Investor Insights & Outlook

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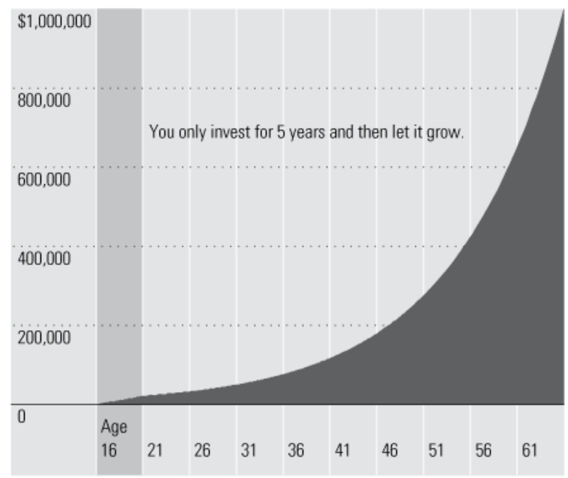
Retirement: The Next Generation

If you had a dollar for every time you heard the phrase "Start investing early," you could retire with a million. If you actually acted on that phrase, you are probably retiring with more. Now is the time to encourage your children and grandchildren to start saving as soon as they get their first job.

Let's assume that your teenage child or grandchild is employed for five years from age 16 to age 21. During this time, he or she saves $277 per month and invests the money in a Roth IRA (paying taxes, but at a low tax bracket). This may be a serious sacrifice for a teenager, so any contribution from you would be of great help. Assuming the money returns the historical equivalent of a diversified 60% stock/40% bond portfolio, your child can retire at 65 with $1 million tax-free, without having to invest another dollar after age 21.

Retiring With $1 Million



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond. An investment cannot be made directly in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs. The diversified portfolio was rebalanced every 12 months. The return used for calculations was the average of 50-year rolling returns for 1926–2010.

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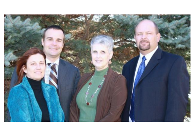

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The Labyrinth of Financial Statements: The Income Statement

Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the income statement.

The income statement shows how much money the company has made (or lost!), how much of that it has spent, and how much it has retained as profit (net income). An income statement begins with the revenue generated from sales and deducts the various expenses to determine the amount of profit or loss.

The first item on an income statement is sales revenue. The table illustrates a hypothetical income statement. Let's say the company sold goods or services worth $100 million. The first expense to deduct is called cost of goods sold (COGS), which represents how much the company has spent on items directly related to what it produced (for example, the cost of raw materials and the salaries of non-managerial employees). If we assume COGS was $70 million, deducting that from revenue leaves us with $30 million. This is called gross margin or gross profit.

From gross margin we deduct general, administrative, and selling expenses. These include the cost of managing the firm (managers' salaries), marketing and distribution costs, rent, heat, electricity, and others. The result after these expenses are deducted is called operating income: $20 million. The firm pays interest on its debt, and interest expense has to be taken into account, which brings us to taxable income. This is the income that is subject to corporate tax. We deduct taxes paid, and the final number we arrive at is net income, or profit: $9.6 million.

Simply put, the income statement can be summarized like this:

Total Sales – Total Expenses = Profit

It is important to remember the income statement displays information on the company's profitability during a certain period of time (a quarter or a year); for example, Coca-Cola's income statement for the year ending Dec. 31, 2010. This is different from the balance sheet, which displays information at a specific point in time.

Hypothetical Income Statement

Sales revenue	**$100**
Cost of goods sold	($70)
Gross margin	**$30**
General, administrative and selling expenses	($10)
Operating income	**$20**
Interest expense	($4)
Taxable income	**$16**
Tax expense	($6.4)
Net income	**$9.6**

All numbers listed above are in millions.

How to Make the Best of a Lousy 401k

Should you even bother investing in a company plan that doesn't measure up? If you're not earning a match on your contributions, your first step should be to consider a Roth IRA—or even a traditional deductible IRA—before steering funds into a company retirement plan that's a stinker. But if you determine that the tax-deferred nature of the company retirement plan offsets the weaknesses therein, it's possible to at least make the most of that subpar plan. Here are some tips if you find yourself in this predicament.

1. Go the index route. Maybe your plan doesn't feature mutual funds managed by topnotch stock-pickers. But if the plan's options include index funds—offerings that track a given market benchmark rather than attempting to beat it—you can obtain broad market exposure at a reasonable cost. Even if the index funds in your plan aren't the best, you're probably still better off going the index route than opting for a lackluster active fund. True, active managers—even the ones with subpar past records—have a shot at beating their benchmark, at least in theory. In practice, however, the active fund's expenses—as well as transaction costs that aren't reflected in its expense ratio—weigh heavily on that manager's ability to beat the benchmark.

2. Take the best and leave the rest. It's natural to want to craft a 401(k) portfolio that's diversified across all of the major asset classes (bonds and U.S. and foreign stocks), but that might not be practical or prudent if your company plan doesn't offer viable options in all of these areas. If your plan features a few standout options and the rest are subpar, load up on the few decent funds and avoid the rest. You can use your IRA, your taxable accounts, or your spouse's retirement plan to delve into the asset classes and investment styles that your own plan lacks.

3. Investigate the brokerage window, but do so with care. Increasingly, 401(k) plans—particularly those from large employers—are offering so-called "brokerage windows," also called "self-directed accounts." If your plan offers such an option, you'll have the opportunity to get into hundreds of other mutual funds, stocks, and even exchange-traded funds that aren't part of your 401(k) plan's preset menu. But before you jump aboard, be sure to read the fine print. You may pay an extra fee to participate in the brokerage window. In addition, you may pay separate transaction costs to buy and sell securities that are part of the brokerage window.

4. Talk to HR. If the employees in your company are grumbling about a subpar retirement plan, let your human resources department know how you feel. You may not be able to enact change overnight, because a lot of factors—not just the quality of investment options—figure into a company's decision to opt for one retirement-plan provider over another. But your employer should still be aware that its benefits package isn't measuring up.

5. Check out other options. If you've determined that your company plan is weak, that means you'll have to make the most of all of the investing options available to you, tax-sheltered and otherwise. Investigate whether you're eligible to contribute to a Roth or other IRA, and plan to max out your spouse's plan if it's better than yours. Also be savvy about investing in your taxable accounts.

Diversification does not eliminate the risk of experiencing investment losses. Stocks are not guaranteed and have been more volatile than bonds.

Handling Sudden Wealth

If you have suddenly come into a large sum of money, whether it's a payout from an inheritance, the lottery, stock options, or a favorable verdict in a lawsuit, there are some important steps that you might want to take.

First and foremost, try to keep your bearings about you. Don't immediately quit your job; avoid any temptations to spend most or all of it on frivolous items. Be on the lookout for crooked financial operators who make offers that seem too good to be true, or friends and family who appear out of the blue with loan requests and business proposals. Don't feel that you have to invest your money right away. There's nothing wrong with letting it sit in the bank while you carefully consider your options.

No matter how you've obtained your windfall, there will be tax consequences. It is highly recommended that you consult with a tax lawyer to make sure you follow the right steps.

Before planning your long-term investment strategy, make sure you've taken care of some immediate needs. Establish an emergency fund (make it three to six months' worth of expenses), and if you've been carrying consumer debt like car loans or big credit-card balances, now's a great time to pay it all off.

Finally, consider how your windfall can serve you for long-term goals such as paying for children's education and your retirement. The questions are many. You might want to consult with a financial planner, who can help you figure out all the complicated variables and options.

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