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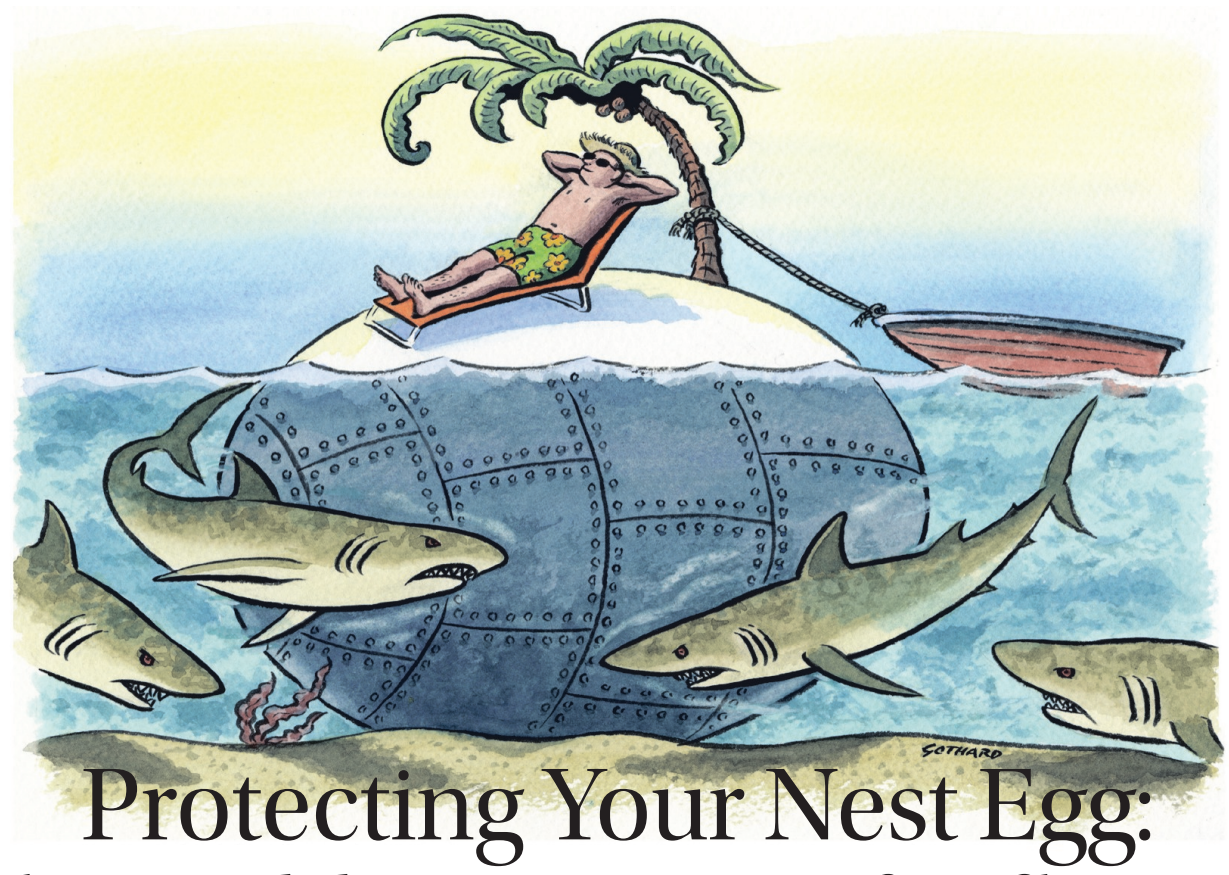
PRIVATE WEALTH MANAGEMENT



Protecting Your Nest Egg: The Hidden Impact of Inflation

By ***Randy Myers***

In 1981, a gallon of gas cost $1.35, about a third of what it will set you back today. The price of the house you bought that year may have been about the same as the price of the car you purchased last month. This is inflation at work. The question is, what are you doing about it?

On Wall Street, inflation is a threat whose importance ebbs and flows from month to month as the Department of Labor compiles and releases data on consumer prices. On Main Street, where investors must make sure their retirement savings will last a lifetime, inflation is a constant enemy. Over time, even seemingly modest upticks in the cost of goods and services can jeopardize their financial security.

The problem, of course, is that inflation eats away at the purchasing power of retirement nest eggs. Over the course of 30 years — a plausible retirement period for many Americans — a 3.5 percent annual rate of inflation will cause the value of a dollar to fall to about 36 cents. Put another way, someone who can get by comfortably on $50,000 a year right now will need about $140,000 a year in 2041 if inflation holds at that pace.

Lately, it has. The Consumer Price Index (CPI), the most common measure of inflation in this country, rose at a 3.6 percent annual rate in July. That's above its historical average and high enough to worry some economists, who fear it could dampen the Federal Reserve's willingness to try to stimulate the still sluggish economy. Others contend that with the economy floundering, inflation is unlikely to get much worse in the months ahead.

> "PEOPLE REALLY NEED TO PLAN EFFECTIVELY IF THEY WANT THEIR INVESTMENT PORTFOLIO TO OUTPERFORM EVEN A SEEMINGLY MODEST INFLATION NUMBER."
> **Kevin McGarry**

Either way, it's scant comfort for long-term investors looking to build a retirement nest egg that keeps pace with, or better yet, outpaces inflation. While workers enjoy a natural hedge against rising prices — wages tend to go up with inflation — retirees must depend on income from their investments.

"One of the questions I routinely ask clients is, 'What have you done to double or triple your income in retirement?'" says Kevin McGarry, director of retirement income strategies for financial services firm Nationwide Financial. "That's the magnitude of the issue. People really need to plan effectively if they want their investment portfolio to outperform even a seemingly modest inflation number."

Eric Thomes, senior vice president with Allianz Life Insurance Company of North America, agrees. "Inflation is one of the top risks in retirement that people don't often think about," he says. "With no cost-of-living increases to Social Security over the past two years, many retirees are already feeling the effects of what fixed payments with no chance for increase would be like. It's important that people address this issue when they're working with financial professionals to develop their retirement plans."

In fact, official inflation numbers may understate the risk of inflation for some people, since healthcare needs usually grow in retirement and healthcare costs have been rising faster than inflation generally. At the very least, the rising cost of healthcare can offset spending declines in other areas after someone stops working.

"The Consumer Price Index consists of a variety of goods and services — housing, transportation, food, entertainment, medical care, education, apparel and other personal expenses," McGarry explains. "Medical care has an approximate 6.6 percent weighting in CPI. At the beginning of retirement, healthcare accounts for about 25 percent of your essential expenses, and near the end of retirement it can account for almost 50 percent of your essential expenses. As other basic living costs decline later in retirement, such as transportation, entertainment, apparel and other expenses, investors still need to plan for a 3 percent inflation rate for their essential expenses during their retirement years."

There are, fortunately, ways to hedge against the ravages of inflation. The simplest is to make sure your investment portfolio includes assets that have historically outperformed inflation, such as stocks. Real estate and commodities often have done better too. More recently, inflation-protected bonds have helped investors stay ahead of the increasing cost of living, as have annuities with riders that automatically boost payouts to policyholders each year.

Randy Myers is a freelance writer whose work has appeared in Barron's, CFO, Corporate Board Member *and other prominent business publications.*

Illustrations by David Gothard

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Hedging Inflation: Successful Strategies

Keeping pace with inflation after you've retired is a challenge, but not an impossible one. The simplest strategy is to include assets in your portfolio that traditionally increase in value faster than the cost of living goes up.

Historically, stocks have handily outperformed inflation, but their returns have also been volatile at times — a turnoff for retirees who crave a steady income from their nest egg. Accordingly, many investment professionals recommend building a diversified portfolio that includes a variety of asset classes which can keep up with inflation. Since those asset classes won't always trade in sync with the stock market, they can soften the blow when stocks hit a rough patch. While this diversification strategy can be tested in periods of extreme market volatility, like the one we saw during the 2007-2009 credit crisis, it has generally worked well over longer periods of time.

Commodities, real estate and even bonds have all joined stocks in being able to match or exceed the rate of inflation over long periods of time, without necessarily tracking the stock market directly. Investors seeking even more diversification might also consider adding annuities to their portfolio. Specialized insurance contracts that can offer lifetime income guarantees, they can also offer a hedge against inflation when paired with supplemental riders that provide for annual cost-of-living adjustments to their payout rates.

"A well-diversified, properly allocated portfolio will automatically give you a hedge against inflation," says Certified Financial Planner Paul Auslander, chairman and CEO of American Financial Advisors Inc., a registered investment advisor in Orlando, Fla., and president-elect of the Financial Planning Association.

Here's a closer look at how various investment products can help you keep pace with the rising cost of living:

STOCKS

Equities in Wall Street parlance, stocks have long been viewed as an inflation hedge because their returns historically have outpaced inflation by a greater margin than any other traditional asset class. From 1926 though 2010, large-company stocks generated a compound annual rate of return of 9.9 percent, while small-company stocks earned 12.1 percent, according to Ibbotson Associates, a subsidiary of research firm Morningstar Inc. Inflation, by contrast, averaged 3 percent annually over that 85-year period.

There's no single answer to the question of how much of your portfolio should be allocated to stocks, since that can depend on the length of your investment horizon, your tolerance for risk and the makeup of the rest of your portfolio. However, almost all investment professionals agree that the amount should be more than zero, even if you are near or in retirement. Otherwise, the income generated by your nest egg could fall short of your needs in the later years of your life.

By contrast, Auslander recommends that most people over the age of 65 should keep as little as 30 to 35 percent in stocks. "Even the little push that amount of equities can provide, in a portfolio that also includes some short-term bonds and CDs, should give you average annual returns in the range of 5 percent to 7 percent over time," he says. "That will offset inflation."

Investors can seek to minimize the volatility of their stock portfolio by making sure that it too is broadly diversified, incorporating both large- and small-company stocks, for example, as well as domestic and international shares. Investors can also make sure to own "growth" stocks that are attractive primarily for their issuer's growth potential, and "value" stocks that are attractive primarily because they appear to be undervalued relative to their intrinsic worth.

TREASURY INFLATION-PROTECTED SECURITIES, OR TIPS

The federal government began issuing Treasury Inflation-Protected Securities in 1997. Unlike ordinary Treasury securities, the value of these bonds rises with inflation, as measured by the Consumer Price Index. Investors can buy TIPS directly from the U.S. Treasury or invest in them indirectly via mutual funds or exchange-traded funds (ETFs). ETFs are similar to mutual funds but can be traded intraday on an exchange, just like stocks.

McGarry notes that TIPS have been good performers over the past couple of years as inflation has risen from the negative levels that prevailed in 2009. According to Lark Research Inc., an independent research firm based in Norwood, Mass., TIPS of all maturities collectively returned 6.1 percent in 2010, and earned another 5.5 percent in the first half of 2011.

Conventional bonds have also outpaced inflation over the long haul, but not dramatically. According to Ibbotson, long-term corporate bonds earned an average of 5.9 percent annually from 1926 through 2010, while long-term government bonds earned 5.5 percent. Treasury bills — short-term U.S. government bonds that are traditionally considered the least risky, or volatile, asset class — did much worse, returning an average of just 3.6 percent annually.

REAL ESTATE

Despite the recent woes in the housing market, real estate, in moderate amounts, can be an important component of a well-diversified investment portfolio, Auslander says. Investors today can easily invest in real estate without actually buying or managing apartment buildings or commercial property. Instead, they can simply steer some of their money into real estate investment trusts, or REITs. Or they can invest in mutual funds that invest in REITs and/or real estate operating companies. REITs are similar to mutual funds, but are required by law to distribute 90 percent of their taxable income to their shareholders. As tracked by the FTSE EPRA/NAREIT Global Real Estate Index Series, U.S. equity REITs generated average compound annual returns of 11.9 percent for the 30-year period that ended on December 31, 2010.

COMMODITIES

Like stocks, commodities can be volatile. Still, gold and other precious metals, as well as agricultural and energy commodities, can act as a hedge against inflation since their prices typically rise in an inflationary environment. Once largely accessible only by institutions and wealthy individuals, commodities are now easily available to all investors via mutual funds and, increasingly, ETFs.

Some investment professionals see commodities as a smart investment today because emerging economies in Asia and Latin America are growing fast and gobbling them up as they seek to feed their growing populations and build out their infrastructure, from highways and power plants to communications networks. Meanwhile, gold has been a particularly hot commodity lately as investors have flocked to the precious metal, viewing it as a hedge against both inflation and a weak dollar. For the 12-month period that ended July 31, SPDR Gold Shares, one of the most popular ETFs, generated a return of 38.8 percent.

Still, given the volatility to which commodities are prey, Auslander recommends that they account for only a modest portion of an individual's retirement portfolio. "If you're 50 and have 15 percent of your portfolio in commodities, that's okay," he says. "If you're 70, you should have no more than 5 percent."

ANNUITIES

Annuities are a unique type of insurance contract that can offer the buyer guaranteed payouts for life. Increasingly, they are being viewed as a smart way for investors to convert retirement savings into retirement income. According to a recent survey by Allianz Life, consumers ranked annuities second highest (50 percent) in satisfaction among all financial instruments, outpacing mutual funds at 38 percent, stocks at 36 percent, U.S. savings bonds at 35 percent and CDs at 25 percent.

The U.S. Department of Labor has been looking into ways in which annuities might play a bigger role in 401(k) and other retirement plans, but meanwhile, many individual investors aren't waiting. Industry-wide, sales of both major types of annuities, fixed and variable, were up 13 percent in the first half of 2011 versus the same period a year earlier, according to LIMRA, a research, consulting and professional development organization for the insurance industry.

Though their features and applications can vary, the ability of annuities to convert your savings into a stream of income for life is unique in the investment universe. That income stream is guaranteed by the insurance company (that issued your annuity) to last as long as you are alive, or, if you prefer, as long as you and your spouse are alive — even if the value of the assets in your account falls to zero.

While that guaranteed stream of income is attractive, its purchasing power, over time, can still be eroded by inflation. To counter that problem, many insurers now offer, for an additional fee, riders to their annuity contracts that provide a cost-of-living adjustment each year, either for a predetermined period of time or for the life of the contract. For example, the insurer might agree to boost your payout by 3 percent annually for, say, 10 years.

"Annuities are not right for every investor and they are not meant to make up a person's entire nest egg," Thomes says. "But they can be a valuable part of any retirement portfolio. We recommend that investors set aside at least a portion of their nest egg in an annuity to cover basic expenses, and include some provision for inflation protection in that annuity. That's an effective way to guarantee a portion of your savings against market turmoil and inflation risk, as well as the very real risk of outliving your assets in retirement."

Unlike a big stock market crash or the recent mortgage-bond crisis that crippled the housing market, inflation isn't usually one of the flashier opponents in the battle to build a financially secure retirement. But it is a persistent opponent, effectively functioning as a hidden tax on your investments. By creating a diversified portfolio that includes inflation hedges, you can minimize the impact of that tax.

— ***R.M.***

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Wealth in Transition: Gifting Strategies

Shifting Assets to Children is a Way to Reduce Your Taxable Estate

By ***Grace W. Weinstein***

Last year, when gift tax rates were at a historic low, was an ideal year in which to make large wealth transfers. But as you will see, every year can be a good year, and now is the perfect time to evaluate the ways in which you can shift assets to younger generations.

THE GIFT TAX EXCLUSION

The most straightforward strategy — one that should be utilized by everyone with money to spare — is giving the amount of the annual gift tax exclusion to as many people as possible.

The amount rises with inflation but did not go up this year. In 2011, you can give up to $13,000 to each of as many recipients as you like. Married couples can agree to double their gifts, giving as much as $26,000 each year per recipient without incurring gift tax liability. Since the number of recipients is limitless, the sums can add up. If you have three children, and you and your spouse agree on a joint gift, each child could receive a tax-free $26,000, for a total of $78,000 removed from your estate. If your children are all married, and you wish to make gifts to their spouses as well, then the total reaches $156,000. Now, if you are the proud grandparents of four grandchildren, you can add another $104,000 to the total sum, and so on, with each individual gift removing a like amount from your estate, with no tax consequences. (Note, though, that if gift tax does become due, it is generally paid by the donor and not the recipient.)

LARGER GIFTS

In addition to the gift tax exclusion of $13,000 per person per year, you are entitled under the last-minute 2010 tax legislation to a lifetime $5 million exemption from federal gift tax.

Beyond the cumulative total of $5 million, you must pay gift tax. Nonetheless, for those with substantial accumulated wealth, giving large taxable gifts is a way to significantly reduce a potentially taxable estate. In fact, although federal gift tax and estate tax rates are identical, the way in which they are calculated may make it less expensive to pay gift tax on lifetime transfers instead of estate tax on transfers at death.

But choose the gifts carefully. Because the transfer value is fixed at the time of the gift, think in terms of "assets that are likely to appreciate greatly in the future — but also those that have not appreciated much in the past," says Ralph M. Engel, a trusts and estates attorney with the law firm of SNR Denton US LLP in New York. Assets appreciating in the future are clearly doing more to reduce your taxable estate, but already appreciated assets may be handing the recipient a sizable capital gains tax bill. If you are inclined to give a taxable gift this year, look for assets with values that are depressed by the current economic doldrums but that are likely to rebound along with the economy.

SKIPPING A GENERATION

2010 was an atypical year because, along with the temporary repeal of the estate tax, there was no generation-skipping transfer tax. This year, the GST tax is back with the same $5 million exclusion that applies to the federal estate tax. The GST tax kicks in when you "skip" a generation to make sizable gifts, as to grandchildren. The reasoning behind the GST tax is that if you gave the money to your child who in turn gave it to his child, the gift would be taxed on each transfer. The GST imposes a double tax at the time of the one and only transfer to someone who is at least two generations removed from the original donor.

In 2010, there was considerable opportunity to plan for grandchildren because the 2010 Tax Act made the GST tax zero for the year. As a result, Martin Shenkman, a financial planner and estates attorney in Paramus, N.J., suggests forming special grandchildren trusts that did not require GST exemption and distributing assets out of non-GST exempt trusts to grandchildren. In 2011, with the $5 million gift and GST exemption, there are huge opportunities to shift wealth.

TRUSTING IN TRUST

If you set up a multi-generational trust, and you pay the annual taxes on the trust income, you can help generations of beneficiaries while reducing the tax bite on your estate. Such "grantor trusts" are, Shenkman believes, "a great way to leverage more money to the younger generation."

Trusts are a key component of an estate plan, and gifts and inheritances received in trust are often substantially more valuable to the recipient than assets received by the beneficiaries outright, says Richard A. Oshins, an estate planning attorney with Oshins & Associates in Las Vegas. For example, he says, "If Mom leaves you $100,000 in trust, you may use the money to start a business, which eventually may grow to $20 million. That business in a properly drafted trust will never be subject to estate, gift or GST taxes, nor will it be subject to your creditors in your lifetime even though you have substantial control over the trust. If the business is passed down to a child or any younger descendants in trust, the same rules apply."

GIFTS FOR HEALTHCARE AND EDUCATION

You can make unlimited payments for qualified education and medical expenses directly to the institutions providing the services. Pay college tuition or, for that matter, elementary school bills on behalf of your child or grandchild and you are still allowed to give that child additional tax-free annual gifts up to the $13,000 exclusion amount. Pay for braces on a child's teeth, and the same is true.

Funding a 529 College Savings Plan is another way to provide tax-free gifts. In fact, you can put aside up to five years of the annual exclusion ($65,000 in 2011 or twice that sum for a married couple agreeing on a joint gift) for one child's future education, thereby allowing the money to grow in a tax-exempt environment. Be aware, though, that once you take advantage of this five-year plan, you cannot give additional annual gifts to the same child without eating into your lifetime gift tax exemption.

Grace W. Weinstein is a former columnist for the Financial Times *and has written for* Money, Kiplinger's Personal Finance *and* Business Week.

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