

MONEY MAKEOVER

And baby makes 3, thus a new look at finances

By Ann Perry
May 2, 2004

When couples are expecting a baby, it's not unusual for them to experience the "nesting urge," a desire to prepare the home for the baby, tie up loose ends and get their lives organized.

For Mary Beth Zopatti and Mark Rago, the expected arrival of their firstborn on May 15 motivated them to do something they'd been meaning to do – get their finances in order.

"I thought, 'Wow, I'm going to have to plan for college,'" says Mary Beth, a kindergarten teacher at Oneonta Elementary in South Bay. "I don't know how to do it.

"Our investments were spread out all over. We didn't know if our investments were working together. They were just things we picked on our own. We weren't on the same page."

Mark, a district sales manager for Scotts, which produces such familiar yard products as Roundup and Miracle-Gro, He wanted to be sure they were on track to pay for college for their daughter and to retire in their early 60s.

So they volunteered for a San Diego Union-Tribune Money Makeover, sponsored by the newspaper and the San Diego chapter of the Financial Planning Association.

The association chose Terry Green, a certified financial planner in San Diego, to work with the couple and make recommendations. In exchange for sharing their story in the newspaper, Mary Beth and Mark received a comprehensive financial plan at no charge.

When Green met with them, the couple stressed two things: Mary Beth would work half time for two years after their baby girl, whom they plan to name Anamarie Elizabeth, was born. And they wanted to have their home paid off by the time they retired in their early 60s.

Green showed them what kind of belt-tightening they would need to do to make these scenarios happen. With the arrival of the baby, their annual income will drop from \$140,000 to \$106,000.

But to meet their goal of paying off their mortgage in 18 years, they will have to pay an extra \$100 a month toward the mortgage for the two years Mary Beth works part time, and increase the extra monthly payment to \$650 when she returns to full-time work.

During the two years, they will have to temporarily decrease their retirement savings: Mary Beth will continue to contribute to her pension fund, the State Teachers' Retirement System, but will not pay in to her 403(b) plan, while Mark will trim his 401(k) contribution from 15 percent to 10 percent.

When Mary Beth returns to full-time work, they will resume their previous levels of retirement investing.

Looking ahead to their retirement, Green says, "Their key asset is going to be her pension." At age 60, Mary Beth would qualify for a \$65,000 annual pension. At 62, Mark would qualify for a Social Security benefit of \$16,200.

Mary Beth and Mark estimated they would need approximately \$57,000 annually after taxes in today's dollars to live comfortably in retirement starting in 2026.

Their retirement income will also be supplemented by what they set aside in their retirement plans at work. Mark currently receives a company match of 100 percent for the first 3 percent of his wages he invests in his 401(k) plan and a 50 percent match for the next 2 percent.

Like most teachers, Mary Beth can also set aside money in a tax-deferred retirement account similar to a 401(k) known as a 403(b). And like many teachers, says Green, she was persuaded to put her savings into an annuity, often known as a tax-sheltered annuity or TSA, which is also tax deferred – needlessly, because the 403(b) already is.

"Annuities are a horrible investment option," says Green. "They usually involve paying a commission, being subject to surrender charges, incurring higher expenses, and limited investment choices. It is said that teachers are conservative, so agents like to sell them fixed annuities. Well, there's nothing safe about eroding purchasing power due to inflation."

Green recommends she stop her contributions while she is working part time and invest later using lower-cost mutual funds, allocated in a diversified portfolio of investments that will keep ahead of inflation.

Once Green explained the downsides to her, Mary Beth was willing to make the change.

"I don't have a business background," she says. "I would just walk in the teachers lounge at lunch and they (the annuities sales representatives) are sitting there."

Mark and Mary Beth's current investments are 90 percent in stocks, with more than 70 percent exposure to large U.S. companies like those in the Standard & Poor's 500 Index.

"People hear about the cost and diversification benefits of indexing and think that if they just buy an S&P 500 index they're set," says Green. "But they are really limiting

themselves to just one asset class and taking more risk than they think. With a better asset allocation, we can get them a better return with lower risk."

Green believes in passive fund management, where the funds mimic the markets, because over time almost all actively managed portfolios, where managers buy and sell trying to beat the market, just don't.

"Over time, markets go up," he says. "Let's be the market."

He recommends the couple have an overall asset allocation of 80 percent equity and 20 percent fixed income in the following breakdown: cash, 2 percent; global short-term core bond, 8 percent; global intermediate-term core bond, 10 percent; U.S. large market, 16 percent; U.S. large value, 16 percent, U.S. micro cap, 16 percent; international large market, 12 percent; international small market, 12 percent, and real estate investment trusts or REITs, 8 percent.

Mary Beth and Mark would like to provide enough money for their daughter to attend a state college, at a cost of approximately \$10,000 a year in today's dollars.

Green believes their plan of paying off their mortgage in 18 years and shifting their \$27,840 annual mortgage payment for that purpose instead should work, given inflation and the rising cost of college. But he estimates they'll need to come up with an extra \$6,000 in today's dollars as well.

Green's other recommendations to the couple included:

- Increase their emergency fund. The couple now have \$2,500 set aside. Green recommends they use \$4,000 of their unusually large \$5,000 tax refund this year to bolster the fund, and strive to set aside more when possible.
- Revise their estate plans. They need to redo their trust to ensure that their child would not receive their entire estate at age 18 in the event they both died prematurely. The trust could provide for "stage distributions" during young adulthood.
- Revise their beneficiaries. They need to update their life insurance policies and retirement plans to name each other as primary beneficiaries, with the trust as contingent beneficiary.
- Both need to increase their life insurance. Mark currently has \$326,000 of group life insurance and \$258,000 of accidental death and dismemberment insurance through his employer. Mary Beth has \$20,000 worth of life insurance and \$15,000 of accidental death insurance.

Green explained to them that accidental death insurance is not the same as life insurance, nor as desirable, because it pays only if the insured dies as a result of an accident. He recommends that they drop the accidental death policies and, with the arrival of the baby,

increase their life insurance: Mark should buy an additional \$400,000, 20-year term life policy and Mary Beth should purchase a \$700,000, 20-year term life policy from top-quality companies.

- Put student loans on their home equity line of credit. The couple are reluctant to add more debt to the \$14,000 now on their home equity loan because they feel it is "real money" that must be paid off.

But after talking with Green, they decided to pay off their \$22,900 in student loans with the equity line, because the interest on their home equity payments would be tax-deductible, unlike the student loans.

Mary Beth says they have a lot of work ahead of them, but they're relieved they did the makeover: "It feels good that we're getting things in order, while we're relatively young and other people haven't thought about it."

Planner biography

Terry Green, a fee-only financial planner located in San Diego, works with young professionals, pre- and post-retirees, and those seeking investment management. His firm is also an approved adviser to DFA Funds, a group of low-cost, index-style funds that incorporate modern academics theories, available only to fee-only advisers.

Green is a board member of the San Diego chapter of the Financial Planning Association. He is also an Accredited Investment Fiduciary, a professional designation for training in fiduciary responsibility.

For a planner

For a referral to a certified financial planner in your area, visit the Financial Planning Association of San Diego's Web site (fpasandiego.org). Click on Visitors, then on Planner Search. If you don't have Internet access, call (800) 322-4237, press '0' and ask for Membership Services. A customer service representative can mail or fax a list of planners near you.

Makeover Cost

The planner would have charged \$1,600 for this makeover.

Financial concerns:

- To get their financial lives in order before the arrival of their first child.
- To get on track for retirement in their early 60s.
- To pay off their mortgage when they retire and use freed cash to pay for college.

Recommendations

- Increase emergency savings funds, raise life insurance coverage, update estate plans and refinance some debt with home equity line of credit.

- Diversify retirement investment portfolio and have Mary Beth contribute to mutual funds rather than an annuity.
- Pay \$100 extra each month toward mortgage while Beth works part time, then increase extra monthly payments to \$650.