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Economic Shifts Bring New Pitfalls And Prizes

Prepare yourself for a bumpy ride. As the new year dawned, most economists still expected the United States to avoid a recession in 2008. But then the stock market began a persistent downward slide, housing news kept getting worse, and America's economic woes seemed to spread around the globe. Add in the unpredictability of the presidential election and you have an equation that almost guarantees investors a turbulent year.

Consider these recent developments.

- The housing market remains in a tailspin. Faced with sluggish sales, sellers have been forced to slash their prices or take their homes off the market. With the current glut of homes, most experts don't expect much improvement before 2009.
- The subprime mortgage crisis hasn't abated, and major financial institutions continue to write down bad debt. Some estimate the total cost at over $100 billion.
- The price of oil cracked the $100-a-barrel threshold, and gas prices could soar to $4 a gallon or more this summer.
- In 2007, the dollar suffered through its worst year since 2003, falling by about 9% against other major currencies. Low interest rates, a credit crunch, and related economic worries have kept foreign investors at bay.
- The Dow Jones Industrial Average set a record last year, but then suffered two of its biggest-ever daily point drops and slipped below 12,000 during January.

It's impossible to know what the next months will bring. Steep interest rate cuts and an economic stimulus package may eventually get the economy out of its doldrums, and investment markets could bottom out and begin a comeback. But an extremely tough year is equally possible.

What's an investor to do? These seven ideas could help keep you moving toward your financial goals.

1. Diversify, diversify, diversify. Now is not the time for big bets on asset classes or sectors. Instead, use a broad mix of investments to reduce downside risk.

2. Review your asset allocation. Even if you started out with a diversified portfolio, the recent market turmoil may have pushed it out of balance. For example, emerging markets have been outperforming other stocks, and what was once a relatively small allocation to these investments may have grown to a much larger share of your overall holdings. You should sell some of those stocks or funds to reduce risk and get back to your original portfolio weightings.

3. Investigate refinancing your mortgage. Don't be scared off by the mortgage crisis if you qualify for a lower rate through a reputable lender. You could use some of your savings to pay off your new loan ahead of schedule.

4. Shore up your cash reserve. If you squirrel away enough cash, you'll be able to weather an economic storm or pounce when a good financial opportunity arises. You should set aside enough to last from three to six months, but more if you're self employed or feel your job is vulnerable.

5. Prepare your bonds for uncertain times. Questions about the economy, interest rates, and inflation could mean a volatile year for fixed-income investments. Creating

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Spending And Saving

Summer is generally a time that many families plan vacations with their loved ones. With the current turbulent economic environment, many people wonder how much they should spend for their vacation. Rising prices for oil, food and other essentials can make this a difficult process. These issues may also bring to mind current spending habits, how much can or should be saved, and how to increase assets when planning for retirement. Some people have a formal budget and use a computer to track cash flow. Others handwrite figures on paper or prefer to keep track of what they spend and save in their head. No matter which method you favor, the key to budgeting is establishing how you spend or save your cash. If you have considered evaluating your level of debt, expanding your standard of living or eliminating negative cash flow, a serious look at your budget may be what is in order. We hope the articles in this issue of our newsletter stimulate your thoughts about your own financial plan. Please feel free to call us if you would like assistance evaluating your financial condition, budgeting or addressing any concerns that you may have.

Horace

Rolling Over A 401(k) To A Non-Spouse

If you participate in a 401(k) or other employer plan, you have to designate who receives the assets when you die. Typically, you'll name your spouse, though you might also choose a child, grandchild, or favorite niece or nephew. You can also decide to spread the wealth by designating multiple beneficiaries. Yet while the choice is yours, keep in mind that it could have tax implications.

In the not-so-distant past, tax rules clearly favored spousal beneficiaries. Then as now, a spouse could roll over inherited funds tax-free into his or her own IRA, and required minimum distributions (RMDs) would be based on that person's life expectancy. Until a recent rule change, though, anyone other than a spouse who inherited the account had much less palatable choices. Non-spouses had to take an immediate lump-sum distribution, often resulting in a massive tax bill, or empty out the account within five years, which was only slightly less punishing.

But then came the Pension Protection Act of 2006 (PPA). It lets a non-spouse roll over funds from the decedent's account, much as a spouse would, although there are a few extra wrinkles.

Initially, the IRS interpreted the PPA provision to mean that a non-spouse beneficiary who inherited a 401(k) could roll it over only if the plan sponsor agreed to accommodate the transfer. That's not what Congress had intended, though, and the IRS has

acknowledged this by indicating that all plan sponsors must provide this option to non-spouse beneficiaries, effective January 1, 2008.

However, calling the post-death transfer of funds a rollover is a bit of a misnomer. It is actually a transfer from one account to another that must remain titled in the name of the decedent. For instance, suppose that Jack Hill inherits an account from his aunt Jill. The name on the IRA should read, "Jack Hill as beneficiary of Jill Hill." In contrast, if Jack had been Jill's spouse, the IRA could have been titled as if he had owned it all along.

More significantly, the asset switch must be a direct "trustee-to-trustee" transfer. A non-spouse beneficiary can't touch the funds or take 60 days to redeposit them in an IRA the way a spousal beneficiary could. Also unlike a spousal heir, a non-spouse can't move the cash into an existing IRA. The funds must be deposited in a new IRA set up for this purpose. Finally, a non-spouse beneficiary can't wait until age 70½ to begin taking RMDs. This option is still available only to spousal beneficiaries.

Despite these restrictions, non-spouse beneficiaries get a huge lift from the PPA. For example, if you've named your 50-year-old child as a beneficiary, he or she should be able to stretch out withdrawals from the account based on a life expectancy of 34 years, according to IRS-approved tables. That's a whole lot better than a forced five-year withdrawal.

The exact calculation depends on whether the IRA owner had started receiving RMDs before death. This is a complex area of tax law. But we are here to help you ensure that your heirs get the full benefit of your generosity. ●

Who Would Pay Your Bills, If You Were To Become Disabled?

What would happen to you if you became disabled or incapable of caring for your financial affairs? Who would pay your bills? Who would make crucial estate planning decisions? Who would execute trusts and make other important financial choices on your behalf?

If you don't have answers to those questions, you need to know about a legal instrument called a durable power of attorney, or DPOA. Establishing a DPOA probably isn't as high on your must-do list as, say, writing a will. But the DPOA may be even more important. While a will can help your loved ones after you're gone, you may need a DPOA when you're alive and most vulnerable.

Creating a DPOA is generally a job for an attorney, who can write your will and health-care proxy at the same time. A DPOA is similar to a health-care proxy in that both give someone you trust the right to make decisions for you under circumstances that you specify.

Some states permit two types of DPOA: a "springing" power of attorney that becomes effective only when you become incapacitated, and a "general" power that is effective the moment you sign it—even if you are in good health. Some people, who balk at the idea of giving even a trusted friend carte blanche to make financial decisions, may favor a springing power. With a springing power, however, if you are in a car accident or otherwise suddenly become incapacitated, a doctor must certify that you aren't able to make your own decisions. And physicians are sometimes reluctant to do that for fear of becoming enmeshed in a family struggle for your assets.

To solve this problem, you could establish a durable power that names two agents and requires them to act

Succession Planning For Solo Businesses

You are your company, from CEO to receptionist. While that keeps costs low and affords considerable operating flexibility, flying solo makes succession planning problematic at best. There is no "& Son" in the company name to suggest who will take the reins when you retire, and you have no employees to buy the business from you. When you leave your business, it may cease to exist.

That's not what you want to happen, of course. You'd like your company to have value beyond your involvement in it, so you can translate years of hard work into a sizeable asset for retirement and your estate. That's what succession planning can achieve. With a good plan in place, your business can give you (or your estate) one last payout.

A simple sale of a solo business, however, can be difficult to arrange and may yield a selling price far below what you believe the company is worth. Buyers may be skittish, worried that your clients won't stick around—particularly if your business revolves around a personality-driven service relationship.

With foresight, though, you may be able to sell for a good price. One option is to make a deal a few years before you retire, offering to stay on board to effect an orderly transition with your clients. The more clients you are able to retain for the new owner, the higher the price is likely to be.

Another possibility is to take on a partner who will agree to buy you out when you're ready to leave. That way, the partner has a chance to get to know the clients and should be able to keep most of them after you're gone. From the clients' point of view, they're getting a known entity, and that should be preferable to starting over with a stranger.

Engaging a partner also gives you more flexibility about how and when you retire. You might simply want to say farewell at a specified time, or you could prefer to ease out of the business gradually. You could spend a few years trimming your full-time commitment to part time, ultimately working with only a few select clients before you retire completely. Such an arrangement should maximize client retention and give you a few extra years of income. If your partner agrees, you could even retain a small, passive stake in the company after retirement, giving yourself an ongoing stream of income and providing your heirs a nice payout when the partner buys back your stake.

Sometimes, though, death or disability makes an orderly exit impossible. The need for a quick sale, with little or no transition for your clients, can obliterate the value of your business. But even in these situations, it's often feasible to extract some value—and the better your succession plan, the higher the price you or your heirs are likely to get.

If you become disabled and have a short- or long-term disability policy to provide some income, you'll have more options than if you must sell immediately. You might hire someone to fill in temporarily, and depending on the severity of your disability, you may be able to stay involved with the business to some degree while you search for a buyer. Chances are, you'll have to accept less than full value for the company, but you shouldn't have to give it away.

In the case of death or total disability, the task of finding a buyer will fall to your heirs. You can help them now by creating a written succession plan. Make sure it includes:

- A list of likely buyers (talk to them first, if possible)
- Instructions about how to handle records, equipment, and sensitive information
- The names of advisors (attorneys, bank representatives, accountants, and financial advisors) who can assist with the sale
- A letter for your clients explaining the situation and endorsing the buyer as your successor

This succession plan should be as clear and direct as possible, and it should be backed up by an up-to-date will to facilitate a smoother sale. Your heirs will be grieving and distracted, and your succession plan can help them cope with the sale of your business during an emotional time.

Planned or unplanned, the sale of a "single shingle" business is seldom simple and lucrative. But thinking now about how your company might be passed along at your retirement or death can help ensure the best possible outcome for your heirs, the buyer, your clients, and even the business itself. ●

If You're Not Sure, Here's An Idea

jointly on your behalf. Putting your financial decision-making in the hands of two people you trust should eliminate any fear of wrongdoing.

You could write a DPOA yourself, using software or forms available in an office supply store. However, the boilerplate language of do-it-yourself solutions may not cover all of the situations that your document should address. For instance, your DPOA could allow your agent to make gifts of your assets to family members if you become incapacitated. Such gifts or transfers to a trust could allow you to qualify for government assistance in a nursing home without first having to deplete all your assets. Even if you are married, your spouse can make decisions only about assets that you hold jointly. A DPOA could allow your spouse or another agent to manage the assets that aren't held jointly.

These days, with life expectancies lengthening and Alzheimer's Disease on the rise, DPOAs have become an essential financial planning document. And they are not just for the old or infirm. A DPOA can protect anyone who becomes suddenly disabled or incompetent, even if just for a temporary period. ●

Don’t Bet Farm On Financial Calculators

Financial calculators, found everywhere on the Web, can be helpful planning tools. But different calculators may produce markedly different results, depending on the assumptions and defaults built into them. While these online calculators are okay to use as a guide, it’s a little scary to think that some people actually rely on these tools to plan anything as important as their retirement finances.

For example, suppose a 45-year-old husband and wife want to determine how much they’ll save by retirement at age 65. They have a combined annual income of $130,000 and savings of $350,000 in their employee retirement plans, with half the assets in stocks, 35% in bonds, and 15% in cash equivalents. Both plan to continue making 10% annual 401(k) contributions.

Enter these assumptions into one popular online calculator and you get a projection of $1.45 million in retirement assets. But type the same numbers into another calculator, and the couple’s nest egg grows dramatically, to $1.925 million. Because they assume different rates of return, inflation, taxes, and other variables, the two calculators project drastically different outcomes. For instance, the calculator with the higher result anticipates 3% annual pay raises, whereas the other doesn’t factor in salary increases. The calculator providing the lower estimate assumes a 31% combined federal and state tax rate, whereas the other calculator takes into account only a 25% federal rate.

And the differences matter. Assuming a withdrawal rate of 4% during retirement, that $1.925 million would provide $77,000 annually, whereas the $1.45 million would mean yearly income of only $58,000.

Which brings us to the problem of making realistic assumptions. Economists are hard-pressed to predict inflation and interest rates a year in advance, so how can you know what will happen in 10, 20, or 30 years? To calculate investment returns, you can use historical averages, but those are only educated guesses—and a miss by a few percentage points either way could compound into a mammoth error.

Still, the ballpark estimates you get from most online calculators could be useful as a first step when planning how to pay off debt, save for your children’s education, or invest for other long-range goals. You may be able to change some of a calculator’s assumptions, substituting other, perhaps more realistic numbers for return projections, inflation, and other variables. And to get a better idea of likely outcomes, you could rerun calculations several times with different variables. For example, if a calculator lets you assume different inflation rates, you might test the impact of rates varying from 2% to 6%, keeping in mind that the very low inflation of the past few years is well below historical averages.

Monte Carlo analysis software takes exactly that approach, instantly considering a multitude of assumptions and scenarios and providing a percentage probability of success rather than a specific outcome. But there are few online Monte Carlo calculators, and in any case, planning your retirement and the rest of your financial future is much too important to entrust to simple Web tools. ●

Economic Shifts

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a bond ladder[1], a strategy in which you buy bonds with different maturities and reinvest at prevailing rates when short-term holdings mature, will help you minimize risks, but may not be ideal while interest rates remain low. In this environment, favor short-term bonds for more upside, less volatility, and less inflation risk than long-term bonds.

Be sure to examine bond holdings for hidden risks like mortgage-backed securities, bonds issued by shaky financial institutions, or paper that has been or is more likely to be downgraded. Even money market funds may now exhibit new risks.

6. Consider joining the gold rush. In late 2007, gold prices reached their highest level since the gold boom of 1980, and many experts expect a further rise. Investors typically turn to gold as a hedge against a weak dollar and rising inflation, but until recently, buying bullion or gold coins meant also having to pay storage and transportation fees. Now, exchange-traded funds[2] enable you to own gold without the hassle. Remember, the price of gold can be volatile and has already appreciated significantly. It is a good idea to wait for a price dip to buy, and limit your gold investment to a small percentage of your holdings. Diversified commodity funds are a less-risky alternative to buying gold directly.

7. Maximize tax benefits. This may be a year when some market losses are inevitable, but you can use them to help keep your tax bill in check. Capital gains and losses cancel each other out for tax purposes, and, if you lose more than you gain, you can use the excess to offset up to $3,000 of ordinary income in 2008.

We’re ready to help you with strategies that could turn a bad year to your advantage. If you’re nervous about the economic outlook and wonder whether you’re on track to reach your financial goals, please give us a call. ●

1. All bonds, including Treasury bonds, fluctuate in value day-to-day. If sold prior to maturity, they may be worth more, less, or the same as your original investment.

2. You should consider an Exchange Trades Fund’s investment objectives, risks, charges, and expenses carefully before you invest. The fund’s prospectus contains this and other information about the fund and should be read carefully before investing. A prospectus may be obtained from your advisor or from the fund company directly.

Horace C. Gordon, IV, CPA/PFS, CFP® Gordon & Associates Financial Advisors, Inc. 2907 W. Bay to Bay Blvd, Suite 104B, Tampa FL 33629
Phone: (813) 289-9877 Fax: (813) 289-9878 email: hgordon4@gafainc.com

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