The ABCs of Money

By Russell Wild
Modern Maturity
July-August 2002 Edition

"I've got all the money I'll ever need — if I die by four o'clock this afternoon," said comedian Henny Youngman.

Presumably you're in the game of life for longer than that. Which is why you need a money plan. A good one needs to cover all the bases—savings, investments, pension (if any), Social Security, taxes, debts, household budgeting, and more. Unfortunately, if you're like most people you may not have such a strategy in place yet. A recent study co-sponsored by AARP found that only 32 percent of American workers had even figured out how much they'll need for retirement, much less felt confident about their overall financial picture. But have no fear. The solid planning starts now! Because time is money, all this good advice has been tightly compressed and neatly alphabetized.

A

Assets, Fiddling With

Where are you going to find the time to manage your assets more closely? The best advice: Don't. You know that neighbor of yours, the guy who checks his portfolio balance every morning and every night, and who knows to the cent what he has lost or gained with every hiccup of the Dow? Chances are, he isn't doing anything more than giving himself heartburn. "The most financially successful people tend to spend no more than three hours a month on their personal finances—and that includes not only portfolio management but paying bills and balancing the checkbook as well," says AARP MODERN MATURITY's own "Mr. Money" columnist Ric Edelman.

What's the harm of spending more than three hours? It's been well-documented that overzealous monitoring of one's stock portfolio leads to over-frequent buying and selling, with the result that much of the investment profits get eaten away in trading costs. "If you're fiddling with your finances a lot, maybe it's time to find a more productive hobby," says Edelman.

Bank on this: Aside from the high cost of buying and selling securities, there's yet another reason why frequent traders lose out: They tend to have their money in cash at just the wrong times. For example, in one recent five-year period stocks gained 25 percent, but it happened in just 40 (non-sequential) uproarious days. Anyone out of the market on those days would have been left in the dust.

B

Better, Not Bigger

In the past three decades, the average new home has increased in size from 1,500 to about 2,300 square feet. Probably the greatest single savings older Americans can make—and something most of us don't even ponder—is downsizing once the nest has emptied. "Simply reducing your living space—and along with it the cost of housing—could go a very long way toward financing your future," says Todd Cleary, director of financial planning services for the Baltimore-based brokerage giant T. Rowe Price.

C

Communication

It's hard to devise a good money plan without knowing what your parents (and your kids) are thinking. "Generations need to communicate," says elder-law attorney John F. (Jay) Kearns, adviser to the GE Center for Financial Learning. "There's a silent dance that often takes place between family members who are hesitant to discuss financial issues. But you need at some point to stop dancing and start talking." At your next family gathering—Labor Day weekend?—ask your parents how and where they see spending their final years. Ask about their financial resources. Ask how you might help them to prepare. Think about how you would answer those questions yourself and then share your thoughts with your own kids.

D

Dogs, When To Ditch 'Em

If you have any investments that have slipped and you want to unload them, now's a very good time. "Because the market has been down, chances are you'll be taking a capital loss on anything you sell. Why not let Uncle Sam help subsidize your losses?" says Muriel Siebert, president and chair of Muriel

Siebert & Co., an investment firm in New York. If selling the security won't generate a loss, experts recommend the following litmus test: Imagine yourself with a wad of cash. Would you invest it in your present holding? If the answer is no, then sell.

E

Eggs, Not All In One Basket

The world economy is a roller coaster, with interest rates, stock markets, and inflation rates constantly zipping up and down. The best way to prevent your eggs from getting scrambled is to spread them about. For years, the rule of thumb was to subtract your age from 100, and that was the percentage you were supposed to keep in stocks. (So, if you were 60 you'd deposit 40 percent of your wealth in stocks.) "Today, that's considered a tad conservative," says Craig Israelsen, associate professor of economics at the University of Missouri-Columbia and author of *The Thrifty Investor* (McGraw-Hill, 2001). Reason: We're all living longer, so we need to be more aggressive to keep inflation from eating away at our savings. If you've got enough saved to pass along something to the next generation, you should probably have about 60 percent of your portfolio in stocks at age 60—and only slightly less at age 70. Even at 80, you might still have a healthy chunk of well-diversified stocks, as much as 50 percent. For safety, always mix up your holdings among large, medium, and small cap companies. Include some foreign securities as well. Plunk the rest of your savings in short- or intermediate-term government or investment-grade corporate bonds.

F

Franklin, Ben

Preached frugality right along with democracy and an early bedtime. For a period of his life, Ben gave up meat, largely as a means to save money. You can't save effectively unless you know how much you're spending, says Christopher Jones, president of Keystone Financial Planning in Easton, Pennsylvania.

One solid strategy: Put everything on a debit or credit card for a month or two. "That way, you'll have it all printed out in front of you," says Jones. "You'll know how much you spend on housing, food, entertainment, and just about everything else." (Be sure to pay off your credit card before interest kicks in.) As for incidentals like candy bar and newspaper purchases, start off each week with a certain amount of dough in your wallet and keep a petty cash tally. Or don't. An effective reckoning of your expenses doesn't have to be to the penny, says Jones.

G

Grim Reaper, The

Remember when you opened that IRA account in 1987? Or when you bought that life insurance policy in 1977? You were asked to fill out a beneficiary form for each. Whose name appears on those forms? Quick! Did you know that your listed beneficiary has a legal right to these assets when you die—even if your will stipulates that you want your money to go elsewhere? For example, let's say you wrote in the name of your brother, Chip, the one who never remembers your birthday, doesn't even know your kids' names, and still hasn't returned your copy of *The Catcher in the Rye*. When you go to that great reading room in the sky, unless you affix your spouse's name or those of your kids to the policy, Chip still gets the loot. "I've seen many people who haven't updated their beneficiary forms in 25 years," says attorney Bruce Wexler, co-chair of the trust and estates department in the New York office of law firm Loeb & Loeb.

H

Home Sweet Home

Sure, paying off your own home is a comforting thought. But not paying it off might make for a better fiscal reality.

Here's why: A 30-year fixed mortgage can be had for around 7 percent. The interest you pay the bank is tax-deductible. If you're in a 28 percent tax bracket, that means your real cost of borrowing is closer to 5 percent. Is it sensible to make extra payments to reduce a 5 percent debt? No way, says Ric Edelman. You could invest that money in a relatively safe blue-chip stock or government bond fund with probable gains in the range of 8 percent a year. "Often—and so few people realize this—not paying off the mortgage can 'earn' you 3 percent a year," he says.

Caution: If you're in less than a 28 percent tax bracket, this strategy may not pay off.

Bank on this: Reverse mortgages may be a good way for cash-strapped older homeowners to get money while staying in their family homes. For info, call 800-424-3410 (TTY: 877-434-7598) for a copy of AARP's "Home Made Money: A Consumer's Guide to Reverse Mortgages" (D15601). Or go to AARP.org's primer on reverse mortgages.

I

Interest, Losing It

U.S. savings bonds are exempt from state and local income taxes—plus they're backed by the "full faith and credit of the U.S. government." So you can't find a safer investment other than perhaps the gold in your teeth.

One caution: At some point, U.S. savings bonds stop earning interest, and you then need to cash them in or exchange them. Forget to do so and you might as well have your savings in a big mayonnaise jar. To find out which U.S. savings bonds have expired, call toll-free 800-487-2663 or go to www.savingsbonds.gov/sav/savstop.htm.

J

Joy Of Giving, The

Give generously, but think twice about giving cash. "That's one of the most common mistakes people make. It's very tax-inefficient," says Craig Brimhall, a vice president at American Express Financial Advisors. Say you bought $1,000 of ACME Tools stock back in 1980 and today it is worth $5,000. If you were to cash out on that stock and then pass the money to your favorite charity, you would owe tax on the capital gain. On the other hand, if you were to pass the stock directly to your favorite charity, the charity would get the full $5,000, you would get a $5,000 tax deduction, and you would owe capital gains taxes of zero dollars. Now that's joy!

K

Kilter, Out Of

Many Americans' idea of what constitutes "well-off" is a bit, well, off. Sure, Bill Gates could buy the typical small American city with what he's made since the first of last month. It's easy in this country to start thinking you're not doing well enough. To help keep one's personal financial problems in perspective, Christopher Jones suggests spending at least a day or two a year, every year, volunteering at a homeless shelter. "Many who do this find that their notions about comfort are based on totally inappropriate benchmarks," he says.

L

Learning, Paying For

Are college expenses in your future? Whether you're thinking of paying for the education of your children, your grandchildren, or even yourself, there is a new investment tool, thanks to an act of Congress, that can't be beat. Meet the 529 savings plans. They're run by states and, as of 2002, educational institutions. Everyone is eligible. And you can take anywhere from $20 to $200,000 (or more, depending on the individual plan), nestle it into a professionally managed account, and watch it grow tax-free until college time—yes, you heard that right, tax-free, not tax-deferred. Unlike a traditional trust account, you, not the future student, maintain control of the money.

One catch: If you don't wind up spending your loot on schooling, you'll owe taxes on the cash withdrawn, plus a 10 percent penalty on earnings (not principal).

The 529 plans are quite flexible. The education doesn't have to be the traditional kind. For example, 529 money can go toward photography lessons, as well as music, drama, culinary arts, language, even golf. The only provision is that the school you attend must be federally approved. The list is long. For information, call the Department of Education's federal student aid information center at 800-433-3243 or search the entire list on the Web at www.ed.gov/offices/OSFAP/Stu dents/apply/search.html.

M

Moving Investments Around

Few things in life are as fraught with peril as rolling over money from a company-sponsored profit-sharing plan, 401(k), or defined benefit plan (traditional pension). One potential mistake is leaving a job and rolling a 401(k) into an IRA, only to discover you need the money before age 591/2. (IRA money generally can't be tapped until that age without penalties, but 401(k) money can be withdrawn by any 55-year-old who leaves his job.) Another one: rolling over a 401(k) with company stock in it. The IRS is very generous in its taxation of company stock withdrawn from a 401(k), but the day that money goes into any other retirement plan the rules change.

Also critical to know: The government makes special allowances for people born before January 1, 1936.

Bottom line: Before making any moves it's a good idea to check with a certified financial planner (CFP). For a referral to a fee-only planner near you, contact the National Association of Personal Financial Advisors at 800-366-2732.

N

Non-Taxable Accounts

If you own an IRA or 401(k), that's where you should keep interest-bearing bond funds or actively managed stock mutual funds.

Reason: These kinds of investments spit out annual gains that would otherwise be taxable.

Plunk growth-type investments such as stock index funds in your taxable accounts. (Index funds usually generate significant gains when you cash out of them, rather than year to year.) Another candidate: tax-free investments such as municipal funds. Two new options that you may not have heard of yet, although investment pros have been buying them up like fire sale hotcakes, are exchange-traded funds (ETFs) and unit investment trusts (UITs). ETFs are like index funds in that they're tax-efficient and pegged to an index. Unlike index funds, ETFs are traded like regular stocks. UITs are similar to ETFs, but the selection of stocks, rather than being pegged to an index, is handpicked by a fund manager.

O

Over-Insured

Many people are paying a fortune for insurance they don't need, says Thomas Gilovich, professor at Cornell University and co-author of *Why Smart People Make Big Money Mistakes—and How to Correct Them* (Simon & Schuster, 1999).

One rule of thumb: If you think you have enough in the bank to cover a potential loss, then don't insure it. In addition, three kinds of insurance are almost always a waste:

- **Airport life insurance policies.** "The low probability of a crash is reason enough not to buy this insurance. Also, if you purchased the ticket with a credit card, as most people usually do, chances are you've got coverage through the card," says Gilovich.

- **Zero-deductible policies.** To possibly save a few dollars on a health or auto insurance claim, in most cases you'll pay dearly.

- **Extended warranties on consumer products.** Sales clerks are always pressed to sell you these. "They're big moneymakers for the retailers," says Gilovich. "But many people who are tempted to buy such warranties could, if they needed to, pay to fix a TV or washing machine and should not waste money on a warranty that they'll probably never need."

P

Ponzi, Charles

If Ponzi, the namesake of pyramid scams, were around today, he'd most certainly be plugged into the Internet. Cyberspace is jam-packed with investment scams. To protect yourself, be especially wary of:

- Any investment offering described as "risk-free" or even "low-risk."

- Online investments with off-shore mailing addresses.

- Salespeople named "J.D." Anyone asking you to invest should provide you with first and last name (no aliases or initials), full address (no P.O. boxes), and a telephone number. The hesitancy to disclose this information should be seen as a big, flapping red flag, says Audri Lanford, editor of the online newsletter Internet ScamBusters.

Q

Quality Investments

No one likes to lose money. But the perennial paradox in any savings strategy is that the safest-seeming options can actually be quite risky. That's because the rates on CDs, passbook savings accounts, and the like are so low that you barely stay ahead of inflation. For example, had you invested $10,000 in a super-safe money market fund in 1992, that amount today, after adjusting for inflation and taxes, would have grown in value by $500. That's scant bang for 10 years of investing your bucks. Had you, however, sunk that same $10,000 into a Ginnie Mae fund, a slightly more volatile but far from risky investment, you'd be ahead by over $2,000.

R

Risk, Limiting

Want to stay out of trouble? A little diversification goes a long way toward safeguarding your nest egg. Studies show that a portfolio of 80 percent stocks and 20 percent bonds can be expected to provide 97 percent of the return of the S&P 500, with just 85 percent of the risk. A portfolio of 20 percent stocks and 80 percent bonds can be expected to provide about 110 percent of the return of an all-bond portfolio, with 95 percent of the risk.

S

Savvy Fund Buying

Mutual funds are a terrifically good investment. They're easy to buy and sell, and they help to diversify a portfolio. The trick is picking a good one. Most wannabe tycoons tend to go with previous winners. If only investing were that simple. Studies show that an investment in last year's top-yielding 10 or 20 mutual funds has about as much—or less—chance of beating the S&P 500 as choosing randomly. What does matter:

- **Fund expenses.** Small differences in expenses can make a huge difference in yield. Example: Fund 1 has an expense ratio of 0.2 percent. Fund 2 is 1.3 percent. If both start at $25,000 and earn the same market rate—10 percent compounded over 20 years—Fund 1 will yield $31,701 more than Fund 2. Rule of thumb, per Frank Armstong III, author of *The Informed Investor: A Hype-Free Guide to Constructing a Sound Financial Portfolio* (AMACOM, 2002): "If an expense ratio is over 0.5 percent per year for a U.S. fund or 1.0 percent for a foreign fund, think twice."

- **Turnover rate.** The greater the buying and selling by a fund manager, the higher the fund's costs and the lower your returns. High turnover also creates capital gains and that spells T-A-X-E-S. Be cautious about any fund with a turnover rate over 20 percent a year.

T

Tube, Tipsters On

A Tulane University study looked at 20 years of data and concluded that someone who rushes out to buy every "hot" stock touted by financial pundits will do absolutely no better than someone who picks companies by reaching into a sombrero with a blindfold on. Yet advice about the next hot stock is everywhere. (Economists describe this omnipresent teasing as "investment pornography.") The pundits' calls sure do sound alluring. But c'mon. If these guys in fact ever knew what stock was going to fly, by the time you hear it, it's no longer news.

Bottom line: Trying to pick hot stocks is a loser's game. Stick with well-diversified, low-cost mutual funds.

Bank on this: The largest and most influential provider of business and investment advice in the world, Dow Jones & Company (publishers of *The Wall Street Journal*), lost a whopping $118,962,000 in 2000.

U

Uncle Sam

Think you're getting everything you should from Social Security? Maybe you are. Maybe you're not. "Usually the system works, but sometimes people do fall through the cracks," warns Ethel Zelenske of the National Organization of Social Security Claimants' Representatives in Washington, D.C.

One way to check: Spend 10 minutes with the Social Security Administration's Benefit Eligibility Screening Tool (BEST). This is not a formal application, but it can give you a pretty good idea where you stand. Or call the SSA hotline at 800-772-1213. Once you actually apply for benefits, you'll receive a written decision. If you're not satisfied, you have the right to appeal and the right to representation.

Bank on this: If you smoke, you probably know that quitting will boost your life expectancy. But you may not know that the IRS now allows you to write off the costs associated with quitting.

V

Volatility, Caution On

The more volatile an investment, typically the higher the returns. It's tempting to place your bets on the hottest stocks out there. But too much volatility and you risk everything. Remember, a hypothetical stock that gained 100 percent each year for nine straight years—and then lost 100 percent in the 10th year—is worth zero in the end. That's why the most wildly fluctuating investments—such as, say, pork belly and platinum future—are not the wisest choices for a retirement account.

W

Wizardry

You may think the magic of compound interest works only for the young. Not so. If you are now 60, have $150,000 saved, and stash that money into an account that earns 7 percent a year, you'll have $295,000 by age 70, $580,000 at age 80, and $1,142,000 at age 90. Should you live to 100, you'd have $2,246,000. (Calculations do not account for taxes or inflation.)

X

Xerography

It's critical to photocopy all your important financial documents and leave them where your heirs can find them. Good place: your top desk drawer. Bad place: the secret hideaway under the attic floor that only you know about. Keeping copies in easy-to-find locations is especially vital when it comes to beneficiary forms. "I've seen situations where financial institutions can't find the beneficiary forms, and there are no copies around the house. Then it's anybody's guess who inherits," says Bruce Wexler.

Y

Yodeling

Hey, if you can get a job doing it, find yourself a pair of lederhosen and shout it from the mountain. Effective January 1, 2000, the law changed to allow you to earn as much as you can, starting the month you reach full retirement age (from 65 to 67, depending on your birth date), without your Social Security benefits being reduced. So if you want to go back to work, your Social Security benefits will be yours to keep. (Prior to the year you reach full retirement age, if you've chosen to receive Social Security benefits, $1 will be deducted from each $2 you earn above $11,280 in 2002. In the year you reach full retirement age, $1 will be deducted from each $3 you earn above a different limit—$30,000 in 2002—only for the months before you reach full retirement age.)

Z

Zero-Coupon Bonds

Most have expiration dates of at least 20 to 30 years in the future. That makes them a poor investment for most individuals, says Frank Armstrong. "Zero-coupon" means that the bond doesn't pay dividends, so there's no stream of income. The only way you can get cash out of your investment is to sell the bond. That's especially tricky because long-term bonds—especially zero-coupon ones—are super-volatile, shooting up in value every time the interest rates drop and plummeting when they rise. To make matters worse, you need to pay taxes yearly on money you don't even collect. (Yes, even though you do not receive your interest payments in cash while you hold the bonds, you must cough up income taxes each year on the interest as if you had.) It all adds up to a bad deal, says Armstrong. "Why hold an investment vehicle that is more volatile than stocks,yet, over the long run gives you half the return?"