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THE FINANCIAL FORMULA

Giving You The Financial Information You Need

July 2011

Welcome to the 1st edition of THE FINANCIAL FORMULA! If you have any questions regarding this month's articles, please call or email me - enjoy your newsletter!

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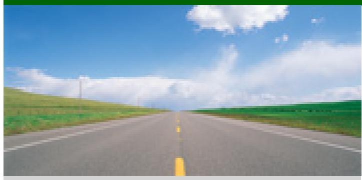

Five Reasons to Make an IRA Part of Your Planning Strategy

IRAs typically give investors access to a wider range of investment options than workplace-sponsored plans, such as a 401(k).

There could be an important tool already in your portfolio that can help you save more for retirement. It's your IRA. Nearly 50 million American households own an IRA, but it is often an overlooked component of most investors' financial planning strategies. In fact, over the past two years, only 15% of households that were eligible to contribute to an IRA did so.[1]

Have you forgotten your IRA? If you don't have one, should it be part of your overall investment plan? Here are some compelling reasons why this vehicle can help you plan for your future.

1. **Tax deferral:** Traditional IRAs allow your investment earnings to grow tax-deferred until withdrawn, typically at retirement. For 2011, the maximum contribution is $5,000, but for those aged 50 and over, the limit is $6,000. The limits are the same for a Roth IRA, but to be eligible to fully contribute, an investor must have a 2011 modified adjusted gross income of less than $107,000 for singles and $169,000 for married couples filing jointly. Singles earning up to $122,000 and couples earning up to $179,000 are eligible for partial contributions.
2. **Deductibility:** If you are a single taxpayer who doesn't participate in an employer-sponsored plan and you earn less than $56,000 in 2011, you can deduct your contributions to a traditional IRA off your income taxes. Couples earning under $90,000 are also eligible for a full deduction. Partial deduction limits also apply, up to $66,000 for singles and $110,000 for couples. Note that Roth IRA contributions are not deductible.
3. **Investment flexibility:** IRAs typically give investors access to a wider range of investment options than workplace-sponsored plans, such as a 401(k). Depending on the financial institution you use to open your account, you can invest in a broad array of mutual funds, ETFs, individual stocks and bonds, CDs, annuities, even commodities and real estate.
4. **Convertibility:** Traditional IRA holders can convert to a Roth IRA to enjoy some of the additional benefits listed below. But before you decide make a switch, be sure to investigate the tax consequences of such a move.
5. **Portability:** If you have assets in an employer-sponsored plan and you leave your job, you can easily roll over those assets into an IRA. Rolling over your assets can make sense, particularly if you change jobs frequently and don't want to devote too much time to coordinating and tracking your accounts.

Additional Benefits of Roth IRAs

- **Qualified tax-free withdrawals:** Since Roth IRAs are funded with after-tax dollars, your withdrawals are tax free, as long as you have held the account for at least five years and are over age 59 1/2.
- **No RMDs:** Unlike traditional IRAs, Roth IRAs are not subject to required minimum distributions (RMDs) once the accountholder reaches age 70 1/2.

Contact your financial professional to discuss a strategy for your IRA or to see if investing in an IRA makes sense for you.

[1]*Source: Investment Company Institute, The Role of IRAs in U.S. Households' Saving for Retirement, December 2010 (http://www.ici.org/pdf/fm-v19n8.pdf).*

Four Tips for Tax Smart Investing

At times, you may be able to use losses in your investment portfolio to help offset realized gains.

Savvy investors have long realized that what their investments earn after taxes is what really counts. After factoring in federal income and capital gains taxes, the alternative minimum tax (AMT), and potential state and local taxes, your investment returns in any given year may be reduced by 40% or more. Luckily, there are tools and tactics to help you manage taxes and your investments. Here are four tips to help you become a more tax-savvy investor.

Tip #1: Invest in Tax-Deferred and Tax-Free Accounts
Tax-deferred investments include company-sponsored retirement savings accounts such as traditional 401(k) and 403(b) plans and traditional individual retirement accounts (IRAs). In some cases, contributions to these accounts may be made on a pre-tax basis or may be tax deductible. More important, investment earnings compound tax-deferred until withdrawal, typically in retirement, when you may be in a lower tax bracket.

Contributions to Roth IRAs and Roth 401(k) savings plans are not deductible. Earnings that accumulate in Roth accounts can be withdrawn tax free if you are over age 59 1/2, have held the account for at least five years, and meet the requirements for a qualified distribution.

Tip #2: Manage Investments for Tax Efficiency
Tax-managed investment accounts are managed in ways that can help reduce their taxable distributions. Your investment professional can employ a combination of tactics, such as minimizing portfolio turnover, investing in stocks that do not pay dividends, and selectively selling stocks that have become less attractive at a loss to counterbalance taxable gains elsewhere in the portfolio. In years when returns on the broader market are flat or negative, investors tend to become more aware of capital gains generated by portfolio turnover, since the resulting tax liability can offset any gain or exacerbate a negative return on the investment.

Tip #3: Put Losses to Work
At times, you may be able to use losses in your investment portfolio to help offset realized gains. It's a good idea to evaluate your holdings periodically to assess whether an investment still offers the long-term potential you anticipated when you purchased it. Your realized losses in a given tax year must first be used to offset realized capital gains. If you have "leftover" losses, you can offset up to $3,000 against ordinary income. Any remainder can be carried forward to offset gains or income in future years.

Tip #4: Keep Good Records

Keep records of purchases, sales, distributions, and dividend reinvestments so that you can properly calculate the basis of shares you own and choose the most preferential tax treatment for shares you sell.

Keeping an eye on how taxes can affect your investments is one of the easiest ways to help enhance your returns over time. For more information about the tax aspects of investing, consult your tax professional.

The information in this article is not intended to be tax advice and should not be treated as such. You should consult with your tax advisor to discuss your personal situation before making any decisions.

While fees shouldn't be your only determinant when selecting investments, costs should be a key consideration of any potential investment opportunity.

New Fee Disclosure Rules Help Make Costs More Transparent

Ask most retirement plan participants how much they pay to participate in their workplace plan, and answer will probably be, "Nothing."

But your retirement plan isn't really free. While employees typically aren't charged any out-of-pocket costs to participate in their plans, participants do pay expenses, many of which are difficult to find and even more difficult to calculate. New regulations from the Department of Labor (DOL), which oversees qualified workplace retirement plans, should make it easier for participants to locate and comprehend how much they are paying for the services and benefits they receive.

The regulations take effect for plan years beginning on or after November 1, 2011, so most participants won't start receiving the new information until the beginning of 2012, probably with their 2011 year-end statements. The DOL will now require your employer and any other provider to the plan (such as the plan's financial advisor and recordkeeper) to ensure the distribution of the following information to you.

1. **Investment-related information**, including information on each investment's performance, expense ratios, and fees charged directly to participant accounts. These fees and expenses are typically deducted from your investment returns before the returns (loss or gain) are posted to your account. Previously, they were not itemized on your statement.
2. **Plan administrative expenses**, including an explanation of fees or expenses not included in the investment fees charged to the participant. These charges can include legal, recordkeeping, or consulting expenses.
3. **Individual participant expenses**, which details fees charged for services such as loans and investment advice. The new disclosure would also alert participants to charges for any redemption or transfer fees.
4. **General plan information**, including information regarding the investments in the plan and the participant's ability to manage their investments. Most of this information is already included in a document called the Summary Plan Description (SPD). Your plan was required to send you an SPD once every five years. Beginning in 2012, you will receive one annually.

The new regulations have been hailed by many industry experts as a much-needed step toward helping participants better understand investing in their company-sponsored retirement plans. Why should you take the time to learn more about fees? One very important reason: Understanding expenses could save you thousands of dollars over the long term.

Calculating Fees and Their Impact on Your Account

While fees shouldn't be your only determinant when selecting investments, costs should be a key consideration of any potential investment opportunity. For example, consider two similar mutual funds. Fund A has an expense ratio of 0.99%, while Fund B has an expense ratio of 1.34%. At first look, a difference of 0.35% doesn't seem like a big deal. Over time, however, that small sum can add up, as the table below demonstrates.

	Expense ratio	Initial investment	Annual return	Balance after 20 years	Expenses paid to the fund
Fund A	0.99%	$100,000	7%	$317,462	$37,244
Fund B	1.34%	$100,000	7%	$296,001	$48,405

Over this 20-year time period, Fund B was $11,161 more expensive than Fund A.[1] You can perform actual fund-to-fund comparisons for your investments using the FINRA Fund Analyzer (http://apps.finra.org/fundanalyzer/1/fa.aspx).

If you have questions about the fees charged by the investments available through your workplace retirement plan, speak to your plan administrator or your financial professional.

[1]*Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so you may lose money. Past performance is no guarantee of future results. For more complete information about any mutual fund, including risk, changes and expenses, please obtain a prospectus. Please read the prospectus carefully before you invest. Call the appropriate mutual fund company for the most recent month-end performance results. Current performance may be lower or higher than the hypothetical performance data quoted. The hypothetical data quoted is for illustrational purposes only and is not indicative of the performance of any actual investments. Investment return and principal value will fluctuate, and shares when redeemed, may be worth more or less than their original cost.*

Giving Clients What They Need

This approach of trying to keep clients from making mistakes isn't something that traditionally many, if not most, advisors have used.

Are there ways to prevent clients from acting on self-defeating impulses and faulty thinking? Look to the fascinating findings of behavioral finance.

Apart from higher returns, investors seek other payoffs: enhanced self-esteem, and feelings of hope and exuberance, for example. But this often leads to their making the wrong financial decisions. Similarly, they can be impeded by negative emotions such as fear and despair, and by cognitive errors, like overconfidence and hindsight.

In his new book, *What Investors Really Want* (McGraw-Hill), Meir Statman, Santa Clara University professor of finance and behavioral finance researcher, provides deep insight into just what drives investor decisions.

A consultant to money management companies and brokerages, such as Merrill Lynch and Russell Investments, Statman, 63, educates clients and helps design diversified portfolios.

Science is the route to smarter investing, says Statman, who's also a visiting professor at Tilburg University in the Netherlands. He urges FAs to deter clients from "the tempting voice of wants" - often prompting bad investment choices - and steer them instead toward "shoulds" - which mostly lead to smart choices.

Research recently interviewed Statman - recipient of two IMCA Journal awards, three Graham and Dodd awards and the Moskowitz Prize for best paper on socially responsible investing - to shed further light on how advisors can use the science of behavioral finance to build client trust and add value. Here are excerpts from our illuminating conversation:

***Research:* How can advisors save clients from themselves?**

Statman: Clients are their own worst enemies. They come to advisors to tell them when to buy and when to sell, and what to buy and what to sell. But that's not what advisors can do - period. Advisors cannot beat the market. But they can prevent clients from doing really stupid things. If advisors have that kind of conversation with clients, both would benefit.

Do FAs, then, act in a parental role?

Yes. If investors cannot control themselves, the advisor has to be the one who provides control - with a gentle voice and a bit of humor: "You'll have to listen to me because a lack of self-control is going to do you in, and you'll regret acting with haste. I'm here to prevent that." Clients will understand that the advisor isn't being a dictator but, rather, a parent. That's what fiduciary duty is about.

What's the best way for advisors to deal with clients' cognitive errors, that is, flawed thinking?

Present them with science: what we know from systematic studies and logic about investing.

What's a good strategy with clients who overestimate their investing skill and think they know more than the advisor?

Tell them, "Here's an advantage I have over you: I've already learned the lesson that I'm trying to teach you, which is that there are illusions, and they're common. For example, we remember our gains and forget our losses. I'm trying to teach you science so that you can make informed decisions."

We know that people who try to beat the market are more [often] beaten by it. If a client thinks they can tell where the stock market will go in the coming week, ask them to keep a log, and then check it after 30 weeks.

How should advisors handle clients who want to trade often?

Scientific studies show that people who trade more, sacrifice returns and utilitarian benefits. If you show clients that trading actually reduces returns, maybe they'll stop!

But you write that advisors shouldn't tell investors to use reason vs. emotion. Don't emotions lead to cognitive errors?

Investors should be mindful of their emotions. But emotions in investing aren't always bad. Emotions reinforce learning rather than interfere with it. But you have to figure out when they get in your way.

Such as?

If a client is fearful, advisors can tell them: "Fear is a natural emotion; but in financial markets, fear and its evil twin, exuberance, are going to mislead you. We know from science that fear decreases risk tolerance and increases risk aversion." Then the advisor can point out: "I counter this by reminding myself that [in a down market], the world isn't coming to an end. And when the time comes for real exuberance, I remind myself that the world isn't going to be all roses."

What if [clients are] fearful because they think the market will plunge and want to sell their stocks?

Tell them: "How about if we do this with dollar-cost averaging and get out of the market over a period of two years? And suppose we arrange that there has to be at least 10 days between the time you make a decision to buy a stock and when we execute it so that you'll have a chance to cool off and reconsider? If it's such a bargain, it's likely to be a bargain in 10 days as well."

What about anger? You write that angry people seek risk.

It's not for nothing that our mothers taught us to count to 10 before we open our mouths when we're angry - people who are angry are thoughtless. Anger is one emotion that drives investors to say, "I'm going to time the market"; that is, get out when stocks are high and get back when stocks are low.

When is taking risks generally a good thing?

It's important for financial advisors to tell clients who are still young that risk-taking isn't a luxury and that if they put all their money into Treasury bills, they're going to live on very little in retirement.

Let's say a client is feeling very sad, and this sadness is influencing her to make a bad investment decision?

Sadness causes people to want to get rid of investments. The advisor can refer to some of the studies in my book that support this. If people are sad and disgusted, and want out or want to do something rash, the advisor can delay it by saying, "Let's talk about it next time we meet. Let's give it some time because all of us are rattled by the market today."

How should an advisor deal with clients who are overconfident about a specific investment they're intent on making?

Say to them: "If you want to buy emerging markets because it will diversify your portfolio, go ahead. If you want to buy emerging markets because you're confident they're sure to go up, stop." The question to ask whenever you're buying is, "Who is the idiot on the other side of the trade? Is it possibly Goldman Sachs?" Also: "What do I know that isn't known that's going to give me an advantage relative to the person on the other side?"

TV broadcasters and their Wall Street guests get excited when the market goes up, leading viewers to believe that it must be the time to buy. What should FAs tell clients?

Individual investors tend to extrapolate from recent returns. If the market has been up, they think it will continue to do so; if it's down, they think it will continue to go down. But we know from systematic studies, including my own, that the relationship is just the opposite and that when investors are bullish, markets are more likely to go down.

What advice should the advisor give in the above TV scenario?

Say: "When you heard someone on television [recommending] to buy such-and-such stock, who do you think was also listening to the same program? Who is taking advantage of this before you have a chance to? It's possible that some people knew ahead of time that the person was going to say that and positioned themselves to profit from it."

Please talk about the danger of hindsight.

Hindsight is most pernicious. If the client decides: "Don't buy stocks on Mondays or those whose names begin with 'A,'" they're going to find that in hindsight, that rule worked or didn't work - and they'll think they found the rule, when in fact it was luck. Investment performance is so much luck and so little skill. People believe it's in the opposite proportion. This is something advisors have to educate investors about.

You write that it isn't wise to buy early into a revolutionary new industry. That's so counterintuitive!

Again, the fundamental question is: Who else knows what you know? You have to take into account how good the prospects are for the new industry. It might have wonderful prospects. But in all [probability] everybody knows that, and the price is likely to be too high. Advisors should provide clients with evidence that buying early wasn't a good idea with either the automobile or the Internet industries.

Still, many investors are looking for a thrill - the thrill of winning, of getting rich. Does the FA simply ignore that?

The advice that we academics provide feels like, "Eat spinach, never taste a cheesecake." So advisors can say, "How about if we let you have 5 percent of your money to get thrills - just don't get thrills with money you'll need for retirement or your kids' education." It's a matter of not prohibiting fun and games altogether, just that you need to have a balanced portfolio. As with a balanced meal, it cannot be all ice cream.

Financial advisors warn against mixing investments with patriotism, you point out. What's the harm?

We have evidence that people who are [very] patriotic are more likely to restrict their investments to those in their own country, or at least tilt that way. This is taking away the benefits of diversification. It's possible to persuade clients using logic: "If you want to show your patriotism, there are many ways that are useful and are actually going to do some good. You can volunteer at the Veterans [Administration] or make donations to organizations. But by concentrating your investments in the U.S., you're not going to add anything to any veteran."

This approach of trying to keep clients from making mistakes isn't something that traditionally many, if not most, advisors have used.

If they haven't, it's about time! Some advisors are frustrated hedge fund managers. To them, clients are a nuisance - what they really like to do is pick stocks. Those advisors should quit the business. The role of the advisor is to advise, to guide, to help clients get to their financial goals.

That doesn't mean you have to be a certified psychiatrist; but you need to find what the client wants, consider whether it's reasonable to be achieved and show them how to get there - while all along the way, avoiding the problems of their misleading emotions and cognitive errors.

If advisors say, "That's not for me because I'm a numbers guy," I tell them what I'd tell a physician who says he doesn't care about bedside manner: "You can be a pathologist!"

A final word for FAs?

Financial advisors are very much like the physicians who resist science. Such advisors just want to think about their work as art, when it's really science. They want to consider themselves painters, when in fact they should be more like technicians and good physicians - people who are on the frontier of financial knowledge but who also have a good bedside manner.

It's important for advisors to know that their job isn't just maximizing wealth but maximizing well-being at least as much, if not primarily.

*The author of this article is **Jane Wollman Rusoff**. Reprinted with permission from the June 2011 issue of **Research magazine**.*