The Kelemen & Way

FINANCIAL PERSPECTIVE

Creators of The Planning Vision Process®

Ron Kelemen, CFP®

Mary Way, CPA, CFP®

Feb. 2010 / Vol. 19, No. 1

CREATING CLARITY & CONFIDENCE IN A COMPLEX WORLD

Is the (Recent) Past Prologue?

Calendar years are so artificial and misleading. In 2009, for example, the stock market as represented by the S&P 500 (an index of the 500 largest companies) turned in a very respectable 27% return. But that doesn't tell the story of a first quarter decline of nearly 10% and a stunning 45% return since March 1. And it certainly doesn't tell the nerve-wracking story of the 42% plunge from September 2008 through February 2009.

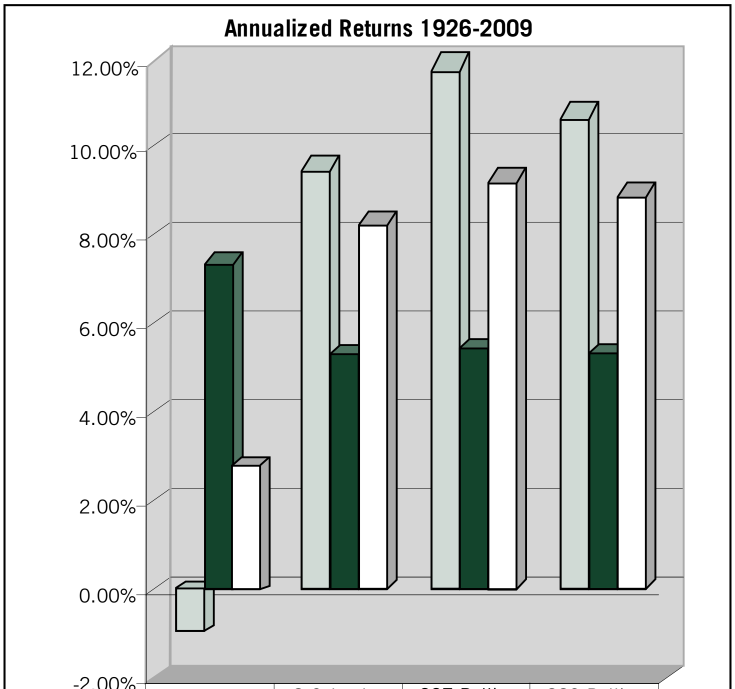
Decades can change the same way. From January 1, 2000 to December 31, 2009 the annualized return for stocks was -0.95%. Many pundits have been describing the 2000's as **"The Lost Decade."** But bonds had a total return of 7.30%--not exactly a lost decade for bond investors.

But looking at returns through the prism of "official" decades can lead you astray because it selects only eight arbitrary starting and ending dates. We thought it would be interesting to look at rolling averages for 12 month periods and 10 year periods. Using data from Ibbotson & Sinquefield going back to 1926, we started a new year every month, starting in 1927. This gave us 997 "years." And we started a new rolling decade every month starting in 1936, giving us 889 "decades."

As you can see by the chart, the results put the last year and the last decade into better perspective. They reinforce the idea that one shouldn't make all future assumptions based on the 2000's. (The 60/40 blend, by the way, helps illustrate the power of asset allocation, as other asset classes perform differently under different market conditions.)

So, for stocks at least, maybe the pundits were right about the 2000's being the lost decade. **But is that helpful? How will that help you set assumptions as you plan for your future? Should you really plan three decades of retirement around what just happened?** Looking at the calendar decades suggests that you shouldn't, any more than you should have made plans to live large off the huge stock returns from the 80's and 90's. And this simplistic approach doesn't account for the results one would have with different asset classes thrown into the mix, particularly now in this global economy.

Calendars are a wonderful tool to help us grasp the abstract concept of the future. So, use them to set goals and deadlines. But forget about using their artificial boundaries as a way of describing the past when making your planning assumptions. That's like trying to read the highway signs through the rear view mirror after you've already passed them. Hopefully you'll be retired for at least three decades, so plan for them accordingly!



	The 2000's	8 Calendar Decades	997 Rolling Years	889 Rolling Decades
Stocks	-0.95%	9.61%	11.96%	10.83%
Bonds	7.30%	5.46%	5.77%	5.47%
60/40 Blend	2.79%	8.35%	9.38%	9.06%

Source: Statistics from Ibbotson & Sinquefield, starting 1926. Stocks represented by the S&P 500 Index. Bonds represented by long-term government bonds from 1926-1970, then by Barclays Aggregate Bond Index, formerly Lehman Aggregate Bond Index.

500 Liberty Street SE, Suite #310
Salem, OR 97301
(503) 371-3333

www.planningvisionprocess.com

Providing Fee-Only Wealth Management and Creative Planning for Your Family, Business and Estate

THE H GROUP INC®
INDEPENDENT WEALTH MANAGEMENT SOLUTIONS™

Tax-Deferred Annuities: Too Good to be True?

Tax-deferred annuities are sold, not bought. Especially in a volatile market like we are experiencing today. Our clients are being approached by annuity salespersons from banks, insurance agencies, and brokerage firms and we're experiencing new clients seeking a second opinion about the latest generation of annuity products with certain guarantees.

Tax-deferred variable annuities are like a portfolio of mutual funds wrapped inside an insurance contract. They offer a **death benefit** guaranteeing the amount of your contribution, or portfolio value, which ever is greater. Some even guarantee your purchase payment plus say, 5% per year, if you die. The money in it grows tax-deferred. At a later date, you can withdraw your money or you can take a series of payments over your lifetime, called an annuity.

What is being pitched heavily today are what the insurance companies call **"living benefits."** They promise, for example, that no matter what your account value is at the time you are ready to annuitize the contract, you will be guaranteed a certain level of income based upon the account's highest value over the past 10 years. This can sound pretty appealing in this market environment. **Do not confuse the usually higher living benefit value (used to set a monthly annuity payout) with the usually lower cash value (what you get when you surrender the contract).**

But before you take the leap, consider the following:

1. All variable annuities have an extra layer of fees over and above what a comparable mutual fund would have. These are typically 1.3% to 2.2% each year, depending upon the extra whistles and bells you add for death benefits. (However, some no-load contracts have mortality and expense charges of only 0.25-0.6% per year, but you won't be offered one of those from a commissioned agent.) Those with guaranteed income minimum benefits (GIMB) have unusually high fees.
2. If you select any of the guaranteed income minimum benefits (GIMB) your investments will need to earn another 0.5% to 1.5% to break even each year. (Add that to the numbers above.)
3. If you select any of the guaranteed withdrawal benefits, you will need another 0.5% to .95% to break even each year on top of the numbers in #1 and #2 above.
4. The underlying investment funds have internal charges of .55% to 1.76% each year, depending upon the mix of funds you use. Of course, you would have similar expenses such as these internal expenses in a mutual fund, so this isn't as important as the costs in items #2 and #3.

So what does all this mean?

You have a huge handicap before you even earn a penny. Those extra whistles and bells really detract from your investment return. Taking the mid-point of the basic fee (1.95), plus .75% for a middle of the road GIMB, and a low end .5% for one of the withdrawal guarantees, **your investments in a typical contract need to earn (after portfolio fees) 3.2%!** So even if the portfolio earned 10%, your net would be only 6.8%. What if it earned only 7% gross before these fees? Then your net return would be 4.22%. You might be better off just going into a lower cost conservative investment instead.

Continued on page 4

Remember When?

One year ago life was not fun. The economic storm clouds seemed to get darker. The news was grim. We had many serious short-term economic issues demanding attention as financial institutions and major corporations were failing. We were "group-thinking" ourselves into another Great Depression. Seems like everyone was in a bad mood.

Well, here we are, one year later. We still have problems. However, the overwhelming majority of the data we review indicate that a recovery is under way. But if all we had to rely upon were the questions and comments we receive from clients and acquaintances, one would think that conditions are much worse. Yes, we have major long-term problems out there, but not as many short-term ones. And, unlike the urgency of things a year ago, the good news is that we now have time to deal with them. It will take time and patience, but we will get through this! After all, we're Americans.

In the spirit of keeping the *Kelemen-Way Financial Perspectives* more focused on less dated planning issues we will continue to send special email updates and white papers to our clients as events unfold. If you are not a client and would like to receive these updates, please let us know.

Meanwhile, our advice is the same we gave 18 months ago and last year at this time: limit your consumption of news and get it from a variety of sources. Separate your political views from economic news. **Above all, take time to focus upon our many blessings. It's hard to shout or be angry and depressed when one is filled with gratitude. After the past year, we all have much for which to be grateful.**

Thinking Twice About Converting Your Roth IRA

Since our widely published white paper last December on Roth conversions, we've received many follow-up questions. We'd be happy to send you a copy if you want to see it again. In the interest of providing some balance to all the recent articles advocating for a Roth conversion, we thought it would be helpful to give you some reasons to think twice before converting.

Just because you can, doesn't necessarily mean that you should. **The absolute risk of paying taxes up front may be greater than a potential benefit many years later. So, challenge your assumptions!** Unless your IRA balance is very small, this is one financial decision you should make with careful consideration based on your own unique situation.

1. When a Roth IRA Conversion May Not Make Sense

Circumstance	Comments
Already in a high tax bracket, but expect the same or lower tax bracket at retirement	Why pay taxes now at a higher bracket?
Your heirs will most likely always be in a lower tax bracket than you currently are	Why pay higher taxes, now? Paying less taxes later is almost always better.
Need to tap IRA funds before age 59½	Gains on the withdrawals of conversions taxed at ordinary income if withdrawn before the later of age 59½ or 5 years since conversion.
Want to leave to charity	IRAs going to charity are not taxed. You would have paid an unnecessary tax to convert.
Already relying heavily on IRA for retirement income	Paying the taxes up front could shrink your main retirement asset unless your IRA is sufficiently large and/or you are making the conversion as a tax-free legacy to your heirs after making certain that you have enough assets for your lifetime.

2. When a Roth Conversion May or May Not Make Sense

Circumstance	Comments
Will need much of your IRA for retirement income	Depends upon how many years to retirement. The longer the better. Also assumptions about your current and future tax bracket could tip the scales either way.
An on-line Roth conversion calculator says, "it pencils out"	Many on-line or proprietary Roth calculators are predisposed to favor a Roth conversion. Challenge your assumptions! We're finding with our clients that the qualitative factors are more important than just the numbers.

The Team Advantage™

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants. They jointly serve their clients as a team with over 42 years of combined experience. They are 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* continues to list him as one of the 150 best financial advisors for doctors. He is Immediate-President of the Rotary Club of Salem, chair of the Willamette Academy Advisory Board, and a founder and the past president of the Medical Foundation of Marion and Polk Counties. Ron is frequently quoted in the national press and professional journals.

About Mary Way, CPA, CFP®

Mary Way, CPA, CFP® joined the practice in 1995. 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., is President of the Willamette Valley Estate Planning Council, and a board member of the Salem Rotary Foundation. She is also active in the Financial Planning Section of the Oregon Society of CPAs.

TEAM UPDATE

As you read this, we are most likely packing boxes and getting ready to move to our new office suite in late February. Watch for your official announcement. Now that the walls are in and painted, we can see that it will be worth the wait, the effort, and the cost. Thanks for your loyalty, referrals, and support, which are making this necessary expansion possible.

In addition to tax season, January and February are busy continuing education months for **Ron** and **Mary**. They attended the Oregon CPA conference on retirement planning in late November, the annual Portland Estate Planning Council Conference in January and the two-day FPA conference in February.

Lani took a week off in early January to help her daughter Holly in Yreka, CA with a new baby. She is the kind of helpful nurse that any young mother would want. She's also nursing us through all the moving arrangements and getting her garden cleaned up for Spring.

Debbie has been busy arranging for client RMDs from retirement accounts and getting the 2009 tax information to our clients and their tax professionals. She and Bob spent the holidays at Sisters with friends.

Mary has been exceptionally busy transitioning in some new clients, year-end issues, the Investment Policy Committee, and as President of the Willamette Valley Estate Planning Council. She and husband Steve are restoring a salvaged Boston Whaler. The hardest part was getting the garage cleaned out so the boat would fit. She started working out with a personal trainer late last year, and is really starting to feel and see the results.

Ron was selected by *Money Magazine* to do a "Money Makeover" for a Corvallis couple. The article appeared in the January-February issue. Truth be told, Mary did most of the work for it. Kathy, Ron, and their two daughters spent Christmas week together at daughter Skyler's flat in Boston. Ron managed to get in four days of snowboarding here and there and started taking Pilates lessons twice a week at 6:00 a.m.

THE H GROUP INC®
INDEPENDENT WEALTH MANAGEMENT SOLUTIONS™
Ron Kelemen, CFP®
Mary Way, CFP®, CPA
The Kelemen & Way Financial Perspective
500 Liberty Street SE, Suite #310 • Salem, OR 97301

ADDRESS SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
SALEM, OR
PERMIT NO. 106

Tax-Deferred Annuities: Too Good to be True?... *Continued from page 2*

Here are two other points to consider:

- Annuity contracts have surrender charges. A typical one might be 7%, 6%, 6%, and 5% of your purchase payments in each of the 1st four years respectively. These go to the brokerage firm's commissions, which are typically 5-6% upfront. Some contracts have even larger and longer surrender charges and periods.
- All earnings are taxed at ordinary income and are deemed to come out of the contract before principal. Any withdrawals before age 59½ also have a 10% tax penalty on the earnings withdrawn.
- **The GIMB sounds very appealing. But you often don't get those guarantees until you have had the contract for 10 years.** Insurance companies generally don't lose money. One of the ways they can offer these guarantees (in addition to the extra fees they charge) is that they offer you a lower annuity rate when those contracts are annuitized than if you purchased an immediate annuity with outside funds. So even if you lost money in an alternative portfolio invested elsewhere, and you purchased an immediate annuity with that lower value <u>with the same company</u>, the odds are high that you would get a higher monthly income by foregoing the GIMB option.

An immediate annuity purchased at retirement can make sense in some cases. And deferred annuities have unique benefits when used within a charitable remainder trust (CRT). But for most people, saving money in less costly vehicles and then purchasing the annuity income stream at retirement is the way to go. Use your 401-k or retirement plan for efficient tax deferral. If you are really worried about risk, you can structure your investment portfolio to minimize it (the way an insurance company might do). You could also spend less and save more. **But paying extra (and often hidden) fees transfers the obvious <u>potential</u> risk of unknown magnitude to the less obvious—and <u>guaranteed</u> risk of an expensive insurance contract. There is no free lunch.**