of their efforts. After all, a good part of our job is helping clients own pieces of businesses via stocks and other investments.

Having said that, we believe that private accounts are not by themselves going to save Social Security, nor are they going to be that attractive an alternative for the following reasons.

Reason #1: Simple math, investment history, and the underlying assumptions of the privatization proposal. The 2004 Economic Report of the President and the Social Security actuaries assume that stocks (not a prudent mix of stocks and bonds) will earn 6.5% after inflation for the next 75 years.

That's not too unreasonable over the next few years if our economy continues at its current rate, but 75 years is a long time. In the long run, profits grow at the same rate as the economy. Our economy has only averaged a 3.4% growth rate over the past 75 years. So for stock prices to grow by at least 6.5% per year net of inflation, stocks would have to grow much faster than our economy.

Historically the Price Earnings ratio (PE) of stocks over the past 75 years has averaged about 14. According to Dean Baker, at the Center for Economic and Policy Research, **to meet the privatization assumptions, the PE would need to go from about 22 today to 70 by 2050, and more than 100 by 2060! In other words, stocks would be priced like they were at the height of the 1999 technology stock craze.**

But if stocks were doing so well because the economy was doing so well, the U.S. Treasury would be flush from the revenues from payroll and other taxes. Thus, Social Security wouldn't have a crisis. In short, the assumptions that make privatization look good would also make Social Security solvent.

Reason #2: The rewards aren't worth the risk. All of the illustrations we have seen in various publications show only a very modest increase in monthly income if market conditions are favorable. In our years of modeling retirement forecasts for clients, the projections that looked the most solid had a steady source of predictable income that did not change with market conditions. These took the form of pensions, annuity payments, and Social Security. Growth potential is nice in retirement, but at least some guaranteed income is prudent.

Reason #3: Many workers don't make good investment decisions. If they did, we would be out of a job. We have seen too many well-intentioned or just plain stupid mistakes people have made with their 401-k plans. This just isn't anecdotal. The December 1, 2004 *Wall Street Journal* quotes research documenting the performance advantage of professionally managed pension plans compared to self-directed accounts.

Continued on page 4

Financial Planning Numbers for 2005

Between inflation adjustments and phase-ins from previous tax law changes and two new tax law changes in 2004, we start 2005 off with changes in tax rates, thresholds, and retirement plan contribution amounts. So here are some handy references on some of the more significant changes to assist you with your financial planning during 2005.

Income Taxes

Your tax bracket is important because it determines the relative value of one investment over another and the timing of when to liquidate an investment or take a withdrawal from a retirement plan. Interest income, bond interest, and dividends from real estate investment trusts are taxed at your tax bracket rate.

The standard deduction for all filers will rise slightly to $5,000 for singles and $10,000 for couples. Two very important parts of figuring your taxable income are the itemization of your deductions (such as property taxes, contributions, and mortgage interest) and your personal exemptions (now $3,200). The Alternative minimum tax (AMT) was slightly modified in 2004, but the exemption remains unchanged in 2005: $58,000 (joint) and $40,250 (single). These calculations are best left to your tax professional.

TAX ON SOCIAL SECURITY BENEFITS		
Joint Combined Income	Single Combined Income	Amount of benefits subject to tax
$32,000-$44,000	$25,000-$34,000	50%
Over $44,000	Over $34,000	85%

Source: www.socialsecurity.gov

Social Security and Medicare Tax

Your first $90,000 (up from $87,900) of employment income is subject to FICA at the rate of 7.65%, paid by you and 7.65% by your employer (which could also be you if you are self-employed). There is no wage limit for Medicare; so all employment income above $90,000 is taxed at 1.45%.

Social Security Benefits

Taxes on Social Security benefits remain unchanged. They are taxed based on your "combined income," which is your AGI plus tax-free bond interest, plus ½ of your Social Security Benefits.

After a 2.7% cost-of-living adjustment, the maximum benefit is $1,939 per month at normal retirement age. (By the way, for each recipient, it takes 3 workers earning $50,000 per year to pay for this benefit.) If you were born in 1939, normal age is 65 and 4 months. If you were born in 1940 it is 65 years and 6 months.

2005 MARGINAL INCOME TAX RATES		
Single	Married	Marginal Federal
Taxable Income Over:		Tax Rate*
$0	$0	10%
$7,300	$14,600	15%
$29,700	$59,400	25%
$71,950	$119,950	28%
$150,150	$182,800	33%
$326,450	$326,450	35%

Source: Internal Revenue Service

* If you can fog a mirror, your Oregon bracket is 9%.

Investments

Just like last year, capital gains on most assets held over one year are taxed at 15% (plus 9% for Oregon). It's only 5% for those in the 10% and 15% brackets. Dividends are taxed at 15%, instead of at ordinary rates. Dividends from retained earnings from your closely-held businesses may also be treated more favorably, but be sure to work closely with your tax professional on this.

Estate Taxes

If you die in 2005, you can leave $1.5 million gift tax-free at death. However, if the sunset provisions on the 2001 law are not repealed, and you die in 2011 or later, the exemption at death falls back to $1 million per person. Given our Federal budget deficit and the baby boomers entering retirement, we wouldn't count on the repeal. So plan your estate accordingly. If you want to make a tax-free gift or series of gifts while you are still alive, the cumulative amount is $1 million. Double that if you are married. You can still give $11,000 each year tax free to anyone; $22,000 for married couples. These are not included in the $1 million lifetime exclusion.

The "Kiddie" Tax

Between the standard deduction of $800 for a child who is claimed as a dependent, and the higher "Kiddie" tax exemption of $800, children under 14 can earn up to $1,600 without it being taxed at the parents' tax rate.

Retirement Plans

Many of the retirement plan contribution limits have been increased, most by $1,000.

RETIREMENT PLAN CONTRIBUTION LIMITS	
Max compensation base used to calculate contribution % to most retirement plans	$ 210,000
Max contribution to defined contribution plans (401(k), profit sharing, SEP IRA, etc.)*	$ 42,000
401(k), 403(b), 457(b) plans elective deferrals	$ 14,000
Catch-up provisions for those over 50 (over and above the $14,000)*	$ 4,000
SIMPLE IRA plans, elective deferral limit	$ 10,000
SIMPLE IRA plans, catch-up provisions for those over 50	$ 2,000
Fully Deductible IRA (if not covered by other retirement plans, or if so, joint Modified AGI is <$70,000; $50,000 single.)	$ 4,000
Roth IRA (if joint Modified AGI <$150,000; $95,000 single)	$ 4,000
Traditional & Roth IRA catch-up provisions for those over age 50	$ 500

Source: Internal Revenue Service

* This means that if you are over age 50, you could potentially put $18,000 into a tax-deductible retirement plan; and perhaps up to $46,000 with an employer profit sharing contribution!

Other Changes

Use these numbers for approximations and rough calculations, or in the case of retirement plan contribution limits, as a goal or budgeting number. Many other changes take place this year, but they are either smaller in nature, or may not necessarily apply to most readers of *The Kelemen-Way Financial Perspectives*. There is no substitute for good tax, legal, and financial planning advice, so we encourage you to seek it from a qualified professional.

10 Ways to Filter Financial Noise

(Some of you may remember this topic from an article Ron wrote four years ago. But based on today's investment environment and the types of questions we are receiving these days, it's time to update this topic and review some investment basics.)

In many ways, investing is harder today than it was over 24 years ago when Ron started the practice. **Back then the challenge was getting information and being able to act upon it.** It was expensive, slow, and always filtered through intermediaries. **Today the challenge is too much information and the ease of overreacting to it or becoming paralyzed by it.**

We are awash in financial information. In 1980, for example, *Money* magazine didn't even exist and neither did *The Kelemen-Way Perspective,* for that matter). Research on Google and Amazon now shows thousands of books, magazines, newspapers, and websites devoted to investing and financial planning.

In 1980 there were 564 mutual funds. Now, according to Morningstar's Principia, there are 17,500 funds, which include 350 exchange funds that didn't exist in 1980.

There were no Internet or financial TV shows in 1980, and there were very few cable stations. Now, CNBC alone hosts about 50 guests a day, virtually all of whom are asked for their hot stock tips. And many of the broader networks and news shows contain regular segments on investments and financial planning, as do our newspapers and general magazines. But at what point does all this information become just "financial noise?"

All of this overload and confusion out there can be divided into a spectrum:

So much of what is out there really falls into the data and information categories, kind of like the news. They may be timely, but they are not timeless. (Do you remember exactly what the Dow Jones index and the headlines were six months ago today?)

Data and information are noise. They crowd out knowledge. And knowledge without a sense of perspective and experience cannot become wisdom. With all the financial noise these days, it is challenging to develop adequate knowledge and convert that to wisdom-based action. That's where a good professional can help, whether it is in law, medicine, accounting, or financial planning. If I want medical data, information, or sensation, I can easily find it, even at the grocery check stand. But if I want knowledge and wisdom (and good hands-on attention), I definitely want an experienced doctor.

So, before you read that next financial magazine, surf the Web, or tune into that TV financial news show, spare yourself the overload and save some time by asking yourself the following questions from our financial noise filter.

The Financial Noise Filter

1. **Will this information be obsolete and forgotten within a few hours, days, or weeks?** If yes, go do something more productive.
2. **Does this apply to me?** If not, skip to the next article. (The hardest part about writing this news letter is selecting a topic that has the broadest appeal, so well be the first to admit that not everything we write is relevant to every reader.)
3. **Will this information give me peace of mind or increase my anxiety?** (Good news rarely sells; and disturbing people is a basic fundamental of advertising.)
4. **Can I do anything about it?** If not, don't worry about it.
5. **Will I do anything about it?** If no, then why waste your precious time and mental energy?
6. **How will this information get me closer to my financial goals?**
7. **Does the source know my circumstances and me?**
8. **What is the source and its interests in promoting the information** (more subscriptions, more viewers, more Internet hits, sales, higher ratings, etc.)?
9. **Does this source have hands-on experience "in the trenches" providing financial advice and managing money,** or is the source merely reporting about it?
10. **Is the source accountable if it is wrong?** Your licensed professional providing specific advice to you for a fee are held to a much higher standard than a stock analyst's report, an Internet chat room, TV talking head, or the author or publisher of any book or article!

Life these days is demanding enough. You already have enough medical noise, news noise, and advertising noise in your life as it is. Why not make this the year to turn on the financial noise as well with this noise filter? By the way, it works well with other "news noise" too.

THE KELEMEN-WAY ADVANTAGE

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants and jointly serve their clients as a team with over 33 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 $400 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 1998 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,* was published in 2002. His next one on retirement and education planning will be published in June 2005. He is President of the Willamette Valley Estate Planning Council, active in mentoring and in several local charities, and is frequently quoted in the national press.

About Mary Way, CFP®, CPA

Mary Way, CFP®, CPA is a professional team member on Ron's team for 10 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.

The opinions expressed in this newsletter are those of Ron Kelemen, CFP® and Mary Way, CFP®, CPA. They do not necessarily reflect those of The H Group, Inc. or Financial Network. They are general comments that may not be appropriate for every individual. They should not be construed as legal or tax advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. All economic information is historical and not indicative of future results.

Team Update

The first two months of 2005 blended in with a blur from wrapping up 2004, our busiest and best year ever. Annual reports, tax information, IRA minimum distributions, and portfolio modifications made the time fly. We also started the process of finding a new professional to help us with our workload, but our high standards make it difficult.

Lani Moore spent the first week of 2005 near Salt Lake City helping her youngest daughter April and her husband take care of their newborn son. (Grandchild #4, for those keeping score.) She also visited with her mother who was widowed in November.

Debbie Renggli and husband Bob attended son Pete's graduation from Embry Riddle Aeronautical University in Prescott AZ in December. He took them for a joy ride (Debbie wouldn't call it that!) in a helicopter to celebrate. He is now a helicopter pilot and flight instructor, so if you need some real heavy lifting done, contact Debbie.

Mary attended the two-day Financial Planning Association conference in Portland and an all-day conference in Eugene. She and Steve are looking forward to a vacation later in March to Jekyll Island, Georgia. Their beloved German Shepherd, Lucy, has responded extremely well to acupuncture—not that she likes it, but it helps her hip.

Ron also attended an all-day planning conference in Eugene, plus went to his 41st consecutive quarterly Strategic Coach session in Chicago, and is busy editing the manuscript of his next contributory book. **Kathy's** father, who Ron and Kathy took to Europe in September, died unexpectedly of a brain aneurysm one week before Christmas at the age of 84. They took her mom with them to Kona Hawaii with daughters Skyler and Feruza over the New Year holiday, while daughter Shanti participated in the World Collegiate Debate Tournament in Kuala Lumpur, Malaysia. Ron celebrated his 54th and his friend's 50th birthday without incident snowboarding in Utah—exactly one year to the day of breaking his ankle there last year. This time he was a little slower and much more cautious.

It's Here—Almost

Living and Learning: Achieve Retirement & Education Security is finally scheduled for publication in June. Edited by CPA and retirement plan expert Bob Keebler, Ron is one of over 50 contributing authors to this 500+ page reference book on retirement and education planning. The gestation period of an elephant is 18-22 months, and this has taken at least that long! We'll have more details for you in the months ahead.

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The Kelemen-Way Financial Perspective

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Based on our experience, we suspect that at the first market hiccup, people in privatized accounts will opt for mostly the bond portfolios—after the market has already gone down and bond prices have gone up.

Reason #4: The money diverted to private accounts may actually add to the future shortfall. The Center on Budget and Policy Priorities, a Washington think tank, estimates the borrowing costs to cover this shortfall would be $1.3 Trillion (with a capital T) over the next 10 years and $4.5 Trillion over 20 years if 2/3 of the eligible workers opt for private accounts. How can this be called "ownership"? **This borrowing will compete against the borrowing for defense, education, health care, tax cuts, student loan guarantees, homeland security, national parks, pork, and other federal spending.**

The Real Issue

This year Social Security will take in $150 billion more in payroll taxes than it pays out. Those taxes go to fund <u>other</u> federal programs, including interest on our budget deficit. They don't go into a special long term trust fund—it's a myth. At some point between 2018 and 2030, depending upon who you talk to, these extra payroll taxes will be less than Social Security benefits paid to retiring baby boomers. This off-book disguising of the deficit through excess payroll taxes is the type of behavior that created the corporate accounting scandals. **<u>If</u> we want to get serious about solving the problem of paying benefits in the future, we need to get serious about eliminating the federal spending deficit and retiring long-term debt, much of which is owned by other nations.**

We also need to make hard choices about Social Security and Medicare. Nearly all experts agree that only some combination of fixes, such as tax increases, delayed benefits, means testing and reduced benefits for future retirees can truly save the Social Security and Medicare systems. But these appear to be politically untouchable. As economist and *Newsweek* columnist Robert J. Samuelson says, "Americans prefer to be deceived rather than face the hard choices of doing something about budget deficits and funding Social Security."