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COMPREHENSIVE FINANCIAL SOLUTIONS™



DEAN ZAYED

JD, LL.M., CFP®

SR. FINANCIAL ADVISOR

1751 S. NAPERVILLE RD.
SUITE 203
WHEATON, IL 60189



(630) 665-4848 x12 • FAX: (630) 665-4343

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PRIZM PERSPECTIVE

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What's Going on with Muni Bonds?

Traditionally, municipal bonds have been relatively safe investments. Over the past couple of years, however, that market has been extremely volatile, due to several factors:

Credit ratings of bond insurers have been downgraded. Historically, the municipal bond market has experienced very few defaults, making their credit quality relatively high.

However, a significant portion of municipal bond investors are individuals, who wanted added assurance that these investments were safe. Thus, in the late 1980s, insurance companies started issuing municipal bond insurance, which grew significantly in popularity. The bond issuer purchases the insurance when the bonds are brought to market, with the insurance company committing to make timely

payment of principal and interest in the event of the bond issuer's default. When the bonds are insured, the bond receives the same rating as the insurance company's rating.

Initially, insurance companies only provided insurance for municipal bonds, but then they started insuring taxable bonds as well. Some of that debt was tied to subprime mortgages, which caused problems for the insurance companies. Due to sizable losses from the subprime mortgage products, the ratings of several insurance companies were downgraded, causing the downgrading of ratings of underlying municipal bonds. Typically, most of the insured bonds are investment-grade quality, even without the benefit of the insurance. However, many municipal bonds are trading based on the underlying rating of the bond or even lower, with no consideration given for the insurance.

Auctions for auction-rate bonds started to fail. Auction-rate municipal bonds are long-term bonds with maturities of 10 to 30 years that have a floating interest rate. Every seven to 28 days, the bond underwriter holds an auction to reset the interest rate. The auction is a Dutch auction, which means that the interest rate is reset at the lowest rate that results in a sale of all the bonds. For issuers, they are basically issuing long-term bonds at short-term rates. Investors receive a highly liquid bond that can be sold in

Using a Bond Ladder

A bond ladder is a portfolio of bonds of similar amounts that mature in several different years. For instance, a \$100,000 portfolio might consist of 10 different bonds of \$10,000 each, maturing in 10 consecutive years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date.

By spreading out maturity dates, the effects of interest rate changes are lessened. Since the bonds are held until maturity, changing interest rates don't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at the higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest.

When designing a bond ladder, decide on an average maturity date, which could be five, 10, or even 20 years, depending on your financial needs. There should be enough "rungs" on the ladder for principal to mature every year or two. If the rungs mature in longer than two-year increments, you might miss interest rate changes. Consistently follow your plan by automatically reinvesting principal at the longest maturity date.

You can also set maturity dates in your ladder to coincide with a specific financial need. For instance, a bond ladder might mature in each of four consecutive years while your child is in college, allowing you to pay college costs with maturing principal. ○○○

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Muni Bonds

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an upcoming auction, while earning interest rates slightly higher than money market rates. If there are not enough bids to complete the auction, the sellers are not able to sell their bonds, but they receive a predetermined penalty interest rate. Traditionally, if there were not enough buyers, the underwriter would step in and purchase the bonds. In January 2008, an auction failed because the underwriter would not step in. After that, auction failures became widespread, putting further pressure on municipal bonds.

Many institutional investors sold their muni bonds. Some institutional investors had to sell muni bonds because their ratings had dropped below allowable limits. Of more consequence, however, was the fact that billions of dollars of municipal bonds were sold by hedge funds to meet margin calls. Troubled banks, brokers, and insurance companies have also sold massive amounts of muni bonds to raise cash. The end result has been that there are more sellers than buyers.

What Is the Current Situation?

Historically, municipal bonds have yielded less than Treasury securities, because their income is exempt from federal income taxes and possibly state and local income taxes. The ratio of yields between the two securities has varied over time, depending on prevailing interest rates and tax rates. For individual investors, the attractiveness of municipal bonds is highly dependent on their individual tax bracket. Municipal bonds with maturities of 10 years or more have typically yielded between 80% and 90% of Treasury bonds.

Over the past several months, it has not been uncommon to see ratios of 150% to 300%, meaning that the interest rates on municipal bonds are substantially higher than Treasury securities, despite the income tax advantages. Currently, interest rates

as of April 24, 2009, are:

Maturity	Treasury	Municipal Bond Yields			
	Yields	AAA	AA	A	BAA
1 year	0.50	0.97	1.25	1.88	2.47
5 years	1.96	2.12	2.40	3.06	3.71
10 years	3.03	3.23	3.60	4.33	5.00
20 years	3.99	4.66	5.05	5.76	6.46
30 years	3.89	5.04	5.42	6.16	6.87
% of Treasury yields					
1 year		194%	250%	376%	494%
5 years		108%	122%	156%	189%
10 years		107%	119%	143%	165%
20 years		117%	127%	144%	162%
30 years		130%	139%	158%	177%

Sources: *Federal Reserve Statistical Release*, April 27, 2009, and *The Bond Buyer*, April 27, 2009.

Should You Invest in Municipal Bonds?

By historical measures, municipal bonds are very cheap compared to Treasury securities. On a tax-equivalent basis, assuming you are in the 25% tax bracket, a AAA-rated 10-year municipal bond is yielding 4.31% compared to 3.03% for a 10-year Treasury security. But

does that mean that you should purchase them?

The municipal bond market has become very volatile over the past couple of years, and no one knows when or even if it will return to normal levels. However, if the current situation corrects itself and the ratio between Treasuries and munis goes back to more traditional levels, purchasing now makes sense. Also, if income tax rates increase, current yields will be even more attractive.

If you purchase individual municipal bonds and hold them to maturity, then you do not have to worry about changes in principal value. You will receive all of your principal when the bond matures. And at this point in time, the yields of even the highest quality municipal bonds are attractive. If you'd like to discuss this in more detail, please call. ○○○

Get Your Finances in Order

Before worrying about investing, you should get your finances in order. Consider these tips:

- **Have insurance in place for all major risks.** At a minimum, make sure you're adequately insured for life, health, disability, long-term care, homeowners, automobile, and personal liability.
- **Pay off your credit card debts.** If you're struggling to pay credit card debts, it's unlikely you'll have much additional cash for investing purposes. Also, you are unlikely to find better guaranteed returns than you get from paying off these debts.
- **Establish an emergency cash reserve.** This will give you funds to deal with short-term emergencies, such as a temporary job loss, a short-term disability, a major home repair, or a large medical bill. How much

you need in that reserve will depend on your age, health, job outlook, and ability to borrow.

- **Take advantage of matching contributions in your 401(k) plan.** Make sure to contribute enough to your 401(k) plan to take advantage of all employer matching contributions. When you do not contribute, you simply lose that money. Additionally, your contributions are made from pretax dollars, with earnings accumulating on a tax-deferred basis.
- **Establish financial goals based on your time horizon for investing.** Thoroughly evaluate your financial goals and how long it will take to reach them. The answers will significantly impact your investment decisions and will ensure that your investments are compatible with your financial goals. ○○○

Assisting Your Parents with Their Finances

Discussing financial matters with your parents can be difficult. You don't want to seem concerned about how much money they may eventually leave you, while they may fear you are interfering in their lives. Yet, without discussing these matters beforehand, you may have trouble finding financial records or determining their wishes if you need to take over their finances. Consider discussing financial matters with your parents when they are in their early 60s, making sure to cover the following:

- **Where are personal records kept?** You don't need to know specifics, but you should find out where important records are located.
- **Who are their advisers?** Ask for a list with names, addresses, and phone numbers of all advisers and physicians. Get details about medical conditions and medications being taken.
- **What are their monthly income and expenses?** This will help you determine whether they have sufficient income to pay bills. If they don't, you may be able to help them change investment selections or find ways to increase income.
- **Do they have adequate insurance?** Make sure your parents have adequate insurance coverage and have made provisions for long-term-care needs. Have them investigate long-term-care insurance when they are still healthy and young enough to qualify for reasonable premiums.
- **Do they have up-to-date estate planning documents?** Don't ask for specifics, just make sure documents are in place so their wishes can be carried out. Find out if they have a durable power of attorney and health care proxy. With a durable power of attorney,

they designate someone to control their financial affairs if they become incapacitated. If your parents are concerned that this person may assume control prematurely, suggest leaving the document with their attorney, who can deliver it to the appropriate person when necessary. A health care proxy delegates health care decisions to a third person when your parent is unable to make those decisions. Usually, this document also outlines procedures to be used to prolong life.

- **What are their preferences for the future?** Find out where your parents would like to live if they're not physically able to live in their current home. Do they want to

move in with relatives or live in an assisted-living facility? Discuss in detail what procedures they want performed to prolong life in the event of a terminal illness. Determine their preferences for funeral arrangements.

While these topics are sometimes not easy to discuss, they are important to know in case you need to help your parents with their financial matters. ○○○



Rolling Over to a 401(k) Plan

If your 401(k) plan permits, you can roll over balances from a traditional individual retirement account (IRA), but not a Roth IRA, to a 401(k) plan. To qualify as a tax-free rollover, the balance must be rolled over to a 401(k) plan for the same person who owns the IRA, the balance must be rolled over within 60 days, and the maximum amount rolled over cannot exceed amounts that would be included in gross income if not rolled over. Thus, contributions to nondeductible IRAs cannot be rolled over, but contributions to deductible IRAs and all earnings in both types of IRAs can be rolled over. Also, any required minimum distributions for the year cannot be rolled over.

Why would you want to roll over these balances to a 401(k) plan? By doing so, you can utilize one of these strategies:

- After rollover, you could withdraw any remaining funds in your traditional IRA free of taxes or penalties, since only nondeductible contributions would be

left in the IRA. If you withdrew funds before the rollover, a pro-rata share of the withdrawal would be subject to income taxes and possibly the 10% federal tax penalty.

- If your income is under \$100,000 in 2009, you could convert the remaining funds in your traditional IRA to a Roth IRA with no tax cost. Again, since the IRA only contains nondeductible contributions, there would be no income taxes associated with the conversion. Also keep in mind that starting in 2010, there will be no income limitation for Roth IRA conversions.
- Once the funds are rolled over to the 401(k) plan, you could withdraw the funds without penalty at age 55 if your employment is terminated, rather than waiting until age 59 1/2 to withdraw the funds without penalty from the IRA. If permitted by the 401(k) plan, loans can also be taken to gain access to the funds. ○○○

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Should You Contribute to a Roth 401(k)?

Although Roth 401(k) plans became effective on January 1, 2006, they are just now starting to gain momentum. Originally, Roth 401(k)s were scheduled to expire after 2010, so companies were not willing to start a plan that would expire after a few years. However, the Pension Protection Act of 2006 made Roth 401(k)s permanent.

The Roth 401(k) is patterned after the Roth individual retirement account (IRA) — contributions are made from after-tax earnings that grow tax free, and qualified distributions are withdrawn tax free. Here are the basics, including how Roth 401(k)s differ from Roth IRAs:

- **Eligibility** — Employees eligible for their employer's 401(k) plan are also eligible for the Roth 401(k). There are no income limitations for contributions to a Roth



401(k). With a Roth IRA, single taxpayers with modified adjusted gross income (AGI) less than \$105,000 and married taxpayers filing jointly with modified AGI less than \$166,000 in 2009 can make contributions, regardless of their participation in a qualified retirement plan. Contributions are phased out for single taxpayers with modified AGI between \$105,000 and \$120,000 and for married taxpayers filing jointly with modified AGI between \$166,000 and \$176,000 in 2009.

- **Contributions** — The contribution limits for the Roth 401(k) are the same as for the regular 401(k) plan. In 2009, you can contribute a maximum of \$16,500 plus a \$5,500 catch-up contribution for those age 50 and over, if permitted by the plan. However, your employer may set lower limits to comply with nondiscrimination rules. Contributions can be split between a regular and Roth 401(k), as long as total contributions do not exceed the maximum. Funds contributed to each type must be held in separate accounts. Any matching contributions made by the employer must be held in the regular 401(k) account, so they will be taxable when withdrawn. In 2009, the contribution limits for a Roth IRA are \$5,000 plus an additional \$1,000 catch-up contri-

bution for individuals age 50 and over. You can make contributions to both a Roth 401(k) and a Roth IRA, as long as you meet the income eligibility rules for the Roth IRA.

- **Required distributions** — With a Roth IRA, you are not required to take distributions during your lifetime. With a Roth 401(k), annual distributions must be taken after age 70 1/2, unless you are still working and are not a 5% or more owner in the company. However, funds in the Roth 401(k) can be rolled over to a Roth IRA, which would not require distributions.
- **Conversions** — Individuals under certain income levels can convert a regular IRA to a Roth IRA, as long as income taxes are paid on the amount that would have been taxable if withdrawn. Starting in 2010, all taxpayers, regardless of income level, can convert a regular IRA to a Roth IRA. There is no provision to convert a regular 401(k) to a Roth 401(k).

Please call if you'd like to discuss the Roth 401(k) in more detail.
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COMPREHENSIVE FINANCIAL SOLUTIONS™
1751 S. NAPERVILLE RD., SUITE 203
WHEATON, IL 60189