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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

The financial turbulence of the last few years has settled down. Politicians have backed off any significant reform initiatives. Western Europe has moved beyond their immediate liquidity problems. The US economy continues its slow growth. Stock market valuation risk continues to grow, while waiting for a trigger that will begin a move back to more normal levels. At this moment of relative calm, we offer you the second installment in our discussion of comparing, understanding and managing your retirement plans. This time our topic is allocating investment assets among different types of plans.

The Economy

While officially measured growth has dropped back from 4.1% to 2.6%, the economy continues to improve, although still more slowly than one might wish or expect based on prior history. US employment is once again nearing the peak level that it reached in 2008. Housing is a mixed bag. Prices of existing homes are up 9% over last year, but sales have dropped off as mortgage rates have risen. Not surprisingly, consumer malaise remains, and while the confidence index ticked up a bit, it is still languishing at the 35th percentile, according to commentator Doug Short.

The Federal Reserve continued to back out of the Quantitative Easing business. Some serious people question whether the program had any real effect other than lifting the stock market, elevating market risk, and reducing interest rates (along with the government's debt bill and savers' income). Apparently, many supporters have concluded that the point of diminishing returns has been reached.

The Markets

The Fed policy change last quarter may have affected the market trends. Stocks were basically flat, while bonds rallied. Longer-term valuation measures peg stocks to be about 60% over-valued now, like the peaks of 1909, 1929, 1937, and 1968. This suggests long-term returns will likely be sub-par for a number of years, and volatility could grow. Only during the "irrational exuberance" rally of the late 1990's, another time of active Fed intervention, did stocks continue to rally significantly higher. The national mood does not seem as exuberant today.

Admittedly, we have been concerned about this Fed-induced rally scenario for a long time. Eventually valuation levels will normalize. Exactly when remains anybody's guess. Although the water seems to be calm right now, we continue to be concerned about the possibility of sharks below the surface. In our planning work, we are considering lower return expectations than the historical averages for both stocks and bonds.

Allocating Retirement Plans

Predicting the economy or investment performance is not possible, particularly over the short-term. We can observe valuations and manage our risk, but it is impractical to guess whether Russia will invade the Ukraine, the composition of congress will change in the next election, or an unknown asteroid appears from nowhere. What we can do, however, is understand and apply tax laws and benefits, as they currently exist, to intelligently create some diversity and flexibility in our future financial options. In the last quarter's issue of *Outlook & Trends,* we compared the effect of saving for retirement in several different types of investment accounts, showing widely varying results. If you missed it, or would like to refresh your memory, you may find the issue on our website, www.linnardfinancial.com.

It is easy to unknowingly increase your taxes in retirement if you are not careful or not prepared. There are several issues to consider. First, while accumulating earnings in a tax-deferred account provides a benefit over the long-term, the short-term effect may lead to a different result. For example, investments that generate long-term capital gains are taxed at a lower rate in a normal taxable brokerage account than when they are removed from a traditional IRA, 401(k) or variable annuity. On the other hand, five years after opening the account and after age 59 ½, earnings in a Roth IRA are not taxed at all. Therefore, often it makes sense to use Roth accounts to concentrate high earning assets. Consider organizing your investments:

Bonds and bond funds	Traditional IRAs, 401k(s), 403(b), Variable Annuities, HSAs used for annual medical expenses
Cash	Taxable account or HSAs used for annual expense
Long-term core equity holdings	Taxable account or HSAs used for long-term investment
Expected short-term equity holdings	Roth IRA or HSAs used for long-term investment

This does not mean that you should only put bonds in your 401(k). If a 401(k) is your only account, it is more important to follow your appropriate asset allocation. However, if you have some flexibility while maintaining your appropriate asset allocation, be sure to consider the tax consequences of your options. Also, when preparing for retirement, give some thought to creating flexibility, so all your investments are not in the same type of account. Distributing funds among several different types of accounts will provide an important ability to manage your income and minimize taxes after you retire.

For example, after contributing enough to receive maximum employer matching funds in your employer retirement plan, it may make sense to contribute additional dollars to a Roth IRA. If you bought a variable annuity for its tax-deferral value, a partial surrender could be a source of Roth contribution funds and provide worthwhile diversification. Likewise, if you have a rollover IRA, it may make sense to begin slowly converting some of those funds to a Roth. It may sound like heresy, but depending on your financial structure and investment philosophy, it might even make sense to skip the traditional IRA or 401(k) and keep funds for expected long-term holdings in a regular taxable account.

Not only is pairing your assets with the best account important for today's taxes, it will also give you important flexibility later when you begin to withdraw funds to provide your retirement cash flow. This benefit may be well in the future, but it is important to start thinking about today.

Harvesting retirement cash flow will be our topic for the next issue of *Outlook & Trends*. Preparing now will help you to reach financial independence in the future. Developing, implementing, and living your financial plan ideally should be an ongoing process. The earlier the process is started, the more flexibility you will have and the more good and informed decisions you will make in the interim. If you would like us to help you begin or continue, please give us a call.

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