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Borrowing from Your Retirement

- Earlier in my career, I was an investment consultant for CIGNA Retirement Services and I had the opportunity to meet with representatives of companies that offered CIGNA 401(k) plans.
- In plans that allowed participants to borrow from their 401(k) accounts, many took advantage of this "benefit." Too often the 401(k) account became a piggy bank to be plundered, rather than an investment account to be used for retirement.

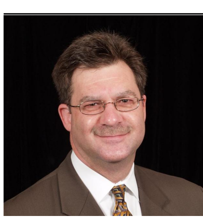
Barbara is 40 years old, has a child in college, and needs to take out a loan to help with tuition. She is considering either a home-equity loan or a loan from her 401(k), and is not sure which would be the better choice. She has heard that taking out a loan from a 401(k) is painless, since "you don't pay penalties and pay the interest to yourself, not to a bank." What should she do?

Many 401(k) plans offer a loan provision and the process is fairly easy. There is no credit check (since you are borrowing from yourself); the interest rate is usually low (maybe a percentage point or two above prime); you can generally borrow up to 50% of your vested account balance to a maximum of $50,000; you have up to five years to repay the loan (longer for loans used to purchase a primary residence), and the plan administrator usually deducts the loan payments automatically from your paycheck.

However, the real cost of borrowing from your 401(k) is not the rate you pay yourself in interest, but the amount you would have earned on your balance had you just left the money in the account. This is called an "opportunity cost," and it can be significant. In addition, if Barbara loses or changes jobs, a 401(k) loan will most likely come "due in full" within a limited amount of time, while a home-equity loan will not. The balance is taxed as if it were ordinary income and, unless she is at least 59½ years old, failure to pay the 401(k) loan back by the due date triggers a 10% penalty.

So, what are Barbara's choices? In general, if she can take out a home-equity loan at a lower after-tax cost than the return she expects to receive on her 401(k), she should choose the home-equity loan.

Advisor Corner



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Our wealth management services include investment management, retirement and gift planning, education funding, and other advisory services.

We take pride in offering you expert financial advice along with personalized service. Assisting you in reaching your financial goals is our business and we take that responsibility very seriously.

For details on the selection criteria used to determine the recipients of the 2012 FIVE STAR Wealth Manager award, please visit our web site.

Breaking Up Is Hard To Do

By Louis E. Conrad II, CFA

- Unfortunately, many marriages end in divorce. Those going through the divorce process should seek appropriate legal and financial counsel.
- A financial advisor can offer perspectives on the division of assets, as well as debts, plus the implications of alimony and child support, and the need for changes in beneficiary designations, estate planning documents, and insurance.

Approximately 2 million people in the U.S. divorce each year, with nearly 50% of first marriages ending in divorce and roughly two-thirds of second marriages. Financial issues are often a cause of breakups and can continue to be significant as partners transition to a single life. Consequently, individuals proceeding through the divorce process may want to seek the counsel of a financial advisor in addition to a divorce attorney to ensure that financial matters are addressed appropriately.

Division of Assets

A Qualified Domestic Relations Order (QDRO) is boilerplate language that should be included in a divorce agreement and approved by the family court for the division of qualified retirement plan assets to ensure a tax-free distribution. Following court approval, the QDRO then must be submitted to the administrator of the retirement plan. Without a QDRO, the distribution will be treated as a taxable payout to the account's owner and, if they are not yet 59½ years old, a 10% tax penalty will also be assessed. Individual Retirement Arrangements (IRAs) do not require QDROs, but to ensure the tax-free nature of a transfer to the ex-spouse, the divorce decree must outline its intent. To transfer the assets in an IRA, either (1) the name on the IRA must be changed to the new owner or (2) a direct trustee-to-trustee transfer must occur into the new owner's IRA. The IRA's custodian should be consulted to determine its requirements.

Other assets that are often involved in a divorce proceeding include non-retirement brokerage accounts, bank accounts, pensions, and stock options. How these assets will be allocated should also be included in the divorce agreement and the value of all marital assets should be evaluated on an after-tax basis.

The largest and least liquid marital asset is often the personal residence. If the home will be sold as part of the marriage's dissolution, then it may benefit the homeowners to sell the home while they are still technically married and filing tax returns jointly to claim as much as a $500,000 capital gain exemption that is available for married couples. If the residence is sold after the divorce and while single, then only up to a $250,000 capital gain exemption would be available. If the home will be maintained by one of the parties after the marriage and a mortgage exists on the property, then a new mortgage will need to be obtained based on the continuing owner's income and assets.

Other Financial Planning Issues

Aside from the division of assets, numerous other steps should be pursued or understood during the divorce process depending on the situation: (1) The couple should pay off and close or place in the name of one person any joint accounts, such as credit card and bank accounts, as well as open individual credit card and bank accounts as needed. All parties involved should monitor their credit reports especially closely during the divorce and ensure that all joint accounts are shown as closed. (2) Alimony is tax deductible to the payer and taxable to the payee, while child support is neither tax deductible nor taxable. (3) Beneficiary designations should be updated on retirement plans, IRAs, pensions, and life insurance and annuity policies. (4) Estate planning documents, such as wills, durable powers of attorney, health care proxies, and trusts should be updated as a result of the marriage's dissolution. (5) Insurance, especially for health care, should be maintained and life and disability policies on the ex-spouse should be held if they are responsible for support payments, college tuition payments, or a future property settlement.

Divorce is usually a tumultuous and emotional process that involves significant legal and financial decisions. To ensure the divorcing parties' interests are served, each should engage appropriate professionals to provide the necessary counsel.

Monthly Market Commentary

- A slow, muted recovery has continued in the U.S., though a deceleration in growth was seen in the second quarter.
- The European Union has entered into recession, which heightens the risk that the U.S. economy could slip into recession.
- COMPASS believes that U.S. economic growth will stabilize at current levels before accelerating later this year.

Much of July consisted of market participants eagerly awaiting announcements from the U.S. Federal Reserve and the European Central Bank (ECB). The main expectation was for some form of concrete action to revitalize lackluster economies in the wake of the global slowdown. Markets soared after ECB chief Mario Draghi made strong statements, including how the ECB was "ready to do whatever it takes to preserve the euro," but unfortunately fell sharply again when the ECB failed to actually provide any strong policy support to troubled Eurozone economies. Earnings season showed corporate earnings mostly came in better than expected, though revenue was mostly light as the European crisis continued to affect many companies.

GDP: Second quarter real GDP growth came in at an anemic, but not surprising 1.5%, down from a revised 2.0% in the first quarter. A slowdown in consumer spending and a rise in imports were the main causes of this deceleration. While many have questioned whether the U.S. might already be in a recession, the latest GDP results do not currently reveal that. At the same time, it is difficult to argue that the U.S. economy is booming.

Employment: Investors breathed a huge sigh of relief as 172,000 jobs were added in July, up from a revised 73,000 jobs in June. Most of the job growth came from business services, restaurants, health care, and manufacturing while government hiring shrank by 9,000. Unfortunately, the construction industry continued to contract from poor construction hiring in the commercial sector. The unemployment rate inched upwards slightly to 8.3%.

Housing: Housing data continued to show improvements, as July builder sentiment made its largest single-month increase in a decade. June housing starts set a new recovery high after rising 29% year-over-year, and June existing home inventories remained about 20% below year-ago levels. While low inventories have started to weigh on existing home sales, which fell 5.4% from May to June, lower inventory levels also caused a dramatic rise in median prices. Morningstar economists believe that while it is unfortunate housing is improving at such a slow pace, it still has a lot of room to expand and may drive the economy even higher as exports and manufacturing begin to slow.

Manufacturing: The purchasing manager reports in July indicated paltry gains for both U.S. and China manufacturing, while the Eurozone continued to show broad-based weakness with a 37-month low reading as European companies continued to cut employment and inventories in the face of further expected declines. More importantly, slowdowns in France and Germany suggest that further weakness lies ahead.

Auto: Auto sales were a big help for the economy in both the December 2011 quarter and the March 2012 quarter, but were essentially flat from March to June. With July's vehicle sales of 14 million units, the auto industry continued to hold steady and will most likely not be a big help in the second half of 2012. Although sales did not accelerate, more sales were made to consumers instead of corporate fleets or rental car companies. It is worthwhile to note that consumer sales tend to occur at higher prices and are considered more indicative of economic strength.

Inflation: June's CPI report showed that medical services and apparel prices increased, while overall energy and airline prices fell. Droughts in the Midwest continued, which could mean even higher corn and soybean prices that may further drive up the prices of items (such as pork and chicken) higher up the food chain. Unfortunately, this may hurt consumers, who were just beginning to get ahead of inflation.

Dollar-Cost Averaging: Slow and Steady

- Dollar-cost averaging is a simple, yet effective means of disciplined investing.
- It allows for the purchase of more shares when they are on sale (i.e., at lower prices).

The concept of “dollar-cost averaging” might initially appear intimidating to some, but the practice is actually quite simple. All you have to do is invest the same amount of money each and every month. Pretty simple, right? But what's really nice is that something as straightforward as dollar-cost averaging actually helps you invest smarter.

Say you want to invest $900 in a certain mutual fund. Over three months, the fund's price is $30, $20, and $25. If you invested all of your money immediately, you'd wind up with 30 shares of the fund. However, if you invested $300 into the fund each month, you'd end up with a total of 37 shares. By dollar-cost averaging you were able to obtain seven more shares. Of course, if you knew ahead of time that the fund would fall to $20, you could have bought all of your shares then. But you obviously can't predict the future. Dollar-cost averaging is a smart strategy that forces you to keep investing, even if the market is dropping.

It encourages discipline. Instead of being tempted to sell your investments when prices are falling, you actually buy more.

One great thing about an employer-sponsored retirement plan is that it automatically uses dollar-cost averaging—the same amount is taken out of every paycheck. You can also set up automatic dollar-cost averaging programs with most individual retirement accounts (IRAs).

Please keep in mind that dollar-cost averaging does not ensure profit or protect against a loss in a declining market. However, its benefits are quite clear: Dollar-cost averaging minimizes the effects of market fluctuations, encourages discipline, eliminates the need to decide when to invest, and avoids the temptation to time the market.

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