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BFAS Money Line

INVESTMENTS

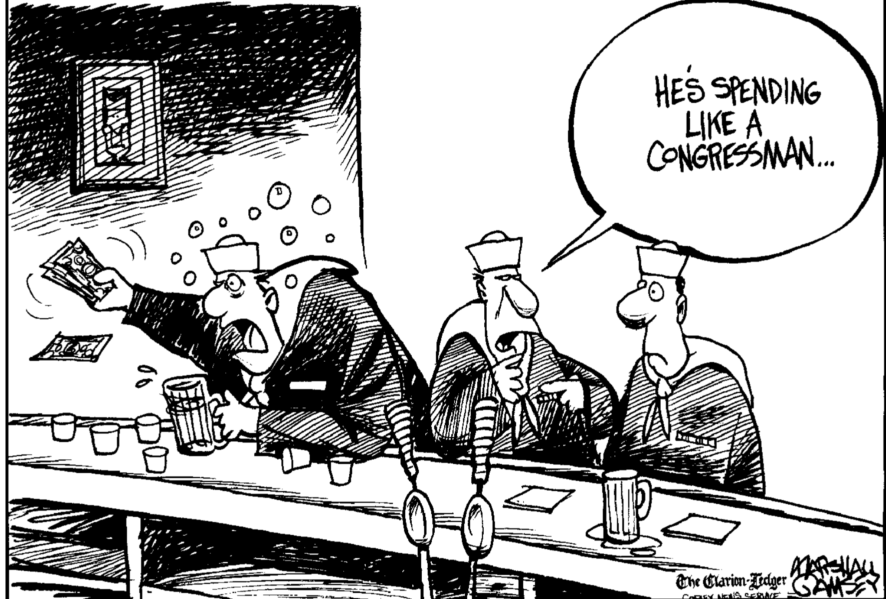
Will It Last?

The **first three years of this century produced the worst three-year stock market performance since the Depression**. This time last year, pretty much everyone was consumed with concern about the economy and an impending war with Iraq. By the end of February, 2003 the market was down 4%.

Yet, even before the guns were silenced in Iraq, the market turned around to produce a 28% return in 2003. However, the market (S & P 500) is still down almost 20% since January of 2000.

Now that I've demonstrated 20/20 vision on the past, **what about the future?** Pretty murky out the windshield. **The economy is expected to continue its growth at even a higher rate this year**. **Jobs**, left behind thus far, **are expected to grow by 1.5 - 2 million in 2004 and continue to grow**.

This sets the stage for continued market growth, although probably not nearly as strong as last year.



Will an increase in interest rates sink bonds this year? Opinions are mixed, but the consensus is that interest rates should stay the same until after the election. This would avoid protests that changes in interest rates are politically motivated.

However, **interest rates are sure to go up either late this year or next year**. A rise in interest rates has no impact on individual bonds held to maturity. That is, individual bonds will continue to pay their normal coupon until the bond matures.

Remember, bonds are simply loans to someone who promises to pay a coupon (4%, 5%, etc.) to you each year they have your money until the bond matures, when they are supposed to return your original loan. One of the risks of bonds is high inflation reducing the value of your "fixed income". Another risk is the possibility of the bond holder not returning your "loan", or defaulting.

Bond ratings help somewhat, by giving us a clue who might or might not default. Those in danger of defaulting are called junk bonds. These companies must pay a much higher coupon to compensate for their higher risk. Last year, they paid almost 8% more than high-grade bonds. This year, they are paying only about 4% more.

When interest rates change, the values of bonds change. Interest rates up, bond values down. The longer the maturity of the bond, the more it goes down. Again, although the value of an individual bond might change

over time, you should recover all the money you invested in it originally if held to maturity. However, bond funds buy and sell bonds frequently and do not hold bonds to maturity. Thus, they can lose value.

This is why managers of bond funds are reducing the average maturity of their bond holdings; so that an increase in interest rates will only minimally lower bond fund values.

Why not just switch to individual bonds? Transaction costs and lack of diversification are the primary reasons. Most advisors recommend funds for those holding anything less $300,000 in bonds.

Another reason to hold funds is professional management. Bill Gross, manager of the PIMCO Total Return Fund – largest mutual fund in the world, has significantly out-performed bond index funds. Is his, and other bond manager, expertise worth the expense? In many cases, yes.

While I speak about bonds in general, there are almost as many varieties of bonds as there are stocks. There are U.S. Treasury's, Corporate's, Municipal's, mortgage, foreign government bonds, foreign corporates, junk and convertible bonds. Each has unique capabilities and limitations, and they do not move up and down together. Thus, diversification in types of bonds can add value to a portfolio.

I went back to **1994**, a black year, to review what could happen in a rising interest rate environment. Stocks went nowhere, up 1.3%. **Interest rates increased 2.5% and intermediate (3 – 10 year) bond funds lost about 3.5%** while long-term (10+ year) bond funds lost 6.5%. Although having a losing year in a bond fund is no fun, you can see that these rare events aren't nearly as painful as a down year in stocks.

On a general note, economists are very happy with the economy. Low interest rates, high productivity, soaring corporate profits, and stable inflation are all good for the economy. They did express concern longer term about the deficits.

All of the above is based upon what we know. However, the unknowable frequently slaps us up side the head. **Unknowables include a terrorist attack, North Korea, Iran, or Taiwan blowing up**. Who knows, maybe one of our rovers on Mars will spy Martians in the act of launching an invasion of earth! Wouldn't that change the discourse on our planet!

The table below shows what the various markets did in the last year:

Asset Class	1 Yr Rtn (01/31/04)
S & P 500	+34.55%
NASDAQ	+56.42%
Lg Cap Gwth	+33.63%
Lg Cap Val	+34.06%
Mid Cap Gwth	+41.93%
Mid Cap Val	+40.61%
Sml Cap Gwth	+54.79%
Sml Cap Val	+51.09%
Foreign	+41.55%
Interm Corp Bds	+ 6.36%
Foreign Bds	+12.07%

Retirement

With this new year, some of your retirement contribution limits have increased. **Make sure you maximize your retirement contributions!**

Although the IRA/Roth IRA contribution limit is still $3,000 ($3,500 for those over 50), the limit for qualified plans (401(k), 403(b), 457) increased from $12,000 to $13,000. In addition, those over 50 can contribute another $3,000 for a total of $16,000.

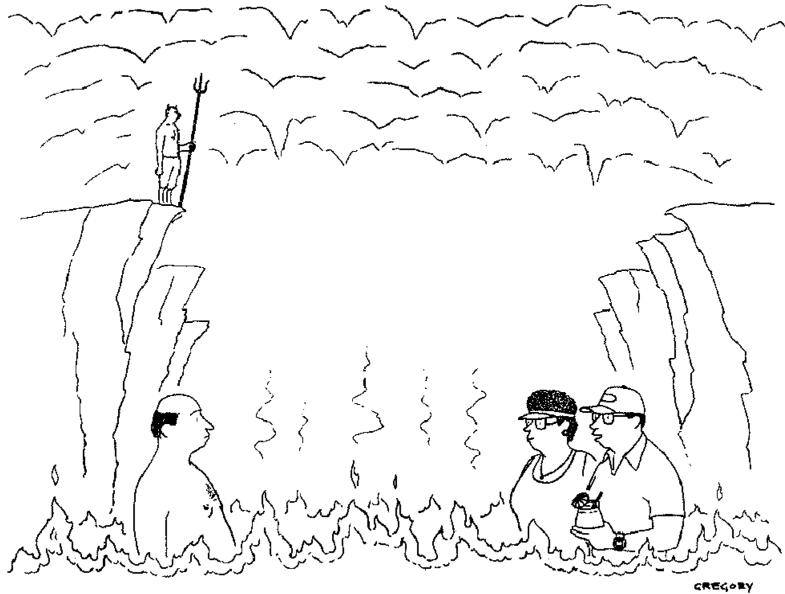
Those with SIMPLE IRA plans can contribute $9,000 this year plus another $1,500 for those over 50.

If you are a spouse worried about the tax man taking all your earnings if you join the workforce, remember you can contribute 100% of you pay up to the limits above. Thus, if you make $20,000 and can live without the cash, you can contribute $16,000 to your 401(k) and only be taxed on the last $4,000.

In the same vein, if your child/grandchild is working, you might consider contributing up to $3,000 to a Roth IRA (as long as he/she makes at least that). It doesn't have to be the dollars he/she earned that goes into the IRA. You can contribute the money directly and get a savings plan started for them.

In addition, **they would likely be eligible for a tax credit of up to $2,000 for contributions to their IRA (or other pension plan).** This credit would probably insure they paid no income tax on those part-time summer jobs, as long as they contributed to a retirement plan.

I consistently **advocate putting 10%, preferably 15%, of your income away for your retirement**. These new rules make it much easier to get a tax break for putting that money away. Fewer excuses!



"Oh, we're just down here for the winter"

Taxes

Last year was a **split year for capital gains taxes**. Remember that **capital gains earned before May 6th are taxed at a maximum of 20% while those after that date are taxed at 15%.**

In addition, **some dividends will be eligible for a 15% tax rate while others are taxed at your normal tax bracket**. Mutual fund corrections of their dividend eligibility for the 15% rate will cause some 1099 revisions.

I expect the end of year 1099's to be revised once if not two or three times. Thus, racing to file your return this year might just result in having to file amendments when the revised 1099's arrive. I'd **recommend holding off filing until at least the later part of March**!

Housing Bubble?

Judging by the run-up in housing prices in my neighborhood, you'd think we were in a housing bubble. Low mortgage rates have helped people purchase more expensive houses with the same monthly payments.

This can lead to problems as an unexpected layoff or health problem forces over-extended families to consider foreclosure or bankruptcy. Both categories are up substantially.

Yet, **rental and homeowner vacancy rates in our region are at their lowest in years**. Also, the ratio of home price to household income is right on the 27-year average.

So, **don't be too concerned about a housing bubble in Hampton Roads**. There are, however, places around the country with potential bubbles or potentially overbuilt. Some are the usual suspects of Washington D.C., Baltimore, Ft. Lauderdale, Miami, Ft. Myers, L.A., San Diego, San Francisco and Los Vegas. Others are more unexpected (just a sampling): Corpus Christi, Buffalo, Cleveland, Indianapolis, Tulsa, El Paso and New Orleans.

Although they weren't on the official list, I think Nags Head is in bubble territory. Remember, you'd rather buy low than high. I don't think anyone can make a case that Nags Head prices are low right now. However, they may well come down. Best to buy when they do, not now.

So, be careful while evaluating that next home or vacation home purchase. Rapidly rising prices may look great, but could trap you in a house worth less than your mortgage. I have personally witnessed responsible people make the agonizing decision to walk away from a loan rather than having to pay $15,000 to sell their house because the selling price was less than their mortgage.

Estate Planning for Children

You may have that bumper sticker, "I'm spending my children's inheritance", but **most of you have some plan to leave assets to your children. Parents typically want their children to have a strong work ethic and a sense of responsibility**. Therefore, many parents, if they do plan to leave money to their child, won't let the child know about it for fear of de-motivating the child.

Yet, children can have a strong work ethic and a sense of responsibility without having to earn a high income. **Some children will be most happy to work as a writer, painter, teacher or poet**. Enabling them to do so would be a wonderful gift.

Warren Buffet has been quoted as saying he **would leave his children enough money to do anything but not so much that they could do nothing**. Bill Gates plans to leave his children only a limited amount of money. Yet, the Walton family (of Walmart fame), left vast fortunes to their children and it worked out fine.

Studies have shown that entrepreneurial children do better with inheritances than employee children. Another study has shown that a child receiving a $150,000 inheritance is four times more likely to retire early than one receiving $25,000. Again, **the key is the child having a guiding interest or passion for something**. **How will you know how the child will react to an inheritance? Despite the misgivings, you should have a conversation with your child.** You may be surprised to find that they don't want it, or at least not now.

One son asked his parents not to make a significant gift, saying, "I'm a hunter and gatherer right now. I'm learning how to handle it and make things work. I don't want you to put a bunch of berries in front of me that I didn't find on my own. That would defeat the purpose."

Another issue to consider is your **expectations as a result of a gift while you are still alive**. These expectations may or may not be expressed. An example is the mother who gave her son and daughter-in-law $100,000 for a down payment on a house. Does she expect to be invited over for dinner regularly? Does she expect them to purchase a house in a certain price range or near her? Will she be judging their every expense?

What about the parent who gives a child $10,000 for college only to find the child spent $2,000 on a spring break trip to Cancun? Mom was outraged. Maybe the child just needed help on how to handle money. Are the parents in these situations being too controlling rather than fostering growth?

We all want our children to lead responsible and self-supporting lives. How we handle gifts while we are alive as well as after we are gone can have a significant impact on their ability to do so.

BIZNET Project

You may remember BIZNET as the local, all-volunteer non-profit that raises funds to purchase homes for the developmentally disabled. Currently, **BIZNET owns (without mortgage) two condo's, a five bedroom house and an eight bedroom duplex for medically fragile residents**.

The BIZNET board is excited about their latest proposed project: **a partnership with Virginia Beach and the Community Development Corporation (CDC) to build four homes with twenty six bedrooms**.

We're close to a decision by the city to donate the land needed. Following that decision, BIZNET will provide architectural and engineering work while the CDC will obtain grants/loans (about $2.5 million) to build the properties. Upon completion, the city will choose the residents and provide staffing. The BIZNET board is very hopeful that this partnership will be able to pull off this very ambitious project and significantly reduce the waiting list for services.

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