

FINANCIAL PLANNING *Outlook*



JANUARY 2012

A Turbulent Year in Review

One of the most interesting things about investing is the long-term disconnect between world events and the behavior of investment markets. Every day, we hear that the markets went up or down as a result of this or that dramatic event or piece of economic data in the news. But if Rip Van Investor had fallen asleep at the start of the 20th century, and woke up with a yawn 100 years later at midnight, December, 1999, he would have been startled to see that his investment in the S&P 500 had gained more than 10% a year, on average, during his 100-year nap. He might fairly have concluded that he'd slept through ten decades of happiness, sunny economic climate and smooth sailing, when in fact the century included two horrible world wars, the Great Depression, the Cold War, the disastrous war in Vietnam, stagflation, a presidential assassination, impeachment hearings, the rise of global terrorism and truly disturbing social trends like reality TV.

2011 proved to be a microcosm example of this odd-but-important investing lesson. If you had gone to sleep on January 1, woke up on December 31 and immediately checked your U.S. stock portfolio, you would have seen



the most boring possible outcome: stocks basically unchanged for the year. The Standard & Poor's 500 index finished the year exactly 0.04 points below its level prior to the opening bell on January 1, 2011. That translates to almost exactly a 0% total return. Add in dividends, and the total return came to 2.11%.

The broad-based Wilshire 5000 index rose 0.98% for the year, while the Russell 3000 was up 1.03%. Larger stocks generally fared better than smaller ones. The Wilshire U.S. large cap index went up 1.59%, and the Russell 1000 gained 1.50%. Wilshire's U.S. midcap index fell 1.52% during 2011; the Russell midcap index was down 1.55%. The Wilshire U.S. smallcap index dropped 3.40%, while the comparable Russell 2000 was down 4.18%. Performance in the technology and commodities markets were also mundane; the Nasdaq composite index fell 1.8% during calendar 2011, and the Standard & Poor's GSCI commodities index was down 1.18%

That means it was a boring, uneventful year for investors—right?

In fact, this less-than-inspiring stock market performance was achieved in the

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most exciting possible way. Remember August, when the average spread between the highs and lows on the S&P 500, per day, was an astonishing 3.39%? Remember all the political bickering over raising the U.S. debt ceiling, when we worried that the United States government was teetering on the brink of default? Or how the S&P credit evaluators stripped the nation of its AAA rating? Yet somehow, despite the best efforts of our politicians, a broad index of U.S. government bonds gained 9.6% for the year. All year long, we heard one gloomy report after another on housing and real estate, yet the Wilshire REIT index gained 9.24% for the year.

In 2011, we watched the European Union teeter on the edge of collapse, the sovereign debt contagion spreading from Greece to Spain and (gulp!) Italy. Yet the international EAFE index of developed foreign markets closed the year with a quarterly gain of 2.86%, cutting an international investor’s losses down to 14.82% in dollar terms. (EAFE’s emerging markets index, the trendy investment choice for many pundits at the start of the year, was down 20.41% for 2011.)

Amid the Arab Spring uprisings and regime changes in Egypt, Tunisia and Libya, constant tensions over the nuclear program in Iran, the terrible tsunami tragedy leading to a nuclear catastrophe in Japan, and the recent unpredictable regime change in nuclear-armed North Korea, it seemed like every other week there was a reason for investors to believe that the markets would finish 2011 well below their pre-crisis levels.

It’s true that portfolios that held foreign stocks would have shown overall losses for the year. But the bigger picture, here in America, begs an important question: Why is there such a broken connection between tragedy, political turmoil and scary headlines, on

the one side, and market returns on the other? The answer may be that the underlying forces driving our economic growth are more stable than the headlines suggest. Quietly, despite the best (or worst) efforts of Congress, the U.S. unemployment rate has steadily declined from over 10% at the peak down to 8.6% last month, its lowest level in three years. Factory output is rising, consumer spending has been surprisingly strong, and for the first time in decades, the U.S. is a net energy exporter.

Profits, economic growth and jobs are ultimately created by the ingenuity and hard work of millions (or, globally, billions) of people who come to work every day, put their heads down and accomplish the things set before them. Rip Van Investor would have told you that this drive and initiative was the really big story of the 20th century, more important than the incidental wars, recessions and political bickering. All he had to do is see that his horse and buggy had been replaced by a Lexus, the telegraph he wanted to send could be handled via e-mail and the Internet, walk with wonder through skyscraper cities and see the planes overhead outrun the birds in the sky.

The same hidden underlying force that powers the markets has taken the human species from cave dwellings to a modern electronic age that is still, admittedly, far from perfect. World events have gotten more complicated, more interesting, sometimes more disturbing, so much so that it takes a bit of perspective to see the long-term trend behind the scary headlines, behind the dips and swirls of the markets.

The major U.S. market indices avoided a downturn in 2011 after two strong recovery years. Those who bailed out after the market took any of its many tumbles would have risked missing the year’s many improbable, unpredictable recoveries. Rip Van Investor came out all right—and suffered a lot less anxiety than the rest of us. ■

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Do You Know the Best Time to Begin Taking Your Social Security Benefits?

By Clarissa Hobson, CFP®



Many people minimize or discount the importance of Social Security benefits when it comes to their retirement income planning. In reality, these benefits

represent one of the only streams of lifetime income available with a built-in cost of living adjustment. In addition, Social Security benefits come with rights of survivorship, which means that when one spouse dies, the other spouse can continue to receive the higher of the two benefits until they die. The value of this benefit can be tremendous, and proper planning can help ensure that you don't make common errors such as:

- leaving money on the table,
- failing to coordinate IRA required minimum distributions with Social Security taxation, or
- failing to consider the impact of marriage, divorce, remarriage or widowhood, each of which can dramatically impact your income stream.

To provide an example of how significant the value of Social Security benefits can be, in 2008 the maximum annual benefit an individual could receive at full retirement age was \$26,220. If an individual were to live an additional 30 years, they would collect more than \$1.2 million in benefits (in-

cluding the annual 2.8% cost-of-living adjustment projected by Social Security trustees). To purchase an immediate annuity that would achieve the same amount of benefits, an individual would likely need to spend over \$500,000 out of pocket, and this wouldn't even include survivor benefits.

In addition, the decision of *when* to begin taking Social Security benefits can be critically important in maximizing benefits received over the long term. Social Security benefits may be claimed as early as age 62, but generally speaking, if you don't need the income from Social Security to live on, or if you are still working, it makes sense to wait to start taking benefits at least until you have reached your full retirement age (which currently ranges between 65 and 67, depending on when you were born). If you choose to take benefits prior to your full benefit age, your benefits will be *permanently* reduced, and the earlier you take benefits, the greater the reduction will be. For example, if benefits are taken at age 62, they will be permanently reduced by 25% for the rest of your life.

However, if you wait to take benefits until after your full benefits age, you'll receive a delayed credit of 8% per year for each year that you delay receiving benefits (up to age 70), as well as cost-of-living adjustments. This means that if your full retirement age is 67, your monthly benefit amount will be

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Social Security benefits represent one of the only streams of lifetime income available with a built-in cost of living adjustment.





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24% higher (plus cost-of-living adjustments) if you wait to receive benefits until age 70. In addition, the annual Social Security Cost of Living Increase (COLI) will be applied to the higher benefit amount, enhancing your benefits even further. As an added benefit, the higher benefit amount also applies to survivor benefits, which can mean significantly improved lifetime survivor coverage for your surviving spouse. This higher lifetime income stream can be critically important, particularly if Social Security benefits will represent a large portion of your retirement income.

For married couples, Social Security planning is more complex than it is for singles. There are a number of factors to consider when deciding when to take benefits including:

- Are both members of the couple eligible for benefits based on their own working record?
- Should both members of the couple claim benefits at the same time, or will they maximize benefits by claiming at different ages (this can be particularly important if there is a significant age difference in the members of the couple)?
- Does it make sense to employ a strategy such as “file and suspend” or “restricting an application” to maximize benefits?

If both members of a couple are eligible to receive benefits based on their own working records, it is helpful to calculate whether each individual should claim their own benefit versus claiming a spousal benefit. For example, if one member of the couple earned significantly more than the other over their working career, it may make more sense for their spouse to

claim a spousal benefit (which would be ½ of the higher earner’s benefit) rather than claiming their own full benefit.

In addition, planning the timing of when each member of the couple claims benefits can be very helpful in maximizing the benefits received over the long term. Sometimes, when both members of a couple are eligible for benefits, they may choose to retire, and/or receive Social Security benefits at the same time, even though it may not be advantageous to do so. Many people are still choosing to receive benefits at age 62, even given the significant, permanent reduction in benefits. Often the argument is made that “benefits could change in the future and I don’t want to miss out or lose benefits by waiting”. Given the number (and the voting power!) of Baby Boomers who will be retiring in the coming decades, I doubt that benefits will change significantly for these individuals. It is more likely that the retirement age will be increased or benefits modified for younger generations. It’s a greater risk to permanently reduce a lifetime of benefits than to make guesses as to what future legislation will entail!

Finally, there are two strategies that can help couples maximize their benefits. These strategies are relatively new, and thus may be unfamiliar to you (and sometimes to members of the Social Security Administration!). The first strategy is known as “file and suspend,” and is often employed when one member of a couple is a significantly higher wage earner than the other. In this strategy, the higher wage earner wants to maximize their benefits by waiting until age 70 to receive them. If their spouse is older than age 62, and thus eligible for benefits, the spouse can choose to claim on their own record, but may prefer to opt for the higher spousal benefit.



The problem is that the lower-earning spouse cannot claim spousal benefits unless the higher-earning spouse has already filed for benefits. The way to work around this issue is that so long as the higher-earning spouse has reached their full benefits age, they can file for benefits; the lower-earning spouse then files for spousal benefits, and then the higher-earning spouse immediately suspends the receipt of their own benefits. This allows the lower-earning spouse to claim a spousal benefit amount that is higher than their own benefit and the higher-earning spouse to continue to accrue credits and ultimately increase their own benefit amount. The impact of this strategy

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becomes even more significant if the higher-earning spouse is the first to die, which results in a higher survivor's benefit for the surviving spouse.

A second strategy for married couples, known as "restricting an application" to a spousal benefit only, and is even less commonly used than "file and suspend". Usually, it is the lower-earning spouse who applies for spousal benefits (as described in the "file and suspend" strategy above), but the higher-earning spouse can also choose to take a spousal benefit temporarily. To utilize this strategy, the higher-earning spouse must have reached their full retirement age, desires to wait to take their own

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benefit until age 70, and also wants to bring in some extra money via a spousal benefit.

In this strategy, the lower-earning spouse claims their own benefit, and then the higher-earning spouse can apply for a spousal benefit. If the lower-earning spouse has not reached full retirement age, their own benefit will be reduced. However, as long as the higher-earning spouse *has* reached full retirement age, they are eligible for ½ of the lower-earning spouse’s *full* benefit amount, not the lower-earning spouse’s reduced benefit amount! At any time until age 70, the higher-earning spouse can switch to their own higher benefit amount, and at that point, the lower-earning spouse may switch to a spousal benefit (al-

though if the lower-earning spouse claimed their benefit early, their spousal benefit will also be reduced. Their survivor benefit will not be reduced, though).

Clearly, the utilization of these strategies can be relatively complex, and the decision of when benefits should be taken is a personal decision based on calculating the outcomes of taking benefits at different times. Single and divorced individuals also need to take care to understand what benefits are available to them, whether they are eligible for spousal or survivor benefits, and to determine when these benefits should be received. The most important thing to remember is that the lifetime value of Social Security benefits can prove to be very significant, and proper planning up front is critical to maximizing these benefits over the long term. ■

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