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# RETIREMENT INSIGHTS

FALL 2011

## Estate Tax Exclusion Poses Opportunities and Challenges

“ According to a recent survey, 84% of affluent baby boomers expect their retirement to be different from their parents, with most saying they will maintain a more active lifestyle (86%) and enjoy a higher standard of living (72%). ”

Source: Bank of America, 2011

**T**HE NEW FEDERAL tax law ushered in the highest estate- and lifetime gift-tax exemptions in U.S. tax law history: \$5 million for individuals and \$10 million for married couples. While this may appear to have taken off the pressure for careful estate planning — only 1% of U.S. estates are estimated to be larger than \$5 million — the higher limits pose both opportunities and challenges for high-net-worth families.

Given the new law, here are some estate planning considerations married couples should address:

**Change charitable donations?** — The single most obvious benefit of the higher estate tax exemption is that if planned properly, a couple can now leave substantially more — \$10 million instead of \$2 million — to heirs and relatives. This is most significant to those whose primary reason for charitable giving is to reduce taxes. Given the new law, reviewing your purposes and strategy should be your first priority.

**Accelerate and increase gifting?** — For couples who exhausted the previous unified gift-tax exemption of \$2 million, the \$10 million limit represents an unprecedented opportunity to move assets out of their estates without taxation. Keep in mind, however, that the annual limit on tax-free gifts is only \$13,000 in 2011, \$26,000 if a couple splits their gift.

Since the new tax law expires in 2013 and it's uncertain what future exemption limits will be, it may be a good idea to take full advantage of the higher limits over the next two years. Targeting appreciating assets — like stocks and real estate —

should be the first priority; even if Congress reduces the exemptions after 2012, once those assets are out of your estate, any appreciation on those assets is also out of your estate.

**Trust or will?** — The higher limit means you can avoid establishing trusts to remove greater funds from your estate. One disadvantage of testamentary transfers to beneficiaries is you lose control over how and when the funds are distributed. Wills must still pass through probate, which means there is the potential for considerable delay before your heirs gain access to the assets they may need to pay taxes or other bills. Wills also distribute assets without limitations as to the purposes they can be used for or when, such as reaching the age of majority or annual distribution amounts. Only trusts can establish these directions.

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## Think Strategically about Risk

**W**HEN IT COMES to risk, many investors claim to be either “risk averse” or “risk tolerant.” Generally, the risk averse invest more in bonds, while the risk tolerant invest more in stocks. But is risk really that simple?

York University business school professor Moshe Milevsky recently wrote an article on risk featured in *The Wall Street Journal*. In it, he states that investors often don't look at risk as strategically

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## Think Strategically about Risk

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as they should and don't consider the most important asset of all: themselves.

Milevsky believes investors should consider how a high or low day in the stock market directly impacts their take-home pay. The answer varies greatly by industry and job profession: a middle school librarian may have zero impact, while an investment banker or portfolio manager may be highly impacted by the stock market's highs and lows.

After considering this relationship, investors should consider how this relates to their investment portfolio. Instead of assuming a position in one of the risk camps (averse or tolerant), look at how much risk your "personal balance sheet" can tolerate.

### Your Personal Beta

Rather than looking at your assets as allocations of monies into stocks, bonds, real estate, and so on — consider your number-one asset as *you*. Look at your future earnings and consider the amount of income that you will generate before retirement.

After looking at your income and — in generalities — how it is tied to the stock market, actually assign a number to it. Milevsky explains it this way, "If a stock has a beta of 1, it means that it's likely to move in tandem with the overall market. A beta above that means that if the market falls, the stock will likely fall by even more; a beta below 1 means the stock

won't move as much as the market" (Source: *The Wall Street Journal*, 2010).

Most traditional professions have a beta of zero. This doesn't mean the incomes don't fluctuate, but that the volatility of the stock market has no impact on the income.

**A question of balance.** Once you know your personal beta, apply it to how your portfolio is allocated. If you have a high personal beta, if the returns on your human capital tend to fluctuate with the market, then your financial capital — your 401(k), IRA, brokerage account, etc. — should be invested more conservatively. It doesn't matter if you *feel* the market is due to rise. You should instead be considering that if markets decline over a prolonged period of time, there is a greater chance you might lose your job, be unemployed for a long time, own less valuable stock options, and so on.

**Rethink your insurance.** Human capital isn't influenced only by the stock market. It is vulnerable to plenty of other factors, such as death, disability, and extended illness. One way to reduce the risk level on your balance sheet is to ensure that you are properly insured. Insurance allows your family to treat your human capital a bit more like a bond and perhaps take more risk in their financial portfolio.

**Start early.** Assessing your personal beta, understanding your income and human capital worth, and allocating the right assets to your portfolio will help you think strategically about risk.

Please call if you'd like to discuss this concept in more detail. ✓✓✓

## Protecting Your Family's Security

**O**NE OF YOUR first financial goals should be to protect your family's financial security from major catastrophes. To do so, consider these four items:

- ✓ **A cash reserve for short-term emergencies, such as a temporary job loss, major home repair, or large medical bill.** A common rule of thumb states that your cash reserve should equal two to six months worth of living expenses. However, how much you'll need depends on your age, health, job outlook, and borrowing capacity. You may need a larger reserve if you expect to be laid off or lose your job, you are the sole wage earner in the family, or your income fluctuates. A smaller reserve may be needed if you have more than one source of family income or you can borrow quickly, such as through a home-equity line of credit.
- ✓ **Adequate insurance in all major areas.** Your insurance needs will change over the years, so you may find yourself with too much or too little coverage. Thus, periodically review your life, disability, medical, and homeowners insurance. Don't overlook disability income insurance, which can be very important if you can't work due to an illness or injury.
- ✓ **Umbrella liability insurance to protect against major lawsuits.** Umbrella policies are purchased in \$1 million increments and kick in once limits of your homeowners and automobile policies are exceeded. In addition to the items covered by those policies, an umbrella policy typically covers damages from use of nonowned property in your possession and from lawsuits for libel, slander, defamation of character, and invasion of privacy.
- ✓ **A power of attorney.** A power of attorney gives an individual you designate the power to act on your behalf when you are incapacitated, allowing him/her to take over your finances and make investment decisions.

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## Life Insurance for Stay-at-Home Spouses

**W**HEN MOST PEOPLE think about life insurance, they think about replacing the take-home pay earned by the family's primary breadwinner should he/she die. Yet it could be just as important to insure a stay-at-home parent.

The issue is one of valuation: how do you set a dollar figure on the contributions that a stay-at-home parent makes to a family? Start by looking at the functions he/she provides: cooking, cleaning, child care, shopping, laundry, and paying bills. How much would it cost for those same services?

In a recent survey, Salary.com estimated that full-time stay-at-home parents in the U.S. work 96 hours a week and, if paid \$25 per hour, would earn more than \$123,000 a year. Reduce the hourly rate by half, and you're still talking about more than \$60,000 a year.

So for a newly single parent of two children, the price of continuing to work could mean spending as much as \$40,000 or more a year on child care and household services. If you can't imagine finding that kind of additional cash flow, covering your spouse or partner with a life insurance policy to pay those expenses for as many years as needed makes sense.

And there's another consideration, as well. For many couples today, their retirement or college finance plan includes a

nonworking spouse returning to work once the children are in school. If that's the case for you, life insurance can make a critical difference in whether you meet your long-term financial goals.

You have two choices: you can take out a *separate policy* on your spouse that names you as the beneficiary, or you can add a *spouse rider* to your own policy. The advantage of a rider is that it can be cheaper than securing a separate policy for the stay-at-home parent.

On the other hand, if your spouse dies after you do, the rider typically doesn't pay a death benefit to your spouse's beneficiary. In addition, your spouse will have no access to cash value accumulation, since the policy and cash values are owned by you. And with some insurance companies, you can't secure as much coverage on your spouse in a rider as you can in a separate policy.

If there are reasons for your spouse's life to be insured other than simply replacing his/her homemaking services — like designating different beneficiaries or meeting estate planning objectives — then a separate policy might be the better choice.

For help assessing which spousal coverage decision is best for you, please call. ✓✓✓

## Estate Tax Exclusion

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**Understanding the new portability provision** — One new feature of the tax law concerns "portability" of the estate tax exemption between spouses. Under this provision, any credit that has been unused by a deceased spouse can be transferred to the estate of the surviving spouse.

For example, if a spouse's estate has used only \$2 million of the \$5 million exemption, the remaining \$3 million can be applied to the surviving spouse's estate, raising its exemption to \$8 million. But there are two important caveats: 1) It is not automatic. Even if an estate won't owe a

penny in federal estate taxes, it must file a tax return to establish the transferred credit. 2) Portability does not apply to generation-skipping trusts, whose beneficiaries are grandchildren and great-grandchildren.

If the surviving spouse is predeceased by more than one spouse, the additional exclusion amount carried over to the surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last

deceased spouse.

**Avoiding unintended disinheritance** — Because estate laws are constantly changing, when it comes to dividing assets among different heirs, many wills and trusts rely on a "formula clause" that doesn't specify dollar amounts or percentages. For example, a document may simply say that children of the deceased are to receive the maximum amount allowed to pass to them free of federal taxes with the remainder going to the surviving spouse. For an estate that is \$5 million or less, this means the spouse is effectively disinherited. Adding further clarification in such cases is vital to ensuring that an intended beneficiary isn't left penniless.

**Lower state thresholds** — Be aware that more than a dozen states also levy inheritance taxes, and the threshold of taxability may be considerably lower than the federal level.

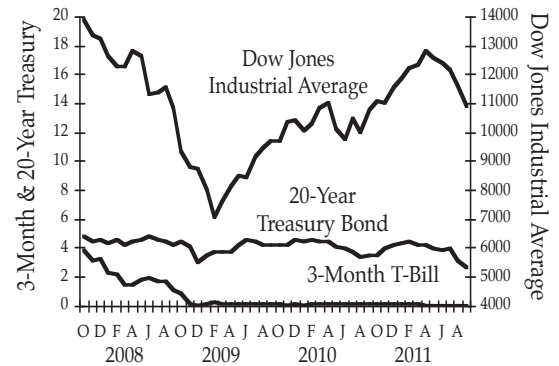
Estate planning is an important part of your overall financial plan, no matter how large your net worth. To review your current estate plan in light of the new tax laws, please call. ✓✓✓



Market Data	Month End			% Change	
	Sep 11	Aug 11	Jul 11	YTD	12 Mon
Dow Jones Ind.	10913.38	11613.53	12143.24	-5.7%	1.2%
S&P 500	1131.42	1218.89	1292.28	-10.0	-0.9
Nasdaq Comp.	2415.40	2579.46	2756.38	-9.0	2.0
Wilshire 5000	11771.86	12792.55	13643.10	-11.4	-1.5
Gold	1620.00	1813.50	1628.50	15.3	23.9
Silver	30.25	41.77	39.96	-0.5	39.3
				Dec 10	Sep 10
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.54	0.57	0.58	0.00	0.02
3-month T-bill rate	0.02	0.02	0.06	0.18	0.16
20-yr. T-bond rate	2.68	3.13	3.93	4.23	3.55
Dow Jones Corp.	3.69	3.60	3.54	3.89	3.45
Bond Buyer Muni	4.92	5.08	5.25	5.51	4.87

Sources: *Barron's*, *Wall Street Journal* Past performance is not a guarantee of future results.

#### 4-Year Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield October 2007 to September 2011



Sources: *Barron's*, *Wall Street Journal*

## Managing Withdrawals in Retirement

“More than half of Americans between the ages of 45 and 70 have no financial plan to protect themselves from the possibility of outliving their assets if they live longer than expected.”

Source: Society of Actuaries, 2011

ONCE YOU’VE RETIRED, you begin a balancing act between two imperatives: withdrawing enough from your retirement portfolio to cover your expenses and not taking out so much that you run out of money. So how do you get the rate of withdrawal that is just right?

Over the years, there’s been a general rule of thumb: keep your withdrawals to between 4% and 6% of your total portfolio a year. Now that the past few years in the stock market have taken such big chunks out of so many portfolios, some pundits are recommending reducing that rate of withdrawal to 3% to 3.5% a year.

While you will still want to consider your circumstances, these general rules of thumb point out that the appropriate rate at which you should take money out of your accounts is much smaller than many people imagine. Just as with every other issue related to retirement planning — like how much you should put away per year, how it should be invested, and when you can afford to retire — the withdrawal rate that’s right for you can only be determined by a sound financial plan.

But right off the bat, it’s safe to say that whatever that rate is, ideally, it should be less than the annual rate of growth your portfolio achieves, minus the rate of inflation. For example, if your expected average rate of return is 7% and you use the long-term average of about 3% for inflation, the maximum you should take out of your nest egg is 4%. This leaves the remaining 3% growth to keep your portfolio value even with inflation and supports your ability to continue to withdraw 4% a year indefinitely, as

long as your portfolio keeps growing and inflation remains at the same average rate.

However, on a year-to-year basis, market returns and inflation fluctuate. Sometimes, as we’ve seen recently, market returns are negative. If you want to avoid shrinking the real value of your portfolio in these circumstances, you should adjust how much you take out of your portfolio for spending purposes.

But does that mean when your accounts lose money in a bad stock market year you shouldn’t withdraw any money from them? Strictly speaking, the answer is yes, but that’s not always realistic. If it means forgoing some luxuries or putting off some discretionary expenses, holding off on withdrawals when market returns are below average might make good sense.

If it means that you’re forced to cut back on necessities, you may have no choice but to take out the money you need. But then ask yourself: does that mean that your lifestyle is more expensive than you can really afford? Or that you need to alter your asset allocation in favor of higher-growth investments?

Whatever the case, it’s to your advantage to have a financial plan for retirement — and revisit it at least once a year. Please call if you would like to discuss this in more detail. vvv

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