



SHARKEY, HOWES & JAVER, INC.

Professionally Speaking

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PERSONAL FINANCIAL MANAGEMENT

FIRST QUARTER 2008

Don't Hit The Panic Button: It's An Economic Cycle

During the past six years, the U.S. economy has consistently confounded naysayers who've predicted a meltdown triggered by (choose one) a collapsing housing market, a plunge in consumer spending, or an increasingly weak dollar. And although uncertainty abounds, Lakshman Achuthan, managing director of the Economic Cycle Research Institute—which has successfully pinpointed the start of past recessions—believes most key indicators still point upward. He cites predictions that the gross domestic product will rise around 2% in 2007, and that it could pick up slightly in 2008. "That's still growth, just at a slower pace than the 3% annual expansion we've seen in recent years," says Achuthan. "It's not a recession."

Officially, a recession is at least two quarters of negative growth. What it means, practically, is high job losses, a slumping stock market, and big drops in consumer and corporate spending. The most recent recession, in 2001, ended quickly, but previous downturns have been long and painful. So what is the likelihood that the current economic expansion will end in the near future, and what should you do if it does—or even if it doesn't?

During the past year, the deepening housing slump, the subprime lending debacle, and stock market gyrations have fueled worries of impending recession. Meanwhile, though, a weak dollar has been good for exporters while slowing down imports and boosting corporate profits. That combination "has offset about one-third of the negative impact of the housing sector," says David Wyss, chief economist at

Standard & Poor's in New York. And though consumer spending was weak during the summer, it picked up in the fall, and jobs remain plentiful and productivity high.

Corporate America, though, seems nervous. Based on the Business Roundtable's third quarter survey of more than 100 chief executive officers, the Roundtable's CEO Economic Outlook Index, which charts expectations for sales, capital spending, and hiring, fell to its lowest level in four years. And former Federal Reserve chairman Alan Greenspan has said he believes home prices are likely to drop further and dampen consumer spending. Greenspan puts the odds of a recession as "somewhat more" than one in three.

That assessment came after the Federal Reserve's half-percentage-point cut in its target for the federal funds interest rate. ECRI's Achuthan believes the reduction had the desired effect, helping bring liquidity and stability back to credit markets. By late fall, interbank lending rates had fallen to more normal levels, and the market for short-term notes was beginning to show life again. But long-term bond yields, which tend to reflect investor expectations, have been more volatile, suggesting worries about inflation. Yet fall readings of "core" inflation, excluding highly variable food and energy prices, were below 2%, well within the Fed's comfort zone, according to Wyss.

Of course, no economic expansion lasts forever, and recession will eventually come. A big oil price shock, a terrorist attack, or another such event

Why Keep All Those Papers?

If your file cabinets are overflowing, it might be time for a change. Which files do you need to keep and why?

TAXES: Keep tax returns and supporting documentation for 7 years.

INVESTMENTS: Keep trade confirmations of all assets in taxable accounts until they are sold, including details of interest, dividends and reinvested capital gains. Real estate investments, keep all documentation on transactions, including receipts for permanent improvements.

ESTATE PLANNING: Keep all documents such as wills, trusts, durable powers of attorney, pre and post nuptial agreements, gift tax returns, beneficiary designations for retirement accounts and life insurance policies.

INSURANCE: Keep a copy of each policy for each kind of insurance together with contact information for the company or agent. Keep a copy of appraisals for art work or jewelry.

EMPLOYMENT: Keep the Employment Agreement, separation agreement, letters of reference and information on any pension plan or other benefit plan still in existence.

PERSONAL PAPERS: Birth, Marriage, Death Certificates, passports, credit cards, drivers license, and other personal papers should be kept and copied in case of loss. Keep a home inventory in the event of a major loss, using photos and digital records of each room. Keep a copy off site.

DON'T FORGET to back up everything on your home computer regularly!

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A Plan For Doctors And Professionals

Suppose you're a partner in a medical practice and you want to maximize your tax-deferred savings for retirement. Your firm already sponsors a 401(k)/profit-sharing plan. But the most you can contribute in 2008 is \$46,000, or \$51,000 if you're 50 or older. One way to sock away more is to establish a cash-balance pension plan.



A cash-balance plan is a new variation of the traditional defined-benefit pension. As with a defined-benefit plan, an employer contributes to a cash-balance plan on behalf of its employees. The money that goes into the plan, as well as investment earnings, is shielded from creditors under the federal retirement law, ERISA. Yet whereas a defined-benefit plan calculates a retirement benefit for each participant based on such things as salary and length of service, the cash-balance plan is simpler. At retirement—or, if an employee is vested, when she leaves the company—the worker is entitled to the money that has been contributed for her, plus interest that accrues either at a fixed rate or at a variable rate tied, for example, to the yield on a one-year Treasury bill. She can take her pension either as an annuity or as a lump sum.

This type of tax-deferred plan can be added to an existing 401(k) or other retirement plan. And it can sharply increase the amount you're able to save. The partners in your practice, for example, may qualify for contributions of more than \$100,000.

Businesses with more than one owner, including professional practices such as law firms, medical clinics, and dental groups, are ideal candidates for cash-balance plans now that they've been improved by the 2006 pension overhaul, according to Jim Van Iwaarden, a consulting actuary in Minneapolis. The chief advantage for multi-owner enterprises is that the owners don't end up paying one another's retirement benefits. That happens sometimes with traditional pensions, Van Iwaarden says, especially if the owners vary in age or hold different percentage stakes in the company.

Cost is the primary drawback. This type of plan is typically more expensive to establish and operate than a traditional pension, and the company

must contribute to workers' nest eggs. Before starting a plan, you should make sure your cash flow is steady enough to fund the required contributions for at least five years, Van Iwaarden suggests.

But cash-balance plans also have cost benefits. One is that you can sort your company's workers into different participant classes. You might have senior owners, junior owners, key employees, and other workers IRS rules require you to include in the plan. Each group gets its own formula for determining contributions, and you may be able to put in a smaller percentage of pay for the non-owner classes.



Of course, the plan can't discriminate against the rank-and-file, and most cash-balance plans are operated in tandem with defined-

contribution plans in order to meet IRS requirements for fairness. Keep in mind, too, that the sponsoring company bears the investment risk for these plans. You'll need to earn a return on plan assets that's adequate to fund the promised interest rate on employees' plan balances. ●

A Consumer-Directed Health Plan May Sound Like A Panacea,

President Bush is all for them, and many health economists believe health savings accounts and other "consumer-directed" health plans (CDHPs) could help expand health coverage to the uninsured while reining in runaway medical costs. The basic idea is to buy a low-premium, high-deductible policy that protects you from the catastrophic costs of a serious injury or illness but leaves you to pay for much of your everyday care. That, in turn, is supposed to make you a savvier medical consumer who doesn't run to the doctor for every headache or runny nose. Yet the trade-offs of a CDHP may not be to your liking,

particularly as you grow older and find yourself needing more frequent and costly medical care.

From a policy perspective, CDHPs seem to be on the right track. According to "Consumer-Directed Health Plan Report—Early Evidence Is Promising," from consultant McKinsey & Company, the number of Americans covered by CDHPs more than doubled during the six months ending March 2005. There may be several reasons, however, not to jump on the bandwagon.

While it's true CDHPs can save you money on insurance premiums, that's less of a selling point for wealthier families than for the population at

large. Moreover, what you don't spend on premiums may come out of your pocket as you meet the high deductible. According to a survey conducted by the Commonwealth Fund and the Employee Benefit Research Institute (EBRI) in December 2005, individuals in CDHPs and traditional health plans tend to have similar rates of health care use. But those in CDHPs are significantly more likely to spend a large share of income on out-of-pocket health expenses than are those in comprehensive health plans. In the survey, 31% of those in CDHPs spent 5% or more of annual income on out-of-pocket costs and premiums,

A Plot Twist In The 0% Capital Gains Rule

One of the biggest tax blockbusters ever is scheduled to debut in 2008: the 0% capital gains rate. Despite advance reviews suggesting it will only benefit individuals in the lowest tax brackets, this marquee tax break could play well with affluent families, too. But a last-second twist in the plot complicates matters for families with older children.

This intriguing tax saga began in 2003. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) lowered the maximum tax rate on long-term capital gains from 20% to 15% for taxpayers in most brackets. But for those in the 10% and 15% brackets, the tax rate was pushed even lower, to 5%.

And that's only part of the story. Under JGTRRA, the 5% rate drops to 0% for qualified filers in 2008, and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended the 0% rate through 2010. Thus, taxpayers in the lower brackets can benefit from this unprecedented tax break in 2008, 2009, and 2010.

What does it have to do with you? Based on the inflation-indexed figures just released for 2008, the cutoff for the 15% tax bracket is only \$65,100 for joint-filers, and \$32,550 for single taxpayers. Short of taking a year-long, unpaid vacation, you're probably unlikely to squeeze under the bar. You'll

probably be stuck with the 15% maximum capital gains rate.

But that doesn't stop your family members from benefitting from the 0% rate. For instance, you could transfer stock or other appreciated assets to a child or grandchild fresh out of school.

Then, the child can sell the shares in 2009, or 2010, when the zero percent tax rate applies. If you were thinking of giving your son or daughter a gift, for a house down payment or to pay off college loans, this approach has the added benefit



of cutting capital gain taxes.

What assets should you transfer? Highly appreciated ones. A block of stock you've been holding for years and that is now worth several times what you paid, for instance, would be a good gift to a child. If you were reluctant to pay a 15% tax on your gain, this would be a good way to get out from under that tax burden.

The current market value of the assets you transfer will be considered a taxable gift. But an annual exclusion lets you give \$12,000 to any individual every year without paying any gift tax.

This exclusion is doubled to \$24,000 if your spouse consents to making a gift. So if you're married and have, say, two low-bracket children, you could give each child securities worth \$24,000, for a total of \$48,000, all completely gift tax-free. And you could repeat the strategy in 2008, 2009 and 2010. (Larger annual gifts would count against your lifetime \$1 million gift tax exclusion.)

There is one complication. The Small Business and Work Opportunity Tax Act of 2007 expanded the reach of the "kiddie tax." Kiddie tax rules say that if a child receives unearned income (usually in the form of capital gains or dividends) that exceeds an annual threshold—\$1,800 for 2008—the excess amount is taxable at the top tax rate of the child's parents. Prior to 2007 law, the kiddie tax applied only to children under age 18. Beginning in 2008, though, it affects any child under age 19, as well as full-time students up to age 24, if they don't have earned income that accounts for at least half of their support.

So if you have a dependent child in college or high school in 2008, you should be aware that gifting appreciated assets for them to sell could backfire. Your child's unearned income in excess of \$1,800 could be taxed at your higher rate and undermine the gifting strategy. The amount of your gift, your child's earned income, and other numbers need to be considered and analyzed beforehand.

If you have a sizable amount of securities with significant unrealized gains, you may want to consider transferring them to a Charitable Remainder Trust to avoid capital gains, receive a charitable contribution deduction and lifetime income, and to benefit one or more charities.

Also keep in mind that it almost never makes sense to sell securities based solely on potential tax savings. Remember, this tax break is scheduled to last through the 2010 tax year. But if everything falls into place, this new tax rule could help your family enjoy the best of all possible tax rates. ●

But May Not Be Right For You

compared with just 12% of those in comprehensive health plans.

You may also simply be happier with a comprehensive plan. According to the Commonwealth Fund/EBRI survey, 63% of individuals with comprehensive health plans were extremely or very satisfied, compared with 42% of CDHP enrollees. That could be because CDHP enrollees are more likely to avoid or delay health care than those with comprehensive plans. According to the Commonwealth/EBRI survey, 35% of people in CDHPs avoided going to the doctor when they were sick, compared with 17% of those in comprehensive plans.

That, of course, is how it's supposed to work, with CDHP enrollees having a financial incentive to avoid unnecessary care. But the line between what's needed and what's not may often blur for health-care consumers. And some policy experts worry that failing to get preventive care or catch medical problems at an early stage could lead to much more serious problems—and much higher costs—down the road. Until more is known about the long-term success or failure of the CDHP concept, it may make sense to spring for a traditional health plan. ●

Treating Your Retirement As A Liability

You already pay your bills on time. So why not add one more really important obligation to your monthly budget. If you begin treating your retirement needs as a future liability that you must fund now, you'll likely put away more money than if you pretend retirement saving is optional.

It's easy to fund your retirement account last. You know you should save, but there are competing priorities. The kids want to go to college, and you would like a new boat. And often, retirement saving loses out. But if you treat your retirement saving as another bill you have to pay, it will stay at the front of your mind. You won't miss payments, because—just as when you're paying the mortgage or the electric bill—getting behind has consequences.

While this solution to retirement planning sounds pretty simple, it comes from the sophisticated world of institutional investing. Pension fund managers, for example, have to treat future obligations—payments to pensioners—as liabilities, and that forces them to deal now with something

that may be years or decades off. Using actuarial tables, they calculate the cost of future obligations to determine what return they require on their investments and whether the pension fund is adequate.

While you may not use actuarial tables, you can manage your retirement account like a pension fund. The first step is to determine the savings you need to support the lifestyle you want during retirement, keeping in mind that you probably want to fund retirement through age 90 or 95. Next, determine how many years you have to reach your savings goal. If you are 45 and plan to retire at 62, for example, you have 17 years to fund your retirement account. Finally, determine how much you must save each year and make projections about returns on your investments.

If you're already funding your retirement goal by contributing to a 401(k) or other plan at work, treating that money along with all of your other retirement savings as a liability, may provide you with a more realistic picture about how much you need to put away and the retirement you should

expect. It may make you save more.

A simple way to establish a monthly liability for your retirement obligation is to divide your goal into equal installments. So if you have 17 years to save \$500,000, you can divide that obligation into 204 monthly payments of just over \$2,450 apiece. Given the expected growth of your investments, you're likely to "over-fund" your retirement obligation.

If you would like us to calculate your payments more precisely, we will estimate the impact of inflation, investment returns, and taxes. That may give you a realistic number for your monthly liability. By thinking of your retirement account as a liability, you're paying yourself along with your other debts. It's a great way of funding retirement. Of course, making calculations about how much you need to save today to fund a debt in the future, while also making judgments about inflation and taxes and selecting the right investments, requires the help of a professional. We're here to assist you with any aspect of this and help you create a disciplined system for planning your retirement. ●

It's An Economic Cycle

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could be the trigger. But Wyss points to several reasons why any downturn is unlikely to be as long, deep, and painful as in decades past. For one thing, he says, the economy now has a much more global focus and depends more on services than on manufacturing, which now accounts for just one in 10 jobs. "The service sector is much less volatile than the manufacturing sector both in terms of employment and spending," Wyss explains. Meanwhile, the Fed has gotten better at eyeballing economic danger signals and managing monetary policy to keep the economy growing. "Monetary policy is more proactive today," Wyss says. "They're doing a better job avoiding the high inflation

rates that in the past caused such sharp economic cycles. Current cycles are much calmer."

Still, it only makes sense to prepare for what may come. Beyond avoiding panic as a possible recession looms and markets become more volatile, some strategic rebalancing may be in order, suggests Michael Gambera, chief economist at Ibbotson Associates. "This seems to be a good time for diversification to international stocks," says Gambera, who believes that allocating as much as one-third of your portfolio to foreign markets could serve as a useful hedge against the weakness in the US dollar and economy. "Different countries have different business cycles, and diversifying internationally is a good way to reduce risk in a portfolio," he says.

Certain sectors, including consumer staples and health care, tend to suffer least in a recession, because people continue to need to visit the doctor and buy household products. Money markets and short-term bonds also tend to hold up well in a soft economy, though Achuthan warns against an aggressive move into fixed income. Another rate cut by the Fed could result in a huge stock market rally, he says, and investors who've abandoned equities would lose out on unexpected gains. And of course, any portfolio adjustments need to take into account your overall situation and long-term financial goals. If you'd like to hear our views on current and future economic conditions and how they may affect you, please give us a call. ●