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Mid-Year Reality Check: Covering Your Bases in Uncertain Times

Retirement Rules of Thumb

Four Things to Do in the Four Years Before College

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LIFE THE WAY YOU PLANNED IT.

Mid-Year Reality Check: Covering Your Bases in Uncertain Times



Imagine playing a complicated game, but the rules of the game are changing, and the new rules have yet to be announced. That's what income tax planning is like this year. In fact, if there was ever a year to spend some quality time with your financial professional, this is it. Here are a few items to discuss.

How will higher rates next year affect you?

Federal income tax rates are scheduled to jump in 2013, with the bottom (10%) rate disappearing, and the top rate increasing from 35% to 39.6%. Starting in 2013, high wage earners--those with wages exceeding \$200,000 (\$250,000 for married couples filing jointly and \$125,000 for married individuals filing separately)--will also have to pay an additional 0.9% in the hospital insurance (HI) portion of their payroll tax, commonly referred to as the Medicare portion.

Could the current federal income tax rates be extended again? Of course, but it's far from a certain bet, and the odds are that any action would not take place until after the presidential election. That means any financial plan you put in place has to account for this uncertainty. And the uncertainty extends beyond just tax rates, because a number of popular tax breaks are also scheduled to expire at the end of the year, while others have already expired. So, any potential moves have to be considered in the context of several "what if" scenarios. For example, if you have the opportunity to defer compensation to next year, you have to really think about whether that makes sense, or if you would be better off paying tax on the income at this year's rates.

Potential investment moves

In addition to increased tax rates on earnings, the rates that apply to long-term capital gain and qualifying dividends are scheduled to increase in 2013. The maximum rate on long-term capital gain will jump from 15% to 20%. And while qualifying dividends currently benefit from being taxed at the rates that apply to long-term capital gain, in 2013 they'll be

taxed at ordinary income tax rates. Also beginning in 2013, a new 3.8% Medicare contribution tax will be imposed on the net investment income of individuals with modified adjusted gross income that exceeds \$200,000 (\$250,000 for married couples filing jointly and \$125,000 for married individuals filing separately). That means someone in the top tax bracket could potentially end up paying tax on some investment income at a total rate of 43.4%.

Potentially higher rates in 2013 could be a motivating factor in your investment strategy. For example, you might want to consider selling investments that have appreciated in value to recognize long-term capital gain in 2012, before the maximum rate is scheduled to increase. Alternatively, you might consider timing the sale of an investment to postpone the recognition of a capital loss until 2013, when it could be more valuable.

Roth conversions--is this the year?

If you've been on the fence about converting traditional IRA funds or pretax 401(k) contributions to a Roth account, you ought to give the matter one last hard look before the year ends. That's because when you convert a traditional IRA to a Roth IRA, or pretax dollars in a 401(k) plan to a Roth account, the converted funds are subject to federal income tax (to the extent the funds represent investment earnings, tax-deductible IRA contributions, or pretax 401(k) contributions) in the year that you make the conversion.

If tax rates go up next year, so will the effective cost of doing a Roth conversion. Additionally, qualified distributions from Roth IRAs and Roth 401(k)s are free from federal income tax. That could make a big difference in retirement if you're paying tax at a higher rate at the time. Whether a Roth conversion is right for you depends on a number of factors. If it makes sense for you, though, it might pay to think about acting now, rather than later.

Retirement Rules of Thumb



Rules of thumb are usually based on a sound financial principle, and can provide a good starting point for assessing your retirement needs.

Because retirement rules of thumb are guidelines designed for the average situation, they'll tend to be "wrong" for a particular retiree as often as they're "right." However, rules of thumb are usually based on a sound financial principle, and can provide a good starting point for assessing your retirement needs. Here are four common retirement rules of thumb.

The percentage of stock in a portfolio should equal 100 minus your age

Financial professionals often advise that if you're saving for retirement, the younger you are, the more money you should put in stocks. Though past performance is no guarantee of future results, over the long term, stocks have historically provided higher returns and capital appreciation than other commonly held securities. As you age, you have less time to recover from downturns in the stock market. Therefore, many professionals suggest that as you approach and enter retirement, you should begin converting more of your volatile growth-oriented investments to fixed-income securities such as bonds.

A simple rule of thumb is to subtract your age from 100. The difference represents the percentage of stocks you should keep in your portfolio. For example, if you followed this rule at age 40, 60% (100 minus 40) of your portfolio would consist of stock. However, this estimate is not a substitute for a comprehensive investment plan, and many experts suggest modifying the result after considering other factors, such as your risk tolerance, financial goals, the fact that bond yields are at historic lows, and the fact that individuals are now living longer and may have fewer safety nets to rely on than in the past.

A "safe" withdrawal rate is 4%

Your retirement income plan depends not only upon your asset allocation and investment choices, but also on how quickly you draw down your personal savings. Basically, you want to withdraw at least enough to provide the current income you need, but not so much that you run out too quickly, leaving nothing for later retirement years. The percentage you withdraw annually from your savings and investments is called your withdrawal rate. The maximum percentage that you can withdraw each year and still reasonably expect not to deplete your savings is referred to as your "sustainable withdrawal rate."

A common rule of thumb is that withdrawal of a dollar amount each year equal to 4% of your savings at retirement (adjusted for inflation) will be a sustainable withdrawal rate. However, this

rule of thumb has critics, and there are other strategies and models that are used to calculate sustainable withdrawal rates. For example, some experts suggest withdrawing a lesser or higher fixed percentage each year; some promote a rate based on your investment performance each year; and some recommend a withdrawal rate based on age. Factors to consider include the value of your savings, the amount of income you anticipate needing, your life expectancy, the rate of return you anticipate from your investments, inflation, taxes, and whether you're planning for one or two retired lives.

You need 70% of your preretirement income during retirement

You've probably heard this many times before, and the number may have been 60%, 80%, 90%, or even 100%, depending on who you're talking to. But using a rule of thumb like this one, while easy, really isn't very helpful because it doesn't take into consideration your unique circumstances, expectations, and goals.

Instead of basing an estimate of your annual income needs on a percentage of your current income, focus instead on your actual expenses today and think about whether they'll stay the same, increase, decrease, or even disappear by the time you retire. While some expenses may disappear, like a mortgage or costs for transportation to and from work, new expenses may arise, like yard care services, snow removal, or home maintenance--things that you might currently take care of yourself but may not want to (or be able to) do in the future. Additionally, if travel or hobby activities are going to be part of your retirement, be sure to factor these costs into your retirement expenses. This approach can help you determine a more realistic forecast of how much income you'll need during retirement.

Save 10% of your pay for retirement

While this seems like a perfectly reasonable rule of thumb, again, it's not for everyone. For example, if you've started saving for retirement in your later years, 10% may not provide you with a large enough nest egg for a comfortable retirement, simply because you have fewer years to save.

However, a related rule of thumb, that you should direct your savings first into a 401(k) plan or other plan that provides employer matching contributions, is almost universally true. Employer matching contributions are essentially "free money," even though you'll pay taxes when you ultimately withdraw them from the plan.



Four Things to Do in the Four Years Before College



Spiraling student debt

According to the New York Federal Reserve Bank, total outstanding student loan debt (from both federal and private sources) surpassed total outstanding credit card debt last year, and is on pace to surpass a trillion dollars this year. Unlike credit card debt, student loan debt generally cannot be discharged in bankruptcy.

For your child, high school means football games, a driver's license, SATs, and the prom. For you, it means college is right around the corner. Before your child starts touring college campuses, here are four things you can do to get ready.

1. Take stock of your savings

A few years before you need to start paying tuition bills is a good time to take stock of your college savings. How much have you saved? Are you making monthly contributions, and is there any room to increase them? Now is the time to make sure your investments aren't weighed too heavily towards equities, because any losses suffered at this point could be difficult to make up. Consider shifting your investments to less risky ones as college approaches. In addition, estimate how much savings you'll have--factoring in your current balance, monthly contributions, and estimated rate of return--when your child graduates from high school. Finally, you might ask grandparents if they plan to help with costs.

2. Get familiar with financial aid

For your child to be eligible for federal student loans, grants, and/or work-study, you must complete the federal government's aid application, the FAFSA. The FAFSA looks at your family's income, assets, and other information (e.g., the number of college-age children in the family, the age of the older parent when the child starts college) to arrive at a figure called the expected family contribution (EFC). This is the amount the government deems you can afford to pay each year. This figure stays the same no matter what college your child applies to. The difference between the cost of attendance at a certain college (a variable) and your EFC (a constant) equals your child's financial need.

To get an estimate of your EFC ahead of time, try filling out the government's FAFSA4caster tool at www.fafsa.ed.gov. Though you'll still have to fill out the real FAFSA later, the FAFSA4caster will give you a ballpark EFC figure and an idea of what family financial data is required in the financial aid process. Plus, the FAFSA4caster will automatically import your data into the FAFSA later on.

The two main federal education loans are the student Stafford Loan and the parent PLUS Loan. There are two types of Stafford Loans: subsidized, for which the government pays (subsidizes) the interest while your child is in school and six months after school (the grace period), and unsubsidized, for which the government does not pay the interest during

these periods. The maximum borrowing limits for Stafford Loans are currently: 1st year, \$5,500 (\$3,500 subsidized); 2nd year, \$6,500 (\$4,500 subsidized); 3rd-5th years, \$7,500 (\$5,500). The current interest rate is 6.8% fixed for unsubsidized loans and 3.4% fixed for subsidized loans disbursed between July 1, 2011, and July 1, 2012 (this rate is scheduled to increase to 6.8% after July 1, 2012).

A PLUS Loan is available to parents with good credit histories; parents can borrow up to the full cost of their child's education. Currently, the PLUS Loan has a fixed interest rate of 7.9%. The unsubsidized Stafford and PLUS Loans are available without regard to financial need.

In addition to loans, your child should spend time in high school researching scholarships. There are several free scholarship websites that let your child tailor his or her search by interests and abilities. Obviously, scholarships are the preferred method of college funding because they don't need to be repaid.

3. Talk to your child about college costs

At some point during junior or senior year, it's important to have a frank conversation with your child about college costs. Tell your child how much you expect to have saved, and how much you will be able to contribute each year during college. If costs exceed what you can pay, explain that the rest will need to be borrowed by either you or your child, or covered by a scholarship, grant, or work-study job.

When talking about loans, show your child exactly how much a certain amount will cost to repay each month over a 10-year period. For example, a \$27,000 loan (the current max in federal Stafford Loans that can be borrowed over four years) at 6.8% interest will cost \$311 each month. The idea is to take an abstract loan amount and break it down into a figure--and monthly obligation--your child can understand. Ultimately, as the parent, it's up to you to make sure your child does not go into too much debt to pay for college.

4. Research colleges wisely

In addition to thinking about the qualities of his or her ideal college (e.g., geographic region, setting, size), your child should develop a list of colleges that are a good match for his or her academic abilities, interests, and talents. To maximize the chances of receiving a favorable aid package, consider your child's academic profile--by looking at GPA, class rank, and SAT/ACT scores--and encourage your child to apply to at least a few colleges where his or her academic credentials are better than those of the average admitted student.



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Is it true that Social Security beneficiaries are being required to receive their payments electronically?

That's correct. On March 1, 2013, the U.S. Treasury Department will stop mailing paper benefit checks. After that date, all Social Security beneficiaries (as well as anyone receiving another type of federal benefit, such as Supplemental Security Income benefits, Railroad Board annuity payments, federal retirement benefits, or veterans benefits) will be required to receive their benefits electronically. The federal government estimates that switching to electronic payments will save taxpayers \$1 billion over 10 years, and cut down on the risk of lost and stolen checks.

Most Social Security beneficiaries are already receiving benefits electronically, and if you're among them, you don't need to do anything—you'll continue to receive your benefits via the method you've chosen. But if you're receiving a paper check, you need to choose one of two electronic payment options as soon as possible.

The first payment option is to have your benefit directly deposited to a bank or credit union account. The second option is to have your benefit put on a Direct Express® Debit

MasterCard® prepaid card that can be used to pay bills, make retail purchases, or withdraw benefit funds from an ATM or a financial institution. Most transactions are free, although fees do apply to certain services. The Treasury Department recommends the direct deposit option for anyone with access to an account at a financial institution. The Direct Express® card is most appropriate for individuals who need the benefits of direct deposit but who don't have an account at a financial institution. If you haven't chosen an option as of March 1, 2013, you'll be automatically enrolled in the Direct Express® card option. If you're applying for Social Security benefits for the first time, you'll be asked to choose your payment option at that time.

To sign up for electronic payments, you need to visit the government website, www.GoDirect.org, or call the U.S. Treasury Electronic Payment Solution Center at (800) 333-1795. You can also sign up for the direct deposit option at your bank or credit union, or for the Direct Express® card at www.usdirectexpress.com.



Is the Social Security Administration mailing out annual Social Security Statements?

In 1995, the Social Security Administration (SSA) began mailing out annual Social Security Statements to everyone age 25 and older. These statements were designed to help Americans plan for the future by providing a detailed record of their earnings and estimates of Social Security benefits. Last year, the SSA suspended mailing these statements because of budgetary concerns, but in March 2012, the SSA resumed mailing annual statements to workers age 60 and older. If you're age 60 or older, you should receive your statement every year, about three months before your birthday. The SSA is also resuming the mailing of one-time statements to workers who are age 25 to introduce them to Social Security programs and benefits.

The SSA has also unveiled an online version of the Social Security Statement, available at the SSA website, www.socialsecurity.gov. You'll have immediate access to your statement once you've signed up for a "My Social Security" account. Statement information includes a projection of your retirement benefits at age 62, at full retirement age, and at age 70; projections

of disability and survivor's benefits; a detailed record of your earnings; and other information about the Social Security program. Individuals who are receiving paper statements in the mail will have the option to sign up for online statements instead. While workers are encouraged to use the online statement option, in some cases, the SSA will mail statements upon request to individuals under age 60, including domestic violence or identity theft victims who have blocked online access to their personal information.

There's also another way to estimate the amount of Social Security retirement benefits you will be eligible to receive in the future under current law. You can use the SSA's Retirement Estimator, which is also available at the SSA website. To use this calculator, you must have enough credits to qualify for benefits, and you must not already be receiving benefits or waiting for a decision on your benefit application. You can create various scenarios that will illustrate how different earnings amounts and retirement ages will affect your future retirement benefit.



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