Personal Financial Planning for the Music Teacher

Presented by Randy Vaughn
Retired - Klein ISD - Klein, TX
banfluman@comcast.net

The Midwest Band and Orchestra Clinic
December 19, 2013

Set Financial Goals

Goals that matter

get out of debt

emergency fund- 3 to 6 months living expenses

house

funding retirement

college for kids or paying off your own

transportation – car

vacations

Include wife and kids if you have them

Start now by putting time on your side

Be careful when buying something that may take away from goals

Be prepared for change --
reexamine every few years

Have a Plan or Budget

Identify how you spend your money

Analyze current spending and see if it fits your financial goals

Keep up with your spending to make sure you stay on track

Things to be careful of with plan...

- Spending beyond your limits
- Cash leakage -- ATMs
- Luxuries dressed as necessities
- Watch out for spending creep

Things to do with budget...

- Pay yourself first -- 10%
- Use software like Quicken, Mint and Manilla
- Relax -- Don't go overboard by being overzealous
- Tithing or contributions to a worthy cause

Manage Debt and Cutting Costs

- Refinance your mortgage
- Cut taxes -- itemize
- Raise insurance deductibles
- Latte & martini factor
- Brown bag it
- Golf -- sports package -- symphony, etc.
- Buy used cars -- no leases
- Shop WalMart
- Pay cash for vacations
- House too large for budget?
- Cell it – Get rid of home phone
- Pay off credit cards every month -- have only 1-2 per household
- Rent movies instead of going to the movies
- Cut eating out
- Appeal your home assessment
- Pay off highest rate debt first
- Cable TV
- Shopping --You spend because it makes you feel good in the short term. People who have money think long term.

Six Traits of Wealth Builders

--They spend less money than they make

--They have little or no debt

--They save

--They have a plan for their money

--They do not let emotions get in the way of financial decisions.

--They start saving early in their careers.

Good Debt vs. Bad Debt

A. **Good debt** is anything you need but can't afford to pay for up front without wiping out cash reserves

B. **Bad debt** -- things you don't need and can't afford. Worst form of debt is credit card debt because of high interest. The average American has $15,263 in credit card debt, or $11.15 trillion in total debt. A decrease of 1.4% from last year. (Nerdwallet)

C. **Things to watch out for with credit cards:**

1. Paying only minimum each month
2. Taking out a loan to pay credit card and then running up debt again
3. Using credit cards to make everyday purchases
4. Using credit cards to make payments with other credit cards or all of your credit cards are maxed out and trying to get more credit. Then it may be time cut up credit cards or to freeze your credit cards in a Tupperware bowl full of water.

Debt puts your financial health at risk:

- Allocate most of your monthly debt payment toward the debt with the highest interest and pay the minimums on the rest.
- Once a card is paid off, add the money you were paying on that card to the payment for the card with the next highest interest.
- After all of your debt is paid off, you can start saving and investing what you were paying out on those credit cards and start earning interest instead of paying interest.

Money Moves for the Young Music Teacher

Start an emergency savings account in a safe, FDIC or NCUA protected account. Check out local banks and credit unions. You can often get more personalized service at local institutions, particularly credit unions. Strive to save at least $1,000 to $2,000 before anything else with your money.

Pay off credit card balances. These often charge north of 18%. Why try to get 10% in the market when in essence, you can get a guaranteed 18% return by paying down this high-fee debt?

Consider opening a Certificate of Deposit (CD). This is a super safe, FDIC-insured way to earn a bit more interest than a bank savings account. Set aside $500 to $1,000 dollars in a CD with a maturity date of six months to a year. This is a good way to test your investment patience.

If you have a work-based retirement plan (such as a 403(b)) that offers a match, contribute at least as much to earn the match. If you have a good quality plan, strive to contribute as much as permitted. NOTE: Your investment choices will be limited to your employer's offerings. Put this money in a no-load mutual fund, like a target date fund, good balanced fund and/or index funds. You can contribute $17,500 a year in your 403(b). If you are lucky enough to have access to mutual funds from companies like Fidelity, TIAA-CREF, T. Rowe Price, USAA, and Vanguard, consider yourself lucky.

Get emergency savings account to $5,000.

If your investment companies in your 403(b) are limited, then open a Roth IRA in a low-cost target date fund with a company like the ones mentioned above. Strive to contribute the maximum allowed each year (currently $5,000).

Eventually, increase your emergency savings account to $10,000.

Where To Invest Your Retirement Money

401(k) - A work-based, tax-deferred retirement plan for those working in the private sector. May contribute up to $17,500; or for those 50 and older, $23,000.

IRA - There are two types: a traditional IRA offers tax-deferred growth and a Roth IRA in which contributions are made with AFTER-TAX income. The advantage of the Roth is that qualified withdrawals are not subject to taxation. Resource: IRS Publication 590 available at irs.gov. May contribute up to $5,500; or for those 50 and older, $6,500.

403(b) - A work-based, tax-deferred retirement plan for those working in the public sector, such as a K-12 teacher, or those working for non-profit organizations.
Resources: 403bwise.com and IRS Publication 571 available at irs.gov. May contribute up to $17,500; or for those 50 and older, $23,5000.

457(b) - Is another tax-deferred retirement savings plan for employees of state and local governmental agencies, which includes public school employees. Thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), teachers are eligible to contribute the maximum elective-deferral limit to both a 403(b) and a 457(b). This means that participants with enough includable compensation can now contribute $17,500 to each plan- for a whopping $35,000!

Seven Tips for Making the Most of Your 403(b)

Set Goals

Make it automatic

Don’t say no to free money

Diversify, diversify, diversify

Pay attention to costs

Gradually increase your savings rate

Don’t wait

Taxes - Pay later or Pay Now:

Contributions to a traditional 401(k) or 403(b) reduce your taxable income.

A Roth IRA flips this tax arrangement. Instead of reducing tax obligation up front, you reduce it later. Contributions to a Roth IRA are made with after-tax money. Like the 403(b), investment earnings grow tax-deferred during the life of the account.

Facts About 403(b)

The 403(b) is a retirement plan available to certain employees of public schools; employees of certain tax-exempt organizations. The 403(b) is named after the section of the IRS code governing it.

The 403(b) can be an excellent way to save money for retirement. It can serve as a supplement to a traditional pension plan or other retirement plans, or as a stand-alone plan. Eligibility: All public school employees and not-for-profit workers are eligible to participate in a 403(b) .

403(b)7 Custodial Accounts: This is the name of the 1974 addition to the IRS code allowing participants to invest directly in mutual funds through a custodial account.

Tax-Sheltered Annuities (TSA): The 403(b) is also known as a tax-sheltered annuity, but this is an outdated expression. It can give the impression that participants can only invest in annuity products, which was the case when section 403(b) was first added to the IRS code. However, since 1974, participants have also been able to invest in mutual funds through a 403(b)7 custodial account.

How a 403(b) works:

Employees enroll and participate through their employer. Contributions to a 403(b) are made on a pre-tax basis through a Salary Reduction Agreement. This is an arrangement where the participation employee agrees to take a reduction in salary. The amount by which the salary is reduced is directed to investments offered through the employer by and selected by the employee. These contributions are called elective deferrals and are excluded from the employee's taxable income. Contributions grow tax-deferred until the time of retirement, when withdrawals are taxed as ordinary income.

Roth 403(b):

This is a provision that permits employees to designate all or a portion of their 403(b) as an after-tax Roth contribution. This type of contribution will not lower the employee's taxable income. However, distribution of Roth designated funds in retirement will NOT be subject to taxation. Participants have the option of making pre-tax 403(b) contributions, and after-tax Roth 403(b) contributions, or as a combination of the two. Total contributions cannot exceed the year's contribution limit. Not all employers offer a Roth 403(b), nor are they required to do so. Check with your employer for details.

How is a Roth 403(b) is different from a Roth IRA:

The tax treatment of a Roth 403(b) and a Roth IRA is similar (after-tax contribution, tax-free withdrawal in retirement). However, the Roth 403(b) is an employer-based plan, while the Roth IRA is an individual-based plan.

What you should know before opening a 403(b):

All investments carry with them a degree of risk. It is important to understand your tolerance for risk before investing. It cannot be emphasized enough that risk tolerance is highly individualized: An investment strategy that is acceptable by one person my not be suited to another. It is also important to know that fees, operating rules, and investment objectives may vary greatly among product vendors and across investments offered by a particular vendor. Some investments impose surrender charges or restrictions on withdrawals.

Asset allocation (one way)

Your Attitude	Bond Allocation (%)	Stock Allocation (%)
Play safe	Your age	100 minus age
Middle	age minus10	110 minus age
Aggressive	age minus 20	120 minus age

What Investment Products Are Available in a 403(b) Plan?

Fixed Annuities: Fixed annuities are essentially CD-like investments issued by insurance companies. Like CDs, they pay guaranteed rates of interest, in many cases higher than bank CDs. Generally, investors are given two interest rates: the current rate and the guaranteed rate. The current rate is the return that the insurance company promises to pay for a set period of time, typically between one and five years. The guaranteed rate, usually lower, is the minimum rate that investors will receive after the current rate expires, regardless of market conditions.

Variable Annuities: A variable annuity is a tax-deferred retirement vehicle that allow you to choose from a selection of investments (stocks, bonds, and money-market funds), and then pays you a level of income in retirement that is determined by the performance of the investments you choose.

Mutual Funds: There are two kids of mutual funds: loaded mutual funds and no-load mutual funds. A load is a commission the investor must pay in order to purchase/sell that fund. All mutual funds have operation costs. They are regulated by the SEC but not guaranteed or insured by the FDIC. We want to use no-load mutual funds in our portfolio.

What Should I Know Before Opening a 403(b)?

Fees, operating rules, and investment objectives can vary greatly among vendors and across investments. Therefore, it is important to understand all of these before you begin contributing to any investment.

All Mutual funds and variable annuities are required to produce a document called a ***prospectus***, which details specific information about investment costs, objective, risk, performance, and operation rules.

Ask to see the prospectus before contributing to a variable annuity or a mutual fund. Fixed-Annuity products do not have a prospectus. Instead, they have a contract that details operation of the annuity. Ask to see the contract before investing in a fixed annuity.

What Does It Cost to Invest in a 403(b)?

<u>Fixed Annuities</u>: There are no separate fees for a fixed annuity. Similar to the way in which a bank makes money on a certificate of deposit, annuity fees are built into the product: usually these are between 1 and 2% annually. If you do not like the new rates and want to withdraw your money early, heavy surrender charges could kick in and cut into your returns.

<u>Variable annuities</u>: These charge on average 2.25% a year, according to fund tracker, Morningstar Inc. Aside from surrender charges that dock you for early withdrawals, variables can also come with steep sales commissions (often 4%). Consult the prospectus.

<u>Mutual Funds</u>: These charge on average 1.4% a year, according to fund tracker, Morningstar Inc. Some mutual funds charge as little as 0.10%; most of these being index mutual funds.

You do not need an agent or an advisor to start a 403(b). You are free to invest on your own. You may also use the services of a vendor representative or independent financial advisor. Financial representative can provide valuable services to their clients. These services can include retirement planning, information about state retirement plans, and analysis of other financial needs. Annuity and variable-annuity products are often sold by vendor representatives who are also referred to as agents.
All financial professionals charge a fee for their services.

Advantages of Mutual Funds

* Professional management
* Low cost
* Diversification
* Low cost of entry
* Audited performance records and expenses
* Flexibility in risk level

Various types of Mutual Funds

* Money Market Funds
* Bond Funds
* Stock Funds
* Hybrid Funds - These commonly invest in bonds and stocks and or cash
* International and/or Global funds
* Index funds
* Specialty funds or sector funds

QUESTIONS?

Will 403(b) contributions reduce Social Security benefits? NO.

Will participation in a defined benefit plan like (TRS) affect one's ability to contribute the maximum to my 403(b) plan? NO.

Can I change companies/vendors? YES.

Can I change the amount I am contributing? YES.

Why are annuities so prevalent in 403(b) plans?

a. Pushed by commission-based sales force
b. Lack of employee understanding about workings of the 403(b)
c. Lack of employer oversight and understanding about workings of the 403(b).

Is there any place for annuities in retirement? YES

Immediate annuities or "annuitizing" portions of retirement balances can make a lot of sense in retirement. This involves trading a sum of money for a steady stream of income.

Fixed annuities with a fair rate of return and a reasonable surrender charge, and no-load mutual funds from the likes of Fidelity, T. Rowe Price and Vanguard can be attractive, low-cost options. Loaded mutual funds can be just as expensive as high-fee variable annuity products. The notable exception to high-cost annuities are annuity products from TIAA-CREF. With fees that are among the lowest in the financial service industry and the absence of surrender charges, a fixed or variable annuity from TIAA-CREF can be just as affordable as a low-cost, no-load mutual fund.

Annuity Warning:

Equity-indexed annuities are being heavily pushed by the insurance industry as a way to enjoy the growth of the stock market without the risk. Lack of disclosure and complicated return formulas, coupled with extremely high commissions and long surrender periods have combined to make this "investment" a riddle wrapped in an enigma. Two-tier and bonus annuities are equally suspect. Some agents push the tax-deferred benefits of annuity products. The 403(b) is already a tax-deferred plan. So why would you even need that benefit again? It makes no sense. Finally, be wary of those touting the loan provisions of annuity products.

Advantages of Mutual Funds:

The biggest advantage is the instant diversification a fund can give you. Many people don't have enough money to buy a portfolio of stocks and bonds that is varied enough. Pooling your money with thousands of other investors solves that problem, ideally spreading your money across enough investments to reduce the risk of you being wiped out by a single bad bet.

Another advantage is that investing in mutual funds saves time. You've essentially hired a professional investor to monitor your portfolio's holdings and do his or her best to buy and sell at appropriate times. This is not true, of course, with index funds where the manager in not "actively managing" but "passively managing" the funds. That's one reason they are so much cheaper.

403(b) Suggestions

Rule 1 - Start early

Rule 2 - Invest with quality company

Rule 3 - Know about fees and surrender charges

Rule 4 - Diversify investments

Rule 5 - Increase 403(b) contributions annually

Rule 6 - Work or ask for better investment choices from you employer.

Rule 7 - Take a long-term view -- don't obsess daily

Rule 8 - Be sure entire financial house is in order

Rule 9 - Learn -- educate yourself

Rule 10 - Share your knowledge with colleagues

How to Start a 403(b)

Ask district for list of participating investment companies or vendor list. Watch out for performance and expenses. Example of how fees impact returns: Value of portfolio after 35 years, assuming $250 contributed monthly with an 8% annual return.
(a) Average Variable Annuity with 2.25% in fees, you would have $336,320.
(b) Average Managed Mutual Fund with 1.40% in fees, you would have $409,585.
(c) Average Index Fund with 0.08% in fees, you would have $548,750!!!!!

1. Vanguard
2. Fidelity
3. Schwab
4. TD Ameritrade
5. TIAA-CREF
6. T. Rowe Price
7. Folio Investing

Research several investment companies from this list. Set up a 403(b) account with your chosen investment company or companies.

Next, determine how much to contribute monthly. Most require $50.00 per month. Be sure to name a beneficiary.

Last, fill out a salary reduction agreement, known as elective deferrals and are excluded from your income. You now have started retirement savings and reduced your taxable income!

For 2013, you can contribute up to $17,500: for individuals that are 50 years or older, you can contribute $23,000. Check to see if your employer matches your contribution.

Funds to Use in Your Retirement Account

Target Date Funds and/or Life Cycle Funds:

A mutual fund is in the life-cycle category that automatically resets the asset mix (stocks, bonds, cash) in its portfolio according to a selected time frame that is appropriate for a particular investor. A target-date fund is similar to a life-cycle fund except that a target-date fund is structured to address asset allocation automatically for a specific date in the future; usually retirement.

Advantages:

Simple -- some are actively managed; others are passive by using mostly index funds.

Asset allocation made simple. 90% of variables of returns are due to asset allocation.

Takes the emotion out of investment decisions. According to the Dalbar Quantitative Analysis of Investor Behavior (QAIB) report, it showed the average investor earned 3.49% annually, from 1991 to 2010, as compared to the S&P 500 Index, which earned 7.89% in the same period. The reason for the poor showing was making decisions based on emotions.

Fees less than average mutual funds cost of 1.4% (Morningstar). Target Date expenses range from 0.18% to 0.77%.

Plan sponsors (school districts) like them because with these funds they know they are providing a simple, cost-effective way for most employees to save for retirement. They do not have the money to provide retirement plan communication and financial education to employees.

Designed to be sole investment in your portfolio. Mixing target-date funds with other funds can throw an investor's portfolio out of proper diversification.

No single approach is suitable for all investors. Beginners and experts alike may appreciate the pure simplicity of the target-date approach which is important when so much about investing can be confusing.

Some Life-cycle Funds do not change allocation over time. Examples below:

Growth -- 80% to 20% stock to bond ratio

Moderate Growth -- 70% to 30% stock to bond ratio

Conservative Growth -- 50% to 50% stock to bond ratio

Income -- 20% to 80% ratio of stocks to bonds

Balanced Funds or Hybrid Funds

These funds are called "balanced" because they have two asset classes using stocks and bonds usually placing about 60% in stocks and about 40% in bonds. They are convenient and cost effective if you do your homework, but they are more expensive because they are active, managed funds.

Index Funds

Build you own smart portfolio with core index funds.

Total Stock Market Index Fund---60%

Total International Stock Index Fund—20%

Total Bond Market Index Fund—15%

Total International Bond Market Index Fund—5%

or

Money Market Fund —5%

Subscribe to fund newsletter and use its recommendation

I have used Mark Salzinger, Editor & Publisher of "The No-Load Fund Investor" Newsletter: P.O. Box 3039, Brentwood, TN 37024-3029.

800-706-6364, $149.00 for 1 year subscription.

Hire a Fee only Financial Planner

1. if you're too busy
2. if you keep putting it off
3. if you lack knowledge
4. need a second opinion

Do it yourself

1. go to school (Rice continuing studies)
2. read books
3. browse the internet
4. go to investment seminars and conventions (Money Shows) around the country.

Web sites – 403bwise.com, CNNmoney.com, Vanguard.com

Some Things I've Learned

- Start your 403(b) investing now. Don' wait – no excuses!!!!
- Don't waste money on annuities in 403(b). Keep insurance and investing separate.
- Don't buy individual stocks – buy No-Load Mutual Funds
- Be careful who you trust with your investments
- Trust your own instincts -- even over the pros
- Don't chase winners.
- Use Index Funds as core for most of your 403(b).
- Cost matters a LOT.
- You don't have to know everything about investing to make smart decisions
- Don't buy hedge funds or options
- Use term life insurance for insurance needs. No whole or universal life.
- DCA works! Dollar cost averaging.
- Best investment tool is the power of compounding.
- Stay the course – Control your emotions -- Be smart
- Ignore the daily noise in the media - CNBC, etc.

THE PAST IS NO GUARANTEE OF FUTURE RETURNS, BUT CONSIDER THIS: SINCE 1802, STOCKS HAVE NEVER PRODUCED A NEGATIVE INFLATION-ADJUSTED RETURN IF HELD FOR MORE THAN TWENTY YEARS!

Money Terms

Short Term Savings

Generally less than five years. Includes such items as: emergency fund for car repairs, house repairs, health issues, job loss, etc.

Long Term Savings

Generally more than five years. Includes such items as: college, house down payment, retirement, etc.

Money Market

A relatively safe, low-interest paying investment, not FDIC-insured. Money in this type of fund is typically invested in safe investments like Certificates of Deposit and Treasury bills.

Certificate of Deposit (CD)

FDIC-insured saving instrument that generally offers higher returns than a bank savings account. Maturity dates for CDs range from six months to ten years.

Stock

Ownership share or shares in a company.

Bond

A loan to government (city, state, or federal) or corporation to pay for things like bridges and factory expansions. When you invest in a bond you are lending money. In return you are paid interest. Bonds can be segregated by credit quality and maturity. Rising interest rates are bad for bonds. Longer term bonds are riskier than short term bonds.

Exchange-traded Fund (ETF) is an investment fund traded on stock exchanges, much like stocks. Most ETFs track an index, such as a stock index or bond index. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. They are like mutual funds but trade like stocks.

Portfolio

A collection of investments.

Mutual Fund

An investment that pools money from many investors and invests in stocks, bonds, cash, or some combination of the three. Some mutual funds invest in specific sectors of the market like energy, health care or real estate.

Target- Date Mutual Fund or Lifecycle Funds

A mutual fund aimed at a future date that automatically becomes less risky the closer it gets to its target date. The ideal is to ensure a generally appropriate asset mix at each life stage of investing. The annual changes in the allocation of investments is done automatically from more aggressive to more conservative:

Stocks ➡ Bonds ➡ Cash

Index funds are funds that can be and are, for the most part managed by a computer. An index fund's assets are invested to replicate an existing market index such as the S&P 500, an index of the 500 largest U.S. company stocks. One of my favorite is the Total Stock Market Index which seeks to track the performance of a benchmark index that measures the investment return of the overall stock market or the Wilshire 5000.

Growth-and-Income, Equity-Income, and Balance Funds

These three types of funds have a common goal: providing steady long-term growth while simultaneously producing reliable income. They all hold some combination of dividend-paying stocks and income-producing securities, such as bonds.

Index

A collection of generally like-minded investments. Examples include: Dow Jones Industrial Average, NASDAQ Composite, S&P 500, and Wilshire 5000.

Dow Jones Industrial Average

An index of 30 stocks chosen by editors of The Wall Street Journal that are generally representative of the market. It is the oldest and most famous index.

NASDAQ

The Nasdaq Composite is a stock market index of the common stocks listed on the NASDAQ stock market, meaning it has over 3,000 components. It is highly followed in the U.S. as an indicator of the performance of stocks of technology companies and growth companies.

S&P 500

A kind of funny name for an index made up of the 500 most held stocks in the United States. Generally made up of the biggest American companies such as Apple Inc., Exxon Mobile Corp., and General Electric.

Wilshire 5000

Is an index of the market value of all stocks actively traded in the United States. Also know as the Wilshire 5000 Total Market Index.

Diversification

Essentially this means: "Don't put all of your eggs in one basket." It is the process of spreading your investments across a variety of asset classes (bond, stocks, cash) and within asset classes (small, medium and large company stocks) to reduce risk. Not all investments move in the same direction.

Active Mutual Fund Management vs. Passive Mutual Fund Management

Most mutual funds are actively managed. This means the manager (or team of managers) selects investments believed to be appropriate. Some mutual funds, however, are passively managed. This is also know as index investing or passive investing. These mutual funds simply make purchases that mirror investment benchmarks like the S&P 500 and the Wilshire 5000. Index funds are known for their low operating costs.

Dollar Cost Averaging

Buying a set dollar amount of an investment at regular intervals.

Beta

A measure of a fund's sensitivity to market movements. The beta of the market is 1.00 by definition.

References

Books

Teach and Retire Rich, by Dan Otter, Ph.D.

The Money Book for the Young, Fabulous & Broke, by Suze Orman

Mutual Funds for Dummies, by Eric Tyson

The Total Money Makeover: A Proven Plan for Financial Fitness, by Dave Ramsey

Morningstar Guide to Mutual Funds: 5-Star Strategies for Success, by Christine Benz, Peter DiTeresa and Russel Kinnel

Start Late, Finish Rich: A No-Fail Plan for Achieving Financial Freedom at Any Age, by David Bach

Websites

www.403bwise.com

www.financialengines.com

www.kiplinger.com/fronts/channels/retirement/index.html

http://money.msn.com/retirement

http://www.morningstar.com/cover/invest-in-retirement.aspx

www.fool.com/retirement/index.aspx

www.smartmoney.com/retirement

www.401khelpcenter.com

www.401k.com

http://quicken.intuit.com/

www.troweprice.com