



# Cash, Money, Moolah or Scratch

*Whatever you call it you need  
to know more about it.*

By: Henry L. Becker, Jr., CFP®  
*Founder of Sustainable Investment Strategies  
and editor of the ETFGPS.com Blog*

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## About The Author

Henry L. Becker, Jr., CFP®  
President & Investment Strategist

Henry specializes in exchange-traded fund (ETF) investing and is well versed in the utilization and impact of investing in regards to tax, estate planning and retirement planning. In addition, he is the editor of the ETFGPS.com blog that helps people navigate the world of ETF investing.

Henry has been quoted in the Baltimore Sun, Frederick News Post, The Gazette, and Smart Company Magazine and is very active in the Frederick community. He is:

- a member of the Frederick County, MD Chamber of Commerce
- member of the board for Frederick County Big Brothers Big Sisters
- co-founder of the Frederick Young Professionals Business Referral Group
- citizen blogger for the Frederick News Post titled Key to Investing

A veteran of the United States Air Force where he was a logistics specialist Henry also holds a bachelor's degree in European History from the University of Pittsburgh. Although a native of Pittsburgh, he relocated to Maryland in 1999 and currently resides in the Frederick, MD area with his wife and three sons.

When not at work Henry can be found mountain biking, skiing or traveling with his family. He and his wife are one of a small number of people who have completed a round-the-world trip. From August 2000 to July 2001 the pair traveled to 23 countries as they circumnavigated the world in one trip.

## Chapter I - First Things First

Why was this book written? Believe it or not only seven states of the 50 United States requires high schoolers to take personal finance courses. Most of us were not taught anything about money in all our years of school - even college. If I did not do what I do for a living I would probably be financially lost.

This book is meant to introduce you to something that you deal with everyday - money. You know how to spend it and perhaps the basics of investing it. Money has a finite number of uses. You can pay taxes with it, spend it, pay off debt with it or invest it. You should do all the best you can.

My hope is that you use this book as a financial reference. You will find practical, useful information in this book. Within these pages you will find tips and pointers that I have picked up over the years of working in the financial services industry.

Keep in mind that this book is intended to give you the basic information to make informed decisions about money. This book is not a full fledged course in financial planning but a resource to stimulate your thoughts, attitudes, and desire to learn more about how to handle your scratch. Lets get in to it!

## Chapter II - Money Essence

Essence is the nature of something. It is what makes that something what it is. Your Money Essence is how you handle (or in some cases mishandle) your money which results in who and what you are. Think about it. Your money situation has a lot to do with your life circumstances. First, understand that money is like a drill. No one really wants a drill right? You want the holes that the drill makes. Money is the same. You do not want these little pieces of paper in your pocket. You want what you can do with your money.

Let's get one thing clear financial success is not always vast wealth. Financial success is the balance of having the financial means to achieve your desired lifestyle.

Everyone wants something different out of life. Some want to travel (like me), some want fame and still others want a quiet life. Far too many young folks (me included) go from college or the military straight to jobs or vocations without much thought as to their lifestyle. There is a reason why the divorce rate is super high. The number one reason cited for divorce - money.

I am no marriage counselor nor do we want to be. But, here is some advice that will help in all facets of your life. Know your Money Essence! If you just consider the following points and how they are intertwined you will have a better grasp of what your Money Essence should be.

- **Location** - Where do I want to live? (big city, little city, mountains, ocean...)
- **Job** - Do I want to work for others or myself?
- **Pleasures** - What do I enjoy doing?
- **Money** - How much do I need to make to...?
- **Family** - Am I the marrying kind? Do I ever want kids? If I am the marrying and kid kind, how will they affect my lifestyle if at all?

We know these are heavy topics and you would rather think about which bar to go to tonight or what is on TV. To have the lifestyle you want you must consider these points. Be assured that just thinking about these points right now it may prevent at least one large regret in life. Regrets like I should have never taken that job, married so and so, moved here or there etc...

Consider how the different facets of your life work together to reveal your lifestyle. The long and short of it is this. If you set yourself up in a place that you like to live, doing something that you enjoy, with the people you want around you and the outlets for your pleasure activities you will be a hell of a lot happier than if any one of these are off kilter.

As an example what good does a great job, great family, and great place to live do for you if you have no place to sail and sailing is what you really love? What good does a great place to live, great family and all the resources to do what you enjoy matter if you spend all your time at a job you hate?

Do yourself a favor and find your Money Essence. Sit down for fifteen minutes and answer the questions posed above and do not forget the answers. We guarantee you will live with a great many less regrets in life and probably lead a much happier existence.

## Chapter III - Long Range Financial Planning

We have to get to this topic straight away. The most common question financial planners get from people is “can you tell me if I am on track?” Let’s break it down by saying unless you are one of the fortunate few that have an extraordinarily large income saving for your future is going to take prioritization.

What is most important to you? If your kids future opportunities (college savings) is top priority so be it. Further chapters will discuss how to save for college and your own future. For now, let’s clear the air on a few topics. Do you really want to retire? Let’s take your grandfather’s generation who worked 30 plus years at the same job retired to a nice pension and did little else for another 20 plus years. Not doing anything of any significance for 20 years for some is like death.

Your parents’ generation has figured out that “retirement” in the traditional sense (sitting on your butt for 20 years) does not look appealing and have taken to “consulting” or 2nd careers in fields they love. The point here is they are not retiring (not working all together) and you will probably not either for the same reasons and then some.

You are facing a different beast all together. Social Security as we know it now will either not exist or will not provide the level of benefits it does for current retirees. Most of us do not have pensions to look forward to which means for us to retire (sit on our butts for 20 years) you will have to save the money. If you look at the numbers most of us will have to put aside some things now to have a meager retirement existence later. There is always the off chance that you inherit some dough or perhaps you do not retire.

A reality may be that we will have to continue to work because saving enough to stop working will be hard. The chips are stacking up against us:

- Pensions are disappearing or gone already
- Costs to educate your kids are rising meteorically
- How about the cost of healthcare?
- Social Security is in jeopardy
- Cost of a home relative to incomes is way out of whack
- More “things” are necessary - cell phone, iPod, Cable TV, two cars etc...

The above list does not mention how many people, as a result of the ‘08-’09 financial crisis, have lost significant value in their homes and are not strapped to a house worth less than their mortgage.

The important thing is to balance the future with today. Sure you have to save for a house, car kids future but not at the expense of your own future. You can borrow for a car, a home and a kids education but you cannot borrow for your future. Prioritize!

## Chapter IV - Lifestyle Banking

Far too many people open bank accounts, and credit card accounts without much thought of how those relationships fit with their lifestyle. How about you?

- Are you earning interest on your checking?
- When was the last time you set foot in the bank?
- What is the interest rate on your credit card(s)?
- Is there a reward system on your credit card?
- Why did you pick your credit cards?
- Do you deal with more than one bank? And if so are the accounts linked?

### Nervous Nelly

Since we are going to discuss online banking, how about a word regarding identity theft. For those of you who still find the internet to be a scary place and feel your identity will be compromised consider the following from a Javelin Strategy & Research Survey from February 2007:

- most thieves still obtain personal information through traditional rather than electronic channels. In the cases where the method was known, 68.2% of information was obtained off-line versus only 11.6% obtained online.
- lost or stolen wallets, misappropriation by family and friends, and theft of paper mail are among the most common ways thieves gain access to information.

### Check Me Out

With that bit of housekeeping aside where do you start when addressing lifestyle banking. Let's start with your checking account. If you are not earning interest on your checking account get with the program. Most traditional brick and mortar banks offer interest bearing checking accounts if you cough up an arm, first born, or leave an obscene amount of money in a checking account. Thankfully, there are online banks. Online banks operate just like traditional banks except that there are no (or very few branches) which keeps costs down and therefore they are able to give higher interest rates. All the reputable online banks are FDIC insured.

At the time of writing this book (Winter 2010) a few of the recommended online banks are:

- ING Direct
- MetLife Bank
- HSBC Direct
- Emigrant Direct

Is online banking for you? If you write very few checks (less than 5 per month) and very seldom need to visit a branch online banking should be looking real tasty. Besides earning interest on your checking, you save trees by not do not having to fuss with silly old checkbooks, since you do not have a checkbook there is not one to be stolen.

## **Save Me Baby**

The online savings accounts offer the same advantages and conveniences as the online checking accounts discussed above. So, even if you decide you just cannot live without your old brick and mortar bank you can still have an online savings account where you earn higher rates than traditional banks. For convenience you can electronically link your online savings to your other accounts so you can easily shoot money between accounts.

## Chapter V - Give Me Credit

Keep good credit. Truer words have never been spoken. Here is an all too familiar example. A young man in the military gets his first credit card at 18 years old. Being young and not very worldly he signed up for the first card offer received. A 24.9% Visa that he summarily ran straight up in short order. Welcome to the world of credit cards. He ate at the chow hall for months and scrimped on everything for months when he then realized he would never payoff the card with \$10 minimum payments on the \$1,000 balance.

Now-a-days you have the FICO credit scores that helps you gauge how credit worthy you are (according to the FICO system). So what factors in to your FICO score?

- Payment History (35% of FICO score) - account payment information. This part of your credit score measures your ability to pay on time and the amount you have past due.
- Amounts Owed (30% of FICO score) - total amount of credit you have outstanding, number of accounts, balances on account and how much credit you have relative to the maximum creditors are willing to lend to you.
- Length of Credit History (15% of FICO score) - this dimension measures how long your accounts have been open with creditors and lenders. The longer the better.
- New Credit (10% of FICO score) - used to calculate your credit score and reflects how much credit you've applied for lately. How many times you've applied for credit recently? The silent killer.
- Types of Credit (10% of FICO score) - this is the diversity of credit you have in your portfolio. For example, do you have a mortgage, car loan and credit cards?

If you have lousy credit there are numerous resources online about fixing credit scores. Start your adventure to repair your credit at [www.myfico.com](http://www.myfico.com).

### Using Credit To Your Advantage

Credit cards. They are a necessary evil. The sad reality is that many people do not leverage their credit purchasing wisely. There are plenty of clever ways to manipulate the use of your credit cards to get more bang for your spent buck.

Step one in getting more out of your credit card is to find one that works with your lifestyle. Here are a few examples:

- tech person that likes gadgets - Sony Visa
- outdoors guy/girl - LL Bean Visa
- big traveler - Airline Credit Cards

You get the point here. Match your interests or spending habits to your credit card to leverage your spending.

Step two is doing little research. Start at [www.creditcards.com](http://www.creditcards.com) or more simply if you are a great patron of a particular store check their card first. Bottom line of things to look at are:

- interest rate on purchases
- interest rate on balance transfers
- late payment fee
- annual fee
- can you pick your billing cycle
- rewards program details
- currency conversion fee (foreign purchases)
- payment grace period
- online access
- paperless statements

### **Quick Credit TIPS**

Do - Do get a credit reports periodically, do pay your bills on time, do use your credit don't let it go stale

Do not - Do not apply for too much credit as too many inquiries will drag down your credit, do not max out cards, do not close old cards to improve your credit score it will only lower your available credit which may lower your score.

## Chapter VI - Account Ownership Options

There are essentially two tax status types when it come to investment accounts - non-taxable and taxable. Examples of non-taxable money would be money in your employer retirement plan that was put in before the money was taxed, traditional IRAs and Roth IRAs. An example of taxable money is your paycheck after it has been taxed and stuffed in your checking account, savings account, or brokerage investment account.

The account ownership options for taxable accounts are:

- **Individual** - just like it says you own the account in your name only and upon your death the account is part of your probate estate (probate is the court supervised process of figuring out who gets your assets upon your death which can be a lengthy process). A con would be that upon your death the account must go through probate.
- **Joint with Rights of Survivorship** - two or more individuals who share equal interests in an account. In the event of one person's death, the surviving person(s) automatically inherits the property without the necessity of court probate proceedings. A pro of this arrangement would be the account avoids probate upon the death of one owner. A con would be creditors of one joint tenant can reach the assets in the account.
- **Tenants in Common** - two or more individuals who own a certain (maybe unequal) portion of an account. Each tenant's portion is as part of that person's estate, so that if one of the account holders dies, his/her heirs are entitled to the proportional share of the account. A pro here would be that each party can dispose of their interest without dismantling the agreement.
- **Tenancies by the Entirety** - is similar to joint with the right of survivorship but differs in that the parties must be husband and wife and only exist during marriage and terminates upon divorce. One pro of this arrangement is that under most state laws the creditors of one tenant cannot reach assets owned in this manner.
- **Trust** - assets held in trust are held for a beneficiary or multiple beneficiaries. There are many types of trusts which will be discussed later in this book under legal issues. The primary benefit of a trust is that assets held in trust avoid probate.
- **Payable on Death POD** (also known as Transfer on Death TOD) - this type of account ownership allows you to name beneficiaries to an individual account or joint account. The purpose is that upon your death the account would be payable to the beneficiary. The primary benefit of POD/TOD accounts is avoidance of probate.

The account options for non-taxable accounts that are not part of your employer retirement plan are:

- **Traditional Individual Retirement Accounts (IRA)** - money can be put into an IRA one of two ways. The first is by making annual contributions and the second is by rolling money in from an old employer plan or from another Traditional IRA. There are limits as to how much you can contribute to a Traditional IRA. For 2010 the limit is \$5,000 for individuals under the age of 50. For 2010 and beyond the amount will go up in \$500 increments for inflation. Your contributions to your IRA may be tax deductible if you get past a few weird rules regarding your tax filing status and if

you are covered by a retirement plan at work. Check IRS Publication 590 for more on the weird rules.

The benefits of a Traditional IRA are not only the possible tax deductibility of contributions but the account grows with taxes deferred until you withdrawal the money later in life. The possible taxes that you avoid with a Traditional IRA are capital gains tax and the tax on dividends and interest. So, by not having to pay taxes on your gains or income in the account there is more money in your account to grow.

- **Roth IRA** - is similar to a Traditional IRA in that you can contribute \$5,000 per year if you are under the age of 50. But, Roth IRA annual contributions are not tax deductible. Better yet if you hold a Roth IRA for 5 or more years and you are over the age of 59.5 (thank the IRS for the .5 year) then all the earnings in the account when you remove it are tax free (yahoo!). Roth IRAs are a good deal and get better the younger you are. The two best friends to money are more money and time. So, the younger you are the more time your money will have to grow tax free. Again, Roth IRAs have strange rules regarding how much you can earn and still be able to contribute to a Roth IRA. The rules for a Roth IRA can also be found in IRS Publication 590.

### **Keep your hands off**

Both Traditional and Roth IRAs are meant to be retirement accounts. Therefore, the IRS imposes a 10% tax penalty on early withdrawals (withdrawals prior to age 59.5) from both types of accounts. There are a few undesirable ways around the 10% penalty like dying, becoming disabled, extraordinary medical expenses, divorce etc... Suffice it to say consider the money you put in these plans off limits until you are at least age 59.5.

### **What can I put in my Traditional IRA or Roth IRA?**

You can invest your IRA in just about anything except, collectibles, real estate, and privately held businesses (some companies will allow you to invest in real estate and privately held businesses). That means you can have stocks, bonds, mutual funds, ETFs, CDs, and savings accounts as the investments for your Traditional and Roth IRA accounts.

### **IRA Quick Tip**

The bottom line of which type of IRA you should contribute to will have a lot to do with taxes. Typically, we do not recommend Traditional IRAs if you cannot deduct your contributions. There are two reasons for this. First, if you cannot deduct the contributions you are not getting any tax break now. Second, reason is that even though the account would grow tax-deferred there will still be taxes due some day on the earnings in the account. Those taxes that will be due will be at whatever your income tax rate is at the time of withdrawal versus if you put the same money in a taxable account the earnings will be taxed at capital gains rates which are likely lower than your income tax rate.

Where as a Roth on the other hand even though has no opportunity for a tax break now it allows for tax free withdrawals all the while growing tax-deferred. So, the case is clear. If you cannot deduct your Traditional IRA contributions then use the Roth.

Lets take it a step further. What do you do if you cannot deduct contributions to a Traditional IRA and you make too much money to contribute to a Roth, should you contribute to the Traditional IRA even though you get no deduction? Answer is...no. You are better off putting your investments in a taxable account.

The reason being IRA growth will be taxed at your income tax rates later in life versus the growth of a taxable account later in life will be taxed at long-term capital gains rates (which are currently max of 15%). A secondary reason would be what is called stepped up basis. If you die holding an appreciated asset in a taxable account your heirs get to move the cost of the asset up to the date of death value of the asset. As an example if you bought 100 shares of Google for \$10,000 and it is now worth \$50,000 and you die your heirs do not pay taxes on the \$40,000 gain (\$50k value minus \$10k cost equals \$40k). The cost basis is moved up to the value on the day of your death thereby eliminating the capital gain up to your date of death. Traditional IRAs do not get stepped up basis if you die holding a Traditional IRA your heirs will pay taxes on the account when they withdrawal the funds.

## Chapter VII - How, where and with whom to invest?

The answer to the question depends on what type of investments you will hold. If you are going to invest in individual stocks or actively managed mutual funds be sure you have the time to research and follow your holdings. If you do not have the time or inclination to follow your holdings diligently or do not want to pay and advisor then use index mutual funds or ETFs. Accordingly, lets look at the best places to invest based on what you will be holding in your account.

- Individual US Stocks, ETFs and ADRs - [www.zecco.com](http://www.zecco.com) - Zecco offers 10 free trades per month on accounts over \$25,000 (at the time of writing)
- Active Mutual funds - [www.scottrade.com](http://www.scottrade.com) - have consistently been at the top of the online brokers.

The above assumes you want to manage your own money. Maybe you have no desire to deal with managing your own money and need to hire someone. You have essentially two options:

- Registered Investment Advisor (RIA) - is a firm that is registered with either the state of incorporation or the Securities and Exchange Commission (SEC) and manages money for others for a fee. RIAs must follow the rules prescribed in the Investment Advisors ACT of 1940. RIAs are considered fiduciaries to their clients which means they have a legal obligation to hold the interest of their client above their own.
- Brokerage Firm - are licensed by the SEC to buy and sell securities on behalf of others. Brokers are not held to a fiduciary responsibility with their clients but are held to a suitability standard which means they must show their clients suitable investments.

Questions to ask your advisor regardless of whether they are an RIA or broker.

- How do you pay the advisor? - Do you pay hourly, flat annual fee, or a percentage of assets under management?
- Are you a big investor among smaller portfolios or vice versa?
- How often are portfolios reviewed?
- Are portfolios custom for each client?
- What is the average age of client base?
- Do you have a fiduciary responsibility to me as a client?

**The remainder of this book assumes you are going to invest on your own and outlines your options when it comes to types of investments you can choose from. Additionally, I will give you my opinion on investment strategy, choice of investment and portfolio construction.**

## Chapter VIII - Different Types of Investments

In this chapter we are going to make sure we are all on the same page by describing what different types of investments are and their significance.

### What is a Stock?

Stock is the capital raised by a company by issuing shares. The shares entitle holders of the stock shares to an ownership interest in the company. Essentially, a company that needs to raise money will give you some ownership of the company in the form of shares in exchange for your money. In the old days you actually received a fancy-shmancy certificate with how many shares you owned printed on the certificate. Now-a-days most people that own stock own it in "street name" which means the shares are owned in a brokerage firm's name for your benefit.

Stocks trade on various markets. The most common stock markets in the U.S. is the New York Stock Exchange and the NASDAQ. Today most trading is done electronically through the exchanges. You can purchase shares of foreign companies through U.S. stock brokers. The shares of foreign companies on the U.S. exchanges are called ADRs. ADR stands for American Depository Receipts. Stocks trade throughout the day between 9:30 am and 4:00 pm (EST). A stocks price will fluctuate throughout the day based on supply and demand for shares.

When purchasing a stock you can enter different types of buying requests the most common being:

- Market Order - purchases or sells shares at prevailing prices
- Limit Order - limits the buy or sell to a certain price
- Stop Loss Order - is a trigger price telling your broker that if the stock falls to this price sell at that price
- Trailing stop loss similar to a stop loss order the trailing stop loss order does not have a static price point for sale. Instead, the trailing stop loss price rises will follow the price of the security up if it rises.

People buy stocks for many reasons but the common theme is that people buy a stock because they think the value of the shares will appreciate. Investors from professionals to novices look at many different elements of a stock price like trends, price ratios, who is buying, who is selling and many other criteria. The point of this book is not to teach you how to pick stocks but to familiarize you with what a stock is and how it functions.

### What is a Bond?

If a stock is ownership in a company then a bond must be? You are correct it is owning the debt of a company. Essentially when you buy a bond you are loaning money to whomever is issuing the bond be it a company or government. Bonds are issued at what is called "par." Par is the face value of the bond usually bonds are issued in denominations of \$1,000. Your investment in the bond is backed by the assets of the company. As a bond holder you are first in line to get your money back should the company (if it is a corporate bond) go bust.

When you buy a bond the issuer states the "terms" of the bond. The terms being how long your money will be on loan (otherwise known as the bond's maturity date - when are they giving you your money back) and what interest rate they will pay you while they use your money. There are other things involved in the terms such as "call ability" which is when the company gives you your money back early.

I am not going to get into all the different terms that can be associated to bonds. Just know that there is more to bonds than how long until maturity and interest rate.

There are many different types of bonds. There are:

- U.S. Government Bonds - you are correct a U.S. Government bond is loaning the Government money. This is considered the safest bond investment as it is backed by the full faith and credit of the Government.
- Corporate Bonds - loaning money to a company
- Municipal Bonds - loaning money to states, and local governments

Listen up! One of the most critical items when considering an investment in a bond or bond fund is the credit worthiness of who you are loaning money to. In the corporate and municipal bond world you can buy less than credit worthy bonds (companies or municipalities with questionable ability to return your money). Think about it if you had two friends hit you up for loans and one is a degenerate that is financially irresponsible and the other is the pinnacle of responsibility who would you help out? Same for bond investing you want to know you will be getting your money back at maturity of the bond.

Keep in mind that the higher the credit worthiness the lower the interest rate that the bond will pay. The lower the credit worthiness the higher the interest paid. This is a function of the lower credit worthiness needing to attract investors by offering a higher interest rate.

What function does a bond serve in a portfolio? Why buy them? Good questions. Typically, bonds or bond funds serve two functions in a portfolio. The first is to provide income. Bonds and bond funds usually pay a monthly dividend. The second purpose of bonds in a portfolio is diversification. When added to a stock portfolio bonds tend to reduce the overall volatility of the portfolio.

#### **Stock / Bond Quick Tip**

It is widely accepted but not always true that stocks and bonds move like a seesaw. When the price of stocks are up bonds are down and vice versa. This is not always true but mostly true. Why? As the stock market falls people conduct a flight to safety meaning move to high quality bonds for their security. Remember a bond is backed by the company or government.

#### **What is a Mutual Fund?**

A mutual fund is an investment where multiple investors pool their money into a common portfolio of investments. The common pool of investments is run by a fund manager who makes the day to day decisions about where the mutual fund will invest. The fund manager must follow the charter of the fund as to how the fund will invest. Historically mutual funds were a diversified portfolio unto themselves containing both domestic and foreign stocks and bonds. Today mutual funds are usually focused on a category for example large company foreign stocks or could be as narrowly focused as a fund that invests in healthcare companies. Most mutual funds have a minimum initial investment of anywhere from \$250 to \$10,000 or more. At the end of each day the funds tally up the total value of the underlying investments and divides it by the number of shares outstanding to arrive at the price per

share each day. So, mutual funds price (calculate share price) once per day at the stock markets close at 4:00 pm eastern standard time.

Mutual funds come in two basic types open end and closed end. Open ended funds constantly create new shares or buy back redeemed shares. Closed end funds have a finite number of shares outstanding and trade based on not only the value of the underlying shares but demand for shares since the number of shares are finite. Closed end funds can trade at discounts and premiums to the net asset value (NAV) per share.

We are going to focus on the more widely popular open ended funds. Open ended mutual funds come in two basic type load and no-load. The difference - the load. A load is a sales charge for purchasing or selling the fund (**don't buy load funds**). A no-load fund has no fee for purchasing or selling the fund. Never buy a load fund.

Beyond the fees for buying and selling funds there are fundamental differences in how funds are managed and that is either *active* or *passive*.

An actively managed fund is run by a fund manger or team who have to make the day to day decisions of what to buy and sell and when. There are some active fund managers out there that have a track record of out performing the overall market.

A passive fund is also known as an *index fund*. Passive funds or index funds follow a benchmark index like the S&P 500 by holding the securities that make up the index. Meaning the index fund will seek to match the performance of the index (good or bad). There are a ton of indexes out there but the most common indexes are the Dow Jones Industrial Average, the S&P 500, and the NASDAQ 100. Index funds are very tax efficient since there is very little trading. Actively managed funds are constantly buying and selling generating taxable capital gains that are passed on to investors. Index funds and ETFs do very little trading and therefore distribute little in taxable, capital gains.

### **What is an Exchange Traded Fund (ETF)**

An Exchange-Traded Fund (ETF) is essentially an index mutual fund that trades like a stock throughout the day. ETFs bridge the gap between the diversification of a traditional mutual fund and the trading flexibility of an individual stock. **I believe ETFs are the best investment option going.** The next chapter will explain why.

## Chapter IX - What type of investments should you use?

In my investment management practice I use exchange traded funds (ETFs) as the investment vehicle of choice.

### Why do I prefer ETFs?

I prefer ETFs over individual stocks because of the high amount of individual risk with each company. If the last ten years have taught me anything it is that no company is beyond cheating or less than full disclosure (consider Enron, Worldcom, Toyota, Goldman Sachs, Lehman Brothers, etc...) There is too much risk investing your money in individual companies where an ETF allows you to invest in a diversified portfolio of companies from an industry, sub sector, country or companies of a particular size. ETFs allow for the exposure to a specific area without the risk that one company could sink your portfolio.

The best way to explain why I prefer ETFs over actively managed mutual funds is the following chart.

	ETF	Actively Managed Fund	Winner
<b>Transparency</b>	Holdings are reported daily	Holdings are reported quarterly	ETF
<b>Operating Expenses</b>	Average ETF expense ratio is .55%	Average active fund expense ratio is approximately 1.40%	ETF
<b>Tax Issues</b>	Since there is minimal trading in an ETF capital gains distributions are very small.	Active mutual funds typically have much higher capital gain distributions as they rely on the trading of the fund manager to generate gains	ETF
<b>Liquidity</b>	ETFs can be bought and sold throughout the day like a stock	Active mutual funds are only bought and sold at the end of the day	ETF
<b>Diversification</b>	Hold a large number of securities. Some hold a smaller number of securities or one asset like a gold fund.	Hold a large number of securities. Some hold a smaller number of securities or one asset like a gold fund.	Tie
<b>Style Specific</b>	ETFs stick to the asset class they are meant to be invested in. A large company international ETF will not have small company international stocks in it	Have large amounts of drift as fund managers will invest in areas that have opportunity. This makes asset allocation difficult as you never know what the fund is invested in.	ETF
<b>Performance</b>	You get the performance of the index the ETF tracks.	Mutual funds stay fully invested and ride the market up and down. A countless number of studies have shown that over the long-term mutual fund managers do not outperform their respective benchmark indexes.	ETF

Keep in mind that when you buy and sell ETFs you will pay trading commissions. Trading commissions have come down in price and will continue to do so. Items to consider when researching ETFs are:

- **Fees** - look at fees for the fund relative to similar funds. Obviously, the lower the fees the better but fee is not the only selection criteria.
- **Total assets in the fund** - look for funds with over \$50 million in assets. Anything less than \$50 million is probably not profitable to the company behind the ETF and therefore the ETF may not be around long.
- **Percentage assets in the top ten holdings** - This is important for a diversification standpoint. The lower the percent the better. There are some funds though that cannot keep the number low because they have limited holdings but these are typically very specialized funds.
- **Index style** - Not all indexes are the same. We tend to prefer ETFs that follow passive indexes versus actively managed ETFs. Our preference for passive indexes is due to our belief that active managers tend not to out perform their benchmarks and charge higher fees for such under performance.
- **Returns** - look at each fund's performance not only relative to other funds in the category but how well each fund has performed in up and down markets. More weight is given to a fund that out performs in down markets.
- **Tracking Error** - How closely a fund tracks its respective index is very important.

### ETF Providers

More and more ETFs are coming on line everyday. The big players in the ETF market are below:

iShares  
 Vanguard  
 PowerShares  
 Van Eck  
 State Street SPDRs  
 Wisdom Tree  
 Claymore  
 Rydex

## Chapter X - Investment Strategy

The world has changed. Yes, that is a profound statement but globalization and technology really have made a significant impact on global finance. The speed at which information and therefore money moves around the world is remarkable. The days of buying and holding a bunch of stocks or mutual funds is gone. Buy and hold for many years has been the self serving mantra of the financial services industry. Do not be fooled buy and hold will not serve you well going forward. Consider adopting a trend following strategy.

### **Trend Following**

Following Trends by definition is an investment strategy that takes advantage of long-term positive and negative moves that play out in the financial markets. A trend following strategy will have a particular metric or a series of metrics that trigger buying and / or selling. The goal of following trends, is to be invested in the positive trends in the market and sitting out of the negative trends in the market. Trend following is not a buy and hold strategy nor is it market timing.

*Buy and hold* is an investment strategy that is exactly as it sounds you buy an asset and hold through ups and downs in the market. Recent history (late 1990's through the present) has shown that long stretches of time can go by and your portfolio can rise and fall many times only to leave you in the same place you started many years before. Buy and hold should be seriously reconsidered.

*Market Timing* is defined by the website investorwords.com as “Attempting to predict future market directions, usually by examining recent price and volume data or economic data, and investing based on those predictions.”

### **What is the benefit of following trends?**

The single biggest mistake the average investor and professional investors make is letting emotion get involved in the investing process. A trend following investment strategy removes emotion and the urge to time the market and puts in its place a disciplined set of metrics for buying and selling. The metrics answer the following questions all investors share:

- How and when to enter the market
- How much to buy
- When to exit if the position is unprofitable
- When to exit if the position is profitable

The second benefit is being out of the market for most if not all of down market trends. Most investors look to get as much of the upside of the market as possible. Why? The media and the financial services industry have conditioned the public and itself that beating the broad market indexes is paramount. While it is nice to beat the broad market indexes in the good years it is more important to not lose as much in the bad years.

### **A simple strategy that works**

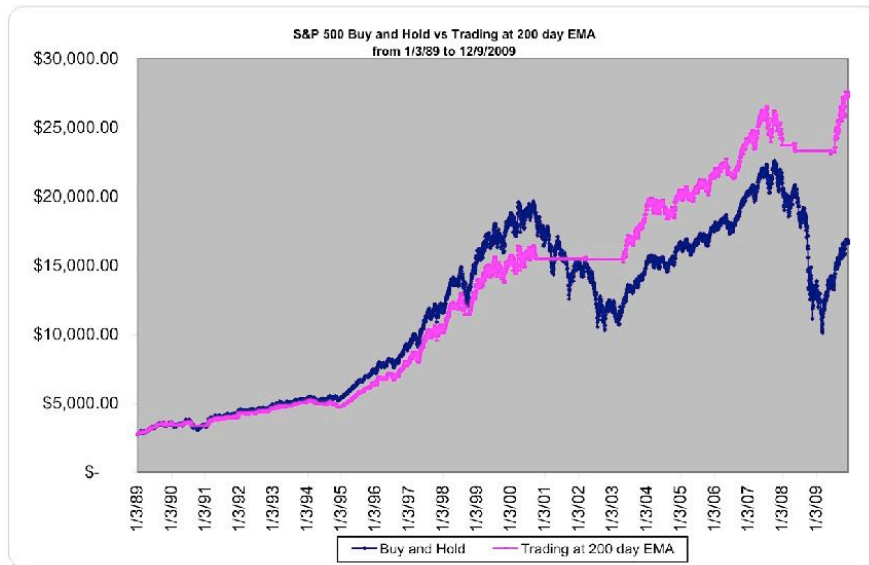
At my firm we follow the 50 and 200 day exponential moving average (EMA) for each holding. The EMA is average price of the holding over the number (50 or 200 days in my case) of days with a slight weighting toward more recent prices. A simple moving average would be the typical average with a formula of (total prices for period / number of days in period). I prefer the EMA. Here is part of my strategy in a nutshell.

Investment Price	Action
Goes below 50 day EMA	Find out why price is falling and perhaps sell some
Goes below 200 day EMA	Sell 100%
Goes above 50 day EMA	Find out why moving up and perhaps buy some
Goes above 200 day EMA	Buy in 100%

This is a simple, reliable strategy. The 50 day EMA is your pay attention indicator and possibly actionable. The 200 day EMA is your actionable event. This strategy, like any other good strategy, removes emotion and guesswork both of which are the kiss of death for investors. The 200 day EMA is a reliable long-term trend indicator. So reliable this has been that had you followed the simple strategy outlined above you would have missed most of the major downturns in the market over the last century. Now that says something. Keep in mind the single worst thing in investing is losing money. Consider that a 50% loss requires a 100% return to get back to whole (\$100 less 50% is \$50 to get back to \$100 your \$50 must double). Losses stink especially big losses.

This strategy will work for ETFs, stocks or mutual funds. Again, my preference is ETFs. On the next page are the results of a 21 year study (from 1/3/1989 to 12/09/2009) comparing buying and holding the Vanguard S&P 500 Index fund (VFINX) and a strategy that trades VFINX around its 200 day exponential moving average (EMA). Under both scenarios dividends and capital gains were reinvested. The 200 day EMA strategy involves selling all shares when the price of the fund drops below the 200 day EMA and buying back when the fund is above the 200 day EMA. To keep things simple three assumptions were made: all proceeds after a sale were kept in non-interest bearing accounts, no transaction fees and no taxes.

One very important item to note about the study is that it is much more important to do well in the bad years than the good years. You will notice from the study that in years like '91, '03, and '04 trading around the 200 day EMA under performed the index. But in the bad years like '01, '02, and '08, trading around the 200 day EMA paid off in spades by out performing the index by leaps and bounds. So, the moral of the story is do well in the good years and do really well in the bad years.



The above chart is a comparison of buying and holding the Vanguard S&P 500 Index fund (VFINX) and a strategy that trades VFINX around its 200 day exponential moving average (EMA). Under both scenarios dividends and capital gains were reinvested. The 200 day EMA strategy involves selling all shares when the price of the fund drops below the 200 day EMA and buying back when the fund is above the 200 day EMA. To keep things simple three assumptions were made: all proceeds after a sale were kept in non-interest bearing accounts, no transaction fees and no taxes.

Source: Sustainable Investment Strategies LLC, Pricing Data provided by Yahoo Finance  
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#### Returns by Year

	Buy and Hold	Trading 200 day EMA
2009	24.17%	17.09%
2008	-37.02%	-3.14%
2007	5.39%	-0.01%
2006	15.64%	13.08%
2005	4.77%	3.98%
2004	10.74%	7.49%
2003	28.50%	23.40%
2002	-22.15%	-0.19%
2001	-12.01%	0.00%
2000	-9.06%	-2.01%
1999	21.07%	17.19%
1998	28.62%	27.68%
1997	33.21%	33.21%
1996	22.86%	22.86%
1995	37.45%	35.37%
1994	1.18%	-6.31%
1993	9.12%	9.12%
1992	8.21%	7.63%
1991	30.19%	28.26%
1990	-3.33%	-5.53%
1989	31.35%	31.35%

\* 2009 figures are through December 9th 2009

#### Statistics

	Buy and Hold	200 Day EMA
Beginning Value	\$ 2,718	\$ 2,718
Ending Value	\$16,645	\$27,293
Drawdown '00-'02	47.40%	5.80%
Drawdown '08-'09	56.10%	11.40%
Percentage Increase	512.40%	904.16%

**What is the 200 day exponential moving average (EMA)?** The 200 day EMA is the average price of a security over the last 200 days slightly weighted toward the most recent prices. A simple moving average (SMA) would be the actual average over the last 200 days. The 200 day EMA is a common technical indicator of a security or market's strength.

Source: Sustainable Investment Strategies LLC, Pricing Data provided by Yahoo Finance  
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## Chapter XI - Portfolio Construction

### Portfolio Contents

When building a portfolio you want to be sure not to have too much home country bias. Far too many investors invest a significant chunk of their money in American companies and forget about the rest of the world.

The US makes up approximately 38% of the total value of stocks traded in the world. Therefore, the rest of the world makes up the difference. By looking at statistics from the World Federation of Exchanges the world stock market value breaks down as follows:

Country/Region	% of World Market Value
United States	38.00%
Western Europe	26.00%
Japan	8.00%
Asia/Pacific excluding Japan (Australia, Hong Kong, Singapore...)	8.00%
Emerging Markets (China, India, Brazil, South Korea...)	20.00%
	100%

Lets first figure your risk tolerance level and then pick a portfolio.

### Risk Tolerance Understood

To assess your investment risk tolerance we suggest you go to the following link on the MSN Money Central website: [www.moneycentral.msn.com/investor/calcs/n\\_riskq/main.asp](http://www.moneycentral.msn.com/investor/calcs/n_riskq/main.asp)

Once you have a handle on your risk tolerance you will want to build a portfolio that allows you to sleep at night. The central point in portfolio construction is diversification. You want to diversify your portfolio to reduce the overall risk of the portfolio. Diversify means holding different types of securities as indicated above. How much of each asset category should you hold? The answer depends on your risk tolerance.

Here are three portfolios you could use depending on your risk tolerance would be:

Asset Class	Aggressive Growth	Growth	Conservative
United States Total Market Index	31.00%	25.00%	15.00%
Europe	21.00%	17.00%	10.00%
Japan	6.00%	5.00%	4.00%
Developed Pacific excluding Japan	6.00%	5.00%	3.00%
Emerging Markets	16.00%	13.00%	8.00%
Precious Metals	10.00%	5.00%	5.00%
Trend Fund(s)**	10.00%	5.00%	5.00%
US Bonds	0.00%	12.50%	35.00%
International Bonds	0.00%	12.50%	15.00%
	100.00%	100.00%	100.00%

*\*\* The trend fund(s) would be selecting an area(s) that are doing well and you research and believe will continue to do well. This may also be an area that you already have exposure to through one of the other investments but you want more.*

The portfolios above give global stock exposure, global bond exposure and hold precious metals which tend to behave differently than stocks and bonds.

## Chapter XII - Monitoring the market and your holdings

So, you have selected a place to hold your accounts, you have invested the money in a diversified portfolio - now what?

The last thing you want to do is buy and forget or buy and hold your investments. You must monitor your portfolio. The days of sitting on holdings for decades is gone. The speed of information and financial transactions along with investor impatience has driven the markets to move faster than ever before. With this in mind you want to protect your portfolio and the best way to do that is with an investment strategy which I have already given and monitoring your holdings.

Here are some things to look at to determine the health of markets. All of the below can be found on either Yahoo Finance or StockCharts.com.

- 50 day exponential moving average (EMA) - short-term market trend indicator
  - On Yahoo Finance interactive charts under technical indicators
- 200 day exponential moving average - long-term market trend indicator
  - On Yahoo Finance interactive charts under technical indicators
- Market volume - market sentiment indicator
  - Yahoo Finance under market statistics
- Volatility Index (VIX) - market sentiment indicator
  - On Yahoo Finance under the ticker symbol (^vix)
- Market Breadth - as measured by advance decline lines. Advance decline lines simply show the path of the number of advancing stocks and declining stocks day over day.
  - On StockCharts.com under Free Charts > Market Breadth Indicators. I like to look at the Nasdaq \$NAAD.

## Chapter XIII - Portfolio Strategies & Tips

The following is a list of tips and strategies for building your portfolio:

### Overall Portfolio Layout

1. Maintain mirror portfolios - Far too many people make the mistake of trying to wrap their personal portfolio of Roth IRAs, Traditional IRAs, and taxable accounts around their employer plan or vice versa. This just causes rebalancing nightmares. It is far easier to make the two portfolios look like one another. A simplistic example would be if you want to hold 50% Large U.S. stocks and 50% international stocks do so in both your outside portfolio and your employer plan. When you make a change in one change the other.
2. Try to limit the number of accounts you have. As my father always said "you cannot measure what you cannot track." If your portfolio is all over the place you are killing trees with all the statements you receive and it is way too hard to determine your returns. Simplify!

### Simple Tax Strategies

1. Location of your investments is important. Your Roth IRA should hold aggressive growth investments to take advantage of the tax free nature of the Roth. Your IRA should hold dividend and income producing assets. Your taxable accounts should hold your growth oriented equity investments.
2. Harvest losses. When you make an investment in a taxable account and you have a loss in an investment sell to capture the loss. The loss can then be used against future gains. If you have no gains you can deduct losses against income on your tax return up to \$3,000 per year.

### Rebalancing

1. Rebalance once per year. Anything more is too much. There have been numerous academic studies done to validate this suggestion.
2. Have a tolerance when rebalancing. Meaning if you intend to have 20% in a particular area let it go 3% either way. Perhaps up to 23% or as low as 17% before tinkering.

### Keeping Records

1. You do not need to keep every trade confirmation your monthly statements are plenty since they have all the information that the trade confirmations have on them.
2. Keep track of any contributions to a Traditional IRA that you do not deduct from your taxes. You do this by filing an IRS form 8606 in the year of the non-deductible contribution. This is important due to the fact that non-deductible contributions when removed from an IRA are tax free as that money has already been taxed.

## Chapter XIV - Personal Insurance

### Homeowners / Renters Insurance

The critical items here are making sure you have the coverage and that you review it with your insurance professional at least once every other year. Additionally, this is one of those places that cheaper is not always better. For renters you are really only covering contents and personal liability coverage. Contents is just what it sounds like. It covers the loss of your stuff. The personal liability covers you should someone hurt themselves on your property or damage to other people's property.

For homeowners, the items to consider are the structure of your home, personal possessions, liability to others, and living costs should your home be uninhabitable.

For the structure of your home most policies cover replacement cost for damage to the structure. A replacement cost policy pays for the repair or replacement of damaged property with materials of similar kind and quality.

For personal possessions, most policies offer coverage equal to a percentage of the structure coverage. Usually this is between 50% and 70% of the structure coverage.

For liability coverage this part of your policy covers you against lawsuits for bodily injury or property damage that you or family members cause to other people. It also pays for damage caused by pets. It pays for both the cost of defending you in court and for any damages a court rules you must pay. Generally, most homeowners insurance policies provide a minimum of \$100,000 worth of liability insurance, but higher amounts are available. Increasingly, it is recommended that homeowners consider purchasing at least \$300,000 to \$500,000 worth of coverage of liability protection. General rule of thumb is to have your liability protection set to match your net worth or more.

There are particular items that you could have that would indicate making sure you have adequate liability coverage. Some examples of those items would be biting dogs, trampolines, pools, or lots of tall trees on your property. These are all potentially dangerous items to others.

Living costs coverage usually amounts to about 20% of the structure coverage.

### Auto Insurance

Again the important thing is having the coverage and reviewing at least every other year. The components of auto insurance are:

#### Liability

Bodily injury liability which is for injuries that you cause to someone else. You and family members listed on the policy are also covered when driving someone else's car with their permission. It is critical to have enough liability insurance. If someone comes looking for litigation after a serious accident, you may be sued for a large sum of money. Definitely consider buying more than the state-required minimum to protect assets such as your home and savings.

Medical payments or personal injury protection (PIP) coverage pays for the injuries to the driver and passengers of the policyholder's car. PIP can cover medical payments and lost income.

Property damage liability coverage pays for damage you (or someone driving the car with your permission) may cause to someone else's property. Usually, this means damage to someone else's car, but it also includes damage to lamp posts, telephone poles, fences, buildings or other structures your car hit.

A quick hint on how to read your car insurance policy liability coverage. You might see something like 100/300/100 or 100,000/300,000/100,000. The numbers here refer to the three components listed above. In the example above the first 100 refers to the bodily injury limit for each person involved in an accident. The 300 refers to the maximum amount that will be paid in bodily injury per accident. The last 100 refers to the amount of property damage covered per accident.

Why should you review your auto liability coverage? It is not uncommon for people to look for ways to keep auto insurance down early in their adult life and therefore carry minimum coverages. Minimum automobile liability coverage required in the State of Maryland for example is 20/40/15. So if you live in Maryland and maintain minimum auto liability coverage and have an accident where you seriously hurt two people in a brand new BMW you are up a creek. Check your coverages!

### Collision

This coverage pays for damage to your car from a collision with another car, object or as a result of flipping over. Collision coverage is generally sold with a deductible of \$250 to \$1,000—the higher your deductible, the lower your premium. Even if you are at fault for the accident, your collision coverage will reimburse you for the costs of repairing your car, less the deductible.

### Comprehensive

This coverage reimburses you for loss due to theft or damage caused by something other than a collision with another car or object, such as fire, falling objects, earthquake, windstorm, hail, flood, vandalism, or hitting an animal such as birds or deer. Comprehensive insurance is usually sold with a \$100 to \$300 deductible, though you may want a higher deductible to lower your premium.

Uninsured and underinsured motorist coverage this coverage will reimburse you, if you are hit by an uninsured or hit-and-run driver.

### **Umbrella Insurance**

Basically, umbrella insurance protects you, your family and your (ass)ets in the event that you are held personally liable for a claim. Umbrella provides additional liability coverage above the limits of your homeowners, auto, and boat insurance policies. In the event of a loss, you would first exhaust your home, auto, or boat liability coverage, and then the umbrella policy would begin providing coverage.

### **Life Insurance**

Let's keep it simple. This an area of insurance that has evolved to be more complicated than needs to be. There are two basic types of life insurance term and permanent. Term insurance is like renting a home and permanent insurance is like buying a house.

Make your life easy and only consider term and whole life. Term insurance is very low cost way of gaining life insurance coverage as you are paying for exactly what you want - life insurance coverage for a period of time. Permanent insurance comes in different forms such as whole life, universal life, variable universal life and so on but it is whole life that is the type that you want to consider. Whole life coverage

stays with you for your whole life so long as you continue paying premiums (premiums stay level your entire life). But, whole life costs considerably more.

Both term and permanent have their place. Permanent insurance should be considered if you have a permanent need for coverage. Common reasons for permanent insurance would be estate planning needs, special needs children, special needs spouse, or health issues that may make you uninsurable down the road.

**Insurance Quick Tip**

Check out Yahoo Finance for great insurance calculators. Particularly the life insurance calculator.

## Chapter XV - Legal Needs

First, the legal disclaimer. I am not an attorney and the following chapter is only some suggestions as to things to consider and discuss with your legal counsel. Let's define one term up front, probate. Probate is the court-supervised process by which a will is determined to be the will-maker's final statement regarding how the will-maker wants his or her property distributed. It also confirms the appointment of the personal representative of the estate.

### Will

A will is a legal document that contains your instructions as to how you wish your property and assets to be distributed at your death. A will is a basic document that is imperative to have especially if you have children. If you die without a will it will be up to the courts to decide how your assets are distributed and where your children end up.

### Trust

Similar to a will a trust is a document that outlines your wishes for your property in the event of death. The biggest difference between a will and a trust is that assets that pass to another through a trust avoids probate and a will does go through probate court. Additionally, trusts provide privacy as property and assets passing by trust are not public information versus a will which is part of public domain. The two main types of trust are:

- Revocable Living Trusts - A revocable living trust is an arrangement you make for management and distribution of your property. Like a will, the trust is "revocable," meaning that you can modify or eliminate it at any time. The trust must have a trustee which is almost always the person that set up the trust. Benefits of:
  - Avoidance of probate; specifically, avoidance of expensive multiple probate proceedings when you own real estate in several different states
  - Reduction of delays in distribution of your property after you die
  - Privacy, because your trust instrument would ordinarily not be filed in court
  - Continuity of management of your property after your death or incapacity
- Irrevocable Trust - is a trust that cannot be changed or cancelled once set up without the consent of the beneficiary. Contributions cannot be taken out of the trust by the person who placed them in the trust.

### Advance Medical Directives (Living Will)

These documents outline your medical wishes should you be incapacitated. Items such as life support, medications, withholding of food are addressed in these documents.

### **Legal Quick Tips**

1. If you are pinched for money a viable option is to draft your own documents using legal software from Quicken the makers of the powerful money management software. The Quicken Will Maker product will walk you through creating a will, trust and medical directives unique to your State.
2. Draw up a letter of instruction to your heirs outlining where your accounts are held, where to find important documents, username and passwords to internet based accounts and so on.
3. Don't wait to create these documents.

## Chapter XVI - Employer Benefits

Do not leave money on the table! We are always amazed at how many people do not take the time to investigate their employer benefits. Worse is self-employed people that do not take the time to establish benefit programs for themselves. In this section we will discuss the most common employer benefits and what you should look for and know about each.

### Retirement Plans

Most employers in today's world offer some type of retirement savings plan to employees. The most common being 401k, 403b, 457, and SIMPLE IRA.

401k, 403b, 457 and SIMPLE IRAs all allow you the employee the ability to defer some of your income into a retirement savings plan. The benefit to you is that the money you defer goes into the plan before the money is taxed and grows with taxes deferred until you withdrawal the money. Saving before tax lowers your taxable income and therefore lowers your taxes. As an example:

Deferring some of your income

You make \$50,000 per year and defer \$5,000. Your taxable income is now \$45,000. You pay taxes on \$45,000 versus \$50,000 therefore lowering your taxable income by \$5,000. The whole \$50,000 is still yours. You just deferred \$5,000 into a retirement plan.

The catch! Money placed into all of the above plans cannot be touched until you are 59.5 years old. If you remove the money from tax deferred accounts prior to 59.5 you will not only have to include the money removed in your income in the year you remove it (thereby paying taxes on the money) but you will also pay a 10% tax penalty for early withdrawal of retirement funds. There are a handful ways to remove money prior to age 59.5 without the 10% tax penalty like your death, disability, etc... We are not going into the details of the exemptions of the 10% penalty. Just know that exemptions exists and the details of the exemptions can be found in IRS Publication 575.

The kicker! Some employers match a portion of the money you defer. As an example:

You defer 10% of your \$50,000 salary ( $\$50,000 \times .10 = \$5,000$ ) and your employer matches dollar for dollar on the first 3% of salary you put in the plan. So, you are getting free money from your employer bringing the total contributions into your plan to \$8,000. Don't pass up free money.

Bottom line on employer retirement plans is to be sure you participate up to the amount that your employer's matching. You do not want to pass up free money. Accordingly, you also do not want to put money in the plan that you will have to take out in six months for an emergency.

### **Quick Savings Tip**

Be sure to have at least 3 months worth of expenses in an easily accessible account like a money market, or savings account so you do not have to raid your employer retirement plan when the car needs fixed.

## **Employer Disability Insurance**

There are some great calculators under the Under the Personal Finance section of Yahoo Finance. To the point of this section there is a calculator that will tell you the chance of you becoming disabled for three months or longer at any age. According to a 1985 Social Security Administration study you are three times more likely to become disabled during your working years than you are to die. With that knowledge how is your disability insurance?

If your employer offers disability insurance it likely comes in two flavors - long-term and short-term disability insurance. So, what is the difference? Long-term disability insurance pays a monthly benefit to you if you become disabled and cannot work. Long-term disability benefits pay a percentage of your salary after an elimination period which is a period of time between the onset of disability and when benefits begin. Typical elimination periods are usually anywhere from 30 days to 90 days. The percentage of income that is paid as a benefit under long-term disability insurance varies. Typically long-term disability benefits range from 40% to 70% of salary.

Short-term disability benefits typically pay a percentage of salary starting from the onset of disability to the start of long-term disability benefits. Typically there is also an elimination period with short-term disability of one day to 30 days.

### **Quick Tip**

Along with the quick tip above be sure to have enough in a ready access saving account to cover your income needs up to your elimination period on your disability insurance.

Are long-term and short-term disability benefits taxed? That is a good question. Generally, if your employer pays the premium for your disability benefits then the benefits paid are taxable as income. If you pay for your benefits with pre-tax dollars benefits paid would be taxable. Conversely, if you pay for benefits with after-tax dollars then benefits paid under the plan are tax-free. This is a very important point to consider if your employer offers options on how much of your income to cover. Additionally, the taxation of benefits is important if you are considering buying additional personal disability insurance.

## **Health Insurance**

Health insurance is a very personal issue but there are a few things to consider when looking at plan options. Whether you work for a massive company or you are a one man show you have options. Most plans now offer an HMO option or PPO option. Both HMOs and PPOs are organizations of healthcare providers (e.g. doctors and hospitals) that have contracted with an insurance company to offer their services at a fixed price.

The difference is one is more restrictive than the other. The HMOs typically are more restrictive requiring members to select a primary care physician who manages all aspects of your healthcare. The benefit of an HMO are lower cost.

PPOs on the other hand will allow you to see any doctor. If you go to a doctor in the PPO network of doctors you pay much less than if you go to a doctor out of the network.

What are these Health Savings Accounts (HSA) I keep hearing about? These are tax-advantaged medical savings accounts that are available to folks that are part of a high deductible medical insurance plan. The skinny on these plans is that the funds you put in the account go in before taxation and can be removed for medical expenses tax free. Amounts in the plan that are not used roll over from year to year. Additionally, the account can be invested in different types of investments like savings accounts, mutual funds etc...

Similar to the HSAs noted above there are plans called Flexible Savings Accounts (FSA). FSAs are plans that allow you to put money into the plan pre-tax but the dollars in the plan must be used for medical expenses by year end or the dollars are lost. Additionally, the funds are not invested and therefore do not grow. FSA accounts are a good deal for those who can project some of their uncovered medical expense.

### **Flexible Spending Accounts**

Flexible Spending Accounts (FSA) are accounts that your employer may offer that allows you to put pre-tax dollars in an account that you can use to pay for qualified expenses as established by the plan. Typically, qualified expenses are medical expenses, dental expenses, and dependent care expenses. If you did not catch it, the benefit to you is that you can remove money from the FSA account to reimburse yourself with money that was never taxed. Therefore, you are saving whatever your combined federal, state and local tax rate is on the "qualified" expenses. The catch with the plan is you must use the money by 2.5 months after the end of the plan year. Typically, the end of the plan year is 12/31. Any money left in the plan after the end of the plan year plus the 2.5 month grace period is lost. So, be sure you estimate, as best you can, how much you will be spending in qualified expenses.

### **Life Insurance**

Even though you are invincible it is still alright to plan for the worst. Employer based group life insurance is usually a good deal for a couple reasons. The first reason is that there is no underwriting. Underwriting being the process of the insurance company looking at your lifestyle and health to determine how much a risk of dying you carry around with you. The second reason is that typically the cost of the insurance is cheap if not free if your employer covers the cost.

If you would like to figure out how much life insurance you need please visit Yahoo Finance calculators for their life insurance calculator. So, even though you will never die, don't pass up the life insurance your employer offers without a look first and consider who or what financial responsibilities you have.

### **Employee Stock Purchase Plan (ESPP)**

Employee Stock Purchase Plans allow you to buy the stock of the company you work for at a discount. Typically, the discount on the stock is 15% (sometimes lower).

If you want to get in on the ESPP, you have to sign up by a particular date to have from 1% to 10% of your pay withheld for the purchase of company stock over a particular offering period. The dough withheld from your pay will accumulate for that period of time, and then be used to buy stock at the end of the offering period.

Some companies provide a "look back," so that the price you pay can be based on the price at the beginning of the offering period or at the end, whichever is lower. With this type of plan, if the price goes up during the offering period you get an extra kick.

There is an important point to note from a tax standpoint. Normally, if your company gives you shares at a discount price, you have to report the economic benefit as income, even before you sell the shares. With an ESPP you do NOT have to claim the economic benefit from the discount until you sell the shares.

When you sell the shares the sale can either be a qualifying disposition or a disqualified disposition. What's the difference? A qualified disposition is if both of the following are met:

- it is more than a year after the purchase of the shares, and
- it is more than two years after the beginning of the offering period.

To determine the tax impact of the sale of your ESPP shares you have to know if the sale was qualified or disqualified. The minutia of how to calculate the tax on the sale of ESPP shares is beyond the scope of this book. There is plenty of information on the internet about taxation of ESPP or contact your tax advisor.

## Chapter XVII - College Savings Options

So, you have some little ones that you would like to put money away for. There are a number of options for saving for a child's future college needs. There are a few house keeping items before we get into the options.

First, a child's education can always be financed through, loans, grants, scholarships, or even military service but your retirement or future cannot be financed. Before you begin a college savings program make sure you are not selling your own savings short.

Second, you must understand how different account types (both college savings plans and non-college savings plans) affects the potential for financial aid. The following is a brief guide about what assets are considered available to pay for college expenses:

- 20% of a student's assets
- 50% of a student's income
- 2.6% - 5.6% of a parent's assets based on a sliding income scale
- 22%-47% of a parent's income based on a sliding income scale

### 529 Savings Plans

These plans are quickly becoming one of the more popular college savings vehicles. The name comes from the Internal Revenue Code which created the plan. Each 529 plan is sponsored by a State. The real draw to 529 plans is the tax free nature of the accounts. Earnings in 529 plans are tax free if used for qualifying college education expenses (tuition, room, board, fees, books). Some plans offer a State tax deduction for contributions made by residents. (Example being the State of Maryland offers residents up to a \$2,500 State tax deduction for contributions made to the Maryland 529 plan.)

Important items to consider regarding 529 plans:

- Deposits into a 529 plan are considered a gift to the beneficiary (child). The most that can be gifted to the 529 plan in the child's name is \$13,000 (in 2010) by any one person. An example would be a married couple filing a joint tax return can gift \$26,000 into a 529 plan for each child.
- If the child ends up not going to college the account owner (usually a parent) can change the beneficiary to a sibling, parent, cousin or grandparent.
- Consider the overall fees like annual maintenance fee and underlying investment option fees. One way to keep expenses down is if you have multiple kids open one plan and split the benefits down the road.
- When considering which plan to use look at the underlying investment options. The underlying investment options are usually:
  - age based portfolios that become more conservative as the child gets closer to college age
  - static portfolio investment options like equity, bond or balanced
  - individual mutual fund options

- Look at your home state plan first as there may be a state tax deduction. But, do not let the tax deduction be your only decision. If the plan has a tax deduction but the investment options stink what is the point?
- Be sure the child is **not** the owner of the plan but is the beneficiary only. This small detail will ensure from a financial aid perspective the assets in the plan are not considered an asset of the child. As indicated above assets in the child's name are not favorable for financial aid.
- You can only make one change per year to your investment strategy. Meaning for money on the 529 plan you can only switch the fund or set of funds you are invested in once per year. The investment strategy could be that you are moving from one age based portfolio to another or it could be that you have selected a portfolio of funds and want to switch the funds around. Either way you can only adjust the strategy of the portfolio once per year.

### **529 Prepaid Tuition Plans**

These type of plans are exactly what the name implies. You can prepay tuition. The earlier you do this for a child the cheaper it will be. The prepaid tuition credits you buy locks in future tuition costs at today's rates. Some states give a tax break for contributions and there is no income limit restricting donors.

The drawbacks to these types of plans are that they are administered by the state and can therefore be mismanaged by the state. Another significant, potential drawback in some plans is a benefit reduction if the kid goes to college out of state and room and board is not usually covered. Many times there are limited contribution and enrollment periods.

### **Coverdell Education Savings Account**

Coverdell plans tend to get less press than their sibling 529 plan but that should not sway your attention. The Coverdell accounts are similar to a Roth IRA in that you make non-deductible contributions and the earnings are tax free if used for education expenses. The Coverdell differs from a 529 plan on many fronts but there are two big differences. First, Coverdells have a \$2,000 contribution limit per year. Second, funds can be used for elementary and secondary school expenses. Some other key information about Coverdells is as follows:

- You can choose your investment option you are not limited to a set investment scheme like a 529 plan.
- If owned by parent for the benefit of the child it will ensure that the account is considered an asset of the child.
- A potential drawback is the Pension Protection Act of 2006 guided up the contribution limit to \$2,000 and made plan assets available for primary and secondary school. But, it did not make them permanent which means unless the Government extends these points they will expire in 2011.
- There are no state income tax deductions for contributions. As well, one must be eligible to contribute to the Coverdell. Eligibility is based on the contributor's income.
- Assets in the plan must be distributed by the beneficiary attaining age 30.

## UTMA / UGMA Accounts

Uniform Transfer to Minor / Uniform Gift to Minor Accounts. These accounts have lost their luster in recent years due to tax law changes but can still be a useful tool in saving for college. These types of plans can be opened at any bank, mutual fund company, or brokerage firm. You can invest the assets in just about any investment from stocks, mutual funds, bonds, to bank accounts. Any contribution to the account is considered an irrevocable gift to the child and if removed from the account the funds must be used for the child's benefit. Points to consider:

- The child typically is granted control of the account at the age of majority 18-21 in most states. Check your state rules.
- Accounts must be terminated and relinquished to the beneficiary at the age of majority in your state.
- Accounts subject to the Kiddie Tax. Kiddie tax as an example for 2010 states that the first \$950 of unearned income (income from investments such as dividend and interest) for a child is not taxed the next \$950 is taxed at the 10% tax rate and anything over \$1,900 is taxed at the parents rate.
- Because the child owns the account up to 20% of the account will be counted toward the family contribution when calculating financial aid.
- This type of account works well if you do not think your child will be college bound.

This section is only to give you the basics of the most popular savings vehicles for kids. There are other ways to save such as through complex trust arrangements or your retirement plans.

## Chapter What XVIII - Online Tools

Paralysis by analysis. Wow! I can only imagine what you are going through or may go through when it comes to financial decisions. As a financial professional the issues around money and investing are easy to conquer as we work in the field. Just as a mechanic does not need much help with a car or a doctor does not need to seek much medical advice. Believe us we understand. So, we know what it is like to research and look for answers to questions outside our expertise.

Here are some great online tools that we use professionally:

- [www.ETFGPS.com](http://www.ETFGPS.com) - this is my blog site where you can also find my podcast. You will find timely information on the markets as well as ETFs.
- [www.stockcharts.com](http://www.stockcharts.com) - good site for charting the market or your holdings.
- [www.morningstar.com](http://www.morningstar.com) - this is a great site for mutual fund, exchange traded fund (ETF) and stock research. They offer both a free and pay memberships
- [www.mint.com](http://www.mint.com) - this site is an account aggregation service where you can see all your financial accounts (savings, credit, investments) in one place.
- [www.bankrate.com](http://www.bankrate.com) - great site for banking and credit card and loan research
- [www.finance.google.com](http://www.finance.google.com) - awesome stock quoting and timely articles regarding researched security
- [www.investinginbonds.com](http://www.investinginbonds.com) - great resource to learn about investing in bonds
- [www.finance.yahoo.com](http://www.finance.yahoo.com) - awesome site for investor knowledge and great stock, mutual fund and ETF screeners.
- [www.savingforcollege.com](http://www.savingforcollege.com) - site for all things college savings. Especially 529 plans.
- [www.etfreplay.com](http://www.etfreplay.com) - great site for researching ETFs