

WEALTHWISE

SUMMER 2005 NEWSLETTER

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Tips for Managing Longevity Risk

During recent client meetings, Tracy Kuntz, president of Towneley Capital Management, Inc. and a Certified Financial Planner™, offered some strategies for reducing longevity risk; an issue of growing concern for aging baby boomers and soon-to-be retirees. Tracy shared her insight with Wealth Wise in the following discussion:

Wealth Wise (WW): Why has longevity risk become a hot topic with high-net-worth investors?

Tracy: With medical advances extending life expectancies and growing numbers of individuals targeting early retirement, many investors are wondering whether they can continue to enjoy their current lifestyle during retirement, without running out of money.

WW: What is longevity risk?

Tracy: Longevity risk is the risk that an individual will run out of money before the end of his or her life. The primary factors contributing to longevity risk are: 1) not starting to save early enough or saving too little during one's working years; 2) withdrawing too much too soon during retirement; and 3) investing too conservatively, both before and during the retirement years.

WW: So, how much can a retiree withdraw from savings every year without outliving his or her money?

Tracy: That's the million dollar question and there is no one-size-fits-all answer. Determining one's optimal withdrawal amount depends on several factors. One of the most important factors is market conditions at the time you begin taking withdrawals. Basically, the earlier your portfolio assets experience losses, the harder it is to sustain higher withdrawal rates over your lifetime, even if your portfolio assets later earn bull market returns.



Tracy Kuntz

Benefit from Towneley's Experience

Since we entered the investment advisory business in 1971, we have experienced more than three decades of market ups and downs, which makes us uniquely qualified to offer expert advice to clients in all market climates. Over the years, we have developed a consistent, sophisticated investment strategy that can be readily customized to meet the needs of our diverse clientele.

The Towneley Strategy

Towneley's portfolio managers customize each client's portfolio with a combination of no-load mutual funds, taking into account each client's risk tolerance, long-term goals, and other relevant factors. New funds are chosen, and current funds continue to be held, only after thorough research and assessment to ensure that the funds meet our high standards. We rebalance client portfolios whenever the economy and/or the client's needs or goals necessitate.

Expert Personalized Service

With an average company tenure of 14 years, our staff is dedicated to Towneley and to the clients we serve. Because our portfolio managers are also Certified Financial Planners[®], we are qualified to assist clients with many different financial issues in addition to investments. We make our clients' best interests our priority, and work hard to ensure that none of our clients are overlooked, or "get lost in the system".

Cost-conscious Approach

We strive to keep investment costs down to maximize client returns. Towneley's fees are among the lowest available for customized investment management that also includes detailed quarterly and annual reports and access to financial planning assistance and advice. We charge one fee for all of our services; there are no "hidden" costs or start-up fees. Towneley does not collect 12b-1 fees or sales loads from any of the funds we use. We believe that what you see should be exactly what you get.

Don't Miss the Next Issue of Wealth Wise!

If you enjoyed your first issue of *Wealth Wise* and would like to continue to receive up-to-date financial insight designed specifically for high-net-worth individuals and institutions, call 800-545-4442 and ask to be added to the subscriber list. *Wealth Wise* is only available to subscribers by email or regular mail. Call now!

Also, if you are currently reviewing your investment goals and strategies, please call us for a complimentary initial consultation. You may reach us by calling 800-545-4442 or by email at: info@towneley.com.

Tips for Managing Longevity Risk

Let's use as an example people who retired in the late 1960s. In the first few years of retirement, these investors faced the 1973-74 bear market: 21-months of stock market declines. During that time the S&P 500 lost 43% of its value. By the time higher returns came along in the 1980s, many of these folks didn't have enough assets left to rebuild their portfolios.

Periods of market decline and subsequent recovery, called drawdowns, are a normal part of the market cycle. Even though we know that drawdowns will occur, no one can accurately predict when the next one will begin. In fact, it often takes several months of data watching before analysts conclude a drawdown has already begun. We are currently in the middle of a long drawdown that started in August 2000 and bottomed out in September 2002, marking a 44.7% decline in the S&P 500 Index. This current drawdown has cost investors more, and lasted longer, than any other in the last 36 years; and it's not over yet. Although the market is recovering, as of June 2005, the S&P 500 needs an additional 18% increase to return to its August 2000 peak.

The drawdown of the technology-laden Nasdaq Composite Index has been even more devastating. That index lost 75% of its value between February 2000 and September 2002, and still faces a steep uphill climb of 127% to return to its previous peak. To illustrate, if you had invested \$1,000 in a Nasdaq Index fund on February 1, 2000, your investment would have been worth \$250 in September 2002, and only about \$440 today (as of May 31, 2005).

WW: So if I need to take regular withdrawals from my savings, what can I do to ensure that my money will last 30, 40, 50 years or more?

Tracy: That question has been the subject of many studies conducted by financial professionals and educators over the last 10 years, attempting to identify an optimum strategy for hedging longevity risk. Each researcher sought to determine a withdrawal rate that could be sustained for a long period of time regardless of market conditions. The general consensus was that the optimum withdrawal amount that would sustain a retirement portfolio for 30 years was approximately 4% of the initial account balance, adjusted annually for inflation. However, regardless of the research, we believe that 4% is not necessarily the optimum withdrawal rate for everyone.

WW: Why isn't 4% the right number for everyone?

Tracy: Some of the researchers who concluded that 4% is the optimum withdrawal rate used rolling periods of historical returns and inflation rates, others used randomly selected historical returns and inflation rates, and still others used an average annual return, standard deviation and average inflation rate generated from several decades of data. Regardless of the methodology, however, all researchers used actual historical data from the last several decades. So, the validity of their conclusions, including the 4% withdrawal rate, depends on the market and the economy performing the same way in the future as they did in the past, which is highly unlikely. In fact, we believe the stock market will under-perform historical averages over the next 7 to 10 years, and that inflation may well exceed its long-term historical average of 3% over the same period.

WW: So the 4% withdrawal rate basically depends on history repeating itself, is that right?

Tracy: Yes, with respect to market returns and inflation. However, investors also need to consider whether their withdrawals will be taxed and at what rate, how long they are likely to live given their current health and family history, and how their portfolio is allocated between equities and fixed income securities.

WW: How do income taxes affect the sustainable withdrawal rate?

Tracy: We believe that a meaningful withdrawal analysis must take taxes into account and the research backs us up. Two studies looked at the effect of income taxes on the sustainable withdrawal rate. Both concluded that when a portion of the withdrawal was used to pay income taxes, the sustainable withdrawal rate for a retirement account dropped to 3.5% of the initial balance. Factoring taxes into a withdrawal projection for a taxable account is more difficult because invest-

ment returns are taxed differently, and at different rates, depending on whether the returns are characterized as long- or short-term capital gains, dividends or interest payments.

WW: What about life expectancy? I have no idea how long I'll live so how can I possibly factor that into the withdrawal rate equation?

Tracy: The 4% withdrawal rate assumes that the portfolio is completely depleted after 30 years of regular withdrawals. Thus, theoretically, individuals requiring less longevity may be able to withdraw more each year, while those requiring more longevity should

withdraw less than 4% of the initial balance. Unless the facts and circumstances indicate otherwise, we generally use 95 as the minimum life expectancy in our withdrawal analyses and retirement plans. Individuals considering early retirement at age 55 should plan on a minimum of 40 years of longevity, whereas individuals retiring at age 70 may only need their assets to last for 25 years. Also, if an individual's family

history indicates that family members regularly live into their 90s, we may recommend a target life expectancy of at least 100. Couples should base joint life expectancy on the age of the younger spouse.

WW: What if a client wants to leave assets to his children or his favorite charity after his death, rather than spending everything during his lifetime? How does that change the withdrawal rate?

Tracy: We suggest that individuals who want to leave an estate for their heirs exclude those assets from the withdrawal calculations. For example, if a retired couple wants to leave 25% of their current assets to their children, their maximum initial withdrawal rate would be 3%, rather than 4%. The final withdrawal rate might then be adjusted downwards in consideration of other factors.



WW: You mentioned that equity exposure also impacts the validity of the 4% withdrawal rate. Would you please clarify what you mean?

Tracy: Again we go back to analyzing the research. Most of the sustainable withdrawal studies also concluded that the validity of 4% as the optimum sustainable withdrawal rate for retirement accounts required that between 50% and 75% of portfolio assets be invested in domestic equities.

Determining the appropriate equity exposure for a particular client requires that the advisor consider a number of factors, not just how much the person wants to spend during retirement. Many of these factors are subjective, but still important. For example, we consider an individual client's age, marital and family status, health, existence of other assets, prior investment experience, ability to tolerate market fluctuations, among other things, before we arrive at an asset allocation recommendation for that client. In my experience, most individuals who require regular withdrawals from a pool of assets should have no more than 30% to 50% of their portfolio invested in equities. Some equity exposure is necessary to grow the portfolio for the future. However, too much equity exposes the client to undue risk, particularly if the client unknowingly begins taking regular withdrawals the same year a major market drawdown starts. I believe that the 50-75% equity exposure required to support the 4% withdrawal rate carries too much risk for most retirees.

WW: With all that in mind, what do you feel is the best way for a person to reduce longevity risk?

Tracy: Because no one knows how the securities markets will perform in the future, or at what rate the cost of living will increase or decrease, it is best to utilize an "optimal withdrawal rate" with cau-

tion. Putting too much importance on formulas can blind you to the need to make adjustments in your withdrawals. The timing of your first regular withdrawal plays a huge role in determining whether you'll outlive your assets. This doesn't mean you need to worry about returns on a daily or even monthly basis. Market cycles can last many months, or even years. When a client is ready to begin taking regular withdrawals from her accounts, we generally prepare a withdrawal analysis. We may also prepare a retirement plan to help a client determine how much she should be saving now for retirement in the future. We then periodically revisit and revise each plan or analysis as time passes to keep the client "on track." In these ways, we help

minimize longevity risk, and maximize the life span of client portfolios.



To learn more about Towneley's withdrawal strategy or to talk to Tracy Kuntz directly, call Towneley Capital Management, Inc. at 800-545-4442.

More about Tracy Kuntz and Towneley Capital Management, Inc.: Tracy Kuntz, president of Towneley, has more than 20 years experience in portfolio management. Towneley uses proprietary asset allocation and diversification strategies to manage assets for high-net-worth individuals and institutions interested in long-term investing.

Roth Conversions Become More Attractive for Retirees

Affluent retirees who have wanted to convert sizable traditional individual retirement accounts into Roth IRAs but weren't eligible because of income restrictions may find 2005 the year to make the conversion.

Starting in 2005, an obscure provision in a 1998 federal tax act allows retirees age 70 1/2 or older to exclude from their income the required minimum distributions from traditional IRAs when determining conversion eligibility. Consequently, conversions should become a possibility for some affluent retirees, say financial planners.

To understand how this all works, let's quickly compare traditional and Roth IRAs. A traditional IRA is funded with pre-tax dollars, it grows tax deferred, and withdrawals are taxed at the owner's ordinary income tax rate. Furthermore, the owner must begin taking minimum mandatory withdrawals after turning 70 1/2. These minimum withdrawals eventually drain the IRA account.

A Roth IRA is funded with after-tax dollars and grows tax deferred. Withdrawals are tax free as long as the account has been open for at least five years and the owner is 59 1/2 or older. Furthermore and this is the key for affluent retirees there are no mandatory distributions beginning at age 70 1/2. It can be left untouched until death and passed on income-tax free to heirs.

This makes Roth IRAs especially attractive to affluent retirees who may want to pass IRAs on to their heirs or who may want to conserve IRA assets until much later in life to pay for such things as high medical or long-term care expenses. So, if you have tradi-

tional IRAs you may want to convert them to Roth IRAs. The catch is that you have to pay income taxes on the amount you convert, and you can't convert in a year in which your modified adjusted gross income (before the conversion) exceeds \$100,000.

That's where the 1998 provision helps. Those required withdrawals are often a significant source of income for affluent retirees even if they don't need the money at that time. And until now, those mandatory withdrawals counted toward the modified AGI. But they won't starting in 2005.



Assume that you earn \$70,000 in non-IRA income, you are age 72, and you have \$800,000 in a traditional IRA. Your required minimum distribution for that IRA is \$31,250. Because your total modified AGI is \$101,250, you wouldn't qualify for a Roth conversion in 2004. But you would qualify in 2005 because that \$31,250 no longer counts toward the \$100,000 conversion limit.

But even if you now qualify for a conversion, you need to weigh other factors in deciding whether to convert. First, all that money that comes out of the traditional IRA for a conversion will count as income for that year, and may push you into a higher tax bracket. You could end up with a hefty tax bill.

On the other hand, argue some tax experts, tax rates are not likely to go any lower, and some believe that they may rise in the future to offset the growing federal deficit. So it may be a matter of getting in while the getting's good.

It's best if you can afford to pay that tax bill with money from outside the IRA withdrawal. That allows you to roll the full amount into

Roth Conversions Become More Attractive for Retirees (Continued from page 5)

the Roth IRA. Other tax factors include the conversion's impact on state income taxes and the alternative minimum tax, so you'll want to work closely with a tax expert.

Are potential creditor lawsuits a risk for you? Federal law does not shield IRAs from creditors. Many states do, but not all include Roth IRAs in that protection, so you may want to see what your state's laws are before converting.

Lastly, keep in mind that if you do convert, you have until October 15 of the year after the conversion to switch back to the way things were (your conversion tax will be refunded). You will want

to do this if your income for the conversion year unexpectedly exceeds \$100,000. You may also want to consider reconverting if the value of your new Roth has dropped substantially since the conversion. You would reconvert to a traditional IRA, wait 30 days, and convert again with the lower account value (thus incurring lower conversion taxes than you incurred in the original conversion).

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Contribution Limits Increase in 2005

This year, you can sock away more money in your tax deferred retirement accounts than last year; up to \$2,000 more depending on your age and your retirement plan. If you are 49 years of age or younger in 2005, you can contribute up to \$1,000 more this year to your IRA accounts, and/or to your defined contribution plan, than last year. If you are age 50 or older in 2005, you can make an additional \$500 to \$4,000 "catch-up" contribution to those same plans. Congress approved periodic contribution limit increases to help retirement savings keep pace with inflation. So take advantage of those higher limits. You'll not only be closer to your retirement savings goal, you're also likely to pay less tax this year.

Contribution/Deferral Maximums for 2005

Type of Plan	Regular Contribution	Catch-up Contribution
Traditional IRA	\$4,000	\$500
Roth IRA	\$4,000	\$500
401(k)	\$14,000	\$4,000
403(b)	\$14,000	\$4,000
457	\$14,000	\$4,000
SIMPLE 401(k)	\$10,000	\$2,000

2005 Holiday Schedule

Towneley Capital Management, Inc. is open Monday through Friday from 8:00am to 5:00pm (Pacific Time) and will observe the same holidays as the New York Stock Exchange. Following is a list of upcoming holidays.

Holiday	Date
Independence Day	July 4
Labor Day	September 5
Thanksgiving Day	November 24
Christmas	December 26

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