financial focus

**Lynch Financial Advisors** successfully **moves individuals**, **couples and small business owners** from where they are to **where they want to be**.

Fall 2004

LYNCH FINANCIAL ADVISORS

**Michael S. Lynch**
Lynch Financial Advisors
916.772.3103 • 916.772.3104 fax
info@lynchfinancialadvisors.com
www.lynchfinancialadvisors.com
*Fee-Only Financial Advice*

## INHERITING IRAs CAN BE TRICKY

As members of the first generation of investors in traditional individual retirement accounts begin to die, an increasing number of their beneficiaries are inheriting those IRAs. Unfortunately, in the process many inheritors are making irreversible mistakes that can cost them thousands of dollars in extra taxes. It is important to understand that the inheritance rules for traditional IRAs (versus Roth IRAs) differ for surviving spouses and non-spouses such as children or siblings.

**Spousal rules.** A surviving spouse has three options when inheriting an IRA from his or her deceased spouse. First, the spouse can simply cash in some or all of the IRA and pay income tax on the withdrawal. Second, the spouse can leave the IRA in the deceased's name. Third, the spouse can roll it over into an IRA in his or her own name. The decision will be influenced in large part by the survivor's age, the age of the IRA owner at the time of death, whether required withdrawals had already begun, income requirements, and other financial circumstances.

Let's say the inheriting spouse is younger than age 59½ and needs money from the IRA for household expenses. If the survivor leaves the IRA in the deceased's name, he or she can make withdrawals before age 59½ without paying the ten percent early withdrawal penalty, though ordinary income taxes will still be due. On the other hand, it usually makes more sense for an inheriting spouse age 59½ or older to roll the IRA over into his or her own IRA (retitle the inherited IRA in his or her own name). This makes it easier to manage and allows the surviving spouse to name new beneficiaries.

**Non-spouse rules.** Options are more limited for non-spousal heirs inheriting IRAs. If the IRA has no designated beneficiary (that is, a named person), and the owner had already started required distributions, then the heir must continue taking out distributions based on the owner's remaining single life expectancy at death. If distributions had not started, the heir must take all the money out within five years and pay ordinary income taxes.

If the IRA did designate a specific non-spouse beneficiary, then that person can take annual minimum withdrawals based on his or her own life expectancy regardless of whether the owner had already started required distributions. Unlike a spouse, a nonspouse cannot roll an inherited IRA into his or her own IRA. Multiple non-spouse heirs, such as a brother and sister, can split the inherited IRA into separate IRAs for each beneficiary. If they don't split it, then the minimum withdrawals are based on the life expectancy of the oldest heir, which obviously may not be to the benefit of the younger beneficiary or beneficiaries.

Other provisions apply when a charity or trust is a beneficiary. Inheriting an IRA can be a tricky business, with potentially large tax consequences. So don't make any decisions before consulting a financial professional who is very familiar with the IRA inheritance rules. *Caution:* not all IRA custodians allow all of the above options, even though federal law does. In such cases, you may need to change custodians to achieve the desired result for your intended beneficiaries.

This column was produced by the Financial Planning Association, a membership organization for the financial planning community, and is provided by Karen F. Folk, CFP®, a local member of the FPA.

## INSIDE THIS ISSUE

2 Tips for College Graduates
3 Real People and Risk
4 Ask An Advisor

# TIPS FOR COLLEGE GRADUATES

*by Patricia A. Konetzny, CFP®, EA*

For many of our "kids," this summer is their first after graduating from college. They have either started their first real job or are still looking. Our family reached this major milestone when our daughter Mary graduated in May. She asked for my help in getting her financial house in order, so we started by setting up a file system to organize her bills and important papers. Next, we talked about how to divvy up the money she had received for graduation – how much to put toward bills, how much to save, and how much to keep for an emergency fund. Before our talk, she had planned to "just spend" the graduation money. But after only one discussion about her financial goals and how she wants to achieve them, she is already making better financial decisions. We encourage you to spend some time discussing these types of issues with your graduates as well. Here are a few other ideas to discuss:

- **Pay Yourself First –** The best way to start on your path to financial independence is to always pay yourself first by saving at least 10% of your income.
- **Create an Emergency Fund –** Prepare for the inevitable things that happen in life, like car repairs or a possible job layoff.
- **Track Your Daily Spending –** Write down what you spend money on for 30 days. After that, you'll have a good idea where your money goes. The little things like daily coffee, fast-food lunches, and soda can add up fast. Think about what's really important to you and then choose to spend your money on the things you value. Make a decision to live within your means and avoid impulse spending.
- **Make Savings Automatic –** Start automatic transfers from your checking account to a savings account.
- **Start a Christmas Club –** This is an "oldie but goodie." Planning how much you will spend on Christmas and saving for the holidays will help you avoid using credit cards and spending more than you can afford.
- **Open a "Big Bill" Account –** Some bills, like car insurance and excise tax, come annually or semi-annually. Calculate how much you need to save from each paycheck and have that amount automatically deposited into your "Big Bill" account. When the bill arrives, the money will be there.
- **Consolidate Student Loans –** Rates for student loans are at their lowest. Consolidate loans to fixed payments while interest rates are still low. Act now because Congress is considering changing the rules and not allowing fixed rates in the future.
- **Understand the Power of Compounding –** Albert Einstein once said that compound interest is the "the greatest mathematical discovery of all time." Time is the best friend of a prudent investor. Money saved at an earlier age has the advantage of compounding longer. This will give the early saver a much larger nest egg than someone who delays saving until later in life.
- **Get a Copy of your Credit Report –** Many students are leaving college with high credit card debt and a history of late payments for utility bills and cell phones. It's important to understand your FICO score and how it affects borrowing rates. Your FICO score measures your credit worthiness. Bad credit means you pay higher interest rates for auto and mortgage loans, as well as higher insurance premiums; bad credit could also affect your employment options.
- **Start Your Nest Egg ASAP –** Sign up for your 401k during the new employee orientation! Waiting until you can afford to contribute is one of the most expensive mistakes you can make. You won't miss money you never had, and if your employer contributes a matching percentage, you may be passing up free money. Increase your contribution with each pay increase.
- **Discuss Finances with a Grandparent –** Many of your grandparents are living a nice retirement now because they squirreled money away for their future. Your future may seem like a lifetime away, but it's not. Ask them how quickly tomorrow became today.

Reviewing and employing these strategies will help recent graduates avoid a lot of the financial pitfalls that can hamstring their financial progress. Most college graduates leave school well versed in their fields but woefully lacking in basic financial skills. Good habits, started early, will help them to create a more secure and comfortable future.

# REAL PEOPLE AND RISK

*by Robert Reed, PhD, CFP®*

Cambridge Advisors use Functional Asset Allocation (FAA) to divide risk into two types. *Exogenous* risk comes from events outside your life; *endogenous* risk comes from events inside your life. Exogenous risks include inflation, currency fluctuations, oil prices, and international incidents. Endogenous risks include changes in your income, employment stability, investment balance, health, and family situation.

Typically, people believe that exogenous events should trigger changes in their portfolio. But it is the personal endogenous events that demand changes in a functional portfolio. This is because neither clients nor advisors have control over or special foresight into world-shaping events such as developments in the Middle East, OPEC responses, and the price of oil. Clients do, however, have some control over their life and future.

Thus, a Functional Asset Allocation (FAA) portfolio is structured to do three things:

1. achieve market returns (because no one can consistently beat the market);
2. use an asset allocation based on each individual's situation (because the goal is a better life, not bigger numbers);
3. minimize risk (because who needs extra risk?).

**FAA protects against risk in the following ways:**

### Risk Tolerance vs. Appropriate Risk

Asking, "How much risk can you tolerate?" makes as much sense as a doctor asking, "How much pain can you tolerate?" The answer in both cases is, "A lot if I absolutely have to, but I don't want to!" Furthermore, 'scientific' tests measuring your risk tolerance are not accurate. One failing is that these tests suffer from *recency bias*, when recent experience strongly influences your attitude toward risk. Everyone had a high risk tolerance in the 1990s!

Using FAA, Cambridge Advisors downplay Risk Tolerance assessments to concentrate on Appropriate Risk: that is, how much risk is needed to achieve your goals given your personal situation. Determining your appropriate risk depends on (1) your stage in the Cambridge Life Cycle, (2) other risks you already have in your life (e.g., health and family issues or investments in real estate or your own business), and (3) your goals and time frame. We use various tests and ratios to determine the appropriate level of risk. In addition, we spend time talking with you to find out what is happening in your life, and we factor that into your financial strategy.

### Focused Risk

Some clients are already taking significant risks in other areas of their financial life besides their investments. For example, a small business owner (particularly one just starting out) does not have the same financial security as an employee. In addition to assessing appropriate risk rather than risk tolerance, the FAA approach uses a Focused Risk strategy to balance risk exposure. Whenever clients are taking significant financial risks aside from their investments (e.g., small businesses, professional practices, real estate), we create an investment portfolio with less risk and more liquidity to balance out the risks already taken in other areas. This means that clients focus their risk in the area they know best, and FAA decreases investment portfolio risk to minimize *overall* risk exposure.

### Inflation Risk

While FAA focuses on reducing endogenous risk, it does include protection against the exogenous risk of inflation. Traditional financial advisors make long-term inflation assumptions (guesses, really) when they construct client portfolios. With FAA, inflation adjustments happen automatically as a function of each client's allocation to interest-earning, real estate, and equity investments. By keeping the real estate category at one-third of net worth, FAA emphasizes having the right size house for your income and long-term mortgage leverage to offset inflation. When inflation rises, the value of your home increases, but your fixed-rate mortgage payments remain constant (they actually decrease in real terms). Thus, increased living costs due to inflation are offset by ***increased home value but*** unchanged mortgage costs. At the same time, real estate values have historically kept pace with inflation, so your home's value rises at least at the rate of inflation, increasing your home equity. ■ ■ ■

*Financial Focus is a publication of the Alliance of Cambridge Advisors, Inc. ©2004. All Rights Reserved.*

# ASK an Advisor

## IS A VACATION HOME A GOOD INVESTMENT?

*by Linda Leitz, CFP®, EA*

A vacation home is a favorite dream for many of us, but before you buy, make sure the dream doesn't turn into a nightmare. If you spend a lot of money going to the same location every year, a vacation home might be a good investment for you. Your costs will be more stable, and your investment should appreciate over time. The hitch is that owning a vacation home year around is generally more expensive than paying lodging costs. Even though you do get a tax break for the interest and real estate taxes you pay, you are also responsible for all the maintenance and upkeep.

Many people end up viewing their vacation home as a burden. They want to be on vacation but spend their time doing needed maintenance instead. Vacation properties are also higher risk real estate investments than a primary residence. Resort areas are subject to unstable real estate values, when another locale becomes the "in" vacation spot or demographic or other economic trends change vacation patterns. In addition, as occasional visitors to an area, buyers often lack adequate knowledge about the local real estate market and are less likely to pay a fair price for their dream vacation home, reducing the chances of significant appreciation over time.

**Q. What if I rented the property out when I'm not using it?**

*A. Renting the property can certainly help defray the costs of owning it year round, but often the best times to rent are typically the same times you want to use the property. To find enough renters and to manage the property, you'll need a professional rental agent, which decreases your income considerably. If you try to rent the property yourself, you might not have the resources to find renters, and your efforts increase the time you spend working rather than enjoying the property. Also, renting a property can greatly increase wear and tear, increasing maintenance costs. You may get some additional tax breaks by renting, but if you want to personally use the property more than two weeks per year, the tax breaks will be more limited than on a conventional rental property investment. And once again, if you use the property less than a couple of weeks per year, just paying for vacation lodging is probably a better financial move than buying a vacation home.*

**Q. So if I don't want to use it more than a couple of weeks a year, how about buying a time-share?**

*A. Time-shares aren't usually good investments. Unlike most real estate investments, time-shares don't increase in value over time. You don't have complete control over when you can use your time-share, most require that you go through the management company to sell them, and the annual fees can often increase without your approval. The ability to "swap" time-shares with other time-share owners can help you avoid the boredom of always vacationing in the same place. There may be times, though, when you don't use your time-share at all in a given year because of the cost of the time-share, the lack of desirable swaps, or the travel costs to reach the time-share. And you'll still have to pay the annual time-share assessment, even if you lose the ability to take advantage of it for the year.*

*In general, a vacation is an investment in your mental well being. That can certainly have a good financial return in the form of better professional productivity, but the main reason for vacations is to relax and recharge your batteries. Before you start trying to make your vacations a financial investment by buying a vacation home, talk to your financial advisor about whether or not that makes sense for your situation.*