BWFA Advisor

BALTIMORE–WASHINGTON FINANCIAL ADVISORS, INC.

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

Special *Edition*

At BWFA we understand that it's difficult for people to find sound financial advice. That is why our approach is to provide straightforward solutions you can understand and act on. At BWFA you get the highest quality advice available anywhere, at any price.

We are dedicating this Special Edition of our quarterly newsletter to helping you understand what REAL financial planning is by illustrating a real-life situation. We hope you have as much fun reading it as we did writing it.

Saxon Birdsong, *President and Director of Investments*

By Henry Becker

What Is a Financial Plan?

Part I — The Client Profile

The Franklins

Larry (age 60) and Jill (age 58) Franklin live in Ellicott City, Maryland and have two adult children, Joe (age 31) and Liz (age 33), who live, respectively, in Miami and Naples, Florida. Larry has worked for PFC Corp for 20 years. Jill stopped working while raising their children and returned to work for a small nonprofit company fifteen years ago. Larry and Jill have welcomed the arrival of their first two grandchildren in the last two years. Recently, Jill began to wonder if they could retire in the near future and move closer to their grandchildren. But Larry is concerned that they can't afford for both of them to retire; he thinks he may have to work longer.

Larry and Jill have had many conversations about their retirement. Ideally, they would retire together in two years. But each time they discuss it there seems to be a growing list of issues they face, both financial and nonfinancial. They decided to talk to some friends, Tim and Ann Fisher, who recently retired, to see if they had any advice to offer. The Fishers were frank and said that they tried for many months to put the retirement puzzle together but found the number of issues overwhelming and sought help. They referred Larry and Jill to their Fee-Only Financial Advisor, Baltimore-Washington Financial Advisors (BWFA). Tim and Ann explained that BWFA's objective, team approach to retirement and estate planning, taxes, and investments helped them put all the pieces of their retirement picture together. After meeting with BWFA, Larry and Jill decided to have BWFA prepare a comprehensive retirement plan, manage their investments, and prepare their taxes. Below is a summary of the questions and information they brought to BWFA.

Questions

- Can we maintain our current lifestyle if we retire in two years, or will one of us need to work longer?
- How do we produce an income from our investments?
- How do we make our retirement income last?
- What effect will retiring to Florida have on our taxes?
- How should we invest to meet our goals?

Income, Expenses, Assets, and Liabilities

Incomes		Assets		Notes
Larry	$100,000	**Taxable**		
Jill	$35,000	Mutual Funds	$200,000	→ *$30k in municipal bond funds & $170k in Growth & Inc. funds*
Dividends	$4,750			
Total	**$135,000**	**Tax-Deferred**		
		Larry's old 401(k)	$100,000	→ *S&P 500 Index fund*
After-tax Expenses		Larry's IRA	$100,000	→ *Growth mutual funds*
$80,000		Jill's old 401(k)	$50,000	→ *Growth and Income Fund*
		Larry's Current 401(k)	$800,000	→ *$190,000 employer stock; the rest a mix of Bond funds, Growth & Income funds, and Foreign equity funds*
		Life Insurance Cash Value	$50,000	→ *Face value is $150,000*
		House	$300,000	
		Total Assets	$1,600,000	
		Liabilities		
		Mortgage	$110,000	
		Home Equity Loan	$10,000	
		Total Liabilities	$120,000	
		Net Worth	$1,480,000	

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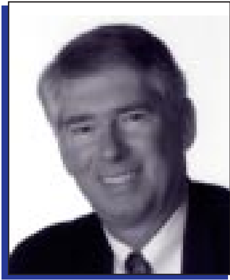
Retirement & Estate Planning



What Is a Financial Plan?
Part II — Retirement and Estate Planning

By Bob Ray

After preparing a highly detailed analysis of the Franklins' current financial position and their future income, expenses, taxes, and asset values, we were able to provide them with the following recommendations about their upcoming retirement and future estate.

Larry and Jill can meet their goal of retiring in two years. By following the recommendations outlined in this plan, they will be able to retire when Larry is 62 and Jill is 60 with an after-tax, inflation-adjusted income stream of $80,000 per year. Their sources of income will include $24,300 from Social Security and $55,700 after-tax from their investment portfolio. This is sufficient to maintain their current lifestyle which costs $80,000 a year.

Larry should begin Social Security at his full retirement age of 66. Larry and Jill are in excellent health and can be expected to live beyond their average life expectancies. Therefore, Larry should delay receiving Social Security until his full retirement age to get the higher monthly payment. As long as he lives beyond age 78, this will ensure he gets the maximum benefit from Social Security.

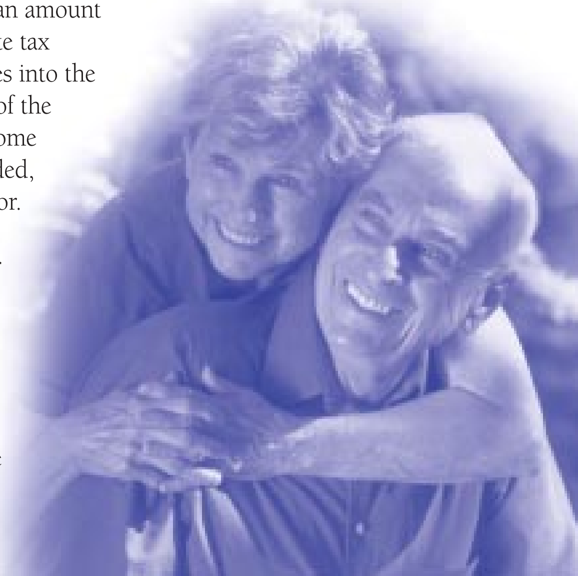
Jill should begin Social Security at age 62. Jill's Social Security benefit under her own work history is estimated to be about $700 a month at age 62. She is entitled to receive the higher of her own benefit or one-half of Larry's benefit, which is estimated at $1,800 a month at his full retirement age. Jill should start her benefits at age 62 of $700 per month, since this will have no effect on her long-term benefit. When Larry begins Social Security at age 66, Jill's benefit will increase to $900 (half of Larry's). By starting early, Jill will receive a total of $16,800 in extra benefits.

Contribute the maximum allowable amounts to your 401(k)s and Roth IRAs prior to retirement. Currently, Larry is contributing $10,000 to his 401(k) annually. Jill is not contributing to her plan. In 2004, Larry can contribute the IRS maximum: $16,000. Jill's plan allows a maximum contribution of 15% of salary, so she can contribute $5,250. Qualified retirement accounts provide the best opportunity to reduce both current and future income taxes. We estimate that by maximizing pre-tax contributions to both of their plans, they could save about $3,600 in taxes annually.

We recommend that Larry redeem his whole life insurance policy. A needs analysis has shown that Larry and Jill have no requirement for life insurance. The policy should be cashed out and the $50,000 in proceeds added to their investment portfolio. This also reduces their monthly expenses by $100.

We recommend that Larry and Jill purchase long-term care insurance with a daily benefit of $100. The high cost of long-term care could quickly deplete Larry and Jill's assets. We recommend purchasing policies with a five-year benefit, a shared care rider, which allows them to use each other's benefit period, and a cost of living adjustment. We estimate the cost of this coverage to be approximately $250 per month. However, the monthly savings from canceling the life insurance policy can help offset these costs. BWFA will recommend an independent agent to Larry and Jill who will discuss these policies in greater detail.

Larry and Jill can benefit from establishing credit shelter trusts. In 2004, the federal estate tax exclusion amount is $1.5 million. That means if Larry and Jill were to die in 2004, no estate taxes would be owed. However, the sunset provision of current estate tax legislation causes the tax exclusion to revert back to $1 million in 2011. At that time, Larry and Jill's estate will exceed the exclusion amount. We recommend establishing a credit shelter trust, which would allow $2,000,000 to pass estate-tax free. When the first spouse dies, an amount equivalent to the estate tax exclusion amount goes into the trust. During the life of the surviving spouse, income and principal, as needed, are paid to the survivor. When the second spouse dies, whatever remains in the trust passes estate-tax free to the heirs. In addition, the full estate tax exclusion amount applies to the estate of the second to die.



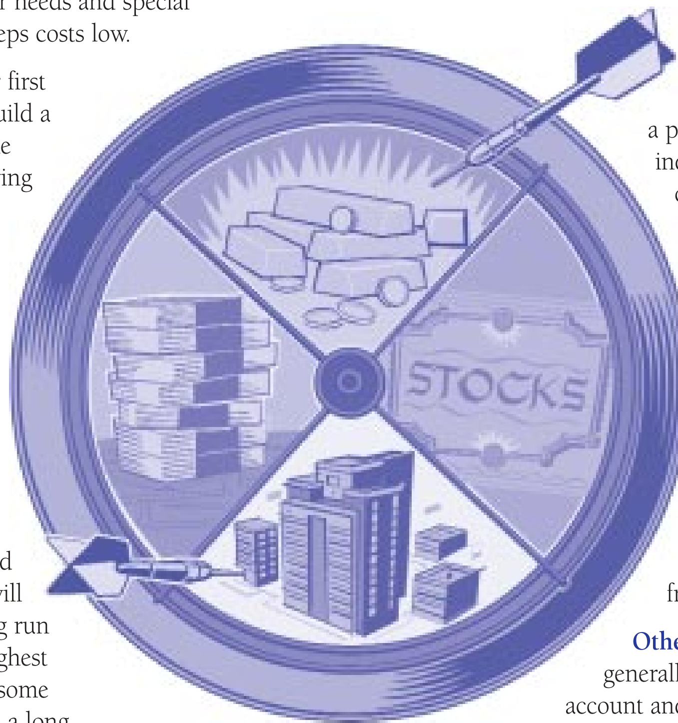
Investment Management

What Is a Financial Plan?
Part III — Investments

By Rob Williams

After careful review of the Franklins' situation, we provided specific recommendations to them in the area of investments. Our investment recommendations are intended to help them manage their money in an intelligent manner that reflects their needs and special circumstances, is tax sensitive, and keeps costs low.

Invest to meet income needs — Our first consideration for Larry and Jill is to build a portfolio that will support their income needs. Once they retire and start drawing Social Security, they will need to withdraw about $70,000 a year from their portfolio. We like to see 50% to 80% of this amount come from dividends and interest (yield) because these sources continue to pay even if the markets go down. This strategy prevents them from having to sell securities at inopportune times and deplete their principle. This means their portfolio must have a yield of between 2.7% and 4.3%. The remainder of their return will come from capital gains. Over the long run stocks have consistently earned the highest rate of return, and most retirees need some exposure to stocks in order to support a long, comfortable retirement.



Select an investment model — To implement this portfolio we recommend our Conservative Growth model. A model is a target allocation among specific asset types. Models provide us with clear guidance about what to buy and give our clients a better understanding of what to expect from their portfolio in terms of growth, income, and risk. The Conservative Growth model is one of seven we have designed. It is 70% stocks of varying degrees of risk and 30% income securities, and has an expected average yield of about 3.4%. This investment model gives Larry and Jill a secure level of income and a reasonable level of participation in the stock market.

Sell the mutual funds — Larry and Jill hold a lot of mutual funds, which is an expensive way to manage a portfolio of their size. There are many costs to owning mutual funds; the most notable are the annual expense charges, which average 1.42% across all mutual funds and 1.6% for equity funds. Investors can build fully diversified portfolios using individual stocks with as little as $250,000 for less than the cost of the average mutual fund. Larry and Jill will get all the benefits of a professionally managed portfolio of individual stocks for less than they are currently paying with their mutual funds.

Municipal bonds are not appropriate — Larry and Jill currently own $30,000 in municipal bonds. Though we understand that no one likes taxes, only those in the top marginal tax brackets benefit from tax-free bonds, because they pay significantly lower interest rates than fully taxable bonds and other income producing securities. The Franklins will be better off earning higher returns from other sources and paying the taxes.

Other stock selection techniques —- We generally buy 30 to 40 different securities in an account and no more than 2% in any one company. This allows us to build a well-diversified portfolio without running up unnecessary trading costs.

We take advantage of the tax characteristics of securities to get the most value for our clients. For example, we buy high dividend stocks in taxable accounts, because dividends are taxed at only 15%. We buy interest-bearing securities in retirement accounts where interest is tax sheltered.

Finally, we ensure that retirees receive a level monthly income deposited directly to their bank account, much like they had while working. To prepare for these distributions, we hold sufficient reserves in a short-term bond fund to keep them secure.

Tax Services

What Is a Financial Plan?
Part IV — Taxes

By Bob Cassel, EA

The table below demonstrates the dramatic changes we expect to occur during Larry and Jill's early retirement years. (The numbers are approximate and are intended to show the trends in retirement income and tax liability for a typical retired couple.)

	Current	1st three years of retirement	Remaining years of retirement
Salary income	$135,000	$0	$0
Social Security	$0	$0	$24,300
Dividend income (on taxable investments)	$4,250	$6,000	$0
Distributions from taxable investments (principal)	$0	$74,000	$0
Distributions from retirement accounts	$0	$0	$70,000
Marginal tax brackets (federal)	28%	10%	25%

Based on our projections of the Franklins' current and future taxes, we offer them the following recommendations:

Delay retirement account distributions — Larry and Jill have sufficient taxable investments to cover their first three years of retirement. By drawing on these funds first and delaying distributions from their retirement accounts as long as possible, they will dramatically reduce their taxes and allow for continued tax deferral on their retirement accounts for three additional years.

Make Roth IRA conversions — Because they will be in a very low tax bracket during the first three years of retirement, Larry and Jill have a wonderful opportunity to move some of their IRA assets to a Roth IRA. The amount converted into the Roth IRA will be taxable but at their very low tax rate. Future earnings and distributions from the Roth IRAs will be tax-free. In addition, the amounts converted now will lower the required minimum distributions from their IRAs later because Roth IRAs are not subject to the minimum distribution requirements. The precise amounts to be converted will be determined each year as part of our yearly tax planning and preparation for estimated taxes.

Remove employer stock from Larry's 401(k) — Recent tax legislation now makes it possible to distribute out employer stock from a 401(k). Ordinary income tax rates (maximum 35%) will apply to the cost basis of the shares (what you paid for them), but the appreciation will be taxed at long-term capital gains rates (maximum 15%) when the shares are sold. Since all distributions from retirement accounts are normally taxed at ordinary income rates, this can provide significant tax savings. The cost basis on Larry's employer stock is $90,000 and the appreciation is $100,000. By distributing out the shares, he will pay 15% tax on the $100,000 appreciation. If he leaves them in, he will have to pay at least 25% tax on the appreciation when he withdraws the funds to live on. That's a tax savings of $10,000.

Moving to Florida will produce dramatic tax savings — Florida does not have an income tax. Compare that with the marginal tax rates in Maryland that reach as high as 7.85%. If Larry and Jill stay in Maryland and take $70,000 a year from their retirement accounts, they'll pay Maryland approximately $4,300 in income taxes. In Florida, the state income tax bill would be zero. However, Florida does have an intangible property tax on taxable investments, which is 0.1%. In their first year in Florida, this tax would amount to about $160.

Plan for estimated tax payments — During their transition to retirement, and through their retirement years, tax planning will be important to Larry and Jill. All government agencies require that you pay your taxes as you go through the year. Since taxes will no longer be withheld from their paychecks, they'll need to plan to make quarterly estimated tax payments directly to the government. This helps them avoid penalties for underpayment of tax.

The value we bring with our comprehensive approach to retirement planning is to prepare our clients for the financial changes they can expect to encounter as they transition to retirement, and to give them the peace of mind that comes from knowing that their financial affairs are being monitored by an advisor who knows their needs intimately and is looking out for their best interests.

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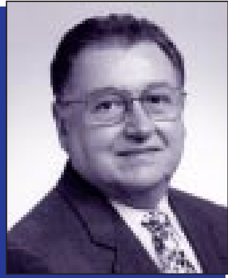

Be Smart — Buy the Right Kind of Investment Return

By Saxon Birdsong, MBA

Before deciding which investments are best for you, you should look closely at the new tax law, which lowered the rate you pay on dividends and capital gains to 15%. This law has provided investors with some really significant opportunities to improve their wealth.

Whereas many investors might have previously favored investing in bonds to meet their income needs, our research shows that most investors would be served far better by investing in certain types of dividend-paying stocks.

Consider these facts:

1. Bond interest is taxed at a higher (ordinary) federal tax rate than dividends, so you give up more of the money your investments produce when you buy bonds.
2. Dividend-paying companies frequently increase the amount of dividends they pay, while bond interest is never increased. Effectively, with the right dividend-paying stocks, you can get a "raise" each year of retirement.
3. With bonds, your strategy should always be to hold to maturity, because they are too expensive to buy and then sell. In any case, you face the possibility that you will be left holding bonds paying lower interest at a time when rates are rising. No such lock-in period exists with dividends, leaving you with more flexibility.
4. When interest rates decline (when the economy slows down), bonds which were issued at higher interest rates when the economy was booming are "called" (paid off), leaving you with the problem of reinvesting at lower rates, effectively taking a "pay cut." Dividends are usually left unchanged during these same events.

Because of the differences in tax rates and considering the effect of normal dividend increases, our research shows that an investor can end up with significantly more money by investing in high-dividend stocks rather than bonds over a 20-year period. As Table 1 shows, an investor that buys a stock paying a 3% dividend and appreciating 3% a year will end up with 28% more money than an investor who buys a bond paying 6% a year. Even though the total returns are the same — 6% in each case — the dividend investor comes out ahead simply due to the difference in tax treatment of the two types of investments. If the stock's dividend is also increasing by 3% a year, as shown in Table 2, then the investor ends up with 55% more after 20 years.

Investors should understand the financial advantages and risks of a portfolio of secure, high-dividend-paying stocks before committing their investment dollars. Our work with retirees over the last 15 years has shown that most people who are retiring today simply cannot afford the lifestyles they want if a significant portion of their investments is in bonds.

Having an advisor who can structure and maintain your investments properly will go a long way toward making your retirement what you desire.

Table 1. Advantage of Dividend Income on growth of $100

	Income	Capital Appreciation	Tax	Balance after 20 Years
Stock	3%	3%	15%	$299
Bond	6%		28%	$233
			Difference	28%

Table 2. Advantage of Dividend Income with Dividend Growth on growth of $100

		Growth of $100			
	Income	Dividend Growth Rate	Capital Appreciation	Tax	Balance after 20 Years
Stock	3%	3%	3%	15%	$361
Bond	6%			28%	$233
				Difference	55%

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What to Do When a Loved One Dies

By Kim Anderson,

Coping with the loss of a spouse or another loved one is terribly difficult. Often, the last thing anyone wants to think or talk about is the financial issues that inevitably arise after someone dies. And yet, these issues cannot be ignored. We hope the following steps may be helpful in guiding you or someone you know in what to do when a loved one dies.

1. Gather documents — The first step is to locate the will, trust documents, life insurance contracts and statements of accounts. You will also need to obtain death certificates. The most common way is through the funeral director. Request multiple copies (10-25); you will need one for each asset held by the deceased and each institution you contact.

2. Contact life insurance companies — After you call the insurance company to let them know what has happened, they will send you a claim form. Upon receiving the claim form and death certificate, an insurance company is usually quick to pay the benefits. Often they will do this by establishing a checking account in your name, depositing the death benefit to the account, and sending you a checkbook, which you can use to draw on the funds. You do not have to leave the money in this account. But it may be a good holding place until you determine how the funds will be used or invested. It's important during this time of transition to have cash on hand. So leave about six months worth of expenses in cash reserves.

3. Contact the deceased's employer — If the deceased was still working, you should receive a check for wages earned, unused sick leave, and vacation pay. There may also be life insurance benefits, survivor pension benefits, and retirement account balances. If you are the surviving spouse, you can roll retirement account balances into your own IRA, which is the wise thing to do in most cases. If you will need to tap into these funds prior to age 59½, you should contact a financial advisor before rolling them over to make sure you do not get hit with early withdrawal penalties. Due to the tax consequences of withdrawing money from a retirement account, other sources of funds should be considered first.

If the family's health insurance was through the deceased's employer, you will have to speak to Human Resources about what happens to your benefits. At a minimum, you should be able to extend your current insurance for 18 months through COBRA. However, you will pay significantly more for this coverage, because you will be responsible for the full premium (both the employee and employer portions), and there is usually a surcharge or administrative fee on top of that. If possible, look for other, less expensive, alternatives.

If the deceased had vested employee stock options, usually there is a period of time in which the family must exercise them or they will be lost. Contact a financial advisor with expertise in this area to help you determine the best course of action.

4. Contact Social Security and Veterans Affairs — Surviving families with children under the age of 18 may qualify for benefits through Social Security. Or, if you are a surviving spouse over the age of 60, you may be eligible to receive retirement benefits. Contact your local Social Security office or call (800) 772-1213 to apply. If your loved one was already receiving Social Security benefits, your call will stop benefit payments. You will have to return the check for the month of death. To learn more, go to www.ssa.gov. If the deceased was a veteran, you should also contact Veterans Affairs to learn of possible benefits.

5. Begin settlement of the estate — If the estate is complex, particularly if there are heirs outside of the deceased's family, contact an estate attorney to help you settle the estate. Otherwise, you may be able to handle the settlement without the use and expense of an attorney. We can help you evaluate the complexity of the estate and determine which way will be most cost effective.

It takes tremendous courage to move forward after losing a loved one. But you don't have to do it alone. Allowing friends and family members to help can relieve some of the burden. Having a trusted financial advisor can also be a source of comfort.