You’ve worked hard all of your life. Now most of that work is behind you, and you’re going to retire. This should be a time of celebration and of making plans to really enjoy life, right?

So why are you so nervous?

Probably because a host of decisions accompany retirement, and you don’t want to blow it!

For those of you who are lucky enough to work for companies that still offer pension plans, you’ll typically have the option to take a lump sum or to take an annuity. The lump sum is generally directly transferred into a traditional IRA (a “direct rollover”). If you choose to take your pension as an annuity, you’ll receive an annual stream of income.

To make the “right” choice of which distribution option to take, consider the following:

DO...

Weigh your payout options. Typically, a plan will offer a payment for the duration of your life only, or a payout for you and someone else (generally your spouse). If you are planning for retirement as a couple, you need to think through what will happen when one of you dies. Frequently, neither spouse will want a drop in the amount of money coming in each month in the event of the death of the other. If this applies to you, the 100% joint-and-survivor pension may be the best choice. Under that option, the surviving spouse will receive 100% of what had been coming in after one spouse dies. If you choose a 50% joint-and-survivor pension, your spouse would get only 50% of what you had been receiving.

Consider how much flexibility you might need with your money. Consider how much flexibility you might need with your money. If you don’t expect to buy many big-ticket items in retirement, an annuity may meet your needs by providing a steady paycheck every month. However, annuities don’t typically offer much flexibility, so if you know you’ll need access to larger amounts of money from time to time, you may be better off taking a lump sum and rolling it into an IRA. Ideally, if you take an annuity, you’ll also have another pool of money you can tap if you need more than your regular check provides.

DON’T...

Do what all your friends are doing without thinking through the consequences. At the end of the 1990s, a lot of retirees chose a lump sum from their pension plan instead of an annuity—often because that’s what their friends were doing. After three rough years in the stock market, many of those people experienced significant losses investing their lump sums, and some have even had to go back to work.

Know how much of your pension the PBGC (Pension Benefit Guaranty Corporation) covers. You may have some safety net when you choose an annuity over a lump sum. The PBGC—essentially a government-run insurance company covering pension plans—may cover all or a portion of your annuity if your company goes belly-up. You can check how much of your pension may be covered at the PBGC Web site at www.pbgc.gov. The maximum paid for an annuity over your life only (a “single life annuity”) is $49,500 currently. This amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary.

Consider taking an annuity if longevity runs in your family. When the actuaries figure out how much you’d get in a lump sum, they use average life-expectancy tables. If people in your family live to ripe old ages, you might be better off taking an annuity that will last as long as you do! That way, you know you’ll never run out of money.

Watch interest rates. As interest rates rise, your lump-sum benefit may go down. (And if they fall, it could go up.) That’s because one of the numbers used to calculate your benefit is an interest-rate factor. When you begin looking at retirement, be sure to understand how your lump-sum benefit might change given differing interest-rate scenarios.
Mess up paying your taxes. Paying taxes was simple when you were working, because your employer deducted what you owed directly from your paycheck. When you retire, you take over responsibility for arranging tax payments. Fortunately, most companies will withhold tax from your pension check if you ask. In some cases, you’ll also need to pay estimated tax each quarter. You can find out more about estimated tax by visiting the IRS Web site.

Take a single-life annuity if longevity doesn’t run in your family. A single-life annuity pays only as long as you’re alive. If your family members tend to live shorter lives, your heirs may be better off with a lump-sum rollover. Or you can always choose a joint-and-survivor annuity that keeps paying your heirs after you are gone.

Forget that an annuity probably won’t keep up with inflation. It’s easy to forget the dangers of inflation since we’ve experienced relatively low rates recently. But that won’t last forever. When inflation does rear its ugly head, an annuity probably won’t keep pace. That’s why it’s best to keep a separate pool of money that can be invested as a hedge against inflation. If you have an option to choose an annuity that grows with inflation, you should strongly consider taking it even if your benefit starts off being somewhat less.

This article is provided to you compliments of your library and Morningstar. A version of this article appeared on Morningstar’s Web site on Aug. 3, 2006.
Dear Sue,

I’m 66 and have retired. Like many retirees today, I work part-time (teaching and consulting). I have found little written about strategies relating to retirement withdrawals from a mix of sources, including Social Security, defined-benefit programs, and tax-sheltered investments. How does one value a pension in calculating future retirement needs? Or Social Security payments? How would such a valuation relate to one’s need for additional investments?

For example, I assume that my Social Security and defined-benefit programs represent a conservative core of retirement income. Thus, I see no need for investments in fixed income/bonds. Since Social Security and defined-benefit payments represent 90% of income in our retirement budget, I have pursued fairly aggressive investments in tax-sheltered programs (i.e., 100% in a diversified portfolio of mutual funds). How do other retirees conceptualize and handle this issue in estimating their investment needs for retirement?

In addition, what are the patterns among current retirees regarding the required minimum distributions to be taken at age 70 1/2? Are retirees spending the funds, reinvesting distributions into other instruments (e.g. Roth or traditional IRAs), or transferring the withdrawals to others?

Finally, how do retirees typically handle health-care insurance in retirement? And, specifically, what are they doing to cover the younger spouse—when the older spouse is or could be covered by Medicare? In the case of my wife and myself, I have Medicare but have to remain on my former employer’s health-care policy because my wife was on that policy prior to my retirement—and cannot be covered as a single. The joint cost for us is more than $10,000 annually ($1,500 deductible). How do other retirees address this issue until the younger spouse reaches 65 and Medicare?

—Ken

These are important and very relevant observations and questions, and you’ve covered a lot of ground. I’ll give you my take on the issues you’ve raised. In my private financial advisory practice, about one third of my clients are retired and many more are about to retire. So I talk about and think about these issues all the time.

Phasing into Retirement

I’m seeing more and more individuals who are opting to work part-time while transitioning into retirement. Sometimes it’s planned and sometimes it’s not. My clients who have continued to work part-time even though they’re of retirement age seem happy and more comfortable transitioning to other interests in life. Plus, they seem very pleased with themselves for earning a little extra “pocket money.” And let me say this—most of my clients tell me they are even busier than they were in their primary working years. They find all kinds of fascinating ways to spend their time, whether that be rewarding work or personal pursuits.

Sequence of Withdrawals

The issue of how to sequence your withdrawals in retirement is a particularly important one. It almost always involves careful tax planning. It’s not uncommon for retirees to have many different streams of income (pensions, Social Security, nonqualified distributions, etc.) and pools of assets (taxable accounts, retirement accounts, etc.).

Here are some guidelines for sequencing withdrawals:

► Set up a cash pool that will cover 2-5 years’ worth of expenses. Take your regular distributions from this pool and periodically fill it up.
► As a general rule, make withdrawals from taxable assets before tax-deferred assets. If you have a particularly large IRA, there may be exceptions.
If you’re in your late 50s and must tap a retirement account, take distributions from your company retirement plan instead of your IRA.

At retirement, consider taking out company stock held in a retirement plan (not rolling it over) to potentially convert ordinary income tax to capital gains tax.

Use substantially equal periodic payments from IRAs to avoid the 10% early withdrawal penalty.

Tap your Roth IRA last.

I’d add a couple more caveats to that list:

If you are still working, delay starting Social Security payments.

If you are under age 59 1/2 when you retire, consider taking out any aftertax contributions before you roll over a company retirement plan to an IRA. You can use those aftertax dollars to spend currently. (Technically, you can also pull out your aftertax or nondeductible contributions from an IRA without penalty, but you may find it simpler to just take the aftertax dollars as you are leaving your employer.)

The issue of when to start taking pension payments may be particularly complex. You will usually have a variety of options—taking payments over the course of your life or over the course of your life and your spouse’s, choosing a guaranteed period of payments, deciding how much a spouse would get in the event of your death, etc.

I find the best way to figure out how all of these pieces fit together optimally is to use some type of retirement calculator. I like the ones that allow you to see cash flows and compare bottom lines. Then you can run varying scenarios and compare the results. (You may also want to hire a qualified advisor to help you with these complicated decisions.)

Valuing Streams of Income

Because pensions and Social Security provide periodic payments, some people like to value them like the coupon payments of a bond. Here’s the technical way to do that: Get any calculator with present value functions and enter the following:

Your monthly payment is “PMT” (on the calculator)

The number of months you expect to receive these payments is “N” (make sure you convert years to months).

The growth rate you expect to apply to these payments is “I”.

Then you hit the “PV” button to find the present value.

One word of caution: sometimes valuing streams of income like this can lead to the conclusion of placing much of the remaining investable portfolio in stocks. That may or may not be the “right” answer. If you can truly tolerate watching your nest egg go through quite volatile periods without selling at a low point, then perhaps this is the right answer for you.

On the other hand, there may be behavioral issues that cloud a strictly numeric exercise. If you think you’d be uncomfortable with that much of your portfolio at risk in the stock market, you might find a more balanced mix of stocks and bonds is better for you, even if the trade-off might mean lower overall returns.

There’s also an argument for not taking more risk than you need to. Some retirees prefer to use their streams of income as a base and find the right mix of assets that will allow them to spend what they choose over their retirement lifetimes. Their preference is to only take as much risk as they need to and be content with more conservatively invested assets that they won’t need to worry about.

Use of Required Minimum Distributions

Most of the retirees I work with use their required minimum distributions (RMDs) to fill up the cash pool in their taxable accounts periodically. Most take these distributions once a year. As long as you are still working, you could contribute up to $5,000 to a Roth IRA in 2007. (You can’t contribute to a traditional IRA once you’re over age 50.)

Retiree Health Insurance

Covering health-care costs is frequently a major sticking point in planning a happy, successful retirement. Health insurance (or the lack of it) should be incorporated into your overall cash-flow plan. As more companies drop retiree health-care benefits, I’ve seen people scramble to try to get something in place and figure out how to pay for it.
I usually figure private health insurance will cost about $10,000 to $12,000 a year per couple until you are eligible for Medicare. That number can go much higher depending on your health status. (I just ran one projection where the cost was $30,000 a year for a couple with significant health concerns.)

The key to managing your future health-care bills is planning ahead. If you don’t know what health-care benefits your company provides to retirees, make a point of finding out. Even if your company will cover your health insurance until Medicare starts, you may want to think about a “backup” plan should your company decide to cancel that plan by the time you need it. Run your retirement projections with and without that expense to see what difference it may make as far as how long you’d need to work, how much more you’d need to save, etc.
No matter what age you are now, you probably think about Social Security benefits as they relate to your retirement planning. If you are younger, you may choose to run retirement projections with reduced or no benefits. For those of you who are middle-age to retirement-age, Social Security will probably be a piece of your retirement picture.

Lots of questions arise about Social Security as individuals go through many of life’s changes including divorce, phasing into retirement, or dealing with the death of a spouse. Use these tips and traps to educate yourself about your options.

**Tips**

- When you get your annual estimate of Social Security benefits, check to make sure your earnings history is accurate. Everyone age 25 and older should be receiving an annual statement. If you suspect something is wrong, contact your local Social Security office to correct any inaccuracies.
- If both spouses work, each is entitled to a benefit based on his or her own earnings history. However, the spouse with lower benefits is entitled to the greater of 50% of his or her spouse’s benefit or his or her own benefit.
- If you did an analysis showing that taking lower benefits at age 62 broke even with waiting to take higher benefits at age 65, that break-even age would be approximately 78. So, if you think you’ll live past age 78, you may want to wait until full retirement age to start taking benefits. Of course, no one knows just how long they’ll live, so look at your family health history and your own health situation to make a realistic guess.
- You can choose direct deposits at your bank for your Social Security benefits and never have to worry about a check getting lost in the mail.
- If your spouse has a pension from his or her former employer that will pay over his or her life only, delay taking Social Security so you’ll get the maximum benefit for your own lifetime.
- If you are divorced and your ex-spouse has remarried, both you and the new spouse can collect benefits based on the ex-spouse’s earnings history provided you were married at least 10 years and you apply for benefits after age 62.
- If you are still working late in life, delay taking benefits until age 70. Social Security will pay a premium above the full benefit if you wait until age 70 to take benefits. If you are a widow or widower, you can start taking Social Security benefits as early as age 60. But you may want to consider starting them later so that you’ll get a larger benefit.

**Traps**

- Even though Medicare starts at age 65 (assuming you’re eligible), full Social Security benefits start later for those people born after 1938.
- If you choose to wait to take benefits until after age 65, don’t forget to apply for Medicare about three months before you turn age 65.
- Not everyone is eligible for Social Security benefits. You need to have 40 credits. You can earn four credits a year, so basically you have to have your own earnings history for 10 years, although it doesn’t have to be consecutive years.
- If your income is more than $25,000 single (or $32,000 married filing jointly) and you’re receiving Social Security benefits, you’ll pay income tax on 50% of your Social Security benefits. However, if your income is more than $34,000 (single) or $44,000 (married filing jointly), you may have to pay income tax on 85% of your benefit. See IRS Publication 915 for more on how to calculate the tax on your benefits.
- If you take Social Security early at age 62, you’ll not only limit your own benefit, but those of your spouse, too (assuming both of you are eligible using one spouse’s earnings history).
- If you are working, are younger than full retirement age, are earning more than $12,960 (2007), and are taking Social Security benefits, you’ll actually lose $1 for every $2 you earn above $12,960. In the year when you reach your full retirement age, you’ll lose $1 for
every $3 you earn above $34,440 (2007). At full retirement age, you can work and not lose any of your benefits (although if you keep working to age 70, you’ll get even higher benefits).

- If you are divorced and receiving benefits based on your ex-spouse's earnings history, your benefits stop if you remarry.

- If you go to prison, your benefits stop (although your dependents can collect their benefits).

- You can continue to collect Social Security benefits even if you retire abroad unless you live in Cuba or North Korea. You may also not be able to receive benefits if you are in Cambodia, Vietnam, or countries from the former Soviet Union (although some exceptions may apply).

Social Security was never intended to cover all of your retirement needs. But it can play an important role in your retirement income, and it’s to your benefit to understand the rules.

This article is provided to you compliments of your library and Morningstar. A version of this article appeared on Morningstar's Web site on Oct. 18, 2006.
A sure rite of passage into retirement occurs when you must begin taking money out of your retirement plans. If you have a traditional IRA or company retirement plan, the “magic age” is 70. If you have a Roth IRA and you didn’t inherit it, you’re off the hook—there are no required minimum distributions (RMDs).

If you’ve inherited an IRA, you’ll have to take required minimum distributions, too (even for Roth IRAs). These rules are tricky, so make sure you leave enough time to figure out what you’re supposed to do before year end.

Certainly, you can always take more than the minimum, but don’t try to take less. If you don’t handle your RMDs properly, you’ll get stuck with a 50% penalty for what you should have taken but didn’t, as well as ordinary income tax on your distribution. So be careful!

Lifetime Distributions
When you’re ready to calculate your RMD, you’ll use one of three tables, all of which appear in IRS Publication 590:

- **Uniform Lifetime Table**: Most people will use this table. The exceptions are: 1) spouses who are sole beneficiaries and who are more than 10 years younger than the IRA owner, and 2) beneficiaries.

- **Joint Life Table**: You will use this table if you have a spouse who is the sole beneficiary and who is more than 10 years younger than you are.

- **Single Life Table**: For beneficiaries.

Let’s start with the most common situation. You’re about to turn age 70 and you need to start taking distributions. Everybody—except those folks with spouses more than 10 years younger—will use the Uniform Lifetime Table. You look up your age and find your factor. Then you take the balance of your retirement accounts as of Dec. 31 of the prior year and divide by your factor.

For example, according to the Uniform Lifetime Table, the factor for age 70 is 27.4. So, for your first RMD, you would take your retirement plan balance as of Dec. 31, 2006, and divide by 27.4 to get your minimum required distribution.

You must start taking distributions by April 1 of the calendar year following the year when you turn age 70. For example, if you turned 70 on May 1, 2006, you’ll be 70 on Nov. 1, 2006. So you’d be required to take your first distribution by April 1, 2007. You’d have to take your second distribution by Dec. 31, 2007. So in this situation you’d be taking two distributions in one year.

If you are married to someone more than 10 years younger than you are, and your spouse is your sole beneficiary, you should use the Joint Life Table. For example, if you are age 72 and your spouse is 56, your joint life expectancy factor would be 30.0, so you’d divide the prior year’s retirement balance by 30.

Whether you use the Uniform Lifetime Table or the Joint Life Table, you go back to the table each year to look up a new factor.

When you take your required minimum distribution, you are taxed at ordinary income rates for tax purposes. If you fail to take your minimum distribution, you are penalized at 50% of what you should have taken but didn’t. That’s on top of paying ordinary income tax on the distribution.

There are a couple of exceptions to the general rule for lifetime distributions:

- If you are still working and participating in a company retirement plan, you can delay taking required minimum distributions from the company plan until you actually retire. This does not generally apply to self-employed individuals. If you have an IRA in addition to your company retirement plan, you must start taking distributions from the IRA at 70 1/2 even if you are allowed to delay distributions from your company retirement plan.
If you participated in a 403(b) plan before 1987, you may be able to delay distributions on that part of your plan until age 75.

Inherited Retirement Plans
So far, so good. Now we get to the hard stuff—which set of rules to follow if you inherit a retirement plan. There are different rules that are dependent on whether the owner died before or after beginning minimum distributions. There are also different rules for spouses and non-spouses.

Inherited Retirement Plans: Final Beneficiary
Before we get into the nitty gritty of handling distributions from inherited retirement plans, let’s deal with the concept of “final beneficiary.” You may be wondering, isn’t the final beneficiary the person you name in your will or estate plan? Yes, but it’s not that simple. Just as you’d expect, you must name your beneficiaries while you are alive; no one can add or change your beneficiaries after you’re gone.

But unlike under the older rules, you can change your mind about your beneficiaries right up until the day you die. Moreover, it’s possible for your beneficiary to change after you’ve died. Say, for example, you name your spouse as primary beneficiary and your daughter as secondary beneficiary. If your wife chooses to, she could disclaim her interest in the retirement plan, and it would pass to the secondary beneficiary. Your daughter would be the final beneficiary.

The new rules specify that the final beneficiary is determined by Sept. 30 of the year following the owner’s death. In our example above, your daughter would be the final beneficiary if your wife disclaimed her interest in the retirement plan by September 30 of the year following your death.

Next, let’s outline different scenarios based on whether the owner had begun taking minimum distributions or not and who is the beneficiary.

Inherited Retirement Plans: Owner Dies Before Starting Required Minimum Distributions

Spouse Is Sole Beneficiary
When the spouse is the beneficiary, he or she will have several choices concerning what to do with the assets:

A  He or she can roll over the deceased spouse’s retirement plan into his or her own traditional IRA (or a Roth IRA can be rolled over into a spousal Roth IRA). Then required distributions wouldn’t be necessary until the surviving spouse turns age 70 1/2. (In the case of a Roth, no distributions would ever need to be made until both spouses were deceased.) The surviving spouse can name whomever he or she would like as beneficiaries of his or her own IRA. Since the surviving spouse now owns the IRA, he or she would follow the Uniform Lifetime Table for determining life expectancy factors.

B  He or she can leave the assets in the deceased’s IRA and take minimum distributions by the later of:

- The end of the calendar year following the year in which the spouse died
- The end of the calendar year in which the spouse would have turned age 70.

If you are using “B” from above, the spouse would use the Single Life Table to determine the factor to use based on his or her own age at the time of distribution. Then he or she would go back to the Single Life Table each succeeding year and find a new life expectancy factor to use. These rules for succeeding years are different than the rules for non-spouse beneficiaries.

A spouse should choose NOT to roll over an IRA into his or her own IRA if he or she is younger than age 59 1/2, and therefore subject to an early-withdrawal penalty of 10%. In this case, the spouse would be better off not rolling over the IRA and waiting until the deceased spouse would have been age 70. At that time he or she could take distributions from the owner’s IRA and not incur penalties.

Non-Spouse Is Beneficiary
First you have to determine if a person (or certain trusts) is the beneficiary, or if an institution such as an estate or a charity is the beneficiary.
If an individual is named as beneficiary, he or she would need to start taking minimum required distributions by the end of the calendar year following the calendar year of the owner’s death. He or she would use the Single Life Table to find the factor based on his or her own age in the year of the first distribution.

In succeeding years, the life-expectancy factor is calculated by taking the prior year’s factor and subtracting one. So, if the first year’s factor is 40.7, the second year’s factor would be 39.7. This is different from the rules in succeeding years for a spousal beneficiary.

If the beneficiary is younger than age 59, there is no 10% early distribution penalty for taking required minimum distributions from an inherited retirement plan.

If an estate or charity is named as beneficiary, the “five year rule” applies. All assets must be withdrawn from the retirement plan by the end of the fifth year following the year of the owner’s death. Partial withdrawals may be made anytime before the end of the fifth year, but everything must be out of the plan by the end of the fifth year. Any failure to withdraw the assets results in a 50% penalty (on top of the income tax) of what should have been withdrawn and wasn’t.

Inherited Retirement Plans: Owner Dies After Starting Required Minimum Distributions

Spouse Is Sole Beneficiary
Similar to when a spouse dies before starting to take distributions, the surviving spouse may roll over the retirement plan into his or her own IRA. The one difference is that if the beneficiary has not yet taken the required distribution for the year in which the owner died, that amount must be paid out before the surviving spouse rolls over the IRA into his or her own IRA.

If the surviving spouse chooses to roll over the retirement plan into his or her own IRA, then he or she will follow the Uniform Lifetime Table for determining life expectancy factors. This table has longer life expectancies than you will find in the Single Life Table for beneficiaries.

Non-Spouse Is Beneficiary
Once again you’ll need to determine if an individual has been named beneficiary or not. If the estate (or a charity) is the beneficiary, for required minimum distribution purposes, there is no “designated” beneficiary.

For example, say the owner’s IRA named the estate as beneficiary, and the owner’s son is the beneficiary of the estate. Because the estate was named beneficiary of the IRA instead of the son, the assets in the IRA must be withdrawn based on the deceased owner’s life-expectancy factor instead of the son’s life-expectancy factor. Further, if the required distribution for the year of the owner’s death has not yet been made, it must be paid out as soon as possible. The first required distribution for the son must occur by the end of the calendar year following the calendar year of death. The Single Life Table would be used to look up the owner’s age in the year of death. Let’s say the factor is 8.6 (death at age 83). The son would subtract one from this factor (to get 7.6) and use that to divide the prior year-end retirement plan balance to get his required minimum distribution.

I told you this wasn’t simple!

Now let’s look at the same example, only this time an individual—the son—is named beneficiary of the IRA. In this case, the son can base his required minimum distributions on his own life expectancy factor using the Single Life Table. If the son was age 65 when his parent died, his factor would be 21. This larger factor will result in smaller required minimum distributions. To calculate his factor in succeeding years, the prior year’s factor is reduced by one.

This article is provided to you compliments of your library and Morningstar.
A version of this article appeared on Morningstar’s Web site on Oct. 12, 2006.
Many of you who have been loyal Morningstar readers for some time are at least somewhat comfortable with choosing funds. Where some need more help is with creating appropriate portfolios that incorporate those fund choices.

Let’s take a closer look at five model portfolios specifically designed for retirees. What makes them different from portfolios appropriate for those still employed is that preservation of principal plays a key role in the investment strategy. So, you’ll see a heavier allocation to cash and bond investments.

Each person’s retirement situation is unique. One size really doesn’t fit all when it comes to retirement investing. You need to consider all sources of income—Social Security, pensions, dividend income, annuity payouts, etc. You also need to think carefully about how much risk you can tolerate. Use the following model portfolios to jump-start your investing strategy for retirement, but make sure you tailor these portfolios to fit your own individual circumstances.

I am only going to talk about mutual funds that are still open to retail investors today.

Preservation Portfolio

If you are having trouble sleeping at night and you constantly worry about losing money in the stock market, then the Preservation Portfolio may be for you. This portfolio may be appropriate for those of you with shorter time horizons—say, fewer than 10 years. (By “time horizon,” I generally mean life expectancy, not years until you retire.) If you don’t have any other sources of income, then this portfolio may help you preserve your nest egg. Of course, even this very conservative portfolio has some risk. For example, when interest rates go up, you may lose principal if you are invested in bond mutual funds. If that’s a concern, you can always use certificates of deposit or individual bonds (holding them to maturity) instead of a bond fund.

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For your stock exposure, consider using T. Rowe Price Value, Vanguard Total Stock Market VIPERS, or iShares Russell 1000 Value Index. The last two recommendations are exchange-traded funds. They act like funds but trade like stocks.

If you’re looking for a real estate fund, consider using T. Rowe Price Real Estate or Vanguard REIT Index VIPERS. If you want to add international exposure, consider Dodge & Cox International Stock or Vanguard Total International Stock Index.

If you want to hold funds that combine stocks and bonds, consider T. Rowe Price Personal Strategy Balanced or Vanguard Wellesley Income.

For your core bond holding, put most of your money in high-quality short- to intermediate-term bonds or bond funds. When interest rates go up, in general you’ll preserve more principal if you’re invested in shorter-term bond funds. Consider Vanguard Short-Term Bond Index or Vanguard Short-Term Investment-Grade. If you want a tax-exempt fund, consider Vanguard Limited-Term Tax-Exempt or Fidelity Short-Intermediate Municipal Income. To add further diversification, consider holding a portion of your fixed-income holdings in inflation-indexed bonds. These bonds have longer maturities, so keep in mind their values may drop further than shorter-term bonds as interest rates rise. That aside, inflation-linked bonds offer a terrific diversification value. A component of their total return increases with inflation, which could be particularly valuable if inflation edges up over the coming months and years.
In taxable accounts, I’d use I-Bonds (a type of U.S. savings bond) for inflation protection. For more information, check out TreasuryDirect.gov on the Web. For tax-deferred accounts, you can buy individual Treasury Inflation-Protected Securities or a TIPS fund such as Vanguard Inflation-Protected Securities. You may also benefit from a small amount of foreign bonds in your portfolio. Consider a fund like T. Rowe Price International Bond, but limit your holdings because these funds can be quite volatile relative to other bond funds.

Finally, make sure you have a comfortable liquidity cushion. You should have enough in cash and cash equivalents (money markets, savings accounts, CDs) to cover two to five years’ expenses.

Conservative Portfolio
If your life expectancy is at least 10 more years, you don’t like taking a lot of risk, and you want modest growth over inflation, the Conservative Portfolio may be for you.

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<td>Real Estate</td>
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<tr>
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<tr>
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<tr>
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</tr>
<tr>
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</tr>
<tr>
<td>Foreign</td>
<td>5</td>
</tr>
<tr>
<td>Cash and Cash Equivalents</td>
<td>10</td>
</tr>
</tbody>
</table>

Any of the funds mentioned above in either the Preservation Portfolio or the Conservative Portfolio will also work well here—you’ll just hold different proportions. For large-cap growth funds, consider Fidelity Blue Chip Growth or T. Rowe Price Growth Stock.

For greater diversification within the bond portion of your portfolio, consider adding just a touch of high-yield exposure. Understand that these are junk-bond funds and they are riskier than high-quality offerings. But in smaller proportions, they can add diversification value. Consider Vanguard High-Yield Corporate. If you want a tax-exempt fund, consider T. Rowe Price Tax-Free High-Yield. You might also want to add a small stake in a multisector-bond fund such as Loomis Sayles Bond.

Growth Portfolio
Like the Balanced Portfolio, this mix is appropriate for people with a life expectancy of at least 15 years. Ask yourself if you want to beat inflation by at least 4% per year. Could you tolerate it if your portfolio lost money for a year or more? Will you have other sources of retirement income, like a pension? Younger retirees or retirees with considerable wealth might find the Growth Portfolio appropriate for their goals.

With more of your portfolio allocated to stocks, you can afford to branch out a little in your security selection. After you have your core funds in place, you can broaden your portfolio’s diversification by considering funds like Artisan International, T. Rowe Price New Era, or T. Rowe Price Emerging Markets Stock. (Although emerging-mar-
Kets stocks have taken a deep plunge in the past month, that doesn’t mean you should shun them altogether. Just keep these more risky funds as a smaller proportion of your overall allocation.

### Growth Portfolio

<table>
<thead>
<tr>
<th>Allocation</th>
<th>%</th>
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<tbody>
<tr>
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<tr>
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<td>Large Blend</td>
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<td>Large Growth</td>
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<td>Bond Total</td>
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<td>Inflation Indexed</td>
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<tr>
<td>High Yield or Multisector</td>
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</tr>
<tr>
<td>Foreign</td>
<td>5</td>
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<tr>
<td>Cash and Cash Equivalents</td>
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</tr>
</tbody>
</table>

### Aggressive Growth Portfolio

Do you expect to live for at least 20 more years? Could you tolerate it if your portfolio declined for at least two consecutive years? Will you have other sources of retirement income, like a pension? If you answered “yes” to these questions, you may be a candidate for the Aggressive Growth Portfolio.

In addition to the investments I’ve outlined in the previous portfolios, you may want to consider including some of the following funds to broaden your diversification: Keeley Small Cap Value or T. Rowe Price Global Stock.

### Aggressive Growth Portfolio

<table>
<thead>
<tr>
<th>Allocation</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Total</td>
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</tr>
<tr>
<td>Large Value</td>
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<tr>
<td>Large Blend</td>
<td>10</td>
</tr>
<tr>
<td>Large Growth</td>
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<tr>
<td>Mid/Small Cap</td>
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<td>Foreign</td>
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<td>Real Estate</td>
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<td>Precious Metals</td>
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<td>Bond Total</td>
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<td>Short to Intermediate Term</td>
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<tr>
<td>Inflation Indexed</td>
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<tr>
<td>Foreign</td>
<td>5</td>
</tr>
<tr>
<td>Cash and Cash Equivalents</td>
<td>5</td>
</tr>
</tbody>
</table>

You’ll notice that even the most aggressive retirement portfolio does not include 100% stocks. Although this may not apply to all cases, the vast majority of retirees should not be risking their entire nest eggs in the stock market.

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Top 10 Estate-Planning Mistakes

As a financial advisor, I see all kinds of issues and problems regarding clients’ estate documents. Many times we’ll discover that the arrangements spelled out in the documents are not at all what a client wants today. Often, we help clients deal with sensitive family issues that need to be reflected legally. Dealing with death is never easy, but it’s worth it to take the time to plan your estate. When you do, watch out for these classic mistakes.

1 Not Having an Up-to-Date Estate Plan
If you’ve worked hard all of your life and accumulated a lifetime of memories and possessions, you will probably want to give some thought to whom those cherished belongings should go to at your death. Now, I know death is not a subject anyone particularly wants to think about or talk about. But there’s no way to avoid it, so let’s just deal with it right now.

If you don’t have estate documents, like a will or living trust, the state decides who gets your assets. If you go to your state’s Web site, you should be able to see how they distribute property.

I bet most of you would rather have some input into that decision. If your estate is at all complicated, please don’t try to create an estate plan yourself. Go to an attorney who specializes in estate planning. (You don’t want to leave it in the hands of an attorney who does many types of law.) One place to look for an estate attorney is www.lawyers.com. Choose “Estate Planning” as the type of lawyer (under “Trusts and Estates”).

If you do have estate-planning documents but they are more than five years old, have an estate attorney review them. If you need to make changes, you may be able to amend your plan rather than start over with new documents.

If you don’t have durable powers of attorney for health care and property, make sure you get those executed when you do the rest of your estate planning. You only need to think of cases like Terry Schiavo to understand that you need to commit your wishes to paper so there is no misinterpretation by hospitals or well-meaning family members.

2 Choosing the Wrong Trustee, Executor, or Guardian
Many of you haven’t created estate documents or updated existing ones because you just can’t settle on whom to have act on your behalf.

You want to find someone with similar values to be guardians to your kids. They shouldn’t be too old or too young. For the trustee’s role, you want to find someone savvy enough financially to manage your money. And you need to find someone who is willing to put in the time and effort to wind up your affairs in the executor role as part of the settling of your estate.

Don’t think you’ll find the perfect person. That’s a sure way to procrastinate indefinitely. Get as close as you can in choosing the right person for each role. And remember, going forward you can always change who is listed in your documents if you find someone better suited to one of these jobs.

3 Not Funding Your Trusts
If you’ve gone to the trouble to put trust documents in place, don’t fail to retitle your financial accounts and fund your trusts. All this boils down to is a flurry of paperwork. But if you don’t do it, your carefully crafted estate plan may be a bust.

If you haven’t completed this paperwork yet, you’ll need to change your individually held accounts to trust accounts. You will be the primary trustee in most cases until you can no longer manage your affairs.

If you have an irrevocable life insurance trust (ILIT), make sure the policy pays out to the trustee of your ILIT.

4 Not Using the Full Exemption Equivalent Credit
The “exemption equivalent credit” is a complicated-
sounding term that just means you get to bequeath up to $2 million without paying estate tax. Even if you don’t have $2 million, you can still use your exemption to pass whatever you do have to the people or organizations that mean the most to you—free of estate tax.

One of the biggest mistakes married people make is leaving all their possessions outright to their spouse. In so doing, each spouse isn’t able to take full advantage of his or her exemption equivalent credit, and the full estate (of both spouses) will be taxed at the second death.

So how can married couples take full advantage of each partner’s exemption equivalent credit? If your estate is more than $2 million, you need to consider a “credit equivalent trust” or “B trust.” Each spouse would set up this type of trust, and each can fund it with up to $2 million. That amount would then qualify for the exemption equivalent credit and would not be subject to estate taxes. Income can be paid out to the surviving spouse, and principal can be tapped for certain purposes.

By setting up the credit equivalent trust, up to $4 million (using the credit for both spouses) is free from estate tax.

5 Failing to Equalize Spousal Estates
A lot of times, one spouse ends up with more of the financial goodies in his or her name. While that may boost an ego here or there, it’s actually counterproductive when trying to pass the most assets you can to your heirs.

Here’s why: If the couple didn’t get the full benefit of both of their exemption equivalent credits, the second spouse may die with more than the $2 million allowed to pass estate-tax-free per person. The assets over $2 million and under $4 million could have been estate-tax-free if the couple had taken advantage of putting up to $2 million in each name.

Sometimes that may mean putting the house (typically one of the bigger assets) in the spouse’s name with fewer assets. If the marriage is on sound footing, that works out just fine. But if you think there’s a possibility of divorce, just remember you’re giving up your ownership in the house.

6 Failing to Plan for the Care of Family Pets
From my experience, I’ve found that many individuals consider pets to be just as much a part of their families as people. To ignore pets’ care after your death would be a mistake. I know there are millions of pet owners out there who would agree with me.

So what should you do? The Humane Society has prepared a booklet called “Providing for Your Pet’s Future Without You” that you can find at www.hsus.org/pets. It explains how to devote a portion of your will or trust to the care you want for your pet after you’re gone. You can name who you want to care for your pets, set up money to pay for that care, and set a level of care that you expect your pet to receive.

7 Not Using an ILIT to Shelter Large Amounts of Life Insurance
We talked about using the exemption equivalent credit to save on estate taxes above. The other common way to manage estate tax is to hold your life insurance policies in an irrevocable life insurance trust (ILIT).

If you have smaller amounts of life insurance, you don’t need to go to the expense of having another trust set up. What’s a smaller amount? Let’s say less than $500,000. A good test of whether you need this type of trust is if your current taxable estate (your house, your retirement plans, your investment accounts) is more than $2 million. If so, it’s relatively inexpensive to set up an ILIT.

The trustee of the ILIT should be the beneficiary of your life insurance policy. As long as you live three years after assigning your policy to the trustee of the ILIT, that insurance money won’t be part of your taxable estate.

Alternatively, if you’re in good health, you can apply for a new life insurance policy purchased by the trustee of the ILIT and avoid the three-year waiting period.

8 Not Sharing Your Estate Plan’s Contents with Your Family
While it may give you some satisfaction to know you control what happens with your assets after you’ve died, you don’t necessarily want to spring this information on your family when the will is read. That often leads to big fami-
ly fights over what each person thinks they “deserve.”

A better approach is to talk to your family before you’re gone. Let them know what you’re planning to do and why. It may not be a particularly comfortable discussion, but at this point in your life you need to be able to speak your mind and live with other people’s disapproval.

In some cases, attorneys recommend leaving $1 to an heir you basically don’t want to receive any of your assets. This makes it perfectly clear you didn’t just forget to mention them in your will (or trust).

9  Leaving an Unorganized Mess of Financial Records
Have you ever had to dig through another person’s paper archives for any reason? If so, you know it can be torture. Not to mention the fact that some of your assets may never be found because no one can find the life insurance policy or bank account records.

You owe it to your family to be organized. You can download a simple form for this purpose by going to news.morningstar.com/docs/001012estateworksheet.txt.

Fill it out and give a copy to the person you choose to be executor and another copy to your attorney.

10  Not Coordinating Beneficiary Designations
Lots of people don’t realize that a will doesn’t necessarily control all of their assets. For example, even if you have a will that leaves everything to your spouse, if you own real estate in joint tenancy with rights of survivorship (a very common way to hold property) with anyone other than your spouse, your spouse won’t be entitled to it. Ditto for life-insurance policies that specify someone other than your spouse as beneficiary. I’ve seen this happen when people name a beneficiary for a retirement account or life insurance policy before they were married (or divorced) but then forget to change it.

Whenever you update (or create) your estate documents, go through all your life insurance policies and work-related benefits, such as retirement plans and even stock options, to see if the people listed as beneficiaries are still who you would choose today.

This article is provided to you compliments of your library and Morningstar. A version of this article appeared on Morningstar's Web site on June 13, 2006.
Prepare Your Spouse for Financial Independence

Sue Stevens, CFA, CFP, CPA

Having observed many couples over the years, I see that the majority of the time one spouse is more “financially attuned” than the other. One spouse usually takes the lead on financial matters. But what happens when that financially aware partner is gone?

The reality is that you need to prepare your partner to manage his or her own financial affairs. Here are some guidelines to get you started.

How to Locate Financial Documents
Take the time now to write out instructions on how to find everything financial. Leave this information with a trusted individual such as your attorney or financial advisor.

► A list of all financial accounts including account numbers, passwords, institution and contact information
► Any hiding places where you’ve stashed things.
► How to value collections of stamps, musical instruments, art, antiques, and so forth.
► If you have any stock certificates or bonds, transfer them to your investment account or www.treasurydirect.gov.
► The combination to your home safe.
► Where you have a safe deposit box and where to find the key.
► Where you keep important papers for annuities, appraisals, birth certificates, cemetery deeds, credit cards, deeds, marriage certificates, divorce decrees, insurance policies, mortgages, income tax returns, retirement accounts, prenuptial agreements, titles for cars, estate documents.

What to Keep and Where
In a bank safe or deposit box:
► Car titles
► Deeds for property
► Business agreements like partnerships or buy-sell agreements
► A detailed home inventory listing all valuables including pictures or videos and appraisals

► Ethical will: typically an account of your life, usually videotaped, that explains important life lessons or values that you want your heirs to know about

In a fire-resistant home safe:
► A copy of your will and/or trusts
► Insurance policies
► Investment account numbers and passwords
► Original powers of attorney for health care and property (copies should be given to those people who are named your agents)
► Letter of instruction explaining final wishes

In a home filing system:
► Three years of statements for insurance payments, bank accounts, investment and retirement accounts
► Credit card and mortgage statements for the past year
► Three years of tax returns (if not seven years)

At your attorney’s office:
► Signed and witnessed will and trust documents
► Copies of powers of attorney

Who to Call, Who to Trust
Make sure your loved ones know where to find detailed contact information for your accountant, attorney, banker, financial advisor, life insurance agent, other insurance agents, and veterinarian (if pets need temporary care).

Share Financial Responsibility Now
You can help this inevitable transition go more smoothly by introducing your spouse to your trusted advisors during your lifetime. There’s just something about that personal bond that brings comfort and reassurance for all parties involved.

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