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ETFs vs. mutual funds

Both have merit, depending on your goals

Exchange-traded funds (ETFs) have exploded in popularity since their introduction in the early 1990s. Total ETF assets in early 2011 were more than $1.5 trillion, compared to only $79 billion in 2000, according to consultants Gerson Lehrman Group (GLG). What's more, GLG reports that, as of early 2011, there were more than 1,100 ETFs listed in the United States and roughly 3,600 worldwide, covering virtually every asset class.

Both ETFs and mutual funds allow you to invest in a variety of securities, providing the potential for instant diversification. However, in many ways, ETFs are a more flexible and easily traded product. That flexibility can be both an advantage and a disadvantage.

What's the difference?

The main difference between ETFs and mutual funds is that, like stocks, ETFs trade on the open market — hence their name. In contrast, you buy or sell most mutual funds at one price established at the end of the market's trading day.

Additionally, you can use limit and stop orders with ETFs. You can even sell short, with the goal of profiting from a drop in an ETF's underlying index. However, bear in mind the heightened risk involved with selling short — the biggest being that the security's price actually rises, in which case your losses are theoretically unlimited. Limit orders, stop orders and short sales aren't possible with mutual funds.

Finally, there are no penalties for short-term trading in ETFs, whereas many mutual funds impose a fee of 2% or more for redeeming shares within 30 days or some other brief period.

ETFs' flexibility can be useful if you're a short-term trader. However, if your goals are longer term in nature, the "tradability" of ETFs can be an unwelcome temptation — and an expensive one, when you consider trading costs — while the restrictions imposed by mutual funds might be a healthy incentive to keep your focus on investing rather than speculation.

Fees and expenses

With most brokers, you'll pay a commission when you buy or sell an ETF, whereas many — but not all — mutual funds can be bought and sold with no transaction fee. The difference can be significant if, for example, you invest a small amount every month as part of a dollar-cost averaging program. In that case, ETF transaction fees can eat up a significant portion of your monthly contributions and possibly leave you with considerably less a decade or two down the road.

On the other hand, the expense ratios of ETFs are relatively low, averaging 0.55%, vs. 1.48% for equity mutual funds, according to Lipper, a provider of mutual fund information. Keep in mind, though, that expenses are lower for passively managed index mutual funds.

Active or passive management?

If you've found one or more actively managed mutual funds run by long-tenured managers who've delivered market-beating performance, you might be happy to pay higher fees. Although the number of actively managed ETFs is growing, passive management is still the norm for these products.

With this in mind, you might want to purchase low-cost, index-tracking ETFs or mutual funds in asset classes such as domestic large-cap stocks, where beating the market is more difficult. Conversely, you might use funds with active managers in asset classes such as small-cap, mid-cap and emerging-market equities, where superior research is more likely to result in above-average results.

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More exotic options

Recent years have witnessed the introduction of ETFs with ever-more-exotic strategies. For example, there has been a sharp increase in the number of leveraged and inverse ETFs.

Leveraged ETFs aim to approximate some multiple of an index's returns, typically double or triple the result of the underlying benchmark. Inverse ETFs attempt to profit from declines in an underlying index. There are even leveraged inverse ETFs, which combine the two features.

Mutual funds also offer leveraged, inverse and combination products. Caution should be the watchword when investing in such products, whether ETFs or mutual funds. Because of the effects of compounding, higher operating expenses and daily resets, the performance of leveraged and inverse funds over longer periods can differ significantly from what you might expect based on the underlying strategy.

Both can keep you diversified

Keeping your portfolio diversified is important. If you're considering ETFs or mutual funds, it's advisable to start with a small group of broadly based funds that provide exposure to overall market trends.

In addition, both investment vehicles provide the option to invest in narrower slices of the market. These types of investments may fulfill specific portfolio niches, depending on your goals. Your financial advisor can work with you to recommend the right solutions for your situation. ■

Turning your ownership interest into cash for retirement

Jay started his aviation-based consulting group 30 years ago. Now well into his 60s, he has been thinking it's time to retire. But Jay has a large amount of assets tied up in the company. Thankfully, business owners like Jay have many options to get cash out of their businesses so they can retire comfortably.

Sell to co-owners or family

When a business has multiple owners, a buy-sell agreement can provide a mechanism for retiring owners to get their money out by selling their interest to the other owners — or to the business itself. But even if you don't have a buy-sell agreement in place, if you *do* have co-owners, the most obvious way to turn your ownership interest into cash for retirement is to sell your interest to them.

If the company is unable to purchase your interest for cash, it can redeem your stock in exchange for company assets, such as equipment. You can then sell the assets — or lease them back to the company.

Another option is to divide the company through a tax-free split-up that allows each owner to receive a separate part. Be aware, however, that this approach can involve complicated tax considerations.

If it's a family business and you want to keep it that way, you can create a succession plan that includes selling stock to your children. There are several techniques that can provide tax advantages.

For example, you can use the installment method, reporting and paying tax on your gain only as principal payments on a note are received. If you sell your stock to a trust for the benefit of family members, and that trust is structured to be a grantor trust with its income taxable to you as grantor, you won't pay tax on the capital gain at all.

Sell to managers or employees

If you have a management team that's interested in owning some or all of the business, you (and any other owners) can arrange for a management buyout (MBO) or leveraged management buyout (LMBO). With an MBO, the management team pools resources or borrows funds on their own to acquire all or part of the business. With an LMBO, the management team uses company assets as collateral to secure financing.

MBOs and LMBOs are typically funded by a mix of personal investors, external financiers and the seller. The seller creates a ready market for his or her stock and an incentive to management at the same time.

An employee stock ownership plan (ESOP) can also provide a market for sale of your stock, and it carries some tax benefits with it. This option may be especially attractive because the gain on the sale of your stock to the ESOP can be deferred and may ultimately receive a step-up in basis at your death. Bear in mind that ESOPs are costly to create and maintain.

Sell to an outsider

Perhaps the most difficult option is to sell the business to an outsider. It could take some time to find a buyer and require significant due diligence.

However, if you find the right buyer, you might even be able to sell your business at a premium.

Boost retirement cash flow

If you're not concerned about selling your interest but simply want to boost your retirement cash flow, consider deferred compensation. Under a deferred compensation agreement, your company can pay you after your retirement, either for services rendered or as payment for recognition of past work.

Alternatively, you and your company can establish a substantial severance package before you leave its employ. The company can deduct the severance payments, if reasonable, as a business expense. But complex rules apply, so be sure to consult your advisor.

Another option is a covenant not to compete. Your company can pay you money under a noncompete agreement and deduct the payments as business expenses. The covenant must be reasonable in light of all surrounding circumstances. If the IRS finds the covenant to be suspect, it can treat the payments as a dividend to you, and the company won't receive a deduction.

In addition, some retirement plans — such as defined benefit plans and target benefit plans — can quickly fund large retirement accounts for older employees. Their structures allow the company to make larger annual contributions for the benefit of older employees because the contributions for the benefit of younger employees are projected to continue for a longer period of time.

And the business can deduct the contributions when made, even though you won't pay tax until distributions are taken out of the plan. Keep in mind that the plan may still be costly if you have a large number of employees.

Review all objectives

Before disposing of his business, Jay should review his financial, business and retirement goals with his advisor. Jay has many options to choose from to get cash out of his business for retirement. ■

Do you need long-term care insurance?

Weigh the costs and benefits before deciding

If in your comprehensive financial planning you haven't addressed how you'd pay for long-term care (LTC) expenses, you should do so. LTC — which can include help with activities such as bathing, dressing and eating — generally isn't covered by Medicare or other health insurance. Because of the increasingly high costs associated with LTC services, an LTC insurance policy is worth considering.

Timing and cost considerations

The most cost-effective time to purchase LTC insurance generally is between the ages of 50 and 65. If you purchase it at a younger age, you'll likely end up paying longer than you need to. If you wait until, say, age 75 to buy a policy, the premiums can skyrocket. And if your health is too precarious, you might not be insurable at all.

Bear in mind that LTC insurance premiums aren't cheap. Moreover, if you happen to be one of the lucky people who never require long-term care, you might receive nothing tangible in exchange for your annual premiums. But don't underestimate the considerably greater peace of mind the insurance coverage can provide you and your family.

New products, new opportunities

The LTC insurance market is rapidly evolving, so consider all of your options before you purchase a policy. For example, a new federally administered program called Community Living Assistance Services and Supports (CLASS) will be available after October 2012. This program will provide most working adults with a new way to pay for services such as personal assistance, homemaker services, specialized transportation and assistive technology.

You may also want to investigate new hybrid products that combine conventional life insurance or an annuity with LTC insurance. With these products, if your premiums aren't used for long-term care, they can be applied to a death benefit or annuity payments.

The self-insurance option

Self-insuring may be a feasible option if you and your spouse have at least $2.5 million in assets. Under this scenario, with a reasonable return on your investments you could potentially withdraw 4%, or $100,000, per year for the rest of your life to pay the long-term care costs for either you or your spouse, assuming the other spouse can live comfortably on income from Social Security and pensions. (The national average annual cost for a private nursing home room is $77,745, according to Genworth Financial's 2011 Cost of Care Survey.)

If, however, you're a single individual with pension and Social Security income, a $1 million portfolio might be sufficient for self-insurance purposes, especially if you also have a home you could sell to help defray LTC expenses.

Reading the fine print

Long-term care insurance policies can differ greatly, so don't sign on the dotted line without asking specific questions, such as:

- What medical conditions qualify for benefits?
- What does the policy cover? Skilled nursing? Custodial care? Assisted living?
- How long before benefits kick in? How long will they last?
- What's the daily benefit?
- Do benefits factor in inflation?
- How will the benefits be paid? Cash? Reimbursement?
- How solvent is the insurer?

Both examples assume you want to have something left to pass along to the next generation. If this isn't a primary goal, you may be able to manage with a smaller portfolio.

Another option might be to have adult children divide the LTC insurance premium costs for their parents among themselves. This strategy — which can make the most sense when parents are still young enough that the premium payments are relatively reasonable — lessens the burden on each household and serves the dual purpose of creating a more secure retirement for the parents and increasing the likelihood there will be some assets left for their heirs.

Evaluate your situation

Ultimately, making an informed decision about LTC insurance involves taking a realistic look at your financial resources, your family health history, and whether any family members might be willing and able to step into a caregiving role. These are all topics you might wish to discuss with both your family and advisor. ■

A primer on the probate process

As you and your estate planning advisor collaborate to create or revise your estate plan, it's important to understand the probate process and why it's generally desirable to avoid probate, if possible. The probate process unfolds in a courtroom, where the court:

- Determines your estate's value,
- Establishes the validity of your will,
- Provides for the payment of taxes and other debts,
- Resolves your creditors' claims, and
- Transfers assets to your heirs.

The probate process, depending on your state's law, can be expensive (because of executor and attorney fees) and time consuming (because court hearings can take weeks or months) for your family. Also, it's a public process, so you won't be able to keep your financial matters private after your death.

Strategies for avoiding or minimizing probate depend largely on the complexity of your estate. For assets such as your bank and brokerage accounts, you may be able to add pay on death (POD) or transfer on death (TOD) designations. (While such designations are permitted in most states, not all financial institutions offer them.) These designations allow the accounts to pass directly to your beneficiaries without being subject to probate.

If your estate is more complicated, a revocable (or living) trust is an effective way to avoid the probate process. This trust type lets you manage the disposition of all of your assets while retaining control of them during your life.

Bear in mind that, if your estate deals with minor children guardianship, disposition of personal property or certain other matters, you may not have the option of avoiding probate.

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By working with our experienced team of advisors, you will benefit from the independent and objective perspective necessary to make your financial vision a reality.

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