

financial focus

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THE CASE FOR TAX DIVERSIFICATION

by William Starnes, CFP®, ChFC; Hockessin, Delaware

Most are familiar with the importance of diversifying their investments to lower risk. Because we cannot predict the precise nature of the risks that may impact our portfolio, we diversify—across market capitalization, style, number of securities, for example. Because there is no way to predict the amount of our future tax, we should also consider tax diversification.

So how can you be tax-diversified? By having a mix of taxable, tax-deferred, and tax-free retirement assets. Most of us already have taxable accounts and tax-deferred retirement assets

(i.e., 401(k)s, IRAs, and 403(b)s).

The only tax-free retirement assets are the Roth IRA, Roth 401(k), or Roth 403(b). These tax-free assets are created using:

- 1) annual Roth IRA contributions,
- 2) Roth IRA conversions, and/or
- 3) Roth 401(k) or Roth 403(b) contributions.

■ Roth IRA Contributions

With a Roth IRA, unlike a Traditional IRA, you pay the income tax up front when you contribute (or convert) to it. After you pay the tax, your Roth grows tax-free forever. It's like paying tax on the seed so the crop can grow tax-free!

Making Roth IRA contributions is a "no-brainer" if you qualify and have the available funds or cash flow. Compare a Roth IRA versus investing the same dollars in a taxable investment account. Your Roth contributions

(not the earnings) are always available for withdrawal, and 100% of the earnings are tax-free. Tax-free is always better than taxable.

■ Roth 401(k) or 403(b) Contributions

In January, 2006 the Roth 401(k) and Roth 403(b) became available to employers. The benefit here is the ability to make substantial (\$15,000/year + \$5,000 catch-up if 50 or older) contributions to a tax-free vehicle without the usual income limitations of a

Roth IRA contribution. Roth 401(k) or 403(b) plans do have required minimum distributions, unlike Roth IRAs.

■ Roth IRA Conversions

Currently, anyone with a Traditional IRA and an adjusted gross income of \$100,000 or less has had the ability to convert all or a part of a Traditional IRA to a Roth IRA by paying the income tax due on the amount converted. However, in 2010

(and later years) conversions will be available to all with no income limitations.

■ Benefits of Tax Diversification

Imagine that you are retired and have both tax-free and tax-deferred investment accounts available to support your current lifestyle. To generate the necessary cash flow, you must take a withdrawal from either your Roth IRA or your Traditional IRA (or some combination). Consider the control you have gained over your tax planning by having both types of accounts. In years with higher taxable investment income, you take your distribution from the Roth IRA to avoid a taxable IRA distribution. In lower income years, you take your needed cash flow from your (taxable) Traditional IRA. With tax diversification, you now have great control over your tax planning—leading to ongoing tax savings!

Tax diversification also enables you to maximize the tax-free accumulation of your investments, leading to

Continued on page 2, Tax Diversification



INSIDE THIS ISSUE

- 2 What Does The Pension Protection Act of 2006 Mean For You?
- 3 Economic Man Meets Reality Man
- 4 Financial Tips for Newlyweds and Graduates



WHAT DOES THE PENSION PROTECTION ACT OF 2006 MEAN FOR YOU?

by J. Marc Vorchheimer, CFP®; Nanuet, New York

Many of you have heard of the Pension Protection Act of 2006 (PPA) but might not be sure what it means for you. The new law promotes increased savings: It makes permanent increased IRA, retirement plan, and catch-up contribution limits, as well as the tax-advantaged benefits of all 529 college savings and prepaid tuition plans. The PPA also eases qualified plan and IRA payout and rollover rules. In addition, it includes many changes for charitable contribution deductions and charitable organizations, including eased rules for transfers from IRAs, tightened clothing and household goods contribution rules, and stricter record keeping requirements for cash contributions. Here is a summary of some of the major provisions of the new law that may directly affect you.

• Retirement Plans

The PPA allows employers to automatically enroll workers in defined-contribution retirement plans. And it provides employers with a safe harbor for automatic enrollment, default investment selection for automatic enrollment, and automatic escalation of contributions. The new law also gives workers the right to sell publicly-traded company stock received as a matching contribution in their retirement plan account after three years of service for original matching contributions, and immediately for employee contributions. The new law prohibits companies from forcing employees to invest any of their own retirement saving contributions in company stock. In addition, the new law permanently extends the "Saver's Credit" for low-income taxpayers who contribute to an IRA, and it indexes that credit to inflation.

The PPA eases a number of qualified plan and IRA payout and rollover rules. For example, after 2007 taxpayers who plan to do a Roth conversion would be permitted to make direct rollovers from qualified plans to Roth IRAs. They will no longer have to go to a regular IRA. For non-spouse beneficiaries, it is worth noting, this must be a trustee-to-trustee transfer. In other words, a check cannot be issued directly to the non-spouse beneficiary and then deposited into his/her IRA. If it's done this way, this opportunity is lost for good. Non-spouse beneficiaries can transfer inherited amounts in qualified plans or IRAs to their own IRAs after 2006. The PPA also gives taxpayers the option of depositing a portion of their federal tax refund directly into an IRA.



The PPA makes permanent the IRA and pension provisions enacted in the 2001 tax cut legislation that were scheduled to expire after 2010. The 2001 law increased annual contribution limits for IRAs and workplace plans such as the 401(k); created additional catch-up contributions for individuals age 50 and older; and created incentives for small employers to offer workers retirement savings options.

Under the new law, the current \$4,000 contribution limit for IRAs rises to \$5,000 in 2008 and is adjusted for inflation after that.

• Other Provisions

The PPA also allows tax-free IRA transfer rollovers directly to charitable organizations for tax years 2006 and 2007. Only taxpayers age 70½ and older can do so, and the tax-free distribution is limited to \$100,000 per year. The legislation also permits insurers to add long-term care insurance riders to annuity contracts, which will likely encourage the

development of combination products that consolidate various insurance protections into a single product while providing a savings feature. The PPA also tightens the rules in areas where Congress perceived abuses in charitable giving. ■ ■ ■

Continued from page 1, Tax Diversification

greater wealth across generations due to the less stringent required distributions. For example, Joe retires at age 65 with \$100,000 in a Traditional IRA and \$100,000 in a Roth IRA. Assume an 8% return on both accounts. The cumulative distributions for the Traditional IRA 58 years later (after the account passes to Joe's wife, then Joe's son) are \$1,202,366 – all subject to ordinary income tax. The cumulative distributions for the Roth at that point are \$3,515,951, all taken tax-free!

So in this ongoing environment of tax law changes, how should you manage the risk that taxes could be higher or lower in retirement? Or how can you manage not only your current tax liability but also your lifetime (and beyond) tax liability? In the face of such risk, consider tax diversification by holding both tax-deferred and tax-free retirement savings. ■ ■ ■



ECONOMIC MAN MEETS REALITY MAN

by Robert Roy Reed, Ph.D., CFP®; Columbus, Ohio

If you ever took an economics course, you met *Economic Man*—the model for human behavior in classical economic theory. Economic Man is totally rational, meaning (for early economists) *he always acts to get the most for himself at the least cost to himself*. Economic Man is never indecisive, never acts stupidly (he has “perfect knowledge”), never berates himself for doing something he knows he should not do.

In the last few decades, economists started questioning this model—perhaps after taking a good look in the mirror—and began studying economic decision-making that is not only irrational, but regularly and systematically so. This field—Behavioral Finance—investigates the psychology of why people consistently make certain kinds of money decisions that undermine their own goals and desires.

One of these is **Mental Accounting**: We tend to treat some money as different from other money. For example, tax refunds are often

treated like money that you can be less responsible with. Tax refunds, gift money, or “found” money rarely go into retirement accounts or emergency funds. This money feels different, and we feel justified in using it to indulge ourselves today.

Another problem is **Loss Aversion**: Everyone wants to avoid losses (this is not news). The news is that losses actually make us feel worse than the same amount of gain makes us feel good. Neuroeconomic studies, which measure brain/emotional activity as people make economic decisions, have shown that a \$500 loss feels two and one-half times worse than a \$500 gain feels good. So to balance the bad feeling from a \$500 loss, you would have to gain \$1,250. Basing economic decisions on these feelings leads to overly conservative investing. You never reach your goal because you avoid reasonable risk.

A corollary to loss aversion is the **Disposition Effect**:

We tend to do whatever makes us feel good now. This observation might inspire little more than a bored shoulder shrug, but seeing how it plays itself out in our lives highlights its pernicious influence. The most common investment result of the Disposition Effect is that we tend to hold our losing investments too long and sell our winning investments too soon. We hold losers because it isn’t “really” a loser until we sell it for less than we bought it (which makes us feel bad now). We too quickly sell winners in order to lock in our gain (which makes us feel good now).

At this point many of you may be thinking all this research is just another case of scientists discovering common sense. But the critical issue is that this research confirms and codifies our unconscious tendencies. These tendencies (and there are more than I have mentioned here) affect different people in different ways. Some folks are strongly influenced by loss aversion

while others see tax refunds as an extension of Christmas (more toys!). But regardless of the specific unconscious impulse (or combination of impulses), we end up being driven to make unexamined decisions based on what feels right and not what advances us toward our own goals.

Long-time clients will recognize that the Cambridge System™ incorporates many behavioral finance insights: (For example, “Don’t mortgage your ‘later’ to pay for your ‘now.’”). Your Cambridge Advisor can be objective about your money and goals and help you to rationally link them. It may interest you to know that most Cambridge Advisors (including myself) also recognize that we cannot do financial plans for ourselves because we cannot be objective. Our psychology influences our financial feelings as much as your psychology influences you. Everybody—even your trusted professional—needs independent advice. ■ ■ ■





FINANCIAL TIPS FOR NEWLYWEDS AND GRADUATES

by Robert Roy Reed, Ph.D., CFP®; Columbus, Ohio

Recently I sent an appeal to my fellow Cambridge Advisors requesting financial suggestions for newlyweds and graduates. I received replies ranging from serious admonitions to lighthearted cautions. (One advisor had been told: “Marry the first time for love, the second time for money.” My wife said she thought it was supposed to be the other way around. As her first husband, I am uncomfortable with how this conversation is developing.)

Several suggestions applied equally to newlyweds and graduates—which makes sense given that both are important life transitions. These suggestions reflected the Cambridge Five Fundamentals of Financial Fitness:

1. Save at least 10% of your annual income. (As one ACA member put it, “Saving is just another word for spending on yourself.”)
2. Have sufficient liquidity. (As another said, “Expect the unexpected: auto repairs, roof leaks, furnace failure.”)
3. Fully fund your pension or retirement accounts. (This counts toward #1.)
4. Buy the right size house for your income. (Or start saving for the down payment).
5. Pay off credit card and consumer debt. (“Live within your means!” many thundered.)

Once these basics were addressed, further suggestions ranged widely.

FOR NEWLYWEDS

Talk about money. This was high on everyone’s list, although I noted that while male advisors saw it as important, female advisors ranked it as THE priority. All agreed, however, that family finance meetings should be held regularly and be scrupulously honest.

Further suggestions divided into “how to talk” and “what to talk about.” “How to talk” included injunctions that couples commit not to use money as a weapon against each other. Just because you earn more doesn’t mean your vote counts more. Also important was not keeping financial secrets (no hidden bank accounts

or credit card debts). Finally, do not restrict talk to just the numbers; share your feelings about money—what makes you nervous, what makes you feel safe. Financial decisions that keep you up at night are rarely worth their return. Finally, if one person keeps track of the finances, make sure the other knows where records are and can read the financial reports.

“What to talk about” brought in a batch of topics. Pull your credit reports and review them together (www.annualcreditreport.com). Decide who is going to pay the bills and who will own what. Discuss your money personalities, as well as your personal and family goals. Keep track of paperwork responsibilities: check/change beneficiaries on life insurance and retirement accounts; get new wills and durable powers of attorney; if you are changing your name, inform the Social Security Administration. If you are an older couple or this is a remarriage, discuss getting a pre-nuptial agreement. (Creating a pre-nuptial does not mean you doubt your new marriage; it is a recognition that you are bringing mature responsibilities into it.)

The last piece of advice is something I personally recommend (especially if you have children). Take a weekend away at least once a year—someplace near enough that the trip does not tire you, but far enough that you are definitely away. Spend a quiet weekend together to review your goals and remember why you got married in the first place.

FOR GRADUATES

Again, the Five Fundamentals of Financial Fitness are a baseline. Special advice for graduates includes consolidating your student loans so you are making a single, manageable payment. Establish a cash fund and an emergency fund. Examine your credit report. Start a retirement account. Make a list of goals you want to reach and review it regularly.

Your Cambridge Advisor is always there to help with any of these suggestions. Remember also that most ACA members offer limited retainers to help people start on the right financial foot, and these limited retainers are a caring gift to those who are just setting out on a new life journey. ■ ■ ■

