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For Your Investment Planning Needs Contact:

Barbara Kazma 515-246-6362
Pat Johnson 515-244-5619

Iowa State Bank Investment Services

627 E. Locust Street
Des Moines, IA 50309
(888) 824-0111
(515) 244-3413

Barbara Kazma and Pat Johnson are registered representatives of LaSalle St. Securities, LLC. Securities are offered only through:



940 N. Industrial Dr.
Elmhurst, IL 60126

Avoid These Four Common 401(k) Mistakes

A 401(k) plan can offer tax-advantaged savings for participants. However, if you are not careful, you might be plagued by several common errors. Here are four mistakes to avoid.

1. Failure to participate:

Can you imagine turning down a pay raise? Probably not. Nevertheless, many employees fail to take advantage of the match that an employer provides for elective deferrals to a 401(k) plan.

For instance, suppose your employer offers to provide a matching contribution of 50 cents on the dollar. If you are able to defer \$10,000 to your 401(k) plan this year, your employer must kick in \$5,000 more.

What's more, these contributions can grow substantially, thanks to tax-deferred compounding. Let's say you contribute \$10,000 annually, so your employer provides a matching contribution of \$5,000 each year. If you earn 7% annually on the funds, you will have accumulated \$984,336 after 25 years. Of course, this is a hypothetical example and not indicative of any particular investment.



2. Errors in diversification:

The most obvious type of diversification mistake is the failure to do it at all. Just as you would be advised to diversify within your personal portfolio, apply the same principle to your retirement plan holdings.

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Avoid these four common 401(k) mistakes

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Other mistakes include “over-diversification,” such as spreading out 401(k) dollars in every possible mutual fund or other investment option, and “under-diversification” in which a disproportionate portion of the pie is devoted to a single investment or type of investment. It is important to find the proper balance.

In the end, an allocation among stocks, bonds and cash should be based on your age, your expected retirement age, the amount you are contributing each year and your tolerance for risk.

3. Early distributions:

Your 401(k) plan is meant to be a savings vehicle for retirement. However, participants often cannot resist taking out

distributions, especially if they are changing jobs. As a general rule, a distribution made prior to age 59-1/2 is subject to a 10% penalty tax on top of the regular income tax that is owed.

If you switch jobs and roll over funds from your 401(k) plan to an IRA or another qualified plan, a timely rollover is exempt from current income tax.

4. Borrowing from your plan:

Along the same lines, you should be discouraged from taking a loan from your 401(k). Even though you will effectively be paying yourself back, it will be more difficult to meet your objectives for retirement. You will not have access to the funds you could have earned if the principal had remained intact.

What is Your Time Horizon?



The investments you choose to make - or not make - are often affected by your “time horizon.” This is the length of time you expect to be investing before you begin to draw on the funds - typically, at retirement. For example, if you are currently age 45 and plan on retiring at age 67, the time horizon (also referred to as the investment horizon” in some circles) may be stated as 22 years.

Your time horizon is also affected by the duration of time over which you expect to be using the money. Say you plan on retiring 22 years from now but end up living for another 20 years after that. In that case, your time horizon is 22 years, but your actual need for income is extended to a total of 42 years. Although you may need some of the money upfront, the balance may be invested for future withdrawals.

Rule of thumb: The longer your time horizon is, the more aggressive you might tend to be as an investor. The rationale is that you have plenty of time to recover from the inevitable ups and downs you might have in the equities markets.

Of course, this is not in any way an endorsement of mere speculation. Investors with a relatively long time horizon are more likely to aim for higher returns than investors who are near or already in retirement. Conversely, it follows that investors with a relatively short time horizon tend to be more conservative.

Naturally, every investor has a different level of tolerance for risk. Your personal risk tolerance, in combination with your time horizon, can have a major impact on current and future investment decisions.

Note also that your circumstances may change over the course of time. For instance, you may be able to extend your time horizon by postponing retirement. The extra time you are earning a full-time salary provides a greater opportunity to build up your retirement nest egg. On the other hand, you may decide that you want to retire early - perhaps in your early to mid 50s - which could significantly reduce your time horizon.

Keep in mind that each financial goal has a separate time horizon. If you are saving for a child’s college education and the child is eight years old, the time horizon for that objective is only 10 years. To help accomplish each investment goal, you might establish a separate savings plan.

Practical approach: Develop a long-range plan that addresses your particular time horizon and financial objectives. You can rely on a financial professional to help guide you down the best path for your situation.

Five Steps to Take Before a Job Change

Suppose you have been offered a job with a different company. Should you make the switch? Of course, salary is a significant factor, but there is a lot more at stake. Here are five steps to include in the process.

1. Review your retirement plan options. Assuming you have a qualified retirement plan at your current position, you will be faced with several intriguing choices if you leave. In general, the vested benefits are portable or can be accessed upon termination of employment. Specifically, you might

- ★ Roll over a lump-sum distribution to the new employer's plan or an IRA. With a trustee-to-trustee rollover, there is no income tax withholding on the distribution.
- ★ Leave the funds in the plan. The amounts are subject to the usual rules for withdrawals (e.g., distributions prior to age 59-1/2 are generally subject to a 10% penalty tax in addition to regular income tax).
- ★ Take distributions in cash and pay resulting income tax plus any penalties.

2. Protect pension plan assets. If you are entitled to a pension, you may not have access to the funds until you retire, even when you switch to a different job. Other plans may permit distributions of vested benefits. Consider all the implications.

3. Cover your insurance bases. In particular, it is advisable to avoid any lapse in health insurance coverage. If



there will be a waiting period with a new employer's plan, you can continue coverage from your old employer through COBRA (short for the Consolidated Omnibus Budget Reconciliation Act). Under COBRA, you usually have to pay the premiums yourself, but it could be well worth the peace of mind. Similarly, see how other insurance benefits will be affected.

4. Evaluate your stock options and grants. A stock option enables you to buy company stock at a specific price while a grant allows you to receive stock at no charge. Determine the value of grants and stocks. If you will be leaving a sizable amount of money on the table, you may want to reconsider the job switch or negotiate comparable benefits from your new employer. Consult with a tax expert regarding the exercise of stock options.

5. Check your FSA status. With a flexible spending account (FSA), you contribute to an account to pay health care or dependent care expenses on a pretax basis. When you leave the company, you must forfeit any unused funds in your FSA. On the flip side, the employer generally bears the burden for expenses if you have already collected on claims that have exceeded your payroll contributions.

Finally, crunch all the numbers factoring in all the benefits, no matter how small. To the extent that it's possible, try to compare apples with apples. Then make a fully informed decision.

A Living Will Can Show the Way

Where there's a will, there's a way. In this case, we are talking about a "living will."

In brief, a living will is a legal document that specifies your intentions concerning medical treatment in the event you are mentally or physically impaired or become terminally ill. The document can be as short as a paragraph or two or as long as several pages.

The primary purpose is to address health care concerns that might arise should you ever become incapable of

making those decisions. For instance, a living will typically could state that you are not to be kept alive on life support systems if you fall into a coma that appears to medical experts to be irreversible. It enables you to make decisions about medical treatment in advance of a debilitating illness or injury.

Most significantly, a living will removes a huge emotional burden from other family members. Instead of having to agonize over what level of treatment you would have preferred, the guidelines will be spelled out for them.

Mixing and Matching Your Investment Assets

With another new year dawning - following a tumultuous year for many investors - possibly the biggest investment challenge you face in 2008 is finding the proper "mix" for your portfolio. At this time, you might rely on the principle of asset allocation so often discussed in financial circles.

Of course, be mindful that asset allocation is not a cure-all for financial ills nor does it provide any guarantee of success. Even though the basic concept is fundamentally sound, investors are still subject to the vagaries of the economic markets and other factors beyond their control.

What exactly is asset allocation?

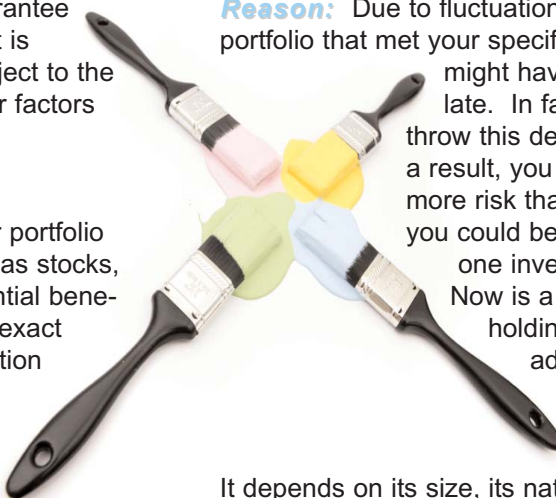
Essentially, it is the process of dividing your portfolio among different kinds of investments, such as stocks, bonds and cash, in order to maximize potential benefits while minimizing investment risks. The exact allocation should reflect your personal situation and long-term objectives.

Typically, you will allocate a certain percentage to a particular asset class. For instance, hypothetically speaking, an investor might decide to assign 50% of his or her investment portfolio to stocks, 25% to bonds, 15% to money market funds and the remaining 10% to cash or cash equivalents. This may be a satisfactory allocation for this individual's personal comfort level.

Caution: Do not assume that these hypothetical designations are appropriate for your situation. The actual percentages and/or types of investments you choose for your own portfolio will probably differ.

If you have not yet assigned asset allocation percentages to your portfolio, the beginning of the year is a good time to do so. A financial services professional can provide the assistance you may require. On the other hand, if you have already gone through the asset allocation process, don't think that your work is done.

Reason: Due to fluctuations within the marketplace, a portfolio that met your specifications a short while ago might have become "unbalanced" of late. In fact, it doesn't take much to throw this delicate balance out of kilter. As a result, you may currently be bearing more risk than you would ordinarily like or you could be disproportionately favoring one investment class over another. Now is a good time to review your holdings and make any necessary adjustments.



How often should you rebalance your portfolio?

It depends on its size, its nature and your personal preferences. For active traders, a review may be recommended each quarter or even every month. At the very least, you should analyze the allocation once a year.

Note: Alternatively, a review may be triggered if percentages fall outside of a prescribed range (e.g., 70% stock holdings for the hypothetical investor with a 50% original allocation to stocks).

There are several other factors to consider, including potential costs for switching from one asset class to another and income/estate-tax implications. Finally, you must stay apprised of changes in economic conditions that could have an impact on your portfolio. You can rely on an experienced professional for assistance.

Questions?

Please contact us. We would be glad to serve you in any way that we can.