

## Do You Expect Investment History To Repeat Itself?

A financial plan is only as good as the assumptions on which it's based, and of all the educated guesses that make up a typical plan, none may be more crucial than expectations about future stock market returns. But how much can you really know about what the market will deliver during coming years and decades?

Money managers, financial planners, and pension trustees routinely incorporate historic returns into their projections of future performance. They know, for example, that the Standard & Poor's 500 stock index has averaged a compound annual return of 10.4% over the last 80 years, according to data compiled by research firm Ibbotson Associates. And while they may not assume their investment choices will exactly match that track record, most probably expect future equity returns to come close to the historic averages.

But will that really happen? When you examine the components of stock market returns, 10% may turn out to be a little too rosy.

The total return from stocks essentially consists of income and capital appreciation. Reinvested dividends determine the income component, and the increase in the value of stocks is the capital appreciation part.

How much the broad market appreciates depends on earnings growth and the market's price-earnings ratio. If earnings grow 10%, the value of the stock market will increase by the same amount as long as the price-earnings ratio doesn't change.

By dissecting Ibbotson's 10.4% figure, you can see how income, earnings, and the change in p/e

ratio affected stock market returns during the past 80 years. Reinvested dividends were responsible for an annual return of about 4.4%, while earnings growth averaged 5% during those eight decades, which amounts to about 2% after inflation.

What enabled the market to grow by 10.4% a year instead of 9.4% (4.4% plus 5%) was an increase in the p/e ratio. In 1926, stocks traded for around 10 times earnings. But by the end of 2005, the market's p/e

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*If your retirement plan is based on double-digit stock returns, consider yourself forewarned*

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ratio had expanded to 18. The willingness of investors to pay more for a dollar of earnings in 2005 than in 1926 added almost 1% a year to the average annual compounded return of the stock market.

To see what the components of stock market return suggest about future gains, first consider what happened during the long bull market from 1982 through 1999. At the end of July 1982, the S&P 500 was valued at less than 8 times earnings, a modest figure. But in March 2000, investors valued the market at 31 times earnings. The fact that the p/e ratio more than tripled accounted for a huge portion of the 19.8% average annual return that the bull market delivered. During the same period, yearly earnings growth averaged less than 12%, and without the sharp increase in the earnings

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## Supporting Grown Children And Your Parents Takes Its Toll

Parents and children are squeezing "baby boomers." Children are leaving the house later, and aging parents are more often in need of financial support and care, leaving many boomers with little alternative but to work longer.

An estimated 45% of middle-aged workers provide financial support to children older than 25, according to a survey by Brightwork Partners, and about 20% of middle-agers are supporting an elderly parent. Contrary to popular opinion, the "me" generation seems to be putting others first.

The heavier financial burdens boomers are taking on are changing the retirement plan of an entire generation. Among boomers supporting their parents, 42% say they will work during retirement and 26% say they will delay retirement, according to the survey, which was sponsored by Putnam Investments.

If you're a member of the sandwich generation, the heavy load being placed on you may be making you worried about how you'll fund your own retirement. That's where a financial plan can be crucial. Your plan will translate your near-term challenges, such as funding care for your parents and supporting your post-graduate children, into real terms and quantify these liabilities. You'll get a clear understanding about what you must do to secure your own retirement.

If you're in your 50s or 60s and worried about mounting financial obligations as you approach retirement, creating a comprehensive wealth management plan is wise and may relieve some pressure.

# Avoiding Mistakes On IRA Rollovers

**W**hen you change jobs, you can make a tax-free rollover of your 401(k) to an IRA. Often, that's a good idea. IRAs generally offer broader investment choices than you get in a 401(k). Moreover, if you switch jobs several times during your career, your retirement savings will be easier to manage if you consolidate the money in one place.

Yet while a rollover often makes sense, rules governing such transfers are complicated and unyielding. Make a mistake and you could pay penalties and taxes and negate the benefits of moving to the IRA in the first place. Consider these pitfalls:

**Failing to do a direct rollover.** It's your last week at work, and when your personnel department asks what to do with your 401(k) balance, you request a check. As long as you redeposit the account's full value in an IRA within 60 days, you won't owe income tax or a 10% penalty for withdrawing retirement money before age 59½. (If you're at least 55 when you leave your job, you can keep the money without penalty.) However, your employer must withhold 20% on the amount of your check—and if you have, say, \$500,000 in your 401(k), that means your check will be for just \$400,000. Yet to avoid taxes and penalties, you'll have to deposit the full \$500,000 in your rollover IRA. Where will the extra money come from? Unless you have that much sitting in a bank account, you may have to sell investments in a taxable account to raise the cash, and that

could generate capital gains taxes. Assuming you do meet the 60-day deadline, you'll eventually get back much of the \$100,000 your employer withheld, but not until the following year, after you've filed your federal taxes. (Whether you get the full amount depends on your overall tax situation for the year.) A better way: You could direct your company plan to roll over the money directly to your IRA and avoid this problem.

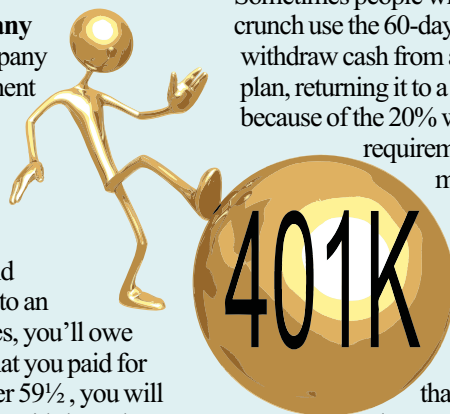
**Rolling over company stock.** Stock in your company that's held in your retirement plan is often eligible for special treatment when you leave a job. So moving the shares to a taxable account may be better than cashing out and rolling over the proceeds to an IRA. If you take the shares, you'll owe regular income tax on what you paid for them. And if you are under 59½, you will also owe a 10% IRS early-withdrawal penalty. Assuming you are over 59½, in the 35% tax bracket, and that your original cost for the stock was \$100,000, you'll owe \$35,000 if you withdraw the shares and place them in a taxable account. But suppose the shares are now worth \$200,000. That, as well as any further appreciation, could be taxed at the more favorable long-term capital gains rate of 15%—and only after you sell the stock. So your tax on the appreciation would be just

\$15,000. And if you never sell, your heirs get a step-up in basis on any appreciation in the stock that occurred after the transfer to the taxable account. If you roll over your shares to an IRA, however, their full value will eventually be taxed as income. So your total bill on the IRA withdrawal, again assuming a 35% rate, would be \$70,000 instead of \$50,000.

**Borrowing from the wrong account.** Sometimes people with a temporary cash crunch use the 60-day rollover window to withdraw cash from a former employer's plan, returning it to a rollover IRA. Yet because of the 20% withholding

requirement, this strategy may only exacerbate problems. A better idea is to take the money from a rollover IRA you've already established (rather than a 401(k)). Here, too, you have 60 days to return the money without penalty, but there's no withholding. You're allowed to make such a transaction once a year.

In these and many other rollover-related transactions—including, for example, the nightmare scenario of splitting a rollover in a divorce settlement—it's all too easy to get it wrong. If you're considering a rollover, we can help you avoid mistakes and chart a course that fits your financial situation. ●



## When Parents Pass On And Leave Children All They Own,

**B**race yourself. When your parents die, you may find yourself regressing, feeling once again like a helpless child—an orphan!—just when you and your equally stressed siblings face the emotionally wrenching task of divvying up your parents' personal belongings and letting go of the family home.

Pity the poor children whose parents named them all as equal beneficiaries. Sure, it seems fair, and that's what your parents intended, for each of you to get no more nor less than your brothers or sisters. But working out the details all too often

brings long-buried childhood grievances and sibling rivalries back into the open.

To avoid painful clashes, begin a conversation now with your parents and your siblings, when decisions can be made without the added trauma of a parent's death. Here are ways to minimize family drama.

**1. Pick a leader.** There are countless details to handle and decisions to be made either after a death or when your parents are no longer able to make their own choices. Even if your parents have already named someone outside the family to serve as executor for their estate,

choose a sibling to be point-person and manage the process alongside the executor.

- 2. Remember, the family home is more than a piece of real estate.** Many families focus on the house, but often it's the contents that hold the most value for children—and the most potential for hurt feelings. Talk among yourselves about who wants your grandmother's china or the piano, and then put a plan together that incorporates these heirlooms into a roughly equal distribution of assets.
- 3. Don't be shy. If you want the**

# When Marriage And Money Must be Split

**W**hile few breakups are as contentious as the one in the film, “The War of the Roses”—in which divorcing spouses are willing to battle to the death over who gets the house—most U.S. divorces involve negotiation over assets, says Lynn Mather, professor at the University of Buffalo Law School. Her research suggests that for many divorcing couples, financial planning expertise may be as important as legal counsel.

Mather spent a decade reviewing thousands of divorces and surveying divorce lawyers. Her findings reveal attorneys frequently frustrated by clients who let emotions cloud their judgment. “That interferes with the ability to ask rational questions and attend to financial details,” says Mather, author of *Divorce Lawyers at Work*.

A further complication is the fact that most divorce attorneys aren’t particularly knowledgeable about dividing complex financial assets, says Mather. That can be costly for clients, who may end up at the mercy of state laws that hold sway when spouses can’t agree. Nine states, including California and Texas, have community property laws that entitle a spouse to 50% of the assets accrued during marriage, while the other 41 are equitable distribution states, in which such variables as length of marriage and earning power help determine who gets

how much.

“Not receiving the right advice in a divorce may be far costlier than any other financial mistake,” says Fadi Baradihi, president of the Institute for Certified Divorce Planners in Michigan, who suggests getting financial guidance as soon as you see that a marital split is unavoidable.

A good first step is simply to draw up a list of assets—income, investments, real estate holdings, personal property, life insurance, pensions, and other retirement accounts. Family businesses may pose particularly thorny issues.

Next comes preparing a realistic budget for separate residences. Supporting an extra household can strain finances, notes Baradihi, and it’s important to divide assets so that neither party will struggle to pay monthly bills. “Expect your income to drop after the divorce is final,” he says. For families used to living beyond their means, that could require palpable reductions in spending and radical changes in lifestyle. If there are children, future college expenses also come into play, and divorcing spouses need to determine where that money will come from.

Who keeps the house, invariably a potent emotional issue, also has serious financial ramifications. If there are children and the mother will have custody, she’s likely to want the house. But on

a reduced income, that can be an expensive proposition, entailing monthly mortgage payments, taxes, utilities, and the cost of upkeep. And if the spouse who moves out leaves his or her name on the mortgage, that person could find it impossible to get a home loan for a new abode.

Couples often overlook how a divorce affects taxes, says Baradihi. If a house is to be sold, for example, there’s the tax exclusion to consider, with individuals able to shield only \$250,000 from capital gains liability, compared with \$500,000 for couples. Moreover, ex-spouses often end up in different tax brackets, with one paying the full 35% rate while the other is on the hook for just 15% or 20%. The tax treatment of post-divorce payments could also have an impact. The payer of alimony, for example, may deduct it from taxes, while the money is taxable to the recipient. That could influence a settlement—with a wife, for example, offering to forgo alimony in return for another asset that might have greater after-tax value.

Splitting a nest egg can be particularly complicated. You need to consider not just investment accounts, but also future pension payments and other retirement assets, such as stock options. “Retirement plans are often a couple’s biggest holdings, yet they may not really know what they’re worth,” Baradihi says. In the case of a pension, divorcing spouses might decide to split future benefits, or they could determine the asset’s present value and use that as a bargaining chip.

Special rules may apply to employer-sponsored retirement plans, and losing track of details could be costly. For example, a qualified domestic relations order, or QDRO, may be required to spell out how retirement assets will be divided in a divorce settlement. Failure to file the QDRO could jeopardize a spouse’s rights.

With so many complicating factors, negotiating a fair settlement often requires legal, accounting, and financial expertise. If your marriage is ending, we can work with your other professional advisors to ensure that your financial interests aren’t compromised. ●

## What Happens To The Family Home?

**house, say so.** Then offer a plan for equalizing the inheritance, such as taking out a mortgage and paying your siblings with the loan proceeds.

### 4. Don’t wait to bring in a mediator.

If two people want the house or other disagreements surface, hire a disinterested third party to mediate before things escalate into a full-blown family feud. Your parents’ estate attorney may be able to lay down some ground rules and diffuse any simmering emotional issues.

### 5. Decide not to decide.

If emotions are raw and you can’t reach consen-

sus, just back away from the process for a little while. Set up a plan for maintaining the home and schedule a time to revisit the issue. If face-to-face meetings are difficult, ask everyone to write a letter explaining what they would like to have happen.

### 6. Put it all in writing.

Whatever plan you come up with, the point-person should write everything down in painstaking detail, and then have all of the siblings sign off on it. Then, if you’re doing this while your parents are living, add the plan to their will. ●

# Choosing An Estate Planning Attorney

**A** recent article in a financial trade magazine describes a case with an unlikely happy ending. A couple had engaged an attorney to help them with their estate planning. But their assets never got retitled in the name of the trust that the attorney created for them, rendering it meaningless. What made the case newsworthy was that the oversight, along with other planning deficiencies, were discovered—and corrected—when the couple later hired a financial advisor. Without those changes, the estate tax at the husband's death would have been hundreds of thousands of dollars higher, despite the attorney's faulty though well-compensated efforts.

The couple might well have stayed out of trouble if they'd chosen their attorney more carefully. Here are six crucial questions to ask at an initial meeting—and what to make of the answers.

**Are you a specialist?** Estate planning is an esoteric area of the law. You want a pro, not a dabbler. Ask what percentage of the attorney's time is spent on estate planning, and how long he or she has practiced in that specialty. Look for

credentials such as certification in estate planning (in some states) or membership in professional organizations and societies, such as the American College of Trust and Estate Counsel, that provide continuing education and information on the latest developments.

**Am I a typical client?** You also want a lawyer whose cases are similar to yours in terms of estate size, the type of assets owned (such as a business or real estate), and estate-planning objectives (philanthropy, for example). Ask for a profile of the attorney's typical client as well as how many cases like yours the lawyer has handled.

**What is the cost?** Will you pay an hourly or fixed fee, or does your quote specify a range? Compare the cost with what others charge. Ponying up for the expertise of a top law firm could be smart if you have a very large, complicated estate, but more routine cases may be better served by a reasonably priced solo attorney.

**How long will the process take?** Ask how many meetings will be needed, what documents you'll receive, and when those will be ready for your signature. Again, knowing how other attorneys

operate can help you evaluate the answer.

**How will you work with my financial advisor?** A coordinated effort between professionals produces the best outcome. Ask: "Will my advisor be invited to attend meetings? If not, can you discuss meeting results with my advisor? Will you copy my advisor on all correspondence and documents? Will there be other interactions between your office and my advisor?" Does the attorney talk about working as a team, and keeping everyone in the loop? Or do you sense an attitude of, "I just handle the legal work. Your advisor can call me with questions."

**What services are included?** As the fortunate couple's case demonstrates, legal documents are only as good as the implementation that follows. But not all lawyers provide the same level of follow-through. Be certain that your attorney is willing to work with your other professionals to handle everything outside his capacity. Also, find out who monitors the paperwork and the cost of this service. By clarifying responsibility at the outset, you won't need happenstance to produce a happy ending. ●

## Investment History Repeating

*(Continued from page 1)*

multiple, that would have been the market's average annual return—under 12%. If not for stock investors' growing enthusiasm, the historic bull market never would have made history.

Today, the S&P 500 is valued at about 17 times earnings, while the dividend yield is less than 2%. If future earnings growth continues at about the pace we've seen during the past two decades (6%), companies don't substantially increase dividend payouts, and the p/e ratio doesn't rise, the market's average annual total return would be under 8%.

What would it take for the stock market to reach the long-term average of above 10%? The p/e ratio

likely would have to increase from current levels. But at 17 now, the earnings multiple is already slightly higher than the long-term average of just under 16—and considerably above that p/e of 8 in 1982. So it's possible the p/e might fall rather than rise, particularly at a time when inflation is accelerating and bond yields are increasing. If the market's p/e ratio shrinks, future returns could come in below 8%.

If the market returns less than its long-term average, a financial plan that assumes a 10.4% return for stocks could fall well short of its goals. A typical portfolio with a 60/40 split between stocks and bonds (and an average 5% return for bonds) would provide average yearly gains of just 6.8%, compared with about 8% for a stock and bond portfolio that benefited from stock returns

matching the historical average. As a result, a \$1 million portfolio that grew to \$3.17 million in 15 years with the higher returns might take an additional three years to reach the same milestone if it earns only 6.8%.

Given the realities of today's stock market, it may make sense not to expect investment history to repeat itself. The old disclosure that the government requires, "past performance is no indication of future results," is so very true, and that could mean adjusting your financial plan accordingly. ●

No particular return can be guaranteed in stock investments. Your experience may also differ from the performance of the stock market. Stocks are not appropriate for all investors, and the portion of your portfolio which should be invested in stocks should be determined in conjunction with your investment professional.