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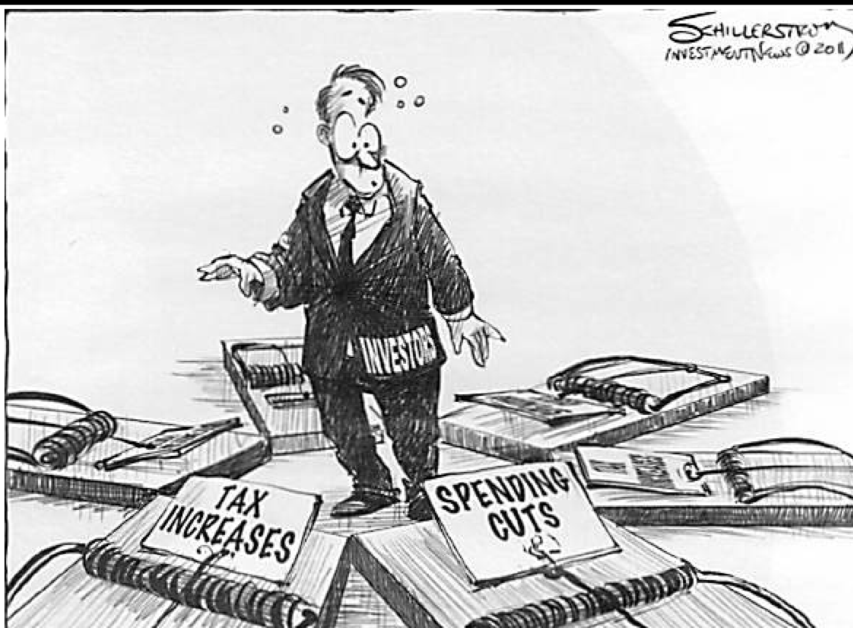
BFAS Money Line

Idiot or Genius?

The **market has been up as much as 9% this year, but is currently down more than 5%.** This year has seen the Japanese earthquake/tsunami, the debt crisis in Europe, and very slow growth in our country with continued high unemployment. The market has been up substantially, and then lost all of its gains twice already this year.

Considering all that has happened, I'm surprised that the market has been up at all this year. Having been concerned about downside risk, I have re-made most portfolios to be more conservative. These portfolios will do relatively well (compared to the market) in down or sideways markets but will trail the market when it is up. Thus, when the market has soared, I'm considered an idiot for being so conservative; when the market has sunk, I'm considered a genius.

The latest cause for the market drop is the slow motion train-wreck of how the country is going to meet (or not) its obligations over the next few decades. Medicare will exhaust its trust fund in 2024 and Social Security in 2036. Our federal budget presented in January forecast $10 trillion in additional debt on top of the country's $14 trillion existing debt.



The country is divided politically about how to address these issues. Recently, the credit agencies have started weighing in. **By down-grading our credit rating, the bond market has voted no confidence in the government's "spend our way out of the slow economy" plans**. What combination of spending cuts (even to entitlements) and increased taxes will ultimately emerge remains to be seen?

What is clear is that spending cuts only on discretionary programs, even defense, cannot save enough money ($1.6 trillion deficit this year) to get our fiscal house in order. Nor can tax increases do the job without touching entitlements. In 2008, all taxable income above $200k equaled $1.12 trillion.

Considering that the political conversation in January was not even discussing correcting our deficit problem; the tone in Washington has dramatically changed. Finally, both parties are discussing how to address the deficit; they just have huge differences in what to do about it.

We will only know the Washington crowd has come up with a viable solution when everybody's ox is gored and there are demonstrations in the streets. The current plan only touches the surface of what really needs to be done. When the Committee of Twelve completes its work, we will still have debt equal to 90% of our economy in 2021. Without the deal, it would have

been 100% (up from 2010's 62%). The percentage is significant because historically every country with 100% of debt to GDP has defaulted on their debt.

Thus, even after the Committee of Twelve is done, the bond vigilantes and rating agencies (not just the Tea Party) will be demanding far greater spending cuts. These cuts will need to reduce overall spending 30% - 40% (depending upon tax increases) to restore fiscal soundness. This will be exceedingly painful. .

Europe has over-promised and under-funded their social programs for years and they are now facing the impact of bond holders who demand higher interest rates due to the riskiness of bonds in Greece, Ireland, Portugal, Spain and Italy. Yet, **most European countries have done far more to get their fiscal house in order than we have. Germany passed a Balanced Budget Amendment (our Senate refused to even vote on one for us).** The **UK and Italy** have drastically cut spending (and raised taxes) such that **their budgets are expected to balance by 2013**.

Canada had a fiscal crisis in 1993, and lost its AAA rating. They dramatically cut spending, regained their AAA rating in 2002 and thrived during the recent Great Recession. We, on the other hand, have passed no plans to balance our budget within the next ten years! Hence, Europe is appalled that we have preached fiscal discipline to them, but done such a poor job ourselves! Stay tuned!

Remember that the Federal Reserve's Quantitative Easing II (QEII) ended in June. QEII basically provided more money to support the stock market. Since QEII ended (in the middle of the deficit fight) the market has dropped. The stimulus and QEII were able to get us to 3% GDP growth, but now the economy is falling back and we are left with a major debt bill and higher government spending. **We are out of fiscal bullets**. The Federal Reserve can cut interest rates no lower. The Federal Government is broke and close to a default on our obligations.

We remain in a **secular bear market; one that goes up and down but generally goes sideways for years. From January 2000 – June 2011, the S & P 500 gained a total of 11%.** However**, a balanced portfolio (60% stocks/40% bonds) gained 55%.** Thus secular bear markets don't reward risk-taking.

The last secular bear market (they happen periodically) was 1966 – 1982. Someone retiring in 1982 (during a recession) would have a hard time being convinced to invest in stocks since they had gone nowhere (averaging 1.6%) for sixteen years. That retiree might have put all his money into CDs that paid almost 14%, at least for a few years. But, the stock market earned over 15% annually during the next eighteen years.

We are probably a few years away (2013 – 2015) from the end of this secular bear market, but it WILL end. In the interim, maintaining a balanced (or even more conservative) portfolio makes sense.

As you see below, the last year was good for growth. Foreign bonds have outperformed U.S. bonds, but foreign stocks have under-performed:

Asset Class	1 Yr Rtn (07/31/11)
S & P 500	+ 19.65%
NASDAQ	+ 22.25%
Lg Cap Gwth	+ 23.09%
Lg Cap Val	+ 16.52%
Mid Cap Gwth	+ 26.67%
Mid Cap Val	+ 19.98%
Sml Cap Gwth	+ 29.65%
Sml Cap Val	+ 20.12
Foreign	+ 17.17%
Interm Corp Bds	+ 5.51%
Foreign Bds	+ 8.60%
Commodities	+ 21.41%

Odds and Ends

Retirement Tips – With the markets failing to grow your portfolio to your target amount, what's a pre-retiree to do? Put your money in cash to "preserve" what you have? Take more risk to attempt to catch up?

I would submit that the **two most important options are to reduce spending or to work longer**. Everyone's spending plan can use a scrub to reduce expenses. This can include driving your car longer before replacing it, deferring home upgrades, eating out less, using Netflix instead of going to the movies, etc. You would be surprised at how all this adds up!

When I mention working longer, people say, "I don't want to be working when I'm 90!" However, **just working an extra two-to-four years can make a dramatic difference. This is two-to-four years that your portfolio does not have to support you as it continues to grow**. It is also two-to-four years when you can defer Social Security (with a guaranteed 8% annual increase that is hard to get in this market!)

Saving While Working Longer – I have seen a number of people who work into their 70's, most because they enjoy it, not because they had to. Can they continue putting money into retirement plans? A qualified yes.

You cannot contribute to a traditional IRA after age 70 ½. However, you can contribute earned income to a Roth IRA. If your company has a 401(k), 403(b) or profit sharing plan, you can usually continue contributing to them and can normally defer mandatory distributions from them. If you are self-employed, you can contribute to a SEP IRA; however you will have to take mandatory distributions also. Thus**, you might want to consider a solo 401(k) if you are self employed and don't want to take distributions while you are still working.**

Equity Indexed Annuities – I recently reviewed an equity indexed annuity proposal from an insurance agent connected to a local credit union. This **annuity paid a 10% bonus and had a 7% Simple Income Rider**. With a bonus and a guaranteed 7% return, what's not to like?

Well, here is the rest of the story. **The 10% bonus came with a limitation on your participation in the S & P 500 gains. Gains were capped at 4.5%.** While it is true that you could not lose money, if the market earned 20%, the most your annuity would gain is 4.5%. Since the market goes down about 1/3 of the time and up 2/3 of the time, **your average gain over ten years would be about 3% annually**. Not a stellar gain, but better than the market has done the last ten years (see page 2), yet less than a balanced portfolio. Of course, once the market exits this secular bear phase, the annuity will drastically under-perform.

But, wait! What about the 7% Simple Income Rider? Doesn't that mean you double your money in nine years, as the agent said? Not really, the Rider will double your money in just over ten years because your money is not compounding, it is a simple 7% return on the original contribution plus the bonus.

Either way, that Rider adds up to a pile of money. Why not just take that money after the ten year surrender charge (10%) is over, as the agent recommended? Not so fast! The Rider allows you to withdraw that money as a single life annuity or a joint life annuity. The joint life annuity pays 4.5%.

What alternatives are there to the high-cost, ten-year limited-access without penalty equity indexed annuity? **If you took the money and put it into a balanced 60% stock/40% bond portfolio that earned 8% annually over twenty years (actual performance over the last twenty years), and took 4% annually, you would receive about 10% more than the annuity would pay.**

I also looked at a specific balanced fund, **Vanguard Wellington, and calculated that over the last**

twenty years, the 4% payout would have been 66% higher than the annuity. In either of the two scenarios, **your money would have been accessible at any time without penalty**. In addition, **your payments would be taxed part as ordinary income and part as capital gains (which are generally less) while income from the annuity would be taxable as ordinary income.**

Once again, I was struck by how an agent, who really believed in his product and used it himself, did not understand what he was selling. He knew enough to sell, but not enough to determine whether it was in the client's best interest. The agent, of course, claimed to be working in the client's best interest and was supposedly not swayed by the 3% commission. I obviously felt otherwise!

How Things Work

So your child is receiving the **maximum amount of Supplemental Security Income (SSI) of $674/month.** Yet, your child is living with you and you are **only receiving $450/month**. What happened?

Social Security (SS) determines the cost of living in your household and how many people live there. They divide the number of people into the household cost to determine each person's "fair share". If your child is not paying you their "fair share", SS deducts a maximum of 1/3 of the SSI payment.

You can receive the full amount by having the child pay you the "fair share" amount and notifying SS. However, if the "fair share" amount is higher than $674/month, that won't work.

Another way your child will receive the full amount is if the child lives elsewhere. This could be a relative, a neighbor, an independent living situation or a group home. But, in a group home, the child's full payment, less $30 for personal needs, goes to the operator of the home to pay for housing, food and clothing.

What do you do if you want your child to live in the community but $674/month won't cover the rent? One option is to **find a HUD subsidized home**. In these homes, **HUD only requires 30% of income for rent**. Your child gets to use the rest for other living needs.

If HUD funding is not available, you might subsidize the child's rent in an independent living situation. This money would go directly to the landlord to avoid dollar-for-dollar offsets to SSI. However, SS will still reduce the $674/month to $450/month due to the subsidy you are providing, even while living elsewhere.

If your child moves out while you are alive, it is easy to make these payments. But what happens after you are gone? **While I am a big fan of Special Needs Trusts (SNT), I prefer to have a separate trust set up specifically to cover the difference in housing costs.** This trust might also cover special assessments for condos, repairs, and other housing costs.

I prefer to see SNTs used only for higher-quality-of-life things so that there will be no question of SS deciding that the SNT is a basic support trust, rather than a Special Needs Trust. If SS decides the trust is a basic support trust, they might eliminate SSI until the trust assets are exhausted. Note: Please see your attorney to discuss these issues!

SSI payments go to a Representative Payee, who is responsible for spending the money for the benefit of the child. That person should be keeping a detailed record of all expenditures for the child.

Picking a Representative Payee is important to ensure the child's money is spent correctly. I have recently seen two situations where the Representative Payee was spending the money on themselves rather than the child.

Hence, I recommend someone periodically check on the Representative Payee to ensure the child is receiving full benefit of the money. If you think the child's money is being misspent, you can notify SS. You will need some proof and you should have someone in mind as a replacement Representative Payee.

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