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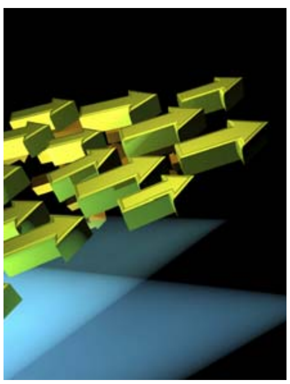
Three Bond Ideas To Protect Against Inflation

In this uncertain economy, rising inflation is a potential concern of investors. Given that rising rates normally hurt bonds, what should fixed-income investors do? Consider ways to orient your portfolio just in case the inflation bug bites again.

Notes and bonds of different varieties could help preserve your principal and even boost your income should inflation flare up and interest rates move higher. Treasury Inflation-Protected Securities (TIPS) and Series I savings bonds (I bonds) provide inflation protection, while step-up notes present a more complex set of tradeoffs. Here's what you need to know about them to consider whether they fit in with your portfolio and your long-term planning strategy.



TIPS notes or bonds are like other Treasury securities, giving you an interest payment every six months and a U.S. government guarantee to return your principal when the security matures. But with TIPS, the interest and redemption payments are tied to the inflation rate. When the Consumer Price Index (CPI) changes, so does the value of your principal, and at maturity, you get back the greater of the inflation-adjusted amount or the face value of the note or bond. Meanwhile, although these securities pay a fixed rate of interest, the amount of income you receive is based on the value of the principal. So, if inflation rises throughout the term, every interest payment will be greater than the last. (If the CPI drops, so do interest payments.)

TIPS aren't easy to sell on the secondary market, so you should be prepared to hold them to maturity. Moreover, if your principal is adjusted upward, you'll be taxed on the bonus amount. You'll owe the tax in the year the adjustment is made, even though you won't receive the extra money until the bond matures.

I bonds, like TIPS, come from Uncle Sam, and they're particularly easy to acquire; you can purchase I bonds online at www.TreasuryDirect.gov. With these securities, interest is added to the bond principal each month, and paid when you cash in the bond. You can hold an I bond for up to 30 years.

The total earnings rate for these bonds is a combination of two separate components. A fixed rate of return remains the same for the life of the bond. But there's also a semiannual inflation component that changes every six months. It's based on changes in the CPI for all urban consumers (CPI-U), and is added to the fixed rate to determine an I bond's total earnings rate during each six-month period.

I bond earnings are exempt from state and local income tax, and you

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You Should Find A New Home For An Orphan 401(k)

If you've "abandoned" a 401(k) account from a past employer, of course you can still get those funds. But if you continue to ignore the account once your mandatory distributions begin at age 70½, you could lose much of it to IRS penalties. Instead, make the most of this orphan 401(k) plan.

Consider consolidating all of your former employer accounts into a single IRA. A tax-free transfer to a traditional IRA will make your assets easier to manage, and should broaden investment choices and reduce fees. Also, distributions on inherited IRAs can be stretched over a beneficiary's lifetime, but 401(k) distributions can't.

Alternatively, you might think about converting old accounts to a Roth IRA. You'll pay income tax on the amount you transfer, but withdrawals during retirement won't be taxed, and your heirs could enjoy a lifetime of tax-free income from the account.

For now, there's a catch. You may convert to a Roth only during a year in which your adjusted gross income is $100,000 or less. But that ceiling disappears in 2010, and if you convert a 401(k) or traditional IRA to a Roth IRA that year, you can spread your tax on the conversion over two years.

Creating A Comfortable Financial Independence Plan

Everyone needs a financial blueprint for life after work. Operating without one is a little like closing your eyes as you barrel down the freeway. It's essential to know where you're going and how you expect to get there. But a financial independence plan will help you achieve your goals only if you incorporate it into your financial life, and that won't happen unless the plan feels comfortable. And that comes from understanding its component parts and how they're connected. Consider these elements:

Cash flow analysis. Your plan needs to project where your money will come from and where it will go during the rest of your life (and your spouse's life, too, if you're married). What will come in during retirement, from Social Security, a company pension, annuities, and from drawing down your savings? And how will that match the needs of the lifestyle you want? Several unpredictable variables complicate these calculations. Inflation affects how far your money goes, and investment returns, based in turn on economic and market cycles and your choices, determine how much you have to spend. Taxes will also play a role.

Investment choices. Three factors affect what should be in your investment portfolio. Your goals: What kind of return do you need, both while you're working and during retirement, to support your lifestyle? Your risk tolerance: How much volatility in portfolio returns are you willing to accept to meet your goals? Taking greater risks may provide higher potential long-term returns, but not if you panic and sell when the market takes a turn for the worse. And your time horizon: How long do you have to save for retirement, what is your tax bracket, and how many years do you need your savings to last?

Contingency plans. Job losses, expensive illnesses, or the unexpected death of you or your spouse could put your plan off track. There could also be unforeseen expenses involving your children or parents, and the need for nursing home care during retirement could quickly drain your savings. Having a cash cushion along with life, disability, and long-term care insurance can prepare you to handle potential setbacks. Not planning for lifestyle changes is a major mistake and will put your financial future in jeopardy.

Estate planning. This is crucial even if estate taxes aren't likely to be an issue. You need a will, periodically updated, and a letter of instruction that tells heirs where to find information about financial accounts, life insurance, safe deposit boxes, and the like. It's also important to designate beneficiaries for 401(k)s, IRAs, and other financial accounts that reflect your wishes and take into account potential tax liability.

It can be complicated to weave together all of these elements. But we have the tools, expertise, and experience to help you create a financial plan that feels comfortable. ●

Avoiding The IRA Rollover Crackdown

To avoid current tax and penalties on money transferred to an IRA from a 401(k) or other tax-qualified retirement plan, you must complete a rollover within 60 days. During the past few years, the IRS has granted waivers to that rule when extenuating circumstances delayed the transfer. But new tax rulings appear to reduce your chances of special dispensation.

Normally, a distribution from a tax-qualified, employer-sponsored retirement plan such as a 401(k) or 403(b) is considered income, taxable at ordinary income rates. Moreover, if you're not yet age 59½, you'll be assessed a 10% penalty on the distribution, unless a special exception applies. And finally, your employer will withhold 20% of the distribution and send the money to the IRS to help pay taxes you may owe.

You can sidestep all or most of those issues by transferring the funds to a traditional IRA within 60 days. You have two choices for doing this.

The preferred method is via a "trustee-to-trustee" transfer, where you arrange for your employer to transfer your existing retirement plan to a new rollover IRA that you've opened. Since you never touch the funds, it avoids the 20% tax withholding and the possibility of missing the 60-day deadline.

If you take a check from your employer and deposit the full amount of the distribution in an IRA within that 60-day window, you'll avoid a penalty, but your employer will still withhold that 20%. While you'll get that back when you file your taxes, you have to come up with the cash before then in order to deposit, as required, the full amount of the plan's pre-transfer value into your new IRA.

Managing Mandatory IRA Distributions

Individual retirement accounts and defined-contribution plans such as 401(k)s let you accumulate funds without paying taxes, but only up to a point. After you turn 70½, you must start withdrawals and pay taxes on the distributions. Fail to make required withdrawals, or take too little, and you'll be hit with steep penalties.

There's not much you can do to avoid paying the tax man, of course, and that's the goal of required minimum distributions, or RMDs—to generate taxable income. But the requirements are complex, and beyond making sure to follow the rules, you could consider strategies that may help postpone or reduce your liability.

The Internal Revenue Service requires you to begin RMDs from tax-deferred accounts by April 1 of the year after you turn 70½. That first distribution actually covers the previous year, and you must make a second withdrawal by December 31. You'll owe an "excess accumulation tax" of 50% on any part of your RMD you don't withdraw.

However, the new pension law enacted at the end of 2008 suspends the RMD rule for the 2009 tax year. You can choose to skip the required distribution normally due in 2009 if you've been taking RMDs or you turned 70½ in 2008. If you turned 70½ in 2008, you're still required to take an RMD for the 2008 tax year by April 1, 2009. Regular RMDs must resume in 2010.

To calculate your distribution, divide your IRA account balance by a figure from IRS Publication 590's life-expectancy tables. There are three: one for beneficiaries who inherit an IRA; another for IRA owners whose spouse is the account's sole beneficiary and is more than 10 years younger than the owner; and a third for other married or single owners. Using the third table, an unmarried, 72-year-old IRA owner would find a distribution period of 25.6 years. To calculate her RMD, she would divide her total account balance by that figure. So if the balance is $500,000, she would have to withdraw $19,531.25 the first year. Each subsequent year's required distribution would be calculated the same way, based on the current account balance and a new distribution figure from the table.

You're always free to take more than the required distribution, but extra withdrawals won't count against the following year's RMD. You will have a smaller account balance, though, and that will mean a smaller required distribution.

If you have multiple IRAs, you must calculate an RMD for each. But the total required withdrawal can come from a single account or from two or more IRAs. You may decide to exhaust a small account, or you could use the RMD to trim allocations that have grown too large.

Other possible strategies include:

Avoid distribution issues by converting your account to a Roth IRA. Roth IRAs don't require RMDs, because a Roth is funded with after-tax dollars, and money you do withdraw isn't taxed. A non-spouse who inherits Roth assets will have to take distributions, but those, too, will be tax-free. If you convert a traditional IRA to a Roth, you'll owe income tax on the amount you convert, but you'll avoid taxes on subsequent investment income. And you can continue to contribute to a Roth even during retirement. Through 2009, Roth conversions are restricted to those with an adjusted gross income (single or joint) of less than $100,000. But in 2010, that ceiling disappears.

Weigh the pros and cons of rolling over a 401(k) to an IRA. Employer-sponsored plans such as 401(k)s are subject to the same RMD rules that govern IRA distributions, and IRAs generally provide more flexibility. But there may be advantages to leaving money in a former company's plan or moving it to a new 401(k), and recent tax law changes leveled the playing field regarding inheritances from the two types of plan.

Split your IRA to ease the tax load on heirs. Non-spouses who inherit IRAs must begin RMDs within a year, with the amount based on their life expectancy (and other factors, including whether the original IRA owner died before or after starting RMDs). If you split a large account into multiple IRAs, and leave one to each child, younger children will be able to take out much smaller RMDs in the early years.

Trusts could help control the proceeds from your retirement account after your death, minimizing tax liability and ensuring your wishes are carried out. But choosing the right trust and structuring it properly can be challenging. We can work with your attorney and your accountant to help you craft your estate plan and manage IRA distributions in a way that fits your financial plan and makes the best use of retirement assets. ●

A 2002 tax law change allows the IRS to grant a waiver if you have a good reason for missing that 60-day deadline. If you can show the delay was the fault of the financial institution receiving the funds, for example, you're off the hook. But in less clear-cut cases, the IRS will decide based on the circumstances. And after being lenient about waivers for several years, the agency appears to have adopted a tougher stance. That's clear in two recent private rulings.

In the first, a widower received his deceased wife's interest in a 403(b) plan. After the plan administrator withheld tax, the husband failed to deposit the balance in an IRA within 60 days. He wrongly believed the withholding absolved his tax liability. The IRS turned down his request for a waiver.

The second ruling involved a retired IRA owner who wanted to transfer funds to an IRA with a provider closer to his new home. But the funds instead went to a non-IRA account, and the account owner failed to move the money into another IRA in time. Again, the IRS nixed the waiver request.

These rulings underscore the need for careful handling of retirement plan transfers. Please give us a call before you make any moves. ●

When Bad Times Force Plan Distributions

The economy is in a slump, the stock market is jittery, and gas prices are volatile. Those circumstances have left millions of Americans strapped for cash and wondering where to get funds in a hurry—say, to help pay for a medical emergency or some other unexpected trouble. And although it's hardly an ideal solution, one possibility is to take a hardship withdrawal from a 401(k) plan. As required by the Pension Protection Act of 2006, Uncle Sam has issued new regulations governing such distributions.

Normally, withdrawals from an employer-sponsored retirement plan can be made only when you leave a job, the plan is terminated, or you die or become disabled. But the law also allows hardship withdrawals, defined as distributions made because of an "immediate and heavy financial need." Even then, you're permitted to take only the amount you need—no pulling out an extra $25,000 for a vacation to Hawaii. And just because it's an emergency, the government isn't about to let you escape the tax hit that comes with early withdrawals from retirement plans. Your distribution will be taxed as ordinary income, and you'll also owe a 10% penalty if you're under age 59½ (unless you qualify for a special exception). So don't forget to take tax consequences into account.

Keeping all of that in mind, an employee is allowed to take a hardship withdrawal for any of these reasons:

- To pay medical expenses for the employee, spouse, or dependent
- To pay college tuition for the employee, spouse, or dependent
- To purchase a principal residence for the employee
- To repair accidental damage to the employee's principal residence
- To make a payment to avoid eviction or foreclosure on the employee's principal residence
- To pay burial or funeral expenses for the employee's parent, spouse, or dependent

Under the new regulations, the rules for hardship withdrawals have been expanded to allow the employee to take a distribution for that worker's "primary beneficiaries" under the plan. For this purpose, a primary beneficiary is any person named as a plan beneficiary who has an unconditional right to at least part of the account balance if the plan participant dies.

While this change gives plan participants more flexibility over withdrawals, it's never a good idea to use retirement savings for any other purpose, and this option should be considered only as a last resort. A better option, though also a last resort, is to take out a loan from your 401(k) plan. While you'll miss out on investment opportunities during the time of your loan, the damage to your retirement savings will be contained, since you'll have to pay back your retirement plan with interest. ●

Three Bond Ideas

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can defer federal taxes until redemption. Moreover, you may be able to exclude all or part of I bond interest that goes to pay for tuition and fees at eligible colleges. You must hold I bonds for at least six months, and you'll pay a penalty of three months' interest on bonds you redeem within five years of the issue date.

"Step-up" bonds pay one coupon rate for an initial period and are followed by a higher coupon rate. In other words, the coupon steps up. Your return on a step-up bond isn't directly linked to the inflation rate, but this bond does come with an above-market coupon rate that rises according to a predetermined schedule over the life of the bond. That could help you keep pace if inflation and interest rates move higher.

There are several potential advantages. A step-up bond's yield to the first possible call date is higher than those of other short-term instruments. If interest rates rise, the bond may not be called, providing you with steadily-increasing income.

However, step-ups have some risks to keep in mind. The call feature means you won't know when you'll get your principal. If interest rates increase more quickly than the bond coupon, you'll likely have to hold the bond until maturity while its value decreases. Also, step-ups are sometimes issued by companies betting interest rates will fall. Then, an issuer can refinance at lower rates. Your bond is likely to be called if rates fall, leaving you to buy lower yielding bonds with the proceeds. Moreover, if rates drop and you try to sell, the call feature will limit appreciation in the bond's price.

Finally, while step-ups are issued by high-quality corporations and agencies and are the most liquid of all structured notes, they are also issued by companies with lower ratings and higher credit risk, with their higher rate compensating an investor for added risk.

These complex arrangements are not for everyone, but may be considered by investors if interest rates seemed poised for a jump. ●

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