JOE LEE'S
FINANCIAL NEWS DIGEST
A COMPILATION OF INFORMATION AND IDEAS FOR EFFECTIVE MONEY MANAGEMENT

Money line

Now May Be Time To Change Your "Mantra"

By Joe Lee

For most of the last three decades the financial "mantra" has been to invest heavily in the pre-tax component in instruments such as 401(k)s, TSAs and deductible IRAs. The plan: defer income during high earning years until retirement, when a lower income is expected, therefore dropping the taxpayer into a lower tax bracket.

This nearly universal strategy was successful for the last generation of investors because they were able to defer income taxes at rates as high as 70% back in the early eighties, and if they are retired now the maximum Federal income tax rate is just 35%.

Even as early as the nineties, with lower income-tax rates, some experts were saying that old "mantra" may not work as well in the future. So when the Roth IRA hit the scene in 1997, some investors began diversifying their holdings between pre-tax assets and after-tax assets. In recent years this approach has become more widespread with many pundits trumpeting tax-diversification.

If you have not yet come to the "party", now may be a good time. This year, congress is allowing conversions from traditional IRAs to Roth IRAs, penalty free, for taxpayers of all income levels.

Joseph H.D. Lee & Associates
One City Place, Suite 270
St. Louis, MO 63141
(314) 991-6080

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Financial Front

NEWS BRIEFS AND HIGHLIGHTS FROM THE FINANCIAL WORLD

Some countries, especially in the Caribbean and Central America, charge tourists exit fees in order to depart—sometimes only in cash in local currency. *Be prepared:* Find out about departure taxes at http://travel.state.gov/travel before departure and be sure to have some local cash on hand when you leave.

Some suggestions to protect your business from the recession: Do not extend credit: this may result in fewer sales but you protect yourself financially from customers who cannot honor long-term credit obligations. Use factoring companies: they buy money owed to your company (receivables) from you at a discount which will give you immediate capital but reduces your long-term profit. Expand your financial capacity with places where you have an established relationship, like banks, credit unions, or private equity partners. Down-size your real estate: sell and lease back any property the business owns. Reinvest in your business: anywhere you succeed in cutting costs, find ways to put that savings back in the business. (For example, if you lay off an assistant, use what you save to hire a salesperson to bring in more income.)

There are many tax credits available for energy efficiency improvements to your home. For example, window and floor replacements (that meet insulation requirements) as well as metal and asphalt roofing (that meet Energy Star specifications) may be eligible for a tax credit at 30% of cost, up to $1,500 for existing homes--but only in 2010. Some water heaters, heating and cooling systems, and certain types of insulation also qualify for the same credit. In both existing homes and new constructions, alternative energy projects such as geothermal heat pumps, solar water heaters, solar panels, and small-wind energy systems are eligible for a tax credit at 30% of cost with no dollar cap through 2016. *How to benefit:* Visit Energy Star's Web site—www.energystar.gov (click on "Tax Credits for Energy Efficiency")—for details, as the rules are intricate. And only work with experienced and knowledgeable contractors.

Subsidized Stafford loans, awarded by your student's college based on financial need, now have lower interest rates. Through June 30, 2010, the undergraduate rate is 5.6% and will drop to 4.5% after that. A year later, the rate will drop to 3.4%. These new, lower rates only apply to new loans. If you already have a rate at a higher interest, the reductions do not apply, and interest on unsubsidized Stafford loans remains at 6.8%. *What to do:* Go to the college's financial aid office to find out if you qualify for a subsidized loan.

Wit & Wisdom

"Things do not change; we change."

— Henry David Thoreau

How Much Money Will You Really Need For Retirement?

By Mark Miller, Tribune Media Services

How much money will you need to live comfortably in retirement?

One way to calculate the answer is the old income-replacement rule of thumb—to retire comfortably, you must replace 80 percent of your annual pre-retirement income. But at best, this is a rough estimate. For example, it doesn't take into account unforeseen spending needs such as higher health care expenses or a long-term care insurance policy.

At the same time, the rule doesn't recognize that some expenses might fall or disappear entirely, such as commuting or maintaining a business wardrobe.

But most importantly, the income replacement method is wrong for our current hard times economy, because it puts all the focus on wealth accumulation. It doesn't begin with the correct questions: What is the lifestyle I want? How much will I need to spend on basics? What can I afford to spend?

"The replacement ratio method is a good place to start, but it ignores major changes that can result from reduced expenses for dependent children, paying off a mortgage or downsizing major items like your home or cars," says Steve Vernon, an actuary and president of Rest-of-Life Communications, a retirement-education concern.

"It also assumes you'll want the same material standard of living in retirement that you had before. That ignores the possibility that you might be willing to live on less. Often, as people age, they're less interested in material things and more interested in learning, hobbies, volunteering, and spending time with friends and family."

A better approach in hard times is to start with a clean slate. Take the time to ascertain what foreseeable retirement expenses you might incur and balance them against the sources of income that you can count on. Here's a checklist of major issues to consider:

A better approach in hard times is to start with a clean slate.

What are you spending now? The first step is getting a precise handle on your current budget. You can do that using any of the major financial-planning software tools or by tracking what you spend on a spreadsheet for a couple of months. Working with a trusted financial planner is another good way to zero in on what you're really going to need.

Subtract for retirement lifestyle. Once you've got a good picture of current spending, subtract any regular expenses that won't continue in retirement—for instance, the cost of commuting, dry-cleaning bills, wardrobe and taxes on income for Medicare and Social Security.

Add back in retirement expenses. Some discretionary expenses could rise in retirement, say, if you plan to travel extensively. And your non-discretionary spending almost certainly will rise, as well. Health care is the expense many of us fail to anticipate; Medicare deducts premium costs from Social Security checks, and you'll probably pay additional premiums for a Medicare supplemental plan and a Medicare D prescription drug plan. Finally, you may want to consider a long-term care insurance policy. Fidelity Investments has been publishing an annual report on retiree healthcare expenses since 2002. In that time, average costs have jumped 50 percent, rising 6.7 percent in 2009 alone. Fidelity reports that a 65-year-old couple retiring in 2009 will need to spend $240,000 out of pocket to cover medical expenses in retirement, assuming that the man lives 17 additional years and the woman 20.

Inflation. While the cost of living has been flat lately, the Consumer Price Index has jumped about 3 percent annually over the past 20 years, and can't be expected to stay quiet forever. Most seniors live on fixed income—with the exception of Social Security, which is indexed for inflation. That means inflation must be factored into your retirement planning as a cost that will erode spending power.

Housing and other debt. It's difficult to overstate the importance of debt reduction as a retirement planning strategy. Avoid carrying a mortgage and other expensive debt--such as credit card balances—into retirement if at all possible. This is one of the best routes available to cutting expenses and boosting monthly retirement cash flow. That means getting on an aggressive debt-slashing path in the years leading up to retirement. And in some cases, it may make sense to sell your home and move to a less expensive part of the country—or even rent.

Emergency funds. Budget for the unexpected--home repairs, emergency medical needs or even money you may want to set aside to help out children or aging parents.

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Too Many Americans In The Dark On Basic Financial Concepts

By Humberto Cruz, Tribune Media Services

So you think you're good at dealing with day-to-day financial matters. Seventy-five percent of Americans say they are, 77 percent say they're pretty good at math and 70 percent rate their financial knowledge as high.

But Americans, including many who give themselves high marks on math and finances, make common mistakes that cost them a bundle in needless charges, penalties and fees. They also have trouble answering five simple questions:

1. Suppose you have $100 in a savings account earning 2 percent interest a year. After five years, would you have more than $102, exactly $102, or less than $102?

2. Imagine that the interest rate on your savings account is 1 percent a year and inflation is 2 percent a year. After one year, would the money in the account buy more than it does today, exactly the same or less than today?

3. If interest rates rise, what will typically happen to bond prices? Rise, fall, stay the same, or is there no relationship?

4. True or false: A 15-year mortgage typically requires higher monthly payments than a 30-year mortgage but the total interest over the life will be less.

5. True or false: Buying a single company's stock usually provides a safer return than a stock mutual fund.

These questions were part of a "National Financial Capability Study" commissioned by the FINRA Investor Education Foundation (FINRA stands for Financial Industry Regulatory Authority). The correct answers, and the percentage of Americans who got them right are:

Americans make common mistakes that cost them a bundle in needless charges, penalties and fees.

1. *More than $102, 65 percent;*
2. *Less than today, 64 percent;*
3. *Fall, 21 percent;*
4. *True, 70 percent and*
5. *False, 52 percent.*

This translates to an average of just 2.72 correct answers out of five (and some correct answers may have been lucky guesses). If you are good at math, you can figure out that's a score of just 54.4 percent, or an "F" on a typical grading scale.

"Many respondents had difficulty with basic financial concepts," concludes the FINRA study, based on a telephone survey of 1,488 Americans 18 and over.

FINRA's survey was developed in consultation with the U.S. Department of the Treasury and the President's Advisory Council on Financial Literacy. By exploring how people manage their resources and how they make financial decisions, the FINRA Foundation and others can best extend the reach of financial education programs in communities across the country.

The need is enormous. Survey results were discouraging in four key components of financial capability: making ends meet, planning ahead, managing financial products, and financial knowledge and decision-making.

Nearly half of survey respondents reported difficulties in covering monthly expenses. Most lack a "rainy day" fund for emergencies and do not plan for predictable events, such as their children's college education or their own retirement.

More than one in five Americans reported engaging in expensive non-bank borrowing methods such as payday loans, advances on tax refunds or pawnshops. Even among those who said they were good with finances; many bounced checks and were late with credit card payments, among other things.

Few compared the terms of financial products or shopped around.

One in 10 people with a mortgage did not know the interest rate they are paying and 17 percent of investors in retirement plans did not know how much of their portfolio is in stocks or stock mutual funds. Regarding investments for retirement, "it is difficult to distinguish accurate responses... from guesses and misstatements," the study said.

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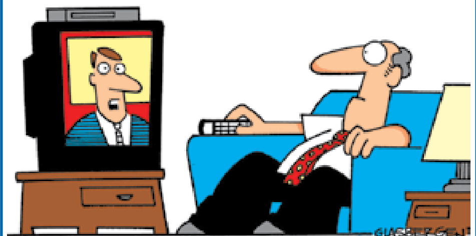
On The Money



"Stocks plummeted today on forecasts that the sun will rise again and tomorrow will be another day."

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One City Place, Suite 270
St. Louis, MO 63141

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(314) 567-9080 - One City Place, Suite 260; St. Louis, MO 63141
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Tax Advantages

A Roth IRA Conversion Question

Q: *I'd like to take advantage of the special IRS tax treatment of Roth conversions in 2010 and pay some of the tax on the conversion in April 2012 and April 2013. I'd convert a large sum this year, if the IRS rules allow, and claim 1/3 of the converted funds as 2010 income (paid in April 2011), 1/3 in 2011 (paid in April 2012) and the last 1/3 in 2012 (paid in April 2013).*

Less than ideal to make a choice and either pay all the taxes in 2010 on all the converted funds or split the income between 2011 and 2012 and pay the taxes in 2012 and 2013. Do you know how the IRS will treat this taxable income over the next three years?

A: Here is how the rule works: For Roth conversions in 2010, taxpayers have 2 options: A) count all of the conversion as taxable for this year and pay the tax by April 15, 2011, Or, B) you may elect not to pay the tax in 2010 and you can spread the conversion amount over the next two years. You would count one half of the converted amount in 2011 and one half in 2012. The income tax due would then be based on your income in those years. The actual tax amount would be based on the tax rates in effect at that time, which is an unknown factor. There is no provision to pay one third for each year, though this misconception does abound.

The only way to spread the taxes over three years would be to make three conversions of one third each year for 2010, 2011 and 2012. Then the taxes would be due by April of the following years. Of course you would run the risk of having the value of your IRA increase, causing additional taxes on the conversion of the higher amount.

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