

# 401(k) UPDATE

JANUARY 2008

## Where Should You Hold Investments?

**H**ow earnings are taxed on investments depends on whether the investments are held in a taxable or tax-deferred retirement account.

Earnings in tax-deferred retirement vehicles, such as 401(k) plans and traditional individual retirement accounts (IRAs), grow tax deferred until withdrawn. When the funds are withdrawn, all income is taxed at ordinary income tax rates, even income attributable to long-term capital gains and dividend income.

In taxable accounts, the long-term capital gains tax rate is 15% (0% for taxpayers in the 10% or 15%

tax bracket from 2008 to 2010), while short-term capital gains are taxed at ordinary income tax rates (10%, 15%, 25%, 28%, 33%, or 35%). Dividend income received by individual taxpayers from a domestic or qualified foreign corporation is also taxed at the same rate as long-term capital gains.

Thus, the difference between the maximum ordinary income tax rate (35%) and the rate on long-term capital gains and dividend income (15%) is 20%. This is a significant difference that could impact your decisions regarding how to invest your savings. Thus, consider the following strategies:

✓ Stocks that generate dividend income may best be held in taxable accounts. While you will have to pay income taxes as the dividend income is received, you will only pay tax of 15%. If the stocks are held in a tax-deferred account, you will pay ordinary income taxes on the dividend income when withdrawn.

✓ Consider holding growth stocks in your taxable account. Again, any long-term capital gains are taxed at 15%. If the stocks are held in a tax-deferred account, ordinary income taxes will be paid on the long-term gains when the funds are withdrawn. However, if your holding period is long enough, the deferral of taxes over many years may more than offset the cost of the higher tax rate.

✓ Investments generating ordinary income, such as bonds,

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## Clean Up Your Portfolio

✓ **Take another look at your asset allocation plan.** Do this before you review your actual investments, so you aren't influenced by your current allocation. Don't just assume your original allocation is still appropriate. You may now realize that your risk tolerance is lower or higher than you originally thought.

✓ **Find your most recent statements.** List each investment and its current value. Total your investments by category. Then compare those percentages to your asset allocation plan. Devise strategies to get your allocation back in line.


✓ **Get rid of small accounts.** It's not unusual to find you have several small accounts. You still have to look at the statements every month and make sure any income is included on your tax return. Take all those small accounts, cash them out, and consolidate the funds.


✓ **Look for ways to simplify your investments.** Do you own similar stocks or other investments that aren't adding much in the way of diversification to your portfolio? While you want to be properly diversified, minimize the number of accounts and investments you own so your investments are easier to monitor. ○○○




## Make Conservative Assumptions


**H**ow can you ensure you'll have sufficient funds to last your entire retirement? So many of the variables used to calculate this amount seem uncertain. What is a reasonable rate of return for your investments over the long term? How long will you live, knowing life expectancies are increasing? How much can you count on from Social Security and pension plans? If you're concerned about running out of money during retirement, you need to be very conservative with your assumptions. Some tips to consider include:


 **Assume your retirement income will be at least 100% of your current income.** Most rules of thumb indicate you'll need between 70% and 100%, but figure on at least 100% to be safe. Nowadays, retirees want to travel, pursue hobbies, and live an active lifestyle, which generally means you'll need the higher end of these estimates.


 **Add a few years to your life expectancy.** You should probably plan on living until at least age 85 or 90. If your family has a histo-


ry of longevity, add a few more years to these figures. While you may find it hard to believe you'll live this long, you don't want to reach age 75 or 80 and find out you've run out of money. At that point, you might not have the option to return to work.

 **Reduce your estimates of Social Security benefits.** The Social Security Administration sends benefit statements every year around your birthday, telling you how much to expect in benefits. While Social Security is currently in sound financial condition, that is expected to change after all the baby boomers retire. To be safe, count on benefits that are somewhat less than the Social Security Administration is estimating, and don't plan on adjustments for inflation.

 **Cut back on your living expenses now.** This has a two-fold impact on your retirement. First, it frees up money to set aside for your retirement. Second, you get used to a lower standard of living, which should also reduce your expected lifestyle for retirement.

 **Reach retirement with no debt.** Mortgage and consumer debt payments consume a significant portion of most people's income. Pay off all those debts by retirement and you significantly reduce your cost of living.

 **Forget about early retirement.** Saving enough to last from age 65 to age 85 or 90 is a difficult task. Trying to retire at age 55 or 60 is just not practical for most individuals, unless you're willing to significantly change your lifestyle. Working a few more years can go a long way in helping fund your retirement. Those years are typically your highest earning years, so hopefully you'll save significant sums during that period. Also, every year you work is one year you don't have to support yourself with your retirement savings.


 **Plan on taking conservative withdrawals from your retirement assets.** Don't plan on taking out more than 3% to 4% of your balance annually. Your funds should last for decades with that level of withdrawal. ○○○


## Bonds and Maturity Dates

**B**onds can be purchased with maturity dates ranging from several weeks to several decades. Before deciding on a maturity date, review how that date affects investment risk and your ability to pursue your investment goals.

Typically, yield increases as the maturity date lengthens, since you assume more risk by holding a bond for a longer time. Investors are often tempted to purchase bonds with long maturity dates to lock in higher yields, but that strategy should be used with care. If you purchase a long-term bond knowing

you'll need to sell before the maturity date, interest rate changes can significantly affect the bond's market value. Two fundamental concepts about bond investing apply:

 **Interest rates and bond prices move in opposite directions.** A bond's price rises when interest rates fall and declines when interest rates rise. The existing bond's price must change to provide the same yield to maturity as an equivalent, newly issued bond. You can eliminate the effects of interest rate changes by holding the bond to maturity, when you will receive the full principal amount.

 **Bonds with longer maturities are more significantly affected by interest rate changes.** Since long-term bonds have a longer stream of interest payments that don't match current interest rates, the bond's price must change more to compensate for the rate changes.

You can limit the effects of rate changes by selecting bonds with maturity dates close to when you need your principal. In many cases, you may not know exactly when that will be, but you should at least know whether you are investing for the short, intermediate, or long term. ○○○

## Reassess at 60

**A**pproximately five years before you want to retire, thoroughly reconsider your retirement plans and make sure all significant financial pieces are in place. Once you retire, you probably won't have the option of going back to your job. So, before you retire, consider these points:

✔ **Take a serious look at your retirement plans.** You're close enough to retirement that you should have a good feel for your retirement expenses and expected income. While you may be anxious to retire, remain flexible about your retirement date. Working an additional year or two can add substantially to your retirement savings and may boost your retirement benefits.

## Hold Investments

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should be considered for your tax-deferred account. Since ordinary income taxes will be paid whether the investment is held in a taxable or tax-deferred account, you delay the payment of those taxes by holding the investment in a tax-deferred account.

✔ The lower income tax rates for long-term capital gains and dividend income will reduce your tax bill in your taxable account, but you shouldn't quit contributing to your 401(k) plan or traditional deductible IRA. Contributions to those accounts are made from pretax dollars. Money invested in a taxable account is made with after-tax funds, so you'll only be investing 65 or 75 cents instead of the dollar that would be going into your 401(k) plan or IRA. That difference makes a tax-deferred account tough to beat over the long term. ○○○

✔ **Get a fix on your Social Security and pension benefits.** Make sure you know exactly how much you can expect from Social Security and defined-benefit plans. How much will your benefits increase if you delay retirement by one year, five years, etc.? If you retire before normal retirement age for Social Security purposes, do you plan on working? Be aware that for those under full retirement age for Social Security purposes, earnings over \$13,560 in 2008 will cause you to lose \$1 of benefits for every \$2 of earnings over that threshold. Make sure you understand your distribution options for any defined-benefit plans. In most cases, those decisions are irrevocable, so you'll want to take some time to assess those options.

✔ **Determine how much income your retirement investments will generate.** As a general rule of thumb, you can multiply your retirement investments by 4% to get an idea of how much you can withdraw annually. You can go through a more detailed analysis, reviewing a wide range of variables, for a more precise answer. However, the younger you retire, the more conservative your withdrawals should be, since your funds will have to last for a longer time period.

✔ **Investigate work options.** If you plan on working at least part-time during retirement, have you decided what you'll do and how much it'll pay? Make sure you investigate your options, including finding out if your current employer provides part-time opportunities after retirement.

✔ **Finalize living arrangements.** Determine whether you want to stay in your current home or move to another one, either in the same city or a different location. At this point, you should be able to

determine whether you will have a mortgage and how much equity you'll have in your home. While approximately 80% of retirees continue to live in their current home, explore whether it makes sense to downsize, freeing up home equity for investments or retirement income.

✔ **Deal with health insurance and long-term-care costs.** Two of the most significant costs in retirement are medical care and long-term care. Make sure you have plans to deal with both. If you are retiring at age 65 or later, you'll be eligible for Medicare, although a spouse under age 65 will not be eligible. You will probably need supplemental coverage with Medicare. If you are retiring before age 65, make sure you know exactly how much coverage will cost you, especially if health insurance is not provided by your employer. Now is also a good time to take a look at long-term-care insurance, since premiums get significantly more expensive as you age.

✔ **Live with your retirement budget for a couple of years.** Want to really make sure your retirement budget is reasonable? Try living with your retirement budget for a couple of years before retirement. If you can do so without increasing your debt, you can be reasonably confident that the budget will work during retirement. ○○○



## Choosing Beneficiaries

**W**hen you sign up for your 401(k) plan, you will typically be asked to fill out a beneficiary designation form listing who should receive your 401(k) plan assets if you die. Make these selections carefully, since they typically override any provisions in your will.

If you are married, federal law dictates that your spouse is automatically your 401(k) plan's beneficiary. Even if you list another person as the primary beneficiary, your spouse will receive the proceeds unless he/she signs a written waiver.

If you remarry and want to keep your children from a previous marriage as the beneficiaries, you must have your current spouse sign a waiver. You should not rely on a prenuptial agreement or other document.

When your beneficiaries are minor children, keep in mind that most 401(k) plans will not transfer money directly to minor children. Thus, you may want to set up a trust, so the trustee can take immediate control of the funds. Otherwise, a court-appointed trustee or guardian may need to be named before your children will have access to the funds.

If you are single and don't name a beneficiary, the proceeds will go to your estate and be distributed with the rest of your assets.

Periodically review your beneficiaries to determine if changes are needed. A divorce, remarriage, spouse's death, or child's birth are all events that may require changes to beneficiaries. ○○○

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## Market Data

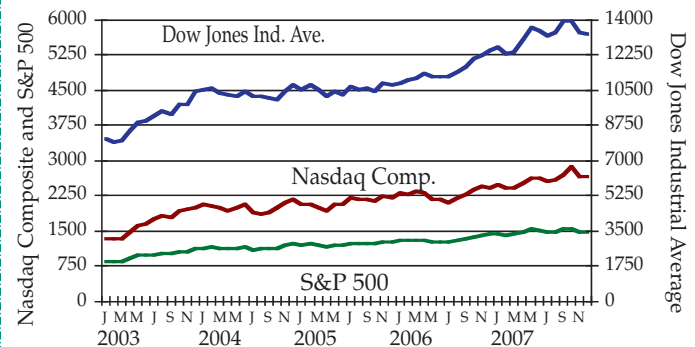


	Month End			% Change	
	Dec 07	Nov 07	Oct 07	2007	2006
Dow Jones Ind.	13264.82	13371.72	13930.01	6.4%	16.3%
S&P 500	1468.36	1481.14	1549.38	3.5	13.6
Nasdaq Comp.	2652.28	2660.96	2859.12	9.8	9.5
Wilshire 5000	14819.58	14932.67	15673.36	3.9	13.9
Gold	833.75	783.39	789.35	31.9	22.5
				Dec 06	Dec 05
Prime rate	7.25	7.50	7.50	8.25	7.25
Money market rate	4.49	4.56	4.77	4.68	3.49
3-month T-bill rate	3.28	3.18	3.92	4.88	3.91
20-yr. T-bond rate	4.58	4.49	4.88	4.82	4.71
Dow Jones Corp.	5.89	5.67	5.55	5.71	5.30
Bond Buyer Muni	4.88	4.78	4.74	4.61	4.78

Sources: *Barron's*, *Wall Street Journal*

## Stock Indices

### January 2003 to December 2007



Past performance does not guarantee future results.

## Thoughts about Retirement Planning

**A** recent survey found that 51% of U.S. workers were worried about paying for health care when they retired, and 35% were concerned that a major medical expense would wipe them out financially (Source: Watson Wyatt, 2007).

In a recent survey, almost 20% of adults expect to remain unemployed until they die, while 39% of working adults age 65 and older expect to work

until they die. Almost 30% of workers age 65 and older saved 15% or more of their income, while that percentage declined to 23% of those between the ages of 50 and 64, 18% of those between the ages of 35 and 49, and 15% of those between the ages of 25 and 34 (Source: Bankrate.com, 2007).

A recent report estimates that a 65-year-old couple will need \$215,000 to cover health care expenses in retirement, including

costs for Medicare Part B and Part D and supplemental insurance. This amount does not include potential long-term-care expenses. It was estimated that a 65-year-old earning \$60,000 in the year he/she retires could spend approximately half of pretax Social Security benefits on health care (Source: PlanSponsor.com, 2007). ○○○