What if Everything You Ever Thought About Income Was Dead Wrong?

Are Your CDs and Mutual Funds Giving You ALL the Income You Want?

What Do You Really Want From Your Investments After You Retire?

After the stock market crash of 2000 to 2002, very few investors who have retired are looking for a hot stock or a hot mutual fund. While the stock market rally of 2003 and late 2004 were encouraging, many investors are wary of putting too much of their net worth back into stocks or mutual funds.

Instead, isn't what you really want a *steady, reliable monthly income* that you can always count on regardless of what happens in the stock market? Stocks and mutual funds may still have a place in some portfolios. However, many investors, especially seniors and retirees, are much more interested in receiving dependable income that they can count on from their portfolios instead of having to deal with the ups and downs that the stock market can throw them.

What Does The Future Hold?

What do Warren Buffet, Jeremy Siegel, Roger Ibbotson and the editors of *Fortune Magazine* all have in common? They are all well respected market experts who are predicting that the stock market will return somewhere around 6% per year over the next decade. The reason they believe this is that stocks cannot grow faster than the economy as a whole, and we all know that the economy has only been growing at a rate of about 3%.

Remember the Beanie Baby phenomenon? Those cute little animals filled with beans? At the height of the hoopla people were buying 25 cents worth of felt and beans for $750. Were they really worth that or were things out of wack temporarily? Once people recognized that all they were buying was beans, the price of Beanie Babies crashed. The stock market can only go up to what it is worth, and its worth (the economy) is only increasing at about 3% each year. The years of double digit growth may not return for some time.

Please understand that during some years, the stock market may have great, positive returns like 10% or 12%, but it is just as likely to suffer from significant losses during other years. According to the experts, when we average out the highs and lows over the next decade, the return will average about 6%. And we all know that timing the market is a fool's errand.

Is All That You Earn Yours to Keep?

Regardless of what you earn going forward, the ride will be volatile and your earnings will be taxable whenever you take them out to spend them. Many investors will be fortunate to earn 4% per year after taxes. When you deduct mutual fund and variable annuity fees and stock commissions, some investors will be fortunate to earn even 2% per year over the coming decade.

What Can You Do?

While most people that have retired should worry about inflation and need some level of growth, millions of Americans are searching for lower risk and steadier returns. What are your alternatives?

Savers now have several trillion dollars wrapped up in certificates of deposit (CDs) and money market accounts. Money market accounts and checking accounts are most appropriate for meeting short-term cash flow needs.

However, given that the yield of these accounts is generally very low, you cannot consider them as long term vehicles to keep your standard of living ahead of inflation.

After factoring in inflation and taxes, funds held in money market and checking accounts lose value each year.

As an advisor that specializes in working with people that are retired, I spend all of my time working on two things for my retired clients:

1. getting them more income
2. having them pay less taxes

In this report, we will examine some of the most common mistakes people make when trying to increase their investment income. This knowledge could help you avoid common mistakes, that have forced many retirees, initially with comfortable lifestyles, to make changes in the way they live due to less income.

Adjustments Made to Current Lifestyle Due to Losses During 2000 – 2002	Percentage of Respondents
Budgeted your money more carefully	59%
Reduced spending in other ways	42%
Taken fewer vacations than you used to	34%
Postponed making a major purchase	30%
Any of the above	**67%**

Impact of Stock Market Decline on 50-70 Year Old Investors ©2002 AARP

"We frequently see people doing one of two things: either they make the mistake of holding hundreds of thousands of dollars in money market accounts earning less than 1% per year, or they put their money at risk in the stock market hoping and praying that it goes up so they can use the gains as income."

Are There Other Choices?

As you will learn, there are ways of earning more than 6% per year ***while paying 95% less tax than you would normally pay on income!***

Now, before we talk about creating income, let's first address cash reserves. Cash reserves are not designed to provide income. It is your rainy day money that you have put aside for emergencies. You should keep between 3 and 6 months of living expenses in a money market or checking account. Any more than that, and you are giving your hard earned money to the bank for nothing. Any less than that, and your stress level could cause sleeping problems.

The rest of your retirement funds should be in investments that will at least keep you even with inflation, with the least amount of risk possible. This means that you have to earn about 3% per year after taxes just to maintain your buying power (assuming a 3% inflation rate). You also want liquidity so that you can easily access your money when it's needed.

What About CDs?

Millions of Americans own CDs but have never really analyzed the after-tax and after-inflation returns they receive. CDs can look tempting because they do offer higher interest rates than money market accounts. However, those higher rates come at the price of reduced liquidity. To get a decent rate on CDs today (one that will at least help you break even after taxes and inflation), you need to tie up your money for five years or longer. In an era of rising interest rates, it may not make economic sense to tie up your money at a fixed rate for so many years.

While illiquidity is one limitation of CDs, for many Americans, the bigger problem is taxes. The interest earned on CDs is taxed at your highest marginal tax rate. If you are in the 15% federal tax bracket and 5% state bracket, you will lose 20% of your CD interest to taxes. The 3% yield the bank advertises on its CDs is reduced to only about 2.4% after you pay the taxes. With inflation running near 3% per year, many CD holders are losing purchasing power. Their ability to maintain their lifestyle is moving backwards.

Many people have owned CDs for decades. When a CD matures, they roll it over into another CD. If the CD continually performs below inflation, an erosion begins to occur. Think about this, if the purchasing power of the CD goes down by just 1% a year, over a decade you would lose 10% of your ability to maintain your lifestyle. You didn't work forty years only to have to give up a little bit more each and every year of your retirement! You should be living it up - not down!

Some savers stay with CDs because of the FDIC insurance. However, it is important to remember that such insurance is limited to only $100,000 per account holder, per institution. While there are ways around this limit, many savers continue to hold more than $100,000 in one CD and therefore face the potential risk of loss should the savings institution get into trouble.

During the bank and savings and loan failures of the 1990s, many savers learned the limitations of FDIC insurance the hard way. Dozens of savings and loans and banks across America failed, ranging from small local firms to multi-billion dollar institutions. Even today, several banks and savings and loans fail each year. For example, when the Connecticut Bank of Commerce failed in June 2002, a whopping 25% of the deposits were uninsured. Depositors – most of whom never dreamed they'd be broken by a bank panic – lost MILLIONS! FDIC insurance was called into play for the 339 banks that failed during 1991-2001. Although recent years have been kinder, there were still 11 bank failures in 2002.

The Invisible "Tax" - INFLATION

The true cost of holding money in CDs hits many people when it's too late. For decades, it can look like you are making money with CDs if you only look at the returns banks advertise. However, the only return you can spend and enjoy is the net return. On a net basis after taxes and inflation, more than 90% of all CD holders lose spending power in any given year.

Inflation is the silent thief that steals from us all. An economy car that cost $3,000 new in the 1970s, now costs nearly $20,000. Gasoline that was 35 cents a gallon, is now more than $2.00 a gallon. Forget about those nickel and dime amounts (though you can be nickel-and-dimed to death) what about health costs? They are going up at 7 times the rate of inflation! And each year it seems we need more drugs or medical help to keep our active, fun lifestyles.

Inflation erodes the buying power of the dollar every day. Many people come to the realization late in life that their CDs have not kept up with inflation. This is one of the reasons that you see so many seniors and retirees working at fast food restaurants and stores. They did not plan to spend their golden years under the golden arches, but they have no choice. Due to how much spending power their savings have lost, "working in retirement" is the only way they can pay their bills.

And No Help In Sight From Uncle Sam!

With the impending Social Security crisis, it is likely that even more retirees will find themselves facing a reduced lifestyle. To avert a wholesale collapse of the Social Security system, the government has been raising the retirement age and taxing an increasing percentage of Social Security payments. It appears that these trends will continue along with a cutback in benefits to retirees. The loss of purchasing power due to CDs combined with reduced and/or more heavily taxed Social Security payments will have a devastating effect on people who keep their savings in money market accounts and CDs.

To increase your financial security and peace of mind, select investments that keep you ahead of inflation and taxes. Some of these investments include real estate funds, corporate bond funds, carefully selected annuities, municipal bond funds and other investments. We have found that even in these categories, very few investments meet all the criteria presented below.

It is now possible to earn more than 6% per year while paying 95% less in taxes. We believe that it is also important to look for investments that are insured and are AAA-rated. Make sure whatever investments you select have very low fees and expenses. Also, we think it is essential that you avoid paying front-end loads or sales charges on your portfolio; this would leave less for you to earn income on. The first and most important step is to avoid placing too much money in CDs or in stock market accounts; these could either lose value each year after taxes and inflation, or lose value in a market downturn, respectively. We have found that people who instead invest using the criteria described above, frequently meet all of their financial goals by beating taxes and inflation, and by earning a safe and relatively high yield each year.

Knowing and Mastering Your Income Investment Alternatives

The financial goal of many people is to increase their monthly, spendable income after taxes and inflation, while also maintaining liquidity. This is a tall order, but the rewards are worth the effort. In many cases, it can mean the difference between having to work during your retirement years or spending it in comfort and with a sense of security. Knowing you have an income you can never outlive provides you with great peace of mind.

In this article, we will examine some alternatives to money market accounts and certificates of deposit (CDs) and the more risk prone stock market. After inflation and taxes, you are virtually assured of losing purchasing power on money you have in CDs and money market accounts, and the stock market entails risk to someone that is relying on it for income.

If you have your retirement savings in a vehicle that can either make money or lose money and need to withdraw any of it, Average Rate of Return does not work. Let's say that you had three pots of money of $100,000 each. Each pot earned an **average** of 6% a year for ten years, and to protect your principle, you would only pull out 6% or $6,000 per year. Let's see if Average Rate of Return will help or hurt you. *(see charts below)*

Pot A:

Year	Rate of Return	Beginning Value	With-drawal	Ending Value
		$100,000		
1	6.00%	$106,000	$6,000	$100,000
2	6.00%	$106,000	$6,000	$100,000
3	6.00%	$106,000	$6,000	$100,000
4	6.00%	$106,000	$6,000	$100,000
5	6.00%	$106,000	$6,000	$100,000
6	6.00%	$106,000	$6,000	$100,000
7	6.00%	$106,000	$6,000	$100,000
8	6.00%	$106,000	$6,000	$100,000
9	6.00%	$106,000	$6,000	$100,000
10	6.00%	$106,000	$6,000	**$100,000**

In **Pot A** you earn 6% a year for an average of 6% per year. You make $6,000 and pull $6,000 out each year so you always end up with the same principle.

Pot B:

Year	Rate of Return	Beginning Value	With-drawal	Ending Value
		$100,000		
1	-30.00%	$70,000	$6,000	$64,000
2	-20.00%	$51,200	$6,000	$45,200
3	10.00%	$49,720	$6,000	$43,720
4	10.00%	$48,092	$6,000	$42,092
5	10.00%	$46,301	$6,000	$40,301
6	10.00%	$44,331	$6,000	$38,331
7	10.00%	$42,164	$6,000	$36,164
8	10.00%	$39,781	$6,000	$33,781
9	20.00%	$40,537	$6,000	$34,537
10	30.00%	$44,898	$6,000	**$38,898**

In **Pot B** you earn 6% a year by first losing 30% and then 20% but then you earn 10% 6 years in a row. The last two you make 20% and 30%. During this time you pull out $6,000 a year. You can see that by the end of 10 years you have lost over 60% of your principle and you will never get back.

Pot C:

Year	Rate of Return	Beginning Value	With-drawal	Ending Value
		$100,000		
1	30.00%	$130,000	$6,000	$124,000
2	20.00%	$148,800	$6,000	$142,800
3	10.00%	$157,080	$6,000	$151,080
4	10.00%	$166,188	$6,000	$160,188
5	10.00%	$176,207	$6,000	$170,207
6	10.00%	$187,227	$6,000	$181,227
7	10.00%	$199,350	$6,000	$193,350
8	10.00%	$212,685	$6,000	$206,685
9	-20.00%	$165,348	$6,000	$159,348
10	-30.00%	$111,544	$6,000	**$105,544**

In **Pot C** you're lucky and earn an average of 6% by first making 30% and 20%, then six years of 10%. The last two years you Lose 20% and 30%. The stars were in line for you. You earned the average of 6% in the most advantageous way you can, making the big bucks the first few years. How did you end up? Just $5,000 ahead of where you began.

"The lesson is that if you are pulling money out of an investment that can go UP…and…DOWN, you are hurt a lot worse by down markets than you will ever be helped by up markets. Average Rate of Return does not work when you pull money out of your investments."

Some other alternatives for increasing your investment income while staying ahead of taxes and inflation include Real Estate Investment Trusts (REITs), Corporate Bonds, Corporate Bond Funds and other investments discussed below.

Real Estate Investment Trusts

Many REITs have outperformed CDs over the past decade. However, real estate is one of the most cyclical investments of all, and many experts now believe that real estate has hit a cyclical peak in value.

If you are not sure as to whether to believe this or not, there is an easy test. REITs are made up of commercial real estate…not the common family home. Therefore, to get a thumbnail sketch as to how REITs will do in the near future, drive around the commercial districts in your area and look for "Now Leasing" signs. What you are sure to find is that there are a lot of them!

In the late 90's, the vacancy rate in commercial buildings was as low as 1 or 2 % in some areas, driving rental prices way up. So everyone and their brother jumped in and started building commercial real estate to capitalize on this fact.

Now we have way too much real estate available for the demand. In fact, in some parts of the country, vacancy is all the way up to over 40%! This will be indicated in REITs as they start to re-negotiate rents in the coming months.

Real estate prices today are much higher than they were even at the peaks in the 1990's. While the returns of some real estate investment trusts still look good, other REITs have fallen by 20% or more in value. This is a cause for concern considering that the real estate market is still at an all-time high. Even a minor correction in the real estate market could lead to multi-billion dollar losses for REIT investors. With millions of baby-boomers retiring and selling large houses that they no longer need or want, one wonders how much longer the real estate run-up can last.

It is also important to remember that while the returns of some REITs are still good, they are subject to taxation at your highest tax rate. REIT dividends do not enjoy the low rates at which stock dividends are taxed.

Several years ago REIT investments were profitable financial instruments, and those who invested made handsome profits. Now it may be time to take some of those profits off the table.

Corporate Bonds

Corporate bonds range from those that are AAA-rated to those that are junk quality. Some AAA-rated corporate bonds and corporate bond funds only pay out as much interest as CDs, without the FDIC insurance CD's offer. Therefore, you do not make much progress by switching from CDs to top-rated corporate bonds.

Low rated or "junk bonds" are by nature some of the most risky investments available due to their underlying issuers razor-thin profit margin. They may pay out higher interest, but have much more risk. In some years, more than 5% of all junk bonds have failed, endangering not just your interest, but your principal as well.

Currently, junk bonds only pay a little more than 6% in interest, which is fully taxable. As you will learn later in this article, there are ways you can now earn about that much interest, on an almost tax-free basis, with investments that are partially to completely insured. Caution is advised for all those who speculate in the junk bond market.

Some corporate bonds and REITs do merit attention, and investors can receive good returns from carefully selected issues.

Tax-Free Municipal Bonds

At first glance it may seem that municipal bonds would be the answer to income needs. Historically, longer-term muni bonds have significantly outperformed CDs, most corporate bonds, and many REITs on an after-tax basis. It is now possible to earn approximately 4% on certain AAA-rated muni bonds if you are willing to hold them for 25 to 30 years.

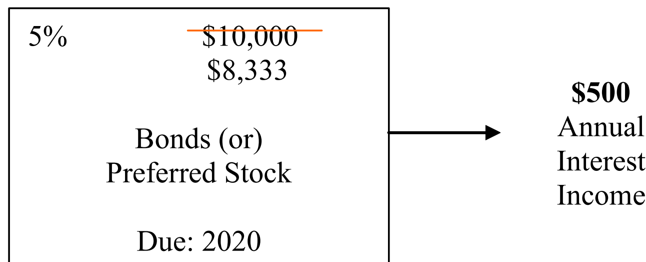
However, most people that are retired are not willing to lock in their money for two or three decades for a 4% yield, tax free or not.

You can sell a municipal bond early if you so desire, but due to the rising interest rate environment we're currently in, you would almost certainly take a loss to do so. This in turn makes this investment very illiquid.

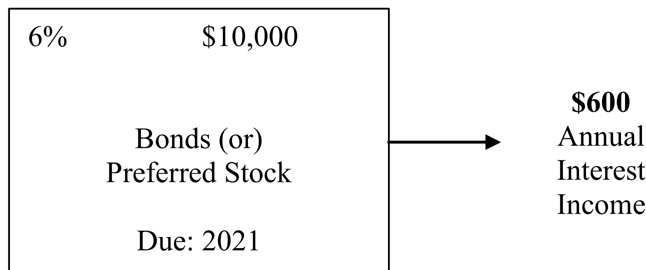
See the diagram below for an example of how rising rates affect municipal bonds.

BONDS DIAGRAM PICTURE:

Currently:



1 Year Later: Interest Rates increase 1%



For example, say you buy a $10,000 bond at a 5% interest rate, and one year later interest rates go up 1%. Then, an investor who has $10,000 and wants to buy a bond goes and finds that he can buy a bond with a 6% interest rate. Do you think that investor is going to want to buy your bond at a 5% interest rate or a new bond with a 6% interest rate?

So if you wanted to sell your bond, would anybody want to pay you $10,000? No way! When interest rates rose, the value of your bond fell, and the only way to get the full value of your money back is to hold the bond to maturity.

How much is your bond actually worth? Well, in order for the $500 of income that your bond provides to be worth the equivalent of a 6% yield, you just divide $500 by 6%... and the answer is: your bond is now worth $8,300 - or a 17% drop in value. And that's if interest rates only go up one percent!!!

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There are more than one dozen different types of muni bonds including revenue anticipation bonds, bearer bonds, general obligation bonds, sales tax bonds, water bonds, power bonds, special purpose bonds, airport bonds, school bonds, highway bonds, mortgage revenue bonds, tobacco revenue bonds, city bonds and numerous other choices. The maturities range from under one year to more than 30 years, and each maturity has its own special risks and rewards.

When investing in municipal bonds, it is not an area in which to speculate. There are many challenges. Just go to Google on the internet and type in "municipal bond problems," you will get 534,000 stories relating to them.

I guess the litmus test for you to decide whether municipal bonds are right for you or not is to go to your next city council meeting. Listen to them. Are those the people that you want to be responsible for taking care of your money? Now don't get me wrong, they are good, decent people (mostly) trying to do their best, but are they really the people that you want managing your money. Because when you invest in municipal bonds, that is who is managing your money? If they make a mistake, as a bond holder, you will be left holding the bag.

Take San Diego as an example. Called "America's Finest City" by some. It was known for being a "tight wad" and extremely fiscally responsible. "America's Finest City" has been dubbed "Enron By the Sea" by the Wall Street bond investors. They claim that they were duped and have caused the bonds to crash.

In fact, one attorney said that if they had borrowed from a loan shark instead of the unknowing public, "there would be bodies floating off Point Loma by now."

What happened to the AAA-rated, fiscally responsible city? Financial shenanigans behind the scenes. There was no way the average investor would have ever known the city was on the verge of bankruptcy.

Oh, when did this occur? In 2003. Do a little research and be appalled.

Other Limitations of Muni Bonds

First of all, the commissions to buy and sell individual municipal bonds can be high. Some brokers charge as much as a 3% commission every time you buy or sell a bond. However, the commission may be hidden in the "spread" between what the broker claims is the "bid price" (what someone else is willing to pay for the bond) and the "ask price" (what you would like to receive).

The net result is that you may end up paying 3% more to buy a muni bond and may receive 3% less when you sell it. On a $100,000 purchase, you could lose up to $6,000 just due to commissions, unless you work with a fee-only financial advisor.

To help overcome the limitations inherent in owning individual muni bonds (lack of liquidity, high transaction fees, difficulty in selecting the right bonds, lack of monthly income, etc.), municipal bond mutual funds were developed. Instead of holding stocks, these mutual funds hold municipal bonds.

Muni bond mutual funds solved several problems. Instead of having to spend hours researching different muni bonds, you could buy one fund that contained a variety of municipal bonds. Thus, muni bond mutual

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funds offered "instant diversification." And, instead of paying high commissions to buy and sell individual muni bonds, you could pay one fee to buy or sell a collection of different muni bonds.

Muni bond mutual funds were an evolutionary advance in the investment field and hundreds of billions of dollars flowed into them. But these funds also have their own limitations.

Instead of paying commissions to buy and sell individual bonds, muni bond funds charge a variety of loads and fees, some of which are hidden and not disclosed in expense ratios. Investors are sometimes charged more than 4% to buy "A" share muni bond funds. "B" share muni bond funds can charge 4% or sometimes more as a back-end sales fee. In addition, some funds charge high management fees and/or 12(b)1 fees that further reduce your gains each year.

The net result is that with dozens of muni bond mutual funds, you could give up all, or almost all, of your first year interest to fees and expenses. Due to the fees and expenses, if you sold your fund during the first year or two, you could actually lose money.

Another limitation is that mutual funds are priced only once a day. This has led to the "late trading" mutual fund scandal that has been featured in newspaper stories across America. Insiders have been able to profit by trading on the stale (old) prices of mutual funds that average investors have to pay. Despite the hundreds of millions of dollars in fines and penalties levied against mutual fund companies and insiders, the stale pricing of mutual funds continues. Rather than being illegal, stale pricing is a feature that is inherent in mutual funds. Mutual funds are still priced only once a day.

Rules are Different for People that are Retired!

And, for someone that is retired, municipal bonds are even under the gun for tax free status. Some are subject to alternative minimum tax. AMT can take away more than 20% of the yield of certain municipal bonds, making their overall return much less attractive. There are ways of avoiding or minimizing AMT, but it takes some work.

Yet another way that munis fail retirees is that once you start drawing Social Security, municipal bonds are used to calculate how much of your Social Security will be taxable. By using your municipal bond interest in the calculation, they are in affect causing your "tax-free" interest to become taxable.

So for a retiree the one advantage of municipal bonds could even be taken away.

Ok! Ok! I Understand the Problems! Let's Get On with the Solutions!

Again, the ultimate goal is to maximize our monthly, spendable income after taxes and inflation while still maintaining our flexibility and liquidity. Getting it right is a tall order, and it can mean the difference between having to work in your retirement years or spending them in comfort with a sense of security. Knowing that you have an income that will support your lifestyle that you can't outlive provides a great deal of peace-of-mind.

A technique gaining increasing attention and popularity utilizes a mathematical formula to structure an individual's assets to provide immediate income while growing the remainder of your assets tax-efficiently in a way that keeps you ahead of inflation. It is called the Startegically Tiered Equity Plan or STEP™.
Why haven't you heard of it before? Because most planners deal with clients that aren't retired. These clients don't need income because they continue to work. As a result, these planners aren't familiar with all of the latest techniques.

How does it work? You simply plug many of your existing assets into the mathematical formula. The formula immediately lowers your tax bill while also showing you exactly how to increase your monthly income without jeopardizing your future principal. Guaranteed! It takes the time-tested idea of "laddering" and supercharges it by incorporating formulas for tax-efficiency and growth that can, for the first time, be **customized to take your individual income and growth needs** into account.

We're not talking about specialized products. We're simply talking about mathematically structuring things you're already familiar with in a formula that maximizes your income and takes advantage of rules that have been in the tax code for decades. And the formula (easy to follow and understand) gives you the power to determine how much you will spend, and still not have to worry about running out of money during your lifetime.

The formula will vary depending on your current investments, income needs and tax bracket. If you'd like a **complimentary STEP™ analysis** done for your specific situation, call the phone number listed on the back page of this report. After a brief meeting and gathering a few basic facts, I can put together an example of how the STEP™ can work to **increase your income while reducing your taxes!**