



# BWFA Advisor

BALTIMORE-WASHINGTON FINANCIAL ADVISORS, INC.

Fee-Only Retirement & Estate Planning, Investment Management, & Tax Services

## New Year's Financial Checklist



By Bob Ray

If one of your New Year's resolutions is to get your financial house in order, here is a checklist of items to help you get started:

### Update Your Will

Recent changes in Federal Estate Taxes make this an ideal time to review your will.

### Rebalance Your Investment Portfolio

Market volatility has probably shifted your assets from your desired allocation.

### Reallocate Your Portfolio

Is your Portfolio Model still appropriate given your goals, time horizon, and risk tolerance?

### Maximize 401(k)'s, 403(b)'s, 404(c)'s, and IRA's

Tax-deferred investments normally accumulate faster than your taxable portfolio, especially with matching contributions from your employer. Don't miss the catch-up provisions for those over 50 years of age.

### Convert Traditional IRA's to Roth IRA's

If your adjusted gross income is less than \$100,000, it may make sense to convert to a Roth IRA now, when asset values are down and taxes you will pay will be less.

### Roll Over Old 401(k)'s, 403(b)'s, 404(c)'s to Rollover IRA's

IRA's offer more flexibility with fewer fees. When you leave your employer, take your retirement plan with you to avoid paying the unnecessary fees associated with the retirement plans!

### Look for Opportunities to Shift Income or Expenses

Shifting income or expenses between tax years can sometimes reduce your tax bill. Estimated tax payments are just one such opportunity.

### Review Your Retirement Plan

Is your Retirement Plan working for you? Don't have a plan? Call us. We can help.

## What's Happening at BWFA

**It's a Girl!** We are happy to announce that Kim Anderson had a healthy baby girl, Olivia Marie, on October 16. Olivia weighed in at 7 lbs. 6 oz. and measured 19½ inches long. (You can see pictures of the new beauty at [www.dadadigital.com/gallery](http://www.dadadigital.com/gallery)). **Kim will be back to work on January 3, 2003.** In the meantime, the staff at BWFA is working together to take care of her clients.

BWFA is pleased to **welcome Bob Ray** to our staff. Bob has over 26 years of investment experience, most recently as a Senior Vice President at Allfirst Bank. He joins us as a financial advisor working primarily with retirees and those nearing retirement. You can learn more about Bob Ray by reading his bio on our Web site at [www.bwfa.com](http://www.bwfa.com). Bob has been a personal friend of Saxon's for over 20 years.

Thanks to all of you who have **referred your friends and colleagues to us!** BWFA is always looking for excellent clients like you. We will always do our best to provide exceptional service to anyone you refer to us.



# Retirement & Estate Planning

## You Can Take It With You!



By Kim Anderson, CFP®

When leaving a company, whether because of retirement, a layoff, or pursuing a new job opportunity, you are faced with many financial decisions. Among those are what to do with the retirement assets you accumulated during your employment. You basically have two important decisions to make:

- 1. Should you roll your 401(k), 403(b) or other retirement plan balances into a rollover IRA?**
- 2. Should you take a lump sum payment or an annuity from your pension?**

The first one is easy: the answer in nearly all cases is YES! When you roll your 401(k) or another plan into an IRA, even if you keep it invested in the exact same funds, you avoid administrative fees associated with the company plan. These fees can be as high as 1%. Over a long period of time, these fees really add up. By rolling your money out, you make sure you avoid these fees altogether.

Another reason you should roll your retirement plan into an IRA is that you greatly improve your investment choices. Most plans have only a few mutual funds to choose from and often these do not represent enough asset classes to give you proper diversification. You may also be excluded from using individual stocks. By rolling into an IRA at a discount brokerage firm like TD Waterhouse or Charles Schwab, you have nearly the entire universe of mutual funds to choose from. In addition, if your account is large enough (generally over \$200,000), you may benefit from using individual securities instead of funds. (To learn more about the benefits of using individual stocks, see the article

“The High Cost of Mutual Funds” in this newsletter and the article “The Case Against Mutual Funds” on our Web site at [www.bwfa.com](http://www.bwfa.com). Enter “mutual funds” in the Search function.)

The second decision is more complicated. Whether to take a lump sum payment or an annuity from your pension depends on a number of factors. Some of the things you will need to consider include:

- **Interest Rates** – Current interest rates are used to calculate a lump sum payment that is equivalent to the stream of income you would receive with an annuity. When interest rates are low, as they are now, this calculation produces a larger lump sum payment. In addition, you have an excellent chance of being able to invest your funds at a higher rate of return than the rate used to calculate your lump sum payment. That means that at times like this you can often get more by taking the lump sum payment.
- **Inflation** – Most pensions do not provide cost-of-living adjustments to your annuity payments. What may look like a reasonable income today may not provide a sufficient standard of living for you in 10 to 20 years. At 3% inflation, a \$2,000 monthly annuity will only be worth about \$1,500 in 10 years, and \$1,100 in 20 years. You have a better chance of beating inflation by taking a lump sum payment and investing a portion of it in stocks.
- **Risk** – One of the benefits of an annuity is that you will probably not outlive it. When you take a lump sum payment, you run the risk of spending down your assets during your lifetime. Whether this is a significant risk for you depends on issues such as your other assets, level of expenses, and risk tolerance.

It is important to seek the advice of a professional when making these important decisions. Be sure to choose someone who has been through the process many times, knows what to look for, and can evaluate your options fairly and objectively.

## The High Cost of Mutual Funds



By Rob Williams

According to Morningstar, the mutual fund monitoring service, the average mutual fund in its 14,592 fund database still charges the following extremely high expenses:

• Investment management expenses	1.39% per year
• Front-end commissions paid to brokers	1.14%
• Deferred commissions paid to brokers	1.00%

This means an investor who puts \$100,000 into the average mutual fund would pay \$2,530 in total fees

in the first year and 1.39% of whatever the fund is worth every year thereafter, and another 1% when they take the money out.\* Since mutual funds' fees vary dramatically, some investors pay a lot more.

### What should an investor do?

- Only use mutual funds when appropriate. BWFA recommends using mutual funds when your account is small or in cases where funds will help diversify your portfolio at a reasonable cost, such as with foreign stocks.
- Always look at fees before buying a mutual fund.

\*Deferred commissions generally do not apply for funds held longer than 5 years.

# Investment Management



By Bob Ray

## Constructing a Retirement Portfolio

You have worked hard your entire life and now you are looking forward to your retirement. Most of your "Retirement Portfolio" has resided in your principal residence and your company retirement plans. Up to this point it has been easy. Most likely, your retirement plan didn't offer you many choices. Perhaps you made a few calls to your friends to see what they were doing and then allocated your retirement savings between four mutual funds. Nevertheless, the markets have treated our generation extremely well, and as we reach retirement our portfolios have grown to tidy sums indeed. But now we must manage these funds to last the rest of our lives.

### The Need for a Comprehensive Retirement Plan

We have found that successful investing is best achieved by preparing a detailed and comprehensive retirement plan before beginning the investment process. The retirement plan will answer many questions about how the money needs to be invested, how much risk you should take based on your existing resources, what you can afford to do in retirement, the risk of outliving your resources, and many other important issues. The savings associated with a good plan are usually 2-10 times the cost of the plan, and sometimes considerably more.

### Effectively Managing Your Investments

The first step in the investment process is deciding which method of management you are going to use. To manage your portfolio effectively, you realistically have three choices, as described below. The one that is right for you depends on your level of investment expertise, the amount of time you can devote to managing your investments, and what you are willing to pay.

- **Purchase mutual funds through a discount broker.**

For people interested in managing their own investments, using mutual funds removes the daunting task of selecting individual stocks and bonds. This is the best option for portfolios of less than \$150,000, because it allows for good diversification at a reasonable cost. On the downside, mutual funds do not offer control over taxes in taxable accounts and for larger portfolios the fees can be high in comparison with other options.

- **Work with a full-service broker.**

Individual stocks offer investors with larger nest eggs lower total costs than mutual funds and provide greater control of your taxes. If you are interested in managing your own portfolio of individual stocks, we recommend using a full-service broker who

can provide you with new ideas and research reports. It is vitally important to understand that a broker is *not* an advisor or a fiduciary (someone who must, under law, always act in your best interest). A broker is in the business of selling stocks for a commission and pushing certain stocks to help his or her corporate clients who are trying to raise capital. Never give a broker free reign or discretion over your investments, because the broker's interests are inherently in conflict with yours.

- **Use an investment advisor.**

If you don't have the time, expertise, or inclination to do it yourself, you can hire an investment advisor. An investment advisor does act as a fiduciary in managing your investment portfolio and is legally responsible for understanding your needs and your risk tolerances. Firms in this category would include bank trust departments and independent investment management firms such as BWFA.

### Selecting Your Proper Portfolio Model

Your next step is to determine the proper mix of assets, which will enable you to achieve both your income and capital growth needs. This will lead you to an appropriate asset allocation and Portfolio Model. Having already prepared a Retirement Plan is extremely helpful in this process.

Here at BWFA, we have constructed seven Portfolio Models that encompass risk profiles ranging from aggressive growth to capital preservation. Each Model has a different percentage of aggressive stocks, long-term growth stocks, growth and income stocks, foreign stocks, and fixed income investments to maintain the proper risk profile for our clients and still meet their retirement income needs.

### Rebalancing and Reallocating Your Portfolio

Unfortunately, the job of portfolio manager is never finished. You should rebalance your portfolio from time to time, as market volatility will shift your planned allocation. In the late 90's, a Conservative Growth Model could have developed into an Aggressive Growth Model as technology stocks soared. Constant rebalancing could have preserved some of those gains and reduced portfolio volatility as tech stocks collapsed.

Finally, you should consider reallocating your portfolio as your goals, time horizon, and risk preferences change. Is your Portfolio Model still appropriate for you today? My guess is that most investors have lower risk tolerances today than five years ago. Good luck! And call us if you want to discuss how we would handle your situation.

# Tax Services



By Bob Cassel, EA 

## Frequently Asked Questions About Retirement Plan Contributions

During the tax preparation process we are often asked questions that have to do with the timing of contributions, the most appropriate account, and the deductibility of

contributions. So we've put together a list of FAQs (Frequently Asked Questions) and hope that you find the answers you need. This article will be posted to our Web site ([www.bwfa.com](http://www.bwfa.com)) for future reference.

### What are the new maximum 2003 contribution amounts for each of the various retirement accounts?

We've provided a table for easier reading.

Type of retirement plan	Maximum contribution limit for 2003	The "catch up" amount for those age 50 and older
401(k) Salary deferral	\$12,000	\$2,000
403(b) Tax sheltered annuity	\$12,000	\$2,000
SEP-IRA (Simplified Employee Pension)	25% of compensation	N/A
SIMPLE IRA	\$8,000	\$1,000
Regular IRA	\$3,000	\$500
Roth IRA	\$3,000	\$500

**What is the "catch up" amount?** Congress has written new tax law that allows people over the age of 49 to make additional contributions to their retirement accounts. The amount of the catch up contribution varies according to the type of plan. You can see those amounts in the table above.

**When is the best time of the year to make my IRA contribution?** The earlier in the year the better. Tax deferral starts the moment you put your contribution into the account. Your 2003 IRA contribution can be deposited as early as January 1, 2003.

**What happens if I prefer to make a Roth IRA contribution but find out when I file my tax return that I am not eligible for a Roth IRA?** You *can* make the Roth IRA contribution early in the year. If you find that the contribution is not allowed because your income is too high,

then you can remove the contribution with the earnings by the time your income tax return is due (April 15) without a problem. Only the investment earnings will be taxable.

### In what order should I fund my retirement accounts?

We've listed them in order of preference. Generally, you should contribute to your employer's plan, **401(k)** or **403(b)**, especially if your employer matches any of your contribution. The employer match is extra compensation to you.

If your total income allows, you should make a **Roth IRA** contribution. Remember, the Roth IRA contribution is not deductible, so there are no immediate tax benefits. However, the earnings in the Roth IRA are NEVER taxed and the Roth IRA does not require you to make minimum distributions at age 70½. Roth IRAs make wonderful inheritances for your children, since they can continue to enjoy the tax-free income from the Roth IRA over their life expectancy.

If you do not qualify for a Roth IRA, then a **traditional IRA** contribution is the next best move. This contribution may be deductible (unlike the Roth IRA) depending on two circumstances: your total income level and whether you are covered by an employer-sponsored retirement plan.

**Can I put money into an IRA for my children?** Yes, if they have a job and have received a paycheck, you can put up to the maximum \$3,000 or their earned income, *whichever is less*.

**If my spouse is not receiving a paycheck, can we still make an IRA contribution to his/her account?** Yes. You are permitted to put up to the maximum amount allowable (\$3,000 or \$3,500 with "catch up") as long as one spouse has earned income equal to or greater than the IRA contributions you intend to make. For example, if Mrs. Howard earns \$60,000 per year and Mr. Howard is not employed, then the Howards can each make a \$3,000 contribution to their IRA, for a total of \$6,000 in contributions, since Mrs. Howard makes more than \$6,000.

Please call us if you have more questions about contributions to retirement plans or IRAs. And, once you've read our newsletter, please feel free to pass it along to a friend.