Family Wealth Management — Planning for Generations

Financial Perspectives

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What Does Inflation Mean For Your Finances?

The primary job of the Federal Reserve Chairman is to fight inflation, and Ben Bernanke, who took over for Alan Greenspan in February, is proposing a new weapon: set pre-determined rate targets. The success or failure of this policy shift could affect your finances.

Bernanke, a former Princeton University professor and past chairman of President Bush's Council of Economic Advisers, says that inflation target rates between 1% and 2% can boost the Fed's ability to forge price stability—and enhance the central bank's credibility. He believes that pre-announced rates can help consumers feel confident the Fed is actively combating inflation.

Though many economists expect inflation to stay near its current level, proponents of Bernanke's plan believe that if soaring energy costs continue to pressure businesses and households, more stringent methods will be needed to keep prices stable.

The idea of inflation targets isn't new, but Greenspan took a more flexible approach during his 18 years on the job. He contended that pre-determining rates could hamper the government's ability to respond to crises—and raise questions of the Fed's accountability if a target is missed. Meanwhile, more than 20 countries have adopted inflation targets.

The actual outcome of a targeted inflation plan may not veer far from how Greenspan's policies played out, say economists, especially since Bernanke said he'd allow adjustments as needed. But the debate over what the Fed's formal policy should be continues—at least until March 28, the first policy meeting Bernanke will lead.

How does this debate affect you? For starters, inflation has a direct impact on your personal finances.

The Inflation-Recession Cycle. Why was a cup of coffee 10 cents in 1960 but over a $1 today? The answer: inflation, which most often coincides with an economic boom and a good job market. The more people earn, the more they're willing to pay—and compete—for goods. And, higher demand creates more jobs. But seeking to pay more workers and afford greater quantities of materials, manufacturers must raise prices. Over time, prices can rise to a point at which salaries no longer keep pace with the cost of living and goods are less affordable. That's when the dollar becomes "inflated" and its value declines.

When demand goes down, companies begin to lay off employees and initiate pay cuts. Eventually, as companies struggle to stay in business, you may see great bargains and liquidation sales.

How does the Fed control the declining value of the dollar? The government cools down inflation by selling government securities, which raises interest rates—the fixed percentage paid to bond holders annually—and slows down borrowing. To avoid a recession, the government later reverses this policy. As interest rates go down and people start borrowing again, the demand for goods increases, the job market improves—and the cycle starts over.

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Free 411 Service At Home, In The Office, By Cell

Remember when directory assistance was available at no cost? Well, it's free again, thanks to a new service from Jingle Networks: *800-FREE-411 (800-373-3411)*, or *FREE411.com*.

Phone companies now charge from 25 cents to more than $3 to look up a number for you. In contrast, with *800-FREE-411*, you don't have to sign up, log in, or pay a fee. The only cost might be a per-minute charge on your cell phone plan.

You can get phone numbers by name, business, or business type. The catch? If you request a number for a personal residence, you'll get it, no strings attached. But if you're seeking a business listing, you may have to listen to a 12-second pitch from a competitor before you get your number. For example, if you ask for the number of your local pizza parlor, you may first be told about the latest Domino's specials. Then, you can choose either to connect to the number you asked for or to call the advertised competitor.

So why pay a service charge when you can punch in a few extra numbers, listen for 12 seconds, and get the information you need for free? The next time you need directory assistance, call *800-FREE-411*.

Martin V. Higgins

Women: Do You Know Your Financial Plan?

While nothing can prepare you emotionally for losing your spouse, there are steps you can take now as a couple to minimize other stresses on whomever outlives the other. Creating a solid plan to alleviate the remaining spouse's financial burdens is a great place to start.

"We are never too young to plan," says Suzanne Rehmani, estate planning attorney at Irvine, California-based Kring & Chung, LLP. "Couples should discuss retirement and death regardless of their age." For example, if a mom stays home with the kids, it's especially important to determine what financial arrangements would be set into action if her husband died.

Statistically speaking, women are more likely to be left to handle finances alone: They outlive men by an average of 5.3 years, according to the National Center for Health Statistics. Yet even during an era when women have returned to the work force in droves, wives still tend to defer to husbands on handling most financial responsibilities.

Why? Many women concentrate on taking care of children and other aspects of daily life, says Rehmani, and working women often opt out of contributory pension plans and deferred savings plans, citing the need for current income. Meanwhile, men tend to participate in the full range of employer benefits, including life insurance and retirement pensions. And women make only 74% of what men earn, she said.

> *"Couples should discuss retirement and death regardless of their age"*
>
> —Suzanne Rehmani
> Estate Planning Attorney

So what can couples do to help ensure each other's financial security? Consider these issues—and be sure to make decisions together so you each understand what lies ahead.

Gauge life insurance needs. You may want a policy on the life of the higher-earning spouse, designating the other as the primary beneficiary. A smaller policy on the second spouse could also be helpful. Your financial advisor can help you determine how much coverage you need and what you can afford to pay. If whole life insurance is too costly, a cheaper term policy could be a cost-effective alternative, covering you when the kids are younger and the death benefit is most important.

Know your will and trusts. Consult a lawyer to write your will; if you already have one, review it together to make sure you both understand and agree with its terms. And ask your attorney or financial advisor whether you need a trust to help shield assets from creditors or estate taxes.

Understand employer benefits. Each spouse needs to know all about the other's retirement and insurance benefits, beneficiary designations, and possible survivorship clauses.

Know how your assets are owned. In most states, property owned with your spouse is held in something known as joint tenancy, while in nine states, most of a couple's holdings count as "community property"—with each spouse owning a half share of those assets. Both joint tenancy and community property ownership have tax advantages and drawbacks—your advisor can help structure the arrangement that's best for you.

Looking ahead to death is never easy. But there are few better gifts for someone you love than to ensure financial security for a lifetime. ●

Can You Leave More Money To One Child Than Another?

Did you treat all of your children the same when they were growing up? Probably not. Every child is different and often one needs more attention and support than another. So when crafting an estate plan, it often makes sense at least to consider the possibility of treating children unequally.

In some families, where one child is developmentally disabled or unable to care for himself, making special arrangements for that child is an easy decision. But most of the time, differences among children are more subtle, and choosing to address their needs in different ways in a will or estate plan can be difficult.

Maybe one child is a doctor, while another is an artist or social worker or is content to stay home to raise a family at the expense of a successful career. Which child will need more help after you're gone? And which will make the best use of what you leave? Every family has its own dynamic, and there are no easy answers. But you owe it to your family to consider alternatives to the obvious equal split.

First, give yourself permission to treat your children differently. To make this easier, think about when they were growing up. Maybe one child was a great ice skater and you got up at 5 a.m. countless mornings to take her for lessons. Perhaps your son went to an expensive private school, while your daughter thrived in public school. You surely tried to give all your kids the emotional and financial support they needed, some may have been needier than others. Why should it be different now? Why should it be different after you're gone?

Harsh Financial Realities For Widows

It seems to be a fact that women outlive men. In 2003, there were 21 million older women and 14.9 million older men—a ratio of 140 women for every 100 men—according to the latest data from the U.S. Administration on Aging. The ratio gets even more out of whack with age, the report says. In the 65-69 age group, there were 115 women for every 100 men. But it widens to a high of 226 women to 100 men in the 85-and-over age group. And, according to the U.S. Census Bureau, women comprise two-thirds of all people over age 85, or almost 2.5 million people, compared to 982,000 men in the same age bracket.

While there are countless jokes about why women outlive men, the financial implications are no laughing matter. With eventual widowhood a distinct statistical likelihood, it makes sense for women and their families to make plans now to confront what may soon become the harsh realities of a singular financial life. Here are several issues widows are likely to face.

Vanishing Income. Many couples in their 70s collect a corporate pension or a pension from the armed services. But a man's military pension drops when he dies, and payments from corporate pensions can be reduced or eliminated at the husband's death. At retirement age, an employee typically must choose between getting larger payments that end at the employee's death, or a smaller amount that will continue at a reduced level for a surviving spouse after the worker dies. Assuming the man was the family breadwinner, a woman will be lucky to be left with half the corporate pension after her spouse dies.

Women should confront the likelihood of a singular financial life

Social Security also gets reduced, if the couple had a traditional lifestyle in which only the man worked. A woman usually will get less than two-thirds the Social Security payment she received when her spouse was alive.

Here's an example of the kind of fix many new widows find themselves in. Suppose a retired couple had been living on a total retirement income of $80,000: $20,000 from the U.S. Army, $30,000 from the husband's former employer, and annual Social Security payments of $30,000. When the husband dies, how much will the wife continue to receive? She might get $7,000 from the Army, $20,000 in Social Security and little or nothing from her husband's former employer. Suddenly, her annual income may drop to about $27,000.

Who To Trust? A widow often must depend on her children for care that she needs. This, unfortunately, can cause problems. Often one child will take more responsibility than another will, and that can cause resentment among siblings. The helpful child may be seen as angling for a larger inheritance, and may in fact deserve more. But depending so heavily on a child raises a difficult issue, particularly if the child must be given control over financial matters. When a son or daughter has control over your accounts and also is an heir to your estate, the relationship between the two of you can become stressful for both—and all the more so if you are widowed after a second marriage and those responsible for your care are offspring of your deceased husband. One solution is to appoint an independent trustee to oversee the child's management of financial affairs.

Estate Planning. A widow should update her estate plan after the death of her husband. If there was no plan, establishing one now is essential. A new will may be needed, and she may want to consider setting up a trust to ensure her assets will be distributed as she intends after her death. A trust is more difficult to contest than a will. She also may want to begin making annual tax-free gifts to her children, thus reducing the size of her estate. And if she was the beneficiary of her husband's IRA, she'll have to decide whether to take distributions from the account based on her age or to continue to use her husband's distribution method. Or she may decide to establish new, separate IRAs with her children as beneficiaries. ●

Yes, You Can Treat Children Unevenly

One way to be uneven but fair is to leave a baseline amount to each child. For instance, if your estate is worth $3 million and you have two children, leave each one $1 million for starters and consider an uneven split for the remaining $1 million.

Another idea: Consider giving one child more while you are alive. Maybe there's an immediate need—buying a home, say, or starting a business. Help with that now and make it up to the other child in your will. And while you may be confident one child can handle a no-strings-attached bequest, you may need to place assets for another child in a trust so they're not squandered.

Making such decisions can be painful. And treating children unevenly could cause disharmony and must be carefully considered. Yet confronting tough choices now may actually help preserve relationships among your children after you die. Just don't ambush your children when your will is read. Talk now, as a family, perhaps with your financial advisor as moderator, about why you've done things as you have. ●

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High Income? Forget About College Aid

Still hoping your child will qualify for college financial aid? It may be time to throw in the towel.

A recent report from TIAA-CREF, the big retirement plan provider and asset manager, is supposed to have good news for parents. According to the report, family savings reduce the chance of aid less than many have suspected, particularly when assets are held in the parents' name in a 529 plan, Coverdell Education Savings Account, or taxable investment account. But the report also concludes that the children of parents with high incomes and substantial wealth are unlikely to get any help with education costs.

The price tag for college continues to rise far more quickly than the overall inflation rate. According to the College Board, total expenses at a public university for the 2004-2005 school year averaged $11,354, 10.5% higher than a year earlier. At private colleges, the average price tag was $27,516, 6% above the previous academic year. But many top schools charge even more. Duke University, for example, now suggests that families budget $44,000 for an undergraduate year.

All colleges, public and private, use complex formulas to determine a student's financial need. By gauging parental and student income and assets, the institutions come up with a figure known as the Estimated Family Contribution, or EFC. That's the amount you're expected to pay. If a school's costs are higher, financial aid—primarily loans, in many cases—could make up the difference.

The TIAA-CREF report points out that commonly quoted yardsticks for calculating the EFC may overstate the actual impact on a family's finances. The rules of thumb are that 35% of the student's assets and 5.64% of parents' holdings must be used. In fact, says the report, most parents pay much less. However, high-income families are likely to be asked to shoulder the entire cost of college.

Consider three families. The first has a pre-tax income of $50,000 a year. If the family has $60,000 in net assets, excluding the value of its home and retirement accounts, its EFC is $0. With $100,000 in assets, it should pay $30, and with $200,000, its EFC is $2,674, according to the TIAA-CREF calculations.

The second family makes $100,000 a year. At the same three asset levels—$60,000, $100,000, and $200,000—this family's EFC would be $7,694, $9,950, and $15,590, respectively.

And family 3? With an annual income of $200,000 and net assets of $60,000, its EFC is $34,421. With $100,000 in assets, it is expected to pay $36,677, and with assets of $200,000—again, not including what its home or retirement plans are worth—its EFC is $42,317.

The TIAA-CREF report emphasizes that for families hoping to receive aid, where they save for college makes a big difference, with parent-controlled accounts far preferable to custodial accounts in a student's name. Some financial aid experts have even suggested families consider depleting custodial accounts while increasing savings in a 529 plan or Coverdell account. But wealthier families needn't worry about where to keep college savings, because they're less likely to qualify for aid in any case. ●

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Inflation Targets

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Inflation and Your Income. If you're a highly conservative investor with significant assets in money market accounts, or a retiree who relies heavily on fixed-income investments—bonds, fixed annuities, and pension payments—inflation can pose a problem. As the cost of living rises, a fixed stream of income buys less and less of what you need to live comfortably. In 2005, $100 had the same purchasing power as $4.59 in 1900, $9.54 in 1925, $13.09 in 1950, $29.22 in 1975, and $93.58 in 2000. But if you own a $10,000 bond that pays 5.5% you'll get $550 per year, no matter what the dollar is worth.

You'll also lose purchasing power if your salary fails to keep pace with inflation. The average American pay raise, one of several possible inflation indicators, trailed the cost of living by 2.3% since mid 2004, according to the Federal Employment-Cost Index.

How to Protect Yourself. While you can't control inflation's impact on your take-home pay, you can help safeguard your investments with an allocation to stocks. Since 1926, equity investments have returned an average of 11% annually, while inflation has averaged a 3.1% yearly increase. Diversified portfolios—with 60% in stocks, 30% in bonds, and 10% in cash—have earned a return at least four percentage points higher than inflation over the long term.

Yet while growth investments can provide the extra return you need to stay ahead, fixed-income securities help cushion the blow when the stock market drops. Although bonds may not outpace inflation by much, they provide steady, healthy returns.

Target or no target, how is inflation likely to fare under a new Fed chair? Unlike Greenspan, who came into power on the brink of a recession, Bernanke is taking over in a healthy economy, according to a Standard & Poor's report. "Growth is stable in the 3.5% range, inflation is 2%, and unemployment is at 5.1%," it said. "The chairman's job will be to keep the economy at these near-ideal numbers."

And if the economy—and inflation—escape that box? A well-diversified portfolio is the best bet to keep your financial progress on track. ●

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