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BFAS Money Line

INVESTMENTS

Muddle Through It Is!

"… And on Wall Street, the markets generated another exciting day's worth of meaningless white noise"

From the market peak in March of 2000 through the end of April 2002, the S & P 500 is down 19% and the NASDAQ is down 64%. But, October – December of 2001 saw the S & P 500 up 11% and the NASDAQ up 30%. Talk of a sharp recovery was rampant. However, through the end of April 2002, the S & P 500 has slumped 6% and the NASDAQ 13% this year.

So, if you have seen your **portfolio drop by 20% - 65% in the last two years**, you were probably mostly in stocks (or stock funds). The higher your technology exposure, the higher your losses. But, good old **bonds returned 21% over the same time period**. Thus, a portfolio 50% in stocks and bonds should have pretty much broken even during the worst market in 30 years.

Will a higher exposure to bonds slow your gains when/if stocks start taking off again? Sure. But, at least you would have slept better and your portfolio will be starting from a breakeven position, not way in the hole!

Such a high bond exposure may not be appropriate for everyone, but some bond exposure certainly is. If you're worried about the taxes on interest, you can always purchase municipal bonds. If you have a tax deferred account (401k, 403b, IRA, etc.), you can hold bonds there with no tax consequences.

This **tradeoff between downside risk and return** is the **essential element in developing a tailored portfolio** for each person's needs. Adding some **bonds** to a portfolio **reduces risk more than it reduces return**. For example, **a portfolio of 50% stocks and bonds reduces risk by 48%** (15.92 to 8.30) **over 10 years with only a 17% reduction in return** (12.22 to 10.12).

Those who are stretching for the last iota of return are taking much more risk than they probably realize. Everything may be rosy as long as the market goes up, but panic sets in when the market turns. I see many people who "say" they can tolerate a 5% dip in their portfolio, yet become very uncomfortable when it really happens. They wanted the upside potential, but really didn't think there would be a downside. Maybe, with the recent market activity, most people better understand market risk.

I recently returned from the National Association of Personal Financial Advisors' national conference at the Opryland Hotel in Nashville. One economist came across as a raving bull, the next as a bear. I didn't hear anything that swayed me from my feeling that **we are in a Muddle Through economy**. Most think we will do well if **stocks rise 5% - 7% this year.** After being up and down all year, we might see that 5% rise come in the last week of December.

With Price to Earnings ratios so high, I believe we **may see Muddle Through for some time (3, 5, 10 years?).** Long term (20+ years), I am still bullish; but we must reduce our expectations in the short term.

As you see in the chart, the Small Cap Value category has excelled recently. There was much discussion at the conference as to whether we could expect to see this continue. I spoke to the rep from Wasatch Funds. They have six funds and all but one is totally closed because they are not able to fully invest all the money people want to give them to manage. While there are a large number of small companies, the dollar value of all their shares is not all that high. I have been happy with Small Cap Value returns, but don't expect to see a continuation of their exceptional performance.

Asset Class	1 Yr Return (04/30/02)
S & P 500	-12.62%
NASDAQ	-20.23%
Lg Cap Gwth	-19.61%
Lg Cap Val	- 6.56%
Mid Cap Gwth	-15.32%
Mid Cap Val	+ 6.46%
Sml Cap Gwth	- 5.11%
Sml Cap Val	+20.89%
Foreign	-12.71%
Interm Corp Bds	+ 5.66%
Foreign Bds	+4.62%

Stocks vs. Mutual Fds

In the March 2002 issue of Financial Planning, Dr. Craig Israelsen wrote about the performance differences between mutual funds and individual stocks.

As you would expect, **individual stocks have a much higher range of returns over the five and ten year periods ending December 31, 2001**.

	5 Yr	10 Yr
Stock Max Rtn	+126.8%	+72.7%
Stock Min Rtn	-87.5%	-59.5%
Mutual Fd. Max	+35.0%	+28.1%
Mutual Fd. Min	-26.2%	+1.0%

Please note that the **worst performing mutual fund was in the black over the last ten years.** Can't say the same for individual stocks.

Over the **last five years, mutual funds averaged a 9.5% return while individual stocks averaged –1.9%.** Over ten years the difference narrows, but is still significant, stocks 9.2% and mutual funds 11.7%.

Significantly, **26% of individual stocks had negative returns over the last ten years, but no mutual funds had negative returns!**

I know, …no one sidles up to you at a cocktail party and says, "How about that Clipper Fund?" Stocks are sexier, no question. The most successful individual stocks will always out-perform mutual funds. But individual stocks also hit lower lows more often as well.

Today they announced that Merrill Lynch is paying New York a $100 million fine for touting stocks to the public that they were trashing internally. With all the built-in conflicts of interest, it is hard to trust any stock analyst anymore.

Think about it!

ESTATE PLANNING

Ethical Will

Nationally only 30% of the general population has a will. Hopefully, every one of you has a will!

A will is a document that passes on our "things". An **Ethical Will is a document that passes on our values and personal history.**

Think about a deceased relative you may have heard stories or legends about when you were growing up. If you could go back in time, what would you ask him/her? What would you want to know about his/her life?

Ethical wills date back to biblical times and were common in the twelfth century. You can use an outline or just journal your thoughts for a period of time. There is a good article on the subject at www.ces.ncsu.edu/depts/fcs/pub/1998/wills.htm. It provides references to several books that can help get you started. For a more recent book, try Ethical Wills – Putting Your Values on Paper by Barry K. Baines M.D. ($13 in soft cover from Perseus Publishing).

RETIREMENT

New Limits

The new tax law has some little-known goodies for retirement planning. For example, under the old rules, a person making $20,000 for a company with a **401(k) or 403(b) plan** could only put a maximum of 15%-25% of pay ($3,000-$4,000) into the plan.

Under the new rules, you can put 100% of pay up to the maximum of $11,000 (plus $1,000 if you are over age 50) into the plan. Thus, if one of you is working and you don't need the income, you can dramatically increase your retirement contributions!

Another major change is the increased limit for **SEP IRAs.** These very simple and inexpensive retirement plans allow you to **contribute up to 25% of your pay** (up from 15%). For most self-employed, this will be the plan of choice.

If you are concerned about **minimizing contributions to employees try the SIMPLE IRA.** For a **maximum contribution of 2% to employees, you can contribute $7,000 plus 3% of your pay** to your plan.

Remember also that the **Roth IRA** limit went up to **$3,000 this year** (plus $500 for those over 50). Thus, if your income is under $150k, you can put away $6,000 per couple this year.

The talk of the conference this year was about a **one-person 401(k).** This plan allows a self-employed person to **contribute $11,000 plus 25% of income** (maximum total contribution $40,000 plus $1,000 if over 50).

These plans should be less expensive than plans covering a number of employees and provide the largest contribution limits outside of defined benefit plans.

The top plan from a contribution standpoint is the defined benefit plan. These plans use actuarial assumptions to determine the amount to be contributed each year needed to pay a certain level of pay in retirement. These plans work best for small business owners over 55 who have a stable excess cash flow to contribute and also have a much younger staff.

COLLEGE

Virginia 529 Plan

If you have read many of my newsletters, you know I am a fan of 529 savings plans. Prepaid tuition plans are better than nothing, but annual tuition increases were zero for 4 years before this year's 9% increase.

Due to the Virginia State Income Tax deduction of up to $2,000 per year per plan, investing in Virginia's 529 usually makes the most sense. Virginia has a 529 they manage, as well as a 529 plan offered in partnership with American Funds, called **College America**.

Rolled out in February, College America is, in my opinion, the best option for parents. However, the only options available today require use of commissioned funds. I have personally spoken to the "horses mouth" at American Funds regarding access to the no load funds (F Shares). They assure me that they will be available before the end of the year. My **recommendation is to keep your powder dry and wait for the F Share rollout**. It will give the greatest flexibility with the lowest cost.

DISABILITY

SNT Info

Special Needs Trusts (SNTs) are frequently critical to the future well-being of children with disabilities. Rather than using scarce family assets to replace government benefits, you can place your assets into an SNT.

The **SNT can be used to raise the child's quality of life by providing those things that government benefits don't**. What things? How about: Supplemental attendant care, transportation, schooling, job training, job coaching, social interactions, recreation, respite care for caregivers, basic home furnishings, cable TV, televisions, computers, Internet access, jewelry, and cutting edge therapies or medical advances not covered by Medicaid.

The SNT should be drafted so that the disabled child has no direct access to the money. The trust should also specifically say that trust money is not to be spent on food, clothing or shelter (the purview of government benefits). It should also say that the trustee has full discretionary authority over all trust distributions. Additionally, the trust should specifically say that it is intended to supplement government benefits rather than supplant them.

Money from an SNT should not be given directly to the beneficiary. Rather, the money should go directly to the provider of goods and/or services.

Many people would prefer to have a family member serve as **trustee of the SNT**. This is the most convenient option since the family member is most likely to know the child's needs.

However, an SNT trustee has three distinct duties: **1. to be custodian of the assets and perform various accounting functions, 2. to invest the assets prudently, and 3. to distribute the assets on behalf of the beneficiary without compromising benefit eligibility.**

Not many families have members qualified to do all three. Even institutional trustees frequently don't have the expertise to distribute assets properly to preserve public benefits. An **inappropriate trust distribution may cause the loss of critical public benefits, violating the basic purpose of the trust**.

In addition to making distributions in accordance with public benefits rules, the trustee must understand the unique needs of the disabled child. This, and other complex issues make the choice of trustee important and difficult. Typical choices:

1. Traditional bank trustee,

2. Corporate or professional trustee or trust company,

3. Professional individual fiduciary,

4. Nonprofessional or nonprofit individual trustee.

Questions to help in the trustee choice process:

1. Experience with SNTs,

2. Investment experience and performance,

3. Fees,

4. Types of investments used,

5. Understanding of tax issues involved,

6. Availability of bonding and professional liability coverage,

7. Experience with disabilities and Social Security/Medicaid rules,

8. Continuity of trustee,

9. Ability to operate in your state.

Thus, there are a number of issues in choosing a trustee. Yes, a knowledgeable family member can do it. Yes, there are nonprofit options. And, yes, there knowledgeable professional options, just not that many. **Consider these needs carefully when choosing your trustee!**

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