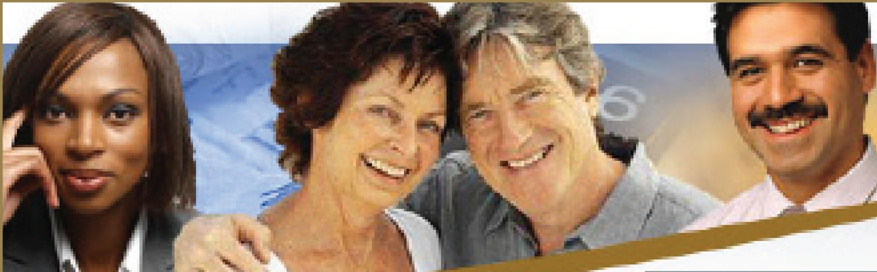

NAPFA Headquarters
3250 N. Arlington Heights Road
Suite 109
Arlington Heights, IL 60004
800.366.2732
www.napfa.org

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NAPFA Planning Perspectives

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IN THIS ISSUE

This is the first issue of our fifth year of producing NAPFA Planning Perspectives—our effort to bring a wide variety of financial advice to consumers.

In this issue, we look at the fallacy of relying on high-profile stock pickers for investment advice, and we compare using exchange-traded funds and mutual funds. We also explore how new federal healthcare laws can have an impact on your taxes, when it makes sense to pay off a mortgage early, and why umbrella insurance can be a valuable contribtor to your financial security.

-- Kevin Adler, Editor

NAPFA Releases New Guide to Finding a Financial Advisor

To make it easier for people to find a financial advisor, NAPFA has created an all-encompassing guide that is now available on www.NAPFA.org.

The Pursuit of a Financial Advisor Field Guide provides a soup-to-nuts approach to finding a financial advisor who can help individuals and families identify and achieve their financial goals.

"We're proud to present this new *Field Guide* as a one-stop resource to get people started on taking control of their financial futures. The *Guide*'s step-by-step approach takes the uncertainty out of the process and gets people on their way to finding the help that they need," said Ellen Turf, NAPFA CEO.

The guide includes seven sections:

- *Preparation for the Pursuit* – Explores credentials, compensation, discipline, elements of financial planning, and the difference between a true fiduciary standard and a lesser suitability standard.
- *Equipping Yourself*: *Knowing What To Ask!* – Provides 26 crucial questions that consumers need to keep in mind when talking with advisors (and the answers that consumers should be looking for!).
- *Selecting Where to Look* – Identifies the most up-to-date and comprehensive sources for finding advisors.
- Evaluating Potential Advisors – Explains what advisors should disclose and address in introductory meetings and conversations with potential clients.
- *Engagement* – Uncovers the information and documentation that an advisor should provide at the time of starting a new-client engagement.
- *Evaluating Your Advisor* – Presents the key metrics that consumers can use to evaluate their advisor's performance over time.
- *Additional Tools and Resources* – Offers an array of consumer-oriented financial tools that have been developed by credible organizations and government agencies.

Stock Ratings, For What They're Worth

By Tom Posey, CFP®, J.D.. AAMS Posey Capital Management, Inc. (www.poseycapital.com)

Remember those 33 Chilean miners from last fall? As they endured 69 days underground, the whole world followed their harrowing rescue.

So what ever happened to those guys? I heard that one of them ran in the New York Marathon. Good for him! Beyond that, no news.

Stock market coverage is like that—in your face today, gone tomorrow. Especially early in the year, hundreds of talking heads offer thousands of "sure-fire" predictions on what's hot and what's not for your next big investment move. Buy Acme Inc.! Sell Beta Corp.! Large-caps are where it's at!

But I challenge you to track what happens to those predictions a year, or even a quarter, later. A *Wall Street Journal* article in January 2011 checked to see how the stock market predictions of top analysts actually performed. It tracked the performance of the 10 stocks that analysts rated most highly, as well as the 10 they most loathed, for each of the past three years, 2008–2010. These years encompassed the worst of the Great Recession and the recovery that followed. The table below shows what happen.

The market average, the S&P 500 Index, beat the picks of the top analysts in two out of three years. If you had bet against the analysts, you would have been ahead in two out of three years.

The moral of the story? I'm not suggesting you go out and buy the opposite of whatever the analysts are recommending. I'm just saying the analysts' picks and pans simply aren't useful. I think it's best to avoid the stock-picking game entirely by recognizing these talking heads for what they are: entertainment. Nothing more. Certainly not useful for investment advice.

Analyst Stock Picks* and the S&P 500 Annualized Returns

	Analysts Say "BUY"	Anaylsts Say "AVOID"	S&P 500 Index
2010	Up 24%	Up 32%	Up 13%
2009	Up 22%	Up 70%	Up 26%
2008	Down 48%	Down 51%	Down 39%

Note: Stock pick data are subject to survivorship bias, which means stocks that disappeared completely during the period were not included in these returns.

Source: Brett Arends, "Why You Shouldn't Trust Wall Street's Top Stocks for 2011," *The Wall Street Journal*, January 6, 2011. http://online.wsj.com/article/SB10001424052748703808704576062033926741952.html?mod=WSJ_hps_sections_personalfinance

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Comparing Mutual Funds and ETFs

By Ara Oghoorian, CFA   ACap Asset Management. (www.acapamcom)

In recent years, more investors are selecting to invest by using Exchange Traded Funds (ETFs) over mutual funds. An ETF can offer benefits of tax efficiency, investment liquidity and transparency, and reduced holding costs.

Tax-Efficiency. If you own a mutual fund that's not in a tax-deferred account, then you have probably experienced a year-end capital gains distribution because trades made by the fund sponsor throughout the year flow to its shareholders. This can create tax liabilities at year-end, even if a fund has lost money overall. ETFs do not have capital gains distributions because ETF sponsors do not transact with their shareholders. ETFs are traded among other investors. Hence, capital gains and losses are controlled by the investor—making ETFs highly tax efficient.

Liquidity and transparency. Mutual fund investors can only buy or sell their shares directly from the fund sponsor and only at the end of each day. ETFs can be traded throughout the day, just like stocks. Investors not only can actively trade ETFs, they can also employ the same trading strategies that apply to stocks (limit/stop loss orders, short-sales, and options). In addition, it's easier to "look under the hood" of an ETF because ETFs report their holdings daily, which gives investors up-to-date information. Mutual funds report their holdings quarterly.

Cost. Mutual funds incur significant recordkeeping expenses to keep track of all their shareholders. ETFs do not have such expenses because they are traded among investors just like stocks. Unlike some mutual funds, ETFs do not have sales loads or require minimum investments, though investors have to pay a commission to trade ETFs. Depending on the liquidity of a particular ETF (that is, how many trades are made in it each day), those trading costs can be very low.

Which is Better?

Given the description above, investors might think that mutual funds are no longer good investment options. However, it's not that simple.

Here are some rules-of-thumb to help make your decision:

- Many mutual fund companies have low minimums for starting investors (as low as $25). In contrast, commissions to trade ETFs make small purchases cost prohibitive.
- If an investor plans to dollar-cost-average (buy a fixed dollar amount every month) or reinvest dividends, then a mutual fund will likely be a lower-cost purchase, too.
- Mutual funds are effective for gaining exposure to a very specific sector of the market. For instance, a mutual fund would be more appropriate for an investor interested seek international high-yield fixed income or exposure to a specific country. Many ETFs have been developed for specific market sectors, too, but there are some sectors for which they are not yet available.

Growth in ETFs has exploded in recent years. According to estimates by the Financial Research Corp. of Boston, ETF assets will most likely reach $1.4 trillion this year. And while mutual funds still remain the dominant investment vehicles in individual retirement accounts—where the bulk of investor assets are held—it is important to determine which investment is appropriate for your unique circumstances.

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Medical Planning Could Lower Your Taxes

By Lisa Brown, CFP®, CIMA Brightworth® (www.brightworth.com)

Many of us have long-term financial plans, and it's wise to now think about a medical plan. This doesn't just mean the treatment that you and your doctor discuss. A medical plan could include a multi-year strategy to determine the ideal time to incur non-urgent medical expenses and the best way to pay for them, given your insurance, cash flow, and tax options.

Due to the changes in federal tax treatment of healthcare expenses as part of the federal Patient Protection and Affordable Health Care Act, planning today can save you down the road. To give a small example, beginning this year, you can no longer use the pre-tax dollars in your Flexible Spending Accounts (FSAs) or Health Savings Accounts (HSAs) to pay for over-the-counter medications such as Tylenol, unless it's prescribed by a doctor. In addition, the penalty for using HSA funds for "non-qualified medical expenses" (non-prescription Tylenol, cosmetic surgery, etc.) has increased from 10 percent to 20 percent.

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In 2013, the IRS will be enforcing new rules that will restrict your tax break on high out-of-pocket medical costs. Beginning in 2013, the itemized deduction limit on medical expenses will increase from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI. So, if you have major medical expenses coming up, paying for them before 2013 may save you some tax dollars.

Also beginning in 2013, the FSA funding limit will be $2,500 per year, indexed for inflation thereafter. Currently, many plans allow you to set aside $5,000 on a pre-tax basis. The lower limit on FSAs could make HSAs more attractive for many families. Not only are the limits higher (this year they are $3,050 for an individual and $6,100 for a family), but they provide a triple tax play: dollars go into HSAs pre-tax, the earnings are tax-free, and qualified medical distributions are tax-free.

HSAs are associated with high-deductible health insurance plans, so having available cash flow to fund them and meet the annual deductibles should be considered before you make this benefit election. Also, keep in mind that if your insurance plan covers adult children who are not listed as dependents on your income tax return, then you cannot use the tax-free money from your HSA to pay for their medical expenses.

These are just a few of the benefit plan changes working professionals may encounter over the next few years. Paying attention to the fine print and thinking ahead about your family's medical plan could save you both frustration and tax dollars when medical expenses arise.

**Please be sure to consult a tax advisor for specific advice regarding your situation.*

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Should You Pay Off Your Mortgage Early?

By Helen Huntley Holifield Huntley (www.holifieldhuntley.com)

Should you pay off your mortgage early? That's a question many people have been asking as interest rates stayed low for the last several years.

Early payoff can make sense if you are thinking about retiring soon and want to reduce your living expenses. However, it's not the right solution for everyone.

Here are some steps to help you evaluate whether making extra payments on your mortgage is right for you.

You are a candidate for early payment of your mortgage only if you can answer "yes" to all these questions:

1. Have you paid off all your credit cards and other non-deductible debts such as car loans?
2. Will you be able to maintain an emergency fund sufficient to cover three to six months of living expenses?
3. Can you make the payoff (or extra payments) without tapping your tax-deferred retirement accounts?
4. Will you be able to continue contributing enough to your 401(k) to get your employer's matching contribution in full?
5. Do you plan to own the house at least for the next few years?

If you've passed that test, here are the points to consider in making your decision:

1. How does the interest rate on your mortgage compare to the return you can earn if you invest the money?
2. Are you still itemizing deductions? If you can't itemize or you barely have enough deductions to itemize, you aren't getting any real tax benefit from your mortgage. This is a common situation for long-time homeowners whose mortgages are approaching payoff. At that stage, the mortgage payments are mostly principal rather than deductible interest.
3. How might payoff (or extra payments) affect your future cash needs? You don't want to pay off debt then have to borrow the money back again.
4. How much will your cash flow improve if you pay off your mortgage? Remember that only the principal and interest portion of your mortgage payment will go away. You'll still have to pay real estate taxes and homeowners insurance.
5. How much will you save in interest over the long run? You can determine that by using a mortgage payoff calculator. (http://www.bankrate.com/calculators/mortgages/mortgage-loan-payoff-calculator.aspx)

Any extra payments should be sent to your lender with a notation that they are to be applied to principal.

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Ever Been Caught in the Rain?

By Troy Von Haefen CFP® Von Haefen Financial Management (www.vhfinancialmanagement.com)

We've all been caught out in the rain, and as an avid golfer, I can honestly say I have played golf in weather bad enough to make passersby stare at me from inside their dry cars. While an all-weather suit is a plus, a good umbrella is a must to stay dry. Just as an umbrella is a necessity in any die-hard golfer's bag, a financial umbrella policy is a wonderful tool to protect your family.

What is an Umbrella Policy?

An excess liability coverage policy ("umbrella" policy) covers additional liabilities beyond the coverage of the underlying policies. An umbrella policy is a broad form of coverage that covers both automotive and general liabilities when purchased in addition to basic liability plans for home and auto. When the limits of the underlying policies max out, the umbrella policy kicks in.

Let's go back to golf. If, while playing golf in the rain, a golf club slips out of my hands and injures a person, my homeowner's policy will kick in first. If the damages were beyond the limits of my homeowner's policy, my umbrella policy will jump in and cover the excess up to the limit of the umbrella, which range from $1 million to $5 million or more.

The good news is that umbrella policies are inexpensive: usually roughly $200 for a $1-million policy. The exception is if you have teenage drivers.

Also, purchasing an umbrella policy will often require an increase in underlying limits, and often far above the minimums set by state regulations (especially for auto policies). But the cost to increase underlying limits on existing policies also is typically fairly small—and it's worth it to build your security.

Also, it's important to make sure the underlying policies and limits are in place. For example, if a parent decides to reduce the limits on a teenage driver to the state minimums in an effort to save money, then underlying requirements of the umbrella policy will not be met. Therefore, if the teenager is involved in an at-fault accident, the umbrella policy will not pay out. The parents would be ripe for a lawsuit.

It should be noted that a personal umbrella policy will not cover a liability created by a business. Commercial ventures require a separate business umbrella policy.

So, just as I won't risk playing a round of golf in the rain without an umbrella, it's important to have proper liability protections in place to protect your financial assets. While not everyone requires an umbrella policy, most people do. Umbrella policies are an inexpensive way to give yourself peace of mind and help you sleep a little better at night.

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Consumer Education

Putting the Markets in Perspective
March 5, 2011 - Noon - 1:00 pm CT

Instructor: Dr. Lew Altfest, CFP®, CFA, CAP/PFS
NAPFA-Registered Financial Advisor

It is easy to watch the news and see that the markets are in a state of volatility. One day the Dow Jones Industrial average goes up 150 points, only to fall 300 points the next day.

What does the fluctuation actually mean to the markets and to your financial planning? This session will put the markets in perspective by explaining how the markets work and how you should view them on a daily, monthly, and annual basis.

Understanding Taxes
April 1, 2011 - Noon - 1:00 pm CT

Instructor: Bernie Kiely, CFP®, CPA
NAPFA-Registered Financial Advisor
Past member of the NAPFA National Board of Directors

Tax time is stressful in every American household. What you don't understand about taxes, and how they affect your short- and long-term financial plan, may come back to haunt you later. Find out what to do about taxes before it's too late.

Visit our website www.napfa.org to register.

All NAPFA consumer webinars are FREE.

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