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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

"Good fortune is what happens when opportunity meets planning."

—Thomas Edison

IN THIS ISSUE:

WHAT TO EXPECT WHEN THINGS DON'T GO AS EXPECTED 1

BACKDOOR ROTH IRA CONTRIBUTIONS 2

WHAT TO EXPECT WHEN THINGS DON'T GO AS EXPECTED

At its most basic, retirement planning is a mathematical exercise. Inputs include annual savings during your working years, expected return on investments, expected retirement date, expected household expenses during retirement, and life expectancy.

Did ya notice that one word popped up an awful lot there? A fairly large amount of the financial planning process is based on *expectations*. The good news is we have a lot of control over several of those expectations, like how much we contribute to our savings while we are working or the date we plan to retire.

But other assumptions can end up straying from our expectations, with little we can do to control them. Perhaps the best example is expected return. In modeling, we look at past returns for similar investments or portfolios to estimate what the return will be going forward.

According to Dimensional Fund Advisors, the historical annual return on the S&P 500 index going all the way back to 1926 is 6.9%. Of course, the return is not fixed at 6.9% each year. In fact, I couldn't find a single year in which the return was 6.9%. Most years, it is significantly higher or lower than that. In 1931, the index fell 37.5%, and in 1954, it rose 53.8%. In fact, in 31 of the 93 years, exactly one-third of the time, the index either r*ose or fell more than 20%*. But all the ups and downs averaged out to 6.9%.

Why is this important in financial planning? Because if the strategy includes investing in large U.S. companies (and it probably should), then we are going to make an assumption about the return we expect to get for that investment, and that 6.9% historical return is as good a starting point as any.

Other investments might be assigned similar assumptions about expected return; then math does its job to compute how your money will grow during your earnings years, whether it will continue to grow in retirement, and if or when you will run out of money. We can even chart out how much we expect the portfolio to be worth year by year.

So that expected return is pretty darned important.

But given our lack of control over that number, actual returns can, and often will be, *very far off* of what we assumed. At any given point, our portfolio value could be very different than what the year-by-year chart said it would be.

So we should entertain the questions: Do we change the financial plan as we find our actual portfolio value straying from the target we set? Or do we just let it ride and stick with the plan, knowing swings will come in the opposite direction that will eventually bring the value of our nest egg more in line with the plan?

A researcher in Spain explored that exact question, and his results were recently published in the *Journal of Financial Planning.* The article is pretty technical, but rather than breaking out my 25-year-old MBA textbooks to refresh myself on C1/(1+R) - C2/(1+R)2-…- C39/(1+R)39 + P40/(1+R)40, I'll just stick with the findings that were laid out in English.

The two scenarios studied were the "stick to the plan" option ("S2P") and a dynamic strategy to adjust the plan to manage to the target ("M2T.") Within M2T, several options were explored, including changing asset allocation or adjusting the amount contributed each year.

Not surprisingly (but still reassuring when backed up by academia), asset allocation change did not have as positive an impact as adjusting savings. Simply put, and particularly important when markets underperform, there is no better defensive move than increasing your contributions to your account. Granted, that might not always be possible, particularly in an economic downturn, but the study reaffirms what we tell clients looking to "flee to safety" after markets have fallen: Not the best move.

As occurs sometimes in academic studies, the best plan on paper is impractical in the real world, and the researcher acknowledges that. Mathematically, the most effective method to hit your number, the amount of money you think you will need at retirement to meet all your financial wants and needs for the rest of your life, is to compare the yearly balance with the plan balance, and deposit the entire amount of the shortfall, or withdraw the entire amount of excess. That method is 100% foolproof. Each year, you will be 100% on target all the way through to retirement.

But what if the market has a particularly bad year and your shortfall is tens of thousands of dollars—or hundreds of thousands? If you actually came up with that amount to deposit into your account, as your advisor I'd have to ask you, *"Why wasn't that money invested in the first place?!"*

Chances are you don't have the money to make up for a large shortfall in any particular year, and while you could withdraw a big surplus if the markets overperform, is that really a better choice than keeping that money in the account earmarked for retirement? What if your retirement money is in an IRA account? Do you want to pay taxes, and possibly a penalty, for withdrawing that money? And if the account is an employer plan like a 401(k), you may not be able to withdraw the surplus at all.

Bottom line: A better approach is to stay aware of how your account is growing compared to plan, particularly as you get close to retirement, and contribute more any time you are able whether the account balance is above or below target. And don't take money out just because it's there. That's a good strategy to end up with nothing.

Markets will rise and fall, which makes investing in them a risky undertaking. A disciplined approach remains the most effective way to get rewarded for taking the risk.

—Steve Tepper

Sources

Dimensional Fund Advisors, Matrix Book 2019, Historical Returns Data—US Dollars.

"Managing to Target: Dynamic Adjustments for Accumulation Strategies" by Javier Estrada, Ph.D., *Journal of Financial Planning*, August 2019.

BACKDOOR ROTH IRA CONTRIBUTIONS

I received two calls this past month asking basically the same thing. "Hey, Allen, I was talking to this guy, and he said I should do a backdoor IRA. It sounded great! What do you think?" My first thought was "Is someone out there doing seminars on this?"

It reminded me of a word that I learned many years ago: Tinstaafl. There Is No Such Thing As A Free Lunch. Or put another way, if it sounds too good to be true, it probably is.

Not that backdoor IRAs are too good to be true. They

are actually a legitimate way to put money into a Roth IRA, even if your income is above the earnings threshold to contribute. But as is often the case, the ways things are sometimes described around the water cooler is too good to be true.

It's important to first understand what a Roth IRA is. Roth IRAs allow you to grow money tax-free and take distributions upon retirement with zero tax liability. So you put money in after-tax, but from that point on, you'll pay no income taxes on the earnings—even when you take them out.

Roth IRAs also avoid the required minimum distribution (RMD) rules that kick in after age 70, which many consider to be a bonus. But the problem is that the ability to contribute to a Roth IRA is based on your earnings, and once your modified adjusted gross income (MAGI) crosses $122,000 for single filers or $193,000 for married filing jointly, a Roth contribution is no longer an option.

However, when you convert traditional IRA money to a Roth IRA, there are no such income limits to be concerned with. You could be making a million dollars a year and still convert your IRA money to a Roth. All you have to do is pay the income tax on the amount you convert. So if you look at it from the IRS's perspective, of course they would like you to convert, especially if you are in a higher tax bracket like a person earning a million dollars a year would be!

So now "this guy" says, "Well, that's where the backdoor IRA comes in. You make an after-tax contribution to your IRA (as long as you are under age 70½) up to the contribution limit ($7,000 in 2019 if you are over 50) and then convert $7,000 to your Roth in the same year. Voila! At the end of the day, you have made a Roth contribution for $7,000 through this loophole those buffoons at the IRS didn't see."

Sounds too good to be true?

Actually, everything he said is *true*—except maybe for the "buffoons at the IRS" part. But he's leaving out an important detail. That detail is this rule the IRS has called the "pro-rata rule," because, yes, they did see this one coming. The rule is how the IRS accounts for after-tax and pre-tax funds in an IRA when the taxpayer is doing a partial Roth conversion.

The formula for the pro-rata calculation is the total after-tax money in all IRAs divided by the total value of all IRAs multiplied by the amount converted. Huh? OK, here's an example. Let's say you make a $7,000 non-deductible contribution to an IRA that you want to convert to a Roth this year. Let's further assume you also have a rollover IRA worth $100,000.

When you convert the $7,000 to a Roth, only $458 will be considered after-tax ($7,000/$107,000 = 6.54%; $7,000 x 6.54% = $457.80). The remaining amount, $6,542, will be considered pre-tax. Because of this rule, you'll have to pay income tax on the $6,542.

The pro-rata rule forces you to consider *all IRAs* when you do this calculation, but you don't have to include your spouse's IRAs if you are filing a joint return.

Is it still a good idea to consider a Roth IRA conversion? It could be based on your unique circumstances, but understanding the pro-rata rule can make a big difference in how you look at it. If it's something you'd like to discuss with your Northstar advisor, well, that why we're here!

—Allen Giese

Sources

rodgers-associates.com/newsletters/pro-rata-rule/

www.thebalance.com/when-does-a-backdoor-roth-ira-make-sense-4153803

rodgers-associates.com/blog/reducing-future-taxes-form-8606/

STEVE'S CHEAP PLASTIC BEADS OF WISDOM

You've sent your kid off to school. Congratulations! If you need a good contractor to convert that bedroom into an exercise room, let me know. And keep that name for four years from now just in case you need to convert it back!

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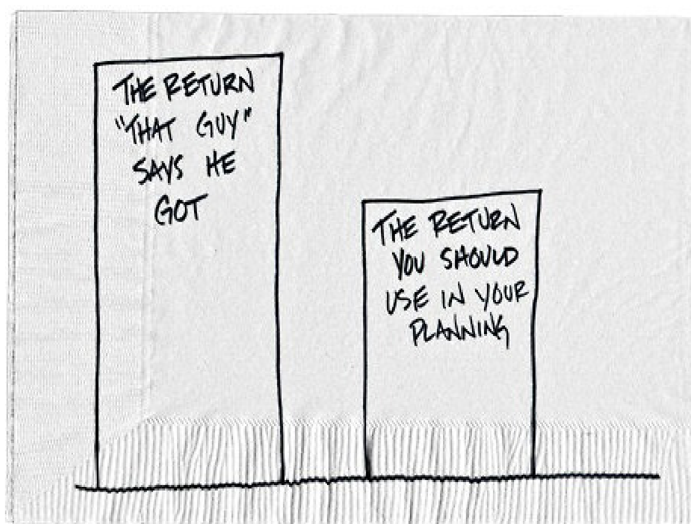
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

Thanks for being so understanding about the early withdrawal I made from my IRA account. I was afraid there might be some sort of penalty.

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