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▶ INVESTMENTS.....2-3

▶ CHARITABLE GIVING.....5

▶ COMPREHENSIVE FINANCIAL PLANNING.....4,6

NAPFA

Planning Perspectives



Keeping an Eye on the Long-Term

The summer is over, and it's time to focus on "serious" matters again.

Unfortunately, that's the way that many of us think about our personal finances. We consider our financial futures only occasionally, such as when an outside event forces us to make a decision. The truth is that we will be more successful if we regularly review our financial affairs and remind ourselves of the goals for which we are striving. The worst thing we can do is to ignore our goals and then make a rash decision based on outside factors.



This issue of *NAPFA Planning Perspectives* brings home this message. We include several articles about keeping your financial affairs and investments on a steady course, with your long-term goals in mind. We also look at how your wealth can support long-term goals beyond yourself and your family, such as through charitable giving.

NAPFA, Kiplinger's Team Up on College Savings Education

In August, NAPFA and *Kiplinger's Personal Finance Magazine* held two national call-in programs during which NAPFA members provided the general public with free advice about saving for college educations. The programs generated more than 8,000 phone calls.

"College savings is one of the largest expenses that families with children are likely to face," said Ellen Turf, NAPFA CEO. "We know that college is a great opportunity for our children, but it doesn't have to be an insurmountable burden for families or the students them-

selves. Our members are experts at explaining the savings techniques and other strategies that can ease the burden."

For more information about saving for college, go to the "Planning Your Future" link on NAPFA's Web site, and read the articles in the "College Expenses" section. NAPFA's Web site is www.napfa.org.



Investments

Why You Need Disciplined Portfolio Management

By Kathleen Cotton, CFP®, NAPFA-Registered Financial Advisor, www.cottonfinancial.com

Risk is a fact of life for any investor. Stocks plunge. Bear markets linger. There's even risk in doing nothing: Due to inflation, \$100 left in the bank earning no interest will be worth about \$55 in 20 years if inflation is just 3% per year.

To outpace inflation, you have to assume a certain amount of risk in your investment portfolio. If you minimize your exposure to the volatility that comes with investing in the stock market, then you have to accept lower returns.

As the graph shows, the past 8 years have given investors a strong lesson in risk. During the late 1990s, most investors thought they had a great tolerance for volatility. But after a 3-year bear market, some of those same investors changed their minds. They decided they had no risk tolerance, pulled out of the stocks, and then they missed out on the market's gains.

Stay in the market. Over the last 20 years, the stock market has averaged a 12% annual return. But according to a study by Dalbar Financial, individual mutual fund investors earned only about 4%. A survey by Vanguard finds participants in its 401(k) plans earn only about 6% a year.

It is unpleasant to contemplate, but most individual investors don't capture market returns. Why? Investors trade more than they should, and each trade costs them commissions and might incur a tax liability. Investors have a poor sense of timing, as they often pull out of the market during a downturn and miss out on the rally that follows. Similarly, investors chase the hot sector, or best-performing segment of the market, but by then the market has turned in another direction. And investors sometimes get stubborn and refuse to sell a poor investment.

Asset Allocation. A landmark study of pension plans by Brinson, Hood & Beebower in 1986 suggested that the asset allocation decision (the percentage of a portfolio to be invested in stocks/bonds/cash) accounted for 93% of the

variability of returns. Asset allocation is the most important decision an investor makes, and should be based on three factors: your risk tolerance; the number of years before you begin taking distributions from the portfolio; and the rate of return required for you to meet your financial goals.

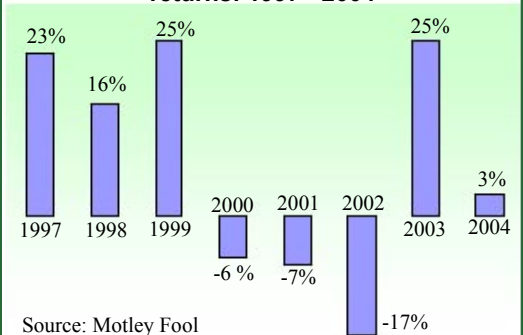
Your asset allocation should change only when one of the three drivers changes. Don't let geopolitical events, market moves, or economic forecasts drive your asset allocation decision.

Diversification. Diversification among the major asset categories (stocks, bonds, and money market investments) can help reduce market risk, inflation risk, and liquidity risk. Diversification within the major asset categories (international and domestic stocks, or large-cap and small-cap stocks) or fixed-income products can help further reduce market, inflation, and business risk. Recommending the mix is the job of your financial advisor.

Rebalancing. Review the actual asset allocation of your portfolio at least once a year, and rebalance to the targets you developed. For example, if you settled on a 50% stock/50% bond asset allocation in the beginning of the year, your actual allocation at year end is likely to be something other than that, given market returns.

You or your financial advisor also should rebalance among the different mutual funds that you own. Are you holding much more of a certain type of investment than you originally intended? If so, you should sell portions of mutual funds whose weight is too high, and purchase additional units of mutual funds whose weight has declined.

What's Your Risk Tolerance?
Dow Jones Average composite annual returns: 1997 - 2004





Investments

“Desperate Housewives” Can Be Stepping Stone to Better Financial Awareness and Management

By Robert Pagliarini, NAPFA-Registered Financial Advisor, MSFS, CFP®, www.sixstepsorless.com

After a life of luxury, could you find yourself suddenly broke and scattered like Gabrielle? Do you over-analyze potential investments like Lynette or under-analyze them like Susan? Which Desperate Housewife has the safest long-term financial plan, and, most importantly, how can this help you in your everyday life?

By reviewing the financial habits of the four Wisteria Lane divas—Susan, Lynette, Gabrielle and Bree—we can learn more about our own money habits and create a road to financial success. Sometimes it’s easy to see in others what we never quite see in ourselves. It’s easy to see Gabrielle is a shopaholic when we watch her Sunday night antics, but harder to see the same behavior in ourselves when we’re in the check-out line in a high-end department store. By thinking about the problems Gabrielle faces from overspending, for example, you may be able to recognize your own spending problems and work on ways to spend less and save more.

Take a short quiz that my firm has developed to discover which character you are most like financially, as well as which characters you most resemble in five important categories related to financial management: trust, emotions, risk tolerance, saving, and involvement. The 15-question quiz takes less than 5 minutes to complete. The quiz can be found at www.DHquiz.com.

Since awareness is only half of the solution, you also will learn how to become more financially successful based on the following four character types.

Bree Van De Kamp: Cool as a cucumber...Bree doesn’t let her emotions get the best of her when she invests. She sticks to a plan and is a dedicated saver, maximizing her 401(k) and making the most of her income. Yet, she has a tendency to be too conservative with her investments and does not take an appropriate amount of risk for her situation.

Susan Mayer: Ignorance is bliss...Susan is an emotional investor. She feels the pain of every a loss and the joy of every gain. But she doesn’t pay too much attention to her accounts, so she doesn’t necessarily act on her emotions. Because she doesn’t do her own research and isn’t involved to any degree, she tends to trust any and all financial advice she receives.

Lynette Scavo: Everything in moderation...Lynette is a “bottom line” kind of gal. She trusts her own research but doesn’t trust the advice of others. While she doesn’t get tricked into investment fads or hype, her unwillingness to listen to others can hurt her portfolio.

Gabrielle Solis: Nothing ventured, nothing gained...Gabrielle is a risk-taker. She tends to take an excessive amount of risk in her portfolio. She’s also a big spender. She gets more enjoyment from buying than from saving and investing.

I believe that when people have someone they can identify with, the improvement process begins. Whether you’re like Susan or Bree, in the end, we can find a way to maximize investments and minimize stress; it all starts with education and, in this case, with the women of Wisteria Lane.

By reviewing the financial habits of the four Wisteria Lane divas—Susan, Lynette, Gabrielle and Bree—we can learn more about our own money habits and create a road to financial success.



Financial Planning

What To Do If Your Net Worth Is Over \$1 Million

By James Shagawat, NAPFA-Registered Financial Advisor
www.baron-financial.com



Wealthy families are finding that money can bring unexpected challenges along with the obvious rewards. What special circumstances should you be aware of if you are in that position?

Diversify. Many wealthy Americans have made their millions by having a large concentration in one stock. Begin paring down on that holding and spread the money into various asset classes. This will reduce your risk, while maintaining opportunities for asset appreciation. For true diversification, an investor should buy into different asset classes. Holding most of a portfolio in one asset class, especially if within it there is one holding, is a very risky endeavor.

Keep estate documents current. A surprising number of people with \$1 million or more in investable assets have done nothing to protect their money. Many of them do not have a will or healthcare proxy; they do not have a trust, despite its importance to privacy and wealth transfer; and they have not named a trustee or administrator for their estate. Whether the excuse is procrastination or not wanting to confront their own mortality, a lack of an estate plan can be a big mistake.

Plan for estate taxes. In 2001, a new federal law reduced estate tax rates. Although estate taxes are to be phased out by 2010 (see table), that does not eliminate the need for planning. Also, unless Congress extends these new provisions, the entire tax act will self-destruct in 2010. After 2010, the estate tax would return, with the exempt amount reverting to \$1 million and the top tax rate to 55%.

Purchase umbrella insurance. Many people these days are concerned about personal liability and the possibility of being sued, rightly or wrongly. As you accrue assets, personal liability protection becomes even more important. Umbrella liability is one of the few truly good values in insurance. I recommend having twice your net worth of umbrella coverage.

Talk to your children. Most wealthy Americans worry that their kids will grow up feeling “entitled,” and nearly as many believe their children are spoiled. Teaching children about money is essential. As in anything, children learn best from parents’ examples. They need to learn what it feels like not to have money available for something they really want.

Be generous. Many people with significant wealth want to make large charitable donations, but selecting a charity can be a confusing task. Your financial advisor can work with you to decide on criteria for selecting recipients of your donations and for monitoring use of your support.

The “World Wealth Report 2004” by Merrill Lynch and Cag Gemini estimates that 2.6 million individuals in North America had investable assets (excluding equity in a primary residence) that exceeded \$1 million as of the end of 2003.

Estate-Tax Phaseout

The federal government’s tax window closes over the next decade as the top estate-tax rate drops and the amount each person can pass free of federal estate taxes increases. The tax expires in 2010, though possibly for just one year.

Calendar year	Exemption	Highest rate
2005	\$1.5 million	47%
2006	2 million	46
2007	2 million	45
2008	2 million	45
2009	3.5 million	45
2010	repealed	0
2011	1 million	55

Source: U.S. Treasury Department



Charitable Giving

Charity Begins At Home

By J. Patrick Collins Jr., CFP®, NAPFA-Registered Financial Advisor, www.jpc-associates.com.

As my wife and I prepare for our first child, we have been reading countless “how to” books on parenting. It is amazing to think of the impact we are going to have on our children’s lives, and we have had numerous discussions regarding the values we would like to instill in them. One area we both feel strongly about is giving.

Charitable giving emphasizes helping those in need, while minimizing the obsession with material wealth. After much consideration, we decided to start a charitable fund in our family’s name. When our children are old enough, we are going to involve them in the management of this fund, and they will have an opportunity to choose a non-profit organization to give a portion of the funds to.

The technical aspects are fairly simple, and your financial advisor can assist you. First, a family opens and funds a Donor Advised Fund. This fund is a charity, so when money is contributed to the fund the donor receives a tax deduction. Highly appreciated assets can be contributed to these funds as well, and since these funds are considered non-profit entities, the assets can be sold without capital gains taxes. Every year, the Donor Advised Fund is required to donate at least 5% of its total assets. The family decides where the donations are directed. Donor Advised Funds are managed by numerous established financial institutions and can be started with as little as \$5,000.

To get the most out of creating and managing a Donor Advised Fund, I recommend that you hold a Family Meeting at least annually and make sure to integrate your children in the decision-making process.

Family Meeting. There are two areas that parents should discuss with their children at these meetings: investing and giving. First, parents should discuss the investments held within the Donor Advised Fund and some of the changes that were made over the course of the year. Although these funds are typically

managed by the institution holding the money, the family should have in-hand annual reports that discuss the fund’s progress. This is a great time to talk to children about areas like mutual funds, stocks, bonds, savings accounts, and the different roles each vehicle plays in an investment portfolio. The family’s financial planner also can be involved at this stage, helping the parents talk to their children about financial management and stewardship.

Second, parents should talk about the funds that were donated the prior year and what they were used for. For example, if the family gave \$4,000 to the Red Cross for Tsunami Relief, the parents might talk about how the money was used to build shelters for those who lost their homes and how those shelters are saving people’s lives.

Children’s Responsibility. At the Family Meeting, parents should ask their children about organizations they are interested in helping. With this in mind, I would recommend allocating 10% of the funds earmarked for giving from the family fund to be entrusted to the children to give, with three stipulations. First, the children must give their money to a qualified charity. Second, the children must account for use of each dollar that is given to those charities. Finally, the children should report back at the next family meeting about who received the funds and the impact of the support.

The responsibility and cycling of information will have a profound effect on children. It teaches stewardship and financial management. Most importantly, your children will have a first-hand look at how their charitable giving positively affects others, and it may promote their involvement in those same charities.

By structuring your family giving, your children will inherit something more important than money: the absolute joy found in helping and serving those less fortunate.

“As the purse is emptied, the heart is filled.”
- Victor Hugo

According to the Giving USA Foundation, philanthropic giving in the U.S. in 2004 reached a record \$248.52 billion, an increase of 5% over 2003. Individuals were responsible for more than 76% of the gifts, or nearly \$188 billion.



Financial Planning

How to Maximize Wealth from Restricted Stock Awards

By Tom Davison, MA, Ph.D., NAPFA-Registered Financial Advisor, CFP®, www.summitfin.com

Employers want employees thinking like shareholders and have long used equity as incentive compensation. Recently, companies have been awarding more restricted stock grants and reducing their use of stock options. Abercrombie and Fitch, JP Morgan Chase, and Microsoft are prominent examples.

A grant of restricted stock costs the recipient nothing. The restriction means it is not fully yours at grant: You can't sell the stock, and if you leave the company you forfeit it. Typically it vests (becomes yours) over several years. A 3,000-share grant may vest 1,000 shares annually for 3 years. Once vested, the restrictions lapse, and you can sell the stock.

Restricted shares are not taxed at grant but later at vesting. Just like salary and bonuses, they are taxed at your ordinary income tax rate, not the lower capital gains rate. If a share of stock is \$20 when your 1,000 shares vested, you would be taxed on \$20,000.

Handling the tax impact of restricted stock is one of the valuable services that a financial advisor can provide. Make sure that you give your advisor all the information about your restricted stock grants well in advance of the vesting period, and ask him or her to explain your different choices for minimizing the impact of taxes.

Many people are surprised to find out that the IRS allows them to choose a different way

to be taxed on stock grants. It is more risky, but can be rewarding. Instead of waiting until vesting to be taxed, you can choose to be taxed earlier by filing an 83(b) tax election at grant. Your taxes will be based on the stock value at grant, and future appreciation will be taxed at the lower capital gains rate. Prepaying taxes with an 83(b) election saves taxes if the stock price goes up.

However, be very careful. If you are not with the company when the stock vests, you lose. You paid taxes on the promise of compensation you never received, and there's is no way to recoup the taxes. You also lose if the stock price drops after your grant and the tax bill is larger than it would have been had you waited.

Basically, an 83(b) election is a bet that your employer's stock price will rise, and that you will be at the company to benefit. Even if you're really convinced this will happen, many advisors recommend that you take the more direct route of simply using cash to buy more shares.

Better planning comes from realizing that the 83(b) election freezes both the stock price and income tax rate at the time of grant. Surprisingly, the 83(b) election is often most useful not when the company stock price jumps, but when your tax rate increases, even by a few percentage points. Your tax rate may increase due to higher tax brackets, changes in law, or moving from one state to another.



83(b) elections offer potential tax savings, but often they are not your best choice for handling restricted stock awards.

More information about restricted stocks:

www.myStockOptions.com provides excellent information about restricted stocks and tax planning. We recommend reading the section about how dividends play into a decision to use an 83(b) election.