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BFAS Money Line

INVESTMENTS

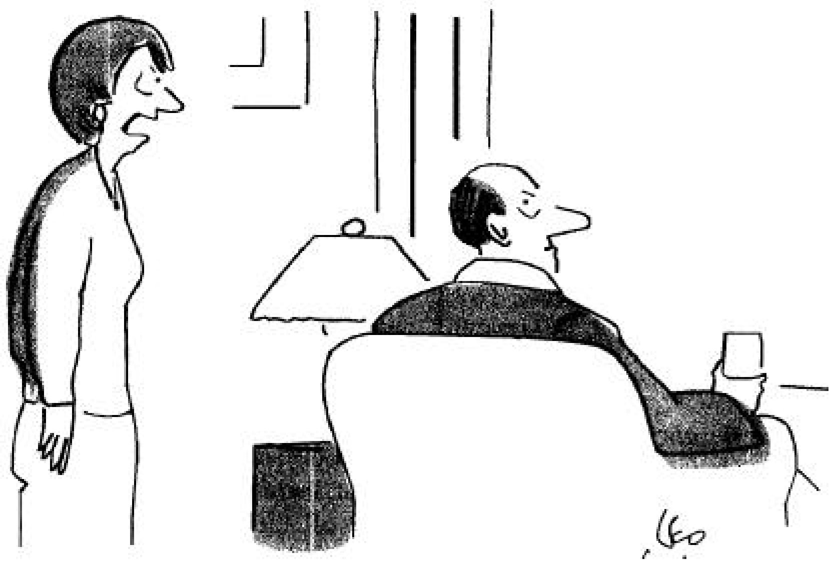
War's Impact on Market

In addition to reading many newsletters and articles on the economy and the market, I recently attended an event with two economists speaking. I have to say **economists are the only people who can make weather forecasters look accurate**; and make Ben Stine seem like an entertaining speaker.

Anyway, the consensus seemed to be that we should expect relatively **normal growth of 3%** in the U. S. economy for 2003. Then, they factored in war scenarios.

In the **short war** scenario (weeks), oil prices peak at $80 per barrel ($2.50 per gallon), but only reduced **growth** by .1% to **2.9%.** Worst case was a **long war** scenario (many months). In this scenario, the extended high oil prices **reduce growth to zero.**

However, the economy is not in lock step with the market. Why else would **the economy grow 2.3% last year while the market dropped 22%?**



"I KNOW you made a small fortune in the market these last two years. But it would have been far more impressive if you hadn't started out with a BIG fortune to begin with."

Earnings announcements thus far this year have been good with twice as many positive earnings surprises as negative.

Yet, the market has dropped recently due to the uncertain international situation. When I look back at **Desert Storm in 1990-1991, I see a 20% market drop before the war and a 25% increase after**. This all happened over about seven months.

We are likely seeing a similar market drop today, though probably not as severe. **We will also likely see a significant market rise after the war** (or Saddam's abdication, whichever comes first).

Does that mean the market bottom wasn't in July or October. I don't think so. What we are seeing now is the normal market reaction to uncertainty on the world stage.

Would it be better that this happened after a nice market recovery? Certainly, but the market doesn't choose to move or not, it just reacts to what is.

In January, the market rose almost 6% early, only to drop on war fears to a 3% loss. The table on the next page shows what the various markets did last year:

Asset Class	1 Yr Rtn (12/31/02)
S & P 500	-22.09%
NASDAQ	-31.53%
Lg Cap Gwth	-24.98%
Lg Cap Val	-17.99%
Mid Cap Gwth	-23.91%
Mid Cap Val	-12.34%
Sml Cap Gwth	-28.90%
Sml Cap Val	-13.29%
Foreign	-15.94%
Interm Corp Bds	+ 6.48%
Foreign Bds	+13.55%

TAXES

Dividend Taxation

The debate over whether or not to make dividends tax-free is already started and will likely get much nastier. The President, over the objections of some of his advisors, decided he wanted to eliminate taxes on dividends. He did this because **he firmly believed that taxing money twice** (at the corporate level and to the shareholder) **was wrong**.

To insure that no income escaped taxes, they added complexity to the proposal by **only allowing tax-free dividends from corporations that paid taxes**. Thus, each company would send out a statement at the end of the year detailing to what extent their dividends were tax-free.

This adds uncertainty to shareholders and complexity to the tax system; all to adhere to the "only tax income once" premise behind the proposal.

Almost none of the debate over the proposal will touch on the **beneficial impact to corporate governance**. **Over the last 75 years, dividends have made up 40% of the 10% return on stocks. Yet, recently dividends have dropped to almost nothing**.

Why? Corporations, and people, react to our tax system. In recent years, capital gains taxes have dropped to 20% (18% if held five years). Yet, dividends are taxed at ordinary tax rates. Thus, shareholders would rather receive capital gains than dividends. Plus, shareholders can control capital gains exposure by selling whenever they choose.

Corporations are happy to keep the money in the company for "growth". They then tell the shareholders how great they are doing so the stock price will go up. Money kept in the corporation can be paid out in options and loans to executives. For those who are ethically challenged, they start cooking the books to continue the upward price of shares.

What happens if dividends become tax-free? **Shareholders will want stocks that pay dividends. Prices of those shares will increase. Corporations, seeing that paying dividends will help their stock price, will start paying dividends or increase their dividends**. Did you notice that Microsoft recently started paying dividends?

More importantly, **companies that pay dividends must have real earnings**. They can't get away with, "Trust me (and my bogus accounting firm), we're doing great!"

Therefore, removing taxes on dividends would provide very positive incentives for companies. It would reduce incentives for stock options and force companies to demonstrate real earnings power by paying real money in dividends. They can't fake that!

Unfortunately, **15-minute sound bites prevent a thorough discussion of the merits and lead to the class-warfare sloganeering we are already seeing.**

How Taxes Work!

This is a VERY simple way to understand the tax laws.

Let's put tax cuts in terms everyone can understand. Suppose that every day, ten men go out for dinner. The **bill for all ten comes to $100**. If they paid their bill the way we pay our taxes, it would go something like this.

The first four men-the poorest-would pay nothing; the fifth would pay $1, the sixth would pay $3, the seventh $7, the eighth $12, the ninth $18, and the tenth man-the richest-would pay $59.

That's what they decided to do. The ten men ate dinner in the restaurant every day and seemed quite happy with the arrangement -

until one day, the owner threw them a curve (in tax language- a tax cut).

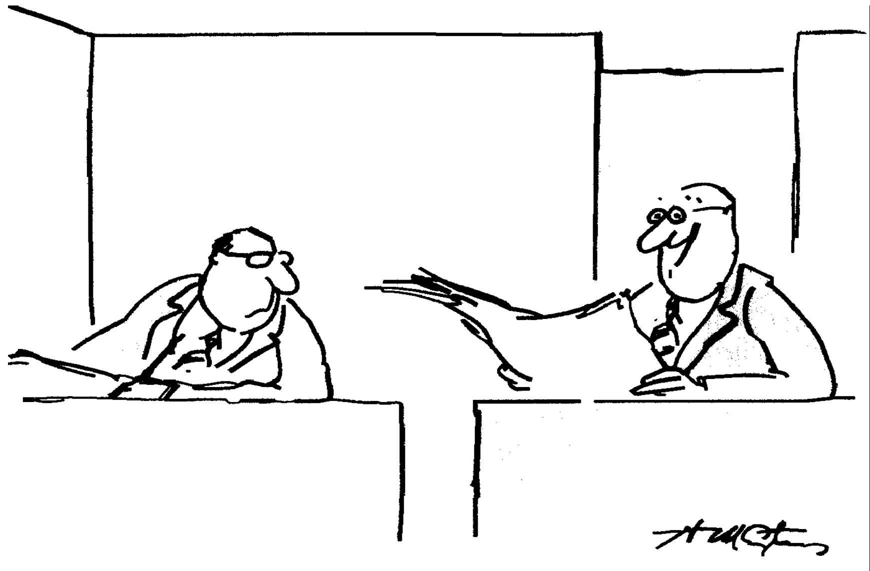
"Since you are all such good customers," he said, "I'm going to reduce the cost of your daily meal by $20." So now dinner for the ten only cost $80.00.

The group still wanted to pay their bill the way we pay our taxes. So the first four men were unaffected. They would still eat for free. But what about the other six - the paying customers? How could they divvy up the $20 windfall so that everyone would get his "fair share?"

The six men realized that $20 divided by six is $3.33. But if they subtracted that from everybody's share, then the fifth man and the sixth man would end up being PAID to eat their meal. So the restaurant owner suggested that it would be fair to reduce each man's bill by roughly the same amount, and he proceeded to work out the amounts each should pay.

And so the fifth man paid nothing, the sixth pitched in $2, the seventh paid $5, the eighth paid $9, the ninth paid $12, leaving the tenth man with a bill of $52 instead of his earlier $59. Each of the six was better off than before. And the first four continued to eat for free.

But once outside the restaurant, the men began to compare their savings. "I only got a dollar out of the $20," declared the sixth man, "but he, pointing to the tenth man, got $7!" "Yeah, that's right," exclaimed the fifth man, "I only saved a dollar



"Here's a company with no product, no earnings, no cash and an outrageous stock price. What say we put our jobs on the line and give it a "Sell" rating?"

too, It's unfair that he got seven times more than me!"

"That's true!" shouted the seventh man, "Why should he get $7 back when I got only $2? The wealthy get all the breaks!." "Wait a minute," yelled the first four men in unison, "We didn't get anything at all. The system exploits the poor!"

The nine men surrounded the tenth and beat him up. The next night he didn't show up for dinner, so the nine sat down and ate without him. But when it came time to pay the bill, they discovered, a little late what was very important. They were FIFTY-TWO DOLLARS short of paying the bill!

And that, boys and girls, journalists and college instructors, is how the tax system works. The people who pay the highest taxes get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy, and they just may not show up at the table anymore.

Where would that leave the rest? Unfortunately, most taxing authorities anywhere cannot seem to grasp this rather straightforward logic!

COLLEGE PLANNING

College Planning

This time of year, many parent's thoughts turn to college funding. With states strapped for cash nationwide, they are cutting college support. **Colleges**, to make up the difference, **are raising tuitions.**

In the past, I have recommended college savings plans rather than pre-paid tuition plans. This is because, here in Virginia, tuition was frozen for four straight years. **This year, tuitions have increased an average of 9%.**

So, with tuitions increasing and the stock market projected to provide sub par returns for the near future, **should you maybe go with the pre-paid tuition plans now?**

The answer is not as clear-cut as it once was**. Pre-paid tuition plans have the additional disadvantage of being counted as the child's assets when calculating eligibility for financial aid.** Thus, financial aid would be less if you owned a pre-paid tuition plan, while a college savings plan with the same value would not reduce financial aid.

Another problem I have with **pre-paid tuition** plans is if your child does not go to a state school, tuition payouts to private or another state's school will **provide only a money market rate of return**. In addition, states have been raising the amount you must pay into pre-paid tuition plans.

The difficult market environment has certainly hurt the growth of money invested in most college savings plans. The five year S & P 500 return is -.58%, while ten year return is 9.34%. On the other hand, a balanced option (roughly 60% stock/40% bond) grew 1.51% over five years and 7.36% over ten years.

On balance, **if your child would not be eligible for financial aid, and you are really conservative, pre-paid tuition might be best for you. However, for most people a balanced investment option in a college savings plan is still the best option.**

DISABILITY PLANNING

New Housing Option?

One of the most difficult problems parents of disabled children face is where their child will live when the parents are gone. Many **people would prefer to leave their own house to someone if only someone would come in and take care of their child**.

However, the **city will seldom accept such a home** due to their need to meet safety requirements, handicapped accessibility requirements and maximum bedrooms for other children to spread their scare resources as far as possible.

One of the problems with leaving a house is **how to pay for upkeep**. Most people make sure their child is eligible for Supplemental Security Income (SSI) and Medicaid benefits while leaving any extra money in a **Special Needs Trust (SNT)** for the benefit of the child**.** One characteristic of an SNT is that **money in one can't be spent on food, clothing or shelter for the child**. Those are the things SSI covers.

Social Security allows the disabled child to own a house, but the $2,000 maximum allowable resource limit is usually not enough to pay for real estate taxes, insurance and repairs.

BIZNET, an all-volunteer non profit organization that builds or buys housing for disabled children, **may provide an option for parents**. The board has decided it **would consider accepting homes from parents** to be used for disabled children. BIZNET would have to work closely with parents to **make sure the arrangement works to help both parties.**

Some parents would rather not have to deal with the current caseworker system. In this case, **several parents could get together to arrange a home transfer to BIZNET**. Since BIZNET is not a care provider, the **parents would have to arrange their own supervision for their children**. They would also **need to establish an endowment and mechanism for caregivers after the parents are gone**.

BIZNET can be contacted at **473-5223** if you are interested. This just might be another opportunity for some of you to meet your needs!

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