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BFAS Money Line

Bulls Run?

U.S. and foreign stocks were up double digits during the first quarter. Does this indicate a new bull market? Not if the trend of the last three years holds. In 2010, the market was up 5% the first quarter only to lose 1% the next two. In 2011, the market was up 6% the first quarter, and then dropped 14% the next two. This year, the market was up 13% the first quarter.

Our economy continues its slow recovery from the last recession. GDP growth is still below par, unemployment is still high and housing is still in recession. Yet, **the market has risen based upon excellent earnings by U.S. companies**. People look at the trillion in cash in American businesses and swoon about the potential growth.

Europe has not gone away, even though their stock markets have risen as well. Much of Europe is in recession and Spain and Greece are in a depression (25% unemployment). Problems in Europe could worsen and cause the collapse of the European Union**. A financial crisis in Europe would likely blowback on us** (even though the Treasury Secretary says it won't).

The **secular bear market continues**. This is a market that can have sharp ups and downs but essentially goes nowhere for extended periods of time. The conditions for an extended Bull Market (unemployment below 6%, housing prices rising, personal and governmental debt under control) are not yet in place. **Caution is still the watchword in portfolios**.

Regarding bonds, the Federal Reserve still says they won't raise interest rates until at least 2014. Bond values have been stable, but returns varied from minus .3% for Treasuries to 2% for U.S. corporate and world bonds to 5% for high yield bonds.

I have spoken frequently about **how the uncertainty of our tax policy and other business policies hurt our economy and the markets**. Recently, researchers ("Measuring Economic Policy Uncertainty", (2012), Scott R. Baker, Nicholas Bloom and Steve Davis, Stanford mimeo) have quantified just how much impact policy uncertainty has (www.policyuncertainty.com).

They found that **policy uncertainty can reduce private investment by up to 20%, GDP by up to 4% and unemployment by over 30%** (or over 3 million jobs). This is what the gridlock in Congress is doing to our economy! We instinctively knew it was doing something, now we have some analysis to show the impact.

As you see below, the recent rise in the dollar has hurt foreign stocks and commodities:

Asset Class	1 Yr Rtn (04/30/12)
S & P 500	+ 4.76%
NASDAQ	+ 6.01%
Lg Cap Gwth	+ 3.13%
Lg Cap Val	+ 0.16%
Mid Cap Gwth	- 1.67%
Mid Cap Val	- 2.43%
Sml Cap Gwth	- 4.17%
Sml Cap Val	- 3.31%
Foreign	- 12.83%
Interm Corp Bds	+ 5.33%
Foreign Bds	+ 2.20%
Commodities	- 19.42%

Odds and Ends

Viagra College Fund – In these days of non traditional families, many of you may have an unclaimed income stream available. If you are receiving Social Security retirement benefits AND have a child under the age of 18, you could be eligible for Social Security payments of ½ your retirement benefit for that child.

There is a maximum family benefit of about 150 – 180 percent of your benefit. If the benefit for your spouse and children exceeds this amount, their benefit would be reduced, but your benefit will not be affected.

Thus, if you had children late in life or married a younger spouse with children, you could be receiving another $1,000 or so a month. You could put this money into a college fund and easily pay for college!

Note: As a grandparent raising a 7 year old granddaughter (one of 12 million in the U.S.), I wondered if I was eligible. Social Security says if you adopt the grandchild, the grandchild would be eligible. Also, if both parents are deceased, the grandchild is eligible. However, custody alone does not qualify. Oh well!

Health Care – While waiting for the Supreme Court to rule on Obamac are, consider this. The **average health insurance premium is $1256/mo. The average employee pays $344/mo or about 27% of the cost** (employer pays 73%).

When an employee is laid off, the employee is eligible for COBRA health care coverage. That means health care insurance can be extended for 18 months after you leave work. The maximum you pay for this coverage is 102% of the coverage's cost. While this is reasonable, many laid off employees are shocked when they realize they must pay $1281 (102% of $1256) when they previously only paid $344 for health insurance. If you are in this situation and wondering if you are being ripped off, no you are not!

Reverse Mortgages – **I have looked at reverse mortgages over the years and found them expensive (typically twice the cost of regular mortgages).** I have kept them in the tool box as a last choice option to fund a person's retirement.

A recent article by a highly respected Fee Only financial planner showed how **a new version of Reverse Mortgages (HECM Saver) could be used to reduce the risk of running out of money in a person's retirement portfolio.**

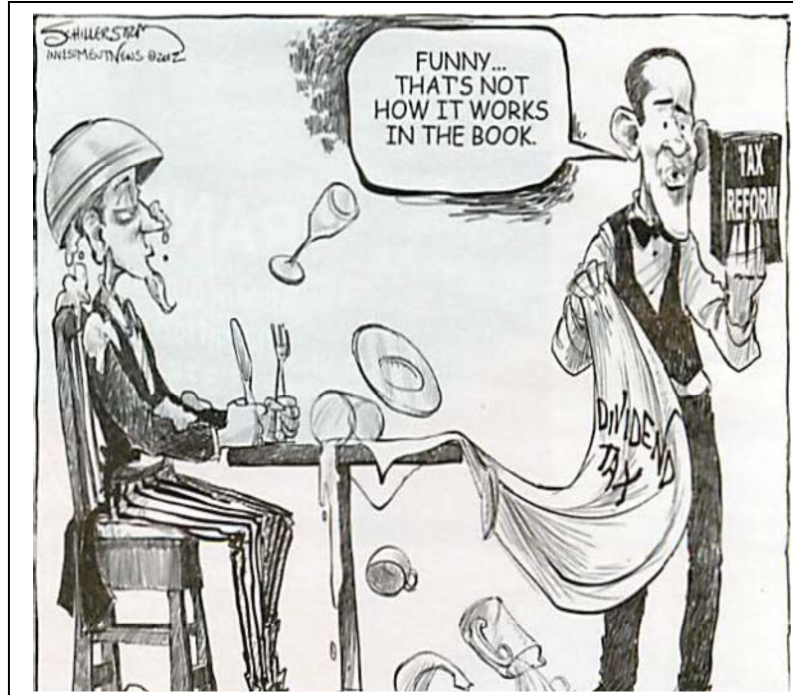
The HECM Saver reverse mortgage is far less expensive than traditional reverse mortgages. It is insured by the FHA. When you obtain one, it becomes a line of credit just like a home equity line of credit except you do not have to pay it back.

The HECM Saver helps extend a person's retirement money by providing a source of cash in the event of a down market. Rather than selling low to generate cash in a down market, the person would use the HECM Saver money while the market is down. **When the market recovered, the person would sell (high) sufficient assets to pay off the HECM Saver in addition to normal cash needs**. The analysis of this technique showed **it improved the length of time that an investment portfolio lasted in retirement by 20% to 60%.**

Most fiduciary financial advisors still feel that regular reverse mortgages should only be used in dire circumstances due to their cost. However, the HECM Saver seems like an excellent choice as a cash reserve for many people.

Economic Misconceptions – A recent Motley Fool column (2/13/12) brought to light a few widely held **misconceptions**.

1. **Most of what Americans spend their money on is made in China** – actually just 2.7% of personal consumption goes to Chinese-made goods and services. Yes, much of Wal-Mart's merchandise is made in China, but Wal-Mart's sales are small compared to our $14.5 trillion economy. Part of this misconception is that American manufacturing is in steep decline when manufacturing is near an all-time high. Yes, far fewer workers are needed, but manufacturing is high. As an example, U.S. Steel in 1950 produced 6 million tons of steel with 30,000 workers, but produces 7.5 million tons with 5,000 workers today.
2. **We owe most of our debt to China**. China actually owns 7.6% ($1.13 trillion) of our $14.9 trillion debt. Japan owns $1 trillion and the U.K. owns $429 billion, thus together they own more than China. Yet, no one complains that Japan and the U.K. own so much of our debt!
3. **We get most of our oil from the Middle East**. Actually, the amount is 9.8% and declining (was 14.1% in 2001). We import more than twice as much from Canada and Mexico than from the Middle East.



Guarantees – With market returns moving rapidly up and down, many of you are attracted to products which guarantee a rate of return to avoid running out of money. Typically these are Variable Annuity products with riders that allow stepping up your portfolio values as the portfolio rises in value but does not fall when the market does. Then, when you decide to start taking withdrawals, it **guarantees a fixed percentage (typically 5%) for your life (less if you want to protect a spouse as well).**

The 5% number is pretty common in financial planning because many advisors say a 5% (inflation adjusted) withdrawal rate from your portfolio has a high probability of success (75% - 80%). A lower 4% withdrawal rate (inflation adjusted) has been shown to have a 100% success rate.

If you were going for the highest income, which would you rather have a 4% inflation adjusted rate or 5% simple (non inflation adjusted)? Over 20 years, the 4% figure provides 13% more income, better tax benefits (capital gains tax rates), and a potential inheritance for heirs.

4% is better than 5% in this case due to inflation protection. When we financial advisors discuss withdrawals, we say 5% meaning inflation adjusted. Insurance companies use their marketing skills to imply that they provide 5% too. True, but it's NOT inflation adjusted, and that makes a huge difference!

The key is that you need to have a diversified portfolio to achieve the 4% - 5% withdrawal rate. **If the ups/downs of the markets are too uncomfortable and you would keep your money in CDs or some similar lower risk (lower return) vehicle, then the VA with a guaranteed rider would be a better option for you.**

These VAs come with high costs (about 3.5%

including the riders) and that extra cost will drag down the returns in your actual portfolio. Commissions to those financial advisors/insurance people who sell them run about 8%. With this high upfront commission cost to the insurance companies, they typically lock you into their product for many years to "recover" the cost to sell you the product.

These products are only as good as the insurance companies that back them. There is no federal guarantee. You might consider the situation that**, if the markets are so bad that your personal portfolio would not last, could the insurance company also lose so much that they would go bankrupt and fail to support the guaranteed income?**

I recently reviewed a guarantee income rider that I can use without commission and with lower costs to clients. It is interesting, but I still believe it is **only appropriate for those rare situations where a client would only be comfortable in CDs or similar low earning portfolios**.

How Things Work

Some of you already have set up **Special Needs Trusts (SNTs**); most have given it some thought. Along with your concern that the trustees know how to use the trust money, **you should be concerned about how that money will be invested.**

Correct investments will allow the trust to grow while distributing up to about 5% annually to enhance the beneficiary's life. Sounds simple in theory, but it's not in practice. When you have an SNT, your trust shouldn't be invested for accumulation (like you would for your retirement).

An SNT should probably be invested conservatively since it will be expected to provide distributions for 50 – 60 years. It will need sufficient cash to meet emergency needs like a crown or bridge.

Another consideration is that the **trust will be taxed differently than your regular or retirement account**. Irrevocable Trusts (most SNTs) are treated as a separate entity for tax purposes (taxes filed on Form 1041). Income in a trust is taxed at the maximum rate of 35% when income exceeds just $11,650 this year (after the $300 exemption for trusts).

Distributions from the SNT, on the other hand, will be taxed to the person, not the trust. Note: I'm simplifying a very complex subject here.

Let's say you have set up an **SNT with $200,000** and it had a great year with **$20,000 of income paid to the trust** (yes, qualified dividends and capital gains are taxed at 15% but I am simplifying). If that money is kept in the trust, it will likely be subject to a tax rate of 35%. If, on the other hand, it is distributed to the beneficiary, the beneficiary would pay 10% tax on the first $8,700 (after an exemption on the first $3,800) and 15% tax on the amount over $8,700.

Thus **a beneficiary would pay about $1,995 in taxes on that $20,000 income while the trust would pay about $5,829 (or more than double).** There must be some techniques that minimize what the tax man takes while maximizing what the beneficiary receives, right? Typically, a trustee would **invest the trust** so that there was **sufficient income to meet the beneficiary's normal and emergency cash needs while allowing the trust to grow through price appreciation** (untaxed until sold).

The trustee could use tax free municipal bonds which would produce the cash needed, but not much price appreciation. The trustee could use dividend paying stocks/stock funds. Stock dividends are only taxed at 15%; but the dividends might not provide enough cash plus stock prices swing wildly.

After considering all of these issues, **a trustee should invest in a mix of stocks/stock funds (preferably tax efficient) and bonds/bond funds that will provide current income plus an opportunity for growth**. The trustee should do all of this while considering the tax consequences.

The expertise to do this is not normally found in a typical family member. Depending upon the size of the trust, you might want to consider a professional trustee, or at least use professional investment advice to help the trustee.

Edited and Published by:

Ronald S. Pearson, CFP®, AEP®

Beach Financial Advisory Service

6204 Ocean Front Ave.

Virginia Beach, VA 23451

(757) 428-6634

E-mail: ron@beachfas.com