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Knopinski & Fauver
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303.666.6292 www.kffainc.com

Study: Laddered Annuities Reduce Retirement Risks

Annuities are forever, or at least they can be, and that's both their strength and their weakness. It's a strength because, at a time when almost everyone is concerned about market volatility and the prospect of outliving retirement savings, annuities can provide predictable payments that will last as long as you do. It's a weakness because, in the case of fixed annuities, the amount of your perpetual payout is determined when you buy an annuity, and if you sign up when interest rates are low, you'll receive less than if you purchase an annuity when rates are higher. Also, fixed annuities don't protect you against inflation unless you pay extra for an inflation-adjustment feature.

But what if you spread out annuity purchases, much as you would build a bond ladder or use dollar cost averaging to add to a stock portfolio over time? In a recent study, "Variable Payout Annuities and Dynamic Portfolio Choice in Retirement," in the *Journal of Pension Economics and Finance*, Olivia Mitchell, professor of insurance and risk management at the University of Pennsylvania's Wharton School, and three German academics found that laddering annuities can reduce the risks of saving for retirement and increase the likelihood of reaching long-term financial goals.

Particularly in today's unsettled investment markets, annuities have an undeniable appeal. You pay a sum of money to an insurance company or other financial firm, and the company promises to make specified monthly payments for a fixed term or life. There are many variations on the annuity theme, but for simplicity, consider a fixed, immediate annuity for a 60-year-old male living in New York. Annuity payouts are based on interest rates and life expectancy, and according to an estimator on ImmediateAnnuities.com, if he had invested $50,000 in late June 2009, he could have received lifetime monthly payments of $311.

Viewed on the surface, that's a very good deal. It amounts to $3,732 a year, or an annual return of about 7.5% on that $50,000 investment. Compare that with a typical withdrawal strategy that calls for taking 4% annually from an investment portfolio during retirement—which would provide only $167 a month during the first year—and the annuity seems clearly preferable, at least for a time. But with the lifetime annuity there's a risk you'll die prematurely, thus ending the payments and greatly reducing the investment's value, as well as the risk of locking in returns based on lower-than-usual interest rates.

Laddering annuities could minimize both those risks. Purchasing an annuity each year for a decade, for example, means that each investment will be based on a different interest rate and averages out the impact of annual variations. It also reduces mortality risk—if you die early, the purchases end—and can often provide slightly higher payouts with each new annuity, because the buyer is one year older and

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Designation Mania Fools Many, So Go With A Fiduciary

The alphabet soup of professional credentials for advisors gets murkier by the month, making it more important than ever for investors to guard against deceptive designations.

While many credentials are legitimate, some issuing organizations make very few demands on applicants. For instance, becoming a "Certified Senior Advisor" only entails taking a three-day course and passing a multiple-choice exam.

Don't put your faith in a professional designation without checking out what's required to earn it.The most credible designations—including Certified Financial Planner™ (CFP®), Chartered Financial Analyst® (CFA®), and Certified Public Accountant (CPA)—have strict ongoing continuing education requirements and codes of ethics.

At Knopinski & Fauver, we take our professional credentials very seriously. We are committed to providing the highest level of professional service possible. This includes keeping up with the latest advances in financial planning and investment management.

Choosing a fiduciary advisor is also important. As fiduciaries, we must disclose and avoid conflicts of interest, and we are legally obligated to put your interests first. Our recommendations must be ideal for you, rather than "suitable," which is the standard for non-fiduciary advisors.

Colleen & Rob

The Right Way To Manage Money

In any relationship between financial advisor and client, trust is crucial. But in the post-Bernard Madoff era, it's not enough to sense that an advisor or a financial firm is reliable. Everyone trusted Madoff. His clients recommended him to their friends, who lined up for the privilege of having him manage their money. Yet all of those trusting clients ended up on the losing end of a $50 billion Ponzi scheme, and several other recent frauds have further shaken investor confidence. These days, trust requires proof, delivered regularly. Keeping your investments in the custody of a major financial firm can help provide that proof.

Madoff didn't use an outside custodian. Client funds were reportedly handled by a custodian at a remote storefront office that had few employees and no independent auditor. That left Madoff with unfettered access to clients' money and little or no accountability. It now appears he claimed to have made trades that never occurred and exaggerated returns from other transactions. But without reports or account statements from an independent custodian, there was no way for clients to know there was a problem.

Although Madoff's firm was a registered investment advisor, that kind of set-up is extremely unusual among RIAs, which are regulated by the Securities and Exchange Commission or the individual states. More than nine out of 10 RIAs serving individual clients work with independent custodial firms that have physical possession of client assets, monitor their value, and provide trade confirmations and account statements directly to clients, who can also check on investments by logging in to their account on the custodian's website.

Custodians, such as Fidelity, Schwab Institutional, TD Ameritrade Institutional, Pershing, and others, provide other kinds of security as well. Insurance from the Securities Investor Protection Corporation covers investors for up to $500,000 of losses of securities and $100,000 of losses of cash if a custodian becomes insolvent, and custodial firms often also purchase additional insurance. A common level of supplemental coverage is for up to $5 million of losses of securities. One company provides coverage for losses in securities accounts of up to $149.5 million and up to $900,000 in cash accounts. Moreover, most firms have automated systems to monitor client accounts.

To deter fraudulent activity, the SEC recently proposed a rule change that would require certain RIAs with custody of client assets to use an independent public accountant to conduct surprise audits of client accounts. But you don't have to wait for a new rule to protect your investments. We work with an independent firm that maintains custody of your assets, and you can easily compare the portfolio performance statements we provide with the custodian's account statements. This relationship is just one way we are working to prove that we deserve your trust. ●

Your 401(k) Choices After A Layoff

If you're one of the millions of people who have received pink slips from their employers during these troubled economic times, things may look bleak. But there's something you can take with you from your old job—your 401(k) account—that could hold the key to better times ahead. Though there's no penalty for leaving your retirement funds where they are, you may be understandably reluctant to entrust the money to your ex-company, continue to pay what may be unreasonably high administrative fees, retain limited investment choices, and risk having uncertain access to your account if you decide to make changes in your investment choices.

So what are the alternatives? Participants in 401(k)s and other employer-sponsored retirement plans can normally choose from among three main options: taking a lump-sum distribution, opting for annuity-type payments, or rolling the funds into an IRA or a 401(k) at your new job. There are pros and cons for each possibility.

1. Lump-sum distribution. If you're in desperate need of cash, this may be what you have to do. But it has several drawbacks. If you request a lump sum from your company, it's required to withhold 20% for federal taxes (and sometimes additional state withholding), and you could owe more than that if you don't deposit the money in an IRA or another 401(k) within 60 days. You'll owe income tax on the amount of the distribution (which might push you into a higher tax bracket), plus you'll likely have to pay a 10% penalty if you haven't reached age 59½, bringing the total tax you pay on the amount received to almost 50%. Finally, of course, you'll be depleting your retirement savings well ahead of schedule.

2. Annuity-type payments. With this option, you're still on the hook for tax payments and a possible early withdrawal penalty, but at least the tax

Roth IRA Conversion & Estate Planning

By now, you've probably been inundated with media stories and ads touting the benefits of Roth IRA conversions, which are now open to everyone, regardless of income. Roth IRAs are known for their ability to deliver tax-free income during retirement. But a Roth may realize some of its most significant advantages after your retirement has ended. When the future of the estate tax finally gets resolved, converting a traditional IRA to a Roth will likely reduce any estate taxes your heirs may owe. And it will definitely cut their income tax bill on distributions from inherited IRAs.

Qualified distributions from a Roth IRA that has been established for at least five years are completely exempt from income tax. You're eligible to receive this tax-free income once you reach age 59½, and qualified distributions are also possible in case of death or disability or to pay first-time homebuyer expenses (up to a lifetime limit of $10,000). Another plus is that with a Roth IRA, there's no rule requiring distributions that must begin for holders of traditional IRAs after age 70½. So if you don't need the money, investment gains in your account can continue to compound indefinitely without being eroded by taxes.

You will have to pay income tax on the portion of a Roth IRA conversion representing tax-deductible contributions and earnings, and it's best to cover that liability with funds from outside your IRAs. But converting to a Roth is usually worth it for retirees looking to preserve a nest egg for their heirs.

Before 2010, you weren't allowed to convert a traditional IRA to a Roth in a year in which your adjusted gross income (AGI) exceeded $100,000. But the Tax Increase Prevention and Reconciliation Act of 2005 eliminated this dollar cap for conversions after 2009. Also, if you convert your retirement account in 2010, you can spread the income from the conversion over two years and pay your resulting tax liability in 2011 and 2012.

When you convert to a Roth IRA, you're effectively prepaying income tax for your heirs without using up the annual gift tax exclusion or your estate tax exemption. You can then use those valuable provisions to shelter other transfers from possible taxes. At the same time, you're able to reduce the size of your taxable estate—by paying the tax due on the conversion—and that could provide further tax savings, depending on what happens to the federal estate tax.

Nonspouse beneficiaries who inherit a traditional IRA normally must empty the account—and pay income tax on the distributions—within five years or over their life expectancies. And though a Roth still requires heirs to make withdrawals spread out over their lifetimes, there will be no income tax for them to pay. That can result in substantial benefits even if a Roth account is established too late for its original owner to enjoy much of its advantages.

Consider the case of John, Jane, and their daughter, Mary. John converts his traditional IRA to a Roth in 2010 when he's 65. He names Jane as the sole beneficiary of the Roth, and when he dies at age 73, she is 70. Based on IRS tables, Jane's remaining life expectancy is 17 years. As a spouse, Jane can choose to treat the Roth IRA as her own and isn't required to take distributions. She designates Mary as sole beneficiary, and when Jane passes away at age 87, Mary inherits the Roth IRA. She's 55, and tax rules require her to take annual payments from the account that she could spread over her life expectancy of 30 years.

What has this accomplished? John lived for eight years after converting his traditional IRA to a Roth. Jane then had access to the account's tax-free income for 17 years, and Mary had the account for another 30 years. That's a total of 55 years for a Roth IRA established by 65-year-old John. Converting to a Roth creates a tax-free annuity for your heirs that should last well beyond your life expectancy.

To get these benefits, Roth IRA accounts must be properly titled and have the appropriate beneficiary designations. And after an account holder's death, nonspouse beneficiaries must begin required (but tax-free) distributions from the account by December 31 of the following year. Miss that deadline and the account will have to be liquidated within five years.

Tax laws are never written in stone, and future changes could reduce the effectiveness of this technique for maximizing tax benefits for your heirs. But for now, at least, a Roth conversion provides substantial estate planning benefits. If you'd like to explore whether it would make sense to convert your traditional IRA, please call to set up an appointment. ●

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liability will be spread out over the years you receive payments. Typically, the amount you get is calculated according to your life expectancy or the joint life expectancies of you and your spouse. If you choose, payments may continue until the death of the second spouse.

3. Rollover. This has obvious advantages. Not only will you have more investment choices, but the transfer—to a traditional IRA or to another employer plan at your new job—isn't taxed, and your money can continue to compound on a tax-deferred basis until you make withdrawals during retirement. Just be sure to complete the rollover within 60 days of taking the money from your old 401(k), and keep in mind that your former employer will still automatically withhold 20% of your balance. To avoid that levy, which you can't recoup until you file your tax return, arrange for a trustee-to-trustee transfer directly from your old account to the new one. Best of all, this option helps your money keep to its appointed task—saving for a secure retirement. ●

Should Retirees Carry A Mortgage?

Your home mortgage is likely to be the biggest debt you ever take on. And if you've moved or refinanced a few times since your first home loan, you may be years or even decades away from owning your house free and clear. But that begs the question: What about retirement? If you're getting ready to retire or already have stopped working, does it make financial sense to keep making monthly payments? Or should you use some of your savings to retire that debt?

Traditionally, paying off the mortgage was a pre-retirement objective, but the recent trend has been to carry the debt longer. A study by the Center for Retirement Research at Boston College found that in 2007, 41% of households with people in their 60s still had a mortgage, even though more than half owned sufficient assets to repay the loan.

Why would you hold a mortgage in retirement? Depending on your situation, you may value the tax benefits and liquidity. Consider these four critical factors.

1. Investment returns. Recently, the average 30-year fixed rate for mortgages has been between 5% and 5½%. You might keep your mortgage if you think you can do better investing the money you would spend to retire it. But retirees who invest heavily in low-risk vehicles such as bank certificates of deposit (CDs) and Treasury securities are likely to come up short. And though stocks and mutual funds may provide higher rates of return, they carry greater risks, and if your portfolio plummets, you could have trouble making mortgage payments.

2. Tax breaks. You can generally write off mortgage interest if you itemize deductions. But people who claim the standard deduction—and that's almost two out of every three taxpayers—receive no tax benefit from mortgage interest payments. So if you're not an itemizer, it may make sense to pay off the mortgage. Also keep in mind that the tax benefit of itemized deductions will be reduced if your income is high.

3. Retirement accounts. It's generally not a good idea to pay off your mortgage if you have to invade your retirement accounts to do it. The money you pull out of a 401(k) plan or an IRA will be reduced by taxes—at ordinary income rates of as high as 35%—plus you'll be hit with an additional 10% penalty if you're under age 59½. And you'll be left with fewer funds to draw upon during retirement.

4. Refinancing. One alternative to paying off the mortgage may be to refinance it at a lower interest rate. That can reduce your payments, or you could use the opportunity to pull out equity you've built. But the deep decline in real estate values has underscored the risks of financial strategies built around home loans.

Choosing what to do about your mortgage is a major financial decision. We can help you choose the best approach for your situation. ●

Reduce Retirement Risks

(Continued from page 1)

his life expectancy one year less. To return to the earlier example, the $311 monthly payment would have been $328 for a 63-year-old male, or $342 if he were age 65.

The results of the *Pension Economics and Finance* study echo those of a 2007 report from MassMutual Financial Group that looked at how three investment strategies would have fared during 181 different 27-year periods beginning monthly from 1965 through 1980 and ending in 1991 through 2006. Comparing a half-stocks, half-bonds portfolio to alternatives that replaced some bonds with either a single annuity bought at the outset or with several purchased in a laddering strategy, the illustrations showed both annuity methods outperforming the traditional stock-and-bond portfolio, and the laddered approach doing better than the single annuity through all of the back-tested periods and many economic ups and downs.

One approach to laddering would be to keep adding annuities until you've met most of your basic retirement income needs. If that 60-year-old knows he'll need at least $10,000 a month and plans to retire in seven years, the first year he might buy a $200,000 annuity that pays about $1,250 a month, then purchase another annuity the next year that adds another $1,250 in monthly income, and so on until, after seven years, he has almost $9,000 in guaranteed monthly income. He may use social security or a pension to fill the rest of his retirement income needs, while keeping any remaining assets in stocks to provide discretionary retirement income and build an inheritance for his children.

Annuities themselves and laddering approaches are complex, with many variables to consider including credit risk of the issuing institutions. We can work with you to see whether an annuity ladder might reduce your retirement risk and help you achieve your long-term goals. ●

Knopinski & Fauver Financial Advisors 315 S. Boulder Rd. Ste 207, Louisville, CO 80027 303.666.6292 www.kffainc.com
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