

Building Wealth: Retirement planning scrutinized

By Pran Tiku

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Recently I had the opportunity to host a call-in radio talk show on WTTK 96.9 FM, which airs weekends. Having had the privilege of hosting or being a guest on similar programs on CNN television before, I am always fascinated by the many questions asked by the listeners and viewers.

I think that a sampling of some of the questions from these shows and some of my own day-to-day experience with our clients as well as answers may be of interest. This time we will look at some of the questions on retirement planning and investments. In future installments we will cover other topics of interest to the public.

QUESTION: I am getting ready for retirement. A broker recently suggested that I consider an annuity since that will guarantee me a monthly income. Is that a wise choice?

ANSWER: Annuities have the advantage of guarantee, usually by an insurance company. However, the distinct disadvantage of a fixed income stream is that it is unlikely to keep up with inflation. Annuities are also irrevocable -- once the contract is signed they do not allow for any future flexibility if your financial situation changes.

QUESTION: I am turning 62 and my investment portfolio is made up mostly of U.S. stocks and mutual funds and about 10 percent in international stocks. I am planning to retire in the next two to three years. I have been told to convert a large portion of my stocks to bonds since I will need income when I retire. Is that prudent?

ANSWER: To put most of your money in any one particular asset class (cash, stocks, bonds, real estate, etc.) is a major folly. The biggest lesson in portfolio management is proper diversification. A mix of investments such as stocks, bonds both domestic and international and cash is always prudent at any age.

However, if you are looking for mostly income, then a larger percentage of your portfolio should be in bonds and cash, which will offer steady income.

Over the long term, however, stocks have delivered much higher returns. For example, annualized rates of return for stocks for the last decade have averaged more than 12 percent compared to bonds at about 8 percent a year. Your mix and asset allocation should reflect your need for income, inflation protection and should aim toward your long-term goals as well as your risk tolerance.

QUESTION: A broker is suggesting that I buy a variable annuity because I will be able to defer any taxes from the gains I make in my investments as opposed to mutual funds where I may be subject to annual taxes on both dividends and capital gains.

ANSWER: It is true that a variable annuity will allow you to defer taxes on any gains, but it can also be a trap for many unsuspecting investors. The taxes are deferred only until you start liquidating the shares or units of the annuity.

To make matters worse, the gains at that time will be subject to ordinary income taxes, which are much higher than the tax for the sale of stocks or mutual funds which, if held for longer than one year, are only taxed at a capital gains rate now capped at 15 percent.

Worse still, sometimes the ordinary income resulting from these annuity sales can push you into a higher income tax bracket. Furthermore, you may be subject to a penalty if you liquidate shares of an annuity in the early years of the contract, which in some cases may be as long as 10 years.

To add to the misery, there is a hefty expense and mortality charge in some cases as high as 1.5 percent or more each year, in addition to the usual mutual fund expense charges.

QUESTION: What is the difference between a load/no load mutual fund and I shares? Which one should I choose and why?

ANSWER: Load is simply a charge levied by some mutual fund companies on their funds. In some cases this is a sales charge and can be as high as 5 percent and is charged up front and, in most cases, this is to compensate the broker or salesperson selling the fund. Such mutual fund shares are also called A shares.

There are other ways in which a fund company may charge a load, such as back-end loads also called B shares or annual loads, which are also known as C shares.

No load funds are funds on which there is no upfront, deferred or back-end sales charge and the entire amount of the investment is used to purchase shares of the fund.

I shares are similar to no-load shares in the sense that the fund company does not levy a charge for buying or selling them. I shares are actively traded on the stock exchanges and can be bought and sold throughout the day like any stock and therefore offer ready liquidity. I shares can also be sold short, which is not possible to do with mutual funds.

However, all mutual funds have expenses charges, which will vary, with each fund family and the type of fund. These charges are disclosed in the fund prospectuses. I shares generally have the lowest expense charges, generally at about 0.25 percent a year because there is no active management of the fund.

Both load and no load funds have active portfolio managers, who select investments for the fund, monitor the portfolio regularly and provide information to investors on a regular basis.

Which type of fund to choose will depend on your individual circumstances. If you have a broker helping you in your selection of a fund, he is likely to suggest a load fund, which will pay him a commission. If, however, you are choosing a fund yourself, there is no need to buy a load fund since there are many no load funds available in all categories to choose from.

If you want to invest in a fund and you simply want exposure to the market or the sector and do not need the active involvement of a portfolio manager, then I shares are an ideal and less expensive choice. For example, if you want exposure to the broad market, such as large U.S. stocks and are interested in investing in the 500 largest U.S. stocks (S&P 500 index) you may choose S&P I shares, also called Spiders. If you want exposure to a specific sector of the market such as health care or telecommunications, you can buy I shares that invest only in those sectors.

There are hundreds of different I shares available to investors today that are specific to different areas of both domestic and international markets.

QUESTION: I have a 401k at my current job. I am changing jobs soon. I have the choice of leaving my 401k account with my current employer or transfer it to my own IRA. Are there any advantages to rolling the money over to my IRA?

ANSWER: Our recommendation generally is to roll over your 401k account to a self-directed IRA plan. The major reason for doing this is that most employer 401k plans offer limited investment choices -- mostly to keep things simple and less expensive for the benefit of the employer.

As a plan participant you generally have no choice but to choose your investments from this limited selection of funds. However, after you leave your job, there is no reason to be subject to this limitation. By rolling the account into your own IRA you will be able to choose from virtually any investment such as mutual funds, bonds, stocks and even real estate -- hence the name self-directed.

Our suggestion is to open an account (unless you already have one) with any one of the numerous discount brokers and request your employer's 401k custodian to transfer the funds to this account, after which you can make an appropriate selection from the investments available through the broker and then monitor the account carefully. You are able to change the investments as often as you like (watch out for early redemption fees) without any tax impact.

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