

February 2008 Issue

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Securing Your Financial Life

In a recent survey, 74.5% of individuals with at least \$1 million in net worth felt that the world is a dangerous place (Source: *Financial Planning*, June 2007). While there might not be much we can do on an individual level to reduce crime, war, or even stock market corrections, we can take all appropriate steps to mitigate the risks under our control. If you're looking for ways to increase your financial security, consider the following tips:

- **Get your estate in order.** While dealing with your own mortality is often difficult, it is one of the most important things you can do to ensure your family can survive financially in the event of your death. Make sure your will reflects your current desires for the disposition of your assets and names a guardian for your minor children. You should also consider a durable power of attorney, which designates someone to control your financial affairs if you become incapacitated, and a health care proxy, which delegates health care decisions when you are unable to make those decisions.
- **Review your portfolio.** Recent stock market fluctuations may have made you a little nervous about holding stocks. But if you're saving for goals that are decades away, stocks probably should continue to hold a major position in your portfolio. The lesson we should learn from recent stock market fluctuations is that our portfolios should be diversified. A properly diversified portfolio will help protect its value during market declines while still offering higher return potential.

- **Take another look at your life insurance.** You need to purchase an appropriate amount of insurance to protect your family in the event of your death. The amount needed will depend on your current net worth, the lifestyle you want to provide for your family, and your personal circumstances and desires. Since your insurance needs will change over time, assess your insurance coverage periodically, especially after major events in your life.
- **Obtain sufficient disability income insurance.** You should consider disability income insurance if your current assets won't support you until age 65. Many companies provide short-term disability insurance that covers 100% of your salary for three to six months. Long-term disability insurance is typically less common and less generous. Thus, even if you have long-term disability insurance at work, you may want to obtain additional coverage. Your available resources and disability benefits should equal at least 60% of your pretax salary.
- **Make sure you have an emergency cash reserve.** Consider setting aside at least three to six months of living expenses, although the exact amount will depend on your age, health, job outlook, and borrowing capacity. This can help tide you over in case of a job layoff, short-term disability, or large unexpected expenditure.
- **Consider long-term-care insurance.** This coverage may be especially important for women, who tend to outlive their husbands. You should probably purchase the insurance while you are in your 50s or 60s. After that, the premiums get much more expensive. Also, if you develop a serious health condition, you may not be able to purchase the insurance.
- **Protect your financial identity.** While you typically won't have to pay for anything charged by an identity thief, you will have to work to restore your credit and to ensure all fraudulent accounts are closed. That can be time-consuming as well as expensive. To help protect your financial identity, only give out your Social Security number when it is required, shred financial documents, cut up old credit cards, and review your credit reports periodically.
- **Keep your homeowners insurance up to date.** Review your homeowners policy carefully so you understand what would happen if your home was totally destroyed. It is your responsibility to make sure you have adequate policy limits, so inform your insurance company when you make major improvements, get an inflation rider for your policy, and make sure your policy covers the total cost of rebuilding your home.
- **Protect your home.** Obtain a good security system for your home. Make sure all doors are metal or solid wood with deadbolt locks, use bars or locks to secure sliding glass doors, and keep all entrances well lit.
- **Properly store important documents.** Documents that you might need when the bank is closed, such as passports, birth certificates, wills, or insurance policies, can be kept in a fireproof home safe. Other documents, such as deeds, stock certificates, and titles, should be kept in a safe deposit box in a bank.



Surviving Spouses and IRAs

When a surviving spouse is the sole beneficiary of a traditional IRA, he/she has the option of treating the inherited IRA as his/her own (or roll it over into his/her own IRA) or remaining the beneficiary on the account. Which option to choose largely depends on the surviving spouse's age:

Surviving spouses under age 59 1/2

Typically, a surviving spouse under age 59 1/2 will want to remain the beneficiary on the IRA so that withdrawals can be made without paying the 10% withdrawal penalty. Once the account is rolled over, withdrawals before the age of 59 1/2 would result in a 10% federal income tax penalty.

Distributions are required by the later of the year the original IRA owner would have reached age 70 1/2, or by December 31 of the year following the IRA owner's death. Required minimum distributions (RMDs) are calculated based on the single life expectancy table for beneficiaries, with the spouse recalculating his/her life expectancy every year by looking up the life expectancy factor on the table. Since this is based on a single life expectancy, RMDs will be larger than if the inherited IRA was treated as the surviving spouse's own IRA.

A surviving spouse can remain the beneficiary on the account until age 59 1/2 to maintain the ability to take penalty-free distributions, and then roll the IRA into his/her own IRA after that age. By rolling the balance over, the surviving spouse will be able to withdraw smaller RMDs and name his/her own beneficiaries for the IRA.

Surviving spouses over age 59 1/2

If the surviving spouse is at least age 59 1/2, it typically makes sense to treat the inherited IRA as his/her own or roll it over into his/her own IRA. By doing so, the surviving spouse can name his/her own beneficiaries for the account. The surviving spouse must start taking RMDs at age 70 1/2. RMDs are calculated using the uniform distribution table, which assumes a joint life expectancy with the beneficiary considered 10 years younger. When the surviving spouse dies, any remaining balance can be paid to the surviving spouse's beneficiaries over their life expectancies.

However, spouses who are significantly older than the deceased IRA owner can delay RMDs by remaining the beneficiary on the IRA. He/she would not have to take RMDs until the deceased spouse would have reached age 70 1/2, even if the surviving spouse is already past age 70 1/2.

Roth IRAs

When a Roth IRA is involved, the surviving spouse would normally want to roll the Roth IRA over or treat it as his/her own. Then, no distributions would be required during his/her lifetime. If the surviving spouse remains the beneficiary, RMDs would be required by the later of the year the original IRA owner would have reached age 70 1/2, or by December 31 of the year following the original IRA owner's death.



Taking Care of Your Children Financially

Caught up in the day-to-day routine of raising your children, it's easy to forget to take care of other financial decisions involving them, including:

- **Naming a guardian for your minor children.** If you and your spouse both die without naming a guardian in your will, the courts will appoint one and will supervise your children's property. You may want to consider naming two guardians - one to take physical care of your children and one to manage their assets. As your children grow, review your guardian choice every couple of years.
- **Purchasing sufficient insurance.** You should obtain enough life insurance to provide for your children until they are adults. Determine how much is needed for living expenses, hobbies, medical expenses, and college. Consider other items as well. For instance, will your guardian's home comfortably accommodate your children, or should you leave funds for an addition to the house? Include a financial cushion so there is plenty of money for unanticipated expenses. Also ensure you have adequate disability income insurance, so your family's lifestyle won't be disrupted if you have an injury or illness.

- **Saving for college.** Determine how much you need to save for your children's college educations. You may have difficulty saving the amount needed to fully fund a college education. However, there are other sources to help fund those costs, such as borrowing and financial aid. Thus, your goal may be to accumulate 30%, 50%, or some other percentage of the total cost of college. Take a look at education savings accounts and Section 529 plans, both of which offer significant tax advantages.
- **Teaching money basics to your children.** In a society that has difficulty managing money, teaching your children good money skills is a lesson that will benefit them for a lifetime. As you teach these lessons to your children, keep in mind that how you treat money is probably the most significant influence on your children's views about financial matters. If you make large purchases only after careful research and price comparisons, your children will learn to be careful before making a purchase. If you use credit cards cautiously and explain how to select a card, what items to charge, and how to pay off the balance every month, your children will learn not to abuse credit cards.
- **Saving for your retirement.** Don't feel guilty thinking about your own retirement when your children still need your help. One of the best gifts you can give your children is the knowledge that you will be financially independent during retirement.
- **Gifting assets to your children.** If you plan to leave assets to your children after your death, you may want to start making annual gifts, up to \$12,000 in 2008 (\$24,000 if the gift is split with your spouse), to any number of individuals without paying federal gift taxes. You can then teach your children how to handle those gifts and share in their joy from the gifts.



Avoid This Mistake

Finding a way to live decades in retirement without worrying about running out of money can seem like an overwhelming task. That goal depends on many variables and assumptions, including your life expectancy, your retirement age, your lifetime earnings, your retirement expenses, retirement income sources, your investment rate of return, and future inflation. If you're wrong on even one of those variables, funding your retirement could be in danger.

With all the potential for missteps, what is the one mistake you want to avoid at all costs? Dipping into your retirement savings. Unfortunately, since the funds in your 401(k) plan or individual retirement account (IRA) belong to you, they often seem like a tempting place to get funds needed for other purposes.

Tax laws don't help, since they often provide tax-advantaged ways for you to access those funds. Loans from 401(k) plans are not taxable events. When leaving an employer, you can withdraw money from your 401(k) plan (you will have to pay income taxes and possibly a 10% early withdrawal penalty). Contributions to Roth IRAs can be withdrawn at any time with no tax consequences. Withdrawals from traditional IRAs before the age of 59 1/2 can be made under certain circumstances, such as to purchase a home or to pay for a child's college education, without paying the 10% tax penalty.

Saving for retirement is a difficult task for most people, without making it more difficult by using retirement funds for other purposes. Even if the amount seems small, don't withdraw funds from your retirement account. While it probably won't add significantly to your lifestyle now, it can grow to significant sums over the long term. For instance, assume you have \$10,000 in your 401(k) plan. If you withdraw the funds and are in the 25% tax bracket, you'll have \$6,500 left after paying income taxes and the 10% federal tax penalty. Keep the funds invested earning 8% annually on a tax-deferred basis, and your funds could grow to \$100,627 after 30 years, before paying any income taxes. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)*

No matter how much you think you need the money now, don't touch your retirement funds for anything other than retirement.

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A Look at Bond Ladders

While bonds are subject to several types of risk, two of the main types are interest rate risk, or the risk that interest rate changes will change your bond's value, and reinvestment risk, or the risk that interest and principal cannot be reinvested at the current bond's interest rate. It is difficult to simultaneously reduce both risks since a rise in interest rates reduces reinvestment risk and increases interest rate risk. Thus, you need to find a balance between the two risks.

Using a bond ladder strategy can help investors strike this balance. A bond ladder is a portfolio of bonds of similar amounts that mature in several different years. For instance, a \$100,000 portfolio might consist of 10 different bonds of \$10,000 each, maturing in 10 consecutive years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date (10 years in this example).

By spreading out maturity dates, the effects of interest rate changes are lessened. Since the bonds are held until maturity, changing interest rates don't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at the higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates. A bond ladder keeps your bond portfolio invested in a range of maturity dates, evening out your interest income over time.

One of the main advantages of this strategy is that you don't just hold short-term bonds, waiting to determine the future direction of interest rates. Your funds are always invested in a variety of maturities.

When designing a bond ladder, decide on an average maturity date, which could be five, 10, or even 20 years, depending on your financial needs. There should be enough "rungs" on the ladder for principal to mature every year or two. If the rungs mature in longer than two-year increments, you might miss interest rate changes. Consistently follow your plan by automatically reinvesting principal at the longest maturity date.

You can also set maturity dates in your ladder to coincide with a specific financial need. For instance, a bond ladder might mature in each of four consecutive years while your child is in college, allowing you to pay college costs with maturing principal.