



## Mismanaged 401(k)s Put Many Retirees In Jeopardy

**T**he traditional approach to 401(k) saving has put the retirement future of millions of Americans at risk. Many workers eligible to participate in 401(k)s choose not to make contributions or participate only minimally. Meanwhile, many make poor investment decisions. While recent tax reform legislation has sought to address some of these issues, the national experiment that has changed the way people save for retirement appears not to be working out very well for many Americans.

During the past two decades, there has been a sea change in how people save for retirement. We've shifted from being a nation where retirees depended on traditional defined-benefit pension plans sponsored by their companies to one where retirees are personally responsible for their own retirement savings.

Consider these facts from a recent study by the Center for Retirement Research at Boston College and statistics from the Federal Reserve's Survey of Consumer Finances (SCF):

- In 1983, more than 56% of workers depended solely on a traditional defined-benefit pension plan. Today, fewer than 20% of employees depend solely on a defined-benefit plan.

- In 1983, just 13% of workers depended on a defined-contribution plan, such as a 401(k), as their sole retirement plan. Today, about two-thirds of all workers depend solely on a 401(k) to fund retirement.

The shift during the past two decades

from retirement plans where your benefits are defined to plans where only your contribution is defined has significant implications for Americans. Traditional defined-benefit plans are managed by investment professionals picked by your company, and they typically promise to pay you in one lump sum upon retirement or in payments that are annuitized over your expected life span. With a 401(k) plan, which is a defined contribution plan, you are responsible for picking your investments and there is

no promise from your company to pay you a fixed amount after you retire. The growth of your retirement savings depends on the financial markets and your asset allocation decisions.

The change effectively shifts the responsibility for retirement saving from an employer to an employee. With a 401(k), workers decide whether to sign up, how much to contribute, how to invest retirement funds, and whether to withdraw retirement savings when they change jobs. In every case, according to the Center for Retirement Research study, employees' decisions are less than ideal.

- **Many don't participate.** Between the 2001 and 2004 SCF studies, the proportion of eligible workers who participated in a 401(k) rose from 74% to 79%. In other words, more of those whose companies offer a plan did sign up, a potentially positive development. But because fewer workers overall had the option of participating—possibly because younger companies, responsible for much

*(Continued on page 4)*



## Where Are We Now?

**I**n our January newsletter, I expressed concern that the U.S. economy would be slowing. At that time, I predicted the Fed funds rate would decline from 5.25% into the 3% area. Today, it's down to 4.50%. I am still of the opinion it will reach 3%. My prediction was that the yield on the 10-year Treasury would drop from 4.50% to the 3.80% to 4.00% range. As I write this, the yield has fallen below 4.20%.

The drag on the economy originated (and continues to originate) in the housing and lending area, and I do believe we have a significant risk of a recession. The market suffered its first "shot across the bow" in February, again in July and August, and now again in November. The majority of the volatility and losses have been confined to stocks of retailers and, of course, financials.

I've heard many pundits talk about the next "shoe to drop," but somehow the shoes just keep coming. Maybe they should stay out of Imelda Marcos' closet.

At this point, the third quarter earnings season is coming to a close, so the negative news flow should subside and the markets should once again calm down for now.

Though often nerve-racking, volatility brings opportunity. If the year were to end today, our equity performance would enjoy one of its strongest years compared to the markets.

# Will Working Longer Make You Happier?

**T**oday's 65-year-olds often are in no mood to retire. Men who reach that age live, on average, for another 15 years, and women almost 20 years, and the idea of spending two decades or more puttering around the house may not be terribly appealing. But is staying in the work force really the secret to happiness in later years?

Under the right circumstances, it seems to help, says Esteban Calvo, a researcher at the Center for Retirement Research at Boston College. Calvo's review of studies about older workers reveals that retiring later than normal frequently has a range of positive physical and psychological effects. And Calvo's own work confirms that older people who work tend to be healthier and happier. But retirement, too, can be satisfying, if you've had time to prepare yourself emotionally and financially.

**The benefits of staying engaged.** One downside of retirement is isolation. Working gave you the chance to talk with fellow workers, do lunch, attend meetings, and bet in the latest office pool. Without that social support—and the boost to self-esteem of knowing you've performed well—retirees often feel at loose ends, unsure of who they are and what their purpose is, Calvo suggests.

In designing his study, Calvo wanted to gauge the effects of working vs. not working after a little time has passed. So, starting with people ranging in age from 59 to 69 who were either on the payroll or retired in 2000, he then checked their status two years later. He considered health,



memory, mood, and mortality as well as activities of daily living (ADLs), such as bathing and eating, and instrumental activities of daily living (IADLs), such as shopping and cooking. ADLs and IADLs are used to measure an impairment and can affect your eligibility for certain insurance benefits.

By almost all of these yardsticks, people who were working in 2000

scored higher on Calvo's scale of satisfaction in 2002. Those in the work force were 6% less likely to report fair or poor health than were those who had retired, and working also had a positive, if modest effect, on ADLs, IADLs, mood, and mortality, according to the study.

## **Retirement on your own terms.**

Of course, retirement also has its attractions, and when leaving work is seen as the start of an exciting new phase of life—rather than as the end of being usefully engaged in the world—it can lead to considerable satisfaction. Another Center for Retirement Research study, looking at who tended to do well after leaving the work force, found that economic well being, as measured by income and wealth, was a relatively small part of the equation. More important was that retirees had left work voluntarily, rather than being pushed out by downsizing or poor health.

Staying in the work force could enhance the quality of your later years. But so could a well-planned retirement. And because you never know when you may be forced out of your job, it pays to be prepared emotionally and financially. If you're concerned about whether you would be ready, give us a call and we'll be happy to review your retirement plans. ●

## Tax Law Now Allows Those Inheriting Retirement Plan Assets

**M**ost 401(k)s and other employer-sponsored retirement plans are bequeathed to spouses, and with good reason. Until a recent change in rules, only a spouse could inherit a retirement plan other than an IRA and avoid immediate taxes. Now, although the process must be handled carefully, any beneficiary should be able to receive a retirement plan and enjoy the same tax-postponing benefits that a husband or wife always could.

Under the old rules, if your husband got the money, fine; he could roll over the windfall into his own IRA and make withdrawals over the course of his expected lifespan. Though each year's

required distribution would add to his taxable income, the rest of the account would continue to compound, and there might be a sizable balance left at his death.

But your daughter? Most employer plans require an account to be emptied within five years of an employee's death. She would have had to take the money and, not being allowed to move it into an IRA, would have been stuck paying income tax immediately—and likely would have lost a third or more of her inheritance to taxes in the process.

The new rules are much kinder to non-spouse beneficiaries. Now, should you choose to leave your 401(k) to a

child, a same-sex partner, or anyone else, that person may roll over the inherited plan to an IRA. But the law is prickly about the process. To make a successful rollover, your heir must:

- Open an inherited IRA to take the money. A spouse who inherits a 401(k) can merge the account with her own IRA, but others must set up a new account specifically created to receive funds transferred from the deceased's retirement plan.

- Be sure to title the new account correctly. For instance, Dad IRA (Deceased) FBO Daughter.

- Make sure the money goes directly from the company plan to the

# Investing In Art As An Asset Class

**Y**ou may not know much about art, but if you know what you like—and you do your homework before making a purchase—art can be a valuable investment. Like stocks, bonds, and other asset classes, art investments perform in ways that can be quantified and tracked, and your fine art may further diversify your portfolio.

Though paintings, sculpture, drawings, and photography may seem to defy characterization as investments—it's certainly much more difficult to put a price tag on a work of Abstract Impressionism than it is to know what 1,000 shares of Google is worth—the MEI Moses All Art Index, developed by Michael Moses of New York University's Stern School of Business, provides a general gauge of art market performance. In recent years this benchmark, based on sales data from art auctions, has outperformed the Standard & Poor's 500 stock index, and over the long haul, the two asset classes, stocks and art, have racked up comparable returns for investors. During the past half century, the S&P's compound annual growth rate has been 10.5%, compared with 10% for the MEI Moses Index. And fluctuations in art prices have tended not to coincide with the ups and downs of stock and bond markets, according to Michael Moses. Because fine art valuations may soar when other

investments stumble—and vice versa—allocating some of your investment dollars to art may help reduce the overall volatility of your portfolio.

Of course, investing in art is fundamentally different from buying stocks, bonds, or options. Instead of poring over earnings statements and annual reports, you attend auctions, visit galleries, and read about Cubism, Surrealism, and Fauvism. Yet whether you're putting your money into art or conventional securities, careful research is essential. According to art investment advisor Richard Rabbito, insufficient study is the main reason for losses in the art market. New investors and collectors enter the market too quickly, eager to generate returns but not taking the time to understand what they are buying. Such zeal commonly leads to mistakes, such as paying too much for mediocre work or selling before a painting or piece of sculpture has had a chance to appreciate. "Investing in art simply in pursuit of a return is risky," Rabbito says.

Because there is a finite supply of valuable artistic work, prices can easily be inflated by demand from inexperienced collectors rushing to pick up available pieces. "Everybody is hoovering paintings," says Rabbito. "Virtually nothing is left from the 19th century, and the early 20th century is

going quickly." And while spiking prices could lead to short-term profits, the long-term impact is likely to be less positive. Rabbito believes an art investment bubble may be forming that could burst when novices flee the market.

For would-be art investors, there's also the matter of how much money to devote to what is an inherently illiquid asset class. Rabbito suggests a minimum investment of \$25,000, and though Moses believes a new collector might test the waters with as little as \$5,000, anyone who is serious about investing in this asset class should be prepared to allocate at least \$50,000, with art comprising perhaps 10% of an overall portfolio.

Most art purchases occur at auctions and galleries, and both Moses and Rabbito advise that investors form relationships with experts at those venues before making a purchase. If you have begun to educate yourself and show genuine interest, a gallery owner, for example, should be willing to help you become well informed about the kind of art that gallery shows, Moses says. Such an owner, passionate about a particular genre or medium, can become a valuable ally in your quest both to buy genuinely valuable work and to develop your own artistic tastes. Auction houses, too, are likely to have staff members who can work with you as you hone your sensibilities and expertise.

Ultimately, what's most important is to buy pieces that you like—after you've done the necessary research, says Moses, who suggests a long-term approach to art collecting and investing. "This is a lifelong pursuit," he says. "Consider keeping posters on your walls of paintings you like, until you can replace them with the real thing."

If you'd like to see whether you could translate your interest in art into a valuable addition to your portfolio, please feel free to give us a call. We can help you gauge how a potential investment in this unique asset class might affect your overall investment strategy. ●

## To Retain Tax Deferral Much Longer

heir's new IRA. If your beneficiary touches the money, he or she will be immediately taxed.

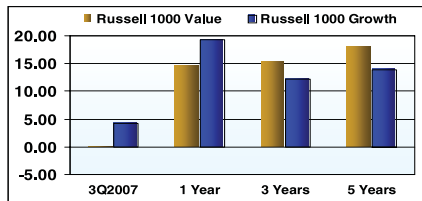
Keep in mind that it doesn't matter when the account owner dies as long as the beneficiary postpones the rollover until 2007. So if the account owner died in 2006, an heir can benefit from the new rules as long as the rollover is made in 2007.

If you've ever changed jobs, you may already have transferred retirement funds from your former employer to an IRA. Until the rules changed, that was the only way to ensure favorable tax treatment for a non-spousal heir. And even now, a rollover

is often advisable. IRAs tend to offer a wider range of investment options than you get in a typical 401(k), and it's easier to monitor investments in a single account.

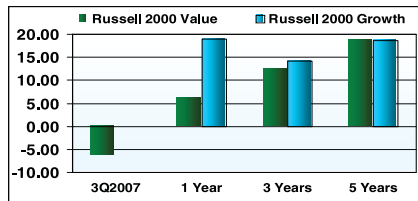
There is at least one advantage to keeping money in a 401(k), however. If you retire, you may begin taking distributions from an employer plan at age 55 without incurring the 10% early withdrawal penalty you would owe for withdrawing assets from an IRA before age 59½. Under the new rules, you can have the penalty-free early access of a 401(k) while also accommodating non-spousal heirs. ●

# Market Data Bank: 3rd Quarter 2007



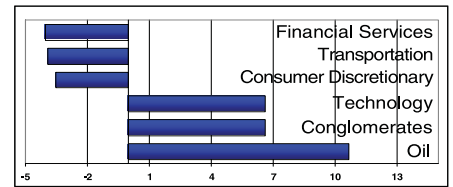
## LARGE VALUE VS. LARGE GROWTH

Investors continued to favor the biggest manufacturers and resource suppliers because of their power to expand internationally. Large-cap growth shares gained 4.21% but large value lost 0.24%.



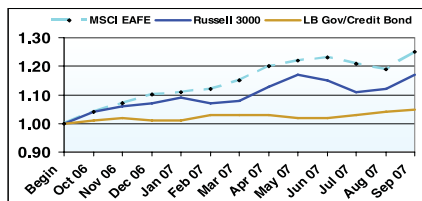
## SMALL VALUE VS. SMALL GROWTH

Hints of a cooling economy in 3Q 07 chilled investors' appetite for small caps. Small value stocks fell 6.26% during the quarter. Growth did better by eking out a fractional gain of 0.02%.



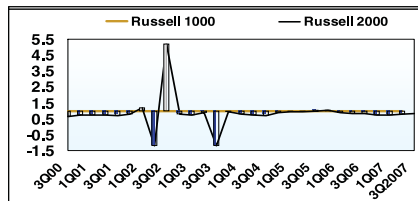
## THREE BEST AND WORST SECTORS

Only five of the 12 Russell sectors ended the quarter in positive territory, led by oil companies as well as technology and other global manufacturers. Financial and retail-oriented shares suffered.



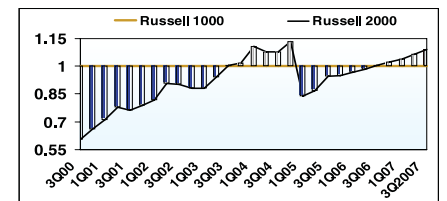
## FOREIGN, US STOCKS & US BONDS

A weaker US currency helped foreign stocks surge 25% in dollar terms for the year that ended in September. U.S. stocks and bonds lagged, up a respective 17% and 5% over the same period.



## LARGE VS. SMALL STOCK EARNINGS

Market volatility masked US companies' ability to fatten their profits. Large-cap names boosted their year-over-year earnings 16.3%, while their smaller counterparts increased their profitability 13.4%.



## PRICE-TO-EARNINGS RATIO

As economic sentiment shifted, investors prized small-cap shares even more highly on a strict earnings basis. In 3Q07, small caps cost \$18.40 per \$1 of profit, compared to \$16.90 for large caps.

*Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do not represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability and currency fluctuation. Past performance does not indicate future results.*

Source: Russell/Mellon

## Mismanaged 401(k)s

(Continued from page 1)

of the expansion in employment, may not initially offer this benefit—401(k) participation as a percentage of the overall work force remained stuck at just under 40%.

- **Contributions are inadequate.** In 2004, just 11% of all surveyed 401(k) participants were putting away the maximum amount allowed by law.

- **Portfolios aren't diversified.** Fewer than half of participants had a well-diversified portfolio in the 2004 survey. More than 20% had virtually all of their savings in stocks, while a third held no equities and many had an excessive concentration in potentially volatile company stock.

- **Too many cash out of their plans.**

The Center for Retirement Research estimates that in 2004, almost half of employees who changed jobs withdrew an average of 18% of 401(k) assets.

As a result of these mistakes, many workers are approaching retirement with nest eggs that are too small to support anything approaching their pre-retirement lifestyle. According to the SCF, the median retirement plan balance for heads of household aged 55 to 64 was \$60,000—enough to provide an annuity during retirement of only \$400 a month.

It wasn't the most ballyhooed provision of the Pension Protection Act of 2006, which became law August 17, 2006, but the act's shift toward automatic enrollment and investment in 401(k) plans could, in the long run, be significant.

Now, instead of waiting for employees to sign up for a 401(k), companies will be able to enroll them automatically unless workers decide to opt out. According to the nonprofit Employee Benefit Research Institute, that change alone could boost participation from the EBRI's estimate of 66% to 92%. The law also lets companies automatically boost employees' contributions when earnings increase and automatically diversify holdings.

Still, the data coming out of recent studies sends a scary message to Americans: if you are eligible for a 401(k), then invest the maximum amount allowed and invest it carefully. If you are unsure about whether you are making the right 401(k) decisions, call our office and we'll do our best to answer your questions.●