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BFAS Money Line

Blue Skies or Rough Weather?

This should be an interesting year for the financial markets. The market believes interest rates will be coming down due to a slowing economy (and less inflation pressure). **Interest rates coming down would be good for bonds and, possibly good for stocks.**

On the other hand, the third year of presidential election cycles usually finds stocks doing well. Indeed, the economy seems to be doing so well thus far, that the Federal Reserve is talking about raising interest rates (which would be bad for U.S. bonds).

Some economists paint a rosy picture saying **corporate profits are the highest in history** (everyone's heard about Exxon Mobile's $39 billion profit) and **corporations have the highest amount of cash on hand in history**. Other economists point to the topsy-turvy yield curve (higher short term interest rates than long term interest rates) and say that **the inverted yield curve is a fairly reliable predictor of a recession sometime this year.**

Who is right? I have no clue. However, if there is a recession this year, or even a market downturn due to a slowing economy, those who have the most aggressive portfolios will feel the pain the most. **This might be a good time to reduce some risk (better diversification, more bonds).** If you reduce risk and the market sizzles, you will lose some upside. However, if you reduce risk and the market tanks (drops more than 20%), you might lose some money, but not as much and will recover faster as the market rises following the recession.

In the last year, value stocks continued to out-perform growth stocks and foreign stocks continued to excel. Commodities performed poorly as oil prices fell from a peak of $76 per barrel. Commodities can smooth out a portfolio's performance since they tend to move out-of-synch to stocks. Since stocks did well last year and commodities did not, that seems to still be the case. If stocks do poorly in the future, one reason could be oil prices which could bode well for commodities.

A final note on real estate (normally a safe haven during market downturns): ODU's Dr. Gilbert Yochum recently pointed out many areas of the country where housing prices were falling. **Dr. Yochum doesn't predict falling prices locally, just a multi-year leveling of prices**. Even with all the bad real estate news, commercial real estate defied predictions and continued to do well last year.

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

Asset Class	1 Yr Rtn (01/31/07)
S & P 500	+14.51%
NASDAQ	+ 6.86%
Lg Cap Gwth	+ 7.64%
Lg Cap Val	+20.20%
Mid Cap Gwth	+ 8.91%
Mid Cap Val	+14.87%
Sml Cap Gwth	+11.03%
Sml Cap Val	+14.61%
Foreign	+19.84%
Interm Corp Bds	+ 4.29%
Foreign Bds	+ 4.14%

Independ't Advice?

All consumer financial advice publications tout their editorial independence from advertising revenues they receive from mutual fund companies. However, a recent study of several national consumer publications brings this premise into question.

An article titled, "**Do Ads Influence Editors? Advertising and Bias in the Financial Media**" by Reuter and Zitzewitz in The Quarterly Journal of Economics (Feb 06) studied this issue. They found a **significant correlation between past ad revenues and mutual fund recommendations by Kiplinger's, Money and Smart Money**. They did not find similar correlations at the Wall Street Journal or the New York Times. Keep that in mind next time you take your mutual fund recommendations from the consumer press!

Retirem't Savings

In January, I spent five hours as a volunteer answering calls from Kiplinger's readers about retirement questions. Unlike most people saving for retirement, most callers were well on-track and just needed reassurance. Many of the calls concerned how best to allocate their investment assets, whether to move their investments from their 401(k) to an IRA and whether to use variable annuities.

One of the common questions is **when to start taking Social Security**. Let me give you an example: say you are eligible for $15,000 annually at age 62 or $20,000 annually at age 66. The first choice comes out ahead until you reach age 77 when the second choice catches up.

If you waited until age 70 to take benefits and received $26,400, you would come out ahead if you made it to age 80. Thus, **when to take Social Security benefits is easy if you know when you will die!** However, since none of the people I talk to are quite that precise, it's not so easy to choose when to start taking benefits.

If you are not in good health, obviously you should take your benefits early. Health can also be a driver in other ways. For example, if you have to leave work early due to health reasons, taking Social Security early makes sense.

However, if you think you might work, even part-time, in retirement, you might want to wait until at least age 65 so that your Social Security benefits will not be curtailed by your earned income.

How much Social Security income you have also impacts how much you need to save in your own investments to meet your overall income needs. Think of it this way: **every year you delay taking Social Security, your Social Security increases by about 7% and the remaining investments you will need drop by about 5%.**

You can figure out how much you need from your other investments by multiplying the annual amount you will need by 20. Thus, if you need $50,000 annually in addition to Social Security, you would need $1 million in investments.

That $50,000 is an inflation adjusted number. Some people think they can retire on the cheap by listening to a product salesperson (usually an insurance agent) who says you only need $715,000 to produce that $50,000 because their annuity pays 7%. While that is true initially, the annuity won't pay an inflation adjustment.

At 3% inflation, your living expenses will double from 65 to 89. Your income from the $1 million investment will double as well by age 89, but the annuity income will still be paying the same amount it did at age 65. **In most cases, those on fixed incomes are struggling to make ends meet by their late 70's, just when medical problems can be increasing their expenses.** Most people would be far better off delaying retirement to achieve that 20-times annual income rather than trying to "stretch"

their nest egg farther than it is capable of supporting them by buying an over-hyped annuity.

College Savings

It's been about five years that 529 college savings plans have been available. The regulators are finally catching up with the commission brokers who steered their clients into their company's 529 plan in some other state (than Virginia).

Virginia has some of the lowest costs 529 plans in the country. The Virginia plans also perform well; plus Virginia offers a $2,000 tax deduction for contributions.

How, then, could a broker justify placing your money into another state's plan? They can't. That's why Met Life and Ameriprise, among others, have paid millions in fines/restitution for not working in the client's best interests.

Ethics

I recently attended a presentation on Ethics at the Economics Club. The presenter, Cynthia Cooper, was an auditor in Worldcom, the once-large purveyor of telecom services that went bankrupt in 2002.

She was a relatively small cog in the only Fortune 500 company in Mississippi. Headquartered in Clinton, a town of 25,000, she nevertheless knew the senior management. She went to church with them, her children went to school with their children. They were "family".

Thus, you can see why it would be difficult to refuse to "go along" for the benefit of the company. The pressure to be "loyal" to management, the company and her friends was immense. By notifying authorities of financial improprieties (of over $1 billion), she helped put her company in bankruptcy, some of her friends in jail and ruined the retirements of thousands (including two of my clients).

When you hear her story, it's not one of "bad" people. **The management of the company were likeable people who gave back to the community**. However, in the cut-throat world of corporate earnings (one slip and the stock price is slammed), **they "fudged the numbers" to make the company's earnings look better than they were. This started as a one-time thing to tide them over one rough quarter.** It would soon be corrected (they said) with future earnings and nobody would be the wiser. Unfortunately, the telecom industry was imploding at the same time, so the "recovery" never came and the "one-time" fix lasted twenty-two months until it was discovered and revealed by Ms. Cooper.

Needless to say, Ms. Cooper's revelations, while ethical, were not popular. Many of her neighbors lost their jobs and retirements, some (including CEO Bernie Ebbers) went to jail.

Being ethical (having integrity) is sometimes called, "doing the right thing when no one is looking". We all face ethical dilemmas every day. Ms. Cooper related a story of her 17-year old daughter getting a speeding ticket. The daughter was mortified, but told her mom that a friend's dad was a police officer who could "fix" the ticket.

Using a good teaching moment, she explained to her daughter why this was wrong. Subsequently, her daughter lost her license for six months, paid a fine and performed community service. How easy it would have been for Ms. Cooper to spare her daughter? But in doing so,

she would have demonstrated that subverting the justice system was acceptable.

For the last four years, I have provided the mandatory Ethics continuing education (two hours) for local Certified Financial Planner (CFP®) practitioners. I try to use real life examples of how seemingly routine situations can get us into ethical trouble. When CFPs, who have such a knowledge advantage over their clients, are dealing with the accumulated life savings of people, being ethically-challenged is not acceptable.

What is your company's policy on accepting gifts? If you are in a position to control decisions on contracts or vendors, you will be a target for every salesperson. They will offer meals, entertainment, tickets to events, trips, maybe even money. What are your ethical obligations? How much of a gift is acceptable? Lunch? a gift basket worth $50? Superbowl tickets?

We live in probably the most ethical country in the world. How many of you have traveled elsewhere only to find that bribery is endemic. The corruption in many countries is so ingrained that only major cultural change can remove it.

Is there corruption here? Certainly, but we have laws and a free press to bring even corporate CEO's and Congressmen to justice when they cross ethical lines.

Doing the ethical thing may put our own interests in jeopardy at times. You are probably doing your taxes about now. Any ethical problems there? **In your daily life, what ethical decisions are you making and what signals are you sending your children?**

IRA Benefits Left to SNT's

To maintain SSI/Medicaid benefits for a child with a disability, the child must not be a named beneficiary of the IRA. Instead, the child's Special Needs Trust (SNT) should be the beneficiary of the IRA. IRA assets left to the SNT are not counted against the asset limits for SSI and Medicaid.

However, there is another issue that needs to be addressed. IRAs provide the greatest benefit when they pay out their distributions over the life expectancy of the beneficiary. This creates a long period of tax-deferred compounding for the IRA assets.

Trusts, by themselves, have no life expectancy. The IRS looks at the beneficiary of the trust. If the primary beneficiary is the child with a disability with a contingent beneficiary of another sibling, then **the IRA can make distributions based upon the age of the oldest beneficiary.**

For example, if the child with a disability is the oldest beneficiary and is age 40, the initial distribution from the IRA would be determined by dividing the IRA balance on December 31st of the prior year by 43.6. Thus, the IRA would only have to distribute about 2% of the IRA to the child with a disability. The rest could stay in the IRA and compound for the future. The next year, the IRA would use 42.6 as the divisor, and so on.

A problem can arise if, say, the contingent beneficiary of the trust is a charity. A charity has no life expectancy. In most cases like this, the IRA would have to be paid out over five years. This, of course, defeats the advantages of a long term (40+ years?) of tax deferred compounding.

There is nothing wrong with naming a charity as ultimate beneficiary. You just need to understand the negative consequences of this decision. Any time there is a person as the contingent beneficiary, you can stretch out the IRA distributions and are not limited to the five year rule. The guiding factor is the age of the oldest beneficiary. Thus, **naming a contingent beneficiary who is younger, or near the same age, provides the greatest tax deferred compounding.**

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