Briefly Noted

Inherited Non-Spousal IRAs Bankruptcy Exemption Questioned

Inherited non-spousal individual retirement accounts (inherited IRAs) are not protected under the federal bankruptcy code, according to a recent ruling by the U.S. Court of Appeals for the 7th Circuit. The ruling is in contrast to conclusions reached in other district level and circuit level cases, according to WealthManagement.com.

The recent ruling was made in response to a bankruptcy proceeding involving Heidi Heffron-Clark and her husband, Brandon Clark. Heffron-Clark was the designated beneficiary of her deceased mother's $300,000 IRA. A bankruptcy judge ruled that the inherited IRA did not represent retirement funds in Heffron-Clark's hands and therefore was not exempt under the bankruptcy code. A district judge reversed the ruling, but the 7th U.S. Circuit Court of Appeals upheld the ruling.

The appeals court based its opinion on how the asset would function in someone else's hands. The court opined that a trustee is a legal owner of the assets he administers, but a trust's assets are beyond the reach of creditors. However, because Heffron-Clark inherited the IRA, the assets "did not represent anyone's retirement funds." Rather, according to the court, "They had been Ruth's, but when she died they became no one's retirement funds. The account remains a tax-deferral vehicle until the mandatory distribution is completed, but distribution precedes the owner's retirement. To treat this account as exempt… would be to shelter from creditors a pot of money that can be freely used for current consumption."

Writing about the case for WealthManagement.com, Edwin Morrow of Key Private Bank concluded that the ruling does not endanger spousal rollovers, where a surviving spouse moves the inherited IRA into his or her name. He warned, however, that the case does endanger spousal inherited IRAs that "are NOT immediately rolled over."

Since there have been other conclusions, such as the 5th Circuit Court's ruling in Chilton v. Moser, it is not completely clear whether inherited IRAs can be claimed by creditors in the event of bankruptcy. Morrow notes that the U.S. Supreme Court could take up the issue.

Sources: In re Heidi Heffron-Clark, U.S. Court of Appeals for the 7th Circuit; "Clark—Seventh Circuit Case Questions Inherited Retirement Plan Protection in Bankruptcy," Edwin Morrow III, WealthManagement.com, May 21, 2013.

The Biggest Retirement Investing Mistakes

Bankrate.com recently published a list of the seven biggest retirement investing mistakes and advice on how to avoid them. Those mistakes are:

1. **Not Taking Full Advantage of Tax Breaks:** Tax-favorable accounts, including 401(k) plans and individual retirement accounts (IRAs), allow savings to grow tax-free, yet many workers do not take advantage of them.
2. **Not Saving Enough, or at All:** Saving 9% of one's salary (including employer matching contributions) may not be enough, especially for those starting late or having gaps in their employment. Plus, more than 80% of those surveyed by TIAA-CREF said they weren't contributing to an IRA.
3. **High Fees in Retirement Plans and Investments:** High fees can negate any outperformance, so it is important for savers to be aware of them and to look for low-cost alternatives.
4. **Focusing on Only One Risk:** Nearly four in 10 people surveyed by Franklin Templeton believe they can get by without investing in stocks. Yet, avoiding stocks increases longevity risk, the risk of outliving one's savings.
5. **Investing Aimlessly:** It is not uncommon for investors to get aggressive when the market is going up, only to cut back on their holdings when stock prices fall. Other investors are good at saving, but lack a long-term plan for managing their investments.
6. **Retiring With No Plan for Income:** Investors need to start adapting a more conservative allocation as they near retirement. This typically means holding less in equities and more in bonds.
7. **Holding Onto the Hoarding Mentality:** Retirement portfolios are intended to be drawn down, a concept some retirees struggle with. An immediate annuity can guarantee a stream of income, while using a 4% withdrawal rate, or a similar strategy, can expose the portfolio to market volatility of the markets.

Source: "7 Retirement Investing Mistakes," Bankrate.com.

The Good and Bad of Large 401(k) Plans

Large 401(k) plans, ones with numerous investment choices, can be good for the employer, but bad for the employee, according to University of Mississippi Law School assistant professor Mercer Bullard. Citing both case law and various studies, Bullard says a paradox exists.

Retirement plans, including 401(k)s, are covered by the Employee Retirement Security Income Act of 1974 (ERISA). ERISA requires employers to follow the "prudent man rule," which means making decisions with care, skill and diligence. In simpler terms, the standard requires fiduciaries to make decisions similar to what a prudent person would otherwise make in the same situation. This requirement has been used in litigation over the construction of and fees within 401(k) plans.

Bullard observes a trend in such cases of allowing employers to argue a "large menu defense." Courts have concluded a large selection of investment options places the employee in charge of his investment decisions. Under such rulings (including Hecker v. Deere & Co.), the employer cannot be held liable for the inclusion of expensive or poor-performing funds. Conversely, Wal-Mart was found liable of managing its plan imprudently for offering a "relatively limited menu of funds which were selected by Wal-Mart executives despite the ready availability of better options." (This case was Braden v. Wal-Mart.)

Though employers may be able to reduce their liability by offering a bigger selection of investment choices, doing so may have an adverse effect on employees. Bullard cites a Columbia University study that found employee participation decreased as the number of investment choices increased. A plan with 11 options had a 70% participation rate, whereas a plan with 56 options had a 61% participation rate.

Studies by behavioral scientists suggest humans tend not to make decisions when confronted with too many choices. Bullard cites an oft-referenced study on jam, which found that as the number of flavors for sale increased, the number of purchases decreased. Emerging analysis on auto-enrollment retirement plans finds many employees do not alter either the default contribution amount or the default fund selection when opted into a 401(k) plan. Such aversion to decision-making can lead to a failure of adequate saving, which Bullard says can leave employees unprepared for retirement.

Source: "The Social Costs of Choice, Free Market Ideology and the Empirical Consequences of the 401(k) Plan Large Menu Defense," Mercer Bullard, May 10, 2013.

From the Bookshelf

"How to Make Money in Stocks—Getting Started" (McGraw-Hill, 2013) is a beginner's guide to Investor's Business Daily's (IBD) CAN SLIM system. Author Matthew Galgani says "this book is meant to supplement, not replace" William O'Neil's "How to Make Money in Stocks" (McGraw-Hill, 2010). Those who have read O'Neil's book and comprehend the system can feel comfortable skipping Galgani's book; those who want a step-by-step approach may find the new text helpful.

Galgani walks readers through the basics of the CAN SLIM system, giving instructions on both buying and selling. At times it is repetitive, mentioning parts of the IBD website—such as the Market Pulse table—frequently. It also veers on the promotional, orienting investors to the IBD website and reminding them of the free trial.

The book does, however, show how to implement the system. There is enough clarity that CAN SLIM could be implemented without subscribing to IBD. To that end, it is a helpful text for those looking for a trading system that incorporates fundamental and technical indicators.

Kimberly Foss intertwines stories about her life and case studies with financial advice in "Wealthy by Design: A 5 Step Plan for Financial Security" (Greenleaf Book Group Press, 2013). The mix is a combination of personal insight, financial planning advice and portfolio management guidance.

At times, the book comes across as self-promotional. Foss, who is a financial planner, emphasizes the importance of working with a fee-only adviser throughout her book. She also routinely discusses using Dimensional Funds, which are only available through adviser and institutional investor channels.

This said, Foss does include good advice and examples. She includes a detailed list of questions to ask a prospective adviser. Her asset allocation models can easily be replicated with exchange-traded funds or index mutual funds (such as those offered by Vanguard). Foss emphasizes the importance of organization, communication and adhering to a long-term strategy.

While we can't say new ground is covered in this book, Foss' personal approach may resonate with some readers. It can also be a useful text for those currently or considering working with an adviser.