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BFAS Money Line

INVESTMENTS

End of an Era?

With seven weeks to go, it certainly looks like this will be the first year since 1994 that the S & P 500's return will be less than 20%. Through Halloween, the **S & P 500 was down 1.81%.**

The long drawn out election has further hurt the market.

Those with a technology bent have watched the **NASDAQ drop over 17% this year (28% since the market peak in March).**

The markets are continuing their trend of rewarding last year's laggards and punishing last year's stars. Large Cap, Mid Cap and Small Cap **Growth indexes are all negative** this year while all the **Value indexes are positive**. The Small and Mid Cap categories have double digit returns (13% and 14%) this year.

Yet, those "boring" bonds have earned almost 7% this year. They look a lot less boring when the markets are in negative territory, don't they?

Across the ponds, foreign markets continue their downward trend. **Foreign stocks are down 14% and emerging markets are down 27% thus far this year**.

Some pundits have said foreign markets are not worth the risk. They say we don't know as much about them as we do U. S. markets. They also say increased international trade and large multinational companies (like Daimler Chrysler) make investing in foreign markets obsolete.

Besides which, **one of the reasons for investing in foreign markets is that they move differently than U. S. markets and, thus, reduce the risk of only investing in the U. S. market**. But, the pundits say, foreign markets lately seem to move up and down right along with the U. S. market.

The arguments on the other side say that 60% of the world's money is invested outside the U. S. Certainly, in that large a market, there should be companies worthy of investment (ever heard of Nokia?).

There is a commonly used measure of how closely one asset follows another. It is called correlation. Two assets perfectly in sync have a correlation of 1.00. Two completely out of sync are –1.00.

Foreign stocks had a correlation to the S & P 500 of .84 in the 80's, but a

"All I said was, I hope my portfolio never loses as much as the investments

correlation of .12 in the 90's. Low correlation makes an asset an ideal selection for a portfolio. **Since foreign stocks and the S & P 500 have nearly identical long term rates-of-return, having them both in a portfolio provides higher returns with lower risk over the long term**. A portfolio solely composed of U. S. stocks will incur much more risk.

INSURANCE

Annuities: Pro & Con

Promoted as the **income you can't outlive**, insurance companies sell annuities to millions of people every year.

The insurance companies have been very creative on the annuity front. There are fixed annuities that pay immediately, and ones that pay on a deferred basis. There are indexed annuities and annuities with bonuses. There are variable annuities paying immediately and on a deferred basis. Bonuses are available here also.

You can have an annuity pay out over a fixed number of years, over your lifetime, or your and your spouse's lifetime, or your and your children's lifetime.

Annuities have some distinct advantages. Among them are **tax deferral, no limit on contributions, flexible payment options and avoidance of probate**.

The very popular **variable annuity** has a number of **sub-accounts** where you can earn returns **similar to mutual funds**.

To better understand the cost and tax implications of annuities versus other

Assumptions:

Investment	$100,000	
Tax Rate (Fed & State)	33%	
Capital Gain Rate	20%	
Fixed Annuity (20 Yr + Life) Rate/Expense	6%	N/A
Variable Annuity Rate/Expense	10%	2.25%
No Load Mutual Fund Returns/Expense	10%	1%
CD Rate	6%	N/A
Bond Rate	7%	N/A

	CD	Fix'd Annuity	Bond	Var Annuity	Mut Fund
2001	$106,000	$106,000	$107,000	$107,750	$109,000
2002	$112,360	$112,360	$114,490	$116,101	$118,810
2003	$119,102	$119,102	$122,504	$125,098	$129,503
2004	$126,248	$126,248	$131,080	$134,794	$141,158
2005	$133,823	$133,823	$140,255	$145,240	$153,862
2006	$141,852	$141,852	$150,073	$156,496	$167,710
2007	$150,363	$150,363	$160,578	$168,625	$182,804
2008	$159,385	$159,385	$171,819	$181,693	$199,256
2009	$168,948	$168,948	$183,846	$195,774	$217,189
2010	$179,085	$179,085	$196,715	$210,947	$236,736
2011	$189,830	$189,830	$210,485	$227,295	$258,043
2012	$201,220	$201,220	$225,219	$244,910	$281,266
2013	$213,293	$213,293	$240,985	$263,891	$306,580
2014	$226,090	$226,090	$257,853	$284,343	$334,173
2015	$239,656	$239,656	$275,903	$306,379	$364,248
2016	$254,035	$254,035	$295,216	$330,124	$397,031
2017	$269,277	$269,277	$315,882	$355,708	$432,763
2018	$285,434	$285,434	$337,993	$383,275	$471,712
2019	$302,560	$302,560	$361,653	$412,979	$514,166
2020	$320,714	$320,714	$386,968	$444,985	$560,441
Total Income	$220,714	$220,714	$286,968	$344,985	$460,441
Taxes	$73,571	$61,285	$95,656	$95,791	$110,506
Net After Tax	$147,142	$159,429	$191,312	$249,194	$349,935
Avail to Heirs	$100,000	$0	$100,000	$0	$100,000
		Notes 1, 2		Notes 1, 2	Note 3

1 Some income is return of capital and not taxed.

2 Annuities can have a joint survivor, but the benefit reduced due to longer payout

3 Assumes 30% of income is ordinary taxed, 70% is capital gains taxed

investment options, we'll take a look at twin brothers, **Tom and Jerry**. They both are age **65, have $100,000 to invest and expect to live another 20 years.**

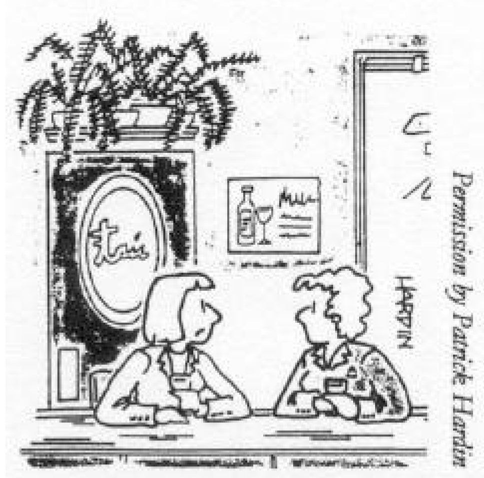
Tom is very concerned about outliving his money and decides to invest in a **fixed annuity paying 6% for a minimum of 20 years and based upon his life expectancy only**. As the table shows, he earns about the same as a CD ($220,714), but pays a little less in taxes since part of his income is a return of capital. His net gain is $159,429 over twenty years and, if he then dies, he has left nothing to his heirs.

Note that **CDs, Fixed Annuities and Bonds all make level payments with no increases to offset inflation**. **Over twenty years, 3.5% inflation will cause Tom's expenses to roughly double.**

Jerry, on the other hand, is concerned about meeting his expenses over the next twenty years. He has heard that only some exposure to equities will offset inflation over a twenty-year period. He **must decide between a variable annuity and mutual funds**.

As you can see in the table, the **higher expenses associated with the variable annuity reduce the net after tax number**. Jerry would earn $249,000 in the variable annuity and $350,000 in mutual funds.

Jerry would incur much more risk in either account and he would have much more money to offset inflation. Notice that Jerry would have nothing left for his heirs in a variable annuity.



"I'm tired of flirting with small-cap success – I want it to commit."

Remember, Jerry annuitized his variable annuity over his life. If he had not yet annuitized, the remaining amount in the variable annuity is payable to his heirs within five years (gains taxed as ordinary income).

One of the selling points to a **variable annuity** is that they **will guarantee that the final amount will be at least what you contributed**. Since 1926, there have been few down market years (20); only two ten-year periods where stocks were negative; and there are no twenty-five year periods where stocks were negative. Thus, **the no-loss guarantee is a pretty safe risk for the insurance company to take, especially with you paying about 1.25% annually for the privilege.**

Another thing to consider is that annuities pay 6 – 14% commissions to the agent. This is generally much higher than commissions on mutual funds. Keep that in mind when considering which course of action is best for you.

Earnings from annuities are taxed at ordinary income tax rates vice lower capital gains rates. Also, unlike stocks and mutual funds, there is **no step-up in tax basis upon death for annuities**.

So who is better off, Tom or Jerry? Well, it depends. If Tom's money was in a bank savings account earning only 3% and he will lose sleep if any of his investments are in the stock market, the annuity may be just fine for him. He might want to consider bonds, though.

If Jerry is in poor health and very concerned about a down market, he might be willing to pay the extra expense of a variable annuity. On the other hand, if he is concerned about maximizing his performance as well as leaving an inheritance, he might prefer the mutual funds.

The key is understanding what the various options can and can't do and what they cost.

RETIREMENTS

Social Security, When to Take It?

When do you plan to die? Seems kind of crass, but this has a dramatic impact on when you should start taking Social Security (SS).

Other issues in the equation include your **work plans** (what me work?) and your **income needs**.

You can **start taking SS retirement benefits as early as 62 (reduced 20 – 25%), or at normal retirement age (66 for us boomers) or even delay it until age 70**.

Quite simply, **if you are working and in good health (with family history of longevity), waiting until age 70 may pay big dividends**. If you live until age 81, you will earn more than if you had started receiving benefits at age 65 (even though there would be no offset for wages).

The age 62 or age 65 issue balances out at age 77. If you wait to 65 and live past age 77, you win.

If you are in ill health (hypochondriacs don't count) **you probably should take SS early**. If you just need it, take it.

For those who were wondering, here are the numbers (maximum benefits): **62 - $1,248, 65 - $1,767**, **70 - $2,895**. As you can see, waiting can have a big impact on your monthly income. **Since women routinely outlive men, women especially should consider delayed SS retirement**.

Having said all the above, I realize that the numbers aren't the only factors. **Many clients would rather "have a bird in the hand"**. After paying into the system for all those years, they want to get some of their money back.

Those **clients working past age 65 get tremendous satisfaction from also receiving SS retirement income.** Many people would rather have the money when they are younger. They expect to slow down by age 75, so having a lower benefit might not be as important.

One final consideration is that, if you are taking SS while leaving your IRA assets alone, you may be better off in the long run.

DISABILITY

Disabled Child at Home

Many families with disabled children have them still living at home when the child reaches age 18 and becomes eligible for **Supplemental Security Income (SSI) and Medicaid benefits**.

One issue that invariably comes up when applying for benefits is the child's **"fair share"** of **household expenses and the "one-third reduction rule".**

In determining benefits, food clothing and shelter provided by the parents are considered "in kind" income and reduce the available benefit. Rather than compute the actual "in kind" income, Social Security will compute what the child's fair share of expenses should be.

The child's fair share is computed by adding the costs of the mortgage, house insurance, repairs, utilities, telephone (but not cable) and food and dividing by the total number of people in the home.

Rather than deduct the full cost of the child's fair share from the SSI benefit, Social Security generally will just deduct one-third.

If, after SSI benefits start, you **have the child repay you for the child's fair share**, you can report this to Social Security and they will **resume full SSI payments**.

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