financial focus

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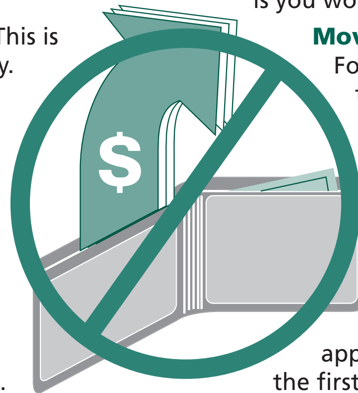
DO MORE IN 2004

by William D. Starnes, CFP®

A reporter recently contacted me to ask what people can do in 2004 to move closer to financial security. I decided to focus on three things everyone should strongly consider, and will share my thoughts with you in this quarter's article.

Hide the Money

No, I'm not talking about your mattress. I'm talking about putting money (that is not needed for immediate spending) in vehicles that feel less "spendable." This is called creating an environment of artificial scarcity.



But don't hide the money you need to operate on a month-to-month basis. For most of you this should be about 10%-20% of your income and should be in cash equivalents that are easily accessible. However, your emergency cash should be less accessible. I love Series EE and Inflation-indexed government bonds for emergency cash because of the unique combination of yield, tax benefits, safety, and the fact that the cash feels "hidden." They are a very good way to ensure that the funds are only used for true emergencies.

It's easy to "hide the money" using payroll deductions for retirement accounts, EE bonds, and medical savings accounts, but it is far more difficult to "hide the money" that is provided in your net pay. Let's face it, net pay that is deposited into a checking account gets spent unless you have put a system in place to ensure money gets saved.

The best method I have come across to hide "net pay" is to deposit it into a separate bank account (other than your checking account). Call this separate account your "income account." Then, once each month you transfer an amount from the income account into your "spending account" (i.e., checking account). But the amount you transfer from the income account into the spending account must be ***less than*** the total monthly deposits into the income account. The income account will then build up cash over time (or you can set up automatic deductions from the income account to an investment account).

By doing this you have essentially cut your spendable income. Cutting your income is the easiest way to cut your spending. For example, let's say your boss told you your pay would be cut by 5%, what would you do? My guess is you would adjust by cutting your spending.

Moving On Up

For most people, buying the right house is one of the best investments they can make. I am talking here about an investment in the traditional sense of the word as well as an investment in the quality of our lives. Let's talk about the home's investment value.

First, a home provides long-term leverage. Using an oversimplified example, let's say you buy a house worth $200,000 and put $40,000 down. If the house then appreciates at 4% a year, it will increase $8,000 in the first year. That appreciation represents a 20% (tax-free) return on your $40,000 investment. This type of return is hard to come by especially when you consider the low risk of home ownership.

Second, it provides on-going tax benefits which make the home less expensive than it appears. This is because the government subsidizes the purchase, ownership, and sale of homes. Continuing with our example of a $200,000 home, the monthly mortgage payment on the financed amount of $160,000 would be $959 (using a 30 year fixed rate mortgage at 6%). Perhaps you are currently paying $700 per month in rent and don't feel that you could afford the extra $259. Well, because the mortgage payments in the first year are made up almost entirely of interest, they are almost fully deductible. If you are in the 30% marginal (federal and state) tax bracket the net payment (after tax savings) will be only $671. Better yet, in future years, the payment will stay the same, while rent would rise with inflation and local market changes (for example, gentrification).

Third, a mortgage provides interest rate protection. When you have a mortgage, you have more cash than you would have if you paid off the mortgage. If interest rates increase, the yield on the cash increases, the home appreciates, but your mortgage payments remain the same.

Finally, the realized gains are tax-free (subject to certain limitations). So, if you were to own the $200,000 home for 10 years and it appreciates at 4% each year, it will be worth $296,000 at the end of ten years. If you sell it, you keep the

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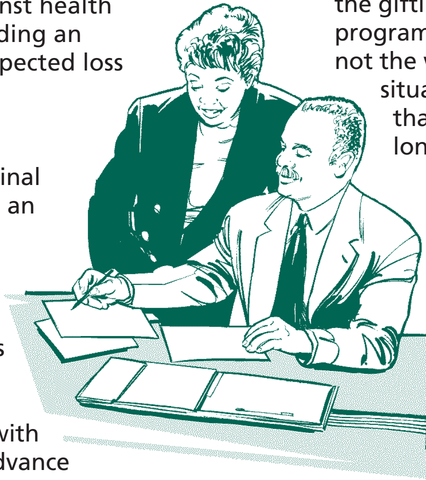
FINANCIAL PLANNING FOR LIFE'S SURPRISES

by Karen Folk, Ph.D., CFP®

Life's full of financial surprises – many unexpected and many that we can see coming a bit ahead of the full impact.

Many people prepare for life's unexpected financial surprises by purchasing insurance against health care costs or auto accidents, or by funding an emergency bank account for the unexpected loss of a job. Yet people frequently fail to anticipate and prepare for financial "surprises" they can see coming: an impending marriage or divorce, a terminal illness, the birth or adoption of a child, an inheritance, a career change.



Many of these events represent major transitions in one's life, and life transitions are the main reasons that propel people into a financial planner's office. Unfortunately, they often seek advice after the event has occurred. These transitions almost always come with discernable financial consequences. Advance planning can lessen the financial impact, but after the event, many planning options may already be lost.

A story recounted in the October 2003 issue of the Journal of Financial Planning illustrates the benefits of planning for life's surprises. During an annual meeting with her financial planner, a 72-year-old woman talked about wanting to move into a continuing-care facility someday, even though she was currently healthy and living in her home. This was a life transition she and her planner could foresee.

But she further revealed that she was gifting large sums of money to her daughter. Her two sons were worried that she might not have enough money to pay for the care she wanted. The planner persuaded her to begin visiting and pricing facilities, and she quickly realized that she would not be able to afford the care she wanted if she continued the gifting. With the help of her planner, she started a program to reduce and end the gifts within five years. Had not the woman, her sons and the planner anticipated this situation, she might have been "surprised" to discover that she didn't have enough money to move into a long-term care facility.

Another example is retirement planning. Most people are aware of this inevitable transition and are taking steps to prepare for it. Many have an age or an idea about when they will retire. But what if you need to retire earlier than planned due to poor health? According to the National Council on Aging, 40 percent of retirees blamed declining health as the major factor in their decision to retire sooner than planned. [July 2003 Observer] While health problems can appear unexpectedly, often they give advance warning. Being aware of this and planning for it can help you through this "surprise" transition of forced retirement.

Life is full of similar "surprises" that result in transitions people can see coming. Divorce, for example, causes numerous financial repercussions. Coming to a financial planner for advice after the divorce means numerous planning options are permanently lost – a common example is taking the house when you really can't afford the mortgage payments on your new level of income.

Consider conducting an annual review of the potential changes and transitions in your life, and how intelligent planning can help you meet and conquer the challenges.

(More in 2004, continued from page 1)

$100,000 of gain (less transfer tax and sales commissions). With other capital investments you would lose $15,000 in capital gains taxes.

Your home is also an investment in the quality of your life. It is the only investment you can really enjoy: you can cozy up to your fireplace, but not to your IRA. We also come to identify our home over time with our families, providing a strong emotional tie. Finally, homes in better school districts provide better educations for our children.

So, in 2004, if you don't own a home, you should seriously consider buying one. I feel strongly that buying your first house is so critical to your financial future that you just need to do it. Also, if you already own a home, you should evaluate the benefits of trading up to a more expensive home (which traditionally appreciates even more).

Melt The Plastic

For a minimum of three months remove every credit card from your wallet including ATM, gas, and department store cards. The only thing they do is make it easier for you to ignore prices and buy things you don't need and possibly can't afford.

By removing these convenient spending methods, you will draw your awareness to your spending by making each purchase a conscious event. Taken further I would even say that you want to make spending as inconvenient as possible. Paying cash will help you do this.

Once you have removed all other forms of spending, you take out a fixed cash allowance each month (for you and your spouse). Now you will only spend if you have the cash in your wallet. Think for a moment how previously unconscious spending decisions turn into conscious decisions. For example, you are at work and your co-workers are going to your favorite restaurant for lunch (very tempting indeed!). You are in your fourth week of your allowance and only have $20 left in your wallet. Yes, you can spend the $20 at lunch, but you will then have an empty wallet for the rest of the week. The decision is yours . . . but now you are ***making a decision***. Voila, conscious spending.

FUNCTIONAL ASSET ALLOCATION: INTEREST-EARNING ASSETS

by Rob Reed, Ph.D., CFP®

Interest-earning assets preserve your money and protect you from deflation (falling interest rates). Yield (how much these assets earn) is secondary to safety. This is the part of your portfolio that lets you feel safe at night. (Perhaps that is why advisors call it your financial cushion.) You run to this money first in case of need and that rationale dictates its division into Cash, Emergency Funds, or Bonds.

Cash is kept in checking, savings, money markets accounts, or CDs maturing within 18 months. This money is for regular expenses and small emergencies. Determining the amount for your Cash account depends on your income reliability and planned cash needs. People with steady wage-earning jobs need a smaller percentage of their annual income as a cash cushion than – in order of need – the self-employed/ commission earners, the retired, and the unemployed. You then increase your Cash account by adding in unusual spending planned for the next few years, such as special vacations or a car purchase.

Emergency Funds are money put aside for true emergencies: a significant interruption in income or large unforeseen expenses. Usually emergencies lower your tax bracket because less money is coming into your household. This "tax fact" determines how you hold your emergency funds. Preferred vehicles impose a penalty if you access your money, but since your income is reduced during emergencies the penalty is less burdensome. For example, if you are at a 25% tax rate and lose your job, your tax rate easily falls to 10% or lower. If you withdraw money from an IRA, it will be taxed as income (10% because your rate fell) plus incur a 10% penalty. In sum, you would pay 20% to get those emergency funds (5% less tax than when you were working). But during non-emergencies (the vast majority of the time, hopefully!) your emergency fund grows tax-deferred. Many clients use retirement savings held in money market funds or short-term bonds for their Emergency Funds. If you use taxable money, U.S. Savings Bonds are an excellent choice.

Bonds are the final portion of your interest-earning assets. This portion of the allocation continues the theme of safety but here the protection is from stock market volatility and ourselves. Bonds in a functional portfolio are invested in vehicles with longer maturities than we use for Cash and Emergency Funds. Yet we still want to protect your money and have protection against deflation.

Given these requirements, "stripped" U.S. Treasuries held in tax-deferred accounts are a great choice. U.S. Treasury bonds are the safest investment in the world. Usually Treasury bonds pay interest semi-annually. If you buy a 7 year $10,000 Treasury at 5%, then every six months the government will send you $250 until after 7 years it returns your $10,000. Buy the same bond 'stripped' of its payments (that is, you get nothing every six months) and the government will sell it for only $7,106.81 (instead of $10,000) to make up for your loss of semi-annual payments.

"Strips" should be held in a tax-deferred account because although the government does not pay you interest, they tax you each year as if they did (go figure). This creates a bookkeeping mess, so it is better to use a tax-deferred account to avoid the problem.

By laddering strips (buying one bond maturing in one year, another maturing in two years, another in three, and so on) you can create a guaranteed cash flow for years to come. Each year a strip matures you have two options. If you need it (because the stock market is down, for example), the money is there. If you don't need the money (because the stock market is up and you can pull out profit), you can buy additional bonds. Because strips are sold at a discount, money from a maturing bond is often enough to buy two bonds at the far end of the ladder. Given years of income security locked into the safest investment on the planet, we can feel more comfortable confronting stock market gyrations and not sell in a panic.

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ASK an Advisor

DO YOU HAVE ANY TIPS FOR SAVING MONEY WHEN BUYING AND SELLING CARS?

by Ed Fulbright, CPA/PFS

Consumers pay thousands more than they need to when selling and buying cars because they don't understand how the system works and they don't do their homework. These tips will help you make the most of your automobile transactions.

How Car Dealers Make Money on You

1. The selling price of the car. Dealers that sell you the car at MSRP will make a fair amount of profit.
2. The profit on the trade-in. They give you $3,000 to $4,000 on your trade-in then sell the car for higher than market value.
3. High-priced extras. In the end, the business office is where they make most of their money. They'll sell you a $1500 or $2000 warranty that cost them $400, or a $100 VIN etching that cost them $15.

Why You Lose 25% or More of the Price of a New Car When You Drive It Off the Lot

1. The price you negotiated is too high.
2. New car depreciation.

Most people don't understand car depreciation – the decline in the car's value over its useful life. When you pay $20,000 for a new Toyota Camry you are paying the retail price – what a dealer sells it for. As soon as the new car is driven off the lot, its value decreases to its wholesale value - what another dealer would pay for it, which is significantly less. That's new car depreciation. It's why if you wreck that new car a block or two away from the dealership, your insurance company won't give you $20,000. Plus, whatever you have paid in taxes and registration is gone forever.

How to Buy a New Car and Avoid the Scams

1. Always remember that you, the customer, are in the position of power and can leave at any time. If you cannot negotiate a fair price with the dealer, don't be afraid to walk out.
2. Shop around for financing. In the last few years financing has become available online from sites like www.lendingtree.com , www.eloan.com , www.peoplefirst.com in addition to banks and credit unions. We were trained to think that if we buy a car at the dealership, we should finance it at the dealership, but that is no longer true.
3. Know the top ten car buying scams (you can learn about these at www.carbuyingtips.com). Most scams are pulled on people with bad credit, so know your credit score before you go to a dealer. Check your credit file and verify that a dealer cannot take advantage of any negative information. Once you are rejected at a couple of places, by the time you get to that third place, they will tell you all sorts of things, like the bank requires that you buy a warranty, get gap insurance, or get VIN etching in order to get the loan.
4. When you walk into a dealership, carry a folder with research that you have done.

What Type of Buyer Are You? A "Car Payment" Buyer or "Trade–In Value" Buyer?

If you are either of these buyers, you are in trouble. If you only care about the payment and a dealer offers you payments of $299 per month, you don't know what generated that number. Maybe you should pay only $229 per month. If you are a trade-in buyer, and focused only on what you will get for your old car, you won't notice what the dealership will do on the back end of the deal. They may charge you MSRP for the new car, sell you a warranty and VIN etching and a couple of other things.

How to Avoid Buying a Used Car Lemon

1. Have a mechanic put it up on a lift and look at it. They can tell you quickly if the car has been in an accident.
2. Get the carfax report from www.carfax.com which gives a history of the car title.

Get the Best Price When Selling Your Car

1. If you have an extended warranty, it is transferable to the buyer and makes your car slightly more valuable.
2. Keep maintenance records.
3. Run the carfax report on it and show it to the buyer.

Seven Tips to Remember

1. Buy the car you can afford.
2. Visit the important websites below.
3. Check and understand your credit report.
4. Know the car dealer cost and negotiate up from there.
5. Don't be afraid to walk out. Some of the best deals happen as the customer is walking away.
6. Make sure you have "The Folder" with your research in your hand.
7. Call your Cambridge Advisor, if you need help.

Important Websites You Must Visit Before Buying a Car

Best Price	Trade-In Value	Warranties
www.edmunds.com	www.edmunds.com	
www.carsdirect.com	www.kbb.com	www.onesourceautowarranty.com
www.invoicedealers.com	www.autoweb.com	www.warrantydirect.com
www.fightingchance.com	www.autotrader.com	

Ed is the host of Mastering Your Money, a syndicated radio show (www.masteringyourmoney.com). These tips are taken from his interview with Jeff Ostroff, known nationally for his website www.carbuyingtips.com, which has helped consumers save over 4 million dollars when purchasing their vehicles. To listen to this interview, visit the Audio Interviews section of www.cambridgeadvisors.com.