financial *focus*

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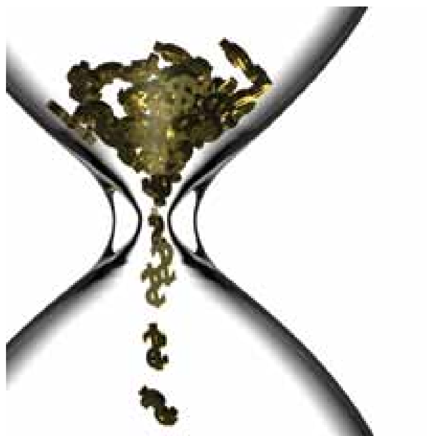
Spring 2010

LESSONS FROM THE "LOST DECADE"

by Bert Whitehead, MBA, JD   Franklin, MI

The Dow and the S&P are the most common indexes of U.S. large company stock valuations. At the end of 2009, they closed lower than their opening values at the beginning of 2000. As a result, many economists have dubbed the "aughts" (2000 to 2009) the "lost decade." They claim there were no investment gains in the large cap stock market for these past 10 years.

In last fall's issue of ***Financial Focus***, Stewart Farnell ably pointed out that this decade was not truly lost, especially for those who continued to save and to rebalance their diversified investments. Still, active money managers will point to the performance of the major indexes to crow about the futility of "buy-and-hold" investing. These managers insist that they are able to add value to an investment portfolio by buying low and selling high, instead of holding on to stocks. Their view, of course, is tainted with self-interest.



The truth is that the decline of 8.7% in the Dow during the so-called lost decade is mostly attributable to the arbitrary selection of the "starting line." The beginning of 2000 was near the peak of the "dot-com" bull market. But start the chart just two months later at the end of February 2000, and "voilà!"–the market shows a gain. Start the chart two years later in February 2002, and there is a 30+% gain by the end of 2009.

The S&P index outperforms 85% of money managers in the large cap arena over almost any 20-year period. The reason? Money managers keep cash in their portfolios, whereas indexes are by definition virtually fully invested. Therefore, active managers tend to underperform less in bear markets and underperform more in bullish markets.

If there are any lessons to be learned from the past decade, it is not about the investing prowess of the active money managers but rather the importance of two fundamentals of investing: dollar-cost averaging, especially in down markets, and having a diversified portfolio.

Dollar-cost averaging (DCA) is a strategy by which you invest new money on a regular basis, usually monthly, instead of investing all your cash at once. It protects you from investing at the wrong time because you invest all the time. Most people use retirement accounts like 401(k)s for their primary investing activity, so they use DCA automatically. Investing a fixed sum each month helps you buy more shares of a stock when the price drops. In fact, investing $1,000 per month (plus dividends) over the past 10 years would have resulted in a small gain (3.2%) rather than a loss.

Diversifying your holdings beyond large cap stocks will protect you from investing in the wrong type of investment. You shouldn't invest in any one thing. Instead, invest in everything. For example, during the past 10 years, small cap and foreign stocks on average appreciated more than 30%, including reinvestment of dividends. The Vanguard REIT (Real Estate Index) was up more than 50%. The 20-year Treasury bond had an average yield of more than 5%, increasing more than 60% during the period.

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ROTH CONVERSIONS: "I make too much money, don't I?"

by Jo Anne Paynter, CFP® Grove City, OH

Have you forgotten about Roth IRAs? You may have, if your income was high enough to prevent you from converting your IRA to a Roth IRA or you couldn't contribute to one.

But it's 2010, and the tax laws have changed again. Now, regardless of the amount of your adjusted gross income (AGI), you can convert your traditional IRA to a Roth.

And you can choose how to pay the tax that the conversion will impose. The standard option allows you to convert a traditional IRA to a Roth and pay no additional tax on your 2010 tax return. Instead, you would pay tax in 2011 and 2012, with half the 2010 conversion amount treated as taxable income in each of those two tax years. The second option, which requires a special election on your 2010 tax return, is to pay income tax on the entire conversion with your 2010 tax return.

Now many more people—even those with larger incomes—can participate in the Roth accounts. But why should you? There are three reasons:

1. Diversification of spending "pots." Especially in retirement, having a source of income to draw on that does not increase your AGI might permit more of your medical expenses to be deductible or allow you to pay for an unforeseen event (maybe enjoy an unplanned excursion). If the money comes from a Roth, and you've met the requirements for tax-free distributions, you won't have to worry about the tax consequences that would accompany funding an expense from an account that adds to your taxable income. Moreover, because our crystal ball can't accurately predict future tax rates or laws, having money in different types of accounts could protect against future rules that raise the tax bite on money coming from some other type of account.

2. Elimination of required minimum distributions (RMDs). Many people with substantial assets and pensions may never need to take money from their tax-deferred savings. But with plans like traditional IRAs and 401(k)s, you must start to withdraw money when you reach age 70½—creating more taxable income and perhaps even moving you into a higher marginal tax bracket. The Roth IRA has no RMD requirement. If you wish, you can leave your Roth savings intact for the rest of your life.

3. Providing an income-tax-free inheritance to heirs. The magic of compound interest, combined with the absence of any RMD, allows Roth accounts to continue to accumulate tax-free wealth beyond your lifetime for the benefit of your heirs.

If you decide it is advantageous to have some of your assets in a Roth account, what are the important decisions for 2010? The first is whether to convert assets to a Roth this year. If you can pay the increased income tax on the conversion, the answer is often yes. Remember, you need to have a Roth account for five years before you can take out the earnings tax free. That five-year clock starts on January 1 of the year you make your first conversion or open your first Roth account. So I'm advising many of my clients that this year, if for no other reason, convert a minimum of $500 or $1,000 to a Roth to start that clock!

The clock is even more important if you are also deciding whether to use a Roth 401(k) or 403(b) for retirement funding (or if you are already funding such a Roth account). These accounts, even though they're Roths, do have RMD requirements. But when you retire or leave your job, you have the option of rolling your Roth 401(k) or 403(b) into a "conversion Roth IRA." This allows you lawfully to escape all the rules about RMDs. And if the five-year clock has finished by that time (and if you are older than 59½), the entire account becomes instantly accessible, without any income tax consequences.

Many more issues are associated with Roth IRA conversions. Ask your ACA advisor how this important change in the tax law could affect you, and look for much more information on Roth conversions as the year progresses.

PERSONAL FINANCIAL SYNERGY

by Troy Von Haefen, CFP® Nashville, TN

Synergy is what we experience when two things working together produce a result greater than the sum of their individual effects—when the whole is greater than the sum of the parts. The term has become a popular buzzword in boardrooms and conferences and is touted by motivational speakers in the business community. You can find books relating synergy to food, clothing, fitness, physical and mental health, and more.

I am a firm believer in applying the idea of synergy to personal finance. As a holistic financial advisor—one who sees the entire financial picture—I see the benefits in my clients' progress because of synergic effects.

How do you create personal financial synergy? It's kind of like Sir Isaac Newton's third law of motion: every action has an equal and opposite reaction. (My seventh-grade teacher would be proud!) Every financial move or decision creates a reaction in another area of your financial life. The key is to create positive reactions, not negative ones.

For example, buying a home that is too expensive will create negative synergy in relation to your cash flow, a negative snowball of reactions that can lead to a deep financial hole and possibly irreparable financial damage (even bankruptcy).

Whereas negative synergy can create a downward spiral, positive financial synergy can spur tremendous financial growth. Think about saving for retirement. Money contributed to a 401(k) is tax deferred; therefore, the contributions will reduce your tax bill. This is positive synergy. But there's more. The tax savings from this 401(k) contribution can also be contributed into the 401(k), for an even greater tax reduction. The more money contributed, the greater the tax reduction. The greater the tax reduction, the more cash is freed up and available for future contributions. This is just one example of financial synergy between two areas of personal finance: taxes and retirement.

All aspects of personal finance—estate planning, retirement, taxes, insurance, cash flow, goal setting, investments, college planning, retirement planning, and more—provide some opportunity for financial synergy. Imagine the traction you gain by constructing a financial plan that integrates all of the pieces. Imagine the power and efficiency of a financial plan created this way. The positive momentum can become incredibly powerful.

Families often employ different professionals to handle different aspects of their personal finances: a CPA takes on taxes, a broker covers the investments, and an attorney handles estate planning. But unless these professionals communicate effectively, unless the right hand knows what the left hand is doing, the power of financial synergy is lost. Whether a family uses various professionals or navigates the financial landscape solo, continuity, connectivity, and efficient synergic decisions are a must for financial success.

Effective financial planning increases efficiencies across all financial areas. It's a specialty of ours as ACA planners. A financial advisor who knows how different financial disciplines are interconnected can help you understand how to achieve greater positive synergy in your personal finances.

LESSONS FROM THE "LOST DECADE"

(continued from page 1)

DCA and diversification are the two primary strategies you can use to avoid investment mistakes. Still, the average annual return of a well-balanced portfolio from 2000 to 2009 (6 to 7%) fell short of returns for similar prior periods. (We usually assume 7 to 8% returns for conservatively balanced portfolios over the long term.)

All of this is small comfort if you bought a home five years ago. Some homes have dropped more than 50% of their value. This is made even worse if your 401(k)s have decreased in value despite your contributions over the past 10 years. If you lost your job on top of these other setbacks, the decade has been ruinous.

No matter what your level of loss, however, beware the temptation to offset your losses by trying to time the stock market. It only aggravates your misfortune. Studies repeatedly show that, on average, individual investors who buy and sell stocks in their portfolios underperform the market by a wide margin of 5 to 7%. They constantly fall prey to trying to select the best time to invest and the best type of investment. Instead of capitulating to your fears when the market drops, and then buying in a greedy frenzy when the market rises quickly, just avoid the temptation to time the market.

In the end, the lost decade is merely a story line for writers and editors who need to sell their publications with "new ideas" and so-called insights on "what to buy now!" After all, if you select a different time to measure, you come up with different results and story lines.

Unfortunately, the most boring story of all is that consistent investing during good times and bad is also the most successful for those willing to stick to it. The only problem with it is that it doesn't sell this month's magazine.

Author's editorial review contributed by Chip Simon, CFP®, an ACA member in Poughkeepsie, NY.

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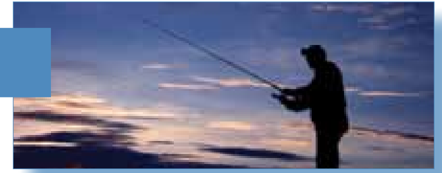

GIVING THE GIFT OF A FINANCIAL PLANNER

by Karen F. Folk, Ph.D., CFP® Urbana, IL

The season of graduations and weddings will soon be upon us. Suppose you gave a different kind of gift to new graduates starting out in their first job or to newlyweds merging households and finances. What if your gift was a chance to build their financial awareness by meeting with a trained expert?

Financial planning is an investment. It costs money. But its potential returns are many—a chance to get a handle on current problems with spending, debt, and investing, and an opportunity to diffuse fear of financial issues by learning about them in a way that's tailored to individual needs. The gift of a meeting with a planner who provides unbiased guidance, even on just the basics of financial fitness, could pay off for years to come.

If you are working with a financial planner yourself, your advisor may be willing to do a onetime review of the basics. Many planners have such programs designed especially for recent college grads or newlyweds. Looking for an advisor in a different part of the country? You can find members of the Alliance of Cambridge Advisors through the "Find an Advisor" feature at www.acaplanners.org. Many ACA members offer a onetime financial review, and some can provide meetings by phone and computer connection with clients in other geographic areas.

Here are some questions you should ask about a prospective financial planner:

What is your background? Find out how long the planner has been in practice and his or her certifications. A Certified Financial Planner™ professional has a minimum of three years experience and has completed a comprehensive course of study at a college or university offering a financial planning curriculum approved by the Certified Financial Planner Board of Standards. Certified public accountants (CPAs) with the Personal Financial Specialist (PFS) designation have also completed comprehensive training in financial planning.

Unbiased objective advice is always in your best interest. Here are a few benefits of working with a comprehensive fee-only financial advisor:
- **You are the only one paying the advisor, so the advisor's only loyalty is to you.**
- **Since the advisor's compensation is not dependent on selling you financial products, you receive advice based on your best interest, even if that advice is to make no changes.**
- **You know exactly how much you are paying and what you are getting in return.**
- **Since you are receiving advice on a comprehensive range of financial topics (not just investments and insurance), you achieve your goals in the most cost-efficient manner.**

What services do you offer? Generally, financial planners cannot sell insurance or securities products such as mutual funds or stocks without the proper licenses or give investment advice unless they are registered with state or federal authorities. For an introductory session, a planner who offers financial planning advice on a range of topics and does not sell financial products is the best source of unbiased review. Ask what topics a financial fitness session will cover. For young people just starting out, the discussion should include building an adequate emergency fund, protecting against risks, handling consumer debt, how to start saving for a home purchase, and how to go about tax-advantaged investing.

Do you have any potential conflicts of interest? It may seem like a pushy question, but the best planners expect it and are prepared to disclose any conflicts. If a planner profits from the sale of investment products to you, obviously he or she must spell that out. Ask what products the advisor is licensed to sell. A so-called advisor who makes money selling insurance or investments has a built-in motive to push a product and may not act in the client's best interest.

How do you feel about teaching and training? Education is one of the most valuable benefits that the gift of a financial planning session can provide. Will the advisor help your gift recipients both by covering the basics of getting started and by providing direction for further self-education?

It's uncommon to give a gift of professional financial advice. But compared with other wedding or graduation gifts they'll receive, the recipients will get much greater value, and benefit from your generosity far longer, than they would if you bought them a microwave.

Adapted from a column produced by the Financial Planning Association.