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Securities America Advisors, Inc.
Marc A. Silverman, Investment Advisor Representative
12325 Port Grace Blvd., La Vista, NE 68128
(402) 399-9111
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Marc A. Silverman, President
Certified Financial Planner™ practitioner

9100 South Dadeland Blvd.
One Datran Center, Suite 1603
Miami, FL 33156-7817
Website: www.sfinancial.com

Phone: (305) 670-7088
Phone: (888) 229-7163
Fax (305) 670-9083
e-mail: marc@sfinancial.com

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SPRING 2010

Calculating Your Financial Ratios

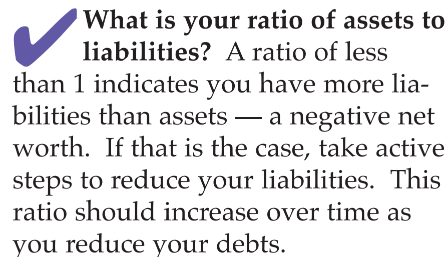
When reviewing the financial health of a company, it's common to look at financial ratios, such as earnings per share, price/earnings ratios, book value, and total return. Consider using the same concept to assess and track your personal financial situation. At least annually, prepare a net worth statement and then calculate various financial ratios.

You should start by preparing a net worth statement that lists all your assets and liabilities, with the excess representing your net worth. Assets should be valued at the price you would obtain if you sold them now, not the amount you paid for them. You'll also want to list your annual income for ease in calculating some of the ratios.

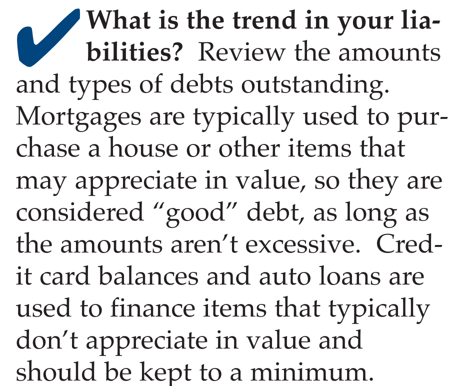
Now, ask yourself the following questions about your finances:

Has your net worth grown by more than the inflation rate?

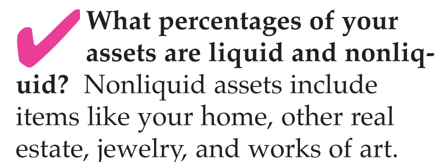
Calculate the percentage growth in your net worth over the past year and compare that to the inflation rate. To make progress toward achieving your financial goals, your net worth should increase by more than the inflation rate. With recent declines in the stock and housing markets, you may see short-term declines, but make sure you are making progress over the long term.



What is your ratio of assets to liabilities? A ratio of less than 1 indicates you have more liabilities than assets — a negative net worth. If that is the case, take active steps to reduce your liabilities. This ratio should increase over time as you reduce your debts.



What is the trend in your liabilities? Review the amounts and types of debts outstanding. Mortgages are typically used to purchase a house or other items that may appreciate in value, so they are considered "good" debt, as long as the amounts aren't excessive. Credit card balances and auto loans are used to finance items that typically don't appreciate in value and should be kept to a minimum.



What percentages of your assets are liquid and nonliquid? Nonliquid assets include items like your home, other real estate, jewelry, and works of art.

Continued on page 2

Avoid Cosigning Loans

To keep your credit rating high, avoid cosigning a loan for someone else. This can be difficult to enforce, since the request typically comes from a family member or friend. When you cosign a loan, you sign a legal document accepting responsibility for the entire debt. If the primary borrower falls behind in payments, the creditor can come to you immediately looking for payment. The creditor does not have to first exhaust legal remedies with the primary borrower.

Additionally, the primary borrower's late payment history is likely to appear on your credit report. The debt is also listed as your debt on your credit report, which may impair your ability to obtain another loan.

If you are a cosigner on a loan that the primary borrower can't repay, call the creditor immediately and try to negotiate. The creditor may agree to settle for a lesser amount to avoid legal or collection fees. But make sure the creditor agrees to keep your credit report clean for that lesser amount. When the debt is paid, review your credit report to make sure it is reported correctly. ❍❍❍

Financial Ratios

Continued from page 1

Although they may increase in value over time, they can be difficult to sell quickly at full market value. Liquid assets, such as bank accounts and stocks, are more easily converted to cash. You want sufficient liquid assets to cover emergencies.

✔ **What is your savings-to-income ratio?** For this ratio, your savings equals all assets designated to help fund your retirement. It typically won't include your home, since you will probably live there after retirement. First, you need to decide what this ratio should equal at retirement. It is basically the amount of savings you want at retirement age, preferably determined after a careful analysis of all appropriate factors, divided by your annual income. For instance, if you want retirement assets equal to $2,000,000 when you retire and you currently earn $100,000, you would need a savings-to-income ratio of 20 when you retire. You might then develop benchmarks over your working years to help you gauge whether you are on track to achieving that goal.

✔ **What is your savings rate?** Calculate what percentage of your income you are saving on an annual basis. Typically, you'll want to save a minimum of 10% a year. This would include 401(k) contributions and individual retirement account contributions. If your employer matches your 401(k) contributions, you can include those contributions in your savings.

✔ **How have your investments performed?** Now may also be a good time to thoroughly analyze your portfolio's performance over the past year. Measure the performance of each investment, comparing it to an appropriate benchmark. Also calculate your overall rate of return.

Please call if you'd like help reviewing your personal financial ratios. OOO

Should You Pay Off Your Mortgage before Retirement?

A recent study found that 41% of homeowners between the ages of 60 and 69 still have a mortgage on their home. Of those, 51% had sufficient assets to repay their mortgage (Source: Center for Retirement Research, July 2009). The study found that most households would be better off paying their mortgage off, since the cost of the mortgage is higher than their investment earnings. But is that good advice for your situation?

Before making this decision, be sure to consider these factors:

✔ **Compare your mortgage interest rate to the rate you are earning on your investments.** If you retain your mortgage because you believe you will earn more on your investment assets, make sure that is really happening. When paying off a mortgage, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk. Very few investment alternatives have a guaranteed return with no risk.

✔ **Consider the tax benefits of the mortgage interest.** Interest paid on mortgages with balances of up to $1,000,000 and on home-equity loans up to $100,000 is deductible on your federal tax return, provided you itemize deductions. You only benefit if your total itemized deductions exceed the standard deduction amount, which in 2009 and 2010 is $11,400 for married couples filing jointly and $5,700 for single taxpayers. According to the IRS, approximately two out of three taxpayers use the standard deductions. Even if you do itemize deductions, you are paying most of the interest cost yourself anyway. For instance, if you're in the 25% tax bracket, you save 25 cents in taxes for every dollar of interest, but you're still paying the remaining 75 cents.

✔ **Pay off consumer debt first.** Consumer debt typically carries higher interest rates than mortgage rates, and interest payments are not typically tax deductible, unless it's a home-equity loan. Thus, you should probably pay off your consumer debt in full before paying down your mortgage.

✔ **Consider which funds you would use to pay off the mortgage.** If you are planning to use tax-deferred monies, such as those in a traditional IRA or 401(k) plan, to pay off your mortgage, those withdrawals could be subject to income taxes, which will impact your decision to pay off the mortgage. Financially, it is typically better to use taxable accounts to pay off your mortgage.

✔ **Retain some savings.** You don't want to use so much of your investment assets to pay off your mortgage that you have difficulty paying for unexpected expenditures.

Please call if you'd like help deciding whether you should pay your mortgage off before retirement. OOO

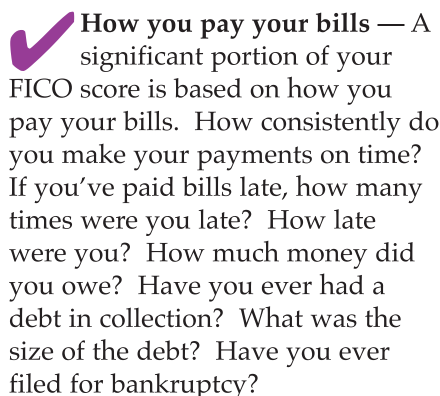
Improving Your Credit Score

As lenders have clamped down on issuing credit, your credit score now has a more significant impact on loans available to you, the interest rate and fees you'll pay, and other terms of the loan. Thus, it is more important than ever to understand your credit score and how you can improve it.

When lenders evaluate a credit application, they usually request both your credit report and your credit score, which is a mathematical calculation based on the information on your credit report. The score is intended to rate your credit risk, although other factors, such as your income, length of employment, and years in your home, are also considered.

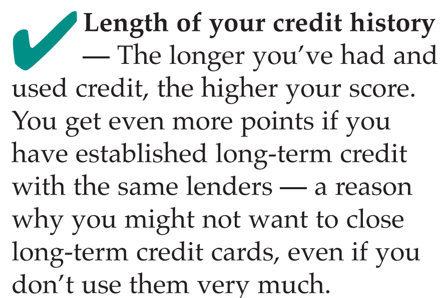
Credit scores are often referred to as FICO scores, since they are produced from software developed by Fair, Isaac and Company (FICO). While all of the major credit reporting agencies use FICO scores, your score from each agency can differ because information on your credit report differs by agency. Your FICO score is used in more than 75% of mortgage lending decisions and by 90% of the largest lenders (Source: MSN Money, December 29, 2008).

FICO scores range from 300 to 850, with higher scores indicating lower levels of credit risk. The major factors affecting your FICO score include:

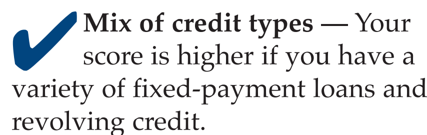


How you pay your bills — A significant portion of your FICO score is based on how you pay your bills. How consistently do you make your payments on time? If you've paid bills late, how many times were you late? How late were you? How much money did you owe? Have you ever had a debt in collection? What was the size of the debt? Have you ever filed for bankruptcy?

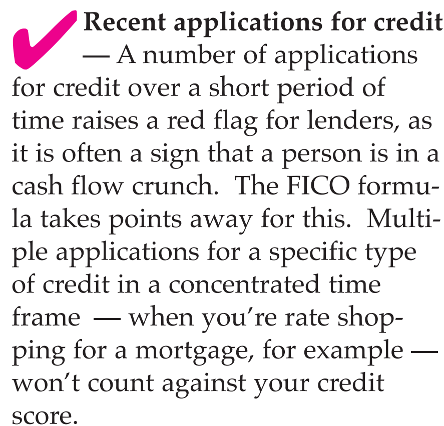
Your total outstanding debt — Outstanding debt is debt of all kinds, including mortgages, car loans, credit cards, home-equity lines of credit, and any other loans that are reported to a credit agency. Another important factor here is how much unused but available credit you have on your credit cards. The absolute amount of available credit you have is less important than how close you are to maxing out the credit you've been granted. The highest scores go to people who use credit sparingly and keep balances low. Ideally, you should use no more than 30% of your available limit, with 10% being even better.



Length of your credit history — The longer you've had and used credit, the higher your score. You get even more points if you have established long-term credit with the same lenders — a reason why you might not want to close long-term credit cards, even if you don't use them very much.

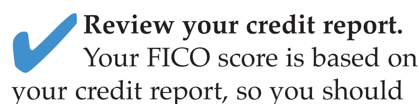


Mix of credit types — Your score is higher if you have a variety of fixed-payment loans and revolving credit.

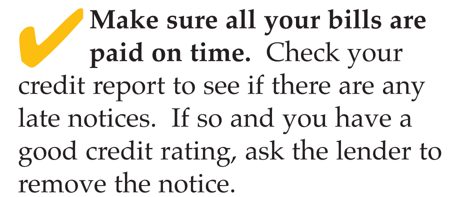


Recent applications for credit — A number of applications for credit over a short period of time raises a red flag for lenders, as it is often a sign that a person is in a cash flow crunch. The FICO formula takes points away for this. Multiple applications for a specific type of credit in a concentrated time frame — when you're rate shopping for a mortgage, for example — won't count against your credit score.

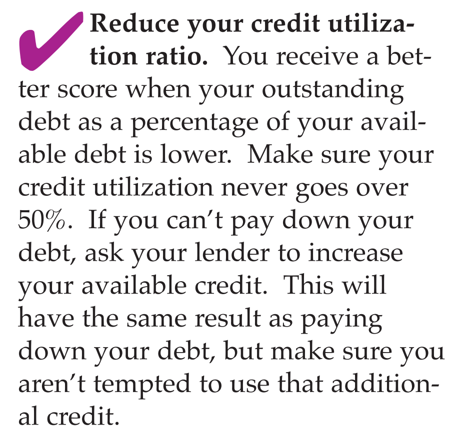
Typically, scores of 720 and above receive the best deals on interest rates. Based on the way the FICO score is calculated, there are strategies to improve your score if you're not at that level:



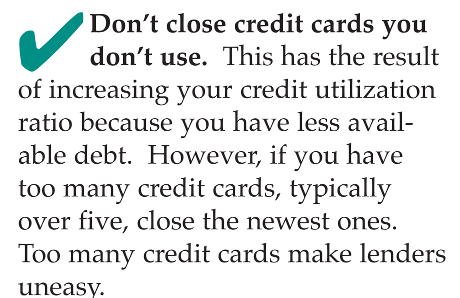
Review your credit report. Your FICO score is based on your credit report, so you should get copies of your report from each of the three main reporting agencies and make sure there are no errors. You are entitled to one free report every year from each of the agencies. Your information can vary by agency, so don't just look at one. Contact the agency if you find any mistakes.



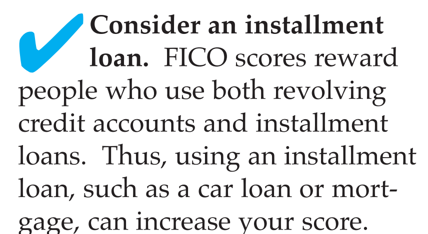
Make sure all your bills are paid on time. Check your credit report to see if there are any late notices. If so and you have a good credit rating, ask the lender to remove the notice.



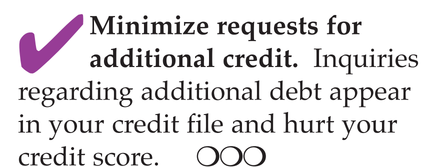
Reduce your credit utilization ratio. You receive a better score when your outstanding debt as a percentage of your available debt is lower. Make sure your credit utilization never goes over 50%. If you can't pay down your debt, ask your lender to increase your available credit. This will have the same result as paying down your debt, but make sure you aren't tempted to use that additional credit.



Don't close credit cards you don't use. This has the result of increasing your credit utilization ratio because you have less available debt. However, if you have too many credit cards, typically over five, close the newest ones. Too many credit cards make lenders uneasy.



Consider an installment loan. FICO scores reward people who use both revolving credit accounts and installment loans. Thus, using an installment loan, such as a car loan or mortgage, can increase your score.



Minimize requests for additional credit. Inquiries regarding additional debt appear in your credit file and hurt your credit score. ❍❍❍

Thoughts from Marc

It comes as no surprise that the market is where it is based on what happened last year. Please consider the following: I have been asked many times as to what percent of one's investment they can take to fund their retirement and lessen the odds of running out of money. *The Wall Street Journal* says that if you take no more than a 2% withdrawal percentage, you essentially bulletproof your retirement. As an example, assume that you had $500,000 to invest in your retirement portfolio, as long as you take no more than 2% ($10,000) per year from the investment, you probably will not run out of money. If you take as much as 3%, you're probably safe. 4%, you run a slight risk, and 5% or more depending on the number of years you have to spend in retirement, you run a much greater risk of ultimately running out of money.

I think we are going to see rapidly increasing inflation in the not-too-distant future. My logic for this is as follows: If you have a dollar bill and another dollar bill is printed, what happens to the value of your dollar? It goes down. What happens to the value of everyone else's dollars? They go down as well. If you want to buy a product, you're going to need more money to do so, because all of the dollars that have been printed are worth that much less. So, you may be asking, Why have we not had inflation with the government printing all of the money they have printed in order to stimulate the economy? There's another factor with respect to dollars called the "velocity of money," and this is the turnover of money in the economy. Consumers stopped spending money during the current recession. Once spending picks up, you more than likely will see a huge increase in inflation. Therefore, your money needs to be invested in such a way that it ultimately outpaces inflation. One of the solutions to this problem has been to utilize the annuity concept with the guarantee of lifetime income that is provided.

Should you wish to address your existing guarantee and/or would like to address the guarantees that do exist today, please don't hesitate to contact our office, as we will be happy to share these concepts with you. *(Guarantees are backed by the claims paying ability of the issuer.)*

Please keep in mind that a well-diversified portfolio that is left alone long term has a much better chance of doing well than one where you are constantly moving in and out of the market. Should you wish to discuss any of these concepts, please don't hesitate to give our office a call. *(Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.)*

Best regards,

Marc Silverman

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Pay Yourself First

If you're looking for ways to start paying yourself first, consider the following:

✔ **Reduce spending, diverting those reductions to savings.** One way to accomplish this is to cut back on your spending, perhaps reducing your expenditures for dining out, traveling, clothing, or entertainment. But for many people, this feels too much like sacrifice. Another alternative is to find ways to spend less for the same items.

✔ **Save all unexpected income.** Immediately save any money from tax refunds, bonuses, cash gifts, and inheritances. Before you get used to any salary increases, put that raise into savings, possibly in your 401(k) plan.

✔ **Make saving automatic.** Resolve to immediately set up an investment account that automatically deducts money from your bank account every month. Start out with small amounts that aren't even noticeable. As you get used to saving on a regular basis, increase the amount periodically. Another good alternative is to sign up for your company's 401(k) plan. ❍❍❍

Financial Thoughts

In a recent survey, 54% of workers age 65 and older said that they were working because they wanted to, while just 17% said it was because they needed the paycheck. Only 20% of those age 16 to 64 said they were working because they wanted to. However, 40% of those over age 62 said that they had delayed their retirement due to the recession (Source: Pew, 2009).

Approximately 44% of retirees are providing support for at least one other person. Of those providing support, 53% are doing so for children, 37% for grandchildren, and 10% for parents (Source: Charles Schwab, 2009).

Medical costs play a role in approximately 46% of all personal bankruptcies (Source: Harvard University, 2009).

In a recent survey, 78% of grandparents said that they prefer to give small financial gifts to children and grandchildren throughout their lifetime rather than leaving a larger legacy at death (Source: *Journal of Financial Planning*, September 2009).

When asked if they were worse off today than a year ago, 53% of women said "yes" compared to 38% of men. Almost 75% of women and 57% of men said the recession has fundamentally changed the way they think about saving and spending (Source: Advertising Age, 2009). ❍❍❍