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(626) 919-3456
(800) 365-7749
FAX (626) 919-6127

JOSEPH N. RUBINSTEIN, MBA

Personal Financial Consultant
General Securities Principal

DIVERSIFIED SECURITIES INC.

COMPLETE INVESTMENT AND ADVISORY SERVICES
1000 LAKES DRIVE, SUITE #420, WEST COVINA, CA 91790
E-Mail: joerubins@yahoo.com CAL. INS. LIC. #0A68771

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Knowing Yourself As An Investor

A new science has evolved over the last 20 years called behavioral finance. It studies the main pitfalls that investors are prone to fall into; if we study or, at least, know them, we'll have a better chance of avoiding them.

The five most common are:

1. Over-confidence. Researchers have found that people often overrate their skills, abilities and knowledge, especially in fields outside of their academic and practical expertise. As investors, we must seek out and act on feedback from experts and stay within areas of competence.



2. Anchoring and adjusting. When decisions carry a lot of weight, we tend to give short shrift to later information, relying heavily on information that we receive first, causing our thoughts to anchor themselves. Seeking diverse information from a range of perspectives helps us make more sound decisions.

3. Improper framing. Often our investment decisions are swayed and



otherwise affected by the circumstances in which problems or situations are presented. Researchers find that the same problem, framed differently and objectively, yields alternate decisions. Conclusion: review alternate frames.

4. Irrational escalation of a commitment. Often, investors make choices that justify past decisions, even in the face of differing circumstances. We can avoid this pitfall by considering only **future** costs/benefits.

5. The confirmation trap. Finally, investors tend to seek out information that supports their existing point of view while avoiding information that contradicts current ideas of what works or is valuable.

Think about each investment decision with broader ideas in mind and, at very least, you will open your thought processes to new ways of thinking, rationalizing and, potentially, new methods of investing.

Questions & Answers

Q. I do a lot of charity work. I design logos, newsletters and other art work for them. How much of a deduction am I entitled to for my donated professional services?

A. You are allowed to deduct out-of-pocket expenses only, such as travel expenses, phone bills, out-of-town hotel charges, etc.

You may not deduct the value of any services that you provide. Even though, as a professional you would be able to value your services accurately and fairly, such deductions are not allowed.

Q. There is an old financial tenet that says there are five steps to financial independence. I don't remember them. Do you?

A. Yes. They are: 1) Get organized. 2) Set goals and objectives. 3) Identify the strategies and tasks that are necessary to achieve the objectives. 4) Implement the strategies. 5) Review and adjust your ideas periodically.

Of course, these steps do not guarantee your success at achieving financial independence, but you'd likely have hardly any chance at all without implementing the above steps.

Q. I often have trouble remembering the old quote by Judge Learned Hand that talks about payment of taxes. Do you have it handy?

A. Yes. Hand said, "Anyone may so arrange his affairs that his taxes shall be as low as possible. He is not bound to choose the pattern which best pays the Treasury. Everyone does it, rich and poor alike, and all do right; for nobody owes any public duty to pay more than the law demands."

Nominated by Calvin Coolidge, Billings Learned Hand was a Federal Appeals Court Judge.

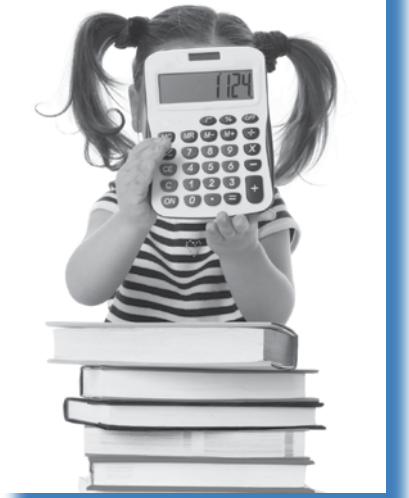
We will accept questions from readers and reprint selected answers in this column. Send your question(s) to us; we'll answer as many as we can.

Financial Notes Worth Noting

The Cost of Raising A Child

With USDA's Cost of Raising a Child Calculator, located at <http://www.cnpp.usda.gov/calculatorintro.htm>, you can estimate how much it will cost, on an annual basis, to raise a child. This may help you plan better for overall expenses. The amount of money you spend depends on how many children you have, the age of the children, your marital status, where you live, and your household income. The results are based on what families similar to your family spend in a year and include a breakdown by major budgetary components. You may especially want to do this for child care and education as these expenses vary greatly among families. The calculator applies to children less than 18 years old. So, it does not include expenses on older children, including the cost of a college education.

The expenses are updated annually. The most recent figures are for 2008.



Compounding Basics

Here's an old trick that still fools most people: offer a friend either \$10,000 a day for 35 days or a penny on the first day, two cents on the second day and double the amount paid each day for 35 days. The answer is obvious if you understand compounding: while your friend would have \$350,000 on the 35th day at \$10,000 per day (not too shabby!), he'd be wallowing in more than a third of a billion dollars at the end of the 35th day if you doubled the payment each day, starting with a penny.

Of course, that's an outrageous example (100 percent compounded daily), but it points to the rather astounding figures that can result from compound interest accumulations. Compound interest simply takes into account the interest that is earned in the first period, and adds it to the principal, upon which the next interest calculation is made.

How about some down-to-earth examples? Here are some with lump-sum and periodic payments:

If you were to invest \$10,000 today at a 5 percent return compounded annually, at the end of:

5 years, you'd have \$12,762;
10 years, you'd have \$16,288;
15 years, you'd have \$20,789; and
20 years, you'd have \$26,532!

If you were to invest \$100 a month beginning today at a 5 percent return compounded monthly, at the end of:

5 years, you'd have \$6,957;
10 years, you'd have \$15,757;
15 years, you'd have \$27,051; and
20 years, you'd have \$41,545!

The percentage is for illustrative purposes only and does not represent the return of any particular investment vehicle. Nor are the examples a guarantee; your investment returns and principal investment amount will vary. An investor's units, when redeemed, may be worth more or less than their original cost. The examples also do not take early withdrawals or penalties into account if funds are redeemed from a qualified retirement account. Taxes are not part of the calculations.

Elective Deferrals, Cost of Living Adjustments Mostly Static

IRS Announces Limitations for 2010

The Internal Revenue Service recently announced cost-of-living adjustments applicable to dollar limitations for pension plans and other items for tax year 2010.

Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under qualified retirement plans, deferred compensation plans and Social Security.

Because the cost-of-living index for the quarter ended September 30, 2009, is less than the cost-of-living index for the quarter ended September 30, 2008, and, following the procedures under the Social Security Act for adjusting benefit amounts, any decline in the applicable index **cannot result in a reduced limitation**, the limitations that are adjusted by reference to Section 415 will remain unchanged for 2010.

Effective January 1, 2010, the limitation on the annual benefit under a defined benefit plan remains unchanged at \$195,000. The limitation for defined contribution plans under Section 415(c)(1)(A) remains unchanged for 2010 at \$49,000.

The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner. After taking into account the applicable rounding rules, the amounts for 2010 are as follows:

- The limitation for **elective deferrals** remains unchanged at \$16,500.
- The annual **compensation limit** remains unchanged at \$245,000.
- The dollar limitation concerning the definition of **key employee in a top-heavy plan** remains unchanged at \$160,000.
- The dollar amount for determining the **maximum account balance in an employee stock ownership plan** subject to a 5-year distribution period remains unchanged at \$985,000, while the dollar amount used to determine the lengthening of the 5-year distribution period remains unchanged at \$195,000.
- The limitation used in the **definition of a highly compensated**

employee remains unchanged at \$110,000.

- The dollar limitation for **catch-up contributions** to an applicable employer plan for individuals aged 50 or over remains unchanged at \$5,500. The dollar limitation for catch-up contributions to certain 401(k) plans for individuals aged 50 or over remains unchanged at \$2,500.

- The annual compensation limitation for **eligible participants in certain governmental plans**, remains unchanged at \$360,000.

- The minimum compensation amount regarding **simplified employee pensions** (SEPs) remains unchanged at \$550.



- The limitation regarding **SIMPLE retirement accounts** remains unchanged at \$11,500.
- The limitation on deferrals concerning **deferred compensation plans of state and local governments and tax-exempt organizations** remains unchanged at \$16,500.

The U.S. Tax Code also provides that several pension-related amounts are to be adjusted using the cost-of-living adjustment. After taking the applicable rounding rules into account, the amounts for 2010 are as follows:

- The adjusted gross income limitation for determining the retirement savings contribution credit for married taxpayers filing a joint return is increased from \$33,000 to

\$33,500; other limitations for married taxpayers filing a joint return remain unchanged. The adjusted gross income limitation for determining the retirement savings contribution credit for taxpayers filing as head of household is increased from \$24,750 to \$25,125; other limitations for head of household remain unchanged. The adjusted gross income limitation for determining the retirement savings contribution credit for all other taxpayers is increased from \$16,500 to \$16,750; other limitations within this category of taxpayers remain unchanged.

- The maximum deductible amount for an **individual making a traditional IRA contribution** remains unchanged at \$5,000.

- The applicable dollar amount for determining the **deductible amount of an IRA contribution for taxpayers who are active participants in employer-sponsored plans, filing a joint return or as a qualifying widow(er)** remains unchanged at \$89,000. The applicable dollar amount for all other taxpayers (other than married taxpayers filing separate returns) is increased from \$55,000 to \$56,000.

- The applicable **dollar amount for a taxpayer who is not an active participant in an employer-sponsored plan, but whose spouse is an active participant** is increased from \$166,000 to \$167,000.

- The adjusted gross income limitation for determining the **maximum Roth IRA contribution for married taxpayers filing a joint return or for taxpayers filing as a qualifying widow(er)** is increased from \$166,000 to \$167,000. The **adjusted gross income limitation for all other taxpayers** (other than married taxpayers filing separate returns) remains unchanged at \$105,000.

As always, remember that the tax code is a complex matter and that individual circumstances are an important consideration. Always discuss tax decisions with a competent tax advisor.

Strategic Financial Ideas

The Dollar Value of Money

This is a story about two friends, Sue Sav-a-lot Now and Sally Save-More Later. (Sally's maiden name was Save-More.)

Both are 35 years old, have good jobs and earn decent salaries.

Sue is conservative by nature and prefers paying cash for most purchases. She drives a small economy car, clips coupons and vacations every year at the beach.

Sally, on the other hand, likes to live "the good life." She has several credit cards approaching their limit, drives a BMW and takes a skiing trip in Europe every year.

Sue has already begun planning for her retirement. She intends to invest \$5,000 per year over the next 10 years and make no further contributions to the account. By her calculations, her \$50,000 investment will grow to over \$700,000 by the time she's 65, if she can earn 6% annually on her investment.



Sally, on the other hand, thinks of retirement as something people her parent's age are concerned with. Sally decides she'll wait until she is 45 to begin retirement saving. When age 45 rolls around, Sally begins investing in the same vehicle as Sue. She decides to invest \$7,500 a year until

Sue Sav-a-lot Now			Sally Save-More Later		
Age	Investment	Value	Age	Investment	Value
35	\$5,000	\$5,300	35	0	0
36	\$5,000	\$10,918	36	0	0
37	\$5,000	\$16,873	37	0	0
38	\$5,000	\$23,185	38	0	0
39	\$5,000	\$29,876	39	0	0
40	\$5,000	\$36,968	40	0	0
41	\$5,000	\$44,486	41	0	0
42	\$5,000	\$52,455	42	0	0
43	\$5,000	\$60,902	43	0	0
44	\$5,000	\$69,856	44	0	0
45	0	\$84,107	45	\$7,500	\$7,950
46	0	\$89,153	46	\$7,500	\$15,900
47	0	\$94,502	47	\$7,500	\$24,804
48	0	\$100,172	48	\$7,500	\$34,242
49	0	\$106,182	49	\$7,500	\$44,246
50	0	\$112,552	50	\$7,500	\$54,850
51	0	\$119,305	51	\$7,500	\$66,091
52	0	\$126,463	52	\$7,500	\$78,006
53	0	\$134,050	53	\$7,500	\$90,636
54	0	\$142,093	54	\$7,500	\$104,024
55	0	\$150,618	55	\$7,500	\$118,215
56	0	\$159,655	56	\$7,500	\$133,257
57	0	\$169,234	57	\$7,500	\$149,202
58	0	\$179,388	58	\$7,500	\$166,104
59	0	\$190,151	59	\$7,500	\$184,020
60	0	\$201,560	60	\$7,500	\$203,011
61	0	\$213,653	61	\$7,500	\$223,141
62	0	\$226,472	62	\$7,500	\$244,469
63	0	\$240,060	63	\$7,500	\$267,097
64	0	\$254,463	64	\$7,500	\$291,072
65	<u>0</u>	\$269,730	65	<u>\$7,500</u>	\$316,486
	\$50,000 Total Invested			\$157,500 Total Invested	

she has accumulated as much as Sue.

At age 65, Sally (\$316,486) only recently caught up with Sue (\$269,730), even though she invested more than three times as much (\$157,500) as Sue (\$50,000).

The lesson to be learned here is that even though procrastination in your retirement investment may make life more

comfortable now, it may force you to play catch-up for the rest of it.

The chart is for illustrative purposes only and does not guarantee any rate of return. It is not intended to depict the performance of any particular investment and assumes a 6 percent annual growth rate. Your investment's returns will vary with economic and financial conditions.

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