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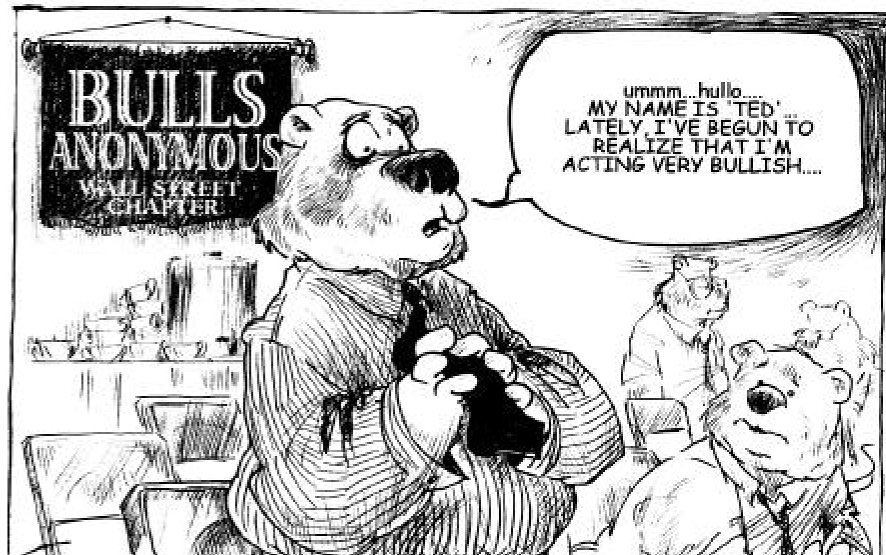
BFAS Money Line

INVESTMENTS

Bond Bubble?



After a sharp rise last quarter, stocks have stayed within a trading range recently. **Companies are reporting increasing earnings, yet the market shrugs it off; it's already priced in**.

Business seems to be making enough money to increase earnings, but not enough to start hiring. Until that happens, and people feel more secure in their jobs, consumer sentiment and spending will be muted.

I think the **economy will continue to improve**. However, **that won't necessarily translate to a soaring market**. More likely, the market will exhibit slow growth overall with significant dips and run-ups.

Now, about those bonds. Unlike stocks which are shares in a "hopefully" growing company, **bonds are loans with a fixed interest rate** coming to you monthly, semiannually or annually. The **interest rate is generally higher the longer term the loan since you are taking more risk that interest rates could change and make your bond investment worth less or the loan holder could default** on their payments.

Well-known companies that have defaulted include Singer, Enron, etc. Ford's bonds are currently barely investment grade.

Your interest payments from bonds are just part of your total return. Bonds have averaged about a 7% return over the long term with most of that being in interest payments. Bonds typically have a value of about $100 (or par**). If interest rates decline as they did last year** (the Federal Reserve dropped them to stimulate the economy), your **existing bonds become more valuable**. That's because new bonds have a lower interest rate, thus investors would prefer to have your old "higher" interest bonds and would pay more than to get them. Thus, when interest rates go down, usually when stocks are doing poorly, bond values go up.

Longer term bond values go up more than short term values because long term bonds are more risky (default risk, interest rate risk, inflation risk). **In 2002, short term (1 3 year) bonds earned about 6%, intermediate term (3 – 10 year) bonds earned 10% and long term (10 – 30 year) bonds earned 15%.**

The same thing works in reverse in a rising interest rate environment. **In both 1994 and 1999, interest rates increased**; 1994 was the worst year for bonds in the last fifty years! **In 1994, short bonds**

earned +0.5%, intermediate –1.8% and long bonds –7.0%. In 1999, short bonds earned +3.0%, intermediate bonds +0.4% and long bonds –7.6%.

Those "bad" years for bonds hardly compare with the last three years of stock returns that were –9%, -12% and –22%. Certainly, those who put **all their money in bonds** after seeing double-digit bond returns last year are likely to be disappointed this year or next year.

However, people who invest by looking in the rear-view mirror are doomed to be disappointed. A recent study by Dalbar, Bogle Financial Center, and Mercer Investment Consulting looked at investor returns from 1984 through 2000. **While the average pension plan earned 12.9% in U. S. equities and the average equity mutual fund earned 13.1%, the average equity fund investor earned 5.3%.**

I submit that the average fund investor is listening to what I call financial porn (CNBC, Money magazine, etc.), following the herd, and investing in the latest hot thing. That has been, and will continue to be, a recipe for poor performance.

Also, since investors feel the pain of losses 2.5 times worse than the thrill of gains, they have a tendency to bail in a down market (sell low) and get back in near the market peak (buy high). Think you can time the market? You only have to be right 60% - 75% of the time to beat buy & hold.

A very common problem for the average investor is the **tendency to focus on individual asset (mutual fund/stock) performance without tracking how the overall portfolio is getting them to their long term goals.** All assets have their day in the sun, and periods of poor performance.

The most important thing to focus on is overall portfolio performance. This is largely determined by what mix of assets will get you to your goals with the least risk. Only after the mix of assets is determined, do you pick individual assets. After that, you **track the individual asset performance against like assets (apples-to-apples), not against the hot flavor of the month.**

Having said all of the above, **what do you do about the fact that bonds will likely under-perform sometime in the not-to-distant future?** Does that mean you shouldn't hold bonds at all? No, bonds have a place in virtually everyone's portfolio.

It does mean that this is a **good time to shorten up on bond maturities**. While bond values may decline some, **bonds are held for diversification purposes and they still perform that function, even in a rising interest rate environment.**

There is no guarantee that one or more of the stock categories won't decline next year either. In fact, I'd say it's **an even bet whether stock or bonds earn more in the next 7 – 10 years**.

The table below shows what the various markets did in the last year:

Asset Class	1 Yr Rtn (07/31/03)
S & P 500	+10.63%
NASDAQ	+30.62%
Lg Cap Gwth	+11.03%
Lg Cap Val	+ 8.53%
Mid Cap Gwth	+15.73%
Mid Cap Val	+12.16%
Sml Cap Gwth	+21.35%
Sml Cap Val	+17.21%
Foreign	+ 5.08%
Interm Corp Bds	+ 6.41%
Foreign Bds	+12.14%

COLLEGE PLANNING

Saving With 529's

Many people need continuing education, yet don't take advantage of their 529 plan options to pay for it. Yes, **you can (in most states) set up a 529 plan with yourself as beneficiary!** In Virginia (and many other states) you also get a state tax deduction for your contributions to the 529 plan.

Virginia allows all of your contribution to be deducted if you are 70 or over; they only allow $2,000 per year to be deducted (until all your contribution is deducted) for those under 70. Since Virginia's tax rate is 5.75%, you would be **getting your education at a 5.75%**

discount. Why pay full price for your education?

Many of you are going back to school, some for degrees, some just for the learning. Indeed, 15% of current community college students are adults.

Adult education funded through a 529 plan can be part-time or full-time, on-campus or off-campus through distance learning programs. All you need to meet 529 plan requirements is that the **course is offered through an "eligible educational institution".**

The 529 plan can **pay for tuition, mandatory fees, and required books, supplies and equipment.** Room and board are qualified expenses only if you (or the student) is attending school at least half-time. So don't plan to take a belly dancing class in Bali and expect to use 529 money to pay for your vacation!

For you Virginia folks out there, the **adult education option only applies to Virginia's College America 529 plan.** The Virginia Education Savings Trust 529 plan requires you to use your plan money within 10 years of graduating high school.

'In market news, stockholders looking for a "Safe Haven" bought bonds, and bond-holders looking for a "Safe Haven" bought stocks

ESTATE PLANNING

The "NO-WILL" WILL

A wise old judge recently wrote an amusing magazine article, which very effectively points out why you need a will. Unless you prepare a will which expresses your own personal wishes with respect to your money, other property and valuables and who should care for your dependents when you die, then you are, in effect, adopting what the judge calls a "no-will will" as follows.

1. By failing to have a will of my own choice prepared by my attorney, I make this my "no-will will".

2. I give two-thirds of all my property, both personal and real estate, to my children. My spouse may have only the remaining one-third. If my spouse can't live on the one-third share, that's no longer my problem. Maybe the children can help with support when they grow up.

3. When our children become age 18, they can do whatever they please with their share of my money and property, No one, including my spouse, shall have the right to question the way our children spend their share.

4. If my spouse does not survive me, or dies while any of our children are minors, I do not care to nominate the guardian of our children, but hope that our relatives and friends may mutually agree on someone nice. If they cannot agree, the Probate Court may appoint any guardian it likes, including a stranger.

5. I do not care to appoint the executor of my estate, and hope the Probate Court appoints someone I would approve of. Hopefully, the individual that the court appoints as executor of my estate will not waste or lose too much of my property due to inexperience or dishonesty and something will be left to distribute to my natural heirs.

6. Any family heirlooms that may be a part of my estate can be sold and converted to cash if my executor wishes. None of my relatives probably wants any of them anyway.

7. I expect that although my executor (appointed by the

court) is probably ignorant of my business, he or she will nevertheless be able to provide for its continuance or arrange to receive a reasonable price for its sale. So, I therefore, see no need to make any provision as to this matter.

8. I do not want to know whether or not there are ways to lower my death taxes. I want as much of money and property as possible to go to the government instead of to my spouse and children.

IN WITNESS WHEREOF, because I really did not care to go to all the bother of making a personal will, I adopt this, by default, as my "no-will will".

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***(Without a will, your name will automatically appear on this signature line upon your death)**

INVESTMENTS

Income?

I have a client for whom I bought a **CD paying 6.9%** three years ago**.** It comes due this month and **new 3-year CDs are paying 2.5%. Money market accounts are paying 0.5%.** What's a person to do for a safe, short-term income vehicle?

Millions of people are facing this same issue. Interest rates won't stay this low forever, but they are unlikely to rise all the way back to their former levels.

Lump sum money needed for college, a home down-payment or a car within five years really shouldn't be in the market. A few people are so risk averse they prefer to stay in CDs so they can sleep at night. Sure, **CDs did better than the market the last five years, but that happens about a often as full eclipses of the sun.**

One solution to the income problem is to roll over to a new CD and tighten the belt. I wouldn't recommend going for a longer term CD to get a higher rate because you would lock in today's low rates.

Treasury's are only paying **2.34% for 3 year** notes, **3.25% for five year** notes.

Some people (100,000) have been tempted by companies like Ford who has been offering a 2.75% money market rate. They claim they can offer this higher-than-normal rate because of their lower overhead and no management fees.

In reality, **Ford's credit rating is so poor (BBB – bare investment grade), they are having trouble attracting money from professional investors/institutions**. Thus, they are after investors hungry for higher returns. While proclaiming the safety of their money market plan, it is neither FDIC insured nor is it diversified like other money market funds.

Highly rated (AAA) corporate bonds are paying 2.67% at 3 years and 3.62% at 5 years.

Should you move further out in time to get a higher rate? What about going for a lower quality bond?

As I said earlier, I think moving out the maturity just locks in today's low rates for a longer time. Regarding quality, while no one thinks Ford will default on bonds, they didn't think Enron would either. And Enron was larger than Ford!

In summary, there is **no silver bullet** for this problem. Tightening the belt can be difficult when income drops to 1/3 of previous levels. Yet, this situation should not be permanent.

My bigger concern is investors unwittingly taking much more risk than they realize in search of higher yields. Yesterday, I spoke to a commercial real estate broker who complained that fixed income investors were distorting the commercial market.

Traditionally, one can earn 8 – 12% in commercial real estate. However, today so much money is chasing the existing properties that prices are up and returns down to only 8%. Long-term real estate investors would turn up their noses, but fixed income investors are delighted. Can you spell bubble?

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