BASIC FINANCIAL PLANNING AND INVESTING
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Steps to Financial Planning Success

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See disclaimer on final page
Debt Management

What is debt management?

As a modern consumer, you need credit. When you were growing up, you may have heard your parents or grandparents say, "If you can't pay for it with cash, then you can't afford to buy it." That may have been sound advice 40 or even 20 years ago, but such attitudes about credit are outdated and unrealistic for most adults working and living in modern times. The average cost of a car, house, or college education has skyrocketed when compared to the average household income, so typical consumers need to borrow money if they want to buy a home, drive a car, or educate themselves or their children. Throw in a handful of charge accounts and credit cards, and it is no wonder that the average consumer is carrying more debt than ever before. With greater credit needs comes a greater need for debt management.

Good debt management ensures that you will have credit when you need it, make wise borrowing decisions, and avoid disaster if you become overextended. You can ensure that loans are available when you need them by establishing and maintaining a positive credit record. You can benefit from many specialized loan programs if you are aware of your borrowing options. You can save money by taking steps to reduce the cost of debt and save yourself from disaster if you know what to do when you can no longer meet your financial obligations.

Establishing credit

You must first establish a credit record if you want to have ready access to loans when you need them. You establish a credit record by borrowing money from a lender who reports to a credit bureau. So, what's the problem? The problem is that few lenders will loan you money if you don't have an established credit record. That is the catch-22 of building credit. However, if you have no credit experience, there are several ways to get started.

Thinking small and taking advantage of special credit deals is one way to establish that first credit relationship. Increasing lender confidence with a large down payment, or posting collateral, is another. Insured credit, guaranteed credit, and secured credit help many borrowers get started. If you pay your obligations as agreed, you will be surprised at how many lenders will offer you credit once the ball is rolling.

Borrowing options

You wouldn't try to buy a house using proceeds from a student loan, nor would you try to finance your college education with a credit card. However, you might use a home equity loan or line of credit to finance your child's college education. Knowing what borrowing options are available to you is important when shopping for credit. Some types of loans carry lower interest rates, some have tax-deductible interest, some are subsidized by government entities, and still others have special repayment terms designed to serve the needs of a special class of borrower.

Whenever you have the need to finance an expense, it is worth your time and effort to educate yourself about your borrowing options. Lenders today are enormously competitive, and there are more than just interest rates to consider when comparing one loan package to another. Find the loan that best suits your needs, and be sure you have examined all your choices.

Credit reports

Part of what makes it possible for you to shop for credit is your credit report, which is a record of your past credit relationships. As mentioned previously, establishing and maintaining a good credit record makes you an attractive customer for lenders. You will get the best deals and have access to the largest number of credit options if your good credit record is maintained.
The first step in maintaining a good credit record is to pay your obligations as agreed. However, merely paying your bills is not enough. Many credit reports contain errors that are clerical in nature or caused by misidentification (e.g., someone else's bad credit gets put on your report). Although these errors are not your fault, they can cause delay or rejection when applying for a loan. To avoid such complications and delays, you need to obtain copies of your credit reports from the various national credit reporting agencies. Once done, you need to interpret the information and determine whether errors have been made. If there are problems with your report, you have specific rights that you can exercise and a procedure for correcting errors. You can force the credit reporting agencies to investigate errors and either correct, confirm, or delete the information, usually within 30 days.

Repairing poor credit

If the information on your credit report is correct but bad, you face a more difficult task. However, a poor credit record can be improved. Adding good credit to your report is helpful. It shows that your period of financial difficulty is over and that you are once again making good on your debts. You can also go back to creditors that reported bad information and negotiate a deal in which you agree to pay off the account, or make additional payments on the account, if the lender will agree to upgrade your credit status.

Your report may contain bad credit because of a dispute with a creditor. Perhaps you purchased a defective appliance on credit, the merchant failed to repair or replace it, you refused to make payments, and the merchant reported you as delinquent. You can add a consumer statement to your credit report to tell your side of the story. If all else fails in your attempt to repair credit, you may have to simply wait out your credit problems. Even bankruptcies disappear from your report in time.

Reducing the cost of debt

It is good to periodically evaluate your debt situation and determine whether you can reduce the cost of debt. It makes no sense to be paying more money for interest if you can be paying less. There are several ways to reduce the cost of debt: You can refinance loans to get lower interest rates, use the equity in your home to pay off high interest loans and credit card balances, or transfer your credit card balances to cards with lower rates.

Other options include prepaying debts and liquidating assets to pay off loans and to avoid further interest charges. You may also seek to reduce or eliminate noninterest costs related to borrowing, such as private mortgage insurance (PMI). If you have kept your mortgage payments current and built up sufficient equity in your house, you may be able to cancel your PMI coverage. Many of these options have tradeoffs. For more information, see a financial professional.

Options when you can't meet your financial obligations

Ideally, you should never incur more debt than you can afford. If that plan fails, then your next task is to recognize when you are financially overextended and do something about it. Doing nothing is the worst possible choice. The longer you wait to take action, the more severe your financial troubles are likely to become.

Increasing your income stream may be an option. If not, there are things you can do to reduce your monthly obligations. Reducing the cost of debt, or negotiating directly with your creditors may enable you to lower monthly payments. If you need professional advice, you can hire a credit counselor or contact one of the many nonprofit credit counseling services, such as Consumer Credit Counseling Services, which can often arrange an affordable repayment plan for you. If things are really out of control, you may want to consult an attorney about bankruptcy and determine whether you would benefit from a self-help support program such as Debtors Anonymous. You should face up to your financial difficulties and take steps to resolve them.
Six Keys to More Successful Investing

A successful investor maximizes gain and minimizes loss. Here are six basic principles that may help you invest more successfully.

Long-term compounding can help your nest egg grow

It's the "rolling snowball" effect. Put simply, compounding pays you earnings on your reinvested earnings. The longer you leave your money at work for you, the more exciting the numbers get. For example, imagine an investment of $10,000 at an annual rate of return of 8 percent. In 20 years, assuming no withdrawals, your $10,000 investment would grow to $46,610. In 25 years, it would grow to $68,485, a 47 percent gain over the 20-year figure. After 30 years, your account would total $100,627. (Of course, this is a hypothetical example that does not reflect the performance of any specific investment.)

This simple example also assumes that no taxes are paid along the way, so all money stays invested. That would be the case in a tax-deferred individual retirement account or qualified retirement plan. The compounded earnings of deferred tax dollars are the main reason experts recommend fully funding all tax-advantaged retirement accounts and plans available to you.

While you should review your portfolio on a regular basis, the point is that money left alone in an investment offers the potential of a significant return over time. With time on your side, you don't have to go for investment "home runs" in order to be successful.

Endure short-term pain for long-term gain

Riding out market volatility sounds simple, doesn't it? But what if you've invested $10,000 in the stock market and the price of the stock drops like a stone one day? On paper, you've lost a bundle, offsetting the value of compounding you're trying to achieve. It's tough to stand pat.

There's no denying it--the financial marketplace can be volatile. Still, it's important to remember two things. First, the longer you stay with a diversified portfolio of investments, the more likely you are to reduce your risk and improve your opportunities for gain. Though past performance doesn't guarantee future results, the long-term direction of the stock market has historically been up. Take your time horizon into account when establishing your investment game plan. For assets you'll use soon, you may not have the time to wait out the market and should consider investments designed to protect your principal. Conversely, think long-term for goals that are many years away.

Second, during any given period of market or economic turmoil, some asset categories and some individual investments historically have been less volatile than others. Bond price swings, for example, have generally been less dramatic than stock prices. Though diversification alone cannot guarantee a profit or ensure against the possibility of loss, you can minimize your risk somewhat by diversifying your holdings among various classes of assets, as well as different types of assets within each class.

Spread your wealth through asset allocation

Asset allocation is the process by which you spread your dollars over several categories of investments, usually referred to as asset classes. These classes include stocks, bonds, cash (and cash alternatives), real estate, precious metals, collectibles, and in some cases, insurance products. You'll also see the term "asset classes" used to refer to subcategories, such as aggressive growth stocks, long-term growth stocks, international stocks, government bonds (U.S., state, and local), high-quality corporate bonds, low-quality corporate bonds, and tax-free municipal bonds. A basic asset allocation would likely include at least stocks, bonds (or mutual funds of stocks and bonds), and cash or cash alternatives.

There are two main reasons why asset allocation is important. First, the mix of asset classes you own is a large
factor--some say the biggest factor by far--in determining your overall investment portfolio performance. In other words, the basic decision about how to divide your money between stocks, bonds, and cash is probably more important than your subsequent decisions over exactly which companies to invest in, for example.

Second, by dividing your investment dollars among asset classes that do not respond to the same market forces in the same way at the same time, you can help minimize the effects of market volatility while maximizing your chances of return in the long term. Ideally, if your investments in one class are performing poorly, assets in another class may be doing better. Any gains in the latter can help offset the losses in the former and help minimize their overall impact on your portfolio.

**Consider liquidity in your investment choices**

Liquidity refers to how quickly you can convert an investment into cash without loss of principal (your initial investment). Generally speaking, the sooner you'll need your money, the wiser it is to keep it in investments with comparatively less volatile price movements. You want to avoid a situation, for example, where you need to write a tuition check next Tuesday, but the money is tied up in an investment whose price is currently down.

Therefore, your liquidity needs should affect your investment choices. If you'll need the money within the next one to three years, you may want to consider certificates of deposit or a savings account, which are insured by the FDIC, or short-term bonds or a money market account, which are neither insured or guaranteed by the FDIC or any other governmental agency. Your rate of return will likely be lower than that possible with more volatile investments such as stocks, but you'll breathe easier knowing that the principal you invested is relatively safe and quickly available, without concern over market conditions on a given day.

*Note:* If you're considering a mutual fund, consider its investment objectives, risks, charges, and expenses, all of which are outlined in the prospectus, available from the fund. Consider the information carefully before investing.

**Dollar cost averaging: investing consistently and often**

Dollar cost averaging is a method of accumulating shares of stock or a mutual fund by purchasing a fixed dollar amount of these securities at regularly scheduled intervals over an extended time. When the price is high, your fixed-dollar investment buys less; when prices are low, the same dollar investment will buy more shares. A regular, fixed-dollar investment should result in a lower average price per share than you would get buying a fixed number of shares at each investment interval.

Remember that, just as with any investment strategy, dollar cost averaging can't guarantee you a profit or protect you against a loss if the market is declining. To maximize the potential effects of dollar cost averaging, you should also assess your ability to keep investing even when the market is down.

An alternative to dollar cost averaging would be trying to “time the market,” in an effort to predict how the price of the shares will fluctuate in the months ahead so you can make your full investment at the absolute lowest point. However, market timing is generally unprofitable guesswork. The discipline of regular investing is a much more manageable strategy, and it has the added benefit of automating the process.

**Buy and hold, don’t buy and forget**

Unless you plan to rely on luck, your portfolio’s long-term success will depend on periodically reviewing it. Maybe your uncle’s hot stock tip has frozen over. Maybe economic conditions have changed the prospects for a particular investment, or an entire asset class.

Even if nothing bad at all happens, your various investments will likely appreciate at different rates, which will alter your asset allocation without any action on your part. For example, if you initially decided on an 80 percent to 20 percent mix of stocks to bonds, you might find that after several years the total value of your portfolio has become divided 88 percent to 12 percent (conversely, if stocks haven’t done well, you might have a 70-30 ratio of stocks to bonds in this hypothetical example). You need to review your portfolio periodically to see if you need to return to your original allocation. To rebalance your portfolio, you would buy more of the asset class that's lower
than desired, possibly using some of the proceeds of the asset class that is now larger than you intended.

Another reason for periodic portfolio review: your circumstances change over time, and your asset allocation will need to reflect those changes. For example, as you get closer to retirement, you might decide to increase your allocation to less volatile investments, or those that can provide a steady stream of income.
Understanding Risk

What is risk?

In general

Risk is all around us, and we all take risks every day. Some people consider driving a car risky. Others don't seem to mind driving but don't like flying in an airplane--even though statistics show you're far more likely to die in a car than in an airplane. Some of us, like racecar drivers, cliff divers, and bungee jumpers, actually thrive on risk. Others go to great lengths to reduce risk.

Risk is multidimensional with many factors interacting. For example, an athlete in top physical condition may suffer a fatal heart attack while exercising because he or she has a family history of heart disease.

Some risks are more apparent than others. For instance, walking a high wire is quite obviously a risk. On the other hand, the danger of being struck by lightning is not so obvious.

The bottom line is that you can't live without taking some risks. Since you cannot totally eliminate them, the best you can do is try to manage them as much as possible. That's why we avoid people with colds, eat healthy diets, wear life jackets when we go boating, and buy life insurance.

Risk in the investment world

Some people view risk as a negative, others as an opportunity. Ask any group of people what risk means to them, and you are likely to get some of these answers:

- Danger
- Possible loss
- Uncertainty
- Challenge
- Potential gain

In the investment world, risk generally is related to uncertainty. It refers to the possibility that you might lose your investment, or that an investment will yield less than its anticipated return. More simply stated, risk has traditionally referred to the probability that an investment will behave differently than expected. Every investment carries some degree of risk because its returns are unpredictable. The more volatile an investment is--the more unpredictable its returns--the riskier it is generally considered to be.

Within this framework, there are multiple ways of viewing risk. Modern Portfolio Theory (MPT), the basis of most portfolio planning processes since it was articulated in the 1950s, views risk as being two-sided; the greater an investment's deviation from an anticipated return--up or down--the riskier it is assumed to be. However, a concept sometimes referred to as Post-Modern Portfolio Theory (PMPT) also has begun to receive attention. It focuses primarily on downside risk: the possibility of loss, or of not meeting a specific investment target. This approach tends to estimate the statistical likelihood of a negative outcome--for example, the odds that a portfolio would fail to produce the return needed to produce a certain level of income for 30 years--and make plans based on that estimate.

The relationship between risk and return

When you invest, you plan to make money on that investment or, more accurately, earn a return. Risk and return are inversely related. In general, the higher the desired return, the greater the uncertainty about the end result; as
a result, you are likely to have to take more risk to obtain it. Conversely, if you want a more certain outcome and lower risk, you may have to accept lower potential return. This is often referred to as the "risk-return tradeoff;" you generally must trade off a higher potential return in exchange for lower risk.

The relationship between risk and time, or the time horizon

The length of time that you plan to remain in a particular investment vehicle is known as your investment planning time horizon. Generally speaking, the longer your time horizon, the more aggressive you may be able to be by investing in higher-risk investments. This is because the longer you can remain invested, the more time you'll have to ride out fluctuations to try to achieve a higher return over that time. Of course, there is no assurance that any investment will not lose money.

Risk-taking propensity

Each individual is able to tolerate a different amount of investment risk. This is known as your risk-taking propensity or risk tolerance. Those who are comfortable taking more risk in exchange for the potential for a higher return are referred to as risk tolerant. On the other end of the scale, those who can accept very little risk are known as risk averse. Many people fall somewhere between these two ends of the risk tolerance spectrum.

There are ways to measure your risk tolerance, using tests to assess how you react to different types of risk, such as monetary, physical, social, and ethical. These tests aren't foolproof, since they generally measure psychological behaviors that may vary under different conditions, and may or may not take into account how your financial circumstances affect your risk tolerance. However, the results from these tests are generally considered reliable and valid.

In determining which investments match your risk-return expectations, your risk-taking propensity is as important as the risk of a given investment itself. If your risk tolerance proves to be lower than you initially thought, you may have difficulty sustaining a financial plan during difficult periods. Also, your risk tolerance may change over time as your circumstances change.

How do you evaluate the risk of a specific investment?

Before you can evaluate the risk of a specific investment, you must understand the types of risk that exist and how to measure them.

As in your day-to-day life, risks are prevalent in the investment world, and some are more apparent than others. Each investment is subject to all of the general uncertainties associated with that type of investment. These are known as systematic risks and include market, interest rate, and purchasing power risk, among others. Risk also arises from factors and circumstances that are specific to a particular company, industry, or class of investments. These are known as diversifiable or unsystematic risks, because they can be addressed (at least in part) by investing in more than just that one company, industry, or class. Diversifiable risks include business, financial, and default risk, among others.

Measuring risk involves analyzing the various types of risk using an array of mathematical tools and techniques (e.g., an investment's standard deviation, beta, alpha, and so forth). The statistics obtained provide an investor with some standardized measurements with which to make an educated decision.

Rating services

Ratings services, such as Standard & Poor's, Fitch, Moody's, Value Line, and Morningstar, compile and publish risk and return statistics for many types of investments. Though they are not infallible, these services provide an investor with key information and statistics in a condensed and easy-to-read format, and often give some context for assessing the data.

To obtain rating service reports, check with your public library. It may subscribe to some or all of these services. You also may find information online.
Research

To do investment research, you may be able to view an annual report, prospectus, or proxy statement with financial information and outlined business strategies. To obtain copies of these documents, contact the issuer of the security. You also may find helpful information in books, newspapers, magazines, journals, newsletters, or online sources.

How do you reduce risk?

Diversify

One of the most common ways to reduce risk is to develop a portfolio of investments that is balanced in terms of the types of assets in which you invest. In other words, in designing and managing an investment portfolio, don't put all your eggs in one basket. This is known as diversification. According to Modern Portfolio Theory, a portfolio that mixes a variety of asset classes (e.g., cash, bonds, domestic and foreign stocks, and real estate) generally has a lower risk for a given level of return than a portfolio that consists of only one of those classes, or a portfolio whose assets are highly correlated and tend to behave in similar ways. Diversification works because it broadens your investment base (though it can't guarantee a profit or protect against a possible loss). It can be achieved by company, industry, type of security, markets, or by investment objective.

How an investor diversifies depends upon his or her own situation. An investor can be aggressive (investing mostly in high-risk vehicles), conservative (investing mostly in low-risk vehicles), or somewhere in between (often by using some combination of high- and low-risk investments).

Allow for the passage of time

Historically, time has helped moderate the riskiness of some investments (though there is no guarantee this will continue in the future). In "investmentspeak," the standard deviation associated with the average rate of return on an investment—the extent to which returns vary from historical norms—tends to decrease over time. In plain English, the longer the investor remained invested—or the longer the investor's time horizon—the more the return over that time will tend to resemble the historical average.

Do your homework

You may be able to reduce some risk simply by being diligent. For example, have real estate inspected and appraised before you buy it, or investigate a company's financial condition before you purchase stock in it.

Gauge the economy by identifying trends in overall business conditions. These trends are indicated regularly (weekly or monthly) by figures on inventories, prices, employment, and the GDP. Is the economy on an upswing or downswing? Knowing this will help you choose an investment you believe is likely to appreciate under the given conditions.

Make sure you understand why you're buying an investment and what role you want it to play in your portfolio. In addition to making you a more informed investor, this also can help you gauge when to sell it.
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Investing in Stocks

Businesses sell shares of stock to investors as a way to raise money to finance expansion, pay off debt, and provide operating capital. Each share of stock represents a proportional share of ownership in the company. As a stockholder, you share in a portion of any profits and growth of the company. Dividends from earnings are paid to shareholders, and growth is realized by the increase in value of the stock.

Stock ownership also generally gives you the right to vote on management issues. Company executives work for the shareholders, who are represented by an elected board of directors. The goal of management is to increase the value of the corporation's equity. If shareholders are dissatisfied with the corporation's performance, they can vote for a change in management.

Why invest in stocks?

The main reason that investors buy stock is to seek capital appreciation and growth. Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return over time than other investments, including bonds and cash alternatives. Correspondingly, though, stocks are generally considered to have more volatility than bonds or cash alternatives.

Can you lose money?

Yes, you can. There are no assurances that a stock will increase in value. Several factors can affect the value of your stocks:

- Actions of investors: If a large number of investors believe that the nation is entering a recession, their actions can affect the direction of the stock market
- Business conditions: A new patent, an increase in profits, a pending merger, or litigation could affect investor interest and stock prices
- Economic conditions: Employment, inflation, inventory, and consumer spending influence the potential profit of a company and its stock price
- Government actions: Decisions on interest rates, taxes, trade policy, antitrust litigation, and the budget impact stock prices
- Global economy: Changes in foreign exchange rates, tariffs, or diplomatic relations can cause stocks to go up or down

Understanding these factors can help you make sound investment decisions and keep losses to a minimum.

What are the different classifications of stocks?

Stocks are often classified in the following ways:

- Growth stocks have earnings that are increasing at a faster rate than the market average. These are usually in new or fast-growing industries and have the potential to give shareholders returns greater than those offered by the stocks of companies in older, more established industries. Growth stocks are the most volatile class of stock, however, and may be just as likely to go down in price.
- Value stocks are those of companies with good earnings and growth potential that are currently selling at a low price relative to their intrinsic value. Due to some problem that may be only temporary in nature, investors are ignoring these stocks. Since it can take quite some time for their true value to be reflected by their price, value stocks are usually purchased for the long term.
Income stocks are generally not expected to appreciate greatly in share price, but typically pay steady dividends. Utilities are an example of companies that have historically been considered income-oriented.

Blue chip stocks are the stocks of large, well-known companies with good reputations and strong records of profit growth. They also generally pay dividends.

Penny stocks are very risky speculative stocks issued by companies with short or erratic performance histories. These stocks are so named because they sell for under $5 per share. Their low price appeals to investors willing to assume a total loss in exchange for the potential for explosive growth.

It is usually best to diversify among the different classifications and not own stock in just one or two companies or industries (though diversification alone cannot guarantee a profit or ensure against a loss).

How are stocks bought and sold?

During an initial public offering (IPO), new issues of stock are sold on the basis of a prospectus (a document that gives details about a company's operation) that is distributed to interested parties. Investment bankers or brokerage houses buy large quantities of the stock from the company and sell them to investors. After the IPO, the stock may trade on a stock exchange or over the counter.

Normally, stock is purchased through a brokerage account. The buy order you place will be directed to the appropriate stock exchange. When someone who owns the stock is willing to sell at the price you are willing to pay, the sale takes place. A commission or fee is charged on your transaction.

Stock certificates may be transferred from one owner to another since they are negotiable instruments. The certificates are issued in the buyer's name or, more typically, held by the brokerage house in street name (i.e., the brokerage firm's name) on behalf of the investor. The advantage of a street-name registration is that if you decide to sell, you do not have to sign and deliver the stock certificates before the sale can be completed. And you don't have to worry about losing the stock certificates.

How do you set up a brokerage account?

You will need to complete a new account agreement and make three important decisions:

Who will make the investment decisions? You will—unless you give discretionary power to your broker or agent. Discretionary power allows a broker or agent to make decisions based on what he or she believes is best for you. Unless you limit the broker's or agent's discretion, this may be done without consulting you about the type of security and number of shares involved, or about the time and price at which to buy or sell. Do not give discretionary power to your broker or agent without seriously considering if it is right for you.

How will you pay for the stock? A cash account requires you to pay for each stock purchase in full at the time you buy it. A margin account allows you to borrow money from the brokerage firm. Securities that you own are held as collateral, and interest is charged on the loan. If the account value falls below the specified amount required to maintain the loan (even as the result of a one-day market decline), you must pay down the loan balance to an amount determined in relation to your new account balance. This is known as a margin call and can potentially require the payment of a sizable amount of money.

What level of risk can you handle? You will be asked to specify your investment goals in terms of risk. Choices such as income, growth, or aggressive growth may be given. Make sure you understand the meaning of each term, and be certain that the level of risk you choose truly reflects your ability to handle risk. Any investment your broker or agent recommends should be based on the category of risk you selected.

Read the account agreement
Keep good records of:

• Documents you sign
• Documents outlining the details of an account or investment
• Periodic account statements
• Transaction confirmations
• Documents verifying an account error was corrected
• Correspondence with your broker or agent

Review these as soon as you receive them. Discuss any discrepancies you find with your broker or agent at once, and follow up on any actions taken until you are satisfied. Never allow your broker or agent to mail statements and transaction confirmations to someone other than you. It's important that you check the accuracy of your own accounts.

Be patient

Some stock investors have made money quickly. But they are the exception rather than the rule. Investing in stocks requires a long-term outlook. Read books, attend seminars, and take advantage of professional advice. Education, good judgment, common sense, and above all, patience increase your chances of achieving your goals.
Introduction to Designing and Managing an Investment Portfolio

Introduction

Once you've identified your financial and investment goals and assessed your investing personality, you'll need to create an investment portfolio that fits your needs and understand what's involved in managing that portfolio on an ongoing basis.

Entire books—actually shelves full of books—have been written about ways to design and manage a portfolio, so this discussion obviously can only serve as a basic introduction to the process. However, it can help you understand the challenges involved and decide just how much assistance you might need, as well as how involved you want to be in managing your portfolio on an ongoing basis.

Designing an investment portfolio

Designing an investment portfolio generally involves figuring out how to integrate all your various financial and investment goals. Generally, this involves some form of asset allocation (the process of deciding how to divide your assets among different types of investments, such as stocks, bonds, cash alternatives, and other investments). It may also include specific tax planning strategies to minimize your tax burden.

Goal-based investing

Some people choose to look at each investment goal separately. Each goal might have its own asset allocation designed specifically for that goal, taking into account such factors as time horizon, risk tolerance, and liquidity needs.

One example of this is what's sometimes known as the "bucket" approach. A retiree might have one "bucket" of assets invested exclusively in short-term investments that will be used to pay living expenses for the next 1-3 years. A second bucket might hold mostly bonds and preferred stock designed to produce income that is used to replenish the short-term bucket. A third bucket might include a growth component designed to help the overall portfolio keep pace with inflation over the long term. And another bucket might be invested to provide for a grandchild's education in five years.

Example(s): Bob prefers to think of his investments as silos. He has an annuity that will provide him with a lifetime income (subject to the claims-paying ability of the issuer) that is sufficient to cover the cost of food, clothing, and housing. He has a portfolio of individual bonds that collectively pay him enough to eat out and travel occasionally. And he owns a group of stocks that he plans to either sell one day to pay for his grandchildren's education or leave to them after he's gone.

Such goal-based investing allows you to match specific assets to a specific time horizon, which can be particularly useful for large, long-term goals or if your assets are relatively modest. However, it also can lead to inefficiency and inadvertent overlap between multiple portfolios. In some cases, it also might not be the most effective way to manage your tax liability.

Return-based investing

Others find it beneficial to establish a single asset allocation that takes into account all or most of their combined investment assets and is aimed at achieving an overall average rate of return for the entire portfolio. This can promote tax efficiency (for example, by facilitating strategic harvesting of tax losses across multiple assets or accounts). It also gives you a broader perspective on your overall financial situation and can mean greater flexibility to shift your overall asset allocation if necessary.

Example(s): When Betty retired, her advisor designed her portfolio to provide an average annual
return of 4 percent, which she uses to pay all of her living expenses that aren't covered by Social Security. The portfolio includes a growth component designed to ensure that the portfolio keeps pace with inflation. It also is structured so that in Betty's later years, she will begin to draw down the principal itself.

Monte Carlo simulations can project a portfolio's performance based on how its asset allocation would have performed in the past. Such a simulation can give you an idea of the range of returns, including best-case and worst-case scenarios, that you might reasonably expect from a given portfolio. (However, remember that past performance is no guarantee of future results and any projections are only as good as the assumptions that go into the computer model that creates them.)

**Strategic versus tactical?**

One fundamental decision you'll want to consider in your portfolio design is whether you want to pursue a strategic investment strategy or be more tactical. If you prefer a strategic, long-term approach to asset allocation, which takes into account your risk tolerance, time horizon, and historic returns for various asset classes, you'll probably gravitate to more of a buy-and-hold approach (see below). By contrast, a tactical approach tends to be more opportunistic and take advantage of changing market conditions by investing a greater percentage in asset classes that are expected to outperform in the immediate future, or that may reduce risk.

A compromise between the two methods is a so-called core-and-satellite approach. To pursue it, you would establish a core strategic asset allocation that is kept relatively constant and is based on your strategic goals, and practice tactical asset allocation with a smaller percentage of the portfolio. For example, you might shift some of the tactical portion of your portfolio into small-cap stocks if you felt they were poised to do well, and then move out of them if your thesis proves wrong or another type of investment presents a better opportunity later.

**Managing an investment portfolio**

Designing a portfolio is only the first step. Once your general approach and asset allocation strategy are established, you'll need to select specific investments and decide on the timing of any purchases and sales. In other words, your portfolio will need to be managed on an ongoing basis. This is never an easy task (just ask any professional investor). Some of the factors that can affect portfolio performance include socioeconomic and political conflict, higher or lower interest rates, changes in laws or governmental regulations, and tax legislation, to name only a few of the many things that professionals keep an eye on when managing money.

Here is a brief list of some of the tasks and decisions you'll face:

**Selecting specific securities**

One of the most challenging tasks of portfolio management is selecting specific securities from the thousands available. Typically you and/or your financial professional would establish screening criteria to develop a list of likely prospects for purchase, then do more detailed research to determine precisely what and when to buy.

One of the choices you'll face is the decision whether to invest directly in individual stocks and bonds, or use a vehicle such as a mutual fund to invest in them. Each has its advantages. Individual securities allow greater flexibility in timing a trade, better management of potential tax liability, lower costs (in some cases), and potentially higher returns if you select a stock that takes off. However, diversification requires a higher minimum investment, and though diversification doesn't ensure a profit or protect against potential loss, you could lose your entire investment if you select the wrong security. Mutual funds offer professional management (particularly actively managed funds) and you can generally achieve greater diversification at a lower cost. However, your fellow investors in a fund can affect your returns, and you have less control over when capital gains are realized.

Many investors use both individual securities and funds to take advantage of what each offers. Before investing in a mutual fund, carefully consider its investment objectives, risks, charges, and expenses, which are contained in the prospectus available from the fund. Read it carefully before investing.
Establishing performance criteria

Benchmarking measures the performance of your investment portfolio against certain models. Although you can use something like the latest 10-year Treasury bond, for instance, as a benchmark for all bonds, the term usually refers to comparisons with standardized indexes. The best-known and most reliable indexes include the Standard & Poor’s 500, the NYSE Composite Index, the Nasdaq Composite Index, Dow Jones 30 Industrials, the Wilshire 5000, the Russell 2000, and Nasdaq 100. Benchmarking can help you determine whether the investments in your portfolio are matching comparable investments, exceeding them, or underperforming. However, it's important to be sure you've selected appropriate benchmarks. And although benchmarking has proved highly effective, past performance as reflected by the various indexes does not necessarily predict future performance.

Managing an income stream

If you plan to rely on your portfolio for income, you'll need to determine how much you need and how the portfolio will produce it. For example, will you withdraw a portion of the principal, or withdraw only the income? Do you need to be certain about the precise amount of each payment or withdrawal, or is there room for flexibility? Even if you're not using any income the portfolio produces, you'll need to understand how factors such as changing interest rates can affect the income your investments will produce.

Some of these decisions will be made in designing the portfolio, but you may also have to reexamine them as your circumstances and the financial markets change.

Deciding how actively the portfolio will be managed

Portfolio managers generally fall into one of two camps (or maybe somewhere in between). Active managers believe that the best way to produce above-average investment returns is through careful selection of individual securities and trading them at opportune times to take advantage of ups and downs in the financial markets. Another camp believes that trying to beat the market averages is not worth the cost and risks involved and is extremely difficult even for professionals. They argue that buying and holding investments for an extended period--typically years--is more cost-effective. Buy-and-hold is an example of a passive management investing style, which is often practiced through indexing: designing a portfolio to match a specific index to try to replicate its performance.

If you prefer active management, you should either be prepared to devote the time and research necessary to make wise trades, or have someone with more experience handle it for you by investing in actively managed mutual funds or working with a professional money manager.

Deciding when to sell an investment

Some investors feel comfortable selecting an investment, but less certain about when it makes sense to sell an investment. Aside from factors that are unique to a specific investment or your own circumstances, you might consider selling an investment when:

- The investment has performed poorly, well below your expectations
- The investment has performed well and exceeded your expectations
- You feel another investment might perform even better
- It is beneficial from a tax standpoint

Caution: A wise investor will understand the importance of properly timing the sale of an investment, as well as any tax consequences.

The costs of managing a portfolio

The rewards of controlling investment-related expenses are twofold: (1) you pay no more than is necessary, and
(2) you pay enough to ensure that your portfolio provides strong returns.

A cost-effective implementation of your investment plan begins with an understanding of the charges associated with managing a portfolio. Some of the most common include:

- **Investment professional's and money manager's fees**: These fees vary widely, depending on the size of your portfolio and the services rendered. Firms and individuals who are registered with the Securities and Exchange Commission are required to publish a fee schedule. Some states permit performance-based fees. Under these arrangements, the fee is higher if the portfolio performs better than expected (a benchmark is predetermined for this purpose).

- **Trading costs**: Whenever securities are bought or sold, commissions and execution costs are incurred. The commission fee is generally calculated as a function of the number of shares traded, price per share, and degree of trading difficulty, among other things. The execution cost (also referred to as the spread) is the difference between what you pay for a security (the ask price) and what the dealer pays for the security (the bid price).

- **Custodial charges**: A custodian serves as the keeper or guardian of the investment and actually holds the securities. This custodian (typically a brokerage firm or trust company) is the intermediary between you and the investment professional. Generally, an annual fee is charged for each account held by the custodian.

  **Tip:** Any management costs and expenses should be adequately disclosed. An above-the-line expense (e.g., administrative expenses) appears on your invoice as a separate line item. Below-the-line expenses (e.g., trading costs) are netted out of the performance of the portfolio.

### Monitoring your portfolio

Even if you pursue a buy-and-hold approach to managing your portfolio, buy and hold doesn't mean buy and forget. Your portfolio's performance will still need to be monitored so that it can be adjusted to changes in your circumstances and/or the financial markets, or simply to ensure that you're getting the performance you expect from it. From time to time, you may need to either rebalance or redesign a portfolio.

Rebalancing simply involves restoring your original asset allocation by shifting your funds among investment categories to regain the ratios you decided on when the portfolio was first designed. For example, if one asset class has done well and now represents more of your portfolio than you originally intended, you might sell some and use the proceeds to invest in another asset class that is now underrepresented.

  **Tip:** Many investment advisors recommend using shifts of 5 percent or more as a trigger for rebalancing. Others recommend that it be done every year. Tax time or year-end are natural times to think about rebalancing.

  **Caution:** You should consider the transaction costs and/or tax consequences that might result from rebalancing. For example, selling an investment might trigger capital gains tax and/or (in the case of a mutual fund) redemption fees.

Rebalancing is less drastic than redesigning your portfolio, which may involve setting an entirely new asset allocation and/or replacing your existing investments with fresh ones. You may want to consider redesigning your portfolio when you are faced with major life changes, such as retirement, or if your investment goals have changed.

### Do it yourself, get assistance, or turn everything over to a professional?

As even this brief discussion shows, designing and managing a portfolio requires at least some understanding and experience with the financial markets and investment planning, plus the time and dedication needed to supervise all the myriad aspects of properly supervising a portfolio on a day-to-day basis.
If you aren’t sure you have the time and/or expertise involved, a financial professional can be involved to the extent you feel is appropriate. That role can be all-encompassing or limited to certain tasks. Either way, the duties can be broken into four major categories:

- Managing all or part of your portfolio: Typically, an investment professional will employ and oversee money managers who evaluate and implement investment options and strategies. You may also employ money managers directly to implement your own investment decisions.

- Reviewing your portfolio's performance: This entails measuring the overall performance of your portfolio, as well as the performance of asset classes and individual investments within the portfolio.

- Reporting to you: Reports on your portfolio should provide you with information about its performance, compliance with your investment policy, your progress toward your financial goals, and the effects on cash flow and taxes.

- Recommending changes to your investment plan as the need arises: In general, there should be guidelines for any changes and any periodic rebalancing.
Mutual Fund Basics

A mutual fund pools the money of many investors to purchase securities. The fund's manager buys securities to pursue a stated investment strategy. By investing in the fund, you'll own a piece of the total portfolio of securities, which could be anywhere from a few dozen to hundreds of stocks. This provides you with a convenient way to obtain instant diversification that would be harder to achieve on your own.

Types of mutual funds

There are many mutual funds to choose from. The two most common types are stock mutual funds and bond mutual funds. A stock fund invests in common stocks issued by U.S. and/or international companies. Funds are often named and classified according to investment style or objective, which can be stated in various ways. For example, some stock mutual funds buy stocks in companies believed to have potential for long-term growth in share price. Other stock mutual funds look for current income by focusing on companies that pay dividends. Sector funds buy stocks in a particular sector, such as technology or health care. Still other mutual funds may purchase stocks based on the size of the company (e.g., stocks of large, midsize, or small companies).

Although the name of a stock mutual fund generally offers insight into its investment style and objective, it is important not to rely on the name alone in determining whether a particular fund is what you want. The fund prospectus is like an owner's manual and contains information about the kind of investment style that the manager(s) employ, and the kinds of stocks that the fund will buy.

Note: Before investing in any mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are discussed in the prospectus available from the fund. Read the prospectus carefully before investing.

A bond fund is made up of debt instruments that governments or corporations issue to raise capital. They are designed to provide investors with interest income in the form of regularly scheduled dividends. If you bought individual bonds, you would need to concern yourself with their maturity dates and the reinvestment of your funds. Buying shares of a bond fund relieves you of these concerns; the fund manager handles them for you.

Bond funds are primarily classified according to the issuers of the bonds in the fund's portfolio and/or to the term of the bonds. For example, municipal bond funds buy bonds issued by municipalities. The income from these is free from federal tax (a portion of the income may be subject to the federal alternative minimum tax) and may be free from state and local taxes. Similarly, some funds invest only in U.S. Treasury debt instruments (e.g., bonds, bills, and notes) or high-grade (or low-grade) corporate bonds. Some bond funds, from all types of issuers, limit themselves to bonds maturing in the short, intermediate, or long term.

There are other types of mutual funds that you will encounter. Funds that invest in both stocks and bonds (or stocks, bonds, and cash alternatives) are often known as balanced funds. A money market fund buys extremely short-term debt instruments and is often used as a place to put cash, short term, until it is needed elsewhere. (Though a money market fund attempts to maintain a $1 per share value, there is no guarantee it will always do so, and it is possible to lose money investing in a money market fund.) Index funds attempt to duplicate a standardized, broad-based index such as the Standard & Poor's 500 (S&P 500) stock index or Moody's bond index by holding a portfolio of the same securities used by the index in an attempt to match the index's performance as closely as possible.

What are the benefits of investing in a mutual fund?

Diversification: Most mutual funds own dozens or even hundreds of securities. The managers often spread the fund's assets over more than one type of investment (e.g., both stocks and bonds, or stocks from a variety of industries). This exposes you to less potential risk than buying just a few individual securities. If some of the fund's holdings perform poorly, they may be offset by others doing well, (though diversification cannot guarantee a profit or ensure against a loss).
Professional money management: When you buy shares in an actively managed mutual fund, part of what you pay for is the fund manager's expertise. The manager analyzes hundreds of securities (both current and contemplated holdings) and makes decisions on what and when to buy and sell.

Small investment amounts: Depending on fund rules, you can open an account and make subsequent contributions with a very small initial investment. You can even set up automatic investments through a transfer of funds from your bank account.

Liquidity: You can convert your mutual fund investment into cash (i.e., redeem your shares) by making a request to the fund company in writing, over the phone, or on the Internet on any business day.

Of course, mutual funds are not guaranteed investments. The price of all mutual fund shares can change daily, and you'll receive the current value of your shares when you sell—which may be more or less than you paid.

**Choosing a fund**

Choosing a mutual fund to invest in requires more than picking a fund from the Top 10 list of the best past performers. Choosing a mutual fund requires careful thinking about numerous factors. The most important of these to consider include your investment objectives, risk tolerance, and time horizon.

Spend some time considering these factors, then do as much research as you can. Many financial magazines and websites are good sources of information to use in an initial screen for suitable mutual funds. Review the fund prospectus. It provides a great deal of information that you'll want to know about the fund, such as the fund's investment objective and style, and the fund's expenses. To get a prospectus, contact the mutual fund company directly, or go on-line to the company's website to download one.

**Sales charge and other costs**

All mutual funds have expenses that investors must pay for, but the sales charge, or load, is probably the most significant and varied among funds. These sales charges are generally paid as commissions to stockbrokers, financial advisors, and insurance agents. The sales charge may be deducted at the time you purchase shares of the mutual fund (front-end load), leaving less to work for you, or it may be charged at the point of redemption (back-end load). Some mutual funds, known as no-load funds, have no sales charges.

Pay attention to a mutual fund's other fees and expenses, as well. Look at a fund's expense ratio, which is calculated by dividing the fund's annual expenses by the fund's average net assets. Expenses affect a fund's net return. The higher the expense ratio, the less money is being put to work for you.

**Turnover ratio**

Portfolio turnover reflects the value of a fund's trades during a year compared to the total value of its assets, and is often used as an indicator of how actively a fund manager trades. If the value of a fund's trades equals that of its entire portfolio, its turnover ratio would be 100 percent.

Aggressively managed funds generally have higher portfolio turnover ratios than do conservative funds, which buy and hold for the long term. High turnover generally adds to the expenses of a fund because of the brokerage commissions paid for each transaction.

More important, however, is that when the fund sells stock at a gain, the gain must be distributed to shareholders. You will then be liable for income tax on your portion of the gain, even if the gain was reinvested, and even if your fund's share value actually decreased that year.

A tax-efficient approach minimizes the tax impact of its trades by implementing strategies such as offsetting gains by selling other stocks at a loss, or holding stocks for long periods. Note that if you own a mutual fund in an individual retirement account (IRA) or a qualified retirement plan at work (e.g., a 401(k)), tax efficiency is not as important. This is because no tax is immediately paid on realized gains in these retirement accounts and plans;
tax is deferred until the money is withdrawn.

**Past performance**

Although past performance is no guarantee of future results, a fund's track record over the past 3, 5, and 10 years is certainly worth considering. How does it compare with its peers--funds with similar risk and investment strategies? Apples-to-apples comparisons of funds are difficult, so a variety of broad market indexes are used as comparison benchmarks. For example, the S&P 500 is often used as a proxy for the U.S. stock market as a whole. Examine how well the fund that you are looking at has performed in both good and bad years relative to the most appropriate benchmark index.

**Fund managers**

One of the advantages of purchasing shares in an actively managed mutual fund shares is professional money management. The past performance of the fund is a reflection of the fund manager's ability to effectively manage its assets. You should research the current manager's history with the fund; was the fund's performance his or her achievement? If the fund has a new manager, make sure that individual's investment style matches your expectations.
Teaching Your Teen about Money

Your teen is becoming more independent, but still needs plenty of advice from you. With more money to spend and more opportunities to spend it, your teen can easily get into financial trouble. So before money burns a hole in your child's pocket, teach him or her a few financial lessons. With your help, your teen will soon develop the self-confidence and skills he or she needs to successfully manage money in the real world.

Lesson 1: Handling earnings from a job

Teens often have more expenses than younger children, and your child may be coming to you for money more often. But with you holding the purse strings, your teen may have difficulty making independent financial decisions.

One solution? Encourage your teen to get a part-time job that will enable him or her to earn money for expenses. Here are some things you might want to discuss with your teen when he or she begins working:

- Agree on what your child's pay should be used for. Now that your teen is working, will he or she need to help out with car insurance or clothing expenses, or do you want your teen to earmark a portion of each paycheck for college?

- Talk to your teen about taxes. Show your child how FICA taxes and regular income taxes can take a bite out of his or her take-home pay.

- Introduce your teen to the concept of paying yourself first. Encourage your teen to deposit a portion of every paycheck in a savings account before spending any of it.

A teen who is too young to get a job outside the home can make extra cash by babysitting or doing odd jobs for you, neighbors, or relatives. This money can supplement any allowance you choose to hand out, enabling your young teen to get a taste of financial independence.

Lesson 2: Developing a budget

Developing a written spending plan or budget can help your teen learn to be accountable for his or her finances. Your ultimate goal is to teach your teen how to achieve a balance between money coming in and money going out. To develop a spending plan, have your teen start by listing out all sources of regular income (e.g., an allowance or earnings from a part-time job). Next, have your teen brainstorm a list of regular expenses (don't include anything you normally pay for). Finally, subtract your teen's expenses from his or her income. If the result shows that your teen won't have enough income to meet his or her expenses, you'll need to help your teen come up with a plan for making up the shortfall.

Here are some ways you can help your teen learn about budgeting:

- Consider giving out a monthly, rather than weekly, allowance. Tell your teen that the money must last for the whole month, and encourage him or her to keep track of what's been spent.

- Encourage your teen to think spending decisions through rather than buying items right away. Show your teen how comparing prices or waiting for an item to go on sale can save him or her money.

- Suggest ways your teen can earn more money or cut back on expenses (e.g., rent a DVD to watch with friends rather than go to the movies) to resolve a budget shortfall.

- Show your teen how to modify a budget by categorizing expenses as needs (expenses that are unavoidable) and wants (expenses that could be cut if necessary).
Resist the temptation to bail your teen out. If your teen can depend on you to come up with extra cash, he or she will never learn to manage money wisely. But don't be judgmental--your teen will inevitably make some spending mistakes along the way. Your child should know that he or she can always come to you for information, support, and advice.

Lesson 3: Saving for the future

As a youngster, your child saved up for a short-term goal such as buying a favorite toy. But now that your child is a teen, he or she is ready to focus on saving for larger goals such as a new computer or a car and longer-term goals such as college. Here are some ways you can encourage your teen to save for the future:

- Have your teen put savings goals in writing to make them more concrete.
- Encourage your child to set goals that are based on his or her values, not on keeping up with what other teens have or want.
- Motivate your child by offering to match what he or she saves towards a long-term goal. For instance, for every dollar your child sets aside for college, you might contribute 50 cents or 1 dollar.
- Consider increasing your teen's allowance if he or she is too young to get a part-time job.
- Praise your teen for showing responsibility when he or she reaches a financial goal. Teens still look for, and count on, their parent's approval.
- Open up a savings account for your child if you haven't already done so.
- Introduce your teen to the basics of investing by opening an investment account for your teen (if your teen is a minor, this will be a custodial account). Look for an account that can be opened with only a low initial contribution at an institution that supplies educational materials introducing teens to basic investment terms and concepts.

Lesson 4: Using credit wisely

You can take some comfort in the fact that credit card companies require an adult to cosign a credit card agreement before they will issue a card to someone under the age of 21 (unless that person can prove that he or she has the financial resources to repay the credit card debt), but you can't ignore the credit card issue altogether. Many teens today use credit cards, and it probably won't be long until your teen asks for one too.

If you decide to cosign a credit card application for your teen, ask the credit card company to assign a low credit limit (e.g., $300). This can help your child learn to manage credit without getting into serious debt.

Here are some things to discuss with your teen before he or she uses a credit card:

- Set limits on what the card can be used for (e.g., emergencies, clothing).
- Review the credit card agreement, and make sure your child understands how much interest will accrue on the unpaid balance, what grace period applies, and what fees will be charged.
- Agree on how the bill will be paid, and what will happen if your child can't pay the bill.
- Make sure your child understands how long it will take to pay off a credit card balance if he or she only makes minimum payments. You can demonstrate this using an online calculator or by reviewing the estimate provided on each month's credit card statement.

If putting a credit card in your teen's hands is a scary thought, you may want to start off with a prepaid spending card. A prepaid spending card looks like a credit card, but works more like a prepaid phone card. You load the card with the dollar amount you choose and your teen can generally use it anywhere a credit card is accepted.
Your teen's purchases are deducted from the card balance, and you can transfer more money to the card if necessary. Although there may be some fees associated with the card, no interest or debt accrues.

One thing you may especially like about prepaid spending cards is that they allow your teen to gradually get the hang of using credit responsibly. Because you can access account information online or over the phone, you can monitor your teen's spending habits, then sit down and talk with your teen about money management issues.
The Best Ways to Save for College

In the college savings game, all strategies aren't created equal. The best savings vehicles offer special tax advantages if the funds are used to pay for college. Tax-advantaged strategies are important because over time, you can potentially accumulate more money with a tax-advantaged investment compared to a taxable investment. Ideally, though, you'll want to choose a savings vehicle that offers you the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

529 plans

Since their creation in 1996, 529 plans have become to college savings what 401(k) plans are to retirement savings--an indispensable tool for helping you amass money for your child's or grandchild's college education. That's because 529 plans offer a unique combination of benefits unmatched in the college savings world.

There are two types of 529 plans--college savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), college savings plans and prepaid tuition plans are very different college savings vehicles. There are typically fees associated with opening and maintaining each type of account.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.

529 plans: college savings plans

A 529 college savings plan is a tax-advantaged college savings vehicle that lets you save money for college in an individual investment account. Some plans let you enroll directly, while others require that you go through a financial professional.

The details of college savings plans vary by state, but the basics are the same. You'll need to fill out an application, where you'll name a beneficiary and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be in cash.

529 college savings plans offer a unique combination of features that no other college savings vehicle can match:

- Federal tax advantages: Contributions to your account grow tax deferred and are completely tax free if the money is used to pay the beneficiary's qualified education expenses. The earnings portion of any withdrawal not used for college expenses is taxed at the recipient's rate and subject to a 10 percent federal penalty.

- State tax advantages: Many states offer income tax incentives for state residents, such as a tax deduction for contributions or a tax exemption for qualified withdrawals. However, be aware that some states limit their tax deduction to contributions made to the in-state 529 plan only.

- High contribution limits: Most college savings plans have lifetime maximum contribution limits over $300,000.

- Unlimited participation: Anyone can open a 529 college savings plan account, regardless of income level.

- Professional money management: College savings plans are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.
• Flexibility: Under federal rules, you can change the beneficiary of your account to a qualified family member at any time without penalty. And you can rollover the money in your 529 plan account to a different 529 plan once per year without income tax or penalty implications.

• Wide use of funds: Money in a 529 college savings plan can be used at any college in the United States or abroad that’s accredited by the U.S. Department of Education and, depending on the individual plan, for graduate school.

• Accelerated gifting: 529 plans offer an excellent estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren’s college education. Individuals can make a lump-sum gift to a 529 plan in 2010 of up to $65,000 ($130,000 for married couples) and avoid federal gift tax, provided a special election is made to treat the gift as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.

• Variety: Currently, there are over 50 different college savings plans to choose from because many states offer more than one plan. You can join any state’s college savings plan.

But college savings plans have drawbacks too. You relinquish some control of your money. Returns aren’t guaranteed—you roll the dice with the investment portfolios you've chosen, and your account may gain or lose money.

## 529 plans: prepaid tuition plans

Prepaid tuition plans are distant cousins to college savings plans--their federal tax treatment is the same, but just about everything else is different. A prepaid tuition plan is a tax-advantaged college savings vehicle that lets you pay tuition expenses at participating colleges at today’s prices for use in the future. Prepaid tuition plans can be run either by states or colleges. For state-run plans, you prepay tuition at one or more state colleges; for college-run plans, you prepay tuition at the participating college(s).

As with 529 college savings plans, you'll need to fill out an application and name a beneficiary. But instead of choosing an investment portfolio, you purchase an amount of tuition credits or units (which you can then do again periodically), subject to plan rules and limits. Typically, the tuition credits or units are guaranteed to be worth a certain amount of tuition in the future, no matter how much college costs may increase between now and then. As such, prepaid tuition plans provide some measure of security over rising college prices.

- Federal and state tax advantages: The federal and state tax advantages given to prepaid tuition plans are the same as for college savings plans.

- Other similarities to college savings plans: Prepaid tuition plans are open to people of all income levels, and they offer flexibility in terms of changing the beneficiary or rolling over to another 529 plan once per year, as well as accelerated gifting.

Prepaid tuition plans have some limitations, though, compared to college savings plans. One major drawback is that your child is generally limited to your own state’s prepaid tuition plan, and then your child is limited to the colleges that participate in that plan. If your child attends a different college, prepaid plans differ on how much money you’ll get back. Also, some prepaid plans have been forced to reduce benefits after enrollment due to investment returns that have not kept pace with the plan’s offered benefits. Even with these limitations, some college investors appreciate the peace of mind that comes with not worrying about college inflation each year by locking in college costs today.

## Coverdell education savings accounts

A Coverdell education savings account (Coverdell ESA) is a tax-advantaged education savings vehicle that lets you save money for college, as well as for elementary and secondary school (K-12) at public, private, or religious schools. Here's how it works:
Application process: You fill out an application at a participating financial institution and name a beneficiary. Depending on the institution, there may be fees associated with opening and maintaining the account. The beneficiary must be under age 18 when the account is established (unless he or she is a child with special needs).

Contribution rules: You (or someone else) make contributions to the account, subject to the maximum annual limit of $2,000. This means that the total amount contributed for a particular beneficiary in a given year can't exceed $2,000, even if the money comes from different people. Contributions can be made up until April 15 of the year following the tax year for which the contribution is being made.

Investing contributions: You invest your contributions as you wish (e.g., stocks, bonds, mutual funds, certificates of deposit)—you have sole control over your investments.

Tax treatment: Contributions to your account grow tax deferred, which means you don't pay income taxes on the account's earnings (if any) each year. Money withdrawn to pay college or K-12 expenses (called a qualified withdrawal) is completely tax free at the federal level (and typically at the state level too). If the money isn't used for college or K-12 expenses (called a nonqualified withdrawal), the earnings portion of the withdrawal will be taxed at the beneficiary's tax rate and subject to a 10 percent federal penalty.

Rollovers and termination of account: Funds in a Coverdell ESA can be rolled over without penalty into another Coverdell ESA for a qualifying family member. Also, any funds remaining in a Coverdell ESA must be distributed to the beneficiary when he or she reaches age 30 (unless the beneficiary is a person with special needs).

Unfortunately, not everyone can open a Coverdell ESA—your ability to contribute depends on your income. To make a full contribution, single filers must have a modified adjusted gross income (MAGI) of $95,000 or less, and joint filers must have a MAGI of $190,000 or less. And with an annual maximum contribution limit of $2,000, a Coverdell ESA probably can't go it alone in meeting today's college costs.

Note: The provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 that increased the annual contribution limit for Coverdell ESAs to $2,000 is scheduled to expire on December 31, 2010. Unless Congress acts, after this date, the annual contribution limit for Coverdell ESAs will revert to $500, its status prior to January 1, 2002.

Custodial accounts

Before 529 plans and Coverdell ESAs, there were custodial accounts. A custodial account allows your child to hold assets—under the watchful eye of a designated custodian—that he or she ordinarily wouldn't be allowed to hold in his or her own name. The assets can then be used to pay for college or anything else that benefits your child (e.g., summer camp, braces, hockey lessons, a computer). Here's how a custodial account works:

Application process: You fill out an application at a participating financial institution and name a beneficiary. Depending on the institution, there may be fees associated with opening and maintaining the account.

Custodian: You also designate a custodian to manage and invest the account's assets. The custodian can be you, a friend, a relative, or a financial institution. The assets in the account are controlled by the custodian.

Assets: You (or someone else) contribute assets to the account. The type of assets you can contribute depends on whether your state has enacted the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA). Examples of assets typically contributed are stocks, bonds, mutual funds, and real property.

Tax treatment: Earnings, interest, and capital gains generated from assets in the account are taxed every year to your child. Assuming your child is in a lower tax bracket than you, you'll reap some tax savings compared to if you had held the assets in your name. But this opportunity is very limited...
because of special rules, called the “kiddie tax” rules, that apply when a child has unearned income. Under these rules, children are generally taxed at their parents’ tax rate on any unearned income over a certain amount. For 2010, this amount is $1,900 (the first $950 is tax free and the next $950 is taxed at the child’s rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn’t exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn’t exceed one-half of their support.

A custodial account provides the opportunity for some tax savings, but the kiddie tax sharply reduces the overall effectiveness of custodial accounts as a tax-advantaged college savings strategy. And there are other drawbacks. All gifts to a custodial account are irrevocable. Also, when your child reaches the age of majority (as defined by state law, typically 18 or 21), the account terminates and your child gains full control of all the assets in the account. Some children may not be able to handle this responsibility, or might decide not to spend the money for college.

**U.S. savings bonds**

Series EE and Series I bonds are types of savings bonds issued by the federal government that offer a special tax benefit for college savers. The bonds can be easily purchased from most neighborhood banks and savings institutions, or directly from the federal government. They are available in face values ranging from $50 to $10,000. You may purchase the bond in electronic form at face value or in paper form at half its face value.

If the bond is used to pay qualified education expenses and you meet income limits (as well as a few other minor requirements), the bond's earnings are exempt from federal income tax. The bond's earnings are always exempt from state and local tax.

In 2010, to be able to exclude all of the bond interest from federal income tax, married couples must have a modified adjusted gross income of $105,100 or less at the time the bonds are redeemed (cashed in), and individuals must have an income of $70,100 or less. A partial exemption of interest is allowed for people with incomes slightly above these levels.

The bonds are backed by the full faith and credit of the federal government, so they are a relatively safe investment. They offer a modest yield, and Series I bonds offer an added measure of protection against inflation by paying you both a fixed interest rate for the life of the bond (like a Series EE bond) and a variable interest rate that's adjusted twice a year for inflation. However, there is a limit on the amount of bonds you can buy in one year, as well as a minimum waiting period before you can redeem the bonds, with a penalty for early redemption.

**Financial aid impact**

Your college saving decisions impact the financial aid process. Come financial aid time, your family's income and assets are run through a formula at both the federal level and the college (institutional) level to determine how much money your family should be expected to contribute to college costs before you receive any financial aid. This number is referred to as the expected family contribution, or EFC.

In the federal calculation, your child's assets are treated differently than your assets. Your child must contribute 20 percent of his or her assets each year, while you must contribute 5.6 percent of your assets.

For example, $10,000 in your child's bank account would equal an expected contribution of $2,000 from your child ($10,000 x.20), but the same $10,000 in your bank account would equal an expected $560 contribution from you ($10,000 x.056).

Under the federal rules, an UGMA/UTMA custodial account is classified as a student asset. By contrast, 529 plans and Coverdell ESAs are considered parental assets if the parent is the account owner (so accounts owned by grandparents or other relatives or friends don't count at all). And distributions (withdrawals) from 529 plans and Coverdell ESAs that are used to pay the beneficiary's qualified education expenses are not classified as parent or student income on the federal government's aid form, which means that some or all of the money is not counted again when it's withdrawn. Other investments you may own in your name, such as mutual funds, stocks, U.S. savings bonds (e.g., Series EE and Series I), certificates of deposit, and real estate, are also classified as
Regarding institutional aid, colleges are generally a bit stricter than the federal government in assessing a family’s assets and their ability to pay college costs. Most use a standard financial aid application that considers assets the federal government does not, for example, home equity. Typically, though, colleges treat 529 plans, Coverdell accounts, and UTMA/UGMA custodial accounts the same as the federal government, with the caveat that distributions from 529 plans and Coverdell accounts are often counted again as available income.
Retirement Plans

Introduction

As an employer, you may want to establish one or more retirement plans for yourself and/or your employees. Having a plan can provide significant benefits for both you and your employees (if any). There are many different types of retirement plans, however, and choosing the right one for your situation is a critical decision. You want a plan that will meet both your goals as the employer and the needs of any employees you may have. In addition, it is important to balance the cost of establishing and maintaining a plan against the potential benefits.

General benefits of retirement plans

By establishing and maintaining a retirement plan, you can reap significant benefits for both your employees (if any) and yourself as employer. From your perspective as an employer, one of the main advantages of having and funding a retirement plan is that your employer contributions to the plan are generally tax deductible for federal income tax purposes. Contributing to the plan will therefore reduce your organization's taxable income, saving money in taxes. The specific rules regarding deductibility of employer contributions are complex and vary by type of plan, however, so you should consult a tax advisor for guidance.

For many employers, perhaps the greatest advantage of having a retirement plan is that these plans appeal to large numbers of employees. In fact, offering a good retirement plan (along with other benefits, such as health insurance) may allow you to attract and retain the employees you want. You will save time and money in the long run if you can hire quality employees, and minimize your employee turnover rate. In addition, employees who feel well rewarded and more secure about their financial future tend to be more productive employees, further improving your business's bottom line. Such employees are also less likely to organize into collective bargaining units, which can cause major business problems for some employers.

So, why are retirement plans considered such a valuable employee benefit? From the employee's perspective, key advantages of a retirement plan may include some or all of the following:

- Some plans (e.g., 401(k) plans) allow employee contributions. This gives employees a convenient way to save for retirement, and their contributions are generally made on a pretax basis, reducing their taxable income. In some cases, the employer will match employee contributions up to a certain level.

- Funds in a retirement plan grow tax deferred, meaning that any investment earnings are not taxed as long as they remain in the plan. The employee generally pays no income tax until he or she begins to take distributions. Depending on investment performance, this creates the potential for more rapid growth than funds held outside a retirement plan.

  **Caution:** Distributions taken before age 59½ may also be subject to a 10 percent federal penalty tax (25 percent in the case of certain distributions from SIMPLE IRA plans).

- Some plans can allow employees to borrow money from their vested balance in the plan. Plan loans are not taxable under certain conditions, and can provide employees with funds to meet key expenses. Plan loans are not without potential drawbacks, however.

- Funds held in a 403(b), 457(b), SEP, SIMPLE, or qualified employer plan are generally fully shielded from an employee's creditors under federal law in the event of the employee's bankruptcy. This is in contrast to traditional and Roth IRA funds, which are generally protected only up to $1,171,650 (as of April 1, 2010) under federal law, plus any amounts attributable to a rollover from an employer qualified plan or 403(b) plan. (IRAs may have additional protection from creditors under state law.) Funds held in qualified plans and 403(b) plans covered by the Employee Retirement Income Security Act of 1974 (ERISA) are also fully protected under federal law from the claims of the employee's and employer's creditors, even outside of bankruptcy.
Qualified plans vs. nonqualified plans

If you are an employer who is considering setting up a retirement plan, be aware that many different types of plans exist. The choices can sometimes be overwhelming, so it is best to use a systematic approach to narrow your options. Your first step should be to understand the distinction between a qualified retirement plan and a nonqualified retirement plan. Virtually every type of retirement plan can be classified into one of these two groups. So what is the difference?

Qualified retirement plans offer significant tax advantages to both employers and employees. As mentioned, employers are generally able to deduct their contributions, while participants benefit from pretax contributions and tax-deferred growth. In return for these tax benefits, a qualified plan generally must adhere to strict IRC (Internal Revenue Code) and ERISA (the Employee Retirement Income Security Act of 1974) guidelines regarding participation in the plan, vesting, funding, nondiscrimination, disclosure, and fiduciary matters.

In contrast to qualified plans, nonqualified retirement plans are often not subject to the same set of ERISA and IRC guidelines. As you might expect, this freedom from extensive requirements provides nonqualified plans with greater flexibility for both employers and employees. Nonqualified plans are also generally less expensive to establish and maintain than qualified plans. However, the main disadvantages of nonqualified plans are (a) they are typically not as beneficial from a tax standpoint, (b) they are generally available only to a select group of employees, and ©) plan assets are not protected in the event of the employer's bankruptcy.

Most employer-sponsored retirement plans are qualified plans. Because of their popularity and the tax advantages they offer to both you and your employees, it is likely that you will want to evaluate qualified plans first. (See below for a discussion of types of qualified plans.) In addition to providing tax benefits, qualified plans generally promote retirement savings among the broadest possible group of employees. As a result, they are often considered a more effective tool than nonqualified plans for attracting and retaining large numbers of quality employees.

Tip: There are several types of retirement plans that are not qualified plans, but that resemble qualified plans because they have many similar features. These include SEP plans, SIMPLE plans, Section 403(b) plans, and Section 457 plans. See below for descriptions of each type of plan.

Defined benefit plans vs. defined contribution plans

Qualified retirement plans can be divided into two main categories: defined benefit plans and defined contribution plans. In today's environment, most newer employer-sponsored retirement plans are of the defined contribution variety.

Defined benefit plans

The traditional-style defined benefit plan is a qualified employer-sponsored retirement plan that guarantees the employee a specified level of benefits at retirement (e.g., an annual benefit equal to 30 percent of final average pay). As the name suggests, it is the retirement benefit that is defined. The services of an actuary are generally needed to determine the annual contributions that the employer must make to the plan to fund the promised retirement benefits. Defined benefit plans are generally funded solely by the employer. The traditional defined benefit pension plan is not as common as it once was, as many employers have sought to shift responsibility for retirement to the employee. However, a hybrid type of plan called a cash balance plan has gained popularity in recent years.

Defined contribution plans

Unlike a defined benefit plan, a defined contribution plan provides each participating employee with an individual plan account. Here, it is the plan contributions that are defined, not the ultimate retirement benefit. Contributions are sometimes defined in the plan document, often in terms of a percentage of the employee’s pretax compensation. Alternatively, contributions may be discretionary, determined each year, with only the allocation formula specified in the plan document. With some types of plans, employees may be able to contribute to the plan.
A defined contribution plan does not guarantee a certain level of benefits to an employee at retirement or separation from service. Instead, the amount of benefits paid to each participant at retirement or separation is the vested balance of his or her individual account. An employee's vested balance consists of: (1) his or her own contributions and related earnings, and (2) employer contributions and related earnings to which he or she has earned the right through length of service. The dollar value of the account will depend on the total amount of money contributed and the performance of the plan investments.

**Questions to consider when choosing a retirement plan**

There are many different factors to consider when choosing a retirement plan for your company. In some cases, more than one type of plan will meet your needs in one vital area. If this is the case, you will need to further refine your choices by looking at how each type of plan meets your needs and their limitations in other key areas.

You can zero in on the key areas of importance and take the first step to finding the right plan by answering the following questions:

- What kind of a business entity do you have? Do you have a sole proprietorship, a partnership, a corporation, a limited liability company filing a corporate return, or a limited liability company filing a partnership return? Some plans are more appropriate for certain types of business entities than for others.

- How many employees do you have right now? How many do you expect to have in one year, three years, and five years from now? Some plans impose limits on the number of employees you can have.

- What is your current compensation and the current compensation range for your employees? What do you expect your compensation and the compensation range for your employees to be over the next year, three years, and five years?

- How old are you, and what is the age range for your employees? Some plans allow contributions to be allocated based on age.

- How much do you want to put away in the retirement plan each year for yourself and/or your employees?

- Who do you want to fund the retirement plan contributions? Just you as the employer? Just the employees? Both the employees and you as the employer?

- If you as the employer are funding at least some of the contributions, what percentage of employee compensation do you want to contribute each year?

- How important is it for you to minimize the amount of contributions to rank-and-file employees, as compared to those for you and other executives?

- How stable or unstable have your company's profits been in the last few years?

- What are the company's expected profits in the next year? Three years? Five years?

- How important is it for you to have flexibility in the amount of retirement plan contributions you make each year, as opposed to contributing a fixed amount or fixed percentage of employee compensation regardless of the company's bottom line?

- How important is it to you to delay vesting and employee control of contributions made by you as the employer?

- How important is it that the retirement plan be simple to understand?

- How important is it that the retirement plan be relatively inexpensive to set up and administer?
• How important is it for the plan to be competitive to attract and/or retain employees?

• How important is it to reduce the current taxable income of you and your employees through employer and employee contributions?

• Do you have a stable workforce, or a high turnover rate among your employees?

**Determine which plan meets your goals**

Here is where your answers to the above questions can be utilized to determine the most appropriate and beneficial plan for your company. Every type of plan has its own advantages and disadvantages. You can find the right type of plan for your company by:

• Seeing how they stack up against one another in certain key areas, and

• Becoming aware of the benefits and potential drawbacks of each type of plan

To make it easier for you, we have prepared the essential information for you in more than one way. First, we have identified seven key areas that can be used to determine how each type of plan stacks up against other types of plans. In addition, we have provided a brief overview of each type of plan that links to a more detailed discussion of pros and cons and other information. Finally, we have listed types of plans that are generally considered appropriate for certain types of employers.

**Tip:** In addition to your own research, it is best to have a tax advisor and other professionals help you evaluate your options and select an appropriate retirement plan.

**Seven key areas to compare**

You can determine the best plan for your company by first seeing how the various types of plans compare in these seven key areas:

1. Maximizing yearly contributions/building retirement benefits for you as the owner

2. Maximizing/weighting contributions for you and other highly compensated employees rather than for lower-compensated employees

3. Flexibility in making contributions each year

4. Building retirement benefits for employees

5. Using the plan as a recruiting tool to attract employees

6. Using the plan to discourage employees from seeking employment elsewhere

7. Utilizing income tax deferral on plan contributions and investment earnings

To determine the right retirement plan for your organization, keep your most important goals in mind as you evaluate plans in terms of these seven key areas.

**Specific types of retirement plans**

• Defined benefit plan: A defined benefit plan is a qualified retirement plan that guarantees the employee a specified level of benefits at retirement. As the name suggests, it is the retirement benefit that is defined, not the level of contributions to the plan. The services of an actuary are generally needed to determine the annual contributions that the employer must make to the plan to fund the promised retirement benefits. Contributions may vary from year to year, depending on the performance of plan investments and other factors. Defined benefit plans allow a higher level of employer contributions than most other types of plans, and are generally most appropriate for large companies
with a history of stable earnings.

- **Cash balance plan**: A cash balance plan is a type of retirement plan that has become increasingly common in recent years as an alternative to the traditional defined benefit plan. Though it is technically a form of defined benefit plan, the cash balance plan is often referred to as a "hybrid" of a traditional defined benefit plan and a defined contribution plan. This is because cash balance plans combine certain features of both types of plans. Like traditional defined benefit plans, cash balance plans pay a specified amount of retirement benefits. However, like defined contribution plans, participants have individual plan accounts for record-keeping purposes.

- **Simplified employee pension (SEP) plan**: A simplified employee pension (SEP) plan is a tax-deferred retirement savings plan that allows contributions to be made to special IRAs, called SEP-IRAs, according to a specific formula. Generally, any employer with one or more employees can establish a SEP plan. With this type of plan, you can make tax-deductible employer contributions to SEP-IRAs for yourself and your employees (if any). Except for the ability to accept SEP contributions from employers (allowing more money to be contributed) and certain related rules, SEP-IRAs are virtually identical to traditional IRAs.

- **SIMPLE IRA plan**: A SIMPLE IRA plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals that is established in the form of employee-owned IRAs. The SIMPLE IRA plan is funded with voluntary pre-tax employee contributions and mandatory employer contributions. The annual allowable contribution amount is significantly higher than the annual contribution limit for regular IRAs but less than the limit for 401(k) plans.

- **SIMPLE 401(k) plan**: A SIMPLE 401(k) plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed persons, including sole proprietors and partnerships. Structured as a 401(k) cash or deferred arrangement, this plan was devised in an effort to offer self-employed persons and small businesses a tax-deferred retirement plan similar to the traditional 401(k), but with less complexity and expense. The SIMPLE 401(k) plan is funded with voluntary employee pre-tax contributions (and/or after-tax Roth contributions) and mandatory employer contributions. The annual contribution limits are less than the limits applicable to regular 401(k) plans.

- **Keogh plan**: A Keogh plan, sometimes referred to as an HR-10 plan, is a qualified retirement plan for self-employed individuals and their employees. Only a sole proprietor or a partnership business may establish a Keogh plan--an employee or an individual partner cannot. Keogh plans may be set up as either defined contribution plans or defined benefit plans.

- **Profit-sharing plan**: A profit-sharing plan is a qualified defined contribution plan that generally allows for some discretion in determining the level of annual employer contributions to the plan. In fact, the business can often contribute nothing at all in a given year if it so chooses. The amount of contributions may be based on a written formula in the plan document, or may be essentially at the employer's discretion. With a typical profit-sharing plan, employer contributions range anywhere from 0 to 25 percent of an employee's compensation.

- **Age-weighted profit-sharing plan**: An age-weighted profit-sharing plan is a type of profit-sharing plan in which contributions are allocated based on the age of plan participants as well as on their compensation. This type of plan benefits older participants (generally, those having fewer years until retirement) by allowing them to receive much larger contributions to their accounts than younger participants.

- **New comparability plan**: A new comparability plan is a variation of the traditional profit-sharing plan. This type of plan is unique in that plan participants are divided into two or more classes, generally based on age and other factors. A new comparability plan can often allow businesses to maximize plan contributions to higher-paid workers and key employees and minimize contributions to the other employees.

- **401(k) plan**: A 401(k) plan, sometimes called a cash or deferred arrangement (CODA), is a qualified defined contribution plan in which employees may elect to defer receipt of income. The amount deferred consists of pretax dollars (and/or after-tax Roth contributions) that are invested in the
employee's plan account. Often, the employer matches all or part of the employees' deferrals to encourage employee participation. The 401(k) plan is the most widely used type of retirement plan.

- **Money purchase pension plan**: A money purchase pension plan is a qualified defined contribution plan in which the employer makes an annual contribution to each employee's account in the plan. The amount of the contribution is determined by a set formula that cannot be changed, regardless of whether or not the corporation is showing a profit. Typically, the business's contribution will be based on a certain percentage of an employee's compensation.

- **Target benefit plan**: A target benefit plan is a hybrid of a defined benefit plan and a money purchase pension plan. It resembles a defined benefit plan in that the annual contribution is based on the amount needed to fund a specific amount of retirement benefits (the "target" benefit). It resembles a money purchase pension plan in that the annual contribution is fixed and mandatory, and the actual benefit received by the participant at retirement is based on his or her individual balance.

- **Thrift/savings plan**: A thrift or savings plan is a qualified defined contribution plan that is similar to a profit-sharing plan, but has features that provide for (and encourage) after-tax employee contributions to the plan. The employee must pay tax on his or her own contributions before they are invested in the plan. Typically, a thrift/savings plan supplements after-tax employee contributions with matching employer contributions. Many thrift plans have been converted into 401(k) plans.

- **Employee stock ownership plan (ESOP)**: An employee stock ownership plan, a type of stock bonus plan, is a qualified defined contribution plan in which participants' accounts are invested in stock of the employer corporation. This type of plan is funded solely by the employer. When a plan participant retires or leaves the company, the participant receives his or her vested balance in the form of cash or employer securities.

- **Payroll deduction IRA plan**: A payroll deduction IRA plan is a type of arrangement that you can establish to allow your employees to make payroll deduction contributions to IRAs (traditional or Roth). It can be offered to your employees instead of a more conventional retirement plan (such as a 401(k) plan), or to supplement such a plan. Each of your participating employees establishes and maintains a separate IRA, and elects to have a certain amount deducted from his or her pay on an after-tax basis. The amount is then invested in the participant's designated IRA. Payroll deduction IRAs are generally subject to the same rules that normally apply to IRAs.

In addition, there are two types of retirement plans that are especially popular with tax-exempt organizations:

- **Section 403(b) plan**: A Section 403(b) plan, also known as a tax-sheltered annuity, is a type of nonqualified plan under which certain government and tax-exempt organizations (e.g., schools and religious organizations) can purchase annuity contracts or contribute to custodial accounts for eligible employees. There are two types of 403(b) plans: salary-reduction plans and employer-funded plans. Even though section 403(b) plans are not qualified plans, they are subject to many of the same requirements that apply to qualified plans.

- **Section 457(b) plan**: A Section 457(b) plan is a type of nonqualified deferred compensation plan for governmental units, governmental agencies, and non-church-controlled tax-exempt organizations. It is similar to a 401(k) plan and subject to some of the same rules.

**Retirement plans most appropriate for small businesses and the self-employed**

If you are self-employed, a sole proprietor, or a partner and want to establish a retirement plan, there are five types of plans you should consider:

- Keogh plan
- Simplified employee pension (SEP) plan
- SIMPLE IRA plan
Retirement plans most appropriate for corporations

If your form of business entity is a corporation and you want to establish a retirement plan, you should consider the following types of defined contribution plans:

- Defined benefit plan
- 401(k) plan
- Profit-sharing plan
- Age-weighted profit-sharing plan
- New comparability plan
- Money purchase pension plan
- Thrift/savings plan
- Employee stock ownership plan (ESOP)
- Simplified employee pension (SEP) plan
- SIMPLE IRA plan
- SIMPLE 401(k) plan

Retirement plans for tax-exempt organizations

If you are involved with a tax-exempt or government organization and you want to establish a retirement plan, your options typically include a qualified plan, section 403(b) plan, and/or section 457 plan. However, not every employer is eligible to maintain every type of plan. For example, governmental employers generally cannot adopt 401(k) plans. And only certain religious, public educational, and 501(c)(3) tax-exempt organizations can maintain 403(b) plans. For more detailed information, see our separate topic discussion, Retirement Plans for Tax-Exempt Organizations.
Starting Out Checklist

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Notes:

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<td>• Cash reserve for emergencies</td>
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<td>• Saving for down payment on home</td>
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<td>• Saving for other major expense (e.g., car, travel)</td>
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<td>• Saving for retirement</td>
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2. Have saving and investment vehicles been established?
   - Savings account
   - Checking account
   - Money market account
   - Certificates of deposit
   - Mutual funds
   - Stocks
   - Bonds
   - Annuities
   - IRA
   - 401(k) or other retirement plan

3. Has making appropriate investment decisions been discussed?
   - Risk tolerance
   - Liquidity needs
   - Time horizon
   - Types of investments (e.g., income, growth)
   - Diversification
   - Tax consequences
   - Dollar cost averaging

4. Has a budget been prepared?

5. Is an appropriate financial record-keeping system being used?

Notes:

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<tr>
<td>2. Have ways to maintain a good credit history been discussed?</td>
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<tr>
<td>3. Has outstanding consumer debt (including interest rates) been listed?</td>
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<tr>
<td>• Credit cards</td>
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<tr>
<td>• Auto loans</td>
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<tr>
<td>• Student loans</td>
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<td></td>
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<tr>
<td>• Mortgages</td>
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<tr>
<td>• Other secured or unsecured loans or lines of credit</td>
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<table>
<thead>
<tr>
<th>4. Have ways to reduce consumer debt been discussed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Paying cash vs. using credit</td>
</tr>
<tr>
<td>• Lowering interest rates on loans and credit cards</td>
</tr>
<tr>
<td>• Consolidation of student loans</td>
</tr>
<tr>
<td>• Debt consolidation loans</td>
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<tr>
<td>• Use of home equity loan</td>
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Notes:

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<th>Insurance planning</th>
<th>Yes</th>
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<tbody>
<tr>
<td>1. Have insurance needs been reviewed?</td>
<td></td>
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<td></td>
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<tr>
<td>• Health</td>
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<tr>
<td>• Life</td>
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<tr>
<td>• Disability</td>
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<tr>
<td>• Auto</td>
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<tr>
<td>• Homeowners/renters</td>
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<tr>
<td>• Liability</td>
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</tbody>
</table>
2. Is group coverage available from employer or other source?
   - Health
   - Life
   - Disability
   - Auto
   - Homeowners/renters
   - Liability

3. Does insurance need to be purchased or upgraded?
   - Health (including short-term coverage)
   - Life
   - Disability
   - Auto
   - Homeowners/renters
   - Liability

Notes:

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<thead>
<tr>
<th>Retirement planning</th>
<th>Yes</th>
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</thead>
<tbody>
<tr>
<td>1. Have retirement income needs been evaluated?</td>
<td>☐</td>
<td>☐</td>
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</tr>
<tr>
<td>2. Have retirement income sources been discussed?</td>
<td>☐</td>
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Notes:

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<tr>
<th>Estate planning</th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
</table>

See disclaimer on final page
1. Is there a will?  

2. If so, was it drafted recently (i.e., within the last five years)?  

3. Have durable powers of attorney been considered?  

4. Have health-care directives been established?  

Notes:

<table>
<thead>
<tr>
<th>Tax planning</th>
<th>Yes</th>
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<th>N/A</th>
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</thead>
<tbody>
<tr>
<td>1. Has appropriate income tax filing status been chosen?</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>2. Has proper income tax withholding amount been calculated?</td>
<td>☐</td>
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<tr>
<td>3. Will estimated income tax payments need to be made?</td>
<td>☐</td>
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<tr>
<td>4. Is self-employment income a consideration?</td>
<td>☐</td>
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<tr>
<td>5. Has personal deduction planning been explained?</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td>• Taking standard deduction vs. itemizing deduction</td>
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<tr>
<td>• Timing of deductions</td>
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<tr>
<td>• Limits on deductions</td>
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<tr>
<td>6. Have relevant deductions and credits been reviewed?</td>
<td>☐</td>
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</tbody>
</table>