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BFAS Money Line

Two Up Yrs, Third Possible?

Last year finished strong for a second consecutive double-digit return (10.85%). The GDP was up over 4% last year and the **economy continues strong** thus far this year.

The Iraqi election, tsunami relief, and Israeli/Palestinian rapprochement have already lowered the tenor of anti-American rhetoric. Islamist extremists are now on record as fighting democracy. That will make it harder for their sympathizers here and abroad to continue their support.

Interest rates will continue their upward trend with negative consequences for U. S. bond fund holders, but some relief for those with CDs. The chart shows how **foreign bonds are currently performing better than U. S. bonds**.

While the fiscal and trade deficits are worrisome, they should not significantly affect the economy. Having said that, the economic cycle has not been repealed, and the recession that usually happens every 40 – 60 months is probably in our future. Most **economists**

predict 2006 or 2007 for our next recession.

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

Asset Class	1 Yr Rtn (01/31/05)
S & P 500	+06.22%
NASDAQ	-00.18%
Lg Cap Gwth	+01.39%
Lg Cap Val	+11.27%
Mid Cap Gwth	+12.12%
Mid Cap Val	+14.43%
Sml Cap Gwth	+07.27%
Sml Cap Val	+13.23%
Foreign	+16.40%
Interm Corp Bds	+3.49%
Foreign Bds	+ 7.56%

Selling Safety

Every day I get emails urging me to sell "High Commission" annuities. These could be equity-indexed annuities, variable annuities, fixed annuities or immediate annuities. Commissions, normally about 6%, could be as high as 10%. Note: I don't accept commissions; I am only paid by my clients. I'm just trying to give you an idea of what's in it for the person pitching them to you.

The script they use on you goes something like this: "Tired of losing sleep in an uncertain stock market? Put your money in "XXX annuity", and we'll guarantee no losses, and/or growth of X% (sometimes tied to the S & P 500), plus you can never outlive your money."

"Is your current money in an annuity? Would there be surrender charges if you moved it? No problem, they say, we'll offer a bonus of 4% to make up for the surrender charge in your old annuity so you can purchase our new, better annuity" (and earn the salesperson another 6% commission).

Now, annuities do have their place. They are not all bad; they are just oversold. A **big downside to an annuity is the fixed income**. (There are some new ones with inflation protection, although they have much lower payouts). Thus, while your annuity may provide a stable, fixed income, your expenses are increasing every year.

You also lose flexibility: can't use a lump sum of that money to pay cash for a car, repair your house or help a child make a down payment on a house.

Most importantly, **if you have "annuitized (i.e. accepted a lifetime income stream)", you are betting that you will live a long time and you are leaving none of that money for your heirs**. If you die early (which the insurance company is betting on), the insurance company keeps all the money. Yes, you can set it up so that the annuity pays for 10 or even 20 years minimum no matter when you die, but you will receive an even smaller monthly payment.

Inflation has a huge impact on your standard of living. A retiree living on $50,000 per year at 65 with 3% inflation will need $100,000 at age 89 to maintain the same standard of living.

Portfolio Dollars Remaining	Years	Portfolio 5% Withdrawal Inflation Adjusted	SPIA Annuity 5.8%	SPIA Annuity 7.6%
	1	$5,000	$5,800	$7,600
$103,000	2	$5,175	$5,800	$7,600
$106,065	3	$5,356	$5,800	$7,600
$109,194	4	$5,544	$5,800	$7,600
$112,386	5	$5,738	$5,800	$7,600
$115,639	6	$5,938	$5,800	$7,600
$118,952	7	$6,146	$5,800	$7,600
$122,322	8	$6,361	$5,800	$7,600
$125,746	9	$6,584	$5,800	$7,600
$129,222	10	$6,814	$5,800	$7,600
$132,745	11	$7,053	$5,800	$7,600
$136,312	12	$7,300	$5,800	$7,600
$139,917	13	$7,555	$5,800	$7,600
$143,555	14	$7,820	$5,800	$7,600
$147,219	15	$8,093	$5,800	$7,600
$150,904	16	$8,377	$5,800	$7,600
$154,599	17	$8,670	$5,800	$7,600
$158,297	18	$8,973	$5,800	$7,600
$161,987	19	$9,287	$5,800	$7,600
$165,659	20	$9,613	$5,800	$7,600
$169,299	21	$9,949	$5,800	$7,600
$172,894	22	$10,297	$5,800	$7,600
$176,429	23	$10,658	$5,800	$7,600
$179,885	24	$11,031	$5,800	$7,600
$183,246	25	$11,417	$5,800	$7,600
$186,489	26	$11,816	$5,800	$7,600
$189,591	27	$12,230	$5,800	$7,600
$192,529	28	$12,658	$5,800	$7,600
$195,273	29	$13,101	$5,800	$7,600
$197,794	30	$13,559	$5,800	$7,600
		$258,113	$174,000	$228,000

Based upon academic studies (AAII Journal, February, 1998), a person with a 60% stock/40% bond portfolio should be able to withdraw about 5% initially at age 65 and increase the withdrawals by the rate of inflation each year thereafter. The study looked back over many years, including the depression, to see if such a plan would cause you to run out of money over 30 years. And, yes, there is about **a 20% chance of running out of money**. However, if you need more money early, less money later or some other flexibility, you have the option.

On the other hand, if you are having a hard time making it on 5% of your portfolio, a salesperson can make a seductive case for buying an annuity paying as much as 7.6% for a single life, 5.8% for two lives. (Note: the chart assumes an initial $100,000 investment with an

8% return on the portfolio, 3.5% inflation; male aged 63 for the Single Premium Immediate Annuity (SPIA).) You initially get much more money; but, it's fixed!

By **year 13**, the **5% portfolio withdrawal catches up with the single life 7.6% payout**. The **total received over 30 years is higher from the portfolio, with the additional benefit that the portfolio may still be worth about $198k after thirty years of withdrawals**.

In general, I recommend you resist the "higher income now" sales pitch because it will leave you short of funds as inflation raises your expenses. Yes, safety if comforting; but are you sure the insurance company paying the annuity will be around in thirty years?

I would **recommend an annuity for a person who had sufficient assets outside the annuity to meet unexpected financial needs and to provide inflation protection**.

Social Security

I see a great deal of rhetoric about Social Security (SS). If there is a website that tries to separate the myths from the truth, I haven't found it yet. Remember that Social Security is insurance (FICA = Federal Insurance Contribution Act).

When someone buys insurance and actuarial circumstances that the insurance company used to determine premiums changes, they either raise the premiums or let you accept lower

"Now try not to get confused this time. Tell the audience to buy the stocks we're selling, and sell the ones we're buying."

benefits. That's what has happened to Social Security (I'm not getting into the Ponzi scheme aspects of young workers payments going right out to retirees and the pox due on both parties for allowing the surplus to be spent).

We're living longer. With no changes, by 2018 we have to raise taxes to pay for the IOUs in SS files because the income from fewer workers will not be enough to pay all the retirees. If no changes are made to Social Security, either FICA taxes must go up significantly or benefits must drop about 27% to balance income and outgo.

One proposal to reduce benefits is to change the calculation method for annual increases. This could make about a 1% difference in benefits each year, with an increasing cumulative impact over time.

Separate from that is the proposal to allow private accounts. I had concerns about people being allowed to invest in individual stocks (I would be opposed).

The latest proposal would limit the choices to five very low cost index funds (Large U.S. companies – 10% long term return, foreign stocks – 9%, Small U.S. companies – 12%, U.S. Treasuries – 6%, U.S. corporate bonds – 7%). This is similar to the Thrift Savings Plan currently available to government employees.

If a young person invests only in the U. S. Treasuries Fund, he should earn exactly as much as if he left his money in Social Security. However, **one big difference is that, with a private account, the money is his, not the government's**.

If he invests in the other accounts over 45 years, the compounding adds up. While a **$1,000 annual investment in Social**

Security would grow to $213,000, the same investment in U. S. common stocks would grow to $719,000.

Yes, stocks are more volatile; so what if in the year before retirement, the **stock market went down 40%.** You would **still have $431,000 or 102% more than just leaving the money in Social Security!**

Personal accounts are voluntary, have the potential for much higher returns and would provide ownership and control. If there weren't conversion costs to make the change, it would be a no-brainer. Paying for the conversion will be the issue.

Sadly, not many people are aware that private accounts have been tested already. **Three counties in Texas opted out of Social Security over twenty years ago**. Their **employees are projected to receive 90% of their current income from their private accounts compared to about 55% from Social Security (google Galveston social security for details**).

In addition, **Chile set up a highly successful and popular (93% opted in) voluntary private account system in 1981 as well (google Chile Social Security**). I believe Australia and the United Kingdom also allow private accounts.

Are the people in these other countries smarter than us? Certainly not. They do seem to be better informed. You might wonder why you have not heard about these positive examples in the major media.

Bottom line: Social Security is in trouble. Those with the political courage to try to fix it deserve informed input, not political posturing. We need to remember that Social Security is an insurance program, not a welfare program.

We need to have a reasoned debate, not the scare-mongering rhetoric (investing in the stock market is called a "risky scheme") that passes for information these days!

LTC Ins

As I write this, the **Virginia legislature is about to send new, very restrictive Medicaid Long Term Care (LTC) rule proposals to the governor**. The new rules would make it much more difficult to qualify for Medicaid-paid LTC in Virginia than the current federal rules used everywhere else.

Virginia is reacting to the dramatic increases in Medicaid costs by trying to limit the Commonwealth's liabilities. As a result, I expect to see a significantly higher interest in LTC insurance.

Many of you may know that, if you itemize, you can deduct some, or all, of your LTC premium as a medical expense. The deduction limits are: age 51 – 60 $1,020, 61 – 70 $2,720 and 71+ $3,400. Since you may still be working, I wanted to remind you of several ways you can pay for LTC insurance through work.

If you are self-employed, in an LLC, Partnership or S Corporation, you can deduct 100% of your and your spouse's LTC premiums up to the limits shown above as a business expense. The LTC premiums for a C Corporation are deductible as well.

Also a **C corporation can pay premiums from retained earnings**; thus allowing owners to take money out of the business in a tax preferred manner.

Unlike some other expenses, **LTC coverage can discriminate**. Thus, **you can offer it to a key employee only**. More importantly, you can purchase a policy (10 pay) that is paid up during working years and leave all the retirement income for retirement.

How about **paying premiums on a policy instead of a bonus?** This saves taxes for the employee because it is pre-tax and it saves FICA taxes for the employer. It's a win-win!

Give some thought to how you might obtain LTC coverage in a tax efficient manner.

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