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# BFAS Money Line

INVESTMENTS

## Rebound, Double Dip or Muddle Through?

**"Don't you <u>hate</u> it when they compare us to Enron executives?"**

**After two years of negative returns, -9.1% 2000 and –11.88% 2001, we saw a glimmer of hope in the last quarter.** Indeed, early January continued the trend and led all of us to figure the worst was over.

Since then, the S & P 500 is down 5% and people are starting to wonder "if" there will be a recovery, not "when". So what's most likely to happen? **Will there be the sharp recovery we are used to seeing? Or, are we in for a double dip recession? Or will we just muddle through?**

There are many mixed signals in the economy. Manufacturing is picking up, unemployment is improving and inflation is tame. On the other hand, even after the recession, stocks are valued highly compared to their earnings (P/E of 29 vs. 14 – 16 historical number). In addition, debt, both business and personal, is very high.

Although, there are arguments for each of the three scenarios above, **I believe we will just muddle through with weak growth**.

As the economy improves, we can expect to see the record-low interest rates start to rise later this year or next year. That means the superb returns in bonds over the last two years is unlikely to be repeated.

Although they produce 6% - 7% yields, bond prices vary with interest rates. For example, if interest rates increase 1%, intermediate bond (10 year) prices may drop by 3% reducing their total return to 3% - 4%.

I mention this because someday soon, Money magazine will have an article correctly showing how **bonds beat the S & P 500 over the last three years, 6% annually for bonds, -1% annually for the S & P 500**. From that you might infer buying bonds is the thing to do. That was true three years ago, might be a mistake to over-weight bonds today.

However, bonds' recent performance is why I typically recommend making bonds a part of every portfolio. There have actually been ten-year periods in our history when bonds have out-performed stocks.

For the **second year in a row, foreign stocks under-performed the S & P 500**. After beating the S & P

500 27% to 21% in 1999, foreign stocks lost, -14% to -9%, in 2000 and -21% to -12% in 2001.

The recession has hit most of the rest of the world, but there were some notable exceptions last year: South Korea was up 45%, Mexico 15%, Malaysia 4%, Taiwan 2% and Australia 2%.

With most of the rest of the world in recession recently, money from overseas continued to flow to the U. S. as the safest economy. Consequently, the **dollar has strengthened by 35% against the world's currencies since the mid-1990's**.

This means that if the rest of the world's stocks gained 10% in their own currencies during that time, we would see a 25% loss in those same stocks in dollar terms. Thus the overly strong dollar is what has allowed the S & P 500 to out-perform foreign stocks over the last few years.

The strengthening of the dollar has made foreign imports cheaper and our exports more expensive to the rest of the world. Cheap foreign imports help keep inflation low, but hurt manufacturing here.

Most observers believe the **dollar has peaked**. A weakening dollar will help exports and jobs. Also, **if both foreign stocks and U. S. stocks go up 10% while the dollar weakens by 10%, we will see a 20% return in foreign stocks**. Foreign bonds will get the same kick.

So, **don't give up on foreign stocks just yet!**

| Asset Class | 1 Yr Return (12/31/01) |
|---|---|
| S & P 500 | -11.88% |
| NASDAQ | -21.05% |
| Lg Cap Gwth | -20.36% |
| Lg Cap Val | - 8.17% |
| Mid Cap Gwth | -12.72% |
| Mid Cap Val | + 7.10% |
| Sml Cap Gwth | -14.31% |
| Sml Cap Val | +10.06% |
| Foreign | -21.44% |
| Interm Corp Bds | + 6.80% |
| Foreign Bds | +4.01% |

# Enron

I am interested in the Enron debacle for a number of reasons, not the least of which is I went to college in Houston (Rice).

Having witnessed the **huge conflict of interest of stock analysts who touted stocks with terrible fundamentals** so that their company could keep the stock's investment banking business, I am not surprised to see the same conflicts of interest in the accounting industry.

The **infamous limited partnerships were initially recommended by Arthur Andersen, acting in their role as a consultant**. This obviously conflicted with their role as auditor.

Although many of the big accounting firms recently have split off their consulting firms to reduce this conflict, **Congress should make this a legal requirement, not a voluntary thing**. Accounting firms, who are supposed to ask the tough questions, are unlikely to do so if the firm will potentially lose consulting business.

The SEC and/or the Financial Accounting Standards Board (FASB) will also have to **set much higher standards of what information must be disclosed, when and how**. Only then can we regain some confidence in the information available about public companies. Uncertainty about the quality of information is what has hurt the market recently.

What about all those unfortunate people who worked for Enron and lost their retirement? There is an organization, the Pension Benefit Guaranty Corp., that makes pensions good if someone fraudulently takes the money out of the pension account. However, that's not what happened here.

This is a situation where **the employees themselves made decisions that cost them their retirement savings**. (I know, I know. Sounds like I'm blaming the victims.) Yet, here are the facts (something rarely mentioned in all the media commentary): **89% of Enron stock in the pension plans was purchased by the employees and eligible to be sold AT ANY TIME.**

Only **11% of the Enron stock in the pension plans was there due to matching contributions by the company**. This 11% **could not be sold until the employee was age 50**. **Congress should, and**

**probably will, change this rule**.

If employees had the opportunity to sell 89% of their Enron stock, why didn't they? (Okay, there was a 10 day period last year when the company changed 401(k) plans and no one could sell anything. During that time the stock did drop from $25 to $9.)

The **employees violated one of the primary tenets of investing, don't put all your eggs in one basket**. I generally recommend **no more than 5% invested in any one company**, whether or not it is the one you work for. That way, one bad company won't destroy your nest egg.

So, they allowed their portfolios to be over-concentrated. **That wouldn't have been fatal if they had just sold when it started down (from $90).** After feeling flush from the phenomenal rise in their retirement portfolios, they didn't want to "lock in their loss" by selling.

They kept thinking they would sell when it came back up. They just held on until the end.

What should be done? I believe **Congress should require that a person can hold no more than 5% of company stock inside their pension plan**. If employees want more company stock, and want to ignore diversification, they can do it outside their pension plan.

Sure, there was wrong-doing going on in the company, but it would not have harmed the employees nearly so much if they had limited their stock concentration or sold when it started going down.

**"Well, it looks to me like somebody's been giving the auditors way too much accurate information."**

**TAXES**

# New Tax Laws

Don't forget that starting in 2002, **you can contribute up to $3,000 each for yourself and your spouse to a Roth IRA** (max income limit is $160,000). You can **also contribute $11,000 to your 401(k), 403(b) or 457(b) plan** this year.

In addition, you can use a **new "catch up" provision if you are over age 50**. That allows you to **add an additional $500 to your IRA or $1,000 to your 401(k), 403(b) or 457(b).**

If you are giving **gifts** subject to the **annual exclusion**, you can give **$11,000** this year, rather than the old $10,000.

As of this year, **withdrawals from your College Savings Plan (529 plan) or Education Savings Accounts are state and federal income tax free if used for eligible education expenses**.

In addition, don't forget to take a **$2,000 Virginia State tax deduction for each 529 plan you set up** (as long as you contribute at least $2,000). Thus, separate plans for three children earns a $6,000 deduction.

This deduction alone is worth 5.75%, so take it into account when your broker suggests using an out-of-state 529. Remember, they get paid for out-of-state 529 plans, but not for the Virginia 529 plan. Make sure you know whose interests are being served!

Note: **The American Funds Family is rolling out a new 529 plan sponsored by Virginia**. Details are not available yet (due out February 15th), but this plan will certainly be worth a look-see. Since brokers will earn money by promoting this plan, you may finally get solicited for a Virginia 529 plan! There will also be a commission-free version available for Fee-Only planners.

Also, don't forget that the **estate tax exemption has increased from $675,000 to $1,000,000 this year**. It goes to $1.5 million in 2004.

While many will think this eliminates the need to do estate planning, they are wrong! Many existing estate plans should be redrafted to prevent some unintended consequences (such as all the estate going to a Credit Shelter Trust) instead of being split between the spouse and the Trust).

**DISABILITY**

# Sudden Money Impact on Benefits

Every week I hear from parents who have worked hard to obtain Supplemental Security Income (SSI) and Medicaid benefits for their disabled child only to lose them due to an influx of sudden money.

The money can come from any number of sources. A grandmother will die and leave a bequest to the disabled child in her will. A sole surviving parent will die with a life insurance policy or IRA that has a beneficiary designation saying "equally to my children".

Sometimes it will be **settlement money from a lawsuit**. It could be Social Security payments based upon a parent becoming disabled, retiring or dying.

All but the Social Security payments are preventable. When you set up your estate plan to avoid leaving money to your disabled child directly (leaving it instead to a Special Needs Trust (SNT) for the child's benefit), you need to tell everyone in your family!

**Let them know that money left directly to your child will not improve the child's quality of life, while money left to a SNT can. Ask them to review their life insurance policies and IRA or other pension plan beneficiaries to insure any money for your child goes to a SNT.**

**Don't assume a lawyer or judge working on an injury settlement understands the nuances of benefit eligibility. Just because they put the money into a trust for your child doesn't mean your child will continue eligibility for benefits. It has to be a special type of trust (an OBRA '93 trust)**. Make sure you are asking the hard questions!

If your child gets a lump sum of money from one of the sources above, you can get your own **OBRA '93 trust or you can participate in the Commonwealth Community Trust, Joanne Marcus, 888-241-6039** www.commonwealthcommunitytrust.com. The Community Trust is less expensive and provides financial oversight. Having your own trust gives you more control over expenses, but costs more.

What about that unexpected income from Social Security? A trust won't fix that in Virginia (in some states you might have another option). If the income is less than the amount of SSI ($545 in 2002), your child may still receive some SSI payment, and, more importantly, Medicaid eligibility. Your annual Social Security benefits statement will tell you how much your child might receive. Take a look at it and plan accordingly!

Some of you have asked how to catch one of my speaking engagements (Planning for Parents of Disabled Children). Here are the upcoming dates:

March 4, 10:15, VB Infant Stim Support Grp

March 7, 10:15, VB Infant Stim Support Grp

March 20, 10:15, VB Infant Stim Support Grp

March 27, 10:30, Hampton Rds Regional Symposium

March ?, PBS TV show, **Right on the Money** (dates vary nationwide, but will not be shown on WHRO)

June 4, 10:10 Virginia Society of CPA's, Richmond VA

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