Steady as You Grow

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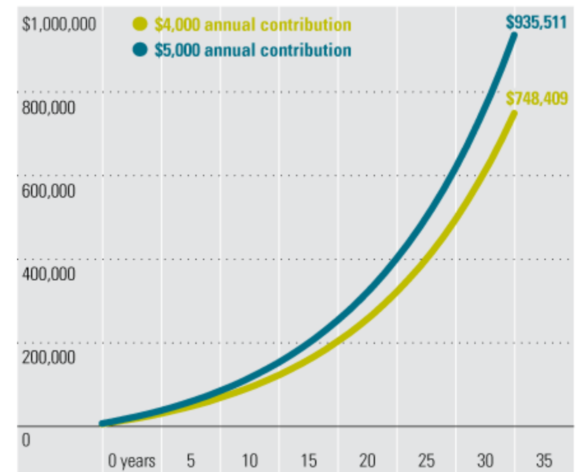
Don't Forget to Raise Your IRA Contribution

In 2012, contribution limits for both traditional and Roth IRAs (individual retirement accounts) will remain the same as in 2011: $5,000 a year for those 49 years of age or younger. If you are 50 or older, the maximum contribution is $6,000. This limit can be split between a traditional and a Roth IRA. These annual contribution limits are imposed by the Federal Government.

The graph shows both a $4,000 and $5,000 annual contribution growing at a hypothetical 8% annual return. Notice the dramatic impact on the ending value of the portfolio. This may be a great time to re-evaluate your financial situation and increase your annual investment to your IRA. Even if you are unable to max out your contribution, any increase you can afford may help you reach your savings goals more easily in the long run.

Hypothetical Growth of Annual IRA Contribution



This is for illustrative purposes only and not indicative of any investment. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free as money withdrawn is not taxed. Penalties may apply for withdrawals prior to the age of 59 1/2.

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Financial Corner

Welcome to our Quarterly Newsletter! We hope you find this newsletter useful and enlightening.

Last quarter we discussed how dividends play an important role in total return, preparing your spouse for financial independence, and the importance of rebalancing. This month we will focus on raising your IRA contributions for 2012, what constitutes a wide-moat company, creating a family budget for those with New Year's resolutions, and what to do with an old 401(k).

We hope you had a wonderful holiday and are looking forward to a prosperous 2012!

What Is an Economic Moat?

Historical data shows that stocks might be the best investment to help you build wealth over time. However, with so many stocks available out there, how do you decide which one to pick? What makes a stock a good or a bad investment? The answer lies in carefully scrutinizing the company.

A company's stock is likely to generate attractive returns if the company outperforms its competitors. The advantage a company builds over its rivals in the marketplace is called competitive advantage. Morningstar has developed a rating to measure this competitive advantage, the "economic moat." There are four main types of economic moats, examined below.

1. Intangible assets: Intangible assets like brands, patents, and regulatory licenses can provide a company with a unique position in the marketplace and a significant advantage over its competitors. A powerful brand like Apple or Nike can bring in more revenue and increase customer retention. Patents are especially important for technology companies and companies in industries where innovation is critical (pharmaceuticals, for example). Regulatory licenses provide a competitive edge in the sense that they can prevent competitors from entering a market.

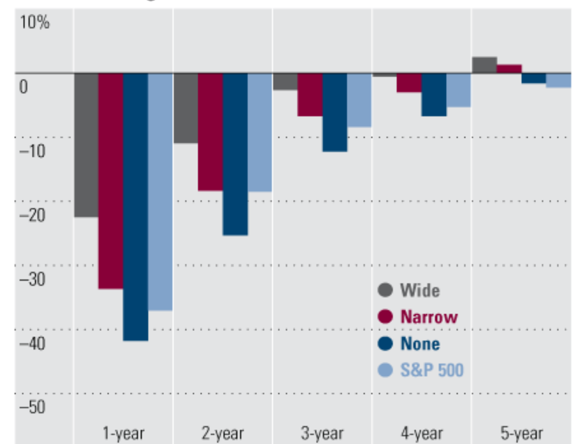
2. High customer switching costs: Basically, if a company makes it difficult (and, ideally, impossible!) for customers to switch to a competitor, that company will have a much easier time growing revenues and expanding. Examples of industries with high switching costs include banks and software companies.

3. The network effect: The network effect is based on the simple premise that the more users a product or service has, the higher its value will be. The most popular example of this type of moat is Microsoft: its success is highly dependent on its enormous user base. In fact, this network effect occurs mainly in businesses based on sharing information and connecting people (eBay is a good example).

4. Cost advantages: This type of competitive advantage is probably the simplest, and yet the most difficult to achieve. Companies can build a cost-based economic moat by improving their business processes (Dell and Southwest Airlines), optimizing their supply chains (Wal-Mart), or by outsourcing in order to reduce labor costs ("made in China," anyone?). Cost-cutting can be a two-edged sword, however, and, once the competitive advantage is achieved, it may prove difficult to maintain.

In Morningstar's database, stocks are assigned an economic moat rating: wide (denoting a strong competitive advantage), narrow (weaker), or none (no competitive advantage). The image shows that wide-moat stocks have outperformed narrow- and no-moat stocks, as well as the S&P 500 index, over the five time periods analyzed.

Total Return by Morningstar Economic Moat Rating, Year-End 2008



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. References to specific securities should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell such securities.

Source: Wide-, narrow- and no-moat stocks from Morningstar. The S&P 500® index is an unmanaged group of securities and considered to be representative of the stock market in general.

Creating a Budget

Creating a budget may seem like a complicated and unnecessary burden for most people, but a budget can be a valuable tool for managing your money. Instead of thinking about it as just another tedious thing to do, think about how a carefully-constructed budget can help you reduce expenses and optimize the way you spend.

Why do you need a budget? First of all, income does not always equal expenses. A budget is a resource-management tool that can help you achieve your long-term financial objectives, for example, saving more in order to meet retirement goals, freeing up monthly cash flow in order to pay down debt, or simply reducing expenses. Think about the budget simply as a plan for what you're going to do with your money. Here are a few guidelines to help you get started.

1. Track your income and expenses. In order to begin building a realistic budget, you'll need to track your revenue and expenses for at least a month or two. Start by writing out any sums of money that you receive and spend. If you have multiple sources of income, make sure to take all of them into account. For expenses, it may help to list them in order of magnitude. You can even create various categories if it helps you stay organized. The largest expense is probably your mortgage or rent. Then you have utilities (water, heat, electricity), auto expenses (car payment, insurance, gas, maintenance), food, medical/dental expenses (insurance, prescriptions), and so on. The important thing here is not to forget the little expenses. For example, if you go out for lunch, buy a magazine to read on the train, or go out for coffee with your coworkers, these expenses, however insignificant they may seem, need to be included in your budget. They say a small leak can sink a great ship; similarly, a few dollars here and there can add up faster than you think.

2. Start planning ahead. Once you have tracked your income and expenses for awhile, you should have a pretty good idea of where your money comes from and where it goes on a monthly basis. However, some expenses do not happen regularly, and you still need to be prepared for these eventualities. If you anticipate these expenses and include them in your budget, you can plan accordingly without breaking the bank. Some examples of such overlooked expenses are holiday gifts, emergency car repairs, and travel or vacations.

Now you are ready to create your budget. Based on the income and expenses you tracked during the past few months, write down what you expect your income and expenses to be next month, or for the next few months. Try to be as realistic as possible; your budget should reflect your actual financial situation, not your ideal one.

3. Stick to your budget. Creating your budget will be easy compared with sticking to it. It's not a disaster if you spend a few extra dollars here and there, but in next month's budget you should account for them. The budget is a plan, an estimate, but it is in your interest to keep this estimate as accurate as possible. Also, if you notice unusually large expenses where there shouldn't be any, now is the time to adjust them. Keep in mind that your budget should change as your financial situation changes, so monitor it regularly and make changes when necessary.

Eventually, a budget is supposed to teach financial discipline and the difference between necessity and luxury. You may be surprised to find out how much money flies out of your pocket for things you don't need and therefore will not use. It may seem that sticking to your budget means making many sacrifices, but ultimately it's your financial future that you're building.

The Rollover IRA, Taking It With You

One of the most convenient and flexible options for dealing with a retirement plan from your ex-employer is to transfer the money to a Rollover Individual Retirement Account. A Rollover IRA is, in essence, a traditional IRA where you can park the cash you're transferring from your old employer's retirement account. The money you invest in a Rollover IRA accumulates tax-free until you take it out in retirement, just as it does in a defined-contribution retirement plan (401k). You can open a Rollover IRA with just about any investment firm, including mutual fund companies, insurance companies, and online brokers. You're allowed to invest the money in stocks, mutual funds, bonds, and other types of investments. That's why the Rollover IRA is your most flexible choice when leaving a job.

You have a number of options after you open your Rollover IRA, too. Of course, you can leave it alone until you retire. But if you move on to a new job, you may be able to transfer the money you have invested in your Rollover IRA into your new employer's retirement plan (assuming the qualified retirement plan has language permitting such rollovers). And if a Roth IRA is more to your liking, you can convert your Rollover IRA into a Roth IRA, if you meet the criteria.

Keep in mind that you can't take a loan from a Rollover IRA as you can from some employer-sponsored retirement plans. Moreover, Rollover IRAs are also subject to the same withdrawal limits as other tax-deferred retirement accounts. So, if you take any money out before you turn 59½, you'll pay a 10% early withdrawal penalty in addition to taxes.

Returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds.

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