

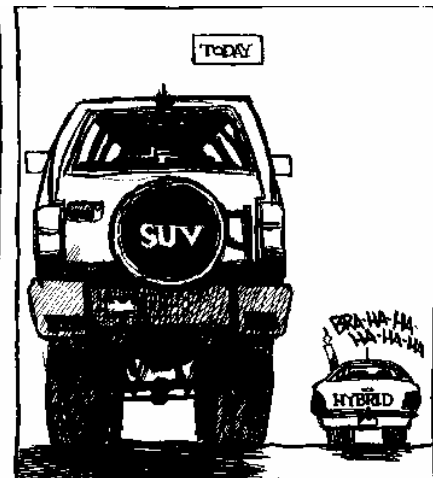
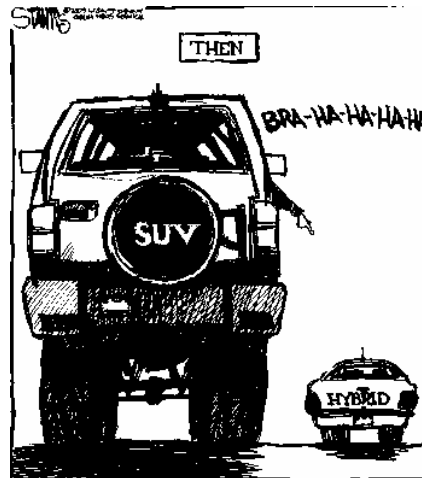
# BFAS Money Line

## Risk, Lowering It Works for You

Investors have the best chance of achieving long-term wealth while reducing risk by applying the three main themes of modern prudent fiduciary investing: **broad diversification of risk, low costs and (for taxable investors) low taxes.**

While it's not hard to understand that every dollar saved in investment costs and taxes goes straight to the bottom line to increase return, **not many people understand that broad diversification of risk can also increase return.** In fact, this broad diversification principle has much better odds of building portfolio wealth than trying to pick stocks or timing the market!

I have discussed before how portfolio gains and losses are not equal: a \$100 portfolio gaining 50% one year and losing 50% the next is not back at \$100. It went to \$150 with the gain, and then dropped to \$75 with the loss. Thus, **any given percentage loss hurts a portfolio more dollar-wise than the same percentage gain.** Likewise, a



**percentage gain must always be bigger than the percentage loss preceding it to get back to the portfolio's original value.**

The following table shows the performance of two portfolios over eight years:

Year	1	2
1998	8.04	28.58
1999	10.5	21.03
2000	1.32	-9.09
2001	0.62	-11.88
2002	-6.33	-22.10
2003	27.56	28.69
2004	13.97	10.87
2005	7.77	4.9

Now suppose you were at a year-end cocktail party in 1998 and said you were pleased to earn 8.04%

on your portfolio. In a nanosecond, your sister-in-law responds that she earned 28.58%, or about 3 1/2 times as much!

Come 1999 at the same year-end party, your sister-in-law makes a beeline to you while crowing about her 21.03% return. This compares unfavorably to your 10.5% return. It would take a ton of discipline to resist immediately dumping your "dog" portfolio and jumping into the hot sector of the day!

Looking at the two portfolios, it's easy to see how portfolio 2 seems by far the better of the two. But, rather than just looking at annual returns, let's look at cumulative returns (what your money would have done):

Year	1	2
1998	8.04	28.58
1999	19.38	55.62
2000	20.95	41.48
2001	21.70	24.67
2002	13.99	-2.88
2003	45.40	24.98
2004	65.71	38.57
2005	78.59	45.37
Simple Return	7.93	6.38
Compound Return	7.52	4.79
Risk (Std. Dev.)	9.32	15.9

The two portfolios in these examples were: **Portfolio 1 representing 60% stock/40% fixed income** and **Portfolio 2 representing the S&P 500**. The Simple Return above is just an average of the eight returns. The Compound Return measures the rate at which actual dollar wealth grows in a portfolio.

**Notice that Portfolio 1's compound return is fairly close to the simple return, while there is a big drop-off in Portfolio 2 between Simple and Compound Returns. This bigger difference in Portfolio 2 is a direct result of the higher risk (and consequent bigger losses) causing a much bigger drag on compound returns.**

## The Market

As I write this, the Federal Reserve (Fed) has finally halted their interest rate increases for the first time in two years, but warned that

more increases could come to fight inflation. Since May, the Market has been telling the Fed "enough already!"

The Fed has a difficult problem because inflation has split. China is focused more on full employment than profit. Thus, they are becoming the low-cost producer of many manufactured items. Internal competition keeps lowering the prices to the rest of the world. This can lead to deflation.

On the other hand, U.S. businesses, which rely more on services than manufacturing, are more profit oriented than employment oriented. Profits, and thus prices, are rising.

Therefore, the **Fed is seeing the prices of many goods go down while the prices of many services rise.**

Interestingly, this split has made life somewhat easier for the poor, who primarily purchase goods. However, the rich, who consume more services, are facing rising prices.

If inflation remains in check, the economy may simply slow down in a soft landing in 2007 rather than slip into a possible recession.

The Market has performed rather well considering the world political situation, rising interest rates, and the high cost of oil. High profits can solve a multitude of problems!

As you can see in the following chart, foreign stocks have been the clear winner over the last year:

The numbers in the chart below represent one-year returns:

Asset Class	1 Yr Rtn (07/31/06)
S & P 500	+5.38%
NASDAQ	-4.27%
Lg Cap Gwth	-0.35%
Lg Cap Val	+8.21%
Mid Cap Gwth	+2.24%
Mid Cap Val	+4.95%
Sml Cap Gwth	+0.66%
Sml Cap Val	+3.72%
Foreign	+24.01%
Interm Corp Bds	+ 1.61%
Foreign Bds	+ 1.89%

## PPA of 2006

Congress recently passed (and the President is expected to sign) the **Pension Protection Act of 2006**. It has a number of provisions which will affect most of us.

The part that gets the biggest headlines requires companies to 100% fund their pension plans. To reduce the pain, companies are given seven years to eliminate the shortfalls in their plans (airlines have 10 to 17 years). In addition, companies must pay more to the Pension Benefit Guarantee Corporation so that it can protect the pensions of companies that go bankrupt.

The Act also **allows companies to automatically enroll employees in company 401(k) plans AND to place their money into a balanced stock/bond fund as a default**. The employee

can opt out and can change investments, but the default provision will overcome a lot of employee inertia and poor investment decisions (leave all the money in a money market account).

Another important issue is that the **PPA extends indefinitely tax free withdrawals from College Savings 529 plans**. They were previously scheduled to be taxed as of 2011 (at the child's tax rate).

The Act also **continues** (previously scheduled to expire) **the maximum contribution amounts (\$15,000 plus \$5,000 catch-up for those over age 50 for most contribution plans; and \$5,000 plus \$1,000 catch-up for IRAs**. (Note: IRA contributions are \$4,000 plus \$1,000 catch-up this year and next year, then move to \$5,000 plus \$1,000 catch-up in 2008.)

Another important provision allows **non-spouse IRA beneficiaries (children/grandchildren?) to roll inherited pension plans into an inherited IRA**. Previously, only a spouse could do this. Most plans required non spouse beneficiaries to take a lump sum distribution. This new provision allows continued compounding and can be a significant benefit to the retirement plans of future generations!

If you are over 70 ½ and charitably minded, there are some very interesting new options. **This year and 2007, a person over 70 ½ can contribute up to \$100,000 from an IRA directly to a qualified charity with no tax consequences**. This could



*"Before we move on to today's remarkable financial news, I strongly urge viewers with low to moderate risk tolerance to please curl up in a fetal position."*

**also take the place of a required minimum distribution!**

Previously, you would have had to take a distribution from your IRA, pay taxes on it, and then contribute it to the charity. Now, you can avoid the minimum distribution if you don't need to take it and don't want to pay the income taxes on it.

## SBP and the Disabled Child

Our area has been designated by the Navy as one of the primary locations for families with disabled children. Thus, when retirement looms, we have many military families with disabled children facing a decision about whether or not to choose the Survivor Benefit Plan (SBP) retirement option.

SBP will pay up to 55% (with annual inflation adjustments) of the military member's retirement pay to a spouse and/or dependent child (member can select a lesser amount at less cost). The military member can select between coverage for a spouse only, a spouse and children, or children only. The member pays about 6.5% of retirement pay for SBP for a spouse, only about \$20/month for dependent children. The member can only refuse this benefit if the spouse agrees with the decision in writing.

While **SBP** is a very significant benefit (cost is partially subsidized by the government) for spouses, it **can be problematic if there is a disabled child involved**. In most cases a disabled child over age 18 can be designated an **Incapacitated Dependent (DD Form 137-5)** and, thus, be permanently eligible for Commissary and Exchange privileges as well as Tricare health care.

In addition, assuming the disabled child over age 18 has assets of less than \$2,000 and minimal income, the disabled child will usually be eligible for Supplemental Security Income (SSI) and Medicaid. Although SSI only pays \$603 and Medicaid may seem to duplicate Tricare, these programs can be critical to the long term support for a disabled child. If a disabled child is living independently, SSI money pays for food, clothing and shelter while Medicaid pays for supervision (which can cost in excess of \$40,000 in our area), job training and job assistance. Thus, **Tricare does not provide the same benefits as Medicaid; they complement each other for the disabled child.**

SSI payments are offset by unearned income to the disabled child. Any unearned income over \$20 offsets SSI income dollar-for-dollar. Once SSI income reaches zero, SSI is lost and, in most cases, Medicaid is lost. If the member dies having chosen SBP for child only, the disabled child will receive 55% of the member's income. If that 55% of retirement pay amounts to more than \$623 this year, the disabled child will lose SSI and Medicaid. If the member and spouse die after having chosen SBP for spouse and child, the same thing happens.

Some people have suggested having the SBP payments go to a Special Needs Trust for the disabled child rather than directly to the child. They believe this will "prevent" the child from having received the SBP payment and avoid the SSI offset. Actually, while the trust would

be useful for distributing the money, Social Security considers it to have been received whether it goes directly to the disabled child or to a special needs trust for the child, since by law the beneficiary is the child. According to an attorney lobbyist for people with disabilities in Washington D.C., Congress would have to change the US Code to allow the trust to "prevent" receipt by the disabled child (and it is unlikely that Congress will do that).

**What about just canceling the SBP beneficiary payments? Unfortunately, once they start, there is no way to stop them.** I have spoken to a lawyer in the SBP office who said he received panicked phone calls from surviving relatives of disabled children. These relatives complained the disabled child was losing SSI and Medicaid due to the income from SBP payments. Since the SBP payments were far less than the combined benefits SSI and Medicaid provided, the disabled child could no longer afford to live independently. While everyone commiserated, there was nothing that could be done.

Thus, you can see the critical need to understand the impact of SBP on SSI and Medicaid benefits. There are, however, two preventative actions available. The **first possibility is to select spouse only for SBP if you choose SBP when there is a disabled child in the situation.**

**The second option, if you have already made an SBP selection including**

**children and you have a child with a disability, is to apply to the Board for Correction of Military Records to modify your SBP election.** This option must be completed while the member is still alive since SBP beneficiary payments to the disabled child start upon death. The member must complete **DD Form 149** justifying why the SBP selection option must not include children (i.e. spouse only). For example, you might tell them you did not understand when you originally made the selection including children the severe negative impact on your disabled child's other benefits. When completed, the DD Form 149 is sent to the respective service address (listed on the form). The individual services each have a Board for the Correction of Military Records that meets periodically to review and approve/disapprove such requests.

If you are eligible for SBP and have a child with a disability, please take appropriate action to insure your child remains eligible for current/future SSI/Medicaid benefits!

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