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BFAS Money Line

Bear Market, What Now?

This has been a roller coaster year. The market dropped 10% the first quarter, then recovered virtually all of that by mid-May. Since mid-May, the market dropped 14% by mid-July before recovering 5% as of August 6th. Since the last market peak on October 9th, the market has dropped a total of 20%, which meets the definition of a bear market.

The market thinks we are in recession, even though the economy seems to be avoiding the negative Gross Domestic Product (GDP) normally associated with recessions.

Oil, and a number of other commodities, has been bid up by traders with an eye on many dicey political situations (Middle East, Iran, etc.). Much of the price has nothing to do with supply and demand. As an example, the price of oil dropped 20% after the President announced an executive order to open up off-shore drilling (like the Chinese are doing off of Florida). No, the announcement didn't add a drop of oil to the supply today, but the just the promise of future oil caused traders to reduce their bids for oil going forward. This seems to get lost in the argument of how long it will take to produce oil from off-shore drilling (Energy Department says ten years, oil companies say 18 months). The price to produce oil varies depending upon where it is being produced; but the average might be $40 - $50 per barrel. The rest of the price is based upon uncertain politics in many areas and prospects for future oil production.

As oil comes down in price, that and the slow economy will dampen inflationary pressures so that the Federal Reserve can start raising interest rates. This will further dampen inflation and strengthen the dollar. As the dollar strengthens, oil prices will come down and the vicious circle that seems so damaging now will reverse itself quickly.

Unemployment continues to creep up, yet perspective is lacking in media reporting. One radio show interviewee likened the current recession to the Great Depression. Now, back then unemployment was 25%. A typical recession sees unemployment of 8% - 10%. During the Clinton administration (only ten years ago) 5.5% was considered "full employment" and there was concern that a drop below 5.5% would spur inflationary wage pressures. Yet, unemployment just last year was 4.4% and has slowly risen to 5.7% today. It will likely rise some more, but probably not more than 6% - 6.5%.

Part of the reason for this recession without significant job loss is that it's **not a typical recession**. Typical recessions are consumer driven. We stop buying things, inventory builds up, manufacturers see the inventories build up and lay off people by the thousands.

But, **this recession is driven by credit and housing problems exacerbated by high oil prices**. The pain is primarily in real estate (concentrated in five states), financial firms (banks and wire houses) and automobiles/airlines. The **cheap dollar has led to a 20% increase in exports to the rest of the world with employment humming in manufacturing**.

Corporations outside the above sectors are profitable (and growing) even though profits are lower than last year's highest profits in history. Business inventories are low so production should grow to refill bare shelves. Productivity is high and rising, versus falling as it would in a typical recession.

As usual with bad news, it is magnified by the media. I can't imagine what the current media would have done with the last real estate/financial bust in the late 80's.

We've had a large bank (well really a large mortgage company that also had some deposits) fail and the media panicked the consumer with headlines that 90 banks were on the FDIC watch list. What they failed to tell you is that typically only 13% of banks on the watch list fail and that in any normal year 5 – 10 banks fail without any headlines. Back in the 80's there were over 2300 banks/savings and loans on the watch list! Again, what the media fail to do is put things into perspective.

The last two recessions lasted eight months, and I believe this one started in January. A typical bear market lasts 18 months. Presidential election years are typically the second best return years in the four-year election cycle.

Does all that help predict the way forward? Not much! So, given a weak economy and a bear market, what's an investor to do? Go all cash/CDs? All bonds? More commodities? Use guaranteed investments like fixed annuities or variable annuities with guarantees?

Many of the above must look pretty good about now. All are problematic, though. Cash, CDs and bonds don't provide sufficient inflation-adjusted income over the long-term and when would you move back into stocks? Commodities have temporarily peaked and will fall back (dropped 11% in July alone) before resuming a long term increase due to developing market demands. Guaranteed investments cost more, reduce returns and don't protect against inflation.

A widely diversified portfolio will probably have lost about half the market's 20% thus far. While painful, it is well positioned to move back up when the market turns around, as it always does. Typical rallies after a recession include 25% to 30% increases within months of the market bottom. Miss that, and your overall return drops dramatically.

As the following chart shows, commodities and bonds have been the only "safe havens" recently:

Asset Class	1 Yr Rtn (07/31/08)
S & P 500	**- 11.09%**
NASDAQ	**- 8.67%**
Lg Cap Gwth	**- 6.73%**
Lg Cap Val	**- 15.02%**
Mid Cap Gwth	**- 7.80%**
Mid Cap Val	**- 12.97%**
Sml Cap Gwth	**- 10.85%**
Sml Cap Val	**- 11.75%**
Foreign	**- 12.19%**
Interm Corp Bds	**+ 1.83%**
Foreign Bds	**+ 7.52%**
Commodities (DJ – AIG)	**+22.24%**

Insurance

Variable Annuities: One of the things a fiduciary advisor must do continually is due diligence on all the latest and greatest products to determine what's in our clients' best interests.

I will say at the outset that I see a gigantic divide in the financial planning world. Those financial planners who earn commissions for recommending products almost always use them. On the other hand, those financial planners who are Fee-Only (and only paid for their advice) rarely use them.

I recently read an article in one of my professional magazines saying that a respected research organization (Ibbotson Associates) had determined that a Variable Annuity with a Guaranteed Minimum

Withdrawal Benefit (VA + GMWB) provided better returns and more safety than a similar portfolio of mutual funds.

I found the actual article ("Retirement Portfolio and Variable Annuity with GMWB") at the Ibbotson website and was immediately surprised that the paper was sponsored by Nationwide, a company that produces and sells Variable Annuities.

As I read the paper, I was looking for answers as to how a VA +GMWB could outperform a portfolio of mutual funds since the VA+GMWB costs, on average, 1% more and the returns are taxed as ordinary income. For example, income on a $50,000 distribution from the VA+GMWB would trigger $20,000 in taxes if you were in the 40% federal and state combined tax brackets. In a mutual fund portfolio with 30% of the income taxed as ordinary dividends while 70% of the income was capital gains or qualified dividends (taxed at 15%), the distributions would trigger $11,250 in taxes.

When I read the paper's assumptions, I found that **taxes were not considered**. Also, **inflation was not considered (probably since no VA+GMWB offers an inflation adjusted withdrawal benefit).** In addition, **Ibbotson assumed expense of .4%, when the average expense of VA+GMWB's is 1.4%!** Yes, the VA+GMWB did provide a guaranteed 5% withdrawal rate on an amount that is locked in annually if the amount in the VA+GMWB is larger than the year before. So, even though your portfolio of mutual fund subaccounts in

"Your portfolio did poorly because you invested in the wrong funds at the wrong place at the wrong time."

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the VA+GMWB might dip during times like these, the guaranteed amount would stay flat, and your withdrawal amount would be based upon 5% of the guaranteed amount.

Other papers discussing VA+GMWB indicated that all the money in the VA+GMWB needed to be invested in stocks in order for the portfolio value and distributions to keep up with inflation. However, many people are uncomfortable with having all of their investments in stocks, even with the guarantees.

Thus, after carefully reading the paper, I **came away with the strong suspicion that the sponsorship by a producer of Variable Annuities caused Ibbotson to use assumptions that made the Variable Annuity look much better than a fair comparison would.** I voiced these concerns to Ibbotson as well as several professional publications and there has been a lively discussion of the issues.

Meanwhile, product salesmen are touting the paper from the rooftops as proof that overpriced Variable Annuities with token guarantees are superior to a portfolio of mutual funds.

Note: I have at least two Variable Annuities available without commissions, with lower costs, and with guaranteed minimum withdrawal benefits. If my analysis showed that my clients would be better off using them, I would use them. However, the extra cost for the guarantee, lack of inflation protection on the guaranteed income and negative tax consequences prevent me from using them at this time.

Life Insurance: It has been some years since I first heard a pitch about **using life insurance to create retirement income. The idea behind it is to purchase a life insurance policy, allow the cash value to grow over time and take loans on the cash value in retirement because the loan would be tax free.**

The advantages of such a plan are that the life insurance protects the family

in the advent of a premature death, the growth of the cash value is tax free, and the retirement money is tax free. I recently met with a prominent local insurance agent who recommends all of his clients (most of whom are heavily invested in real estate) ignore 401(k) plans and IRAs and put all their retirement related income into whole life insurance.

So, I obtained the actual returns that his insurance company earned over the last 28 years and used a premium of $10,000 per year to see how much ended up in cash value after the cost of insurance, administrative expenses, and premium taxes to Virginia.

The assumed $10,000 premium would buy a $500,000 whole life insurance policy for a 35 year old. As a comparison, I analyzed buying $500,000 of 30 year level term insurance (cost $450/yr) and putting the remainder of the $10,000 to work in a portfolio of tax-efficient Exchange Traded Funds (ETFs).

My analysis showed that taking 4% annually as a loan (6% interest) from the cash value of the life insurance would probably be sustainable over a 30 year retirement, although the life insurance cash value would be virtually exhausted at the end of the 30 years. **If the life insurance cash value goes negative, you either have to put more money in or the policy collapses and all the loans become immediately taxable. Additionally, inflation's impact on the 4% withdrawals would dramatically erode the buying power over 30 years (to less than half the original withdrawal amount).**

Withdrawals of 4% (with inflation adjustments annually) from a portfolio of ETFs are considered to be totally safe. **The inflation adjustments alone will make total withdrawals be more than twice as many dollars than the 4% non-inflation-adjusted withdrawals from the life insurance.** In addition, recent academic studies have shown safe withdrawal rates of 5% and 6% from widely diversified portfolios. However, withdrawing more than 4% from the life insurance policy virtually insures a policy collapse well before 30 years.

Thus, **the best way to save for retirement remains the portfolio by a wide margin**. This assumes that the retirement assets eliminate all cash needs during retirement. However, holders of significant real estate or family businesses might be facing estate tax issues.

Some would think only life insurance can solve that problem, but **you should evaluate gifting using the annual $12,000 exclusion, using your lifetime $1 million gifting exemption, Grantor Retained Annuity Trusts, charitable trusts, partnerships, leases, or low-interest loans before punching the life insurance ticket**. Of course, your insurance agent is not likely to evaluate those options!

SBP

I have written before about the **negative consequences of a military person who has a child with a disability signing up for the children's option of the Survivor Benefit Plan**. Most children with disabilities who live independently (virtually all do sooner or later) depend upon Supplemental Security Income (SSI) and Medicaid to pay for housing, food, clothing, supervision in the home, job training, job assistance, etc.

Once the military member dies, the Survivor Annuity is paid monthly to the child with disability. Because it is unearned income, SSI is reduced dollar for dollar until SSI and usually Medicaid are lost. If the child is already in an independent living situation, the child may lose all the benefits that pay for their living circumstances while only having the, usually smaller, Survivor Annuity to replace it.

After a recent nationwide webcast I made to the Academy of Special Needs Planners, I started receiving phone calls from the Congressional Budget Office **asking about the cost of fixing the problem by allowing the Survivor Annuity to be paid into a Special Needs Trust (currently not an option)**. If Congress actually passes such legislation, I will happily pass it on!

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