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Now's A Time To Recall Financial Planning Basics

Just a few years ago, almost everyone knew at least one person who had made a fortune in the stock market. Today, many of us have lost a fortune. For those who are wondering what went wrong, here's a refresher course in financial planning basics.

Diversification. In the late 1990's, many investors thought diversification meant buying three computer stocks and two Internet stocks. Others assumed they were being prudent because they owned a dozen mutual funds. But true diversification means buying a range of investments in markets that do not move in lockstep with each other. Through most of the 1990s, growth stocks were the spectacular performers; in recent years value stocks have been successful. A balanced portfolio will have both. It will also include bonds. But just starting out with the right mix isn't enough; you also need to rebalance your portfolio regularly, trimming positions that have done well and adding to others that may be poised to rebound.

Planning. Establishing clear life goals and a long-term strategy is the essence of sound financial planning. A solid plan lays out the amount you must save annually, assuming an expected average rate of return, to reach your financial targets. It prepares you for future expenses, such as a child's college education, and unexpected setbacks, such as premature death or disability.

Saving. Money doesn't grow on trees, but it does grow provided you invest it. The more you put aside and the longer you allow it to compound, the better off you'll be. The rule of 72 is the easiest way to see how this works*. Simply divide 72 by your rate of return to get the number of years it will take for your money to double. For example, with an 8% return, your investment will double in nine years and quadruple in 18. A steady, automatic withdrawal from your paycheck is probably the most effective way to save. That way, you don't miss the money, because you never see it, and you're able to load up on assets when they're doing poorly and reap the benefits when they go up.

Retirement contributions. The government rewards savers by offering tax benefits to retirement accounts such as 401(k)s, 403(b)s, and IRAs. In most cases, you contribute pre-tax dollars and the money grows tax-deferred, meaning you don't owe taxes on gains until you withdraw the money. With Roth IRAs, you contribute money that has already been taxed but your withdrawals are tax-free. Either way, the boost from Uncle Sam is so generous that it's worth stuffing as much as possible into retirement accounts before allocating to regular savings and taxable accounts.

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A New Way to Think About Retirement

Many baby boomers struggle with the concept of retirement and all that it connotes. But as we all move inexorably toward that time, it makes sense to rethink what retirement means for us.

Gone are the days when workers retired from 40 years on the job, expecting that their retirement would last only about a decade. Retirement, in whatever forms it takes, is now a longer and more vibrant phase of life that may last almost as long as our working careers. This fact brings with it tremendous promise (and plenty of unique financial planning challenges to boot). How should we think about this phase of our lives?

The primary difference between a successful and an unsuccessful retirement is whether you are retiring to something or retiring from something. A fulfilling retirement focuses on the ability to achieve the freedom to pursue your own goals, at your own pace, on your own terms...regardless of age.

We likely won't live the kind of retired life as did our parents or grandparents. For most of us, that may be a good thing. It's a refreshing change to the idea of retirement, and it's about time.

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To Consolidate Your IRAs Or Not To Consolidate

Although this dilemma isn't as life altering as Hamlet's, it could still have a signi-ficant impact on your financial affairs. Here are several reasons to consider one path or the other.

When not to consolidate. While it's generally possible to consolidate multiple traditional or Roth IRAs—that is, merging traditional IRAs with other traditional IRAs, or Roths with other Roths—you can't put a traditional IRA with a Roth, and you can't join an IRA with employer retirement plans such as 401(k)s or 403(b)s.

One reason not to consolidate accounts is that it may mean forfeiting favorable tax treatment. For example, although the law was recently revised to permit a non-spouse to roll over inherited retirement plan assets, those funds must remain in a separate inherited IRA. (You can, however, merge an IRA left by your spouse into your own account.) Or you may have assets in a "conduit IRA," a special kind of account that holds money from a previous employer's retirement plan until you can move it to a plan at your new job. To preserve the advantages of a 401(k) or 403(b)—for example, being able to tap the account at age 55 if you retire early, or getting better tax treatment for company stock—you must avoid mixing a conduit IRA with other accounts.

You may also not want to consolidate if the IRAs have been separated to accomplish specific planning goals involving beneficiary designations or to set up specific streams of income.

When to consolidate. If none of those reasons apply, bringing together two or more accounts may provide several benefits. Almost all of the advantages involve the fact that it's much easier to manage one account than to keep track of several. Consider the following:

- Making changes in your investment strategy—say, moving to a more conservative mix of assets as you approach retirement—is significantly more complex and time-consuming if it involves several accounts.
- If you have many accounts, you may tend to ignore those that are small or aren't performing well.
- If your IRAs are at several institutions, each one may charge you an annual maintenance fee. You'll also have more paperwork, with multiple monthly statements and end-of-year tax forms.
- When it's time to begin distributions from a traditional IRA—the year after you turn 70½—the amount of the required withdrawal is based on the total value of all IRAs. Neglect to include one in your calculations and you'll face punishing tax penalties. (Exemption: The rule for taking required distributions is temporarily waived for the 2009 tax year.)
- Before consolidating IRAs, consider rolling over your 401(k) plan to an IRA so that you can "stretch" the IRA over a beneficiary's life expectancy. If a 401(k) participant dies before doing this, beneficiaries are generally required to take a full distribution and pay income taxes on it within five years.

We can help you decide if you should consolidate your IRAs and consider how those assets fit into your overall financial plan. ●

Managing Cash Flow During Tight Times

In these unstable economic times, virtually every business—from mom-and-pop drugstores to multinational conglomerates—has cause for concern. But the strain may be especially pronounced for small businesses facing what has become a deepening credit crunch.

If you're like many owners of such companies, your cash reserves have been eroded just when lending has dried up. It may be difficult to secure a loan to buy a new car, pay your child's college tuition, or keep your business afloat until conditions improve.

At this point, though the government has made a concerted effort to get credit flowing again, no one knows for certain whether those actions will work or how long it will take before loans become readily available at reasonable rates. But you don't have the leisure to sit on your hands and wait for brighter days. Some of the suggestions that follow directly address cash-flow issues, while others could have a less immediate but equally important impact on the health of your business.

Analyze company expenses. Scrutinize your income statement to see where you're overspending. Highlight cuts you may be able to make without affecting quality or customer satisfaction. And keep in mind that no expense is too small or insignificant—if you can find a few items costing only $50 or $100 a month, that may add up to appreciable savings over time.

Expand your product line. This may be difficult when cash is scarce, but if you can provide a new essential product or service that people need during the economic downturn, it could add to your revenues and improve your balance sheet.

Think outside the box. When

Does Your 529 College Savings Plan Match Up?

When the Pension Protection Act of 2006 made 529 college savings plans a permanent part of the tax code, it ended most debate about the best way to invest for educational expenses. However, there are dozens of state-sponsored plans to consider, each varying in everything from investment choices and performance to plan costs and tax advantages. Understanding the differences can help you find a plan that makes the most of your college savings.

All 529 plans offer these benefits:

• No income requirements and very high caps on account contributions

• No federal income tax on investment earnings, nor on distributions to pay qualified college costs

• Plan owners retain control of how assets are used. If a plan owner's child doesn't go to college, he can name another family member as beneficiary or even take back contributions, though normally with a 10% penalty and tax on investment profits. (One strategy, lets you avoid taxes and penalties by making a charitable donation of an unused plan.)

• Your ownership of plan assets means favorable treatment in federal financial aid formulas, increasing your child's chance of qualifying for federal aid (though it may lower aid packages from institutions).

• You can lump together five years' annual gift-tax exclusions to make a single 529 contribution. Because you and your spouse may each give up to $13,000 a year without gift-tax liability, you can jump-start a plan with up to $130,000 while also removing that money from your estate if you live for five more years.

Get past the basics, and differences among plans emerge. A distinguishing feature is whether the plan is sold directly to investors or through a financial advisor. Savingforcollege.com and Morningstar.com provide databases of 529 plans and guidance on plan selection. Savingforcollege rates effectiveness on a one- to five-cap scale, and each year Morningstar names the country's five best and worst plans. In both cases, evaluations are based on several criteria:

Costs. Some plans dun you for enrollment, account maintenance, and program management charges, while others charge only for your underlying investment expenses, which may range from a few basis points annually to nearly 2%. Each basis point equals 1/100th of a percent. Comparing 10-year costs on a $10,000 investment, Savingforcollege found overall expenses ranging from $0 (for investing in one state's fixed-earning plan) to $2,616. Since fees are a steady drain on investment performance, it makes sense to choose a low-cost plan.

Investment options. Whereas some plans offer just one or two kinds of investments, others provide a broad range of choices. In some cases, your money will be managed as part of a state pension fund. Other possibilities include age-based portfolios that dial down risk as a beneficiary approaches the start of college; static portfolios pegged to investors' risk tolerances or classified by asset type (equity, fixed-income, balanced); menus of individual index or actively managed mutual funds; and money market funds. You'll want a plan that gives you well-diversified choices from a well-regarded fund family. And again, low expense ratios are essential.

Perks for state residents. Many states make plans available to out-of-staters; but all else being equal, an in-state plan may be preferable since they often provide tax deductions or credits for contributions and even contribution matches for low-income residents.

Other advantages/disadvantages. Most 529 plans let you enroll, fund plans, and check balances on the Web. A few plans restrict ownership changes, and a handful of states let out-of-state plan enrollees pay in-state tuition. Some plans have agreements with outside credit-card rewards or scholarship programs that can add to savings.

All of these criteria, useful for evaluating a prospective plan, can also help you gauge the effectiveness of an existing 529 plan. If yours comes up short, plan-to-plan transfers are usually allowed once every 12 months, and you can also establish multiple accounts with different plan sponsors for a single beneficiary. You may also want to explore other savings vehicles like Upromise.com, where you get a kick-back for consumer products that you buy.

You should consider a plan's investment objectives, risks, charges, and expenses carefully before you invest. The issuer's official statement contains this and other information about the plan and should be read carefully before investing. Investors should consider whether the investor's or designated beneficiary's home state offers any state tax or other benefits that are only available for investors in such state's qualified tuition program. A prospectus may be obtained from your advisor or from the fund company directly.

the going gets tough, the tough get creative. Assess your company's strengths and weaknesses. Then match them to a market need. It's far better to revamp your existing operation than it is to start from scratch after an economic meltdown.

Become "lean and mean." Even if your business has managed to sidestep the downturn thus far, you'll likely feel the effects eventually. So plan ahead for the inevitable. You might build up cash reserves, scout out profitable opportunities, restructure under-performing departments, postpone capital expenditures, and pay off debt.

Schedule a meeting with your banker. Although you may not be angling for a loan right now, it still makes sense to assess your credit worthiness, and your banker may have insights into how to shore up your position.

Extend your credit lines. Even now, if your standing is rock-solid, you may have a chance to apply for additional credit. That could come in handy if your situation worsens.

Reach out to your customers. See how they are faring and what you might do to help them weather the economic crisis. That may not improve your balance sheet but it will help foster long-term customer loyalty. ●

Helping Out Adult Children Financially

A recent University of Michigan study revealed something you may already know from personal experience. These days, one in three young adults rely on parents for financial help.

According to the survey, 34% of those age 18 to 34 are getting assistance. In some cases, Mom and Dad make a one-time gift, financing a vacation or the down payment on a house or car. In other instances, parents provide monthly checks to cover expenses such as rent and groceries.

Though you may be surprised to find your financial obligation to your children extending well beyond age 18, there is an upside. Playing a financial role in your child's life gives you the opportunity to teach valuable lessons about financial responsibility. Your guidance, as much as your dollars, can help ensure your children's future financial health.

What's the most instructive way to dole out the cash? One option is to have Junior send you certain bills you agree to pay. You'll see how he's spending his money, and you may be able to suggest strategies for cutting his phone bill, say. But this can undermine your child's sense of independence and discourage him from taking responsibility for himself—a failing that may become more crucial as he acquires a family and larger financial burdens.

Playing a financial role in your child's life gives you the opportunity to teach them a valuable lesson

Another possibility is to transfer a lump sum into your child's bank account. This could be pegged to a particular need, or you could step in whenever cash runs low. This implies less ongoing dependence than the bill-paying route. It also encourages careful budgeting to make the money last—or at least demonstrates what happens without careful budgeting.

But probably the best approach is to provide monthly, salary-like payments gauged to fill the gap between the child's income and expenses. This mirrors the way your son or daughter receives money in the real world, via paychecks. You're just providing a supplemental salary, helping meet ongoing financial obligations for rent and utilities, car payments, and other expenses. This can also help your son or daughter get used to the ebb and flow of earning money and paying bills.

To avoid the awkwardness of handing over a check each month, you could set up an automatic funds transfer to your child's account. Like a direct-deposit paycheck, the money will be part of your son or daughter's normal income. Of course, this can be habit forming, and you may want to strike a deal to reduce your support proportionately when the child gets a raise. ●

Financial Planning Basics

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Tax planning. Hidden within hundreds of pages of tax laws are a broad range of special breaks for taxpayers. Shifting income from one year to another, selling assets that have lost money to balance out gains from top performers, and making contributions to educational savings accounts are just three possibilities. Review your tax situation with a financial professional at the beginning of the year and again in December.

Insurance. Planning for the unexpected is the key when determining insurance needs. You should have enough life insurance to meet heirs' long-term needs. Your health insurance should include coverage of catastrophic accidents or illnesses. Disability insurance is relatively inexpensive, but could make a big difference if you need it. And you should seriously consider long-term care insurance if you don't think your retirement income will be sufficient to pay for nursing home care.

Estate planning. Having the right estate plan will ensure that your wishes are respected. If you have substantial assets, developing a well-thought-out estate plan can minimize taxes even while you are alive and maximize the amount you are able to leave to loved ones and your favorite charities. Even if you don't have enough in your estate to be liable for federal or state estate taxes, having a valid will can save your heirs a lot of trouble and money.

In the dying days of the 20th century, there was talk about how the old financial rules no longer applied. "It's different this time," everyone said. But it wasn't all that different, and millions of investors lost ground and time on the road to their financial goals. It's never fun to start over, but it does give you one more chance to do everything right. Taking care of these basics should prepare you well, and we are happy to help. ●

***The Rule of 72 is hypothetical and there can be no assurance that any investment will double within the specified timeframe.**