the EDUCATED INVESTOR

Summary 2005

LGC&D Wealth Management, LLC
A Registered Investment Advisor

Thirteen Steps Toward a Well-Planned Retirement

Ready or not, here it comes. As millions of baby boomers approach retirement, we are reminded of the classic Aesop fable about the carefree, live-for-the--moment grasshopper, versus the industrious, plan-ahead ant.

Life is all about balance. You want to have some fun along the way, but it's also vital to set aside time and resources for days that lie ahead. As you will see, there are many challenges to developing a well-planned retirement. Mistakes made as you near retirement can be particularly damaging, in that you may not have the necessary time horizon to correct them. With so much to gain — or lose — your fee-only investment advisor can be a powerful ally in your efforts.

Following are a baker's dozen of tips to help maximize the efficiency of your retirement planning. Read on for more details.

1. Start saving early.
2. Develop a plan.
3. Assume modest rates of return.
4. Be extra cautious during the first few years of retirement.
5. Carefully assess your spending and tax requirements.
6. Plan to live long.
7. Assess your risk tolerance — and build your portfolio - accordingly.
8. Plan for potential early retirement.
9. Be aware of the risks of inflation and other cost of living increases.
10. Remember that retirement is a family affair.
11. Minimize your risk with the right tools.
12. Maximize your Social Security benefits.
13. Consider setting up your IRA to benefit your beneficiaries.

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Finding the Right College Savings Plan

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Now that you have made the decision to start saving for your children's education, the next step is to choose from the 100+ state sponsored 529 savings plans (Plan). Practically every state offers some form of plan and many have more than one investment company. Deciding on a plan can feel like going to a restaurant and ordering a meal from a 10-page menu.

In general, plans offer two main investment options; actively managed mutual funds or passive mutual funds. Actively managed funds attempt to beat the market using security selection and market timing. The efficient market hypothesis, however, states that market prices are always fair and quickly reflect information, making it difficult for professional investors to systematically pick winners. Also, active managed funds may experience shifts in their investment strategy (style drift) that may not be aligned with your initial risk tolerance. Passive management refers to a buy-and-hold approach to investing. Studies have shown that passive asset class funds outperform actively managed funds as well as many index funds.

Given the many choices to be made, most investors may have the misconception that they have to go with their local state plan. Also, brokers or investment advisors are likely to recommend a local state plan, especially if that state offers a tax incentive. For instance, Rhode Island residents who invest in the actively managed funds offered by Alliance Bernstein can deduct up to $1,000 of plan contributions on their Rhode Island income tax return. For someone in the highest tax bracket this would equate to a tax benefit of approximately $99 for the first year. Truly, not much of an incentive, considering that broker commissions and high annual fees can easily wipe out such savings.

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Your money, Your family, Your financial security, Your future...

ity, your investment horizon may extend even beyond your own life span, at least for some portion of the portfolio. Also, remember that life expectancy is on the rise. And, by definition, half of us will live longer than our life expectancy.

Planning a sufficiently long investment horizon has at least two implications. You'll minimize your risk of running out of assets before you or your heirs are done needing them. Plus, it enables you to consider an appropriate degree of portfolio risk (and its expected commensurate rewards), a subject we discuss in the next point.

Assess your risk tolerance — and build your portfolio accordingly.

As most of us enter retirement, we tend to become more conservative in our investment strategies, shifting to "safer" asset classes. This is often a very appropriate shift. But how conservative you should become (if at all) will vary widely depending on your unique investment objectives.

There are many angles to consider before arriving at the right mix for you, and what appears safer as a stand-alone holding may not be so in the context of your overall portfolio. For example, there may be compelling and prudent reasons for you to hold more equities (U.S. and international); to hold a mixture of asset classes including value stocks and/or real estate funds; or to consider drawing your income from sources such as capital gains or bond maturations (as opposed to strictly interest, dividends and annual fund distributions).

Your advisor can help you assess all of these factors, as well as consider whether your actual time horizon, as discussed in the previous point, may enable you to take a longer-term view and thus perhaps a less conservative stance than you might otherwise think.

Plan for potential early retirement.

You should also plan for the potential of retiring earlier than expected. Hopefully it will be because you can afford it. Perhaps your investments outperform, or you inherit wealth. But there's also the possibility of undesired early retirement, such as from job loss or health concerns. Plan for various outcomes that include considerations such as your Social Security and/or pension benefits, investment income and part-time employment income.

Be aware of the risks of inflation and other cost of living increases.

While the impact of inflation can be significant, you can generally expect wage increases during your working years to keep pace with cost of living increases. That's why the risk of rising inflation is more significant once you retire, when you can no longer count on rising wages to offset the negative effects. Here are some related issues:

- Historically, medical care costs have risen at a faster pace than has overall inflation. Plus, there is some uncertainty regarding the future of Social Security and Medicare programs. It might be imprudent to rely too heavily on them as a main source of retirement income.
- Your pension plan may not be indexed to inflation.
- The value of longer-term bond holdings deteriorates in the face of inflation.
- For the fixed income portion of your portfolio, TIPS (Treasury Inflation Protected Securities) and I Bonds (another inflation protected security) may help stave off the risk of inflation.

Remember that retirement is a family affair.

When you plan for retirement, there are additional factors to consider if you are planning for both yourself and your spouse. Critical factors that come into play require different solutions depending on your family's needs. For example:

- Planning for your surviving spouse when considering your defined benefit plan payout options
- Planning for sufficient life insurance to replace earned income if you or your spouse die prior to planned retirement
- Considering the cost and timing of regular and supplemental health insurance for both of you, particularly if you are different ages
- Accurately assessing living expenses upon the death of the first spouse (when some expenses will be reduced, but so too will Social Security benefits)
- Ensuring a surviving spouse has the information he or she needs to manage the family assets and carry out carefully established plans

In our Business, You Count...

Start saving early.

The younger you are, the harder it can be to think about retirement savings — but ironically it's when saving will by far have the most dramatic impact on your likely success. This is thanks to the power of compounding.

For example, consider this illustration:

- 25-year-old Sally begins saving $5,000 annually for 10 years, until she is 34, for a total of **$50,000** saved.
- 35-year-old Sam begins saving $5,000 annually for 30 years, for a total of **$150,000** saved.

Let's (arbitrarily) assume that they both earn 7 percent annualized return on their respective savings until they reach 65. Who comes out ahead? While Sam's portfolio would grow to about $505,000, Sally's would be worth approximately $563,000. Sally saved only a third as much as Sam, but because she started younger, time and compounding were on her side. The message is simple but powerful. The earlier you start saving, the better.

Develop a plan.

Among our most fundamental but profound tips is to simply ensure that you take the appropriate steps to plan for retirement:

- Determine how much you will need to accumulate to achieve your desired lifestyle. A powerful tool known as Monte Carlo simulation can analyze an enormous number of potential outcomes given your particular situation, helping you plan for your expected savings requirements up to 30–35 years into the future.
- Form an investment plan that is most likely to help you achieve the outcome you seek.
- Integrate your investment plan into your overall estate planning.

Assume modest rates of return.

The *historical* annualized rate of return (after discounting inflation) is right around 7 percent. But, is expecting a 7 percent return above inflation a safe number to hang your retirement hat on? We would suggest a more conservative figure, perhaps in the range of 4–5 percent. If returns are higher, all the better. But if you plan for returns that are higher than what occur, you don't get a second chance.

Be extra cautious during the first few years of retirement.

In planning for retirement, you tend to plan for the *average* return you hope to achieve. However, *actual* returns can significantly vary from one year to the next. Even if you still achieve your desired average return in the long run, nobody can predict which years the actual returns will be above or below the overall average.

That's why it is important to determine conservatively how much money you can withdraw, especially during the first several years of your retirement, when an underaverage performance can have the most significant impact on your long-term financial outcomes. Just as in the Sally and Sam example, underperformance early on has a bigger hit on your long-term ability to benefit from the compound growth upon which your portfolio's health depends. You'll want to arrive at a cash withdrawal figure that makes sense for you — both in early retirement and as you move forward.

Carefully assess your spending and tax requirements.

Don't sell yourself short when it comes to your retirement spending needs. A study about replacement ratios, conducted by AON Consulting and Georgia University, found that the average person needed to replace 75–89 percent of his or her preretirement income. And even this percentage may be low in the face of increased medical insurance concerns. Contrast these figures with the findings of a 2004 Retirement Confidence Survey that found one in 10 people thought they'd need less than 50 percent, almost three in 10 said 50–70 percent, and another 7 percent admitted they had no idea.

If you are underestimating your spending needs, you may also be underestimating your tax rate in retirement, an important component in accurately determining your overall cash flow needs.

Plan to live long.

Plan for an investment horizon that includes the rest of your life, not just your years until retirement. In fact, if you hope to leave your estate to family or char-

Minimize your risk with the right tools.

Most people understand the need to purchase life insurance as a hedge against the risk of dying early.

It's also important to consider minimizing the "risk" of living longer than expected — potentially longer than your financial assets hold out.

Long-term health care (LTHC) coverage is one important tool to assist in this effort. A 2004 national survey by MetLife Mature Market Institute determined the average daily rate for a private room in a nursing home was approaching $200, or $70,000 a year. It is estimated that easily half of us will likely require long-term care at some point in our lives. Even as costs and use are rising, our government's ability to assist is being strained. Determining whether (and, if so, which) LTHC coverage is right for you is a complex but important issue to include in your financial planning.

Maximize your Social Security benefits.

Should you wait until full retirement age to take Social Security benefits or should you take early benefits at age 62? What impact, if any, does your birth year have on the decision? Should you wait until after full retirement, perhaps until age 70, to take advantage of increased benefit payouts?

These are just a few questions that come to mind as you plan to take advantage of your Social Security benefits. Primary factors in the decision include your and your spouse's life expectancy, birth years, benefits levels, earned income plans and future benefits discount plans. It is important to understand the implications of and weigh all of these factors prior to making irrevocable choices.

Consider setting up your IRA to benefit your beneficiaries.

If your goal is to leave as much as possible to beneficiaries, you can take steps to ensure that your IRA grows tax-deferred for as long as possible after your death. This provides the dual benefits of easing your family's tax burden and allowing them to build more wealth. Making appropriate determinations regarding whether to bequeath your IRA to your spouse, to your children or to multiple beneficiaries can have a significant impact on the distribution period as well as tax-deferred growth of your hard-earned assets.

The moral of the story?

Taking all of the steps described herein may seem daunting. But remember, you do not have to take these steps alone. Your investment advisor can serve as a constant ally. In addition, we advise heeding the approach taken by the industrious ant who, one grain of sand at a time, can build quite an impressive hill.

Finding the Right College Savings Plan, Continued...

Investors too often neglect to investigate plans offered by other states. One such plan is the SMART 529 College Savings Plan offered by the State of West Virginia. It is the only known plan with no commissions, low fees, non-drift passive asset class funds, and an integrated rebalancing mechanism to keep your investment objectives in check. The investment company, Dimensional Fund Advisors Inc. (DFA) has a management style that captures specific dimensions of risk recognized by academic research. DFA is among a small group of investment firms that have obtained awards in excellence from the nation's leading independent financial-services market research firm of Dalbar Inc.

If you would like additional information about the SMART 529 College Savings Plan, or have questions about 529 options available to you, please call me at 401-421-4800 or email me at jdorfman@lgcd.com.

"We translate the academic research conducted by Nobel-Prize winning professors into a practical, disciplined investment approach designed to achieve your personal long-term investment objectives."

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**

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