CREATIVE Wealth Maximization Strategies

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FLAWED THINKING

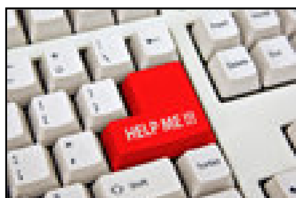
Why do seemingly rational, intelligent people make poor financial decisions? Often the reason is an inaccurate perspective; the decisions may be logical, but the assumptions are faulty. If you believe you can fly, it's logical to jump off a 20-story building. The problem isn't with your logic, but your underlying assumptions on gravity and human capabilities.

Financial evaluations may seem to begin and end with numbers. But like everywhere else, ideas matter. Good financial assumptions can be expected to deliver good results. In contrast, the financial consequences of bad assumptions may range from inconsistent performance to catastrophic losses.

Here are three examples of flawed thinking in regard to financial matters, and some ways to keep inaccurate perspectives from creeping into your financial world: Y2K, A Nirvana Mindset, and WACronyms.

> ***"It's tough to make predictions, especially about the future." - Yogi Berra***

Y2K: 10 Years After



Ten years ago was January 2000. It was the beginning of a new year, a new decade, a new century, and a new millennium.

Hard to believe it was 10 years ago, isn't it? What do you remember about that momentous date in history? Do you remember…

- The price of gas? (National average was 1.51/gal.)
- Who was president?
  (Bill Clinton was wrapping up his second term)
- The predictions for the future?
  (Ah yes, the predictions…)

Apocalyptic, optimistic…& completely wrong

You do remember Y2K, don't you? The need to change the date format in computers from "1999" to "2000" was going to wreak havoc on society. The prospect of damage was so great, in the words of one computer programmer,

> "We must also prepare ourselves for the very real possibility that the outcome of this situation might well be the total extinction of the entire human race. It really could be worse than I am predicting and I really am being optimistic…"

But it wasn't just the Y2K problem that was a cause for concern…

> Richard W. Noone, author of "5/5/2000: Ice: The Ultimate Disaster" (Crown, 1997), claimed that May 5, 2000 was when Mercury, Venus, Mars, Jupiter and Saturn would be aligned with the Earth for the first time in 6,000 years. On that day, he predicted an ice buildup at the South Pole would upset Earth's axis and send "trillions of tons" of ice and debris "toppling into our oceans, flooding the planet and destroying all known forms of life."

Not every prediction for the new millennium was apocalyptic. Some people were incredibly optimistic.

> In 2000, Harry Dent, a financial analyst and author of several books on investing, predicted the Dow Jones Industrial Average would exceed 40,000 during the next decade. 40,000 would represent a huge increase since the DJIA was just below 11,500 on January 1, 2000.

Uh, just to review…The Y2K problem was a non-issue. And while global warming may cause climate

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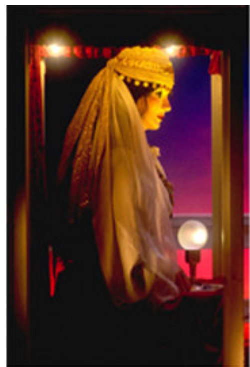
change, there was not a natural disaster caused by ice *(and a book written by "Noone" might actually be "no one," even if it is available on Amazon)*. The DJIA index peaked at 14,164 on October 9, 2007 and then retreated, falling as low as 6,547 on March 9, 2009, a decline of 53% in 17 months. As of December 15, 2009, the DJIA recovered to stand at 10,501, but nobody thinks the Dow will reach 40,000 by December 31, 2009. Like a lot of other prognostications, both fearful and exciting, these guesses were way off target.

There were, however, some momentous and unexpected events during the decade, both apocalyptic and optimistic. There was a contested presidential election, the 9-11 terrorist attacks, the war in Iraq, and the mortgage and financial failures that led to the deepest recession since the Great Depression. After being shut out for 86 years, the Red Sox won the World Series twice in the past decade! Gold rose to more than $1,200/oz. and gasoline passed $4.00/gal. And what about Blackberries and iPhones and Wii Fit? Who could have imagined, right?

No one sees the future, but everyone keeps looking.

The truth is we are constantly surprised by what comes next. In hindsight, we may be able to see how things took place, but rarely can we see clearly what's ahead. Most of the time, the historically significant changes are the ones that no one recognizes at the time. When the first transistors, computer chips, and fiber optics were developed, how could anyone have the insight to see them as the building blocks for cell phones, laptop computers, and the Internet?



Yet because we are intensely interested in the future, particularly as it relates to us, our inability to accurately predict it doesn't deter people from trying – or from making outrageous predictions. People still read horoscopes, still pay for a psychic hotline, and still subscribe to financial newsletters claiming "insider information" about the stock market. Whether it's a vision of impending disaster or great financial opportunity, there's an almost irresistible attraction to a message with a TEOTWAWKI element, i.e., the-end-of-the-world-as-we-know-it. Or as one marketing campaign put it "this changes everything."

Resisting the Prediction Impulse

There are two practical ways to blunt the impact of predictions on your financial life.

First, follow the money. Remember, there is often a profit motive attached to the prediction. If someone wants to charge you for an exclusive look at the future, it should give you pause. One Y2K doom-and-gloom futurist who has moved on to predicting other end-of-civilization scenarios has the nickname "Scary Gary," because he constantly promotes the next "big problem." Not surprisingly, he also has the next answer – for a price. If the prediction is coupled with an inducement to make a financial decision that enriches the predictor, be careful.

Second, sound principles for present circumstances usually trump unique predictions and strategies for the future. There are time-tested financial principles with a track record of success, and there are "special situations" that supposedly require a unique approach because "this is a once-in-a-lifetime" occurrence. No-money-down, no-documentation mortgages were made because both borrowers and lenders believed the predictions that housing values would always increase. When the prediction proved false, both parties were stuck. On the other hand, if everyone had insisted on sound financial principles (demonstrated by a substantial down payment), both borrowers and lenders might have been able to weather the storm of depressed housing prices.

- **HOW MANY OF YOUR FINANCIAL DECISIONS ARE BASED ON PREDICTIONS?**
- **DO THE PEOPLE WHO INFLUENCE YOU PROVIDE *PREDICTIONS* OR *PRINCIPLES*?**

REMEMBER: SOUND FINANCIAL PRINCIPLES DELIVER PROVEN RESULTS. PREDICTIONS MAY ENTERTAIN, BUT THEY DON'T ALWAYS WORK.

2010: The Year of the Roth IRA Conversion

If the early announcements are any indication, 2010 could be the Year of the Roth IRA conversion. How do we know this? Well…

An August 27, 2009 article from *Morningstar* (news.morningstar.com) calls the chance to convert to a Roth IRA "the planning opportunity of the decade."

In an article for the *Detroit Free Press,* on November 19, 2009, Susan Tompor reported "the Roth IRA conversion is definitely building buzz."

On November 24, 2009 *Forbes.com* led with "Get ready to be bombarded with information about Roth IRA conversions."

Admittedly, three sources by themselves do not make a trend, but they are representative of the general media buzz. What's the big deal? Here's the story:

Roth IRA retirement plans have the following features:

- Eligibility to make deposits to a Roth IRA is dependent on your income level.
- Deposits receive no tax deduction.
- Once you have held the Roth IRA for at least five years, and are at least age 59 ½, withdrawals are tax-free.
- There are no required minimum distributions from a Roth IRA at any age.
- Roth IRA assets can be left to children or other heirs.

A change in tax law, effective 2010, broadens the ability of owners of Traditional IRA accounts to convert them to Roth accounts. This is what the fuss is all about.

Beginning in 2010, the income limits on Roth IRAs will be eliminated, so investors of all income levels will be able to convert their Traditional IRA assets to Roth IRA assets. This is significant, because prior to this change, only those with a modified adjusted gross income (MAGI) of $100,000 or less could execute a conversion.

Reasons to consider a conversion to a Roth IRA

You may pay less in taxes. If you convert your Traditional IRA balance to a Roth IRA, you'll pay taxes on the amount being converted. But because of recent market volatility, your account balance may be lower than it was when the market was stronger. In effect, you may pay less in taxes.

If you convert in 2010, you have the option to spread the tax burden over two years. When you convert to a Roth IRA, you will have to pay taxes on any deductible contributions and investment earnings. But, if you make the conversion in 2010, you can pay the taxes in 2010 or you can spread the taxes over the subsequent two year, 2011 and 2012.

There are no required minimum distributions. Unlike Traditional IRAs, Roth IRAs do not require that you take minimum distributions when you reach age 70½. That means your account can continue to grow tax-free until you – or your heirs – are ready to withdraw the money.

Reasons to not convert to a Roth IRA

Money. The Roth conversion isn't a freebie. In order to convert to a Roth IRA, you must pay income taxes on the Traditional IRA as if you had cashed out. If you pay the tax from funds in the IRA account, it will decrease the transfer amount and diminish the tax-free growth that might occur over time. Further, if you use funds from the IRA and are younger than 59 ½, the amount used to pay the tax may be subject to an early withdrawal penalty. "A Roth conversion is expensive. There's a big up-front cost to doing this," Tim Steffen told Tompor. Steffen is a financial and estate planning manager for Robert W. Baird & Co. in Milwaukee.

You think you'll be in a lower tax bracket in retirement. If your financial situation is such that you anticipate future income will be much lower than it is today, paying the tax now may not make sense.

You have a short time until you intend to withdraw the funds. Money transferred to a Roth IRA must remain in the account for five years, or it will lose its tax-free withdrawal status.

"It goes back to: What's your tax bracket? Do you have the funds outside the IRA to pay the tax? And what's your time frame for needing those assets?" said Jill Garvey, vice president and regional manager for the wealth planning group at Comerica Bank.

Another twist: *(see next page)*

What might happen to tax rates in the future? In the *Detroit Free Press* article, Garvey points out that the current federal income tax rates expire at the end of 2010. If Congress takes no action to renew these rates, the highest tax rate would jump to 39.6%, up from 35%. And with the deficit ballooning, it's not unthinkable that Congress might authorize even higher marginal tax rates.

The conversion decision is "a little more art than science," according to John Carl, president and founder of the Retirement Learning Center in Brainerd, Minnesota. "How much [in] taxes are you willing to fund now for a lifetime of tax-free income?"

IRA Help is Everywhere. To assist you in your decision, many financial companies are offering Roth Conversion Calculators on their web sites. But this is a transaction that probably can't be decided by answering a few questions or entering some numbers in an on-line calculator. A consultation with your tax advisor is a must, as well as the financial professionals who will be handling the conversion paperwork.

Is a conversion to a Roth IRA right for you? Here are some points to consider:

My tax rate will not decline when I retire.
NO → If you think you'll be in a lower tax bracket in retirement, then converting to a Roth IRA might not make sense for you. You may prefer to leave your assets in a Traditional IRA and pay the taxes when you take the withdrawal.
YES ↓

I won't need to withdraw the money for at least five years and I will be at least 59½ before I need to make a withdrawal.
NO → If this is not a long-term investment, the Roth's potential for tax-free earnings may not make back the money you pay in taxes on the conversion, and early withdrawals are subject to penalties.
YES ↓

I can pay the taxes due on the conversion without dipping into my IRA.
NO → If you can't pay the taxes from sources other than your IRA, then converting to a Roth may not make sense. There are two reasons why paying the taxes with your IRA may not make sense: 1) you will lose the potential benefit of tax-free growth on that amount and, 2) if you're under 59½ you will also incur a penalty for early withdrawal.
YES ↓

You may want to consider converting your Traditional IRA balance to a Roth IRA. Talk to your tax advisor to learn more about the important tax and retirement planning considerations.

5-MINUTE FINANCIAL THOUGHT: Which is easier: Managing your debt, or managing your assets?

Most of the factors regarding your debt are under your control. The terms and conditions of borrowing are typically well-defined, and with minimal effort, you can determine a payment strategy that matches your circumstances. Over time, a reduction in your indebtedness should free up more money for saving and investing.

By comparison, you may frequently find you have limited control over some of the factors affecting the performance of your invested assets. The broader market will determine the value of your equity holdings, whether in paper assets like stocks, or real assets such as rental property. And interest rates and dividend distributions are usually someone else's decision, not yours.

With so many of the variables associated with asset management beyond your control, it's worth asking the question:

Would you be better off devoting most of your energies to re-structuring debt to free up more money for saving, then using conservative, safe low-yield financial vehicles instead of trying to squeeze higher returns from riskier options?

Think of it this way: $100 earning 4% annually results in a larger amount than $75 earning 10%. If you can find the extra $25 through debt management, why take the risks associated with trying to earn 10% on a smaller amount?

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice.

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