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Make tax-free retirement plans part of the portfolio



John Schooler

Will 2006 be a good year for financial markets? The answer depends on whom you ask.

Every January, we review the predictions of “financial experts” for the preceding year and how they fared on stocks, credit, currency markets, growth, and inflation. Once again, only a minority were correct in 2005.

Unfortunately, some people base investment strategy on these predictions and inevitably experience disappointment.

“Predictions are for show, while the coming year’s ongoing portfolio shifts are for dough,” said money manager Steve Leuthold of the Leuthold Group in Minneapolis, Minn.

“For it is the markets themselves that always seem to provide both unexpected opportunities and unanticipated risks,” Leuthold said.

Whether managing your own money or paying an adviser to do so, no one can predict which mutual fund or private money manager will out-perform similar investments, particularly over periods of the next year or two. Investors who are so focused on performance numbers over a short time horizon are most likely to make the big mistake of making a change at exactly the wrong time.

No one can reliably and consistently forecast the course of the economy, interest rates, and markets. It is also impossible to predict, with consistency, which market sectors are ready to run and which are ready to flame out.

However, we can control nearly all our lifetime returns through four decisions:

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1. Have and maintain a well-diversified portfolio.
2. Own equities in your portfolio. The actual long-term risk of equities is in not owning them.
3. Don't panic. Many people invest based on fear or greed. Human nature itself renders many people incapable of succeeding on their own. Experienced investors distinguish between temporary fluctuations in the market and permanent losses.
4. Don't try to time the market. Instead, develop an asset allocation strategy based on your own tax situation, risk tolerance, expected return, asset allocation preferences and, most importantly, your time horizon.

In making 2006 financial resolutions, your goals should be specific, measurable, achievable and compatible. Here are a few areas you may need to address:

Increase your savings. Unlike years ago, most people will not have a pension at retirement. In Japan, individual savings rates are in double digits. Unfortunately, the United States savings rate has been declining and is minimal at best, according to recent studies. Saving NOW for your future is crucial. Start saving now and increase your savings rate by at least 1 percent each year.

Pay off debt. The average credit card debt per household is estimated at \$9,312, according to cardweb.com. Interest rates are higher now for those with home and equity loans or adjustable rate mortgages. Develop a plan of action and focus on paying off your debt.

Review your insurance. Whether life, property and casualty, or long-term care insurance, now is a good time to review what you own. Are you over- or under-insured? If the hurricanes taught us anything, it's to make sure you have enough. Is it still the right kind of insurance you need? Are you paying too much? Take the time to look at what you own and evaluate whether it still makes sense for your situation.

Here's something most of our parents never heard of: tax-free retirement income.

Beginning in January 2006, companies will have the choice of offering employees a new retirement option, the Roth 401(k) plan.

This plan combines elements of the traditional 401(k) with the tax-free benefits of the Roth IRA. You can contribute to tax-deferred savings accounts with after-tax dollars in exchange for the benefit of withdrawing that money tax-free in retirement. The traditional 401(k) is funded with pre-tax dollars, and withdrawals are taxed as income.

With a Roth 401(k), distributions are tax-free and penalty-free, provided the assets have remained in the plan for at least five years and a distribution takes place after age 59 1/2.

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Unlike Roth IRAs, there are required minimum distributions (RMDs) on Roth 401(k) plans, under regular RMD rules that apply to both 401(k) and IRA plans after age 70 1/2. However, the Roth 401(k) required minimum distributions are easily avoided. One can roll a Roth 401(k) over to a Roth IRA where there are no required distributions.

Individuals with both a Roth and a traditional 401(k) will be limited to the same contribution cap as people with just one 401(k) - a maximum of \$15,000 for 2006, or \$20,000 for people age-50 and older by year-end. There are no income limits with the Roth 401(k). However, there is with a Roth IRA.

By each contributing to both a Roth 401(k) and a Roth IRA, a married couple both older than 50 could put away \$50,000 in tax-free monies in 2006. This will give employees three choices: contribute to their existing 401(k) plan, divert their contributions to a Roth 401(k) or split their contributions between the two.

“This is a fantastic way for people to contribute more money on a tax-free basis to accumulate tax-free wealth,” said Ed Slott, certified public accountant and author of several books on IRA retirement planning. “Once the pain of paying taxes is over, the money grows tax free for the rest of your life. You just can’t beat that kind of account.”

Slott believes it wise to contribute to these accounts if money is available.

“It is all long-term versus short-term thinking,” he said. “Building retirement wealth requires a long-term mindset. Yes, short-term, you will save a few dollars in taxes, but that doesn’t pan out because most people don’t invest the tax savings or refund. Most people have spent it weeks before they even have the money.”

“With a regular 401(k), it is like you are dealing with the devil,” Slott added. “Yes, you get a tax benefit, but then you are paying for it for the rest of your life.

For questions, call John Schooler, at (858) 677-0477.