Dimitri Maraletos
CA Lic: 0767048
10221 Slater Ave., Suite 219
Fountain Valley, CA 92708-4751
(714) 593-6414 Bus
(714) 593-6104 Fax
dimitrim1@aol.com

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Money Management

Young Couples and the Challenge of Uncertainty

For today's young couples, the road to the future may look far different than it once did. Their incomes may be less certain compared to previous generations, and the demands on their financial resources may be greater. In addition, rapidly evolving technology may require multiple career changes or transitions. What's more, many employers no longer offer traditional defined benefit pension plans. Instead, employees must rely on their own savings to fund their retirement.

Meeting the Challenge

What's a young couple to do? Meet Jake and Jane. They're both in their mid-twenties and have been married for two years. Jake is a software engineer, and Jane is a curator at an art museum. Before they were married, they lived in the city and enjoyed relatively carefree financial lives. Now, they own a home in the suburbs and are hoping to start a family soon.

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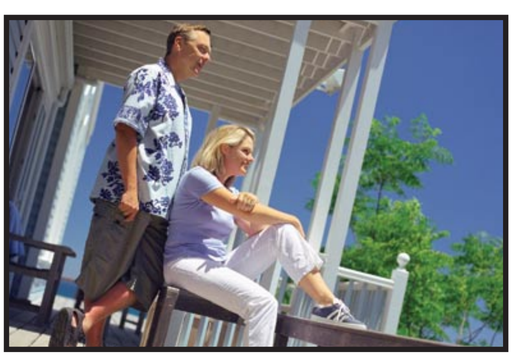
When Does It Make Sense to Refinance Your Mortgage?

Over time, mortgage rates often fluctuate. Depending on where rates currently stand, now may or may not be a good time for homeowners to consider **refinancing** their mortgage. How can you determine whether it makes sense at any given point to refinance your mortgage?

In the past, one rule of thumb was if the current interest rate was 2% lower than the rate you were paying on your existing mortgage, it made sense to refinance. Today, that general rule may still hold true in some cases. However, even if the current rate is less than 2% lower than your existing rate, refinancing may still be appropriate.

Of course, a lower interest rate is not the only reason to refinance. Here is a review of several reasons why refinancing might make sense for you:

To Move from an Adjustable Rate to a Fixed Rate Mortgage. Many first-time homebuyers must go with an adjustable rate mortgage (ARM) because they do not qualify for a fixed rate loan. If that was the case for



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Divorce and Retirement Plan Proceeds

Unfortunately, divorce is increasingly common in our society. Because divorce entails the division of assets, some of which have tax implications, it is important to be aware of potential "tax traps" when you begin planning. One such trap in the area of retirement plan assets is the existence of **vested account balances**.

In the past, with traditional **defined benefit plans**, the plan participant received a retirement benefit, but he or she had no vested balance in an individual retirement account. However, with the shift toward **defined contribution plans**, vesting for employee contributions is immediate, and employer contributions also vest according to the schedule set forth in the plan document. Consequently, as participation increases in **401(k) plans** and other defined contribution retirement plans, dividing vested retirement plan assets in divorce situations has created complex financial issues.

Protect Yourself with a QDRO

A **qualified domestic relations order (QDRO)** is a judgment or order that involves child support, alimony, and property rights pertaining to a spouse, former spouse, child, or other dependent. A QDRO can be used to establish one spouse's right to part or all of the

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you, perhaps your ARM is about to go up. If so, you may be able to "lock in" a lower rate by refinancing with a fixed rate mortgage.

To Build Equity at a Faster Rate. Perhaps you would like to pay off your mortgage in less than the traditional 30 years. A drop in interest rates may allow you to refinance your 30-year mortgage and replace it with a 20- or 15-year mortgage at a monthly payment that may be close to what you have been paying. This option may be attractive to homeowners who are nearing retirement and would like to pay off their mortgages before that time.

To Replace a Jumbo Mortgage with a Conventional One. The threshold for a jumbo mortgage has steadily increased in the last few years to its current level of $417,000 (and 50% higher in Alaska, Guam, Hawaii, and the U.S. Virgin Islands).* The difference between a jumbo and a conventional mortgage can be significant—usually 3/8 of a point or more. If you have a jumbo mortgage, you may be able to refinance and pay down enough to qualify for a conventional mortgage to get the lowest possible rate.

To Eliminate Private Mortgage Insurance (PMI). PMI, which is required by most lenders if your original down payment was less than 20%, is tacked on to your monthly payment. If the value of your home has increased since you bought it, you may be able to eliminate the PMI just by having your house appraised. Or, you can eliminate the PMI when you refinance if you have more than 20% **equity** in your home.

To Tap into Your Home's Equity. If you have other debt or are anticipating new expenses, such as college tuition bills, you may want to refinance for a larger mortgage at a lower interest rate and use the extra cash to pay off the debt or forthcoming tuition bills.

To Take Advantage of a Lower Interest Rate. The most common reason for refinancing is that the current interest rate is significantly lower than the rate you are paying on your existing fixed rate mortgage. You will also need to consider variables such as refinancing costs, points, and how long you plan to stay in your home. It is wise to shop around to ensure you are getting the lowest rate possible and paying the lowest cost.

Deciding when to refinance depends on your personal financial situation and your plans for the future. You may want to do some number-crunching in advance to determine how low rates would need to drop for refinancing to make sense for you. Then, if rates decline, you will be ready to make your move. *MM*

* Fannie Mae, "Announcement 09-34: Confirmation of Conventional Loan Limits for 2010," November 12, 2009.

Young Couples and the Challenge of Uncertainty

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As they begin to pursue their dreams, Jake and Jane begin to encounter the uncertainty that will be faced by many young couples. Although their jobs are presently secure, many of their friends and relatives work for companies that are struggling, leaving them less certain about their professional futures. Since they'll be depending on two incomes to support their family, how will they manage if one of them loses his or her job? And, will their standard of living be affected if they each undergo a number of career transitions?

The possibility of an uncertain income stream raises additional questions. Will they be able to afford the number of children they want? Once they've started a family, will they be able to save for their children's education? Will they have adequate financial resources should either of them become sick or sustain a disability? What about their retirement? Although they both participate in 401(k) plans at work, will they be able to save enough to retire comfortably?

A Realistic Assessment Today: A Brighter Tomorrow

Although they face a challenging future, Jake and Jane are getting off on the right foot by asking these questions. A realistic assessment of their goals and the economic climate will allow them to develop alternative courses of action. If they start now, while they're still young, they may have more flexibility in their spending choices and in determining the sacrifices they may need to make to meet both their current and long-term goals.

If Jake and Jane chart their future course prudently, they may be in a better position to achieve their dreams. By making informed financial decisions and choosing appropriate strategies today, they'll be less likely to lose their way if they encounter personal and economic detours tomorrow. MM

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other spouse's retirement plan(s)—and ensure that the recipient spouse pays the tax.

To be protected through a QDRO, it must specify the following:

- The name and address of the plan participant and the "alternate payee" (typically, the participant's spouse).
- The name and account number of each retirement account involved.
- The percentage (or dollar amount) of each plan that is to be paid to the alternate payee.
- The period of time or the number of payments covered by the QDRO.

The QDRO must be a part of the divorce decree or a court-approved property settlement document. The decree should also specify that a QDRO is being established under Section 414(p) of the Internal Revenue Code (IRC) and the particular state's domestic relations laws. Intent to establish a QDRO is insufficient; it must be spelled out in the divorce papers.

Divorce can be "taxing" enough, but it need not be exacerbated by mishandling the division of assets in a retirement plan. Through a QDRO, an individual can provide retirement funds for a former spouse, child, or other dependent, and ensure that those assets are taxed appropriately. Obtain qualified legal advice to help ensure that the QDRO is structured properly. MM

Building a Strong Financial Foundation

Today, many individuals are concerned about saving for retirement or a large ticket item, such as a child's education. If you are among this group, now may be the time to organize your finances. It's never too early to begin, and the sooner you start, the better. Consider the following steps to building a strong financial foundation:

1. Get organized. Smart money management begins with organizing your financial papers. By grouping documents according to categories (e.g., insurance papers, account statements, bank statements, and tax returns), you will be able to find them quickly when you need them.

2. Determine your financial status. Once your files are organized, construct a **net worth** statement and a **cash flow** statement. Your net worth is the difference between your **assets** (what you *own*) and your **liabilities** (what you *owe*). A cash flow statement itemizes all your sources of income (e.g., salary, interest, and rental income) and all your expenses (e.g., mortgage payments, food, clothing, etc.).

A firm financial foundation includes having a **positive net worth** (meaning you own more than you owe) and **positive cash flow** (meaning you have more money coming in than going out). Even small steps toward better money management can help you create a positive outcome. Look for areas where you can cut back on your expenses, and put that money toward savings.

3. Set financial goals. Once you have an idea of your financial status, make the most of your money by establishing financial goals to direct your saving and spending patterns. Because your specific goals may change over time, it's a good idea to regularly assess your financial priorities.

4. Control your credit card spending. It's convenient to say "charge it," but buying on credit can create an illusion of wealth, tempting you to buy things you can't afford. If you carry large balances and make only minimum payments on your credit cards, the interest charges you pay may exceed whatever you have saved buying at bargain prices. A practical guideline for controlling credit card spending is to have enough cash available (for example, in your checking or money market account) to pay off your credit card balances immediately, should you need or choose to do so.

5. Develop a tax strategy. Many people don't think about taxes until it's time to file their tax returns. However, if you wait until tax season, it may be too late to implement some tax-saving strategies. While you probably don't want to spend your free time thinking about taxes, developing tax strategies, with the help of a tax professional, may pay off with a better bottom line.

Sound money management starts with good organization—knowing where your hard-earned dollars are going. If you follow the steps outlined above, you'll be on your way to building a firm financial foundation. *MM*

A Parting Thought...

Even if your retirement is years away, it's important that you understand how **inflation** can affect your retirement savings. You probably know that inflation can depreciate your savings over time. But, how seriously do you consider the impact of a decrease in the purchasing power of your money on your future plans? At 3% inflation, $100 today will be worth only $67.30 in 20 years, which is a loss of one-third of its value. At 35 years, this amount would be further reduced to just $34.44. Therefore, in order to outpace inflation, your long-term retirement strategies must account for a decrease in the purchasing power of the dollar over time.