Raymond James & Associates, Inc.
Joe Ciaramitaro, CFP®
Sr VP, Investments, Managing Director
325 N Old Woodward
Suite 320
Birmingham, MI 48009
248-901-3938
800-544-8754 ex 3938
Joseph.Ciaramitaro@raymondjames.com
www.joecthefinancialcoach.com

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Coaching Your Financial Future

Four Numbers You Need to Know Now

When it comes to your finances, you might easily overlook some of the numbers that really count. Here are four to pay attention to now that might really matter in the future.

1. Retirement plan contribution rate

What percentage of your salary are you contributing to a retirement plan? Making automatic contributions through an employer-sponsored plan such as a 401(k) or 403(b) plan is an easy way to save for retirement, but this out-of-sight, out-of-mind approach may result in a disparity between what you need to save and what you actually are saving for retirement. Checking your contribution rate and increasing it periodically can help you stay on track toward your retirement savings goal. .

Some employer retirement plans let you sign up for automatic contribution rate increases each year, which is a simple way to bump up the percentage you're saving over time. In addition, try to boost your contributions when you receive a pay raise. Consider contributing at least enough to receive the full company match (if any) that your employer offers.

2. Credit score

When you apply for credit, such as a mortgage, a car loan, or a credit card, your credit score is one of the tools used by lenders to evaluate your creditworthiness. Your score will likely factor into the approval decision and affect the terms and the interest rate you'll pay.

The most common credit score that creditors consider is a FICO© Score, a three-digit number that ranges from 300 to 850. This score is based on a mathematical formula that uses information contained in your credit report. In general, the higher your score, the lower the credit risk you pose.

Each of the three major credit reporting agencies (Equifax, Experian, and TransUnion) calculates FICO® scores using different formulas, so you may want to check your scores from all three (fees apply). It's also a good idea to get a copy of your credit report at least annually to check the accuracy of the information upon which your credit score is based. You're entitled to one free copy of your credit report every 12 months from each of the three credit reporting agencies. You can get your copy by visiting annualcreditreport.com.

3. Debt-to-income ratio

Your debt-to-income ratio (DTI) is another number that lenders may use when deciding whether to offer you credit. A DTI that is too high might mean that you are overextended. Your DTI is calculated by adding up your major monthly expenses and dividing that figure by your gross monthly income. The result is expressed as a percentage. For example, if your monthly expenses total $2,200 and your gross monthly income is $6,800, your DTI is 32%.

Lenders decide what DTIs are acceptable, based on the type of credit. For example, mortgage lenders generally require a ratio of 36% or less for conventional mortgages and 43% or less for FHA mortgages when considering overall expenses.

Once you know your DTI, you can take steps to reduce it if necessary. For example, you may be able to pay off a low-balance loan to remove it from the calculation. You may also want to avoid taking on new debt that might negatively affect your DTI. Check with your lender if you have any questions about acceptable DTIs or what expenses are included in the calculation.

4. Net worth

One of the key big-picture numbers you should know is your net worth, a snapshot of where you stand financially. To calculate your net worth, add up your assets (what you own) and subtract your liabilities (what you owe). Once you know your net worth, you can use it as a baseline to measure financial progress.

Ideally, your net worth will grow over time as you save more and pay down debt, at least until retirement. If your net worth is stagnant or even declining, then it might be time to make some adjustments to target your financial goals, such as trimming expenses or rethinking your investment strategy.

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Is It Wise to Trade Your Pension for a Lump Sum?

About 41 million people are participants (active, retired, or separated vested) of PBGC-insured corporate pension plans.

Source: Congressional Budget Office, 2016

Most private employers have already replaced traditional pensions, which promise lifetime income payments in retirement, with defined contribution plans such as 401(k)s. But 15% of private-sector workers and 75% of state and local government workers still participate in traditional pensions.[1] Altogether, 35% of workers say they (and/or their spouse) have pension benefits with a current or former employer.[2]

Many pension plan participants have the option to take their money in a lump sum when they retire. And since 2012, an increasing number of large corporate pensions have been implementing "lump-sum windows" during which vested former employees have a limited amount of time (typically 30 to 90 days) to accept or decline buyout offers.[3] (Lump-sum offers to retirees already receiving pension benefits are no longer allowed.)

By shrinking the size of a pension plan, the company can reduce the associated risks and costs, and limit the impact of future retirement obligations on current financial performance. However, what's good for a corporation's bottom line may or may not be in the best interests of plan participants and their families.

For many workers, there may be mathematical and psychological advantages to keeping the pension. On the other hand, a lump sum could provide financial flexibility that may benefit some families.

Weigh risks before letting go

A lump-sum payout transfers the risks associated with investment performance and longevity from the pension plan sponsor to the participant. The lump-sum amount is the discounted present value of an employee's future pension, set by an IRS formula based on current bond interest rates and average life expectancies.

Individuals who opt for a lump-sum payout must then make critical investment and withdrawal decisions, and determine for themselves how much risk to take in the financial markets. The resulting income is often not enough to replace the pension income given up, unless the investor can tolerate exposure to stock market risk and is able to achieve solid returns over time.

Gender is not considered when calculating lump sums, so a pension's lifetime income may be even more valuable for women, who tend to live longer than men and would have a greater chance of outliving their savings.

In addition, companies might not include the value of subsidies for early retirement or spousal benefits in lump-sum calculations.[4] The latter could be a major disadvantage for married participants, because a healthy 65-year-old couple has about a 73% chance that one spouse will live until at least 90.[5]

When a lump sum might make sense

A lump-sum payment could benefit a person in poor health or provide financial relief for a household with little cash in the bank for emergencies. But keep in mind that pension payments (monthly or lump sum) are taxed in the year they are received, and cashing out a pension before age 59½ may trigger a 10% federal tax penalty.[6] Rolling the lump sum into a traditional IRA postpones taxes until withdrawals are taken later in retirement.

Someone who expects to live comfortably on other sources of retirement income might also welcome a buyout offer. Pension payments end when the plan participant (or a surviving spouse) dies, but funds preserved in an IRA could be passed down to heirs.

IRA distributions are also taxed as ordinary income, and withdrawals taken prior to age 59½ may be subject to the 10% federal tax penalty, with certain exceptions. Annual minimum distributions are required starting in the year the account owner reaches age 70½.

It may also be important to consider the health of the company's pension plan, especially for plans that don't purchase annuity contracts. The "funded status" is a measure of plan assets and liabilities that must be reported annually; a plan funded at 80% or less may be struggling. Most corporate pensions are backstopped by the Pension Benefit Guaranty Corporation (PBGC), but retirees could lose a portion of the "promised" benefits if their plan fails.

The prospect of a large check might be tempting, but cashing in a pension could have costly repercussions for your retirement. It's important to have a long-term perspective and an understanding of the tradeoffs when a lump-sum option is on the table.

[1] U.S. Bureau of Labor Statistics, 2016

[2] Employee Benefit Research Institute, 2016

[3, 4] *The Wall Street Journal,* June 5, 2015

[5] Society of Actuaries, 2017

[6] The penalty doesn't apply to employees who retire during or after the year they turn 55 (50 for qualified public safety employees).

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Converting Retirement Savings to Retirement Income

Regardless of which path you choose with your retirement accounts, keep in mind that generally, you'll be required to begin taking minimum distributions from employer-sponsored plans and traditional IRAs in the year you reach age 70½; you can delay your first distribution as late as April 1 of the following year.

Taxable distributions from traditional employer-sponsored plans and IRAs prior to age 59½ may be subject to a 10% penalty tax, unless an exception applies.

Different rules apply to Roth accounts. For information on how Roth accounts may fit into your retirement income picture, talk to a financial professional.

You've been saving diligently for years, and now it's time to think about how to convert the money in your traditional 401(k)s (or similar workplace savings plans) into retirement income. But hold on, not so fast. You may need to take a few steps first.

Evaluate your needs

If you haven't done so, estimate how much income you'll need to meet your desired lifestyle in retirement. Conventional wisdom says to plan on needing 70% to 100% of your annual pre-retirement income to meet your needs in retirement; however, your specific amount will depend on your unique circumstances. First identify your non-negotiable fixed needs — such as housing, food, and medical care — to get clarity on how much it will cost to make basic ends meet. Then identify your variable wants — including travel, leisure, and entertainment. Segregating your expenses into needs and wants will help you develop an income strategy to fund both.

Assess all sources of predictable income

Next, determine how much you might expect from sources of predictable income, such as Social Security and traditional pension plans.

Social Security: At your full retirement age (which varies from 66 to 67, depending on your year of birth), you'll be entitled to receive your full benefit. Although you can begin receiving reduced benefits as early as age 62, the longer you wait to begin (up to age 70), the more you'll receive each month. You can estimate your retirement benefit by using the calculators on the SSA website, ssa.gov. You can also sign up for a *my* Social Security account to view your Social Security Statement online.

Traditional pensions: If you stand to receive a traditional pension from your current or a previous employer, be sure to familiarize yourself with its features. For example, will your benefit remain steady throughout retirement or increase with inflation? Your pension will most likely be offered as either a single life or joint-and-survivor annuity. A single-life annuity provides benefits until the worker's death, while a joint-and-survivor annuity generally provides reduced benefits until the survivor's death.[1]

If it looks as though your Social Security and pension income will be enough to cover your fixed needs, you may be well positioned to use your other assets to fund those extra wants. On the other hand, if your predictable sources are not sufficient to cover your fixed needs, you'll need to think carefully about how to tap your retirement savings plan assets, as they will be a necessary component of your income.

Understand your savings plan options

A key in determining how to tap your retirement plan assets is to understand the options available to you. According to the Government Accountability Office (GAO), only about one-third of 401(k) plans offer withdrawal options, such as installment payments, systematic withdrawals, and managed payout funds.[2] And only about a quarter offer annuities, which are insurance contracts that provide guaranteed income for a stated amount of time (typically over a set number of years or for the life expectancy of the participant or the participant and spouse).[3]

Plans may allow you to leave the money alone or require you to take a lump-sum distribution. You may also choose to roll over the assets to an IRA, which might offer a variety of income and investment opportunities, including the purchase of annuity contracts. If you choose to work part-time in retirement, you may be allowed to roll your assets into the new employer's plan.

Determining the right way to tap your assets can be challenging and should take into account a number of factors. These include your tax situation, whether you have other assets you'll use for income, and your desire to leave assets to heirs. A financial professional can help you understand your options.

[1]Current law requires married couples to choose a joint-and-survivor annuity unless the spouse waives those rights.

[2]"401(k) Plans: DOL Could Take Steps to Improve Retirement Income Options for Plan Participants," GAO Report to Congressional Requesters, August 2016

[3]Generally, annuity contracts have fees and expenses, limitations, exclusions, holding periods, termination provisions, and terms for keeping the annuity in force. Most annuities have surrender charges that are assessed if the contract owner surrenders the annuity. Qualified annuities are typically purchased with pre-tax money, so withdrawals are fully taxable as ordinary income, and withdrawals prior to age 59½ may be subject to a 10% penalty tax. Any guarantees are contingent on the claims-paying ability and financial strength of the issuing insurance company. It is important to understand that purchasing an annuity in an IRA or an employer-sponsored retirement plan provides no additional tax benefits other than those available through the tax-deferred retirement plan.

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Joe Ciaramitaro, CFP®
Sr VP, Investments, Managing Director
325 N Old Woodward
Suite 320
Birmingham, MI 48009
248-901-3938
800-544-8754 ex 3938
Joseph.Ciaramitaro@raymondjames.com
www.joecthefinancialcoach.com

Are you ready to retire?

Here are some questions to ask yourself when deciding whether or not you are ready to retire.

Is your nest egg adequate?

It may be obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off your retirement savings. The average American can expect to live past age 78.* With future medical advances likely, it's not unreasonable to assume that life expectancy will continue to increase. Is your nest egg large enough to fund 20 or more years of retirement?

When will you begin receiving Social Security benefits?

You can receive Social Security retirement benefits as early as age 62. However, your benefit may be 25% to 30% less than if you waited until full retirement age (66 to 67, depending on the year you were born).

How will retirement affect your IRAs and employer retirement plans?

The longer you delay retirement, the longer you can build up tax-deferred funds in traditional IRAs and potentially tax-free funds in Roth IRAs. Remember that you need taxable compensation to contribute to an IRA.

You'll also have a longer period of time to contribute to employer-sponsored plans like 401(k)s — and to receive any employer match or other contributions. (If you retire early, you may forfeit any employer contributions in which you're not fully vested.)

Will you need health insurance?

Keep in mind that Medicare generally doesn't start until you're 65. Does your employer provide post-retirement medical benefits? Are you eligible for the coverage if you retire early? If not, you may have to look into COBRA or an individual policy from a private insurer or the health insurance marketplace — which could be an expensive proposition.

Is phasing into retirement right for you?

Retirement need not be an all-or-nothing affair. If you're not quite ready, financially or psychologically, for full retirement, consider downshifting from full-time to part-time employment. This will allow you to retain a source of income and remain active and productive.

* NCHS Data Brief, Number 267, December 2016

What is a funeral trust?

A funeral trust is an arrangement entered into with a provider of funeral or burial services. Prepaying funeral expenses may allow you to "lock in" costs for future funeral or burial services at an agreed-upon price. The funeral home sometimes serves as trustee (manager of trust assets), and you usually fund the trust with cash, bonds, or life insurance. A revocable funeral trust can be changed and revoked by you at any time. An irrevocable trust can't be changed or revoked, and you generally can't get your money out except to pay for funeral services.

Irrevocable funeral trusts may also help you qualify for long-term care benefits through Medicaid. For example, these trusts may be funded with assets that would otherwise be countable resources for Medicaid (i.e., included in determining Medicaid eligibility). They are often sold through insurance companies, in which case they are typically funded with life insurance. And you can fund the funeral trust right before entering the nursing home — there's no "look-back" period for these transfers, unlike the case with certain other transfers that can cause a delay in the start of Medicaid benefits.

Another advantage of funding your trust with life insurance is that the trust will have no taxable income to report, because life insurance cash values grow tax deferred. Otherwise, income from trust assets may be taxed to you as the grantor of the trust, unless the trustee elects to treat the trust as a qualified funeral trust by filing Form 1041-QFT with the IRS, in which case trust income is taxed to the trust.

But what happens if you want to change funeral homes, or the facility you selected goes out of business? Does your irrevocable trust allow you to change beneficiaries (e.g., funeral homes)? Are trust funds protected from creditors of the funeral home? State laws regulating prepaid funeral trusts often require funeral homes to keep trust assets separate from their own business assets, keeping them safe from funeral home creditors. And most irrevocable trusts are transferable to another funeral home should the initial business fail or you change funeral homes.

There are expenses associated with the creation of a trust and the purchase of life insurance, and benefits are not guaranteed.