Sullivan Mermel, Inc.
Fee-Only Financial Advisors

Bridget Sullivan Mermel, CFP®, CPA
3744 North Southport, Ground Unit
Chicago, Illinois 60613
Phone: 773-404-9344
Fax: 773-327-1461

b@sullivanmermel.com
www.sullivanmermel.com

Fall Issue - 2014

Financial focus

Letter from the Editor

Financial planning is about managing and preparing for change. As we head into a new season, ACP's network of fee-only financial advisors was inspired to share about the many changes clients face. Unique financial challenges and questions arise over the course of a lifetime. From facing a change in employment to surviving widowhood, financial planners will help you create a plan for your best financial future.

- JJ Knight, Managing Editor

In this Issue

- Should You Contribute to a Traditional 401(k) or a Roth 401(k)?
- Recommendations for Recent Widows
- Good Debt, Bad Debt, Acceptable Debt – It Pays to Know the Difference

Should You Contribute to a Traditional 401(k) or a Roth 401(k)?

How much of your portfolio are you willing to subject to the risk of the stock market for the chance at achieving higher returns? Knowing and accepting this (and investing accordingly) is critical to your long-term investment success.

Many large employers have started offering employees the choice between a traditional 401(k) and a Roth 401(k). However, only a small percentage of employees have elected to contribute to a Roth 401(k). The primary difference between the two plans is when you pay income taxes. When you contribute to a traditional 401(k), your contribution is currently tax-deductible, but you must pay regular income taxes on distributions taken in retirement. Contributions to a Roth 401(k) are not currently deductible, but you pay no income taxes on distributions in retirement. As with your traditional 401(k), your employer can match your Roth 401(k) contributions, but the match must go into a pre-tax account.

Jane Young, CFP®, EA
@COFeeOnlyAdvice

There are several differences between a Roth 401(k) and a Roth IRA. In 2014, annual contributions to a Roth IRA are limited to $5,500 plus a $1,000 catch-up contribution if you are 50 or older. Contribution limits on Roth 401(k) plans are much higher at $17,500, plus a $5,500 catch-up contribution if you are 50 or older. Additionally, there are income limitations on your ability to contribute to a Roth IRA; there are no income restrictions on contributions to a Roth 401(k). Upon reaching 70½, you must take a required minimum distribution from a Roth 401(k). You are not required to take a distribution from a Roth IRA at 70½. However, you do have the option to transfer your Roth 401(k) to a Roth IRA prior to 70½ to avoid this requirement.

The decision to invest in a Roth or traditional 401(k) depends primarily on when you want to pay taxes. If you are currently in a low tax bracket and believe you will be in a higher tax bracket in retirement, a Roth account may be your best option. On the other hand, if you are currently in a high tax bracket and you think you may be in a lower tax bracket in retirement, a traditional 401(k) could be your best option. A Roth 401(k) is generally most appropriate for younger investors who are just getting started in their careers or someone who is experiencing a low income year. People who are in their prime earning years may be better off taking the current tax deduction available with a traditional 401(k).

Unfortunately, it's difficult for most of us to know if our tax bracket will increase or decrease in retirement. It is also hard to know if tax rates will increase before we reach retirement. From a historical perspective, tax rates are currently low and some believe future rates will be increased to help cover the rising federal debt. Amid this future uncertainty, your best option may be to split your contribution between a Roth and traditional 401(k). This will give you some tax relief today and some tax diversification in retirement.

Make Holidays Jolly

Buy store gift cards: Not to use as gifts, but to use as cash to buy gifts. If you start buying gift cards in January, think how much money you could have stashed by the end of the year for shopping!

Watch for daily deals: Online providers such as LivingSocial, Amazon Local, and Groupon offer great bargains on services, restaurants and products. Sign up to get notifications in your inbox!

Reduce your list: Don't feel pressured to give to everyone. Start your list with those who have impacted your life the most that year and remove those to whom you are just giving out of obligation.

Give free gifts: A gift doesn't have to cost money to be special. Think of ways you can show your love without spending money or with minimal costs.

Use cash: When Christmas is over, you'll love the feeling of not having to still pay for all the gifts that you bought.

- Shanda Sullivan
@SullivanFinanc

Recommendations for Recent Widows

I share an identity I don't like with almost 12 million American women. I am a widow. Becoming a widow was devastating. Widowhood is a heart-breaking event that happens to almost 1 million women each year. My 60th birthday was a month before my husband passed. I fit the norm. In 2011, the U.S. Census Bureau reported the median age of widowhood was 59.4 for a first marriage and 60.3 for second marriages. We women live longer than men. Indeed, half of surviving spouses over age 65 will outlive their husbands by 15 years. That's many years of being solely responsible for financial decisions.

Kathleen M. Rehl, Ph.D., CFP®, CFT™
@KathleenRehl

Making matters worse, death of a spouse unleashes a deluge of financial tasks. Many widows aren't as familiar with investing, insurance, taxes, and estate planning as their husbands. Even if she was the family money pro, a widow is likely to be engulfed in grief and despair.

During early widowhood, a woman's grief can seem to cause a brain freeze. For many new widows, memory is weak, attention span is short, and decision making is downright difficult. Widows can face a double whammy after a husband's death if their knowledge of financial matters isn't strong and their emotions are raw.

Five Suggestions for Navigating Widowhood

1. Don't rush into major irrevocable money decisions immediately.

With important financial choices ahead, speed can make a mess of things. When you are in the midst of grief and mourning, your brain functions differently. Wait until your cognitive functions normalize to make big, irrevocable decisions. For example, don't buy or sell investments you don't understand. Rather, review your money flow, make sure bills are paid, file for death benefits, and maintain enough cash liquidity. Save major decisions for later. For example, if you receive a life insurance death benefit, park that in a safe money market account and later think about how you need to use this money before you invest it.

2. Watch out for financial wolves that prey on widows.

Unscrupulous financial salespeople may take advantage of women after their spouse dies. My elderly widowed aunt was sold Iraqi dinars by "a nice young man who was the nephew of my friend from church." He told my aunt she would double her money with this investment. In return for her cash, she received an official-looking signed "certificate of authenticity" along with the colorful dinar currency. But my aunt never received one penny back. She tried to contact this scam artist later, but he skipped town.

3. Make house decisions carefully.

Although it might be tempting to move in with an adult son or daughter across the country to ease your loneliness, don't leave your home and community right away. Your major support network, social circles, and medical providers are nearby. You might experience secondary grief if you relocate, following the grief you already feel after your husband's death. Some widows stay in their house and want to pay off the mortgage immediately with death benefits. Wait. Keep cash available for the needs in the short term, while making decisions about your life ahead.

4.Get an objective review of your finances.

Family or friends may give you advice without knowing your entire situation. Practice saying, "Thanks for your suggestions. I'll take your ideas into consideration." You may need unbiased guidance from someone who can evaluate your financial position and provide objective, comprehensive suggestions. When you're thinking more clearly, you'll want to review all your investments to determine what adjustments are needed. Getting a realistic understanding of your financial net worth and looking at sources of cash coming in and going out will be helpful.

Some widows benefit from speaking with a financial advisor about their situation. This qualified professional can be a "thinking partner," helping you make decisions—someone who listens with empathy and respect, whom you trust. Your advisor should be experienced in working with widows and have an accepted professional designation. Select an advisor who puts your interests first as he or she provides unbiased and comprehensive advice. Many experts recommend fee-compensated advisors, such those involved with the Alliance of Comprehensive Planners.

5. Don't be a purse for others.

Women may be approached by family members asking for part of their inheritance early. For example, one of my client's stepsons demanded his father's widow give him money to buy a new car. He played on her emotions, saying, "If dad were alive, he would help me now." Be firm and don't give in to pressure. If you later decide to date, be careful about potential partners looking for you to be a purse providing money. Keep money matters to yourself, at least until you know the other person very well.

ABCs for New Widows

a — **ALWAYS ASK QUESTIONS.** How does this investment fit my goals? Why is your financial recommendation good for me? What are my alternatives? What are the fees and expenses involved?

b — **BUYER BEWARE.** If it looks too good to be true, it probably is.

c — **CARE FOR YOURSELF,** with some enjoyable, inexpensive activities. That might include taking a yoga or exercise class, meeting girlfriends for coffee, enjoying a manicure, attending a free concert or art festival, reading an interesting book, writing your thoughts in a pretty journal, and spending time in meditation or prayer.

Five Reasons to Forget Salary and Focus on Net Worth

David Gardner, CFP®, EA
@Dave_CFP

When it comes to finances, our focus seems to be our pay more than our net worth. Applying for a mortgage? You may have a seven-figure portfolio but do not qualify for a loan because your income is relatively meager.

We've found that bolstering your net worth is the true way to financial independence, while merely having a high income can make you no more than a big spender.

Here are five reasons why you should focus more on your net worth and less on compensation:

1. **Net worth opens up financial independence**: Financial independence means having enough saved that you have life options. You're not forced to work in your current profession at the same intensity. You're able to change fields, go into business for yourself without worry, or work at a less hectic pace.

It's the amount you have saved that determines that you are no longer a "wage slave," not your income. We determine financial independence by considering your investible assets in comparison to your annual spending. Notice that compensation does not even enter the picture.

2. **Higher salary can delay freedom:** When your salary increases, spending often increases in lockstep. The more you spend, the more you have to save to be financially free. If you're spending $6,000 a month, you're much closer to financial freedom with a $1 million portfolio than if $10,000 goes out the door every month.

3. **Insulates you from financial emergencies:** Most of us will experience multiple financial emergencies in our lifetimes. It can be relatively small, such as needing to replace a furnace or a transmission in your car, or it can be catastrophic, such as being out of work for a year or suffering a severe medical condition that disables you. Regardless of the source of the financial strain, it's net worth in the form of cash or easily liquidated investments that provides a safety net.

4. **High pay can encourage debt:** If your earnings are high, you know credit is easy to find. You'll be able to qualify for a mortgage you may find difficult to afford, take out more credit cards than you can easily repay, and lease expensive cars that detract from your financial well-being. If you have significant net worth, then you'll be less tempted to borrow to pay for these things and could buy them outright rather than rob your future income with loan payments or years to come.

5. **Higher taxes on compensation:** High-income earners know that in many ways it doesn't pay to earn more money. Of course, I'm exaggerating here, but consider what happens when your income goes up to the higher echelons. Nearly all workers pay 1.45 percent in Medicare tax, but higher earners must pay an additional 0.9 percent. The highest income tax bracket is 39.6 percent.

While there are techniques available to minimize tax, it's hard for the highest wage earners to completely escape high tax rates. In contrast, those who depend on their portfolio for income find a much more friendly tax system.

If you sell an investment that has doubled in value, most will pay only 7.5 percent federal tax *on the proceeds*. The long-term capital gains tax rate is 15 percent for most, but, of course, you're only paying it on your gains.

Qualified dividends also get an advantageous tax rate, and rental real estate has its tax benefits as well.

A higher income can make many aspects of life easier, no doubt, and can fuel high savings. Just make sure you save at least 15 percent of that income to build your net worth, so one day you can enjoy the freedom of financial independence.

Ask Your Advisor

Q. Does it make sense to get a new credit card with a lower interest rate to use for current purchases? I have a card with a 12.9 percent rate and a balance of about $6,000 that I've been trying to pay off, but can't. I looked into balance transfer, but it's too expensive.

A. I would not recommend getting a second credit card if you are having difficulty paying off the first. Day-to-day bills should be controlled to limit spending to 90 percent (ideally 80 percent) of take-home pay. This would include payments on your existing debts. You are better off discontinuing purchases on a credit card and utilizing a cash system for purchases. For instance, having limited amounts of cash when you go to the grocery store forces you to spend only what you have in your wallet. Today's cashless society disconnects consumers from their spendable cash, making it easy to spend more than what is available.

For your existing debts, develop a repayment schedule. How much can you afford to pay each month toward these debts? Pay the minimum payment on all debts except the highest interest rate debt. That debt should receive the remainder of the allocated total debt payments. Once that debt is repaid, move the extra amount to the next debt.

You should be aggressive about the repayment, perhaps making a decision to do without in another area. Perhaps, buying a digital antenna and discontinuing cable services or limiting dining out to once a month, packing lunches, snacks, etc.

- Kelly Adams, CFP®, EA

Pay Off Credit Cards and Consumer Debt First

Good Debt, Bad Debt, Acceptable Debt – It Pays to Know the Difference

Your attitude and behavior about debt is probably shaped by messages you got from your parents. "Neither a borrower nor a lender be." Some of us heard such advice and believe that being in debt is wrong. Some of us were raised in families where being in debt was a way of life, so we believe it's perfectly normal to be one step ahead of the bill collector.

Tim Williams, MA
soundpassagesfa.com

The fact is debt can be a positive or a negative contributor to financial security and peace of mind. There's a distinction between "good debt" and "bad debt," and—regardless of its nature—how much debt is acceptable.

Good debt has two characteristics:

1. Whatever is being financed should last longer than the loan;
2. Whatever is being financed should provide positive financial leverage; it should help purchase something that appreciates in value and/or helps increase your income.

Good Debt

The home you live in will last longer than a 15- to 30-year home mortgage, and its value should appreciate over the long term (recent boom and bust cycle notwithstanding). Assuming you don't borrow more than you can afford, a fixed-rate home mortgage for up to 80 percent of your home's value is generally good debt.

Borrowing to help pay for a college or advanced degree helps you increase your lifetime income. In 2012, median earnings for young adults with a bachelor's degree were $46,900, compared to $30,000 for those with only a high school diploma. Within reason, education loans can be good debt. Our rule is your loans at graduation should not exceed your first year's anticipated salary.

Financing a car so you can commute to work enables you to earn income, so a car loan can be good debt. Limit the length of the loan to 24 or 36 months, so the car will last longer than the loan. We're talking about basic transportation here, and a loan amount that's appropriate relative to your earning ability. If you've just graduated from college earning $35,000 per year, a $50,000 auto loan isn't good debt.

Bad Debt

Credit card and consumer debt is an example of bad debt. Credit cards are typically used to buy things you immediately consume or that depreciate right after you buy them. It's also the most expensive. Yet we live in a society where we're inundated with credit card offers. For all U.S. households, the average credit card debt is $7,221. Looking only at indebted households, the average outstanding balance is $15,480. This is especially alarming when you consider that the average interest rate on credit card debt for such households is about 23 percent. Ideally, your goal should be to have no outstanding credit card and consumer debt. The reality is that as a person starts his or her working career and establishes a household, it may be necessary to incur some consumer debt.

How Much Debt Is Acceptable?

One benchmark is the total monthly debt payments should not exceed 36 percent of gross monthly income. Debt payments include mortgage principal and interest, real estate taxes, home insurance premiums, and homeowner's association fees. They also include education loans, auto loans, credit cards, and other consumer debt. Gross income is before reductions for income taxes, Social Security and Medicare taxes, retirement plan contributions, employee health insurance premiums, etc.

Another benchmark compares your total credit card and consumer debt outstanding balances to your annual income. For this measurement, exclude your mortgage and education loans (but not auto loans). It's acceptable if your credit card and consumer debt (including auto loans) is less than 10 percent of your annual income. But put a plan in place to pay it off entirely. The bottom line is debt can be a double-edged sword. If you carry a credit card, use it for convenience, and pay it off at the end of each month. If you've already incurred some debt wounds, get some help to put a plan in place to stop the bleeding.