The Kelemen, Way & Hanslits

FINANCIAL PERSPECTIVE

Creators of The Planning Vision Process®

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CREATING CLARITY & CONFIDENCE IN A COMPLEX WORLD

Has the Fear of the Stock Market Gone Too Far?

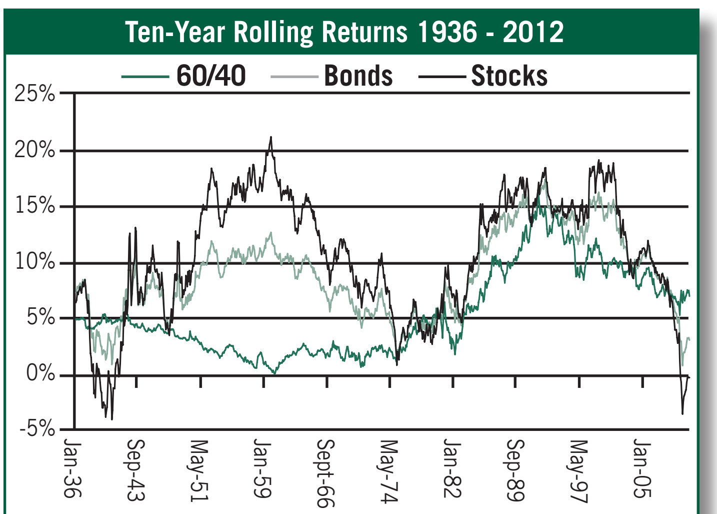
The year 2012 turned out to be a very good one for equity investors, and the stock market (as represented by the S&P 500) recently reached its previous 2007 highs after hitting bottom in March of 2009. And so far, 2013 is starting out well. Yet, some individual investors and pension funds have been pulling out of the stock market or cutting back on their stock allocations.

The Great Recession has spooked investors. They are falling into a classic behavioral finance trap called "the experience effect" in which the recent past distorts perceptions about the present and the future. (It happens in reverse during bull markets.) The perception of the 2000's as "the lost decade" continues to shape people's thinking that they can't make money in the stock market. We continue to get pushback from clients when we use what we think are modest return assumptions of 4-7% for our retirement planning projections.

And just when we start to see this trend is changing, along comes all the *fiscal cliff/debt ceiling/dysfunctional Congress/deficit/gridlock* pessimism. So, it's time for some historical facts to help put things into perspective. This is an update to some data we published in this newsletter in March 2010.

Beware of calendar years and official decades because they are so artificial and misleading. In 2009 for example, (and based on data cited at the bottom of the graphs) 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.

And what about the 2000's, the so-called "lost decade"? From January 1, 2000 to December 31, 2009-–the "Lost Decade"—the annualized return for stocks was -0.95%. But bonds had a total return of 7.30%, not exactly a lost decade for bond investors. However, during that decade there were five good years for stocks. It all depended upon your timing.



What if instead we looked at <u>rolling</u> averages for 12 month periods and 10 year periods? Using data from the Ibbotson Yearbook cited below going back to 1926, we started a new year every month, starting in 1927. This gave us 1033 rolling "years." And we started a new rolling decade every month starting in 1936, giving us 925 rolling "decades." Now those are a lot of years and decades!

As you can see by the chart, the results put any given calendar year or 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**

Continued on page 2

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10 Investment Strategies to Cope with the New Medicare Taxes

It's a whole new year and a lot of big tax changes are upon us. In addition to the last minute Fiscal Cliff deal, two taxes may affect some of our readers in a big way. They are to help pay for the Affordable Care Act.

The 3.8% Net Investment Income Tax

This surtax is applied against the lesser of your net investment income ***or*** modified adjusted gross income (MAGI) in excess of the threshold amounts. (The modified adjusted gross income (MAGI) is found by taking your adjusted gross income and adding back certain items such as student-loan deductions, IRA-contribution deductions, and deductions for higher-education costs.)

The threshold for single and head of household filers is $200,000. For married couples filing jointly it is $250,000 and married filing separately $125,000.

Many high income earners with incomes over the thresholds will have a difficult time avoiding the 3.8% surtax on their investment earnings. These earnings could come from taxable interest, dividends, rent, taxable annuities, net capital gains, and income from businesses you own but don't actively manage.

The Additional 0.9% Medicare Tax

This is an additional 0.9% in taxes on income above $200,000 in a calendar year to help pay for Medicare. And if you are a couple with a MAGI exceeding $250,000, you will be subject to it, even if one spouse is below the $200,000 threshold and not subject to withholding.

10 Basic Strategies

Your basic strategy is to get your investment income and/or your MAGI below those thresholds. Here are a few suggestions to help you do this.

1. Increase contributions to tax-deferred retirement plans. This has the effect of lowering your MAGI, plus assets within tax-deferred plans do not generate any taxable investment income.

2. Beware of high turnover mutual funds, such as those with "long-short," market timing, and "go-anywhere" strategies. They might smooth out the bumps in a volatile market, but end up costing you more in taxes.

3. For those over age 70½ subject to minimum distributions (RMDs) consider a direct charitable rollover to one or more of your favorite charities. You can rollover any amount up to $100,000, even though your RMD might be less. Since this is a direct rollover, the distribution does not increase your MAGI.

4. Harvest your losses by netting them against your gains every year. This seems so basic, but we seldom see that when reviewing account statements of new clients coming in the door. You can always buy that favorite stock or mutual fund back 31 days later.

5. Think about tax-exempt interest from municipal bonds, in lieu of other income-producing securities. However, don't let the tax tail completely wag your portfolio. A higher-yielding corporate bond after paying taxes and the surtax might still result in a higher net return.

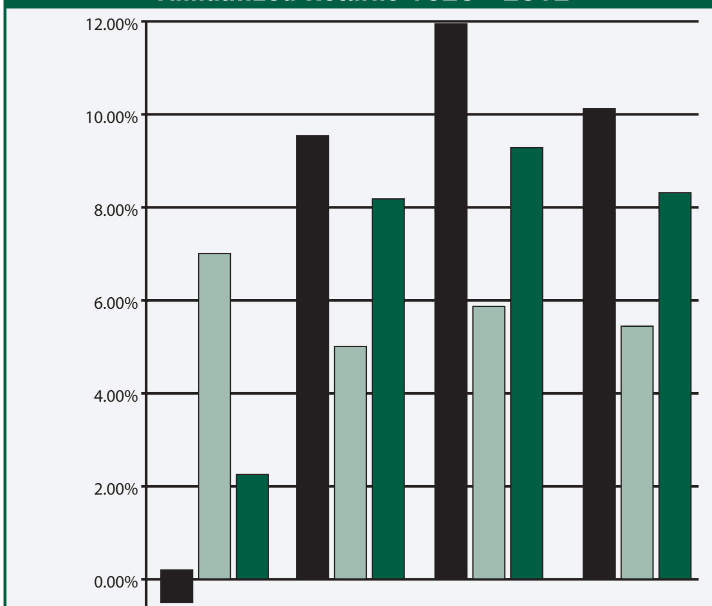
6. Think more about growth stocks as opposed to dividend-paying stocks. Federal income taxes on dividends for high-income taxpayers have gone from 15% to 23.8%. A buy and hold strategy on an asset with good potential for capital appreciation won't incur the tax until it is sold.

Continued on page 4

Has the Fear of the Stock Market Gone Too Far?...

Continued from page 1

Annualized Returns 1926 - 2012



	The 2000s	8 Calendar Decades	1033 Rolling Years	925 Rolling Decades
Stocks	-0.95%	9.61%	12.13%	10.51%
Bonds	7.30%	5.46%	6.01%	5.54%
60/40 Blend	2.79%	8.35%	9.59%	8.91%

or around the current partisan budget debates? 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!

Source: Statistics from Ibbotson & Sinquefield, (now Ibbotson/Morningstar) Stocks, Bonds, Bills and Inflation Yearbook 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.

What's Your Number?

Lee Eisenberg's 2006 best seller *The Number—A Completely Different Way to Think about the Rest of Your Life,* popularized "The Number" as a retirement planning and cultural meme. At its essence, your number is the amount of assets you will need to support a sustainable retirement.

You can't be confident about your retirement unless you know how much you could potentially need at the start of it. Once you have achieved this target you can either retire, or if you already are retired, you can sleep better.

Not knowing your number is like taking a very long vacation without credit cards and not knowing if you will have enough gas money or funds for emergencies or some fun excursions along the way. So, how do you go about finding it?

Finding Your Number—The 4% "Solution"

Finding your number is complex if you want an accurate one, and pretty simple if you want just an approximation. This article, which Ron is excerpting and adapting from a chapter of his upcoming book *The Confident Retirement Journey—Your Road Map,* explores a relatively simple way to get you into the ball park. He calls call it "The 4% Solution." It's very simple, but not so accurate.

You first need to get a grip on the annual inflation-adjusted income you will need at the start of retirement, after subtracting your estimated annual Social Security and pension benefits. (We spend a lot of time helping our clients do this.) Then divide that by .04. So, if you think that you will need $100,000 after subtracting your estimated annual Social Security and pension benefits, then you would need $2.5 million. This assumes that it produces a 4% return that you can spend every year, adjusted for inflation. If it does, and you don't experience any inflation, then your kids or your favorite charity get a nice bequest.

But why divide by 4%? You could divide by 5% or you could be more conservative by dividing by 3%. Over the past 19 years numerous academic papers have been written about the so-called **"safe withdrawal rate"** (SWR). The first and most famous one was William Bengen's 1994 award-winning paper in the *Journal of Financial Planning.*[1] He constructed rolling 30-year periods since 1926 using historical data with portfolios that included at least 50% stocks.

His conclusion? A retiree could safely draw 4.15% of the starting value of the portfolio at retirement, with inflation adjustments to that starting dollar amount each year. Many periods had even higher starting withdrawal rates. Portfolios with less than 50% stocks had a safe withdrawal rate as low as 2.5%.

Other studies, such as the "Trinity Study"[2] in 1998 came up with similar results. Researchers took various portfolio mixes, such as 50% stocks and 50% bonds and back tested them at different withdrawal rates adjusted for inflation over the past 80+ years. Most of the subsequent studies, including a very recent one with 140 years of data[3] basically confirm this number, assuming that the retiree makes adjustments along the way as age, health, portfolio value, bond yields, etc. change.

But please don't take this 4% as gospel. When one retired in any of these studies made a huge difference. Those that retired at the start of a bull market obviously did much better than those who may have started near the top in, say, 1928 or 2000. The unlucky ones took withdrawals in a down market, making it very difficult for their portfolio to recover. **And these studies don't mean that it is safe to withdraw 4% of the market value every year, they mean 4% of the value at the start of retirement.** This means you could be taking out more than 4% during bad years and less than 4% during the good years to meet that inflation-adjusted amount you started with at the beginning of retirement. You will need the good years of portfolio growth to replenish the bad ones.

Once again, these studies included equities in the portfolio. The 4% rule of thumb will not normally work with portfolios heavy in bonds, CDs, and Treasury bills. You would need to use a lower estimate of 2.5%, perhaps lower now, given where we are in the interest rate cycle.

Continued on page 4

The Team Advantage™

Ron Kelemen, Mary Way, and Larry Hanslits are independent Certified Financial Planner™ certificants. They jointly serve their clients as a team with over 75 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 16 professionals and over $600 million under active management.

About Ron Kelemen, CFP®

In practice since 1981, Ron is a contributing author of three financial planning reference books and is frequently quoted in the national press and professional journals. *Medical Economics* lists him as one of the 150 best financial advisors for doctors. He is active in Rotary and several non-profit organizations.

About Mary Way, CPA, CFP®

Mary joined the practice in 1995. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She is board member of the Salem Rotary Foundation, and like Ron, a past president of the Willamette Valley Estate Planning Council.

About Larry Hanslits, CFP®

In practice since 1985, Larry merged his practice with Ron's and Mary's in 2011. He sits on the investment policy committee of The H Group, Inc., provides advanced estate planning case writing services to attorneys nationwide, and is a teacher and a judge for the financial planning scholarship competition at Oregon State University.

TEAM UPDATE

We started 2013 off to a roaring start in early January by holding our annual year-in-review retreat. We came up with two major takeaways: 1) The year 2012 was our best ever. 2) Because of our growth, we need to hire another financial advisor, and definitely someone younger than all of us. So we've started the search process for a bright and ethical person committed to living in or near Salem. We've already started remodeling our office suite to accommodate that person.

We rolled out our new performance reports, and we hope you like them. Next up is the new tax report summaries, which should be arriving from the account custodians any day now.

Lani is in charge of the planning and execution of our office remodel. She and husband Jim completed the installation of solar array panels on their south Salem property. She said the tax credits and the electricity are nice, but it was a muddy mess. If you install one, she says to do so in the dry summer months.

Debbie worked on getting our new performance reports out the door and is currently working on income tax information and new account transfers. She and husband Bob enjoyed following current and former Ducks in the bowl games.

Larry participated in the all-day Portland Estate Planning Council and the two-day Financial Planning Association conferences. He started teaching his financial planning class at Oregon State. He says it's the best crop of students yet, and not just because his son is one of the students. "For once in my life, Eric listens to me," he reports.

Mary also participated in the all-day Portland Estate Planning Council conference. She has enjoyed time with her grandson in Bend and is excited about a granddaughter on the way in May. As this goes to press she and husband Steve are heading to Mazatlan, Mexico for a week. Goodbye fog and rain!

Ron attended his quarterly Strategic Coach session in Chicago, just missing the massive blizzard by two days. He also attended the FPA conference with Larry. Since the last update, he's written two more chapters on his book, and it is now about 75% complete. He enjoyed a couple of superb snowboarding days, and experienced an exhilarating live performance of Beethoven's 9th by the Oregon Symphony.

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What's Your Number...*Continued from page 3*

If you are already retired, another way to use this is to take your financial independence assets and divide by .04. This will give you a degree of confidence about what you can spend without seriously depleting your portfolio over the years of good, average, or bad returns. Many of our clients take more, but we monitor it every year and make adjustments. We may start out with a lower withdrawal percentage at the start of retirement, then open up the wallet with a higher withdrawal rate as they age and conditions warrant.

A Few More Steps for a More Accurate Result

So "The 4% Solution" is a quick and easy way to estimate your number. But we're talking about <u>your</u> retirement here. If you want a more accurate forecast of your number with changing assumptions (like a mortgage payoff in year 10, no COLA with a private pension plan, changing investment returns, part-time work, no travel budget after age 75, etc.) you may need us to help you with our robust software and the ability to run thousands of simulations. Even then, the one guarantee we can safely make to our clients is that their results will never come out exactly as projected. The variability of investment returns and the interesting twists and turns of life are the main reasons.

(Endnotes)

[1] William Bengen, "Determining Withdrawal Rates Using Historical Data," Journal of Financial Planning, October 1994.

[2] Philip L. Cooley, Carl M. Hubbard and Daniel T. Walz *Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable. (AAII Journal* February 1998, Volume XX, No. 2).

[3] Michael Kitces, *What Returns are Safe Withdrawal Rates REALLY Based Upon?* (Kitces Report, August 15, 2012)

10 Investment Strategies to Cope with the New Medicare Taxes...

Continued from page 2

7. Consider taking withdrawals from your Roth IRA first if you depend upon IRAs for retirement income. Roth withdrawals are non-taxable, thus not increasing your MAGI.

8. Use college savings accounts. Save for the education of your children and/or grandchildren using the tax-advantaged 592 plans.

9. Consider installment sales. If you are selling real property, installment sales could defer income over several years.

10. Work closely with your tax professional throughout the year. This is perhaps the most cost-effective suggestion I can make. If you wait until mid-December, it might be too late.

There are a few more strategies that involve the use of trusts and passive business management, but they are beyond the scope of this article. The bottom line is that these new taxes are unavoidable for high income earners. All you can do is control what you can control with proactive planning.