STAGES

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Fidelity Investments® | Spring 2005

FOR INVESTORS IN PEAK SAVING YEARS

TEAM EFFORT

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STAGES | EDITOR'S NOTE

Bob Barrett, Editor

BUSY BUSY BUSY "If you want something done...." There are a number of ways to complete this statement. Recently I heard this one for the first time: "...give it to a busy person." While this may work just fine in many cases, there are some things that are too important, or perhaps too personal, to delegate. Like retirement planning, which many people disregard or discount because, well, they are too busy.

I'm as busy as anyone, I suppose. Still, I've always been more of a do-it-yourself kind of guy. That's especially true when it comes to something as important as planning for my financial future. But even though I've chosen to accept this responsibility, I'm not about to go it alone. Newspapers, magazines, books, newsletters, software, the Internet, television, radio, seminars, my wife, friends, and common sense are among the resources I rely on to make informed decisions. I've yet to enlist the services of a professional adviser, but I certainly recognize that a CFP may one day help me manage my 401(k), 529, and IRA. Until then, I'm comfortable — and confident — with my practical, self-directed approach.

What's your approach to retirement planning? Where does it fall on your priority scale? Are you ahead of the game or behind the eight ball? I think you know where I stand — that's what I like best about writing this letter for each issue. The rest of *Stages* is your forum, and I encourage you to share your experience with other readers. Send your e-mails to Stages@fmr.com. As always, I look forward to hearing from you.

Bob Barrett

FIDELITY | RESOURCES

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ON THE COVER: KEN WHITEHEAD WITH HIS FAMILY, FROM LEFT: CAMDEN, DELENE, JOSHUA, AND DAWSON.

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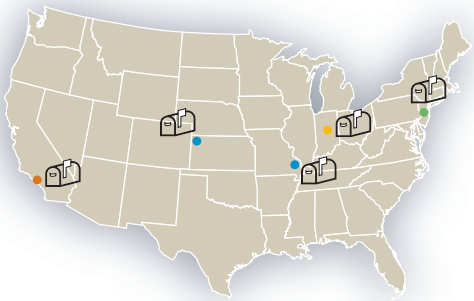
letters

your neighbors' views on topics that matter most



My two sons

I just wanted to compliment you on the autumn 2004 issue of *Stages*. I am very impressed with this publication and have practically read it from front to back. I plan to send it to my sons, ages 21 and 23, for their use. Hopefully, they'll take heed of the good information it included. Keep up the good work!

Rosemary Sparks Schuster
Goodland, Kan.

Hand-me-down knowledge

Autumn 2004 was my first issue of *Stages*, and I'm very impressed, especially because it's written in language the average person can understand. "Lasting Lessons" was well written and informative. I decided to financially empower my daughter during her freshman year of high school — she opened her own checking account. Each month I make a single deposit that includes allowances for clothing, school lunches, and chores. Two years later, I added her name to my credit card account and got her a card of her own. I'd heard too many horror stories of kids getting themselves in financial trouble before their adult life even started.

Kerry Davis
Indianapolis, Ind.

Age ranging

Please consider profiling individuals in various age brackets, rather than focusing exclusively on four investors in their 30s, as you did in the autumn 2004 issue. I am in my late 40s, and my investment strategy is quite different from "thirtysomethings," as you would expect.

Leslie Lam
St. Louis, Mo.

Running the numbers

I think *Stages* is great. I keep each issue so that I can go back and refer to the material over and over again. While I agree that people are not saving enough for retirement, you could do a better job helping them calculate a "potential" retirement accumulation of assets. This should be added to a Fidelity Web site. Let the user enter his or her annual contribution, pick the number of years to retirement, and then select an annual return. The online calculator would return a number. I think it would be easier for people who are not as savvy at investing to see real numbers that apply to their situation.

Robert B.
Independence, N.J.

Editor's reply: Fidelity's Contribution Calculator does all that — and more. Check it out within the Tools & Learning section of NetBenefits at **http://planning.netbenefits.com**. *This online resource will incorporate and display key information, including your 401(k) account balance and your current contribution rate. For more information about Tools & Learning, see the On Site column on page 23 of this issue.*

Words for workaholics

I'd like to see an article addressed to those people who have no desire (or plans) to retire — people who want to work until they drop. What do you think?

William Lenihan
Redondo Beach, Calif.

CALLING ALL REAL PEOPLE

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real life

IN SIGHT
PERSONAL PERSPECTIVE
REAL PEOPLE

Rest, relaxation, and no regrets

How to do away with the working vacation

Have you heard the claim that people spend more time planning their vacations than they do planning their retirement? Even if it's true, many workers still return from their time off wishing they had done things differently, according to a recent poll. So, as you go about planning your next vacation, consider the responses given to the following question: What was the biggest mistake you made when you took your last vacation from work?

No surprise that 43% felt they didn't take enough time off, according to OfficeTeam, a temporary staffing service for administrative professionals that commissioned the poll in May 2004. Maybe an extra day or two would have made a difference for the 17% who expressed that they couldn't relax or get their mind off work. A much smaller group (8%) said they checked in with the office too much, while a similar number (7%) didn't prepare or organize their work prior to leaving.

OfficeTeam suggests that collaborating with coworkers can help you rest easy while away. "Inform colleagues of the status of key projects before you leave, and designate a point person in your absence," says Diane Domeyer, executive director of OfficeTeam. "Also, consider which tasks a temporary or project professional could assume."

Domeyer also suggests the following pointers:

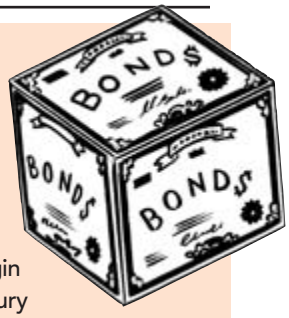
USE HISTORY AS YOUR GUIDE. Consider your last vacation, including what you did, how much time you took, and whether you felt reinvigorated on your return. This experience should serve as a basis for planning your next break.

RESIST THE URGE TO CHECK IN. Change your voicemail and e-mail to let colleagues know you're away. Don't contact the office, unless it is necessary. You'll have more time to unwind if you are not connected to the office.

PLAN YOUR REENTRY. Avoid scheduling too many meetings for the day you return. You'll need time to address immediate issues, catch up on e-mail, and get updates from coworkers on the status of projects.

SEIZE THE DAY. Don't wait until you're in dire need of a vacation to take one; regular breaks can keep you motivated all year long.

U.S. SAVINGS BONDS enter the electronic age



The U.S. Department of the Treasury is rolling out a service that allows bondholders to convert paper bonds to equivalent electronic securities. The SmartExchange service is optional, and will require that you open a TreasuryDirect account — a Web-based resource that allows you to purchase, manage, and redeem Treasury securities. Bonds from Series E, EE, and Series I are eligible for conversion; Series H and HH are not.

"Bond owners who take advantage of SmartExchange may have all their savings securities, whether originally bought in paper or electronic form, in a single account that can be accessed at any time, day or night," says Van Zeck, commissioner of the Bureau of the Public Debt. Account holdings and their current value can be viewed online — there is no paper to be accidentally lost or destroyed. In addition, full or partial redemption of electronic bonds can be scheduled at any time.

Later this year, the agency plans to begin offering marketable bills, notes, and Treasury Inflation-Protected Securities (TIPS) through TreasuryDirect, providing account holders the flexibility to directly hold and manage a wide range of Treasury securities in a TreasuryDirect account.

More information is available at **www.treasurydirect.gov**.

A 4-step plan to tackle credit card debt

Karen Gross likens excessive debt to a bad hangover. "The last thing you want to do is try to relieve your financial headache with a solution that will be worse than the hangover itself," says Gross, the president of the Coalition for Consumer Bankruptcy Debtor Education (**www.debtoreducation.org**). Quick fixes rarely work, according to Gross, who offers the following four-step formula for getting on track.

1 **Hold your horses, stay calm, and don't rush into any impulsive arrangements.** "Don't panic," Gross advises. "It's essential to pause, take a deep breath, and look carefully at possible solutions."

2 **Examine your situation.** While your debt problem may be serious and appear urgent, first get an accurate sense of the extent of your situation. Says Gross: "Lots of organizations offer help, but don't take the first solution that comes along. Take time to assess, compare, and contrast multiple solutions."

3 **List your options, including the pros and cons of each.** For example, while a home-equity loan may seem like an appropriate solution, it's not always the best course of action because it can put your home at risk.

4 **Pay at least the minimum amounts due on all of your credit cards.** This last step is critical because of the "universal default" clause, which permits a credit card company to raise your interest rate if you're late on another company's credit card or any other outstanding loan. Lenders argue that it's logical to raise rates for a consumer who has shown evidence of becoming a greater risk.

Routine inspection

Contributing to your 401(k) plan is an important first step in reaching your retirement objectives. It's just as important to actively manage your account. Like your health and your car, your 401(k) strategy should be subject to routine inspection. Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money. Follow these guidelines to see if your investment in yourself is progressing according to plan.

Save early, save often

An early start followed by years of steady saving is a powerful combination that can help you reach any long-term financial goal.

Make the most of the match

Be sure you're contributing enough to qualify for matching contributions made by your employer — "free money," as it has been aptly termed.

Take it to the limit

In 2005, you're allowed to make pretax 401(k) contributions of up to $14,000. Next year the limit increases to $15,000.

But don't stop there

After maxing out your 401(k) plan, save even more for retirement by opening a Roth IRA, if you're eligible. For 2005, the maximum contribution limit is $4,000.

Allocate and diversify

Balance risk and reward by building a diversified portfolio that is appropriately allocated among the three asset classes — stocks, bonds, and short-term investments.

Find your balance

When your actual asset allocation strays from your target, get it back in line by rebalancing — once a year or as necessary.

OPPOSITE PAGE: GETTY IMAGES (HAMMOCK), JASON SCHNEIDER; THIS PAGE: GETTY IMAGES (CREDIT CARDS), STEPHANIE CARTER/IMAGES.COM

TEENS TO THE RESCUE

College-bound students willing to fund their own higher education

The skyrocketing cost of a college education is enough to make any parent lose sleep. Now comes a bit of good news: 95% of teens feel an obligation to share the financial burden, and nearly three-quarters (74%) think ma and pa should contribute only half the amount or less.

These are among the findings of a recent survey commissioned by Fidelity to better understand parents' and teens' behavior, expectations, and concerns on the topic of paying for college. *Family In-Tuition* also reveals that college-bound teens may not be fully informed when it comes to the price of admission, as 64% report not knowing how much their college education will cost. Parents, on the other hand, appear to be fully aware. But while 87% of parents have begun saving, only one-third (34%) are utilizing a tax-advantaged account such as a 529 college savings plan.

"The good news is that parents and teens recognize the importance of saving for college, and many have already started to save," says Bob Corcoran, vice president of college planning at Fidelity.

On average, parents think they should begin saving before the child reaches age 2, according to the survey. In reality, they start to save when the child is almost 6.

In addition to getting an early start, Fidelity suggests the following:

- Make saving for college expenses a specific goal.
- Open a separate, tax-advantaged account for college savings.
- Make regular contributions — weekly, monthly, or annually.[1]

Corcoran offers one more practical pointer: "Parents and children need to have a discussion about saving for college. It's apparent that both are willing to save. Having a discussion about expectations can help a family develop a common goal and saving strategy."

1. Periodic investing does not guarantee a profit or protect against a loss in a declining market.

Family In-Tuition survey by Opinion Research Corporation for Fidelity Investments. Conducted in May 2004 among 477 college-bound teens (ages 14–17) and 376 parents of college-bound teens, with annual household income of $35,000 or more.

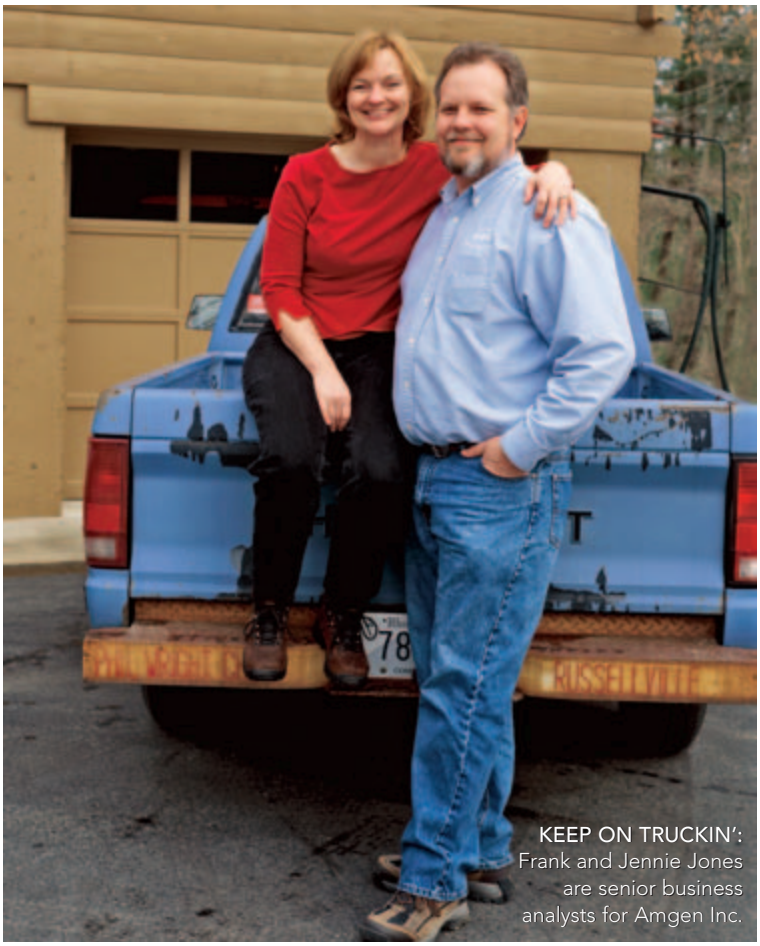
MICHAEL SLOAN

Teens and tuition

How much parents would ideally pay for college versus how much teens think their parents should pay

	Parents	Teens
Pay all	29%	5%
Pay most	21%	21%
Pay half	16%	30%
Pay some	24%	32%
Pay none	7%	12%

Source: *Family In-Tuition*, Fidelity Investments.



KEEP ON TRUCKIN': Frank and Jennie Jones are senior business analysts for Amgen Inc.

REENA BAMMI

Simple dream

How we saved our way to early retirement

By Jennie Jones

Many people dream about retiring early to live the simple life — fishing, gardening, volunteering, or pursuing their hobbies. My husband, Frank, and I have that dream, and soon it's going to become a reality.

Even though we're only in our 40s, we have reached a point where we have enough money in our retirement accounts, real estate, and other investments to take the step that has been our longtime goal — retiring early. We keep our needs simple, watch our spending, and take advantage of tax-deferred retirement accounts, especially our 401(k)s. We also know investing involves risk, and that our success will vary — we may see gains or we may lose money.

As business analysts for a Fortune 500 company, Amgen Inc., Frank and I have respectable incomes. But we also believe that how we spend our money is just as important as how much we make. We never carry a balance on our credit cards, and we don't buy expensive "toys."

Built to last. We're always looking for opportunities to save. Instead of buying the latest TV, we try to negotiate a deal on last year's floor model. We prefer camping rather than stays at extravagant hotels. And we avoid hiring expensive contractors and mechanics by doing house projects and car repairs ourselves. When we do buy big-ticket items like furniture or cars, we choose quality items that are built to last. As an example, Frank is still driving the '84 pickup he bought when he was in his 20s.

By making good spending decisions, we've been able to save a large portion of our income and also tithe 10% to our church. Except for when Frank was earning his degree, we have always maxed out our 401(k) contributions and taken advantage of the stock purchase plan offered by Amgen.

Destination: Arkansas. We do a lot of research on our investments and review them regularly. We've been fortunate that most have been profitable for us. Once a year, we sit down to set goals and strategies, and then we put up mini-posters as a constant reminder of those goals and dreams.

Right now, for example, there's a picture on our refrigerator of our dream retirement home, which we're working to pay off before we retire. The home is in Arkansas, where the cost of living is reasonable and we have family. It's a long way from our hometown of Hope, R.I. There's a lake, space for a garden, and room for pets. Frank has plans to fish and build an amphibious vehicle.

Dare to dream. To cover living expenses, we'll first spend assets we have saved outside of our retirement accounts. When we reach 60, we'll start tapping into our 401(k) savings. We know we won't be able to replace our present income, but we plan to live simply in retirement, on about 20% of what we are making now. Currently, we are practicing living on our anticipated retirement income. We've also told ourselves that if things don't work out, we can always go back to work.

Anyone can dream of retiring early for the simple life. The difference for us is that we are making our dream a reality by setting financial goals and managing our money. What's your dream?

QUEST FOR KNOWLEDGE

By Susannah Clark

ANDY GOODWIN

IRINA ILINA

AGE
30

EMPLOYER
UNITECH SYSTEMS

OCCUPATION
MARKETING SPECIALIST

HOME
OSWEGO, ILLINOIS

Retirement planning challenge: In 1997, Irina Ilina's pursuit of a second master's degree took her from a remote Russian island to southern Connecticut, along Long Island Sound. Before enrolling in her first class at the University of New Haven, however, Ilina had embarked on a different sort of quest for knowledge. "I quickly realized that I had to learn how to manage money — or I would go broke," recalls Ilina, whose socialist upbringing on Sakhalin Island had instilled a profoundly different attitude about money.

Opening a savings account and balancing a checkbook were the least of Ilina's worries. "First, I had to learn that I could actually trust American banks," she says. Years earlier, Ilina had developed a survival instinct and a thirst for financial knowledge — a combination that has served her well in the United States. "I was always interested in financial matters, which was unusual for a female from Eastern Europe," she notes. "I didn't want to be broke. I wanted to be able to rely on my savings well into my retirement years."

Today, Ilina's self-described "learning quest" is playing out in the Midwest, where she and her husband, Jason, are expecting their first child in June. Parenthood is sure to bring new challenges — financial and otherwise — and the couple is already preparing for them.

Her solution: Ilina takes a practical, self-directed approach to maintaining her financial smarts. "I read books, take online classes, and ask a lot of questions," she says. The effort has paid off: The couple paid cash for their two cars, they have a well-padded emergency fund and invest in IRAs, and she's maximizing her contributions to her 401(k) plan.

Ilina knows firsthand the value of an education, and she has already begun saving to give her child the same opportunities she has enjoyed. "One of the first things we did was enroll in a 529 college savings plan," she says.

Her investment strategy: The structured approach of Ilina's 529 portfolio is consistent with the strategy she has taken with her overall investment plan. "I am an index investor," Ilina declares. "For me, it makes sense, since I'm not very aggressive." Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

She's similarly careful when it comes to spending, evaluating each purchase to weigh its true importance. "My husband makes fun of me a little bit, but it's part of my mentality," she laughs. "My thought is, if we save that money today instead of spending it, what will it be worth tomorrow?"

Support from her plan: Ilina's employer matches dollar for dollar up to 5% of her contributions to her 401(k). "That's a nice benefit to have. It's like 'free' money — take it," she advises.

She notes that her employer has been receptive to her suggestions about its plan, too. "We did not have an index fund as an initial offering, and I went to them and asked for one, so they added it to the lineup," she says. "They're responsive to what participants are asking for."

MOVER AND SHAKER

By Jeff Schlegel

Retirement planning challenge: Call it a happy coincidence or a good read on ongoing trends. Like a determined surfer in hot pursuit of the big one, Jim Wagner is riding high on the wave that is Florida's booming real estate market. "Get on the water in Florida and you're bound to do well," says the former surfer and current real estate investor, describing the Sunshine State's abundance of waterfront property. "I've essentially moved up the coast during the past ten years and have seen the market play out as escalating demand moved north from Miami."

Wagner and his family now live on the scenic Intracoastal Waterway, where they sometimes fish from their dock as manatees and porpoises swim by. His wife, Rhonda, left her nursing job three years ago to raise their two children, ages 3 and 2. Wagner started with The Sherwin-Williams Company after college and has advanced from manager trainee to district sales manager of a six-county area in Florida.

Wagner plans to remain with Sherwin-Williams until he retires. By then, his children will have graduated from college, and he and his wife will be ready for yet another move. "We have our eyes on the northern U.S., where the weather is cooler and we can enjoy the change of seasons," Wagner says.

His solution: When Wagner was 15, he talked his father into splitting the $2,000 minimum requirement needed to invest in a mutual fund. "My father started teaching me about investing," he says. "I became enamored with it and that's where my interest came from." In his early 20s, he and his brother made a friendly wager about who would be the first to attain millionaire status, with both predicting it would be before they turned 40. Now 36, Wagner says he is ahead of schedule.

In addition to his home, Wagner's real estate holdings include two waterfront rental properties on the central coast. "The real estate investments play more into our quality of life because we have our primary goals covered with our other investments," he says. Those investments include a pension and 401(k) plan through Sherwin-Williams, as well as an IRA and 529 college savings plans for his kids.

His investment strategy: Wagner doesn't see himself as an overly aggressive investor, although he acknowledges that others might disagree, based on his real estate moves and concentrated portfolio positions. His self-directed pension is invested entirely in an aggressive growth fund, and his 401(k) is evenly split between company stock and a blend fund. Wagner also has a separate account used to invest in individual stocks, although he admits his track record could be better. Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Support from his plan: With extra cash in hand after selling his previous home last spring, Wagner now contributes 20% of his paycheck to his 401(k). Sherwin-Williams matches the first 6% of his contribution. "It's set up in a way where I feel very comfortable," he says. "That helps me sleep well at night."

JIM WAGNER

AGE
36

EMPLOYER
THE SHERWIN-WILLIAMS COMPANY

OCCUPATION
DISTRICT SALES MANAGER

HOME
MELBOURNE, FLORIDA

RIKU+ANNA

HOLD ON TIGHT: Ken Whitehead and his son Joshua, age 2.

MARK TUCKER

Safe & secure

Securing your family's future is critical — and challenging. Following these steps may help you meet your short- and long-term goals.

By Clint Willis

Ken and Delene Whitehead, both 35, see eye to eye on financial matters. "We both believe that investing has to be part of an overall plan and lifestyle," says Ken, a corporate trainer at Ford Credit.

The Whiteheads' plan includes a sensible budget, disciplined savings, adequate insurance coverage, and a carefully planned investment strategy. In addition, the Franklin, Tenn., couple make regular investments in tax-favored Education Savings Accounts to fund college educations for their three sons, ages 6, 4, and 2. They also set aside money in retirement savings accounts that include a 401(k) and three Roth IRAs. "If you're careful, you can save a good amount even if you have only one income," notes Delene, a former teacher who's now a stay-at-home mom.

Like the Whiteheads, you probably have a clear vision of your family's future. Such dreams, however, come with a high price tag: The typical American family will spend more than $260,000 to raise a child from birth to age 17, according to 2003 data from the U.S. Department of Agriculture. By making smart financial moves today, you can meet the many challenges that lie ahead.

The first step is to review your current situation and prioritize regular savings. You can then turn your attention to specific goals such as college costs and retirement. That done, you can protect your growing assets through insurance and take steps to create an estate plan that will benefit your heirs when you are gone.

Order in the house

Every sound long-term financial plan starts with a sensible budget. Your budget can help you become a more mindful spender, so that your money buys the things you and your family value most. A sound budget doesn't require unreasonable sacrifices; it simply sets guidelines for sensible spending and saving.

Tracking your current spending in various categories is the most important step in the process of developing a budget. Chances are, you'll identify opportunities to save a bit more. "The results can be really eye opening," says David Little, a financial planner in Fullerton, Calif. "You may find you're spending far more than you mean to spend in some categories."

Once you free up some cash for saving, you can start to build an emergency fund that can cover three to six months of estimated expenses, if not more. That money will help you manage short-term setbacks like a job loss, unexpected medical costs, or a major auto repair.

Eric and Andrea Braciska have accumulated a rainy-day fund that could support their family for about six months. The Tewksbury, Mass., couple occasionally draws on the account to meet short-term goals, such as vacations or Christmas shopping, but quickly replenishes the fund when they receive a bonus or accumulate other savings.

"We don't believe in borrowing to cover short-term needs," Andrea says. "The emergency fund lets us avoid doing that, so we don't pay interest on credit card bills or home-equity loans. And that leaves us more money to save for long-term goals."

You may wish to set up separate accounts for your short-term goals, which could include a down payment on a new home or a fund to help care for elderly parents. Make sure you choose a relatively stable mix of investments for that money, because you may need to draw upon it soon.

Now is also a good time to start saving for long-term goals, including retirement and college costs, as part of a comprehensive financial plan. The money you save today can continue to grow for decades, with surprising results.

Getting set for retirement

Financing a secure retirement is the most challenging goal you are likely to face. You can begin to meet that challenge head on by carefully estimating how much your retirement is likely to cost.

Many experts contend that retirees will need 85% to 100% of their preretirement income to meet their retirement needs. You may wish to create a more precise estimate of your future costs. Take a look at your budget and think about how your outlays in various categories might change during retirement.

Review your likely sources of retirement income, such as pensions, Social Security, and part-time work. They may not be sufficient to meet all your projected expenses, which is where your retirement savings plan comes in. Estimate how much you need to accumulate in your 401(k) to generate income that can fill your retirement gap. You can then figure how much you need to save to reach your goal. A financial adviser can help you make those calculations, as can the various retirement planning tools available on Fidelity NetBenefits.®

IN BRIEF

- Estimate how much your retirement is likely to cost, and review your likely sources of income.
- Review your insurance needs to prevent your financial plan from getting sidetracked.
- Protect your heirs from estate taxes with a well-crafted estate plan.

Contribute as much as you can to your workplace retirement savings plan. The money you invest in your 401(k) comes out of your salary before that salary is taxed. In effect, your plan offers you an opportunity to save at a significant discount. Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

What's more, you can put off paying taxes on profits you earn within the shelter of your 401(k) plan until you withdraw the money, which may not happen for decades. That tax deferral offers you the potential to earn returns on every penny of your profits. "Some people say they can't afford to contribute to their 401(k) plan," says Greg Schultz, a financial planner in Walnut Creek, Calif. "I tell them they can't afford *not* to contribute."

Earlier this year, Ken Whitehead received a pay raise that allowed him to meet a goal he had set for himself last year — to increase his 401(k) contributions from 7% to 10% of his salary. The Whiteheads also make modest contributions to Roth IRAs, which, along with traditional IRAs, can offer additional tax savings. For example, you can avoid paying federal taxes on profits

in a Roth IRA even when you withdraw the money, provided you meet the five-year holding period and wait until you're age 59½. "The tax breaks can make a real difference in the long run," Ken notes.

Give careful thought to how you'll invest your retirement savings. You may be able to create a relatively aggressive investment portfolio, because you may have time to recover from a market decline. For example, young or midcareer workers might invest the majority of their retirement savings in stock-based mutual funds, with a more modest stake in fixed-income funds.

Once your plan is in place, monitor its progress on an annual basis. You may need to adjust your savings rate or the investment mix in your plan to stay on the right track.

"We both believe that investing has to be part of our overall plan and lifestyle."

— KEN WHITEHEAD (PICTURED WITH WIFE, DELENE)

Saving for college

College costs have climbed sharply in recent years, to around $11,354 a year at public colleges and $27,516 at private schools, according to 2004 data from The College Board. You may be tempted to put off saving for retirement to address this challenge, but that would be a mistake.

Drawing upon a range of resources — which may include a mix of current income, home-equity loans, financial aid, and personal savings — can help you meet college costs. By contrast, your financial options may narrow sharply by the time you reach retirement age.

That said, it's a great idea to save at least modest amounts toward college. Once again, an early start can be a huge advantage, as can tax-advantaged college savings accounts. Many investors choose 529 college savings plans. With these, your contributions grow tax deferred, and you will not be subject to federal income taxes on withdrawals used to pay for qualified college expenses.[1]

Other options, such as Education Savings Accounts and custodial accounts, also offer tax benefits. An experienced financial adviser can help you choose the most appropriate investments for your family.

Reviewing your insurance needs

"Inadequate insurance can really blow a financial plan out of the water," notes Little. Make sure you have adequate coverage in these areas:

Life insurance. A rule of thumb calls for life insurance coverage equal to five to seven times your annual income. You may need more, depending on factors such as your debt, your family's expenses, and future needs, including college tuition for children.

Term life insurance is generally the most affordable coverage. It offers protection for a specific period, usually 10, 20, or 30 years. The premium rates typically rise when you renew the policy. Some families may consider permanent life insurance, which is often more expensive. Such policies provide coverage for your lifetime, and part of your premium goes into an investment account that grows tax deferred and accumulates a cash value.

Disability insurance. This coverage will replace part of your income — typically 60% to 70% at large corporations — if you are unable to work. You may receive such coverage through your employer, but even then, you might want to acquire supplemental coverage on your own.

Health insurance. Rising health care costs can threaten your financial plans unless you have adequate insurance coverage. Take full advantage of your employer's plan. If you have options, choose those that suit your family's special needs.

Homeowners insurance. Find a policy that includes protection against losses from fire and theft and the like, as well as substantial liability coverage.

Long-term-care insurance. Such a policy will provide coverage for nursing home costs or other special care in your old age. For some people, the insurance can serve as an important supplement to Medicare and private health care policies.

Planning your estate

Parenthood brings many new responsibilities, including the need to protect your children when you're gone. A well-crafted estate plan can execute your wishes, potentially protect your heirs from estate taxes, and appoint guardians for minor children.

A good first step is to develop a will that spells out your wishes. You might also decide to create one or more trusts. Some trusts try to shelter assets from estate taxes or control when your children or other heirs gain access to their inheritance. Finally, it's a good idea to review your designated beneficiaries for assets such as IRAs or other accounts, especially after a major life change like marriage or divorce.

The work you do now to put your financial plans on solid footing may begin paying rewards immediately. "The great thing about having a plan is peace of mind," Ken Whitehead says. "Delene and I don't stay up late worrying about money. We know we're doing what we need to do to reach our goals."

1. Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), qualified distributions are federal income tax free. The provisions of EGTRRA will expire on December 31, 2010. Unless the law is extended by Congress and the president, the federal tax treatment of 529 plans will revert to its status as it was prior to January 1, 2002.

DIG DEEPER INTO SAFE & SECURE

Educated savers

Eric and Andrea Braciska have been studying saving for a long time. Eric's parents matched every dollar he saved from mowing lawns and shoveling driveways. Andrea's folks insisted that she take a financial planning course right after she finished college. Those lessons are paying off now that Eric, 35, and Andrea, 36, have three children of their own.

The couple, from Tewksbury, Mass., met with a financial adviser two years ago to create a college savings plan for the kids, who range in age from 3 to 9. The planner estimated that the total bill could amount to $745,000. "The amount seemed daunting, but we're on target to meet that goal," says Andrea, who works part time as a senior analyst at Biogen Idec.

An early start

The couple began saving for future college costs even before their first child was born. Today, they have reached 25% of their goal — the result of setting aside all proceeds from stock option grants and 6% of their combined salaries — in a trio of 529 college savings plans and other tax-advantaged investments. "Maintaining separate accounts gives us the flexibility to invest differently for each child, based on when they will be attending college," says Eric, noting that, for now, they invest mostly in stock funds. "Our oldest child is still nine, so we feel like we can ride out bear markets."

Meanwhile, the Braciskas are determined not to neglect their other goals, such as retirement. They currently save 14% of their income in their 401(k) accounts, and both Eric and Andrea receive generous matching contributions from their respective employers.

Goal oriented

The couple review their college and retirement portfolios on an annual basis and realign them when market movements alter their allocations. Otherwise, they spend little time worrying about their investments. "For us, investing a little money over a long period of time, without trying to time the market, is the way to go," Eric says.

The Braciskas are disciplined spenders. Eric, an account manager for Pfizer, drives a company car, and the couple's second vehicle is a used minivan. "We don't care about keeping up with the neighbors," Andrea says. "We care about accomplishing our family's goals."

ALL TOGETHER: The Braciska family includes (from left) Meghan, Andrea, Eric (holding Kyle), and Allyson.

HEATH ROBBINS

The insight of 1,000 MILLIONAIRES

By Len Abram

When Jim Trippon (left) looks at America's middle class, he sees more than hardworking people striving to make ends meet. He sees potential millionaires.

Trippon, the author of *How Millionaires Stay Rich Forever*, believes that anyone in the middle class can become a millionaire through frugal living and disciplined savings. For his book, Trippon interviewed 1,000 millionaires across the United States. He discovered that many of them became millionaires through a lifetime habit of saving, especially in tax-sheltered accounts, such as 401(k)s and IRAs. Keep in mind, investing involves risk. The value of your investment will fluctuate over time and you may gain or lose money.

In this interview, Trippon discusses the common traits among these millionaires and what investors might learn from their financial success.

Becoming a millionaire by retirement age may seem out of reach for many. How can middle-class people, with proper savings and advice, reach that goal?

JIM TRIPPON: That's how most millionaires became millionaires — through a proper and sound savings approach. If you look at the studies, more than 80% of the millionaires in the United States did not inherit their wealth but are self made.

The problem is that most people live on what I call their "ifcome," not "income." We often think, If I get a raise, if the car doesn't break down, if the kid doesn't need new braces, I'll be okay. But the reality is that those things will happen, and so you have to have the discipline to save regularly.

Your book describes strategies for growing wealth and then keeping it. What are the most important factors in building wealth?

TRIPPON: You can build wealth by developing a game plan and sticking with it. With written budgets, retirement plans, and clear goals, you can track and measure how effectively you're moving toward creating wealth each quarter, month, or even each week. The truth is that not enough people read their monthly financial statements, let alone define where they are going and how to get there. If it's not in writing, it's not a plan; it's a wish.

The 1,000 millionaires I interviewed all had savings plans and made regular contributions into an investment account of some type. Whether it's $25 or $300 a month, they do it month in, month out.

For most middle-income people, 401(k)s, 403(b)s, and IRAs can be powerful tools to help them become millionaires. First, you do it automatically. Second, you defer taxes. The top marginal rate for income, with state and federal taxes, can be more than 40%. If you add in Social Security, that can be almost a 45% tax bite.

LAETITIA CHEVET/IMAGES.COM (ILLUSTRATION)

So, if you can save money on a pretax basis and let it grow tax deferred, that may significantly boost your rate of return.

What about holding on to the million you have made?

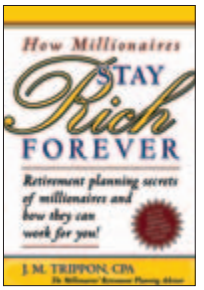
TRIPPON: More than 20% of retired millionaires are forced back to work within five years, according to my research. The major reason is uninsured health care costs. People retiring in their 50s don't realize that they have until age 65 before Medicare insurance becomes available. Unless they're picking up health care benefits from their company, they could face huge expenses to buy insurance. In some cases, they may not even be able to buy coverage, because of preexisting conditions. Unless you are a multimillionaire, long-term-care insurance can be a basic requirement to help protect your assets.

The other problem is that the retirees spend down their principal. I am not a proponent of the "asset spend down" philosophy — that is, dying broke. With more people than ever living past the age of 100, you never know how long your life will be. A professional financial adviser might help you preserve your wealth. For example, in my opinion, the No. 1 tax benefit in the past 20 years is the Roth IRA — and not enough people use it. While your contributions are taxed, any growth is not subject to federal income taxes, even at withdrawal, provided certain conditions are met.

What are some of the common mistakes people make that knock them off the road to millionaire status?

TRIPPON: Probably the biggest is consumer debt. If you look at the average interest rate on credit cards in the United States, it's more than 14%, and a lot of them are as high as 28% and 29%. It's impossible to duplicate that rate of return in the investment markets, yet you could get a 20% rate (or the interest on your credit card balances) of return by paying down high-interest credit cards.

It's not unusual to see college students graduate with $400 or $500 a month in interest payments on their credit cards. That's money better used in a retirement account for their future.



"YOU CAN BUILD WEALTH BY DEVELOPING A GAME PLAN AND STICKING WITH IT."

— JIM TRIPPON

Has the number of millionaires been increasing or decreasing following the bear market of 2000–2003?

TRIPPON: With the decline of equity markets from 2000 to 2003, we had a pullback. However, since January 2003, we've seen a rebound. In fact, unless they were fully invested in technology, the wealth of millionaires is higher than it was 10 to 20 years ago.

The key is demographics, including the largest transfer of wealth in the history of our country. Members of the World War II generation are passing assets to their kids. Having grown up in the Great Depression, they know the value of a dollar and savings. And we've liberalized the amount that you can pass tax free to your children.

Another factor has been the skyrocketing price of housing in many parts of the country, which has been due to increasing population and demand. On the East Coast, for example, prices have maybe doubled, if not tripled, in the past 20 years. People who purchased a home 15 to 20 years ago have seen tremendous, unforeseen equity.

Should people factor the equity of their homes into their net worth when determining if they've achieved millionaire status?

TRIPPON: Yes and no. Because home equity is part of their wealth, yes. Of course, property values can vary throughout the country. For most people, however, their home does not generate income. The 1,000 millionaires I interviewed had actual liquid assets of $1 million or more.

Benjamin Franklin would nod at the many references to frugality in your book. Do you see quality of life taking a backseat to attaining wealth?

TRIPPON: Careful spending is key, but that doesn't mean a diminished quality of life. One of the things I admire most about Benjamin Franklin was his reported recordkeeping. From his writings, you can tell that he knew where he stood with his finances. He also believed in moderation in all things. And you can have moderation in your saving, so that you will save for the future but also enjoy time now. You've got to have a balance between saving and spending. You can accomplish both. Franklin, of course, was also a great philanthropist.

You conclude your book with a chapter on charity, which is unusual for a book about achieving and keeping wealth.

TRIPPON: Not really. People need to learn that to succeed with money, you have to know that there's enough of it out there. If you can help and give to others, you find it comes back to you in ways you'd never expect, and your wealth grows.

A common theory is that people drive themselves hard to achieve wealth and then suddenly become philanthropists. I found that most millionaires have always given to their favorite charity, their faith, their school, and causes they hold dear. Giving helps people accept that there is enough money out there — and there is — if they just plan and save.

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A lesson learned

Mindful of their parents' mistakes in saving for retirement, today's savers understand the challenges that lie ahead.

By Russell Wild

Put any two economists in a room, the old joke goes, and you'll get at least three opinions. But there is one thing that virtually every economist agrees on: Americans need to be saving more for retirement.

The age for Social Security eligibility keeps rising. People are living longer, which means longer retirements. At the same time, retirement has gotten pricier, due in part to spiraling health care costs.

All of this has clearly caught the eye of savers, most of whom say that they're facing up to the challenge of putting aside enough money to last throughout retirement. In fact, nearly three out of four adult Americans feel that they will be financially better prepared for retirement than their parents were, according to "Retirement Trends for Every Generation," a survey conducted in January by Fidelity Investments. Among the reasons cited are a better understanding of investing, an early start on saving, a willingness to save a greater percentage of their income, and more realistic expectations of retirement costs.

"Investors of all ages want to avoid making the same mistakes as their parents, but they need discipline and guidance to get started early and stay on track," says Jeff Carney, president of Fidelity Personal Investments.

Young adults (ages 21–34) who are not as confident that they will be better off than their parents admit that poor spending habits could derail their retirement savings, the Fidelity research reported. But this group does share with midlife adults (35–54) a realistic view of the increased living and health care expenses they will face.

Here are some ways to meet the challenges of saving for retirement.

Start young

In the survey, 71% of young Americans said they started saving for retirement before age 30, compared with 54% of midlife adults. "Perhaps people are finally coming to appreciate that compound interest can be awfully powerful," says Jeffrey Bogue, CFP, an independent financial planner in Wells, Maine.

It's no secret that participating in an employer-sponsored 401(k) plan can be a smart first choice for retirement savings. What often gets overlooked, however, is the critical role a tax-advantaged IRA can play in supplementing workplace savings programs. The Fidelity survey found that six in 10 Americans do not currently invest in an IRA, with 43% of young non-IRA owners attributing it to a lack of time or patience. By contrast, midlife adults point to expenses such as day care, mortgages, and saving for college as common obstacles to opening an IRA.

"IRAs can play a critical role in helping Americans boost their savings from 401(k) or other accounts," Carney notes. "The key is to make saving for retirement automatic and more affordable."

Put your savings on cruise control

Of those Americans who believe they will be less prepared for retirement than their parents were, 55% of young adults and 49% of midlifers claim that their moms and dads were better at following a budget, the Fidelity survey noted. One approach to help stay on track and build your nest egg is to make regular contributions. Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

You may find that building a substantial retirement fund is easier when done in mechanical fashion, with either direct deposit from your bank account or automatic withdrawal from your paycheck. "That leaves nothing to chance," Bogue points out.

Choose the right IRA

Four in 10 adult Americans save for retirement using some type of IRA, according to the Fidelity survey, with the Roth IRA owned by nearly as many investors as the traditional IRA. The traditional IRA is similar to a 401(k). Depending on your eligibility, it can offer a tax deduction for money you contribute, though you are taxed when you withdraw the money (along with any gains) at retirement. The Roth IRA has no such initial deduction, but neither your original contributions nor any gains will be federally taxed upon withdrawal, provided you meet the five-year holding period and wait until you're age 59½ to begin withdrawals. What's more, the Roth offers more flexibility than a traditional IRA as to when and how much you can withdraw. For the self-employed, a SEP-IRA allows the opportunity to stash extra cash as long as the guidelines are carefully followed.

Lasting lessons

Eighty-two percent of young adults and 78% of midlifers plan to rely on personal savings, such as a 401(k) or IRA, for retirement income rather than on government sources, the Fidelity survey found. That, financial experts contend, should carry over to future generations of savers.

"Saving is a learned habit," Sharon DeVaney, Ph.D., professor of family and consumer economics at Purdue University, says. "If we didn't learn it from our parents, we can at least teach it to our kids. Discuss money in front of them. Emphasize the need to save. And when you save, remember that you're doing it for yourself, but you're also, by way of example, doing it for your children."

OPPOSITE PAGE: LAUGHING STOCK; THIS PAGE: BRIAN URKEVIC

Test your IQ on IRAs

Do you think you know the ABCs of IRAs? If you answered yes, you're in the minority, according to the Fidelity survey. Ninety-six percent of Americans, in fact, don't even know the correct IRA contribution limits, with some guessing as low as $1,000. Here are seven questions to test your knowledge of IRAs (answers at the bottom).

1. What is the 2005 annual contribution limit for an IRA?
a. $1,000; $1,500 for those over age 50
b. $4,000; $4,500 for those over age 50
c. No limit

2. Who is eligible to open an IRA?
a. Virtually anyone with earned income
b. Those with incomes greater than $50,000 but less than $150,000
c. Ask your accountant — the rules are very complicated

3. What is the major difference between a traditional IRA and a Roth IRA?
a. The contribution limits for a Roth IRA are much greater
b. Contributions to Roth IRAs are not tax deductible, but unlike a traditional IRA, the withdrawals are not taxed
c. Roth IRAs are only available to those over age 55

4. IRA contributions for tax year 2005 must be made by what date?
a. April 15, 2006
b. December 31, 2005
c. December 31, 2006

5. What is the major difference between a traditional IRA and a SEP-IRA?
a. SEP-IRAs are for the self-employed and have much higher contribution limits
b. The "SEP" in SEP-IRA stands for Special Eligibility for Parents, and it is only available to those with children
c. "Traditional IRA" is simply the old name for a SEP-IRA

6. How are withdrawals from a traditional IRA taxed?
a. At the long-term capital gains tax rate
b. At 20%
c. At whatever your income tax bracket is when you make the withdrawals

7. Contributions to a Roth IRA may be withdrawn without penalty...
a. After age 70
b. After age 59½
c. At any time

Answers: 1, b; 2, a; 3, b; 4, a; 5, a; 6, c; 7, c

EXPECTING THE UNEXPECTED

In the event of a financial emergency, here's how to keep your long-term plans afloat.

By David Whitemyer

Your house might burn to the ground tomorrow. It makes the stomach churn just thinking about it. It's unlikely, but you're prepared. There are batteries in the smoke detector and a fire extinguisher in the kitchen. You've got home insurance, and the kids know how to "get low and go."

Doesn't it make sense to devote the same level of preparedness toward the more likely event of a personal financial emergency? You could lose your job or have to leave work to care for an aging parent. A sudden disability in the family could run up medical bills.

Bad things happen. Better to be prepared. Hoping for the best but planning for the worst is neither optimism nor pessimism. It's responsible realism. It's mental security.

"Disaster — a lost job, a premature birth, a divorce — is the defining theme of the financial lives of millions of families," write Elizabeth Warren and Amelia Warren Tyagi in *The Two-Income Trap: Why Middle-Class Mothers & Fathers Are Going Broke*. Their book has popularized the term "financial fire drill," meaning a mental run-through of financial what-ifs and the responses that follow. Ask the questions, Can I survive if I lose my job? What will I do if Mom needs 24/7 care?

TODD GILMOUR

And then run the numbers. The goal is to make sure that your money and your mind are set up so that you are prepared if the unexpected arises.

CLEANING HOUSE

But first, you've got to make sure that everything is in order. This means not only organizing current financial records, but also making sure that your most important paperwork, like wills and emergency contacts, are up to date. Review these records annually.

Once your information is tidy and placed where it can be easily located during a crisis, take that stack of paper and photocopy it. Leave a set off site, away from your home — at a relative's house or in a safe deposit box, for example.

And, of course, there's no financial product so essential following a tragedy as insurance. Regina Galvin Ballinger, a certified financial planner, advocates looking into disability, life, and long-term care insurance to make sure you have sufficient coverage. It's immobilizing life events that can really shift your savings into reverse gear.

STAYING AFLOAT

Financial experts typically recommend that people keep three to six months' worth of living expenses in an account that is liquid and readily available, such as in a savings account or money market mutual fund. Some even advocate keeping a year's worth on hand during uncertain economic times.

Having a reserve is one thing. Knowing how to use it is another. Don't touch it unless you absolutely must. And steer clear of dipping into your investment funds. You'll weather the storm, so don't sacrifice your retirement.

It's not just the big stuff like death and unemployment that might bite your wallet. Your furnace might break, or you'll need to buy five cross-country tickets to attend Aunt Mildred's funeral.

Theresa Brown, a Boston-area designer, takes her reserve budgeting one step further. In addition to having six months' salary tucked away, "I also assume that once every three months I'll have an arbitrary $800 expense, like a car repair or travel to a family event," she says. Brown puts that money on top of her reserves for the minor what-ifs.

BEYOND THE BIRDS AND THE BEES

If you thought talking to kids about sex might be difficult, try having a conversation with your parents about death and money. It's a taboo topic among relatives, but implementing any disaster plan is going to be easier if everyone knows what everyone else expects.

As well as being clever with her savings, Brown is no stranger to sensitive family talks. Her father-in-law has Parkinson's disease, which has become increasingly debilitating the past few years. They've discussed savings, medical insurance, and retirement homes. "We've even worked out a plan if my husband and I have to move in with his parents," she says.

> The goal is to make sure that your money and your mind are set up **so that you are prepared** if the unexpected arises.

"Meeting the cost of nursing home care is an enormous concern for all families," warns Stephen Pollan, author of *The Die Broke Complete Book of Money*. "In some areas of the country, annual care runs as high as $96,000."

Though it won't make money appear from thin air, a living will can make decision making less stressful for a family. Where a typical will is helpful in death, a living will determines expectations and decision makers in case of incapacity and an inability to communicate.

DUCK AND COVER

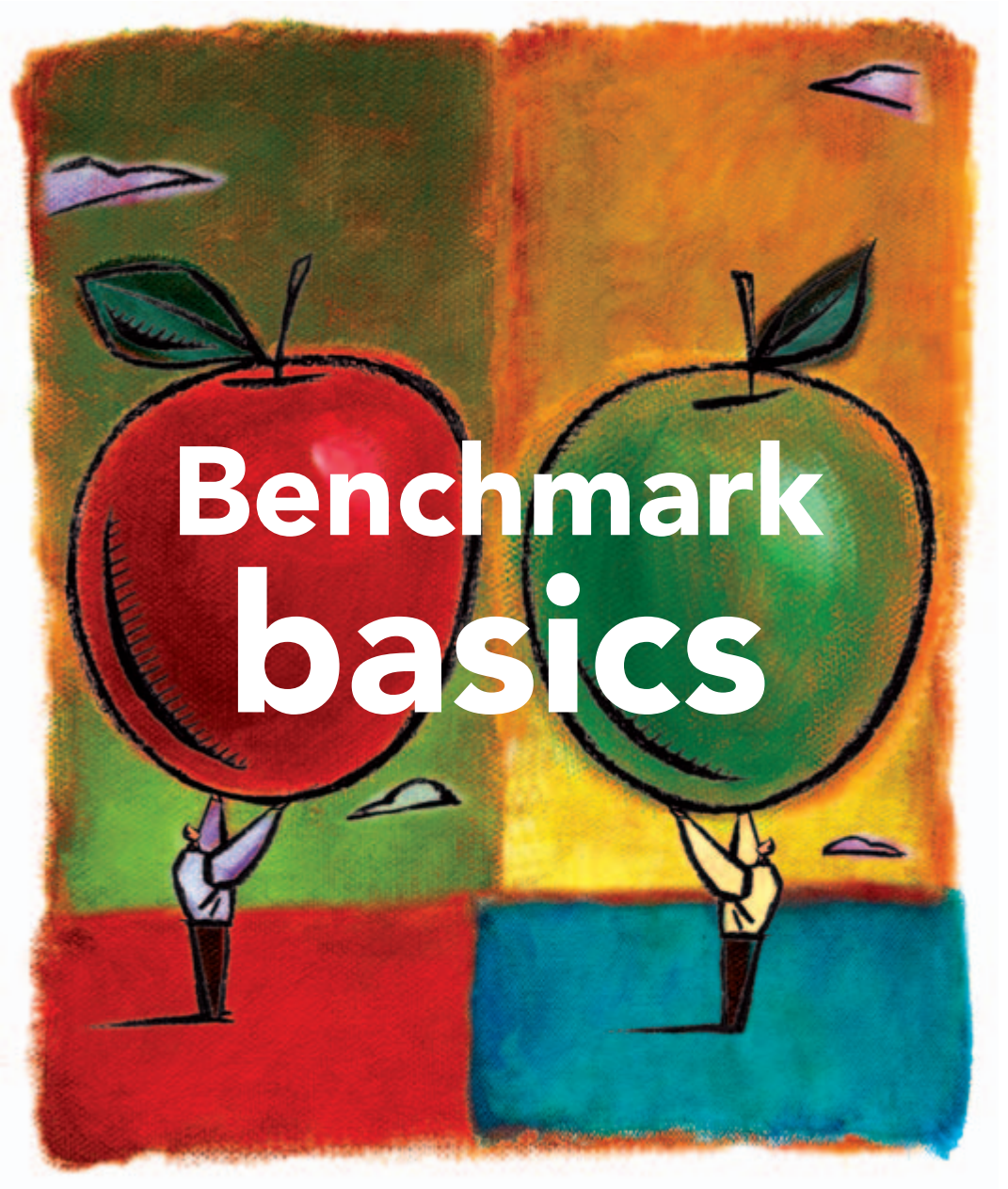
Finally, after getting adequate insurance, storing reasonable monetary reserves, and chatting with the family, it's time to put your plan together. Run your drill, do the math. Months' worth of liquid assets is essential, but exactly how will you spend it if the pink slip comes? Prioritize your fixed expenses, such as car payments and the cable bill, so you'll know where to begin cutting when things get tight.

Ballinger points out that "the time investigating these notions and getting comfortable with the options ahead of time will make their implementation either a done deal or make for swift implementation when needed."

There is a misperception that people who think about disaster scenarios and plan for them are anxious and worried. In fact, the opposite is true. When disaster does strike, it is those same people who tend not to worry at all because they have a preconceived process in place for dealing with the situation.

You have a one in 11.2 million chance of being killed in an earthquake. Yet there are hundreds of thousands of people driving around with earthquake kits in the trunks of their cars, ready for the "Big One."

Go make a plan with your money as if there's a financial "Big One" heading down the fault line of your life. You never know when it'll come. And when it does, you can sleep well, knowing you're prepared.



Benchmark basics

The historical performance of any mutual fund is most meaningful when compared with its designated benchmark index.

By Rick Sauder

Evaluating mutual fund performance would appear to be a fairly straightforward exercise in numbers. A return of 10% is better than 5%, but not as good as a return of 15%. Similarly, a loss of 5%, while not ideal, is preferable to losing 10%. Simple enough.

But while it's helpful to regularly monitor the absolute numbers, the truth is that they only begin to tell the story of whether a mutual fund is indeed performing well. A thorough analysis should also examine how a mutual fund has performed relative to its benchmark index.

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Apples to apples

Here's another way to think about it: A benchmark index gives investors a point of reference for making an "apples to apples" comparison of a fund's characteristics or performance.

One of the best-known benchmarks is the Standard & Poor's® 500 Index. Because the S&P 500® Index is composed almost entirely of large-cap domestic stocks, it is a common performance measure for equity-oriented growth funds, including asset allocation and balanced funds. However, while the S&P 500 might be an appropriate benchmark for many mutual funds, it wouldn't be a good comparison for a fund that specializes in companies with a small-market capitalization. For a so-called small-cap fund, the Russell 2000® Index might serve as a better yardstick.

"There's an appropriate benchmark index for just about every mutual fund out there," says Greg Carlson, a fund analyst at Morningstar, Inc., a leading provider of independent investment research. One of the most familiar indexes, the Dow Jones Industrial Average, is not commonly designated as a benchmark. That's because it measures the stocks of 30 industrial companies that, in total, represent a narrow and specialized segment of the overall market.

As another example, comparing a foreign stock fund with the S&P 500 does not indicate how the fund has done relative to foreign stock markets. The MSCI EAFE® Index might be a better benchmark for a diversified international equity fund. The Lehman Brothers Aggregate Bond Index, which measures the overall bond market, may be a suitable benchmark for U.S. investment-grade fixed-income funds.

How to apply benchmark data

With so many different fund objectives and benchmarks, how can you know which index provides the best comparison? The fund's prospectus and semiannual reports are a start. For Fidelity funds, both these resources are available within NetBenefits,℠ at www.netbenefits.fidelity.com, along with information related to historical performance and the benchmark index.

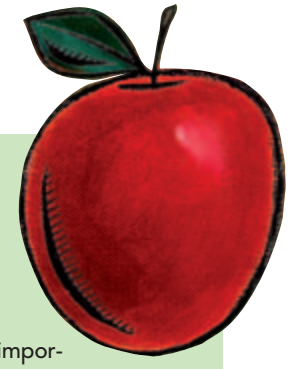
After reviewing this information about your funds, you may ask yourself, How concerned should I be if my fund's performance is different from its benchmark? It's unlikely that any fund's performance is going to exactly match that of a given index. Even index funds that are designed to mirror a particular benchmark will show slight performance variations from their target.

Beyond benchmarking

Morningstar's Carlson suggests that benchmarking has become even more important because of the increasing number and variety of mutual funds available. "There are many different investment styles and objectives among mutual funds," he explains. "You wouldn't expect them all to perform the same." However, he cautions that your selection of a mutual fund should be based on more than just its performance against a benchmark. "A benchmark index is a good place to start, but it's not the only thing to consider," he says.

Case in point

Benchmarking as a fund-selection tool



Here's an example to help illustrate the importance of benchmarking. Let's say you've decided to shift some of your 401(k) retirement savings into an aggressive equity fund. You notice that the fund you're considering gained 10% during the past year, compared with 5% for its designated benchmark. Sounds great — until you notice that other aggressive equity funds have gained an even more impressive 15%, on average. Clearly, you'll want to look at a few more mutual funds before you make your final decision.

Benchmarking can also help you understand that negative returns may not always signal underperformance. "It's important to understand that a mutual fund may be down a lot, but still outperforming the benchmark against which it is judged," says Rick Spillane, executive vice president of Fidelity Management & Research Co. "No one likes to lose money, but if you consider the mutual fund's performance in this context, you may decide that, in reality, it is still okay."

You need to be comfortable that the funds you've chosen are appropriate for your personal risk tolerance, time horizon, and investment objectives. Then, monitoring your funds' performance over time and comparing them to appropriate benchmarks — not just to the overall stock market — will help you judge whether they are meeting your needs and expectations.

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The Russell 2000® Index is an unmanaged market capitalization–weighted index measuring the performance of the smallest 2,000 companies in the Russell 3000® Index.

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7 things you need to know about tax laws and sunset provisions

By Jill Andresky Fraser

Sunsets are often described as romantic, majestic, and awe-inspiring. It's a good bet, however, that investors will have a less-than-glowing reaction to sunset provisions in tax laws.

The current sunset provisions in various tax laws are the result of legislative compromises over tax-relief measures. As currently written, they will cause some popular tax breaks to disappear in just four to six years. Retirement accounts, college savings plans, grandparent bequests, and estate plans may all be affected. Making matters even more complicated, some tax treatments actually are scheduled to change a number of times, creating increasingly favorable opportunities until they're erased at the end of the day on December 31, 2010, the sunset date for many of these popular tax breaks.

In this confusing tax environment, it may be tempting to stick your head in the sand and hope that Congress intervenes to eliminate or modify some or all of the sunset provisions. That may well happen, but, then again, it may not. During these uncertain times, you can help protect your family's future by building flexibility into your financial plans. As you do so, consider these seven tips.

1. Save aggressively for retirement

Among a number of retirement-related rules slated to end at the end of 2010, one of the most significant is the so-called catch-up provision, which permits those age 50 and older to contribute more to various tax-advantaged retirement accounts than younger investors can. This year, the maximum catch-up amount is $4,000 for 401(k) plans and $500 for traditional and Roth IRAs. In 2006, those amounts will rise to $5,000 and $1,000, respectively. This creates a great saving opportunity — for now. Keep in mind, investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

2. Keep an eye on 529 college savings plans

After-tax contributions to 529 plan accounts grow on a tax-deferred basis. Currently, there are no federal income taxes on distributions used to pay for qualified educational expenses. "That's a gift from heaven," notes Patrick Peterhans, a fee-only financial planner based in Boulder, Colo. That tax break, however, is scheduled to disappear at the end of 2010, when distributions for qualified educational expenses will be taxable to the distributee. Under both current law and after the sunset date, distributions of earnings for nonqualified expenses are subject to a 10% penalty, in addition to any applicable income taxes. Unless legislation is passed that extends the current tax treatment of 529 plan accounts, "the benefits of these accounts won't be as great as they are now, but they may still be worth having since funds grow tax deferred until they're used," Peterhans notes.

3. Be realistic about federal estate-tax changes

Between now and 2009, the individual applicable federal estate tax exclusion amount (the "exemption") will increase from $1.5 million to $3.5 million, while the top federal estate tax rate will drop from 47% to 45%. Then, in 2010, the federal estate tax will disappear, but just for a single year. Since you don't know when you are going to die, you should prepare for all the various scenarios through 2011, the first year after these favorable estate tax laws sunset. "In 2011, the applicable exclusion amount will go back down to $1 million and the top tax rate will rise to 55%," notes Domingo P. Such, a partner in the law firm McDermott Will & Emery, LLP, in Chicago. He and other experts expect these rules to change again, although there are no guarantees.

"We recommend estate plans that are designed to be as flexible as possible, so that they'll be effective no matter what the tax rules are when a person dies," says Linda B. Hirschson, chair of the New York Estate Planning Group at the law firm Greenberg Traurig LLP.

4. Don't forget about state estate taxes

Depending on where you own property, state-levied estate taxes may loom as a potential liability. That's because "many states once received a portion of federal estate taxes paid under the so-called state death tax credit," Such points out. "Between 2005 and 2010, states will not receive estate tax revenue from the federal government, so some states enacted their own estate tax laws in order to replace the lost revenue."

5. The tax man giveth and taketh away

Watch out for income taxes on capital gains recognized after property is inherited starting in 2010. In very general terms,

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"basis" is usually the cost paid to acquire an asset. When you sell an asset, basis is subtracted from the proceeds to determine any taxable gains. The basis of many kinds of property acquired from a decedent is now generally its fair market value at the time of the person's death, often referred to as a "stepped-up basis." In contrast, property acquired by gift has a carryover basis — the receiver usually gets the same basis the giver had. This stepped-up basis on inherited property means that any appreciation from the time the decedent acquired the property until the time of death will likely not be subject to income taxes, either at the decedent's death or at any later time.

In 2010, the year in which federal estate taxes are scheduled to temporarily disappear, the provision for stepped-up basis at death will also temporarily disappear. For basis purposes, death transfers in 2010 will be similar to transfers by gift, meaning that basis is carried over. However, "basis increases" will be available to allocate to eligible transferred property — up to $1.3 million of basis increases for property transferred to either a spouse or non-spouse, and another $3 million for transfers to spouses. These basis increases would not be subject to income taxes. This may affect families whose senior generations may have significant taxable estates composed of low-basis properties. If both amounts are fully allocable, $4.3 million of gains can be erased upon the decedent's death.

Make sure any estate plan you devise is flexible enough to cover the various potential estate tax scenarios of dying in different years.

6. Consider the advantages of lifetime giving

Despite other changes in the tax code, each person's lifetime gift tax exemption remains the same, at $1 million. The exemption isn't scheduled to rise, nor is the gift tax itself scheduled to go away. There also aren't any sunsets on this horizon. Even without any tax relief on this front, gifting can offer advantages for affluent families, according to Such. "If I give away $1 million to my children and it doubles in value over the years, all the growth and the original million are out of my taxable estate," he says.

Although a big-ticket gift might be a budget-buster for your family right now, after you manage to pay for college tuition and other major expenses, it may become more feasible. In the meantime, consider making smaller, yearly gifts. Every person currently is allowed to give away up to $11,000 each year per recipient on a tax-free basis. This limit will gradually be increased for inflation, as it is tied to the Consumer Price Index.

7. Plan to create liquidity in your estate

You may or may not die during a year in which federal estate taxes are high, but odds are strong that your heirs will need access to cash or its equivalent, if only to pay probate costs, administrative fees, and any state or federal estate taxes that might be due. For married couples, an effective tool may be a "second-to-die" life insurance policy, which may provide valuable funds when they're really needed — when the estate passes to the second generation. Best of all, these policies may be more affordable than insurance that only covers one spouse's life.

Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), qualified distributions are federal income tax-free. The provisions of EGTRRA will expire on December 31, 2010. Unless the law is extended by Congress and the president, the federal tax treatment of 529 plans will revert to its status as it was prior to January 1, 2002.

Excessive trading: What it means for you

Excessive trading: Generally speaking, excessive trading refers to frequent trades into or out of a mutual fund.

Fidelity has produced a video-on-demand series on the timely topic of excessive trading of mutual funds. The following Q&A has been adapted from one of the videos, which features Fidelity's Laura Wolverton explaining excessive trading and describing why Fidelity believes it's a problem for shareholders. The full video series, which also details Fidelity's updated policy, is available in the Tools & Learning section of Fidelity NetBenefits,® at www.netbenefits.fidelity.com.

Laura Wolverton is a vice president in Fidelity's Business Compliance group.

Excessive trading of mutual funds has become a topic of conversation recently. What's the background?

Let's start by looking back to 2003. You likely have heard about or followed the investigations begun by Eliot Spitzer, the New York state attorney general. His focus has been on the relationship between certain mutual fund companies and a specific hedge fund that had agreements permitting late trading and market timing. Recently, the concern over excessive trading and the need to protect shareholders has reached such a level that it has drawn the attention of Congress and other federal regulators.

What is Fidelity's point of view on excessive trading?

Fidelity has had a history of deterring excessive and disruptive trading. Fidelity strives to protect the collective interests of all shareholders who seek long-term returns on their investments. Our intent is to promote fair and consistent treatment of all shareholders, both retail and institutional, of the fund.

How can mutual fund shareholders be harmed by frequent or disruptive trading?

We believe that excessive trading hurts the long-term interest of our shareholders in two ways: It can harm fund performance and can increase fund expenses. Additionally, it allows some investors to unfairly benefit from the fund and at the expense of other investors in the fund.

Are there other negative implications associated with excessive trading?

Fidelity believes, and others in the industry agree, that large cash flows in or out of a fund on a short-term basis can be disruptive to the manager of the fund and the carefully developed portfolio strategies he or she has in place to achieve the fund's investment objectives. We also believe that these disruptive trading practices result in additional administrative costs for the remaining shareholders in a fund.

Any closing thoughts?

I want to reiterate our commitment to treating all investors equitably and fairly. Fidelity serves more than 10 million people who are saving for retirement through their workplace retirement savings plans. We take the responsibility that you have entrusted to us seriously, and our strong standard of fairness reflects our sense of responsibility.

In December 2004, Fidelity implemented enhanced account monitoring procedures as part of its ongoing efforts to discourage excessive trading. To learn more about Fidelity's specific excessive trading policy and how it may affect you as a 401(k) investor, please log on to NetBenefits℠ at www.netbenefits.fidelity.com. Go to the Tools & Learning section and choose the link for "Excessive Trading Defined, Rules Explained."

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Road map to retirement

A retirement mission statement can provide direction and a sense of purpose

By Michael McDermott

ROBERT SAUNDERS

"So, what are you going to do with the rest of your life?"

That might be the kind of question you'd expect to be posed to a recent college graduate, but it's also the first — and most important — question that everyone should consider as part of the retirement planning process, according to certified financial planners polled by the Financial Planning Association. The best way to answer it, experts say, is with a retirement mission statement.

Just as major corporations and nonprofits rely on mission statements to set the tone and direction for their organizations' future, you also should develop one to capture your thoughts on how you want to live your life in retirement — the things you want to do, the goals you want to achieve, the passions you want to pursue. "It is the road map for what comes next," says Michael Furois, a fee-only certified financial planner based in Phoenix. "It provides solid direction by qualifying and quantifying retirement goals — something that needs to be done before you get into the nuts and bolts of your financial plan."

No mission statement is complete until you put pen to paper. "When you put something down in writing, you are halfway to making it a reality," says Mari Adam, CFP, of Boca Raton, Fla. "The importance of having a written statement of your goals, even if it is very short, is that it makes them real."

For a retirement mission statement to be most effective, Adam and Furois suggest these tips:

Make it a "joint venture." Now is the time to find out if you and your spouse share the same vision for your golden years — and how to reconcile those differences if you don't.

Adam says the primary objective is to create a list of nonfinancial goals. "How do you see your retirement? Will you work or not work? Travel or hang around at home? Get involved in charitable activities? Sell your house and relocate? Write down what you see yourself doing," she urges. "The mission statement should also include at least a commitment about how you are going to handle making those decisions."

Make some assumptions. While contemplating life in retirement can be a fun exercise, the creation of a mission statement should involve some basic assumptions, including when you plan to retire and a general idea of what your expenses will be.

"Nothing is cast in stone, but you have to make some assumptions in order to see if your financial and nonfinancial goals are realistic," Furois says. "You can use those assumptions to work backward in designing a financial retirement plan once the mission statement has been created."

Adam suggests working from the assumption that at least one spouse will live to age 95 — not an unrealistic premise given that the average current life expectancy for Americans is 77.6 and climbing. "A light bulb goes off and people realize how much money they are going to need when they see how long they might live," she says.

Keep it simple. Adam says that a retirement mission statement should be kept to a page or less. Furois counsels flexibility: "It should be simple, but detailed enough so you have something to refer to in gauging how you are doing along the way. Simple is best, but what constitutes simple differs from individual to individual. Some people just need four bullet points. Others need a lot more."

Don't hide it away. Keep your mission statement where it is easily accessible — on your desk, in your wallet, on the hard drive of your computer, or anywhere else where you are most likely to look at it from time to time. Both Furois and Adam agree that it's important to review the mission statement at least once a year or when there's a significant life change, such as marriage or divorce.

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