February 2006 Volume 11.1

BFAS Money Line

What's Ahead?

My crystal ball is pretty cloudy. Although I think I have an idea of what the economy will do, stocks are like teenagers, they have a mind of their own.

Our economy moves in cycles of growth and recession. When we are in recession, the Federal Reserve typically lowers interest rates and the federal government tries to stimulate growth with additional spending and/or tax cuts.

Once growth starts, it tends to accelerate until the labor pool gets tight. This leads to rising wages. In addition, the competition for resources forces up the price of raw materials. At the same time, more is being produced than is wanted by consumers. Facing rising prices for labor and materials as well as falling sales, business production and profits fall and they start laying off people. Layoffs lower consumer spending due to job uncertainty.

Consumer spending makes up about 70% of our economy. When it drops, our economy weakens and can drop into a recession (two consecutive quarters of negative Gross Domestic Product (GDP).

THE NEW YORKER COLLECTION 2006 BARBARA SMALLER/CARTOONBANK.COM

"Have you given much thought to what kind of job you want after you retire?"

Why, when business profits are doing so well, am I talking about recession? Because, recessions typically happen about every four years and stock prices drop, on average, 43% during a recession. Stock prices also typically recover their value within eighteen months of their lows.

Every recession we have had was preceded by an inverted yield curve, although every inverted yield curve did not "predict" a recession. Thus, we have had inverted yield curves without having recessions. However, when the yield curve inverted in late December, it invariably raised the issue of a future recession.

First off, an inverted yield curve simply means that shorter term interest rates are higher than medium or long term interest rates. Banks don't like it because they typically make their money by paying you a low savings account/CD rate while loaning your money longer term (home mortgages, business loans) at higher rates. When banks face an inverted yield curve, they tend to make fewer loans. Fewer loans means fewer houses sold and businesses having difficulty getting credit.

A recent study by the Federal Reserve attempted to

quantify the inverted yield curve/recession connection. The study found that the inversion needed to last at least 90 days to have any predictive value (we haven't been inverted for 90 days yet currently). If the inversion lasted 90 days or more, the probability of a recession increased from a low of 10% for a barely inverted yield curve to a higher probability for highly inverted yield curves. Also, the recessions tended to happen about 12 – 18 months after the inversion.

So, what does all this technical talk mean? **We are entering a time period where an inverted yield curve could be predicting a recession in 12 – 18 months, or the inverted yield curve could mean nothing at all!**

As I stated earlier, recessions happen and happen regularly. They are a part of any capitalist economy. Here's where I'm supposed to tell you how to avoid the pain to your portfolios.

What I won't do is predict when you should get out of U.S. stocks to avoid the cyclical plunge. Although there are many who will make that prediction, every study I have seen says no system can predict when to get out of the market. My personal experience has been that those who attempt to time the market still lose money and frequently miss big upsides, thus reducing their overall returns.

Things that don't necessarily go down when the market tanks: **bonds and real estate. Value stocks tend to do better than growth stocks in recessions.**

Our cyclical economy combined with the **strong emotions of fear and greed cause so many people to earn a low return on their investments**. Fear leads people to believe they can lessen the pain of a recession by trying to time the market. Greed causes them to buy into the market near its peak so they "won't miss out", then fear causes them to sell near the bottom to "avoid losing everything". This is the main reason average investor market returns are around 4% while the market returns more than 10%.

The **best advice to smooth out the cyclical market is to understand the lure of fear and greed, and always have a properly diversified portfolio**. Many portfolios I see are heavily in U.S. large cap stocks, sometimes just technology or health care.

Last year, large cap stocks did poorly (4.91%), while technology was worse at 1.37% and health care better at 9.43%. On the other hand foreign large cap stocks were up 13.5%, foreign small cap was up 25% and emerging markets were up 31%. **A diversified portfolio would have easily out-performed the S & P 500.**

In summary, our economy should do well this year, with storm clouds possibly on the horizon next year. The market will do what the market will do. The coming months might not be a good time to make narrowly focused bets on the market.

The numbers in the chart below represent one-year returns:

Asset Class	1 Yr Rtn (01/31/06)
S & P 500	+10.38%
NASDAQ	+11.80%
Lg Cap Gwth	+ 8.73%
Lg Cap Val	+13.44%
Mid Cap Gwth	+18.43%
Mid Cap Val	+20.33%
Sml Cap Gwth	+20.27%
Sml Cap Val	+22.76%
Foreign	+22.76%
Interm Corp Bds	+ 1.80%
Foreign Bds	+ 2.12%

Savings Updates

As I have said in the past, **you should be saving at least 10% of your income, preferably 15%**. The new year brings some increases in the amounts you can stash in your retirement plans so you can save tax deferred (or tax free in a Roth IRA/401(k)).

IRA contribution limit is **$4,000 regular, $5,000 for those over 50**. Your 401(k)/403(b)/457/Roth 401(k) limit is **$15,000 this year, $20,000** for those over 50. **SIMPLE IRA is $10,000, $12,500** for those over 50.

You can **gift up to $12,000** this year ($24,000 for married couples) without filing a gift tax return. And you can **leave up to $2 million** ($4 million for married couples with the appropriate estate planning) **without paying estate taxes**.

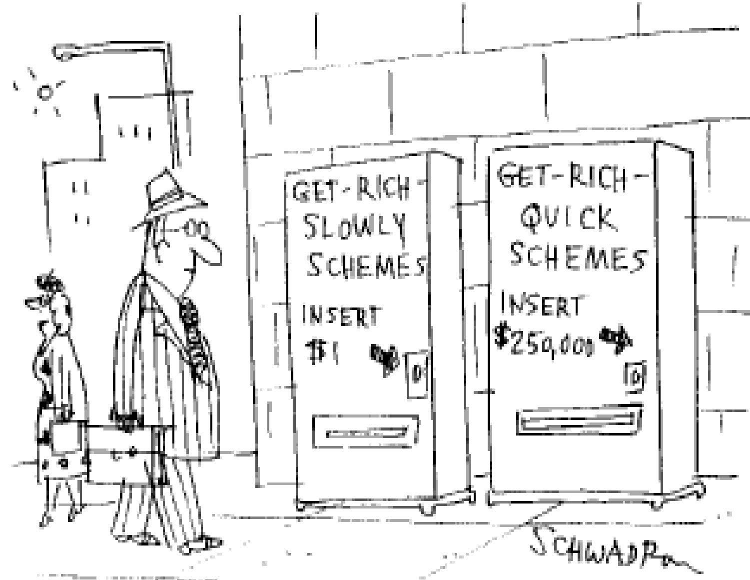
You can also get a tax credit of up to $3,400 for purchasing an energy-saving car. (Note: When I purchased a new car recently, I reviewed the new credit and the savings from increased gas mileage. I found that it would take 12 years, including the credit, to pay back the higher cost of the energy-saving car. That is the dollars-and-cents of it. It doesn't take into account the psychic rewards of "being green" nor the value of being allowed to use the HOV lanes in some towns. Please note that the EPA is significantly revising down the mileage ratings of energy-savings cars.)

There is also a credit of 10% of material costs (up to a maximum of $500) for energy-saving home improvements.

When Annuities Make Sense

Having just seen another example of a senior being sold an inappropriate annuity (annuity bought to make sure her IRA never ran out of money, but there was a significant surrender charge (8%) to be paid to withdraw her IRS mandated minimum distribution from the annuity!), I thought now would be a good time to discuss when an annuity IS appropriate.

An annuity makes sense when you have no interest in leaving money to your heirs, or you have other money available to do so. It makes sense if all your investments are in CDs because you don't trust the stock/bond markets and/or don't have an advisor you trust.



An annuity makes sense when you choose one that has inflation protection built in and is sold by a low cost provider such as Vanguard. It makes sense if the annuity (with inflation protection) covers your fixed (except for inflation) retirement expenses and you have other money to cover your fun things like vacations.

Roth 401(k) Yes or No?

Many businesses are offering Roth 401(k) options in addition to Traditional 401(k) plans. **Should your business offer it?** I say **yes** for several reasons. It doesn't cost much to add the option and it can be very beneficial for many of your employees.

As an employee, should you put part of your retirement money into the Roth 401(k)? For many of you, the answer is yes. If you are starting out in life and your income (and tax rate) is low, use the Roth 410(k) to sock away retirement money. That money grows tax free and you can withdraw it in retirement tax free (when you are likely to be in a higher tax bracket).

High income employees have to ask themselves if they expect to be in a higher tax bracket in retirement. If you are already in the top tax bracket, consider whether you think upper income taxpayers will be paying the same or more in the future?

If you think tax rates will be higher in the future, paying taxes currently for a tax free income in the future could be advantageous. However, if you plan to give away your assets and live simply, you might be in a lower tax bracket in retirement and the Traditional 401(k) would be the better deal.

Some people like the idea of having some money in both a Traditional and Roth

401(k) as a hedge against tax policy. If taxes go up, withdrawals from the Roth 401(k) would be best, if they go down, the Traditional 401(k) would be best.

The biggest drawback to the Roth 401(k) is the lower take-home pay due to higher tax withholding on your higher income (Roth does not get you the up-front tax deduction that the Traditional does). It can be difficult to see the advantage over the long term when you are having difficulty paying bills now. Whether you choose the Roth 401(k) or not, **any company match must go to the Traditional 401(k).**

Deficit Reduction Act

The recently passed Deficit Reduction Act of 2005 (signed 2/8/06) has a number of provisions affecting you. The **FDIC insurance** on savings deposits (previously fixed at $100,000) **will now be indexed for inflation**. In addition, certain retirement plan deposits will now be covered to $250,000.

The Act also makes a significant change to financial aid treatment of pre-paid tuition plans. Previously, **pre-paid tuition plans were treated as the student's resource and 35% was expected to be used each year when calculating financial aid eligibility**. **Now, pre-paid tuition is counted as a parent's asset and only 5.64% would be counted** for financial aid. While pre-paid tuition plans have other provisions that reduce their desirability, this change dramatically improves pre-paid tuition's usefulness.

The Act makes a number of changes to Medicare and Medicaid. Of particular interest are those provisions controlling eligibility for Medicaid in Long Term Care situations. Previously, someone with limited assets could become eligible for Medicaid coverage of nursing home care by gifting some assets and waiting out a period of ineligibility based upon the size of the gift, cost of nursing home care in your state with a maximum wait period of three years. Now, the maximum waiting period is five years and the ineligibility period starts when the need for Medicaid arises, not when the gift is made.

You will also not be eligible if you have more than $500,000 equity in your home (previously homes were not counted as an asset). In the past, you could convert a lump sum of money into an income stream by purchasing an irrevocable annuity. Now, Medicaid requires that Medicaid be named the remainder beneficiary of the annuity (after the spouse if it is a joint annuity).

In case you haven't figured it out yet, **the government wants you to pay for nursing home care, either from savings or by purchasing Long Term Care insurance**!

"The zenith of insanity is that you continue to do the same thing for the next five years that you have done for the last five years, yet you expect different results." Zig Zigler

"Most people will literally spend more time and money planning a vacation trip than planning their future." Guy Cumbie, financial planner

"Emotion is the enemy of sound investment." economist Donald Ratajczak

"I'd like to be rich enough so I could throw soap away after the letters wear off." Andy Rooney

"A billion dollars isn't what it used to be." Nelson Bunker Hunt

"Retirement at 65 is ridiculous. When I was 65, I still had pimples." George Burns

"In spite of the cost of living, it's still popular. Source Unknown

"It is not our job to out-perform markets. It is our job to out-perform client's emotions… to keep them in place so they can reach their lifetime goals. It is never, ever necessary to do the former in order to do the latter." Nick Murray advice to financial advisors

Edited and Published by:

Ronald S. Pearson, CFP®

Beach Financial Advisory Service

6204 Ocean Front Ave.

Virginia Beach, VA 23451

(757) 428-6634

E-mail: ron@beachfas.com

www.beachfas.com