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BFAS Money Line

Will 2005 Mimic 2004?

The market has only recently made it into the black for the year. Last year, we saw much the same, then a big rally once the election result was clear. There's no election this year, so why would I allude to a repeat of last year?

The **market should have been rising based upon corporate earnings at historic highs, low interest rates, low inflation and continued spending by consumers**. However, the market seems to be having difficulty climbing the wall-of-worry about Iraq, terrorism and oil prices. As oil prices (hopefully) recede and the political process in Iraq moves forward, there is a good chance for a year-end rally.

In conversations with clients I often notice the **anchoring phenomenon** kicking in. Those who were primarily invested in the tech-heavy **NASDAQ** on **January 2000** have seen a **46% loss** since then. If you indexed your portfolio to the **S & P 500** in **January 2000**, you have **lost 8%.** On the other hand if you were in **corporate bonds** in **January 2000**, you are **up 39%. Small cap stocks** are **up 87%** and **mid cap stocks 57%** over the same time.

"You have reached our 800 number . . . If you are a preferred account, please dial B-I-G-S-H-O-T now . . . If you are an ordinary account, dial J-O-E-B-L-O-W now . . . If you have a service complaint, dial G-E-T-L-O-S-T now."

Those whose portfolios were 46% higher in January 2000 are still feeling poor even though the NASDAQ has gained 64% since January 2003. Those invested primarily in large cap stocks are still under water and wondering why bother with the market when, after 5 ½ years and a 47% gain since January 2003, they seem to be going nowhere.

I don't relate these numbers to drive all of you into CD's or fixed annuities. That would be a mistake since, unlike stocks, neither of these grow as fast as inflation over the long term. Thus, those who go super-conservative lock themselves into incomes that don't keep up with inflation.

How about those who didn't buy into the Internet boom or concentrate on large cap stocks? A "balanced" mix 30% large cap stocks, 18% foreign stocks, 35% bonds and 17% mid/small cap stocks rose over 40% during the last five years.

While the "balanced" portfolio might not have risen as much as some individual asset classes (small and mid cap value, for example), it provided a much smoother ride than those who bet on the hot asset class of the moment.

Today, everyone is as sure that real estate will only go up as those who were worshipping technology six years ago. Already, San Diego is seeing a real estate slowdown. You'll hear similar stories around the country in the coming months. It may not happen here, unless of course they close NAS Oceana; but **those who think real estate** (like the Internet) **is bullet proof from losing value will find they are sadly mistaken.**

Thus far this year, emerging markets (12%), commodities (10%) and real estate (13%) have seen double-digit returns while the S & P 500 has been barely positive.

Some of you may think commodities are due for a fall when oil prices finally come back to reality. If you've invested in the oil heavy (79%) Goldman Sachs commodities index, you may be right. However, the Dow Jones AIG commodities index limits oil to 33% so it isn't whipsawed by the gyrations of oil prices.

I believe commodity prices will continue to rise over time due to competition for resources from China and India as well as the rest of the third world. The Dow Jones AIG Index (used by the PIMCO Commodities Real Return Fund) and the Goldman Sachs Index (used by the Oppenheimer Real Asset Fund) have similar three-year records. However, the Dow Jones AIG Index provides, by far, the smoother ride.

The numbers in the chart below represent one-year returns from a low of last summer. Since, this year's numbers are so low, it's obvious that most of the gains seen in the chart happened at the end of last year. I believe we may see something like it this year as the market climbs that wall-of-worry:

Asset Class	1 Yr Rtn (07/29/05)
S & P 500	**+14.04%**
NASDAQ	**+15.76%**
Lg Cap Gwth	**+14.85%**
Lg Cap Val	**+15.80%**
Mid Cap Gwth	**+22.31%**
Mid Cap Val	**+22.66%**
Sml Cap Gwth	**+22.21%**
Sml Cap Val	**+24.49%**
Foreign	**+21.06%**
Interm Corp Bds	**+ 4.43%**
Foreign Bds	**+ 7.55%**

Estate Planning

When Congress returns in September, many will be focused on the Supreme Court nominee; however two competing bills to change estate taxes may have more direct impact on you.

One bill, already passed in the House and two votes short of passage in the Senate, would **eliminate estate taxes permanently**. This bill would certainly reduce a lot of "needless" cost that people incur trying to minimize current estate taxes. Some, though, are concerned that charitable gifting would suffer without the incentive of avoiding estate taxes.

In addition, the **elimination of estate taxes causes us to lose the step-up in tax basis upon death**. Currently, we don't have to know what Granddad paid for that AT&T stock in 1950 that has split many times and spun off numerous companies because the value his heirs use for capital gains tax purposes is the value on the day Granddad died. If estate taxes are eliminated, there will be no step-up in basis and the CPAs and lawyers who did estate tax returns will now be making their money doing research in the tax basis of companies, real estate and investments bought many years ago.

The alternative plan put forward in the Senate, which could well pass instead of the estate tax elimination, would keep the current system, but raise the estate tax exemption to somewhere between $3 million and $8 million. For many people, including small farmers and small business owners, this would eliminate their need to worry about estate taxes. This alternative would keep the current step-up in tax basis at death.

We should know which direction estate taxes will take within the next few weeks. You may want to wait to make major decisions that affect your estate taxes until the legislative process is complete.

Even though estate tax laws may change, all of you still need to do estate planning! You need to make sure your heirs get the appropriate shares of your estate. You need to protect some of your children/grandchildren from themselves. You need to have professional management of assets. You need to give someone the power to make financial decisions in case you are incapacitated. You need to give someone the power to make health care decisions if you become incapacitated. You need to leave final medical instructions in case you have a terminal illness or are in a coma.

How many of you promised yourselves to create a health care power of attorney/living will after watching the Terry Schiavo spectacle? **How many of you followed up and did something about it?**

Health Care Powers and Living Will forms are available on the Internet or from hospitals as well as your attorneys. Virginia combines both forms into an **Advance Medical Directive**.

In Virginia, you need two witnesses to your signature, but not a notary. In Virginia, **doctors are required to honor an Advanced Medical Directive**.

Other states have different criteria. If you move, you should verify that your estate planning documents meet the legal requirements of your new state.

Sometimes you will want to set up trusts to protect your child's share from a spouse he/she should never have married or from creditors if they should have money problems. Or, you may want to put it into trust because your child needs to have the assets professionally managed. Finally, you might want to preserve some of the money for your grandchildren.

"The good news is that we still have enough corporate assets left to post bail for the senior management team..."

With all the blended families these days, trusts are critical to keep money in your family. For example, if you are married to your second/third spouse and both of you have children from a former marriage, your current spouse and her children (or his/her future spouse) would reap the benefits of assets that you held jointly.

Instead, you could leave your assets to a trust that your current spouse could use for his/her living expenses while he/she is alive, but upon his/her death, your own children would receive the assets. I see many situations where people take the easy route of putting things in joint names so they won't have to spend money on attorneys only to **unintentionally disinherit some of their own family members**. Too often, some **time spent with an attorney could have led to a solution that would have protected everyone's assets, provided income to current and future families and distributed the assets to all the appropriate people**. Don't be penny-wise and pound-foolish!

Reverse Mortgages

With the latest run-up in real estate values, **many retirees are living in their most valuable asset, their home**. At the same time, the increased value means dramatically higher real estate taxes at a time when their incomes are fixed. That, along with increases in medical costs (drugs, help around the house, etc.) put a strain on retiree budgets.

What to do about it? It depends. If the retiree's overall health is fine, but keeping up with a large house and the attendant expenses is becoming difficult, then selling the house and moving to a simpler (hopefully less expensive) living environment might be best. Another option is to obtain a home equity loan if the retiree can afford the monthly payments on the loan.

One alternative I have seen is for an adult child to move back in with the retiree to help out. Another option, if the house is a family legacy that will be handed down over generations, is for the adult children to contribute money so the retiree can continue to live in the family home. If the retiree's health is in decline, certainly selling the house (to the children?) should be considered.

I mention all of these alternatives because I think they should be seriously considered before resorting to a reverse mortgage.

You can **obtain a reverse mortgage if you are at least age 62, live in your home as your primary residence and have ample equity in your home**. Unlike a traditional mortgage, you don't need to prove your income or ability to repay since the loan is based upon your home equity, not your income.

What are some of the things you might do with the money? You can refinance your existing mortgage, make home improvements (handicapped accessible?), pay medical expenses, pay for long term health care, travel, pay for a new car, pay college tuition for grandchildren or anything else you want.

The amount you can obtain depends upon your age and the market value of your home. The amount also varies depending upon what part of the country you live in and the current ten-year T-Bill rate. The notional loan values below show what might be available in Hampton Roads after paying loan costs:

Age	Home's Equity	Loan Value
65	$150,000	$74,200
65	$250,000	$133,500
75	$150,000	$92,000
75	$250,000	$157,800

You also have six options in how you want to receive your money:

1. Lump sum
2. Line of Credit (draw cash when you want, money not drawn does not incur interest)
3. Equal monthly installments for a fixed period of time that you select
4. Equal monthly installments for life (as long as you occupy your home as your primary residence)
5. A mixture of a line of credit with the remainder coming as equal monthly installments for a fixed period
6. A mixture of a line of credit with equal monthly installments.

Interest on a reverse mortgage is usually variable (rather than fixed) and tied to an index. Interest rate changes don't affect the amount you receive; they just change how quickly your loan balance grows. You also don't incur interest on money you haven't drawn.

Reverse mortgages are not cheap. **While a regular mortgage will cost about 1 – 2% in fees, a reverse mortgage might cost 5 – 6% in fees**. You can't have any other mortgage on your home, so **if you currently have a mortgage, you'd have to pay it off with proceeds from your reverse mortgage.**

You will also incur the cost of purchasing mortgage insurance. When you die, if your loan balance is higher than the value of your home, the insurance pays the difference so your heirs owe nothing. **If the loan balance is less than the value of your home, your heirs will get the remaining value of your home**.

What if your heirs decide they want to keep the house? All they would need to do would be to obtain a new mortgage, pay off the reverse mortgage and keep the house. In no case would your estate have to pay back the reverse mortgage.

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