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BFAS Money Line

How Bad Will It Get?

Those who thought the subprime mess was just a localized problem were whistling past the graveyard. The **problems with subprime have reduced credit availability and the uncertainty has hurt stock markets from here to Greece**. Recent infusions of liquidity by our Federal Reserve as well as the European Central Bank seem to have calmed fears temporarily.

The good news is that **corporate earnings are solid, unemployment remains at historic lows and inflation seems to be under control**.

Private real estate is doing poorly with housing prices soft to declining. **Next year, more than twice as many Adjustable Rate Mortgages will see dramatic rate increases than this year**. This will put added pressure on homeowners, more houses on the market due to financial distress and downward pressure on home prices. **Don't expect the housing market to improve until 2009**.

Commercial real estate (REITs) has finally felt the heat of the private real estate problems. After returns in excess of 30% during three of the last four years, REITs are down this year. I guess people are finally learning that **even real estate is not a sure thing**.

The markets, as usual, are driven by fear and greed. Greed feed the tech boom in the 90's, real estate recently. **Fear of the unknown due to the liquidity squeeze as banks tighten loan standards and over-leveraged hedge funds implode will continue to shake the market.**

Generally, when there is fear in the market, people move money to bonds, which is good for bonds. The first half of the year, bonds did poorly. But, both the market volatility and future Federal Reserve rate cuts bode well for bonds going forward.

The market's recent movements are nothing new. **It has been over 1200 days since the last 10% correction in the market**. This month's correction is less than 8% so far. Historically, 10% corrections happen about every two years. The recent smooth run-up in the market has lulled investors to believe that is the norm. It isn't. What we're seeing now is the norm, even though the ride is still less rocky than in years past!

With the housing market hanging over our heads and more mortgage pain coming next year, market gains could be tough. That doesn't mean you should depart the market, because it can always surprise.

Another change in the market recently has been the reemergence of growth stocks. After four years of

being soundly trounced by value stocks, May saw a change of leadership. As you can see in the table below, growth stocks now outperform value stocks for the last twelve months.

International stocks continue to their superior performance, but they have tumbled lately (8%) because many European Banks had money in the subprime market. Investors have piled a great deal of money into foreign stocks in recent years, and have been rewarded for it.

They fail to remember that foreign stocks can underperform as well. In the 90's, while U.S. stocks soared, foreign stocks performed much less well. This decade has seen the reverse. It won't go on forever, even though the dollar seems destined to continue to fall (good for foreign stocks).

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

Asset Class	1 Yr Rtn (07/31/07)
S & P 500	**+16.13%**
NASDAQ	**+21.75%**
Lg Cap Gwth	**+18.02%**
Lg Cap Val	**+14.30%**
Mid Cap Gwth	**+21.61%**
Mid Cap Val	**+16.30%**
Sml Cap Gwth	**+17.66%**
Sml Cap Val	**+11.29%**
Foreign	**+23.91%**
Interm Corp Bds	**+ 5.00%**
Foreign Bds	**+ 5.58%**

Simple vs. Compound Interest

Some investments, such as money markets and CD's earn simple interest rather than compound interest. What does that mean?

Simple interest pays the interest rate only on the principal invested. Compound interest pays on both the principal and previous interest.

Over short periods of time, there is not much difference, but over longer periods of time you can see in the table below how compound blows away simple interest on a $100,000 investment:

Year	Simple 7%	Compound 7%
1	$107,000	$107,000
2	$114,000	$114,490
3	$121,000	$122,504
4	$128,000	$131,080
5	$135,000	$140,255
6	$142,000	$150,073
7	$149,000	$160,578
8	$156,000	$171,819
9	$163,000	$183,846
10	$170,000	$196,715
11	$177,000	$210,485
12	$184,000	$225,219
13	$191,000	$240,985
14	$198,000	$257,853
15	$205,000	$275,903
16	$212,000	$295,216
17	$219,000	$315,882
18	$226,000	$337,993
19	$233,000	$361,653
20	$240,000	$386,968
21	$247,000	$414,056
22	$254,000	$443,040
23	$261,000	$474,053
24	$268,000	$507,237
25	$275,000	$542,743

So, check which kind of interest your money market or CD earns.

You should also keep in mind this issue when deciding whether to place money into stock/bond investments or a fixed annuity. The **annuity pays simple interest (for example 7%) guaranteed while you might expect to take only 5% from a stock/bond portfolio and increase it for inflation every year (with greater than 80% probability of success):**

Year	7% Simple	5% Inflation Adj.
1	$7,000	$5,000
2	$7,000	$5,175
3	$7,000	$5,356
4	$7,000	$5,544
5	$7,000	$5,738
6	$7,000	$5,938
7	$7,000	$6,146
8	$7,000	$6,361
9	$7,000	$6,584
10	$7,000	$6,814
11	$7,000	$7,053
12	$7,000	$7,300
13	$7,000	$7,555
14	$7,000	$7,820
15	$7,000	$8,093
16	$7,000	$8,377
17	$7,000	$8,670
18	$7,000	$8,973
19	$7,000	$9,287
20	$7,000	$9,613
21	$7,000	$9,949
22	$7,000	$10,297
23	$7,000	$10,658
24	$7,000	$11,031
25	$7,000	$11,417

In this case the **smaller 5% withdrawal catches up with the larger 7% withdrawal at 11 years** and ends up far ahead. But what is really going on the right column is inflation.

Those who fall victim to the siren call of getting a higher payout from the annuity in addition to the safety are setting their lifestyle at the $7,000 amount. **As inflation, which averages 3.5% over the long term, kicks in, that $7,000 buys progressively less and less.** Yes, it's guaranteed to be there, but **at the end of 25 years, it buys only $2,977 worth of goods**.

The **person who took the inflation adjusted 5% annual withdrawal is still able to buy $5,000 of goods after 25 years**. Certainly, there is the uncertainty of outcomes. At a 5% withdrawal rate, an academic study shows an 80% probability of success (no running out of money) after 25 years. This means there is a 20% possibility the person taking a 5% withdrawal might have to reduce their withdrawals to keep from running out of money.

On the other hand, the person with the annuity has no flexibility with the money while living and forfeits the principal when they die. The person with the stock/bond portfolio can expect an 8% return which could double their money in 25 years even though they were making withdrawals! In addition, the person with the stock/bond portfolio has the flexibility to meet one-time money requirements, unlike the annuity.

Both have a role to play, but everyone should be certain they understand all these issues before making an irrevocable decision.

"Hi. My name is Barry, and I check my E-mail two to three hundred times a day."

Kiddie Tax Changes

Congress has slammed the door on one of the best reasons to gift stocks/mutual funds to your children. For years, you could gift to your children, then have them sell the assets as needed for college, wedding, etc. after age 14 and they would only owe 5% (vice 15% for you) capital gains taxes on their gains. Even better, starting in 2008, the children's capital gains tax rate went to zero. What a great loophole!

What is **kiddie tax**? **Children are not taxed on their first $850 of income and taxed at their 10% rate (5% capital gains tax) on the next $850 of income. When they were under age 14, any further income (over the $1,700) was taxed at their parents' rate**.

This led many parents to gift stocks/mutual funds to their children because after age 14, they could sell the assets and pay the lower child tax rate rather than their own tax rate. This seemed like a great plan to help pay for college.

However, **last year Congress raised the age for the kiddie tax from 14 to 18. Then, this year they raised it again. Beginning in 2008, children up to age 19 are subject to kiddie tax.** More importantly**, if the child is attending school full time and is listed as a "dependent" on the parent's tax return, they are subject to the kiddie tax up to age 24!**

Thus, for planning purposes**, if you have a child age 18 or over (or turning 18 this year), you can take advantage of the lower capital gains tax rate (5% vice 15%) THIS YEAR only!**

This also means that Uniform Gift to Minors Act (UGMA)and Uniform Transfer to Minors Act (UTMA) accounts are much less attractive than they have been. Here's an example: Junior is a freshman to State

U. and has an UGMA with $3,000 per year of ordinary income. Junior also works as a lifeguard when not in college full time. In 2008, his income will be taxed as follows:

$850 – no tax

$850 – taxed at 10% (Junior's tax bracket)

$1300 – taxed at 35% (parent's bracket)

You should **remember that money in college savings (529 plans) is not subject to kiddie taxes. Money in them grows tax deferred and is tax free if used for qualified college expenses!**

Saving for a Wedding

I am often asked for advice on what to do about money that has a specific purpose, and is not considered a part of an overall investment policy statement. Certainly, this applies to college, but there are tax-free 529 plans for that.

But what about saving for a wedding? Typically, the time horizon for this savings is about 20 - 25 years (children are getting married later these days). Like college savings, protecting against losses is important. You would hate to need the money just when the market decided to take a nose dive!

Many people use UGMA/UTMA accounts. However, since money in an UGMA is legally the child's money at age 18 (18 - 21 for UTMAs depending upon the state), the child could decide to convert the money into a Harley and motorcycle across the country with their money. When they are young and innocent, no one believes this could happen. Only when they are teenagers does this start becoming an issue of concern!

So, **do you put your wedding savings into an UGMA/UTMA or into a separate account in your own name?** There is still **some tax savings associated with UGMA/UTMA accounts due to the minimal taxes on the first $1,700 of income**. If the money is in your name and the child grows up and decides to join a commune, you can use the money for a trip to Sedona!

You should seriously consider whether you wish to save in your own name or in a UGMA/UTMA account for your children.

Whichever choice you make, if you are saving $1,000 - $2,000 annually, you want to use a savings vehicle that is tax efficient but inexpensive to purchase. Balanced funds (that hold a mix of stocks/bonds) provide the stability of gains that you would prefer. Some can be bought using dollar-cost-averaging with low expenses. However, not many balanced funds are tax efficient.

Exchange Traded Funds are tax efficient, but don't provide the mix of stocks/bonds that balanced funds do.

Looking at balanced funds, some have high minimums ($10,000), some have transaction fees, some have poor performance and many are not very tax efficient. You should closely research funds to find ones that meet the criteria discussed.

Regarding the tax issue, my calculations show distributions of 4% on $20,000 of savings in a balanced fund would be $800. If in a UGMA/UTMA account, there would be no tax. If in your name, you would pay taxes of $264 at a 33% tax rate.

So, **which is most important to you in saving for a wedding: taxes or control?**

For those in the right situation (**self employed, business owners**), you have another option. You could **employ your children**.

With a portion of your children's earnings you could **set up Roth IRAs for them**. When the wedding comes, **they could withdraw tax free all of the Roth IRA contributions with no penalty**. They just have to be careful to avoid withdrawing any earnings because taxes and penalties would apply.

Of course, it's much cheaper to buy a ladder and pay for tickets to Vegas so they can elope!

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