Investor Insights & Outlook

June 2011 | Vol. No. 5 | Investment Updates

Stretching an IRA

Many retirees depend on their individual retirement accounts to fund living expenses during their golden years. However, there are retirees who find themselves in the enviable position of having no need to withdraw from their IRAs. If you are fortunate enough to be in this camp, or if you are fairly confident that you will have plenty of money left in your account when you leave this world (even after taking required distributions), you will want to make sure you preserve as much of your IRA assets as possible for future generations. You can accomplish this by implementing a stretch strategy.

The first step in setting up a stretch IRA strategy is to simply name one or more beneficiaries. If you are married, your spouse can serve as your primary beneficiary while your children or even grandchildren can serve as your secondary beneficiaries. You can also name others as beneficiaries, such as family members or friends. You worked hard to accumulate the funds in your IRA, be sure they are transferred properly.

When you pass on, providing certain conditions are met, each beneficiary who elects to go with a stretch strategy will have a range of options to choose from—depending upon your age at death (and whether or not you have begun to take required minimum distributions from the IRA) and whether a spousal or non-spousal beneficiary is involved. If you happen to be named a beneficiary and choose to implement a stretch strategy, be sure you know what comes next. In some cases you may be able to keep the assets growing on a tax-deferred basis while in other cases distributions will need to be taken soon. Because of the many rules, it is highly advisable that you speak with a financial advisor or tax professional when it comes to stretch strategies.

BR Capital inc.
MORNINGSTAR

Bill Roller, CFA, CFP®
President
billroller@brcapitalinc.com
(360) 735-1900
www.brcapitalinc.com

Advisor Corner

Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the VP of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at www.brcapitalinc.com/newsletter.

How to Handle Beneficiary Designations

Designating beneficiaries for your company retirement plan, life insurance policies, and other assets might seem like a no-brainer. Chances are you would like those near and dear to you to inherit any money you've accumulated during your lifetime, so making sure that happens should be as simple as writing their names on the appropriate forms, right? Well, if only it were that simple. Naming beneficiaries can be more complicated than you might think, and it's a decision that may have significant repercussions for your loved ones.

Know the Basics: You can name almost anyone, or anything, as your beneficiary, including individuals, charities, and trusts. However, it is important to note that children under the age of majority—18 or 21, depending on the state in which you live—cannot be named as beneficiaries of life insurance policies, retirement plans, or annuities. If a beneficiary is not designated, assets will have to go through probate, which can be a lengthy and costly process. Also, be aware that beneficiary designations will override bequests you've made in your will, so please do not rely on your will to sort out these issues. This leads to our second point.

Keep Your Designations up to Date: It would be advisable to review your beneficiary designations on a regular schedule, ideally as part of an annual review of your finances. Major life events, such as a marriage, a divorce, the birth of a child, or the death of a loved one may require that you make changes to your designations. Don't procrastinate on this, as it may end up affecting others' lives. Moreover, you'll also want to review your designations if you or your employer have recently switched retirement-plan or insurance providers. You should not assume that the beneficiaries you specified with your previous provider will automatically carry over to the new one.

Bear in Mind the Tax Consequences: If you decide to designate someone other than your spouse as the beneficiary of your company retirement-plan assets, he or she may have to take mandatory distributions from that plan and, in turn, pay taxes on the money. Your spouse, on the other hand, will be able to roll over your retirement-plan assets into his or her own individual retirement account (IRA) and won't have to pay taxes until distributions begin. There can also be estate taxes to keep in mind if you name a beneficiary other than your spouse. Needless to say, it would be in your best interest to speak with a tax advisor or someone who specializes in estate planning to go over possible tax ramifications.

Be Specific: It pays to be as specific as possible when designating beneficiaries. Most beneficiary designation forms allow you to name multiple primary and contingent beneficiaries and to specify what percentage of assets you'd like distributed to each upon your death. For example, you can state: "I hereby designate my wife, Jane Smith, as primary beneficiary" or "I hereby designate my two children, John Smith and Allison Smith, as contingent beneficiaries, with the proceeds to be divided equally among them." Of course, it is recommended that you discuss these important matters with your family members beforehand, so that they are prepared and know what to expect.

You Can Use a Legal Trust as a Beneficiary: What if you are in a situation where you can't (or you don't want to) name a person as a beneficiary? You can use what is called a legal trust. A trust means that you don't leave the money directly to the beneficiary, but to an institution (such as a bank) who manages it for the beneficiary. This is especially useful when minor children or disabled relatives are involved. A trust can be revocable (you can change the provisions later), or irrevocable (can't be undone).

Staying in Style

Most financial professionals agree that the asset-allocation decision is one of the most important factors in determining both the risk and the return of an investment portfolio. Asset allocation is the process of combining asset classes such as stocks, bonds, and cash into a portfolio that will meet your goals. Taking this process a step further means selecting mutual funds to represent a certain segment or style for your overall portfolio (large stocks vs. small stocks, growth stocks vs. value stocks, etc.).

This can be a challenging task, and once the process is complete and the portfolio of mutual funds built, you'll need to consider something else: style drift. Style drift occurs when actively-managed mutual funds deviate from a particular investment style over time in an effort to potentially improve performance. While improved performance might not seem like a bad thing, a shift in style can be hazardous because it alters your risk exposure and return profile.

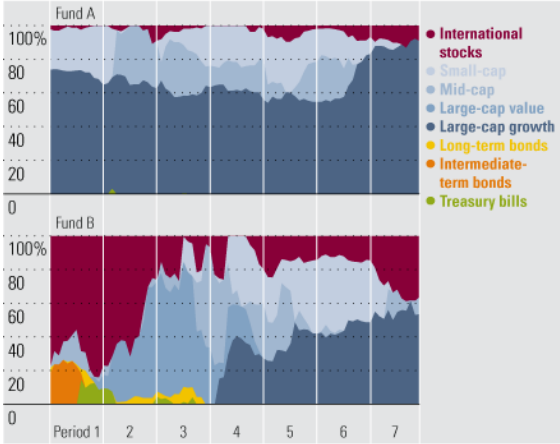
For example, let's say you held a large percentage of your portfolio in a large-cap stock fund. Now, at a certain point in time, this fund's manager got convinced that small stocks would benefit due to certain market conditions. Acting on this belief, he shifted the strategy of what was supposed to be a large-cap stock fund by buying an unusual amount of small stocks. This not only unnecessarily increased the risk of your overall portfolio, but also potentially set you up for large losses if small stocks were not going to behave the way this manager expected.

Style analysis is a technique used to understand investment style and identify the behavioral characteristics of a fund. It matches the returns of a fund to a mix of asset-class benchmarks that best describe the fund's behavior. This process can aid investors and advisors in the selection of funds to assemble a diversified portfolio.

The graph shows the rolling style analysis over time of two hypothetical mutual funds with the same stated objective. Although these two funds have the same objective, their style and consistency differ greatly. Look at international stocks, for example: In Period 1 and Period 2, Fund B had a much higher exposure to international stocks than Fund A. Such style drift can indicate that your manager is not following the fund's stated objective.

If you notice your fund manager jumping on the bandwagon of past trends, he may be trying to save his own hide. Remember, the goal is to buy low and sell high, not jump in late and hope for the best. It takes real discipline to stick to a set of stated investment objectives. So always keep an eye on your investments and evaluate funds periodically to make sure they fit your asset allocation appropriately.

Understanding Fund Behavior:
Some Funds Do Not Behave as Advertised



The percentages illustrated in the image are based on each hypothetical fund's returns-based style analysis results using 36-month rolling periods. Style analysis represents the best combination of benchmarks that match the variation in fund returns over the time period. It does not represent actual holdings.

Roth IRA Versus Defined Contribution Plan

Contemplating whether to contribute to a Roth IRA or a defined contribution plan (such as a 401k)? Words of advice: Follow the money! If your company offers you a match for your DC plan contribution, you should keep investing in the account up to the maximum percentage that it will match. This is free money, and you won't find a better deal any place else.

After you've maxed out the match, it's probably wise to invest any remaining cash in a Roth IRA. You can put in as much as $5,000 in 2012 ($6,000 if you are 50 years or older), as long as your income doesn't top certain levels. You won't get any tax deductions with the Roth, but you won't have to pay any taxes on it for the rest of your life, which can turn out to be an advantage over a DC plan. Another plus for the Roth is that you can keep your money there forever, as opposed to a plan like a 401(k), from which you have to start taking withdrawals by age 70 1/2.

With a Roth IRA, one big advantage is the ability to take certain early distributions without paying the early distribution penalty. However, if you withdraw assets from an employer plan before retirement, you'll pay a penalty and taxes, but many firms offer employees the option of taking loans from their accounts.

If you're fortunate enough to still have money to invest after you've maxed out on your Roth IRA, then by all means start putting it back into your DC plan. It's a good idea to have retirement money in different types of accounts, because you never know what the tax laws will be 30 years down the road. Please consult with a financial advisor or tax professional for the latest rules and regulations.

BR Capital inc.
Bill Roller, CFA, CFP®
President

BR Capital, Inc.
4400 NE 77th Avenue, Suite 275
Vancouver, Washington
98662-6857

billroller@brcapitalinc.com
www.brcapitalinc.com

Tel:(360) 735-1900
Fax:(360) 838-1597