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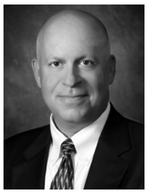

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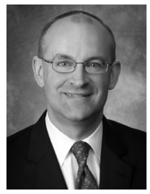

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Estate Planning for Complicated Family Situations

Divorce and remarriage, blended families, children with disabilities, or even a financially irresponsible child can complicate estate planning to the point where procrastination is tempting. While accommodating all of your loved ones is a delicate balancing act with many variables to consider, the reward is peace of mind in knowing your spouse and children will be cared for in the best possible way following your death.

If You Are Divorced

Your top priorities are updating your beneficiaries, last will, trusts (along with the executor/trustee), durable power of attorney, and healthcare proxy. Likewise, because you no longer have the benefit of combining your estate and inheritance tax exemptions with a spouse, you may need to consider more strategic estate planning to avoid estate taxes.

If there are children involved, you'll have even more decisions, including guardians of any minor children. Typically, you will not want your former spouse or his/her new blended family to receive any of your assets.

While you can name anyone as your beneficiary on life insurance policies, annuities, retirement accounts (if permitted by your plan), IRAs, and health savings accounts, your children typically cannot receive these funds until they turn 18. In the meantime, your children's appointed guardian, such as their surviving parent, could be designated by the court to manage these monies until they reach adulthood. Proper estate planning can avoid any mishandling of those funds and provide you with the reassurance that your children will be financially protected.

One way to ensure this outcome is to set up a trust with an appointed trustee, such as a grandparent.

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Why Should You Consider Bonds?

Why should you consider bonds for your investment portfolio? The primary reasons include:

✔ **Bonds add diversification to your portfolio.** One strategy to help counter the effects of stock market volatility is to add investments to your portfolio that aren't highly correlated with the stock market. Historically, stocks have a low positive correlation with corporate and government bonds.

✔ **Bonds offer fixed, periodic interest payments and the return of your principal at maturity.** Thus, even in the event of a significant market decline, you receive some return in the form of interest payments, and you'll receive your principal at maturity.

✔ **Bonds are often better suited to short- and medium-term financial goals.** If you need your money in a few years, you may not want to keep those funds in stocks, since a major stock market decline could occur when you need your money.

Please call if you'd like to discuss bonds in more detail. ❍❍❍

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Estate Planning

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If You Have Remarried

While remarrying is a beautiful reminder that second chances really do exist, this can often complicate estate planning — particularly when at least one spouse has children from another marriage. The first step is to sit down with your spouse and discuss what you both feel is fair for each other and your children.

Because of state marital estate laws, unless you have a prenuptial agreement in place, your current spouse has legal entitlement of up to half of your estate.

It's important to have a plan intact that assures both your spouse and children receive what you intend. You might consider a trust, such as a marital trust, qualified terminable interest property trust (QTIP), or irrevocable life insurance trust (ILIT), which can provide lifetime income to your surviving spouse while simultaneously ensuring your heirs receive the remaining proceeds.

If You Have a Special-Needs Child

Understandably, parents of a special-needs child are often so distracted with accommodating the child's immediate needs that important financial matters are sometimes overlooked. The two most important factors to consider are preserving your child's eligibility for Medicaid and other essential benefits while continuing to provide the best possible lifestyle for them. However, without a proper action plan, an inheritance could disqualify your special-needs child from vital benefits.

To avoid this situation, parents often leave special-needs children out of the inheritance equation, listing other siblings or a designated guardian as heirs with the intention that their special-needs child will be provided for as he/she continues to receive necessary medical benefits. The truth is, intentions and reality often do not mesh. A much more reassuring path is to consider a special-needs trust, which can assure your child continues to qualify for medical benefits while providing a sound financial future.

An Irresponsible Adult Child

It's quite common for parents to worry that a child could get into serious trouble when presented with a large sum of money. This depends on a variety of factors, such as age at the time of inheritance, lifestyle, or even addiction issues. Consider establishing a trust where the appointed trustee can limit your child's inheritance to several installments throughout the course of his/her lifetime, place conditions such as good behavior on the disbursements, or even appropriate the funds for something as specific as college tuition.

Please call to discuss this topic in more detail. ❍❍❍

The ABCs of Risk Premiums

Investing in the financial markets is inherently risky. Of course, some investments are riskier than others, but they tend to offer potentially higher rates of return. That difference in expected return for riskier investments is called the risk premium. It's the investor's reward for taking greater risk.

To better understand risk premiums — what causes risk and why risk premiums are important — let's take a look at the anatomy of an investment's return, which has three components:

- ✔ **Inflation** — Inflation is the rate at which prices increase, typically hovering between 2% and 4%.
- ✔ **Risk-free rate of return** — A risk-free rate of return is the return on an extremely low-risk (so low it's termed risk free) investment. Typically, investors look at the short-term interest rate on a Treasury bill (T-bill) as a risk-free rate. Investors view the backing of the U.S. government and their short maturity as signs of the investment's stability and liquidity, in other words, low risk.
- ✔ **Risk premium** — The third component of an investment's return is the risk premium. On short-term T-bills, the risk premium is zero — those investments are considered risk free. But other investments, including stocks, have added elements of risk. A risk premium is the excess return of an investment that is greater than the risk-free rate of return.

Broadly, there are three reasons that some investments are more risky than others:

- ✔ Returns on stock investments can fluctuate, unlike predictable bond coupon payments.
- ✔ Corporate bond holders have the first claim to corporate earnings before stock holders, who have a residual claim.
- ✔ Stock returns tend to be more volatile.

Historically, bonds and cash equivalents tend to be less risky than stock investments. But even among stocks, risk premiums vary.

Understanding risk premiums is the first step in creating an asset allocation plan for your investments. To determine which assets to invest in, you'll have to determine the optimal risk-premium mix for you.

You need to honestly assess your risk tolerance level, so you can determine the amount of risk that best suits your particular needs. ❍❍❍

Bonds at Every Stage of Life

Bonds are an important component of a well-balanced portfolio throughout every stage of an investor's life. Regardless of your life stage, you should consider having bonds in your investment portfolio.

At the Beginning

As a beginning investor in your 20s or 30s, you have a long time to maximize capital and are probably in the best position to assume risks for larger returns. Even at this early stage of investing, you should develop a portfolio that also balances risk and market volatility. While higher-yield investments are important, you will still want to balance them with some lower-risk investments, including bonds. At this stage, you can:

✔ **Grow capital** with bonds that offer higher yields if you assume higher risk. Make sure you understand the terms and conditions, including the bond's rating, call features, and if it is insured.

✔ **Protect your savings** for a large purchase, such as a car, wedding, or house. Lower-risk bonds can be a better investment than a traditional savings account to save for large purchases. You may want to consider Treasury or corporate bonds with maturity dates that align with your time frame.

✔ **Diversify your employer-sponsored retirement plan** such as a 401(k). Your plan most likely offers a variety of mutual funds, and bond funds are a good way to diversify your portfolio and spread risk. The stock and bond markets do not typically move in the same direction, so bonds can stabilize and help with your overall returns.

In the Middle

Your mid-30s to late 40s should be a time of accumulating wealth and investing for retirement and other long-term goals. At this point in your life, you should rebalance your portfolio on a regular basis to ensure your allocation is keeping pace with your goals. Bonds should become a larger portion of your asset allocation, because they offer more predictable income and will continue to balance higher-risk equities.

✔ **Tax-advantaged bond investing** is a good way to help offset taxes if you're in a higher tax bracket. Municipal bonds, which are issued by state and local governments, are an attractive investment in your income-earning years because they are exempt from federal income taxes. And if you live in the same state as the issuer, they are free from state and local taxes as well.

✔ **Zero-coupon bonds can be a good, cost-effective investment for specific goals,** such as college or retirement. They are sold at a steep discount from their face value; and when they mature, the face value will include both the principal and any accumulated interest.

Approaching Retirement

Now that you're getting closer to retirement, many experts recommend you begin increasing the bond portion of your portfolio to 40% or more to lower your risk. Some issues to consider when evaluating bonds for your portfolio:

✔ **Managing interest rate risk** is important because when interest rates rise, bond prices fall, and vice versa. One way to manage this risk is with a bond ladder. This strategy allows you to invest in a portfolio of bonds with different maturity time frames to help your investments do well in any interest rate environment.

✔ **Tax-advantaged bond investing** will continue to be a good way to manage taxes, especially if you're in a higher tax bracket. Again, municipal bonds can be a good choice.

In Retirement

Now your main goal becomes protecting and maximizing your income for the remainder of your life. Social Security will most likely only replace a portion of your income, so your portfolio and any retirement benefits will need to make up the rest. Bonds will help generate retirement income while preserving your principal. Things to consider:

✔ **Guard against inflation** because you are now living on a fixed income. Treasury Inflation Protection Securities (TIPS) or Treasury Inflation Indexed Securities will help guard against inflation. TIPS have a fixed coupon rate, but their principal amount is adjusted every six months according to changes in the consumer price index.

✔ **Spend from taxable accounts first,** because when you withdraw from tax-deferred accounts, you will pay income tax on your distributions. ❍❍❍

Do You Spend Too Much?

Paris Hilton, reportedly worth over $100 million, recently spent $325,000 on a mansion… for her puppies. That's right, she built a $325,000 dog house. Another celebrity, Justin Bieber, has admitted to budgeting $750 for haircuts.

We meet with new clients on a weekly basis and our first priority, as planners, is to determine if they are on the right savings pace to retire. We also speak with retirees on a regular basis to see if spending is in line. The conversations are one and the same. That is, we are helping people answer the question, "How much can you spend from the resources that you have?" We have clients who struggle to get by on a wide range of budgets. Some can't get by on hundreds of thousands a year, some can make it on a couple thousand a month.

At one point we debated "what is the number at which you just can't blow it?" After all, you can only go out for dinner seven times per week and drive one car at a time, and money spent on real estate can always be recaptured by selling. We settled on a number that is around $30 million, figuring that even the most extravagant can't spend more than $1 million per year.

We figured wrong. The New York Post recently ran a story on a couple getting divorced over money. Apparently, their $200 million net worth was not enough. Spending included a 14-seat private jet costing $26,500 per month, $400,000 in ultra-luxury vacations each year, a personal chef, a chauffeur and personal assistants. Total annual spending, according to their attorney, was $16.2 million. That works out to over 8% per year of the $200 million starting balance. According to the government pension agency, professionally-managed large pension plans have only averaged 6% per year in returns over the last ten years, so you can't spend over 8% and expect it to hold up.

The fact is that most planners settle on an initial spending level of only about 4% of assets per year (maybe less). Expectations may be as high as 6% per year, but you have to leave room for inflation.

We once had someone come in with $1 million to invest from which they expected to retire. When we advised them that they could only expect to spend $40,000 in the first year, based on that 4% spending level, they left in a hurry.

The topic of how much to spend can be a sensitive one. We are never judgmental – we have all had our moments, whether it was spending too much on our children, our pets or on a vacation. In fact, when we speak to clients, we try our best not to patronize, but the topic and the inherent sensitivity is unavoidable.

What is the proper amount of spending? The question should not be simplified to a number like the 4% mentioned above. Those with health problems and a shorter life expectancy can argue that they won't have an average lifespan. Those without children have no need to leave money behind. Other considerations include expected inheritances, tax circumstances, the lack of cost-of-living adjustments for pension payments, and health insurance coverage.

Further, as you age, spending on travel and dining out may decline but spending on healthcare may increase. And as you age, you may well decide to start spending principal or to sell a large home and buy a smaller one. Or you might make it a priority to "age in place," meaning, living out your years in your home.

Sometimes in the planning process we can uncover income or assets. For example, according to AARP, 60% of divorcees are not aware that they can take their own Social Security or alternatively, collect off of their ex-spouse's Social Security, if they were married at least 10 years. An example of a hidden asset that can be used to finance retirement is life insurance. Life insurance policies can be cashed in or even sold to raise money.

Conversations about spending typically lead us to a creating a comprehensive financial plan. We target an 80% likelihood of success, which we define as not running out of money for a specified period of time, usually to age 90 through 95. We generally don't endorse a plan with a 95% - 100% chance of success because it results in too much frugality (though some clients like that kind of security). On the other hand, we don't endorse a 60% or lower chance of success because the idea of running out of money is such a scary thought. Though once again, we have clients who choose to spend money at a higher clip knowing that they risk running out of money – it is the choice they make.

And that is our job – we help you determine how much you can safely spend (or how much you should save) by making sense of the resources available to you. We help you decide while considering all of the relevant factors. Even if you spend a lot on your dog or your haircut, or if you spend $2 million on a collection of Birkin handbags, as Victoria Beckham reportedly has done, we won't judge. If you want help figuring out how much you can afford to spend or you have to save, give us a call.

As we do take referrals, if you have friends or co-workers who are looking for this kind of help, have them call for an appointment. We don't charge for the first appointment.

Sincerely,

John B. Burke

John B. Burke, MS, CFP®
President, BFS

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