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The Impact of Health-Care Costs on Social Security



For many retirees and their families, Social Security provides a dependable source of income. In fact, for the majority of retirees, Social Security accounts for at least half of their income (Source: Fast Facts & Figures About Social Security, 2013). However, more of that income is being spent on health-related costs each year, leaving less available for other retirement expenses.

The importance of Social Security

Social Security is important because it provides a retirement income you can't outlive. In addition, benefits are available for your spouse based on your benefit amount during your lifetime, and at your death in the form of survivor's benefits. And, these benefits typically are adjusted for inflation (but not always; there was no cost-of-living increase for the years 2010 and 2011). That's why for many people, Social Security is an especially important source of retirement income.

Rising health-care costs

You might assume that when you reach age 65, Medicare will cover most of your health-care costs. But in reality, Medicare pays for only a portion of the cost for most health-care services, leaving a potentially large amount of uninsured medical expenses.

How much you'll ultimately spend on health care generally depends on when you retire, how long you live, your health status, and the cost of medical care in your area. Nevertheless, insurance premiums for Medicare Part B (doctor's visits) and Part D (drug benefit), along with Medigap insurance, could cost hundreds of dollars each month for a married couple. In addition, there are co-pays and deductibles to consider (e.g., after paying the first \$147 in Part B expenses per year, you pay 20% of the Medicare-approved amount for services thereafter). Your out-of-pocket yearly costs for medical care, medications, and insurance could easily exceed thousands of dollars.

Medicare's impact on Social Security

Most people age 65 and older receive Medicare. Part A is generally free, but Parts B and D have monthly premiums. The Part B premium generally is deducted from your Social Security check, while Part D has several payment alternatives. In 2013, the premium for Part B was \$104.90 per month. The cost for Part D coverage varies, but usually averages between \$30 and \$60 per month (unless participants qualify for low-income assistance). Part B premiums have increased each year and are expected to continue to do so, while Part D premiums vary by plan, benefits provided, deductibles, and coinsurance amounts. And, if you enroll late for either Part B or D, your cost may be permanently increased.

In addition, Medicare Parts B and D are means tested, meaning that if your income exceeds a predetermined income cap, a surcharge is added to the basic premium. For example, an individual with a modified adjusted gross income between \$85,000 and \$170,000 may pay an additional 40% for Part B and an additional \$11.60 per month for Part D.

Note: Part C, Medicare Advantage plans, are offered by private companies that contract with Medicare to provide you with all your Part A and Part B benefits, often including drug coverage. While the premiums for these plans are not subtracted from Social Security income, they are increasing annually as well.

The bottom line

The combination of rising Medicare premiums and out-of-pocket health-care costs can use up more of your fixed income, such as Social Security. As a result, you may need to spend more of your retirement savings than you expected for health-related costs, leaving you unable to afford large, unanticipated expenses. Depending on your circumstances, spending more on health-care costs, including Medicare, may leave you with less available for other everyday expenditures and reduce your nest egg, which can impact the quality of your retirement.

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What's New in the World of Higher Education?

Business Owners: Don't Neglect Your Own Retirement Plan

I've heard the term "ERISA fiduciary." What does it mean?



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The right plan for you and your business will depend on a number of factors. Consider reviewing IRS Publication 560, "Retirement Plans for Small Business," and consulting a qualified financial professional before making any decisions.

Distributions from pretax accounts and nonqualified distributions from Roth accounts will be taxed at then-current income tax rates. In addition, taxable withdrawals before age 59½ (in some cases age 55) will be subject to a 10% penalty tax unless an exception applies.

All investing involves risk, including the possible loss of principal.

Business Owners: Don't Neglect Your Own Retirement Plan

If you're like many small business owners, you pour your heart, soul, and nearly all your money into your business. When it comes to retirement planning, your strategy might be crossing your fingers and hoping your business will provide the nest egg you'll need to live comfortably. But relying on a business to fund retirement can be a very risky proposition. What if you become ill and have to sell it early? Or what if your business experiences setbacks just before your planned retirement date?

Rather than counting on your business to define your retirement lifestyle, consider managing your risk now by investing in a tax-advantaged retirement account. Employer-sponsored retirement plans offer a number of potential benefits, including current tax deductions for the business and tax-deferred growth and/or tax-free retirement income for its employees. Following are several options to consider.

IRA-type plans

Unlike "qualified" plans that must comply with specific regulations governed by the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA), SEP and SIMPLE IRAs are less complicated and typically less costly.

- **SEP-IRA:** A SEP allows you to set up an IRA for yourself and each of your eligible employees. Although you contribute the same percentage of pay for every employee, you're not required to make contributions every year. Therefore, you can time your contributions according to what makes sense for the business. For 2014, total contributions (both employer and employee) are limited to 25% of pay up to a maximum of \$52,000 for each employee (including yourself).
- **SIMPLE IRA:** The SIMPLE IRA allows employees to contribute up to \$12,000 in 2014 on a pretax basis. Employees age 50 and older may contribute an additional \$2,500. As the employer, you must either match your employees' contributions dollar for dollar up to 3% of compensation, or make a fixed contribution of 2% of compensation for every eligible employee. (The 3% contribution can be reduced to 1% in any two of five years.)

Qualified plans

Although these types of plans have more stringent regulatory requirements, they offer more control and flexibility. (Note that special rules may apply to self-employed individuals.)

- **Profit-sharing plan:** Typically only the business contributes to a profit-sharing plan.

Contributions are discretionary (although they must be "substantial and recurring") and are placed into separate accounts for each employee according to an established allocation formula. There's no fixed amount requirement, and in years when profitability is particularly tight, you generally need not contribute at all.

- **401(k) plan:** Perhaps the most popular type of retirement plan offered by employers, a 401(k) plan allows employees to make both pre- and after-tax (Roth) contributions. Pretax contributions grow on a tax-deferred basis, while qualified withdrawals from a Roth account are tax free. Employee contributions cannot exceed \$17,500 in 2014 (\$23,000 for those 50 and older) or 100% of compensation, and employers can choose to match a portion of employee contributions. These plans must pass tests to ensure they are nondiscriminatory; however, employers can avoid the testing requirements by adopting a "safe harbor" provision that requires a set matching contribution based on one of two formulas. Another way to avoid testing is by adopting a SIMPLE 401(k) plan. However, because they are more complicated than SIMPLE IRAs and are still subject to certain regulations, SIMPLE 401(k)s are not widely utilized.
- **Defined benefit (DB) plan:** Commonly known as a traditional pension plan, DB plans are becoming increasingly scarce and are uncommon among small businesses due to costs and complexities. They promise to pay employees a set level of benefits during retirement, based on a formula typically expressed as a percentage of income. DB plans generally require an actuary's expertise.

Total contributions to profit-sharing and 401(k) plans cannot exceed \$52,000 or 100% of compensation in 2014. With both profit-sharing and 401(k) plans (except safe harbor 401(k) plans), you can impose a vesting schedule that permits your employees to become entitled to employer contributions over a period of time.

For the self-employed

In addition to the options noted above, sole entrepreneurs may consider an individual or "solo" 401(k) plan. These types of plans are very similar to a standard 401(k) plan, but because they apply only to the business owner and his or her spouse, the regulatory requirements are not as stringent. They can also have a profit-sharing feature, which can help you maximize your tax-advantaged savings potential.



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I've heard the term "ERISA fiduciary." What does it mean?

The Employee Retirement Income Security Act (ERISA) was enacted in 1974 to protect employees who participate in retirement and certain other employee benefit plans. There was particular concern at the time that pension plan funds were being mismanaged, causing participants to lose benefits they had worked so hard to earn. ERISA protects the interests of plan participants and their beneficiaries by:

- Requiring the disclosure of financial and other plan information
- Establishing standards of conduct for plan fiduciaries, and
- Providing for appropriate remedies, sanctions, and access to the federal courts

It's the fiduciary provisions of ERISA that protect participants from the mismanagement and abuse of plan assets. The law requires that fiduciaries act prudently, solely in the interests of plan participants and beneficiaries, and for the exclusive purpose of providing benefits and paying reasonable expenses of administering the plan.

Fiduciaries must diversify plan investments to minimize the risk of large losses, unless it's clearly prudent not to do so. Fiduciaries must also avoid conflicts of interest. They cannot allow the plan to engage in certain transactions with the employer, service providers, or other fiduciaries ("parties in interest"). There are also specific rules against self-dealing.

Who is a plan fiduciary? Anyone who:

- Exercises any discretionary control over the plan or its assets
- Has any discretionary responsibility over the administration of the plan
- Provides investment advice for a fee or other compensation (direct or indirect)

Plan fiduciaries include, for example, discretionary plan trustees, plan administrators, investment managers and advisors, and members of a plan's investment committee.

Fiduciaries must take their responsibilities seriously. If they fail to comply with ERISA's requirements, they may be personally liable for any losses incurred by the plan. Criminal liability may also be possible.



Will rising interest rates impact my pension benefits?

If you're nearing retirement and plan to elect lifetime payments from your pension plan, rising interest rates won't have any impact on your

benefits. But if you're considering a lump-sum payment, rising interest rates can be critical.

Pension plans calculate your lump sum by determining the present value of your future pension payments. The two primary components in this calculation are your life expectancy, and interest rates. Life expectancy is determined using IRS tables. These tables are unisex (that is, the same life expectancy factors apply to both men and women). This results in women getting lump sums that are slightly smaller than they would otherwise get based on true gender-based factors, and men getting slightly larger lump sums.

Until recently, the interest rate plans used to calculate lump-sum payments was the U.S. 30-year Treasury bond rate. However, employers can now use a higher corporate bond rate. What's important to understand is that the amount of your lump sum payment is inversely proportional to interest rates--that is, the higher the rate, the smaller your lump sum.

If your plan offers lump-sum payments, there are two questions you need to ask yourself. First, "Is a lump-sum right for me?" This is a difficult question, and the answer depends on a number of factors. Is the pension your primary source of retirement income? How is your (and your spouse's) health? Will you be giving up valuable subsidized benefits built into the plan's benefit payments, or cost-of-living increases? A lump sum gives you control over your retirement dollars and removes the risk of early death, but shifts the investment risk from the plan to you. Remember that you'll be giving up a benefit payment that's guaranteed for your (and if you're married, your spouse's) life. Will you be able to make your lump sum last for a retirement that may last 30 years or more?

If you decide a lump sum is the right choice, the second question is, "When should I take the money?" Interest rates remain near historic lows, and it's only a matter of time before they start heading back up. If you're approaching retirement and believe interest rates will rise in the near future, you may want to consider taking the lump sum sooner rather than later. Your plan can provide you with an estimate of your lump sum based on various interest rates.



Stock Market: Voting vs. Weighing Machine

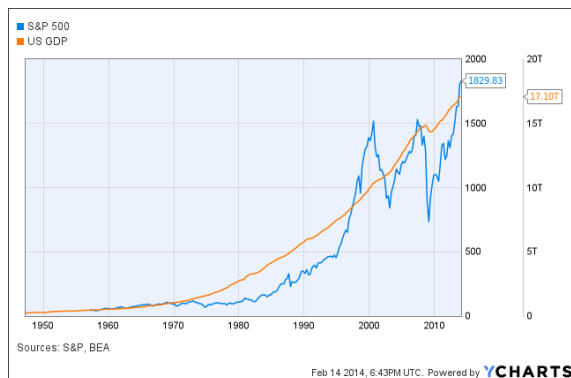
Perhaps you've heard the phrase "short-term, the stock market is like a voting machine, but long-term it acts like a weighing machine" -- a quote attributed to legendary value investor Benjamin Graham. But what does that mean and how does it apply to your investment portfolio?

The quote basically means that the short-term movements of the markets tend to be based on subjective or emotional judgments, rather than any actual change in the value of the securities being traded. In fact, you can be amused when economic pundits say that the markets went up one day because of a positive government economic report, and then a few days later they will say the markets went down because the government's positive outlook might mean that the Fed will taper faster than planned. It is not uncommon for the same type of event to be blamed for a market decline and cited in a market rise within days of each other.

Longer-term, however, the quote suggests markets are driven by something different: gradual changes in the underlying value of the securities being traded. Over time, as a company's business expands -- growing its sales and earnings -- it becomes more valuable. None of this shows up in today's trading, but over the years, the rise in value becomes visible.

One of the valuable lessons in the quote is that it is better for your financial well-being to ignore short-term events and focus on more durable longer-term trends. Another, is when you buy a stock or basket of stocks, you are participating in the growth of the underlying businesses and the economy as a whole. That means that when millions of workers toil away at the office for days and weeks on end, creating value, building enterprises, coming up with new ideas, building and making and creating, you are also participating in the fruits of their labor. The effect is gradual, but clearly visible if you can look at the longer-term impact on your investments.

The graph below shows the growth of the U.S. economy since 1950 (orange line), from less than \$1 trillion in economic activity to more than \$17 trillion today. American workers, in aggregate, appear to have worked wonders in terms of total value creation.



Also shown is the rise in value of the U.S. stock market as measured by the S&P 500 index. You can clearly see that, while economic activity seems to "plod along", the stock market has more intense movements -- sometimes growing more slowly, sometimes quicker.

But overall, the stock market seems to return to the growth pattern as the economy as a whole. This is the "weighing machine" aspect of the markets -- the fact that people eventually notice

whenever the markets are priced higher (lower) than underlying economic value. While it can take years, real value eventually asserts itself over short-term emotional responses.

The graph doesn't tell us whether stocks are overvalued or undervalued today; nor, really, will anything or anybody tell us that with any certainty. The important thing to focus on is the growth. That's why we invest; to capture that long-term growth. The tradeoff is to accept some setbacks along the way -- when the voting machine can't see past the short-term dangers -- for the longer-term opportunities.