



# Back Bay Financial Group, Inc.

Fee-Only Financial Planning, Investment Advisory  
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*Helping Clients Build and Manage Wealth*

## THE BACK BAY ADVISOR

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### Boosting Your 401(k) Plan's Returns

Your 401(k) plan's ultimate size is primarily a function of two factors — how much you contribute and how much you earn. Of course, you know you should contribute the maximum amount possible (\$14,000 in 2005 plus a \$4,000 catch-up contribution for individuals over age 50, if permitted by the plan). But what steps should you take to maximize your returns? Consider these tips:

- **Take advantage of employer matching contributions.** Contribute at least enough to take full advantage of any matching contributions. You simply lose the money if you don't use it. A 50% match on your contributions is like boosting your return by 50% in the first year. If you plan to contribute the maximum and your employer matches contributions, have the \$14,000 taken out of your pay uniformly throughout the year. Most employers match your contributions as they are made, so you could forego some matching if you reach the limit before year-end. For instance, assume you earn \$150,000, your employer matches 50 cents per dollar on up to 6% of your pay, and you contribute 14% of your pay. After two-thirds of the year, when you have earned \$100,000, you will contribute the maximum of \$14,000, and your employer will have contributed

\$3,000. If you contribute 9.33% of your pay instead, your contributions will be spread throughout the year and your employer will contribute \$4,500, an additional \$1,500 match.

- **Select your investment alternatives carefully.** Since you are responsible for investment decisions, understand all alternatives and review all available information before making choices. Keep in mind the long-term nature of your retirement goal and select investments appropriate for that time period. For most partici-

pants, that will mean that a significant portion of their portfolio should be invested in growth alternatives, such as stocks.

- **Rebalance periodically.** Numerous studies have found that rebalancing reduces portfolio volatility, often with increased returns. By rebalancing, you are following a fundamental investment principle — you are buying low (those investments that are underperforming) and selling high (those investments that are performing well). Keep in mind

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### Consider a Conversion

In tax planning, the goal typically is to delay the payment of income taxes. Thus, it can be difficult to understand why it may make sense to convert a traditional individual retirement account (IRA) to a Roth IRA, which results in the current payment of income taxes.

Factors that favor converting to a Roth IRA include:

- You can pay the income taxes due from the conversion with funds outside the IRA. By doing so, you are in essence increasing your IRA's value by the amount of tax paid. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in

nondeductible IRAs), but are exempt from the 10% early withdrawal penalty.

- You expect your marginal tax rate at withdrawal to be equal to or greater than your current marginal tax rate. When your rates are equal at both times, the financial results from either IRA will be similar. Increasing income tax brackets generally make it advantageous to convert to a Roth IRA.
- You won't make withdrawals from the Roth IRA for a long time. Estimates indicate that you generally need five to 10 years of tax-free compounding to compensate for the current payment

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## Are Defined-Benefit Pension Plans Extinct?

Defined-benefit pension plans have been on a steady decline for the last couple of decades, while defined-contribution plans, such as 401(k) plans, have increased dramatically.

A number of factors have led to this steady decline in defined-benefit plans, including:

- **Increased costs to companies** — The recent market declines seriously eroded the value of pension assets, while declining interest rates dramatically increased liabilities for future benefits to retirees.
- **A more mobile work force** — Defined-benefit pension plans provide more significant benefits for workers who stay with the company for a long time, with a substantial portion of the benefits earned during the last few years of employment. With employees changing jobs more frequently, the portability of 401(k) plans make them desirable to younger workers.
- **A changing economy** — Traditionally, defined-benefit plans were offered by large manufacturing companies, often as a result of union negotiations and

contracts. As the economy became more service based, new companies have opted for 401(k) plans rather than defined-benefit plans.

Even companies with defined-benefit plans are looking for ways to reduce the tremendous cost of these plans. While companies can't eliminate benefits already earned, they can change future benefits. Some of the more common options include:

- **Offer a cash-balance plan to new and/or current employees.** Although a cash-balance plan is technically a defined-benefit plan, it operates much differently than a traditional pension plan. The employer still completely funds the payments, but rather than a guaranteed pension for life, a cash-balance plan provides employees with a lump-sum amount that can be used for retirement or to purchase an annuity. By the late 1990s, 11% of all traditional defined-benefit plans had been converted to cash-balance plans, representing 40% of all defined-benefit assets (Source: Federal Reserve Bank of Dallas, October 2004).
- **Freeze the defined-benefit plan.**

Benefits are frozen at a point in time so employees do not earn any additional benefits. In exchange, the company might increase contributions to the 401(k) plan.

- **Terminate the plan.** The most drastic solution is to terminate the plan. When terminated, the plan assets are used to either buy an annuity from an insurance company or issue lump-sum payments to workers.

If you have a defined-benefit plan at work, keep in mind that the pension benefits you're counting on can change. You can only count on benefits you have currently earned, but not benefits that might be earned in the future. Thus, you might want to review your retirement plans to make sure you haven't placed too much emphasis on retirement plan benefits. Rfigure your plans assuming your pension benefits are only half or less of what you currently expect. What would you have to do to make up this shortfall?

If you'd like help assessing your company pension plan, please call. ■■■

## Boosting Your 401(k)

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that you set your asset allocation strategy because you believed those were the appropriate percentages of various investments that you should own. Thus, you need to make rebalancing a habit so your portfolio doesn't become more risky than intended.

- **Limit the amount of company stock owned.** Purchasing too much company stock is risky. Not only is your job and livelihood tied to the company, but your retirement savings are also tied to the same company. It is generally recommended that any one stock not comprise more than 5% to 10% of your portfolio's value.

If you own company stock in your 401(k) plan, look at how much of your total balance it represents. Take steps to immediately reduce that percentage if it is over 10% of your total portfolio.

- **Don't borrow from your 401(k) plan.** While it may be comforting to know you can gain access to your 401(k) funds when needed, only borrow as a last resort. It's true that you are borrowing from yourself and will pay interest to yourself, but there are also hidden costs to this borrowing. When you borrow, some of your investments are sold. While your loan is outstanding, you miss out on any capital gains or other income those investments would

have earned. Interest rates are typically very reasonable with 401(k) loans, often prime rate or a couple of points over prime. That makes it easier to pay back the funds, but could mean your 401(k) account is earning lower returns than if it was invested in other alternatives. Also, if you leave the company while a loan is outstanding, you must repay the entire balance within a short period of time or the loan will be considered a distribution, subject to income taxes and the 10% early withdrawal penalty if you are under age 59 1/2 (55 if you are retiring).

Call if you'd like help with decisions involving your 401(k) plan. ■■■

## Conversion

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of taxes.

- You don't expect to take withdrawals from your IRA. Since you aren't required to withdraw funds from a Roth IRA, even after age 70 1/2, your IRA balance can continue to grow on a tax-free basis.
- You want to leave your IRA balance to heirs. With a Roth IRA, your heirs receive the proceeds free of federal income taxes. Also, if you don't withdraw funds from the Roth IRA after age 70 1/2, you could potentially leave your heirs with a much larger balance than from the traditional IRA.

Some factors that may indicate you should not convert to a Roth IRA include:

- You have to pay income taxes due from the conversion with IRA funds. The amount withheld for this purpose will be subject to income tax and the 10% penalty if you're under age 59 1/2.
- You expect your marginal tax rate when funds are withdrawn to be significantly lower than your current marginal tax rate.
- You will make withdrawals after a short time. Thus, the tax-free compounding of earnings won't offset the current payment of income taxes.
- Income from the conversion would increase your adjusted gross income (AGI) to a level that increases your marginal tax rate or prevents you from using some tax credits, deductions, or exemptions.
- You expect to withdraw the majority of your IRA funds during retirement. Thus, the estate planning aspects of a Roth IRA are not of interest.

To convert from a traditional

## Will Your 401(k) Be Enough?

For the vast majority of workers, a 401(k) plan may be the only retirement plan offered by employers. If you won't receive a traditional pension benefit from your employer, will a 401(k) plan be enough to fund your retirement?

Answering that question is difficult because the 401(k) plan has only been around for 20 years, so no current retirees have saved in a 401(k) plan for their entire working career. However, the Employee Benefit Research Institute (EBRI) conducted a study to determine what percentage of income a typical worker investing in a typical 401(k) plan for his/her entire working career could expect that 401(k) plan to replace. Assuming investment returns similar to the period from 1929 to 1978 and an average contribution rate of 9.3%, the EBRI estimated that a worker could replace 72% of his/her income with a 401(k) plan and Social Security benefits. That assumes that the worker is consistently covered by and contributing to a 401(k) plan from his/her late 20s until retirement at age 65 (Source: *Can 401(k) Accumulations Generate Significant Income for Future Retirees?*, November 2002).

But how realistic are those assumptions? The statistics are not

very encouraging (Source: *Money Central*, 2005):

- Approximately 25% of workers don't participate in their 401(k) plan.
- Only 10% of workers contribute the maximum amount permitted.
- Almost half of those who do participate don't contribute enough to receive the full match from their employer.
- Participants make a variety of mistakes when investing their 401(k) funds, including investing too conservatively, not rebalancing on a periodic basis, and investing too much in their company's stock.
- Almost half of those changing jobs cash out their 401(k) account rather than rolling it over to another 401(k) plan or an individual retirement account.

And remember, the EBRI's study estimated that a 401(k) plan and Social Security would replace 72% of income. With increasingly active retirement lifestyles, it is often estimated that a new retiree will need 100% or more of pre-retirement income to fund their retirement lifestyle. Call if you'd like to discuss your 401(k) plan in more detail. ■■■

IRA to a Roth IRA, AGI for single taxpayers and married taxpayers filing jointly cannot exceed \$100,000 in the year of conversion. This limit does not include any income resulting from the conversion. Also, starting in 2005, required minimum distributions from traditional IRAs are no longer included in the \$100,000 limit. Amounts that have been rolled over from a qualified pension plan, such as a 401(k) plan, to a traditional IRA can also be con-

verted to a Roth IRA. Once the balance is converted, qualified distributions cannot be made until after the five-tax-year holding period. Distributions before then are subject to the 10% early withdrawal penalty, unless one of the exceptions applies.

You do not have to convert your entire IRA balance. You can convert only a portion, which may help with the payment of income taxes.

Please call if you'd like help with this analysis. ■■■