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BFAS Money Line

Bull or Bear?

The **market has continued to surge (up 7% year to date)** in the face of high unemployment, declining housing prices, huge deficits, sky-high oil prices and the end of Federal Reserve showering the economy with money. Company earnings have helped as they remain high coming off the lows of 2008. But, **the 6% pullback in mid-March was a signal that the Bull is easily routed.**

It's been 26 months since the market low. The market has risen 100% but still remains more than 10% below its peak in 2007. Stocks appear fully valued.

Economic growth is slowing as government stimulus spending ends. The private economy is growing, but slowly. **Major cuts in government budgets will be necessary to reduce deficits**, but this will also reduce economic growth in the short term.

The dollar continues to decline. Since oil is traded in dollars, oil prices move in the opposite direction (dollar down, oil up). The Federal Reserve is driving the dollar lower. This helps make our exports cheaper and imports more expensive. It helps create jobs here and helps reduce our trade deficit.

The lower dollar also means that your trip overseas will be more expensive than the last one you took! Also, foreign stocks and bonds (un-hedged) should perform well. If you look at the chart on the next page, you will see that foreign stocks have only matched the S & P 500, but world bonds have out-performed.

As usual, there are a **number of things that can upset the apple-cart: more Middle-East unrest, natural disasters, credit crisis in Europe, debt crisis here**.

I can imagine that many of you see our country's debt as not something that affects you directly. It just seems to be the latest foil for political squabbling and filling the cable news channels.

When we spend more than we take in, we issue bonds which people/banks/pension funds/countries purchase. We use their money to make up the difference between what we take in and what we spend. Since we have historically been a great credit risk, people will buy our bonds at low interest rates.

However, just like in our own lives, as our debt gets larger in relation to our economy (historically 38%, currently 60% and expected to breach 100% by 2021), those loaning us money will want higher interest rates to compensate for the risk. Virtually no country has exceeded 100% debt without defaulting on that debt. For a country, this demand for higher compensation can come about quite quickly. One day we're paying 2% to bond-holders, the next

(2012/2013?) they'll demand 4% or much more to continue loaning us money.

Interest on our debt currently costs $413 billion; interest is projected to be $1.1 trillion in ten years. And that is assuming the bond-holders DON'T demand much higher interest rates. Most observers believe the bond-holders will accept current rates if they see substantial progress towards solving the deficit problem.

Thus, there are two major issues (interest taking up an ever larger portion of the federal budget and the possibility of much higher interest rates driving the cost of borrowing so high that the country defaults on its debt). This is why something must be done and done soon. The political classes will determine what proportion of spending cuts and tax increases are used to reduce the deficit.

There will have to be cuts in entitlement programs. We have over-promised and under-funded our programs. Yes, we do pay something for our entitlements, like Medicare. However, for every $100 people pay into Medicare they receive $300 in benefits and our tax dollars must make up the difference. Already, there is means testing for Medicare since higher income people pay two or three times the normal Medicare Part B (doctors) premium. Yet, there is no incentive to be concerned about the cost of care in this government-run program.

Don't kid yourself that higher taxes will solve the problems. Even confiscating all income over $250k will not close the budget deficit. In addition, the bean-counters never seem to take into account human behavior when they throw numbers around. For example, if you take all income over $250k, what happens to all the high value housing that owners can no longer afford? Construction? Furnishings? Why would the highly productive people who make these incomes continue working if all their work is going into government coffers? What happens to the economy when substantial numbers of them quit working?

Similarly, our corporate tax rate is the second highest in the world at 35%. Ireland, attracted many large companies when it reduced corporate taxes to 15%. Many of our corporations make substantial income overseas. They pay taxes on it overseas. If they bring that money back to the U.S., they must pay much higher U.S. corporate rates (with a credit for the foreign taxes paid).

What corporate board would agree to bring their earnings back to the U.S. under these conditions? Thus, the money stays overseas and helps foreign economies instead of ours. This is an example of corporations behaving rationally given the situation they face. Perversely, corporate tax income to the government would probably increase if the tax rate was decreased!

At a conference I just attended, commentators seemed to think the politicians would allow the debt crisis to get as close to the cliff as they could to extract the maximum concessions. I'm hoping the bond holders don't get jumpy and demand higher rates which would make a bad situation worse. Congress is always good at spending money (gets them votes); Congress is very poor at cutting spending (voters don't like it).

As you see below, the last year was good for equities, especially small and midsized ones. Commodities lead the way and foreign stocks and bonds are on the rise.

Asset Class	1 Yr Rtn (04/30/11)
S & P 500	+ 17.22%
NASDAQ	+ 16.75%
Lg Cap Gwth	+ 18.87%
Lg Cap Val	+ 15.67%
Mid Cap Gwth	+ 25.64%
Mid Cap Val	+ 18.93%
Sml Cap Gwth	+ 28.56%
Sml Cap Val	+ 17.77%
Foreign	+ 20.46%
Interm Corp Bds	+ 6.10%
Foreign Bds	+ 9.85%
Commodities	+ 30.41%

Odds and Ends

Education – **Recent reports put the cost of public college education at $20,000 per year with private colleges more than double that**. These costs are rising much faster than the rise in inflation. With total costs of about $100k - $200k, is college still worth it? Can anyone save enough to pay for it? Should they?

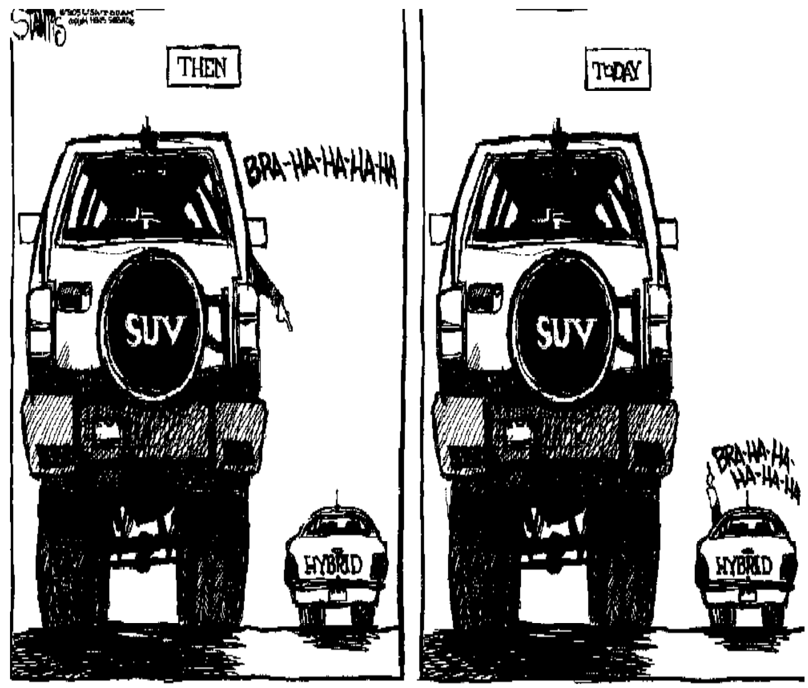
The answer we financial advisors love to give is, it depends. What are your expectations for your children? We all want them to do well. But some want to provide a full parental scholarship for college; while others feel that their children won't value their education unless they are paying a substantial part of college (i.e. they have "skin" in the game).

For those who can afford to put 10% - 15% towards their own retirement and still save enough to cover their children's education, by all means do so. **I typically recommend using a 529 plan to save for the children's education since it grows and comes out tax free and still gives parents control of the money.**

For the many who cannot afford to put 10% - 15% into their own retirement in addition to saving for college, save for retirement first. Your children can borrow for college, you can't borrow for retirement. You should consider reducing the cost of college by pointing your children to two years at a community college.

If they live at home while going to community college, they can cut their college costs almost in half. Your children will find it much easier to transfer to a fine college as a junior than it would have been to get in as a freshman. They will be more mature and serious about their education. Employers look at the degree and where it's from, not how long you attended.

Another option is to maximize advanced placement courses in high school so that your child can obtain their degree in three years instead of the usual four or five. You can tell your child, you will match whatever they earn and save for college.



Between their earnings, your savings and college loans most children can afford a college education especially if they graduate in three years or take the community college route.

Should they go to the effort? What about dropping out and starting a business like Mark Zuckerberg (Facebook)? This is about as rare as a high school athlete going to the NBA or major league baseball. I wouldn't depend upon it.

There are fewer and fewer unskilled jobs in the U.S. Having an employable skill is critical today. During this recession, in 2009, the unemployment rate for high school graduates was 9.7%, for college graduates 5.2%, for those with professional degrees or doctorates it was 2.4%. High school graduates earned $626 weekly while college graduates earned $1,025 and those with professional or doctorates earned $1,530.

So, yes, it does pay to get that education. But that doesn't mean you have to pay top dollar for it!

Estate Planning – One of the problems parents confront when they set up trusts for their children is "how to encourage positive behaviors and discourage negative ones". One tool I have seen discussed recently is to not limit the amount and purpose of distributions or tie distributions to specific behaviors.

Instead, it **directs the trustee to assess whether the beneficiary is learning skills for money management in life**. There may be benchmarks such as:

- **Ability to not spend more than one's income**
- **Ability to save enough to create a reserve, resist**

spending the reserve and retain it for special expenses

- **Ability to manage credit and debt, avoiding excessive debt**
- **Ability to keep track of finances and assets, keep a budget and follow it**
- **Ability to generate income through employment, to get and keep a job, which involves showing up on time, getting along with co-workers, etc.**

Note that there are no value judgments about how the beneficiary spends money. The beneficiary can choose to develop these skills or not, but discretionary distributions wouldn't be granted until the beneficiary demonstrates effective financial skills. Just some food for thought before you approach your attorney about drafting a trust!

How Things Work

I find that **misconceptions abound as to how things work when you have a child with a disability.** Obtaining Medicaid and Supplemental Security Income (SSI) benefits is a major effort (paperwork and time wise). Once your child is receiving these benefits, the last thing you wish to do is something that might put them in jeopardy.

Any time you change your child's financial circumstances, you must report this to Social Security. Giving your child $20 in cash in a month is not reportable and has no impact on SSI. Giving $30 in cash is reportable and will cause Social Security to reduce their SSI payment by $10 for a month.

What about if the cash is given by a Special Needs Trust, not the family? The same issues apply with the additional problem that if the Special Needs Trust (SNT) is providing basic support, Social Security might consider it a support trust, not a supplemental trust. Thus, the SNT would be required to fund basic support; SSI/Medicaid would be cut until the trust was exhausted. This would really prevent the SNT from providing the enhanced quality of life you had planned.

So, if your SNT can't provide cash, how does it help your child? A family member or caregiver can use an SNT check to pay for items at various stores (just not food).

Other people like to help their child by providing groceries. This type of "in kind" support is also reportable and will reduce SSI dollar-for-dollar after the first $20.

Clothing, on the other hand, is just fine. Changes in Social Security (SS) regulations several years ago now allow families to purchase clothing for their child with disability.

Everything may be just fine, your child is receiving SSI; and then you retire (take SS retirement). What happens then? **When you retire, your child starts receiving a check equal to 50% of your retirement amount.** This also happens if you start receiving SS disability. Your child's check **rises to 75% when you die**.

How does this SS check impact your child's SSI check? It reduces it dollar-for-dollar (after the first $20) just as if your child received cash. Thus, your child might receive both checks, but the total amount will be about the same as SSI.

What if your child's SS check is larger than their SSI check? They receive the SS, and lose SSI. Will they then lose their Medicaid coverage? No! There is an exception in the regulations that says, if the only reason SSI was lost was due to SS received as a result of a parent retiring, becoming disabled or dying, Medicaid remains in force.

Some parents mistakenly prevent their children from working because it might affect their SSI/Medicaid. Work income is treated differently than unearned income. The first $65 of work income is not counted. After that SSI is reduced by $1 for every $2 of earned income. **Since work is so valuable for socialization as well as feelings of self-worth, I strongly recommend it!**

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