GUIDE TO: RETIREMENT

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Retirees: Inflation Protection for Retirement Portfolios

Retirees and pre-retirees have been challenged by the investing environment during the past few years. As it becomes harder to generate a livable income stream from retirement portfolios given the low bond yields, retirees have to choose between tapping their principal and venturing into high-yielding, but also riskier, securities. Investors are concerned about what could happen to their bond portfolios if interest rates were to rise. While inflation currently appears to be in line with historical norms, retirees remain concerned about the potential for rising inflation and its effect on their portfolios. Inflation-linked securities like Treasury Inflation-Protected Securities (TIPS) are the most direct way to hedge against inflation.

Here is why inflation protection is important for retirement portfolios. Retirees miss out on some of the inflation protection that working people normally enjoy. Paychecks will generally trend upward to keep pace with rising prices but retirees don't have that safety net. Social Security payments are adjusted upward in an effort to keep pace with rising prices. But to the extent that a retiree is living off a portfolio anchored in fixed-rate investments, the payout from that sleeve of the portfolio will be fixed. If prices go up, the purchasing power of that portfolio, and in turn the retiree's standard of living, goes down. This is why inflation-indexed securities like TIPS, whose principal values adjust upward to keep pace with inflation, are an important part of a retiree's fixed-income portfolio.

TIPS are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. TIPS are subject to risks which include, but are not limited to, liquidity risk, credit risk, income risk, and interest-rate risk.

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Know Your Own Inflation Rate

The Consumer Price Index (CPI), a measure of inflation, is a monthly statistic representing the change in prices paid by urban consumers for a representative basket of goods and services. While this measure serves more as an official gauge, a lot of consumers (especially retired consumers and investors) seem to have a different sense of inflation. The question often arises: Why is it that the official rate seems to be lower than what we're actually feeling out there?

Our inflation rate may vary depending on our individual expenditures. This means that some people may experience higher inflation relative to others. For a senior, food and energy costs are a very high proportion of their total household outlay. The location where you live can also impact your personal inflation rate. If you have a fixed-rate mortgage, or if you're retired and your home is paid for, you won't experience fluctuating housing costs as a result of having an adjustable-rate mortgage or paying rent. But you may see housing costs vary from one region of the country to another. Another big swing factor in your personal inflation rate is health-care cost. If you have purchased a long-term care policy with an inflation rider, you can insulate yourself against rising nursing-home and other long-term care costs.

Anyone who has Social Security has a buffer against higher prices because Social Security includes a cost-of-living adjustment. If a Social Security paycheck is a big proportion of your total income needs, you're likely in good shape as far as inflation is concerned. If it's just a tiny portion of your total income needs, you're not in as good a shape. If you're receiving a pension with an inflation adjustment it can help you stave off inflation, and the same goes for folks who have an annuity with an inflation rider; they will have some protection against inflation. What about folks who are still in employment? If you're still working, either full-time or part-time, you may potentially be able to get a cost-of-living adjustment in your paycheck. If you're not working and not eligible for those cost-of-living adjustments, you'll need to plan for inflation accordingly.

Finally, it's also important to gauge whether your portfolio is built to withstand your personal rate of inflation. Portfolio composition is the key here. Investments such as short-term bonds and cash may not safeguard against the threat of inflation. If a high proportion of your portfolio consists of cash or short-term bonds without any inflation protection built in, you may see a large percentage of your return eaten away by inflation. Next up is your portfolio time horizon. Seniors who are quite far into their retirement and don't anticipate having a long time horizon for their investment assets probably need to be less concerned about the toll that inflation will take over time. However, if you're just starting out in retirement, you may need to plan for inflation-proofing your portfolio, because over time, even a seemingly benign inflation rate of 3% may take a bite out of your portfolio return.

Diversification does not eliminate the risk of experiencing investment losses. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes. Annuities are suitable for long-term investing, particularly retirement savings. Annuity risks include market risk, liquidity risk, annuitization risk, tax risk, estate risk, interest-rate risk, inflation risk, death and survivorship risk, and company failure risk. Withdrawal of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. Additional fees and investment restrictions may apply for living-benefit options. Violating the terms and conditions of the annuity contract may void guarantees. Consult a financial advisor and tax advisor before purchasing an annuity.

Retirees: Non-Traditional Investment Risks

Volatile markets pose several challenges for retirees who rely on receiving a livable income stream from their investments. Interest rates are low and likely to stay low for the foreseeable future, making cash and high-quality bonds a safe parking place for now. Amid such a challenging environment, it's hard to blame retired investors for looking beyond traditional investments like stocks, bonds, and cash, or the mutual funds and exchange-traded funds that invest in these securities.

Many investors have flocked to gold and other precious metals, while others have gravitated toward investment types like life settlements, distressed real estate investments, and private mortgage investments. Such non-traditional investments might hold the promise of higher returns compared with traditional asset classes, but there is often a trade-off of higher risks and/or costs. Moreover, investors in non-traditional investments might not benefit from the same liquidity, transparency, and regulatory oversight that investors in traditional assets have. The following three asset types have picked up traction, but it is important to understand the risks before entrusting your hard-earned cash to them.

Life Settlements: A life settlement originates when a life insurance policyholder, often an elderly or terminally ill person, sells his or her interest in the policy to a third party, usually at a level that is well below the policy's stated death benefit. The third party then resells, often by issuing securities, that interest to investors who in turn must keep the policy in effect by paying its premiums. When the originally insured person dies, the owner of the security collects the death benefit. The rate of return on a life-settlement investment will hinge on when the originally insured person dies. If death occurs within his or her estimated life expectancy, the return will be relatively high. But if the original policy owner lives well beyond the expected time frame, a life settlement can be a poor investment. Not only will it take a while to pay off, but the investor will have to fork over premiums on a regular basis.

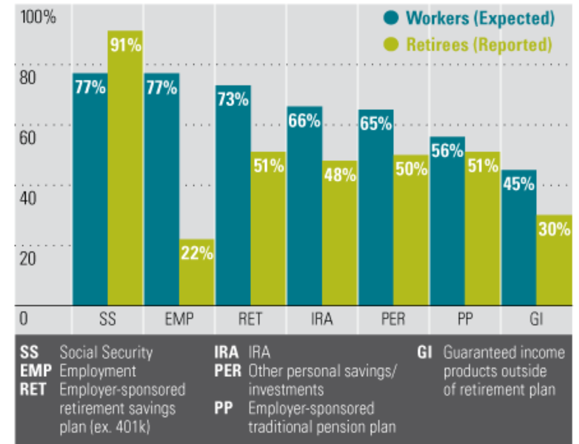
Distressed Real Estate: Distressed properties typically sell at prices lower than what the owners paid and may be under foreclosure; their prices may also be low in absolute terms. As with investing in any other security type, seeking low valuations is a key way to bring down your risk, but distressed real estate investing is far from a low-risk endeavor. Distressed properties may require substantial additional investment before they can be rented or resold, and there is no guarantee that a seemingly low-priced property won't fall further still. Finally, real estate can be illiquid, and for smaller investors can be cost-prohibitive to build a diversified portfolio of properties.

Private Mortgages: The troubled housing market has given rise to another real estate-related investment, the private mortgage. In contrast to a loan extended by a bank or financial institution, a private mortgage is funded by individuals, groups of individuals, or a corporation that specializes in making such loans. A private mortgage holder may be able to earn a substantially higher interest rate than he or she can earn on cash or high-quality bond investment. At the same time, the risks of a private mortgage loan are also a lot higher than cash or bonds, even though the loan is secured by the property. Individuals usually turn to the private mortgage market because they can't secure bank financing; thus, they might have poor credit or limited down payments. Those risks can be exacerbated because it can be difficult to diversify in the private mortgage market.

Retirees should exercise caution when investing in non -traditional assets. It is important to understand that investors in these non-traditional assets might have to give up transparency, liquidity, and regulatory oversight.

Retirement Income Sources

Times are Changing:
Sources of Retirement Income are Shifting



Source: Employee Benefit Research Institute, 2011 Retirement Confidence Survey.

Concerns about shortfalls in traditional retirement income sources like Social Security and pension plans have caused people to expect to rely more heavily on personal savings to fund their retirement. The graph illustrates that while only 50% of current retirees utilize their personal savings for retirement income, 65% of current workers anticipate personal savings to play a role during retirement. Further, 73% of workers expect to receive retirement income from an employer-sponsored retirement savings plan, while only 51% of those already retired actually receive income from such a source.

It may be a good idea to plan for a diminished reliance on Social Security or a pension plan. Whatever extra funds you save by taking this more conservative view will make retirement all the more enjoyable.

Borrowing from Your Retirement

Barbara is 40 years old, has a child in college, and needs to take out a loan to help with tuition. She is considering either a home-equity loan or a loan from her 401(k), and is not sure which would be the better choice. She has heard that taking out a loan from a 401(k) is painless, since "you don't pay penalties and pay the interest to yourself, not to a bank." What should she do?

Many 401(k) plans offer a loan provision and the process is fairly easy. There is no credit check (since you are borrowing from yourself); the interest rate is usually low (maybe a percentage point or two above prime); you can generally borrow up to 50% of your vested account balance to a maximum of $50,000; you have up to five years to repay the loan (longer for loans used to purchase a primary residence), and the plan administrator usually deducts the loan payments automatically from your paycheck.

However, the real cost of borrowing from your 401(k) is not the rate you pay yourself in interest, but the amount you would have earned on your balance had you just left the money in the account. This is called an "opportunity cost," and it can be significant. In addition, if Barbara loses or changes jobs, a 401(k) loan will most likely come "due in full" within a limited amount of time, while a home-equity loan will not. The balance is taxed as if it were ordinary income and, unless she is at least 59½ years old, failure to pay the 401(k) loan back by the due date triggers a 10% penalty.

So, what are Barbara's choices? In general, if she can take out a home-equity loan at a lower after-tax cost than the return she expects to receive on her 401(k), she should choose the home-equity loan.

Creating a Budget

Creating a budget may seem like a complicated and unnecessary burden for most people, but a budget can be a valuable tool for managing your money. Instead of thinking about it as just another tedious thing to do, think about how a carefully-constructed budget can help you reduce expenses and optimize the way you spend.

Why do you need a budget? First of all, income does not always equal expenses. A budget is a resource-management tool that can help you achieve your long-term financial objectives, for example, saving more in order to meet retirement goals, freeing up monthly cash flow in order to pay down debt, or simply reducing expenses. Think about the budget simply as a plan for what you're going to do with your money. Here are a few guidelines to help you get started.

1. Track your income and expenses. In order to begin building a realistic budget, you'll need to track your revenue and expenses for at least a month or two. Start by writing out any sums of money that you receive and spend. If you have multiple sources of income, make sure to take all of them into account. For expenses, it may help to list them in order of magnitude. You can even create various categories if it helps you stay organized. The largest expense is probably your mortgage or rent. Then you have utilities (water, heat, electricity), auto expenses (car payment, insurance, gas, maintenance), food, medical/dental expenses (insurance, prescriptions), and so on. The important thing here is not to forget the little expenses. For example, if you go out for lunch, buy a magazine to read on the train, or go out for coffee with your coworkers, these expenses, however insignificant they may seem, need to be included in your budget. They say a small leak can sink a great ship; similarly, a few dollars here and there can add up faster than you think.

2. Start planning ahead. Once you have tracked your income and expenses for awhile, you should have a pretty good idea of where your money comes from and where it goes on a monthly basis. However, some expenses do not happen regularly, and you still need to be prepared for these eventualities. If you anticipate these expenses and include them in your budget, you can plan accordingly without breaking the bank. Some examples of such overlooked expenses are holiday gifts, emergency car repairs, and travel or vacations.

Now you are ready to create your budget. Based on the income and expenses you tracked during the past few months, write down what you expect your income and expenses to be next month, or for the next few months. Try to be as realistic as possible; your budget should reflect your actual financial situation, not your ideal one.

3. Stick to your budget. Creating your budget will be easy compared with sticking to it. It's not a disaster if you spend a few extra dollars here and there, but in next month's budget you should account for them. The budget is a plan, an estimate, but it is in your interest to keep this estimate as accurate as possible. Also, if you notice unusually large expenses where there shouldn't be any, now is the time to adjust them. Keep in mind that your budget should change as your financial situation changes, so monitor it regularly and make changes when necessary.

Eventually, a budget is supposed to teach financial discipline and the difference between necessity and luxury. You may be surprised to find out how much money flies out of your pocket for things you don't need and therefore will not use. It may seem that sticking to your budget means making many sacrifices, but ultimately it's your financial future that you're building.

The Ins and Outs of Long-Term Care Insurance

When planning for retirement it would be wise to at least consider the purchase of long-term care (LTC) insurance. While not everyone needs LTC insurance, it is recommended that people educate themselves about the issues surrounding this type of coverage. There are a dizzying array of options and features you'll need to understand if you are thinking about buying such a policy.

What daily benefit will you need? The higher the daily benefit, the higher your premium. But you'll need to find a balance between daily benefit and cost. According to the 2009 MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs, the average annual cost for a private room at a nursing home in 2009 was $79,935. The national average for a semi-private room was $72,270. The national average for an individual living in an assisted living community was $37,572.

How long will benefits last? The typical stay at a nursing home is between three and five years, so make sure your coverage lasts for at least that long. Think about your own family's health history when choosing benefit periods. Does longevity run in your family or is there a history of family illness? Many policies offer unlimited benefits, although that obviously gets quite expensive.

What's the elimination period?The elimination period is comparable to the deductible on your other insurance policies. Your long-term care policy won't begin paying out for a certain number of days. Most policies start with a 30- to 90-day elimination period, but you can increase that. The longer the elimination period, the cheaper your premium. Consider, too, that you may be able to pay out of pocket for a limited amount of time.

Is the benefit inflation-protected?Inflation is the rate at which the price of goods and services is increasing. If you are going to need benefits for a number of years, they need to keep pace with inflation. Most policies offer a guaranteed annual inflation increase (more expensive) or the opportunity to increase daily benefits down the road.

What level of care does the policy cover? The policy should cover all levels of care, both skilled and non-skilled. Nurses are generally the ones providing skilled care. Non-skilled care includes assistance with activities that don't require a nurse, such as bathing, walking, and dressing. You should be able to use the benefits not only for care at a nursing home but also for home health care, daycare, or assisted living.

Does the policy cover help at home?Some policies will cover the costs of bringing people into your home to help with physical therapy, bathing, dressing, walking, and so on. Make sure the policy doesn't require a prior hospital stay before this benefit is available.

How financially stable is the insurer?Research the financial rating of the company offering the policy. Check out ratings at A.M. Best's Web site. If you have a policy with a company that goes under, you still have a binding contract with that company.

What are "limited pay” options? A relatively new feature in long-term care policies is the ability to pay the entire cost at once or in a specified number of payments. This can help ensure that you don't have price increases in the future. For example, with a "single pay” option, you would pay all costs at once in one premium.

Exploring Annuities

The financial outlook for retirement has changed dramatically over the past 50 years. Retirement savings now have to last longer due to increasing life expectancy. Savings must also keep pace with inflation and rising health care costs. The traditional retirement resources—pension plans, Social Security, personal savings—may no longer suffice. Annuities are yet another type of investment that can provide powerful advantages in helping you meet your long-term financial goals.

What is an annuity? An annuity is a type of investment that offers tax-deferral and, if elected, guaranteed payments for a specified period of time. Annuities are sponsored by insurance companies and other financial institutions and sold by agents, banks, savings and loans, stockbrokers, and financial planners. They are a contract between the investor and the life insurance company. The vast number and types of annuity products available in the market today can be overwhelming, and understanding them all can be challenging.

Investment Type—Fixed or Variable

Fixed Annuities: A fixed annuity guarantees the investor a stream of fixed-income payments over the payout period of the contract. The payout period of the contract can be defined (for example, 20 years) or throughout your lifetime.

Variable Annuities: A variable annuity allows you to choose from a number of fund-like portfolios, or subaccounts, in which to invest. Investment choices can range from conservative to aggressive funds. Your return depends on the performance of the underlying investments chosen.

Payout—Deferred or Immediate

Deferred Annuities: A deferred annuity allows the investor to postpone paying taxes on earnings until withdrawals are made—usually at retirement. At retirement you have the option of cashing out or receiving income payments.

Immediate Annuities: A person in retirement can purchase, with a single payment, an immediate payout annuity. This type of annuity can provide an income stream throughout retirement. Income payments begin immediately and can be received monthly, quarterly, semi-annually, or annually.

It is important to remember that annuities are insurance products. If you are concerned about outliving your income, some types of annuities may be right for you. They can also act as a savings vehicle once you max out your regular retirement plan but would still like to invest additional cash. However, please keep in mind that annuities may have higher fees than other investment products. It would be wise to investigate the fee structure before jumping into an annuity.

There are certain fees and charges associated with variable annuities, which include but are not limited to: mortality and expense charges, sales charges, administrative fees, and surrender charges. Variable annuities are subject to market risk, will fluctuate in value, and upon surrender, may be worth more or less than the original amount invested. Read your prospectus carefully for all the fees and expenses that may apply to your variable annuity contract. The annuity income guarantee is based on the claims-paying ability of the insurance company that issued the annuity product but does not apply to the variable subaccount performance. Past performance is no guarantee of future results.

Tax-friendly States for Retirees

Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a "no sales tax" policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

In Case of Emergency

Nobody likes to think about the possibility of job loss, serious illness or other major expenses. But these are all possible in an uncertain world, and having an emergency fund in place can help if such situations arise.

An emergency fund is a money market, savings or checking account where you keep a specified amount of money to cover expenses. The important part here is that the money is stored in an investment vehicle that allows quick and easy access to funds. But you do not touch the money in this financially liquid account unless a real emergency pops up. No ifs, ands or buts.

Setting up an emergency fund is usually the first step toward building a solid financial plan. If you don't already have one in place, start building one as quickly as you can. It obviously takes perseverance to stash money from each paycheck into your emergency fund, but it may be well worth it one day.

How much cash should you put aside? Most financial advisors recommend to first aim to keep enough money in the fund to cover at least three months of expenses. However, as your take-home pay increases or your expenses grow, you may need to keep six months or even as much as a year's expenses in your fund.

Take it one step at a time. Once you've saved enough to cover three months of expenses, try for the six-month mark, and so on. Easier said than done, sure, but if you treat your emergency fund like any other must-pay monthly bill, it will undoubtedly grow over time.

IRA Dos and Don'ts

Do

Think of the IRA as a way to take control of your finances amid an unpredictable market. You know that old saying about having the wisdom to know what you can and can't control? Well, you can't control the market's ups and downs, but you certainly can make sure that your investments are as good as they can be, that your investment costs are low, and that you're taking advantage of every tax-sheltered opportunity available, such as contributing to an IRA.

Evaluate whether a conversion from a traditional IRA to a Roth makes sense. Starting in 2010, investors of all income levels will be able to make the conversion and will also be able to spread the corresponding tax hit over 2011 and 2012. To determine whether such a conversion is worth your while, consult with your financial advisor/tax specialist.

Bear in mind your overall asset-allocation plan. Size up your whole portfolio's stock/bond/cash mix and take note of any big sector or style biases; also note any gaping holes in your portfolio. You can also compare your portfolio with a target-date fund designed for someone in your same age range. If you find that you need to add to your holdings in a certain asset class or investment style, your IRA is a logical place to start.

Use an IRA calculator. These tools (make sure they are on a trusted and reputable Web site) can help you identify the IRA type that you're eligible to contribute to and will allow you to maximize your return once taxes are factored into the equation.

Don’t

Forget about your spouse. Married couples that include a working and nonworking spouse can maximize their aftertax results by setting up IRAs for both individuals. A so-called spousal IRA is an option as long as you file a joint return and the working spouse has earned enough qualifying income (be aware of limitations) to fund both his or her own IRA and that of the spouse.

Assume that you need a lot of cash on hand to invest in an IRA. A strategy, called dollar-cost averaging, is a systematic way of investing equal dollar amounts at predetermined times. It allows an investor to purchase more shares of an asset when the price is low, and fewer shares when the price is high. It also makes an IRA a more-affordable option if you don't have the full contribution amount on hand.

Assume that you don't need to contribute to an IRA if you already contribute to a 401(k). If you're maxing out your 401(k), you should consider an IRA as well because IRAs can help you diversify the tax treatment of your retirement assets. For example, if you're contributing the max to your 401(k), you'll owe taxes on a considerable amount of assets when you retire and begin tapping the assets. Withdrawals on Roth IRA assets, meanwhile, will be tax-free. By hedging your bets among the two vehicles, you have less riding on a wager about whether tax rates will be higher or lower in the future; you also maximize your tax-deferred savings.

Shelter investments with tax benefits inside an IRA. IRAs already offer tax-deferred (or in the case of a Roth, tax-free) compounding, so there's no need to stash tax-advantaged instruments like municipal bonds within them. Save those for your taxable accounts and consider IRAs only after you've maxed out your tax-sheltered options.

Be sure to consult with a financial advisor or tax professional for the latest rules and regulations. Stocks are not guaranteed and have been more volatile than bonds. Municipal bonds may be subject to the alternative minimum tax and state/local taxes, and federal taxes apply to any capital gains distributions.

Straightforward Strategies & Solutions

Whether you're preparing for retirement, managing investments, making sense of insurance products or need assistance with your corporate retirement plan, our seasoned advisors can help you navigate the ever changing financial landscape to ensure that you reach your financial goals.

Informed decisions: Our goal is to untangle financial complexities and develop an accessible, realistic plan to meet your goals and your lifestyle.

Individual attention: From the start of our relationship, our goal is to gain a detailed understanding of your expectations, from investment performance to client service.

Strategies that meets your goals: We take an active approach to understanding your needs, establishing individual benchmarks, choosing investments that meet your strategy, and striving to surpass your goals through responsible asset stewardship.

A fiduciary-responsible partner: We take a structured, prudent approach to managing and implementing your investment decisions. Specifically, as investment stewards, we have the legal responsibility to manage your money to the highest standard of care.

Partner with an expert: We have a solid 25-year legacy of establishing and achieving financial objectives for our clients. Over time, we have successfully weathered many market cycles by maintaining a solid, long-term investment perspective and a disciplined approach to meeting client objectives and expectations.

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