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WATERFORD ADVISORS
An SEC Registered Investment Advisor

Quarterly Newsletter

QUARTERLY INVESTMENT COMMENTARY: FIRST QUARTER 2011



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Stocks continued their upward march in the first quarter, with large-caps gaining almost 6%, while mid- and small-cap stocks posted gains approaching 8%. Overseas, returns were not as strong, though still good. Developed-market foreign stocks were up more than 3%, while emerging-market equities gained just under 2% for the quarter. Domestic high-quality, intermediate-term bonds didn't fare as well, barely gaining ground in the first quarter, while foreign bonds did a bit better, with developed-market government bonds gaining 0.7% and emerging-market bonds climbing by almost 3%. Our portfolios performed well despite a continued underweight to equities across all but our most aggressive portfolios.

EQUITY RETURNS—WHY WE REMAIN CAUTIOUS

Equities are the primary asset class for taking on risk. So when expected returns from equities are not attractive to us, our positioning is likely to be cautious, as it is today. To un-

derstand the potential upside for equities it's important to evaluate each of the factors that influence returns. There are three key variables we assess: dividends, earnings growth, and changes in the price/earnings ratio.

Dividends are the easiest to analyze. Today's dividend yield is very low, so low that even strong growth in dividends paid will not make the dividend yield a huge contributor to returns over the next five years. As we write this, the S&P 500 currently yields about 1.8%. Compare this to the 25-year average of 2.3% and the 50-year average of 3.1%. Bull markets in the past have always begun with higher than average dividend yields. Since 1926, the only time the dividend yield was lower than it is now was during the period of elevated stock valuations during the late 1990's and early 2000's. It's easier to capture strong returns over multi-year periods when more of the return comes from dividends.

Earnings growth is more challenging to assess and forecast. We've written extensively over the years about our approach to identifying the potential range for earnings over our five-year investment horizon. We start with a general premise that overall economic growth is an important driver of earnings growth.

Over the very long term, the rates of GDP growth and corporate earnings growth have

been similar, though there are shorter periods when the relationship has not held. Earnings are much more volatile than GDP, and earnings volatility has increased over time.

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MARCH BENCHMARK RETURNS (PRELIMINARY)

Large-Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	0.0%	5.9%	5.9%
Russell 1000 (iShares)	0.2%	6.2%	6.2%
Russell 1000 Growth (iShares)	0.1%	6.0%	6.0%
Russell 1000 Value (iShares)	0.4%	6.4%	6.4%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	1.5%	7.6%	7.6%
Russell Midcap Growth (iShares)	1.6%	7.8%	7.8%
Russell Midcap Value (iShares)	1.4%	7.4%	7.4%
Small-Cap Benchmarks			
Russell 2000 (iShares)	2.6%	7.9%	7.9%
Russell 2000 Growth (iShares)	3.8%	9.2%	9.2%
Russell 2000 Value (iShares)	1.4%	6.5%	6.5%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-0.4%	3.0%	3.0%
Vanguard Emerging Market Stock Index	5.6%	1.8%	1.8%
Vanguard REIT Index	-1.4%	6.5%	6.5%
Vanguard Total Bond Market Index	0.0%	0.2%	0.2%
Merrill U.S. High-Yield Cash Pay	0.4%	3.8%	3.8%
Barclays 7 Year Muni Bond Index	-0.2%	0.6%	0.6%
Citigroup World Govt. Bond Index	0.3%	0.7%	0.7%
JPMorgan GBI-EM Global Div. Index	3.0%	2.9%	2.9%
DJ-UBSCI (Commodity Futures)	2.1%	4.4%	4.4%



Investment Commentary

(continued from page 1)

Earnings have rebounded powerfully since the very deep trough in 2009. This rebound has been driven by cost cutting and government stimulus (neither of which will be sustained) and growth in emerging markets, which we believe is likely to be sustained (though inflation in emerging markets presents a serious risk). Despite the sharp rebound in earnings, growth is likely to be subpar as the rest of the cycle unfolds. Subpar economic growth is consistent with historical outcomes in the aftermath of a financial crisis. This history dovetails with a key assumption that the excessive private and public debt cloud hanging over the economy will result in continued deleveraging and therefore a lower level of consumption than would otherwise be the case. Private debt has declined from its peak but remains historically high while public debt has spiked higher and will continue to increase given growing entitlement costs as baby boomers age.

In addition, profit margins are far above their average level of the past 30 years and tend not to stay elevated for long. This suggests that revenue growth will have to be exceptionally strong relative to expense growth in order to drive continued earnings growth. That would be a particularly impressive achievement in the face of the debt-related demand headwinds we foresee. Increased regulation and the likelihood of higher taxes also could challenge growth.

Changes in the P/E multiple (the price at which stocks sell relative to their earnings) can be affected by a number of factors, including: expectations for growth, the level of interest and inflation rates, and investor sentiment. One issue we keep in mind is that investors don't like extremes of either high inflation or deflation. If they are worried about either of these, stock prices have tended to fall, taking P/E's lower.

This all nets out to a wide annualized return range for equities. We believe the evidence suggests equity market returns are likely to come in around the low to mid single digits over the next 5 years. **Remember, we do not**

own the equity market. Most of our equity exposure is through actively managed mutual funds.

At the low end, we believe the deflationary scenario is not likely. The economy has been improving and the developing world is growing at a healthy clip and is now big enough to have a material impact on global growth. At the other end, we also don't view a return to normal as highly probable given the continued stress points in the economy including high public and private debt levels throughout most of the developed world, weakness in the labor market, and the threat of further declines in housing prices. Additionally there are the global risks of spiking oil prices, food and commodity-driven inflation in emerging markets, and now supply chain disruptions from Japan.

The stimulus and quantitative easing are scheduled to wind down in coming months; it is not clear that the private sector is ready to accelerate into a normal recovery mode. Consumer confidence has improved from its lowest levels but remains weak overall. Business confidence is back to normal levels; however, CEOs remain concerned about consumer demand. The labor market looks set to improve, but the improvement so far is at a rate that is not contributing enough to job growth.

In our view, the **European equity markets** remain similar to those in the United States with respect to overall fundamentals and return potential. Europe continues to struggle with its own debt crisis and economic challenges.

Emerging-market equities should generate higher returns than developed markets over the next 5 years but with potentially much higher short-term volatility.

BUILDING INTELLIGENT PORTFOLIOS IN A HIGHLY UNCERTAIN WORLD

Given the level of macro risks facing a highly indebted developed world, our goal is to build portfolios that can perform reasonably well in most scenarios, and mitigate losses in more severe scenarios. Historically, heightened exposure to investment-grade bonds would be a natural option. However, current yields are extremely and artificially low (because of Fed

policy) and we expect them to be higher over our investment horizon. If we are right, fixed-income returns will be in the low single digits. **For this reason, our portfolios currently have historically low exposure to traditional investment-grade bond funds**, and what we do hold is there solely to provide a hedge against recession and deflation risk.

There are asset classes, strategies, and niche areas that offer attractive fundamentals and high potential for acceptable returns for our conservative and balanced portfolios. These include:

- **Short-term high-yield bonds**—this is a niche area that we invest in through Osterweis Strategic Income. We have a high degree of confidence in the credit research conducted by the team at Osterweis, and believe we are very likely to capture the yield (currently 5.53%) on the portfolio, i.e., that the bonds will mature without defaulting.
- **Flexible, absolute-return-oriented bond funds**—generally these types of funds are not tied to an investment-grade bond benchmark. Instead, they focus on generating return in any environment so they can adjust (reduce) their sensitivity to rising interest rates and inflation, invest outside the U.S. dollar with a portion of their portfolio, and focus heavily, if warranted, on bond market sectors such as corporate bonds or the mortgage sector. PIMCO Unconstrained is our primary holding in this area. It currently has minimal exposure to rising interest rates and a sizable position (about 20%) in Asian currencies that the manager believes will appreciate against the dollar over a period of months and years.
- **Floating-rate loan funds**—we recently added two of these funds to our conservative portfolios because the portfolios are more exposed to risk from a sharp rise in interest rates. These funds invest in bank loans and have adjustable interest rates. Effectively this means that they should experience minimal price risk due to changes in interest rates. However, they do have more credit risk than a typical investment-grade bond fund,

and for that reason we made adjustments in these portfolios to reduce risk (slight reductions to equities and emerging-market local-currency bonds).

- **Arbitrage strategies**—we added exposure to two arbitrage funds in May 2010. These funds aim to generate long-term returns in at least the mid to upper single digits, with a low correlation to the equity and bond markets, by following a merger-arbitrage strategy.
- **Emerging-markets local-currency bonds**—despite the recent trimming, these bonds are a meaningful position in our portfolios, and have been for quite some time (5%–10% allocations depending on the model). We use a PIMCO fund to gain exposure to this asset class because of its yield (currently 6.94%) and our expectation that the dollar is likely to gradually weaken relative to the currencies owned in the fund.
- **Multi-sector bond fund**—we've owned Loomis Sayles Bond for a number of years and the fund has delivered very high returns for a fixed-income fund (10.21% over the last 10 years). The fund has captured these returns via excellent bond picking, flexibility, and a willingness to pursue good value at the expense of short-term volatility. The fund typically owns a meaningful portion of corporate and high-yield bonds. Recently, a third of the fund was invested in mostly better-quality high-yield bonds. It is also willing to own non-dollar-denominated bonds, which currently comprise about a third of the fund's holdings, mostly from commodity producing countries.

Our investment-grade bond exposure is achieved mostly via PIMCO Total Return and municipal bond funds (Vanguard and American Century) for taxable portfolios. We believe they will deliver better returns over our investment horizon than the investment-grade bond index.

Collectively these investments make up a material portion of our conservative and balanced portfolios. Overall, our expectations from these investments are returns that are

not exciting, but are acceptable given the current environment. While they would not be immune to a market sell-off, they would hold up better than the investments we would own if we were more neutrally allocated. So in a market decline we would be in a position to redeploy this capital into stocks or other asset classes that would then be priced at levels more likely to reward us well for the risk we take. *If there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will give us opportunities to take on more risk.*

MARGIN OF SAFETY

We've often said that we view investing as a marathon, not a sprint. We all are investors over a lifetime and any one year is a small slice of our investment timeline. Over our investing lives there will be periods when it pays to be conservative and others when it makes sense to be aggressive. Sometimes these periods will be short, others times they will last for years. Along the way there will be ups and downs within each of these periods. Our challenge is to ignore the ups and downs and focus on the potential returns we believe we can capture and weigh them against the risks.

Ultimately, what drives our risk-taking is the presence of a margin of safety. Today we believe there is an inadequate margin of safety in the stock market. Valuations are not attractive enough to compensate for the many serious concerns we've mentioned that could impact investment fundamentals and returns.

In this environment, we remain positioned with below-average risk exposure. Reduced risk is, for us, a common sense conclusion.

As always, if you have any questions on how your portfolio is positioned or if you would like to discuss your investments in more detail, we welcome you to contact us to review by telephone or schedule a time to stop in the office. We appreciate your continued confidence and trust.

WATERFORD HAPPENINGS

UPDATED FORM ADV

On July 21, 2010, the U.S. Securities and Exchange Commission (the "SEC") unanimously adopted changes to Form ADV, Part 2. All 50 states have also adopted the new format, with some additional state-specific disclosures mandated. The new Part 2, also known as the "Brochure," has 18 separate items that our firm must address (19 for state-registered advisers), each of which requires disclosure on a distinct topic, and answers must be presented in the order of the items in the form, using the headings in the form. Our updated Form ADV, Part 2 has been posted to our website at www.waterfordadv.com/about.

GIVING BACK



Scott McCarthy was recently elected to the executive board of the Greater Niagara Frontier Council, Boy Scouts of America. Scott was

active in scouting while growing up and earned the rank of Eagle Scout in 1981. Scott currently serves as chairperson of the 2011 Friends of Scouting Campaign and has joined the On My Honor Giving Society.

The Boy Scouts of America, Greater Niagara Frontier Council is an incorporated, voluntary association of citizens that provides age-appropriate character-building programs for local youth. The Council serves over 10,000 young men and women in the territory of Erie and western Niagara Counties. Since 1910, the Council's mission has been to prepare young people to make ethical choices over their lifetime as they strive to reach their full potential.

TAX CORNER: ESTIMATED TAX PAYMENTS 101



HERE'S AN OVERVIEW FOR THOSE WHO ARE GETTING STARTED WITH ESTIMATED TAXES

As a rule, federal income taxes must be paid to the IRS as income is earned, on a “pay-as-you-go” basis. Taxes are generally withheld from your wages or salary, and you may elect to have taxes withheld from other types of income, such as pensions, distributions from IRAs and unemployment compensation. But taxes are generally not withheld from other types of income, such as alimony, interest, dividends, rental income, self-employment income, and capital gains.

Simply, estimated tax payments are a method of paying tax on income which is not subject to withholding, and on other income from which not enough income tax is withheld. If you don't pay enough tax, you'll end up with a penalty.

WHO MUST PAY?

The general rule is you have to pay estimated tax if your withholding doesn't cover 90% of your tax liability. But there are exceptions:

- No estimates are required if the amount due after subtracting withholding and credits will be less than \$1,000.
- In general, no estimates are required if your withholding and credits add up to at least as much as your prior year's tax.

Most people can avoid paying estimated tax if their withholding and credits equal 100% of the tax shown on the prior year's return, if your prior year tax return covered all 12 months of the tax year. However, if your prior year adjusted gross income exceeded \$150,000 (or \$75,000 if you filed a separate tax return from your spouse), then you must pay 110% instead of 100% of last year's tax (based on current law).

HOW MUCH TO PAY TO AVOID AN UNDERPAYMENT PENALTY

You figure the amount you need to pay, in the same manner you determine whether you need to pay. It's the difference between

the amount of withholding and credits you would need to have to avoid making payments, as described above, and the amount of withholding and credits you actually have, with one exception: you don't get the benefit of the \$1,000 rule mentioned above once it's determined that a payment is required.

The amount you have to pay is usually easy to determine if you're basing your payments on the prior year's tax liability. Figuring the payment based on 90% of the current year's tax liability requires a detailed estimate of your current year tax liability.

Once you've determined how much you need to pay, you should consider whether to use estimated tax payments or increase other sources of withholdings to cover the amount.

INCREASING YOUR WITHHOLDING

You can avoid making quarterly payments by increasing the amount withheld from your paycheck. You can use extra withholding on one type of income (such as wages) to avoid paying estimated tax on another type (such as interest, dividends or capital gain). Using withholding to cover your estimated tax liability can also get you out of a late payment penalty since withholding is presumed to be received evenly throughout the year.

To increase the amount of federal income tax withheld from your paycheck, file a new Form W-4 with your employer. There are two ways to increase your withholding on this form. One is to reduce the number of allowances you claim, or you can request an “additional amount” to be withheld from your paycheck.

MAKING ESTIMATED TAX PAYMENTS

For nearly all taxpayers, the due date for the first estimated tax payment of each year is April 15—the same day the return is due for the previous year. Subsequent payments are due June 15, September 15, and January 15 of the following year. When you make estimated tax payments you need to enclose Form 1040-ES, Estimated Tax Voucher.

PENALTY FOR UNDERPAYMENT

You may have to pay a tax underpayment penalty if you do not pay enough income tax through withholdings or estimated tax payments, or if you fail to make required estimated tax payments on time. The penalty is equivalent to nondeductible interest on the amount you underpaid, for the period of the underpayment. If you underpay only a small amount, or you correct the underpayment quickly, the penalty will be small.

FEDERAL ESTATE TAX PROVISIONS

Year	Exemption Amount	Highest Rate
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Repealed	No Estate Tax*
or 2010	\$5,000,000	35%
2011	\$5,000,000	35%
2012	\$5,000,000	35%
2013	\$1,000,000	55%

*Limited step-up in basis for income tax purposes.

NEW YORK STATE ESTATE TAX PROVISIONS

- \$1 million exemption
- Highest marginal tax rate is 16% (would apply to an estate of approximately \$10 million)
- NYS tax on a \$3.5 million estate amounts to \$229,000
- NYS tax on a \$5 million estate amounts to \$391,600
- No gift tax provisions

As an added feature to our newsletter, each quarter we will highlight an investment that may be contained within your portfolio. We hope you find this information beneficial. As always, if you'd like to review or discuss your portfolio in greater detail, please feel free to call our office at any time.

HARBOR INTERNATIONAL (HAINX)

INVESTMENT PHILOSOPHY & PROCESS

The management team believes that a low-turnover, long-term investment approach is essential in order to beat benchmarks and their peers. Their investment approach is contrarian/value-oriented, incorporating top-down and bottom-up analysis, though it is the latter that drives Harbor International's country and sector weightings. The Boston-based team work collaboratively to make buy or sell decisions on the fund. They are responsible for most of the bottom-up fundamental research. Management focuses more on identifying secular trends, themes, countries, and industries that might offer fertile long-term stock-picking opportunities for the Boston team to investigate more deeply. They are also actively involved in vetting stock ideas.

The Boston team's fundamental company research is focused on identifying secular trends (rather than shorter-term cycles) that will drive margin expansion in their companies. In addition to margin expansion, they want to see their companies have pricing power, which may be driven by strong brands or industry consolidation, a potential for restructuring, such as lowering operating costs, and undervalued assets. The Boston team travels all over the world, visiting companies and meeting their managements, competitors, and suppliers to gain a deeper understanding of a company's business model and the strengths of its management. The team does not believe in setting strict sell-price targets. They let their winners run as long as they don't believe their holdings have become egregiously overvalued, and focus their purchases on clearly undervalued names. The fund's turnover has ranged between 5% and 25%, but has typically been in the lower half of that range during the past 10 years.

ANALYSIS & OPINION

Opinion: We have been extremely impressed by the four-member Boston team. There are no weak or questionable links in the team. The team appears to enjoy working together. There is a collegial, collaborative, and consensus-driven culture, but we also sense that there is healthy, vigorous debate when they vet new ideas and existing holdings. We also believe their philosophy of long-term, low-turnover investing gives them an edge over their peers. Their high level of conviction in their approach and their willingness to be contrarian and build portfolios that look different from the benchmark (in terms of country and industry exposures) are additional positives.

Concerns: The team runs a relatively large asset base. This large asset base may cause a drag on performance, though the team's larger-cap focus and a diversified, low-turnover approach are significant mitigating factors.

Asset Class	International Blend
Managers	Northern Cross LLC Howard Appleby, Jean-Francois Ducrest, Jim LaTorre, and Edward Wendell
Min. Initial Inv.	\$50,000
Expense Ratio	0.81%

Relative Strength: Fund vs. Benchmark



Performance as of 1/31/2011*

	Harbor International	Vanguard Total International
YTD	1.39%	2.36%
1 Yr	21.27%	15.38%
3 Yrs	-0.35%	-3.21%
5 Yrs	6.05%	1.72%
10 Yrs	8.90%	3.75%
Since Inception (January 1988)	12.73%	5.52%

*Past performance does not guarantee future results



THE ROLE OF PRODUCT ALLOCATION IN SUSTAINING RETIREMENT INCOME



Once it comes time to retire and start withdrawing income from your accumulated assets, the famed role of asset allocation is diminished in importance, and a new concept emerges as the core ingredient of a healthy retirement portfolio, and that is **product allocation**. Utilizing only one product or category may not allow you to maximize your periodic income payments, maintain liquidity for emergencies, satisfy your legacy needs and sustain payments for a lifetime. With the availability of traditional pension plans diminishing and the responsibility of retirement income financing shifting from employers to individuals, the proper practice of product allocation becomes even more vital.

As individuals transition into retirement they face unique challenges, or risks that simply do not arise in the earlier wealth accumulation stage of the lifecycle. The following risks can have a dramatic effect on retirement income sustainability:

Longevity Risk: The most compelling and relevant of longevity statistics is the probability of survival for at least one member of a 65 year old couple. The chance that at least one member of a couple survives to age 85 is 76%; the probability that one spouse or even both are alive at age 90 is one in two.

Inflation Risk: What many retirees fail to realize is that a small inflation rate is an economic given, and that even a very low inflation rate can have a detrimental effect on their purchasing power several years into retirement. An inflation rate as low as 2% can reduce the purchasing power of \$1,000 by more than a third after 20 years.

Sequence of Returns Risk: In the years just before and just after retirement, a retiree's accumulated assets are most sensitive to losses from poor market returns. Thus, if portfolio investment returns are sequenced so that negative or poor returns are experienced early on in retirement, the sustainability of the income strategy will be threatened. In retirement it's the sequence of returns that matters, the average rate of return has little, if any, significance.

INSURE AGAINST THE RISKS

One cannot control the timing of market returns, just as we have no control over the precise length and cost of our retirement years or the rate of inflation throughout our retirement. Rather than trying to predict the outcome of any of these random events, we believe one should insure against adverse outcomes using a product allocation strategy. There are three major financial and insurance categories that should be considered in some combination within a comprehensive retirement income product allocation strategy, and they are:

Systematic Withdrawals from Traditional Investments: The Systematic Withdrawal Plan, or SWP, is a strategy in which money is systematically withdrawn from an account in order to generate a stream of retirement income. The assets within the account are allocated among various traditional asset classes, including equity mutual funds, fixed income mutual funds and cash. Conceptually these withdrawals from the SWP account continue until the account value hits zero, or until the end of the retiree's lifecycle.

Variable Annuities with Guaranteed Living Benefits: The latest generation of variable annuities (VAs) offers the option to elect a number of riders or features with embedded guarantees that address retirement income risks. VAs with Guaranteed Living Benefits offer the option or ability to guarantee an income stream for life. They also offer protection from market declines by locking in account value gains and guaranteeing continued growth from high points for the purposes of calculating income under the benefit.

Fixed and Variable Income Annuities: Income Annuities can be either immediate or deferred depending on when the income begins (immediately or at some point in the future), and either fixed or variable, depending on whether the income amount is the same for each payment or varies with market conditions. Once income begins, it is guaranteed to last as long as the annuitant lives. The embedded longevity insurance protects the annuitant against the risk of outliving their retirement capital.

THE EFFECTIVENESS OF RETIREMENT INCOME PRODUCTS

Since each product category has certain benefits and shortcomings, combining all three product types within one product allocation strategy may help you to better accomplish your retirement income goals.

The SWP is an effective inflation hedging tool. That's because the investment choices within a basic investment account are virtually endless and include equities, which tend to outperform other investments and outpace the rate of inflation over the long run. One could also purchase inflation-linked bonds, such as TIPS or Ibonds which can help hedge and protect against inflation. On the other hand, it is not very effective as a longevity planning tool compared to the other products. There are no associated guarantees and the investor is solely responsible for monitoring and adjusting the spending and investment policy in order to make the account last for the duration of the retirement. The SWP is also not very effective against sequence of return risk as it offers no protection against potential market drops during retirement. However, with a SWP, the investor can meet liquidity needs and legacy planning goals with the greatest ease since he or she retains control over their asset allocation and withdrawal rate. But it is also this exact same reason that the SWP is not very effective in helping the investor stay on course and avoid behavioral mistakes.

Unlike SWPs, VAs with Guaranteed Living Benefits offers the option or ability to guarantee an income stream for life. They therefore are quite effective for managing longevity risk. VAs with Guaranteed Living Benefits are generally better than income annuities with regard to inflation risk, because many offer systematic payment step-ups or minimum percentage increases that could in certain cases potentially offset the impact of inflation in the long run. VAs with Guaranteed Living Benefits also help hedge a retirement against sequence of returns risk through their implicit guarantees and promises. They are also effective in addressing behavioral weaknesses. Analysis of extensive

industry data suggests that since the investor is protected against a market downturn during sensitive years, they are more likely to opt for a riskier asset allocation within the variable annuity. This allocation could potentially result in higher growth over the long-term which could be passed on to loved ones at death. However, the liquidity of a VA with a Guaranteed Living Benefit is somewhat restricted because of withdrawal limits imposed by the riders.

The strength of an **Income Annuity** lies in its promise to pay out a steady, fixed payment for as long as the policyholder lives; as such, longevity risk is directly addressed and hedged. The most common design of this product—the fixed income annuity—is not very effective against inflation risk. However, some versions of this product do offer payments that vary with market performance (like the immediate variable annuity) and others offer income

payments that are adjusted for changes in the CPI index or by a fixed annual cost of living adjustment (COLA) rate, but this protection comes at a price. Finally, the Income Annuity is effective in its ability to hedge against sequence of return risk. While the product does not explicitly provide insurance against an early bear market, it indirectly overcomes the risk, since payments are fixed and guaranteed regardless of market fluctuations. Income Annuities also have the ability to help clients stay the course.

WHICH PRODUCT IS BEST? ALL THREE.

When we look at all three products, each product offers a valuable benefit that is “paid for” via a tradeoff in another risk management or goal achievement attribute. That is, one product may hedge against longevity risk but at the expense of a legacy planning or liquidity goal; another product may offer more guaran-

tees, etc. Therefore we suggest a combination of all three products, namely a product allocation mix.

We strongly believe that in most cases retirees will not be able to finance a sustainable retirement income with only one or two traditional product classes. Indeed, all three product categories—Systematic Withdrawals from Traditional Investments, Variable Annuities with Guaranteed Living Benefits and Income Annuities—mixed and matched in various combinations, are required in order to maximize the sustainability of one's retirement income.

If you'd like to discuss each of these product categories in more detail or how they would fit into your own unique retirement plans, please feel free to contact our office at any time.

SOCIAL SECURITY CHANGES FOR 2011

The Social Security program will be tweaked in several important ways in 2011. Workers will get a temporary tax break on the amount they pay into the entitlement program, and several claiming options for retirees will be eliminated. Here's a look at how the Social Security program will change this year.

Lower Social Security taxes. The amount workers pay into the Social Security trust fund will temporarily drop from 6.2 percent of taxable wages up to \$106,800 annually to 4.2 percent in 2011 only. For self-employed workers, the Social Security tax rate will drop from 12.4 percent to 10.4 percent next year, due to provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed by President Obama on December 17. Employers will continue to pay 6.2 percent of wages into the entitlement program.

Free loan option eliminated. Retirees will no longer be able to get an interest-free loan from the Social Security trust fund this year. The Social Security Administration announced in December 2010 that individuals will not be able to begin payments at age 62, pay back all the benefits received at age 70 without interest, and then reclaim at a higher rate due to delayed claiming. Under the new rules, Social Security beneficiaries may withdraw an application for retirement benefits only within 12 months of their first Social Security payment and are limited to one withdrawal per lifetime. “This free loan costs the Social Security trust fund the use of money

during the period the beneficiary is receiving benefits with the intent of later withdrawing the application and the interest earned on these funds,” says the Social Security Administration in a statement about the rule change. The Center for Retirement Research at Boston College calculated that mass utilization of this claiming strategy could cost the system between \$5.5 billion and \$11 billion, primarily going to high-income households with enough liquid assets to pay back the benefits.

Retroactive benefit suspensions discontinued. Retirees will still be allowed to temporarily suspend their benefits and restart them later, which can result in bigger Social Security checks to account for the months or years in which payment was not received. However, beneficiaries will not be able to retroactively suspend benefits and pay back money already received in exchange for higher payments going forward. Retirees will be allowed to voluntarily suspend benefits only for months in which they did not receive payments or future benefits beginning the month after the request is made.

Paper checks retired. Retirees who apply for Social Security benefits on or after May 1, 2011, will no longer have the option of receiving a paper check in the mail. Seniors can have their entitlement payments directly deposited into a bank or credit union account or loaded onto a prepaid Direct Express Debit MasterCard.

INCOME SECURITY IN YOUR 80S, BOUGHT IN YOUR 60S

Would you be willing to place a bet that you'll live past the age of 80? What about 85?

A relatively new product, known as *longevity insurance*, allows you to put money on those odds and the longer you can beat them, the more money you stand to collect. The insurance is a way to protect you from running out of money should you live to a ripe old age.

At its core, longevity insurance is simply a deferred annuity: you hand over cash to an insurance company, usually around the time you retire, however the guaranteed payments begin much later, usually around age 80 or 85, and last for the rest of your life. As with homeowner's policies and other types of insurance, the idea is to give up a smaller amount of money now, for a potentially larger payout later.

Though many retirees are wary to part with dollars for a benefit they may never receive, some baby boomers may decide it's worth the risk. Consider this: for a healthy 65-year-old couple, there is a 50% chance that at least one of them will live until age 92, according to the Society of

Actuaries.

Even if you don't live that long, the insurance removes some of the uncertainty of how much you can afford to spend in retirement. If you know you have a guaranteed stream of income that will kick in at age 85, for instance, you may be able to spend down your portfolio a little more aggressively before then. The idea is to buy enough insurance so that you'll be able to maintain your lifestyle after the payments begin.

Given the odds, it's cheaper to buy longevity insurance than to build a bond portfolio that will produce the same amount of income. It is also significantly less expensive than buying an immediate annuity, whose payments begin right away.

As attractive as the product sounds, there are several caveats. The biggest drawback, obviously, is that you may never recoup your initial premium. Some companies allow your heirs to receive some or all of your money, but adding those features may double your costs. It may be more cost-effective to purchase this product as a pure insurance policy.

There are other risks to consider. Since your payments don't begin for many years, perhaps even decades, inflation can diminish your future payments' purchasing power. Social Security, which increases with inflation, will provide a partial hedge. But it may pay to buy a larger amount of income, especially if you believe most of your expenses will be vulnerable to inflation. If you don't expect to receive the income for 15 years, you might increase the amount you need by 2 to 3% a year over that time period to arrive at an inflation-adjusted number.

Another big question is the financial stability of specific insurance companies many years in the future. That's why we suggest buying such insurance from several different providers. Should a company fail, the states have guarantee associations that would pay back the amount you invested minus the amount already received up to certain limits.

If you'd like to discuss whether longevity insurance might be an appropriate product for your specific circumstances, please contact our office at any time and we will be happy to answer any questions you may have.



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