

Ask the Experts



What can we learn from the subprime mortgage mess?

The collapse of the subprime mortgage market and the jitters it's sending through the entire economy contain lessons for us all.

Here are a few:

If it sounds too good to be true, it probably is. Based in part on wishful thinking ("housing values will always appreciate") and in part on misleading information ("that's a great rate"), many homebuyers became convinced they could afford mortgages they later found they really couldn't. Similarly, many investors were led to believe that mortgage-backed securities were all about huge rewards with minimal risk. So, the lesson here is: When faced with what appears to be a rosy best-case scenario, always remember to ask "But what if ...?"

Experience counts. When seeking a mortgage broker, loan originator, investment firm and/or fund manager, check out their credentials, and look for those with lengthy experience who are respected within their fields.

When's the best time to refinance my mortgage?

Any time you can refinance your mortgage to save money is a good time to contemplate doing so. Generally, there are two situations when it may be wise to consider this.

If you have an adjustable rate mortgage (ARM) and the rate is about to go up (either because your existing loan is scheduled to reset or because the economy enters a period of rising interest rates), you may save money if you can refinance to a fixed rate mortgage--particularly if the fixed rate is similar to or lower than your current ARM rate.

The other time it's a good idea to refinance (even if you already have a fixed rate loan) is when you'll save money by getting a lower interest rate. An old rule of thumb said that you shouldn't refinance unless the new interest rate will be at least 2% lower than your existing rate, but (depending on the refinancing cost) even a much smaller differential may be worthwhile to some homeowners.

Your refinancing cost is the total of any points, closing costs, and private mortgage insurance premiums (if any) that you'll have to pay when you take out the new loan.

Read (and understand) the fine print. Many people, both homebuyers and investors, got burned in the subprime mortgage mess because they didn't know the details of the contracts they entered--and the devil is always in the details. Review all mortgage documents and/or investment prospectuses carefully before you make a commitment. If you don't understand the ramifications of what you've read, seek assistance from an unbiased qualified professional.

The best regulation is self-regulation. Federal regulations designed to protect the consumer cover many loans resold to quasi-government agencies like Freddie Mac, and loans insured by the Federal Housing Administration also carry strict guidelines. But oversight of these loans is not always as diligent as it should be. What's more, many mortgages are now originated by unregulated nonbank lenders. As a result, you shouldn't assume that governmental and/or institutional regulations will always protect you from getting into financial trouble. Only you can do that.

Ultimately, it may make sense to refinance if you'll recoup the cost of doing so while you still own the home.

To determine the time it'll take to recoup your refinancing cost, divide that figure by the monthly mortgage payment savings you'll realize by refinancing. The result indicates how many months you'll need to stay in the home to recoup your cost. If you don't remain in your home long enough to recover that cost, then refinancing may not be worthwhile.

One final note: If you're experiencing cash flow difficulties, you may be tempted to lower your monthly mortgage payments by refinancing to extend the term of the loan. From a savings perspective, this is not a good reason to refinance. Unless you get a lower interest rate on the new loan as part of the bargain, you're not really saving any money; in fact, you may end up owing more. Extending the term without changing anything else may alleviate your short-term cash flow problem, but it'll cost you more total interest in the long run.

Income in Retirement

You've worked hard your whole life, anticipating the day you could finally retire and enjoy your golden years. Well, that day has arrived. There's still work to be done, however, you'll need to carefully manage your assets so that your retirement savings will last as long as you need them to.

Review your portfolio regularly

It's commonly said that retirees should value the safety of their principal above all else. For this reason, some people shift their investment portfolio to fixed-income investments, such as bonds and money market accounts, as they approach retirement. The problem with this approach is that if returns don't keep up with inflation, an investment portfolio may not enjoy the growth needed to fund today's longer retirements. So while there are good reasons to invest more conservatively as you grow older, consider maintaining at least a portion of your portfolio in growth investments.

Choosing a sustainable withdrawal rate

A key factor in determining whether your assets will last for your entire lifetime is the rate at which you withdraw funds. The more you withdraw, the greater the likelihood you'll exhaust your resources too soon. On the other hand, if you withdraw too little, you may not enjoy your retirement as much as you could. It's vital that you estimate an appropriate withdrawal rate for your circumstances, and determine whether you should adjust your lifestyle and/or estate plan.

An appropriate withdrawal rate depends on many factors, including the value of your current assets, your expected rate of return, your life expectancy, your risk tolerance, inflation, your expenses, and whether you want some assets left over for your heirs.

Studies have tackled this issue, resulting in the creation of tables and calculators that can provide you with a range of rates that have some probability of success. A financial planning professional can help you with this.

Which assets to draw from first?

Most retirees have assets in accounts that are taxable (e.g., CDs, mutual funds), tax deferred (e.g., traditional IRAs), and tax free (e.g., Roth IRAs). Given a choice, which type of account should you withdraw from first? The answer is--it depends.

For retirees who don't care about leaving an estate to beneficiaries, the answer is simple in theory: withdraw money from taxable accounts first, then tax-deferred accounts, and lastly, tax-free accounts. By using your tax-favored accounts last, and avoiding taxes as long as possible, you'll keep more of your retirement dollars working for you.

In practice, however, your choices, to some extent, may be directed by tax rules. Retirement accounts, with the exception of Roth IRAs, have minimum annual withdrawal requirements. In general, your first withdrawal must be made by April 1 of the year following the year you turn age 70½, with subsequent distributions due each December 31. Failure to do so can result in a 50% excise tax imposed on the amount by which the required minimum distribution exceeds the distribution you actually take.



For retirees who intend to leave assets to beneficiaries, the analysis is more complicated. You need to coordinate your retirement planning with your estate plan. For example, if you have appreciated or rapidly appreciating assets, it may be more advantageous for you to withdraw from tax-deferred and tax-free accounts first. This is because these accounts will not receive a step-up in basis at your death, as many of your other assets will.

However, this may not always be the best strategy. For example, if you intend to leave your entire estate to your spouse, it may make sense to withdraw from taxable accounts first. This is because spouses are given preferential tax treatment with regard to retirement plans. A surviving spouse can roll over retirement plan funds to his or her own IRA or retirement plan, or, in some cases, may continue the deceased spouse's plan as his or her own. The funds in the plan continue to grow tax deferred, and distributions need not begin until the spouse's own required beginning date.

By planning carefully, investing wisely, and spending thoughtfully, you can increase the likelihood that your retirement will be a financially secure one.

It's Not What You Earn--It's What You Keep

You work hard for your money. So why shouldn't you try to keep as much of it for yourself as you can? Here are some ways to pay less tax and keep more of your hard-earned dollars.

Tax deferrals rule

Take advantage of tax-deferred retirement plans, such as 401(k), 403(b), and 457(b) plans, offered by your employer. They all allow you to make pretax contributions of up to \$15,500 in 2008 (\$20,500 if you're age 50 or older), and 403(b) and 457(b) plans may also have special catch-up rules that might let you defer even more. The tax savings can be significant. For example, if your marginal tax rate is 28% and you defer \$15,500, you'll save \$4,340 in current taxes. Your \$15,500 contribution will generate tax-deferred earnings for you until you withdraw the funds from the plan, when you may be in a lower tax bracket. And, if your employer matches your contributions, the deal is even sweeter.



Another common way to use tax deferrals to save more of what you earn is by setting up a health-care flexible spending account (FSA) at work. Your contributions reduce your taxable income, saving current taxes, and the funds you set aside can be withdrawn tax free to pay a wide variety of health-related expenses that aren't covered by your health plan. See IRS Publication 502, *Medical and Dental Expenses*, for a list of qualifying expenses.

And don't forget traditional IRAs. If neither you nor your spouse is covered by a retirement plan at work, and you're not yet 70½, you can make a deductible contribution of up to \$5,000 to an IRA in 2008 (\$6,000 if you're age 50 or older). Even if you or your spouse is covered by a plan, all or part of your contribution may be deductible, depending on your income.

But tax free is even better

If you're an income-oriented investor, consider investing in municipal bonds. The income generated is free from federal income taxes and, in some cases, state income taxes as well. (Be sure to compare yields between taxable and tax-free securities, and keep in mind that certain municipal bond income may be subject to the alternative minimum tax.)

Another way you can generate tax-free income is by contributing to a Roth IRA, Roth 401(k), or Roth 403(b) plan. Unlike pretax deferrals, Roth contributions don't reduce your income, so there's no current tax savings. Because you've already paid tax on your contributions, they won't be taxed again when you withdraw them from the plan. But what really sets Roth contributions apart, and makes them so appealing, is that all earnings are also tax free if you satisfy a five-year holding period and certain other requirements are met.

If you have children, don't pass up the tax incentives offered by Section 529 plans and Coverdell education savings accounts (ESAs). Again, your contributions to these plans aren't tax deductible, but your savings grow tax deferred and withdrawals are tax free at the federal level (and typically at the state level too) when used to pay qualifying educational expenses. You can contribute up to \$2,000 to a child's Coverdell ESA in 2008, and most 529 plans let you contribute more than \$300,000 over the life of the plan.

Think long term--for capital gains

Long-term capital gains tax rates are currently very attractive--a maximum of 15% through 2010. Short-term capital gains, on the other hand, are generally taxed at ordinary income tax rates--currently as high as 35%. To qualify for long-term capital gains treatment, make sure you hold your securities and other capital assets for more than one year before selling them.

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