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Build emergency fund, diversify 401(k) plans, unload one stock

By Christine Dugas

The Nicholoses are off to a good start. They have a levelheaded assessment of their financial situation and a solid grasp of their goals, says Nancy Langdon Jones, a financial planner in Upland, Calif.

What's more, they are to be commended for working hard to pay off the lawn mower, vacuum and credit card debt.

"It is terrific that they are aggressively paying off consumer debt and will be free of it all, except for a car loan, within the next few months," she notes.

Once they've accomplished that, they should build up an emergency fund in a liquid account equal to 3 to 6 months of expenses. They're doing a good job saving for retirement. They started contributing to 401(k) plans early and are taking advantage of company matching contributions.

Before boosting their 401(k) contributions, they should fund a Roth IRA, Jones says. Earnings on Roths are tax-free, providing more flexibility in retirement.

Greg and Kim have put the lion's share of their 401(k) assets into funds that invest heavily in large company growth stocks. In particular, they have an emphasis on large technology, health services and financial firms.

They need to diversify. Unfortunately, they are limited to the investment options offered by their plans. Greg has only a handful of proprietary funds to choose among. Kim has more options, but they are from a single fund family. "Generally, a fund family will excel in one or two asset classes, but seldom across the board," Jones says.

Given the limitations, Jones recommends these changes for Greg's 401(k) plan:

- * He should stop putting 10% of his contributions into company stock. Greg already gets his matching contribution in company stock and receives additional stock options. And he should reduce his exposure to the large-cap stock fund to 40% of the portfolio.

- * To provide more diversification, he should shift 30% of the assets into the international stock fund, 25% into the mid- and small-cap stock fund, and 5% into the bond fund, a better performer than the interest income fund he currently has, she says. Jones recommends a similar allocation for Kim's 401(k) portfolio.

- * As for the IRAs, the portfolios need a makeover. Jones suggests transferring their accounts to a company such as Fidelity or Charles Schwab that lets them pick from an array of no-load mutual funds. They'd also get consolidated statements, making it easier to track investments.

Jones recommends the following funds and allocations for the couple's combined IRA accounts. This would give them top-notch funds and a diversified portfolio suited to their risk tolerance:

- * Vanguard 500 Index fund, 25%.

- * Third Avenue Value fund, 20%.

- * Artisan International fund, 20%.

- * Baron Growth fund, 15%.

- * Payden Global Fixed Income fund, 10%.

- * Columbia High Yield Bond fund, 10%.

Greg should also review his stock holdings. Oracle has good cash flow and a strong balance sheet, but Jones recommends that Greg sell ADC because the company has negative cash flows, and the outlook is not good.

Fortunately, the Nicholsons have lots of options for saving for Tori's college education, thanks to tax changes that take effect next year. For example, earnings on state-sponsored 529 plans will be tax-free when used for college expenses. The new tax law also makes Education Savings Accounts more attractive by increasing contribution limits and allowing them to be used to pay for private elementary and secondary school expenses. "They should consider both," Jones says.

The Nicholsons are pleased with the advice. Greg plans to sell the ADC stock. "Kim had encouraged me to unload the ADC stock a year and a half ago, and I just wouldn't," he says. "I could have made a great profit, but I just sat on it."