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BFAS Money Line

INVESTMENTS

Is There Light at the End of the Tunnel?

Or is it a train? Only the bear markets in 1946 – 1949 and 1973 –1974 were longer than our current downswing. September's tragedy seems to have delayed the economic recovery expected in the fourth quarter.

October was a welcome respite from the unrelenting negative market news. The **market low was September 21st**. Time will tell whether it marked the bottom of the bear market.

Amazingly, the same **media** that was trumpeting the technology bubble with, "It's different this time" are **now pious devotees of diversified portfolios.**

Virtually everyone who had much stock exposure has seen their portfolio shrink in the last nineteen months. Even the best-diversified portfolios have dropped 10% - 20%.

Yet, a number of people have come to me recently with portfolios that are down 40% - 60%. I'm not talking about 20 – 30 year olds who just wanted to take more risk; I'm talking about retirees!

Who hasn't at least considered taking their money off the table by now? Most of you, I am sure. Yet, **those who took their money off the table in September have already missed the 10% increase since then**. It seems like, when your gut tells you to do something, alarm bells should go off, along with a flashing sign saying **do just the opposite!**

No one knows if the market will continue its upward trend. Generally, the market anticipates the economy, so a recovery in the second half of 2002 could bode well for the market.

The following table shows the dismal story for equities.

Asset Class	1 Yr Return (10/31/01)
S & P 500	-24.89%
NASDAQ	-49.84%
Lg Cap Gwth	-40.32%
Lg Cap Val	-16.16%
Mid Cap Gwth	-33.66%
Mid Cap Val	+ 4.62%
Sml Cap Gwth	-39.53%
Sml Cap Val	+ 5.19%
Foreign	-24.93%
Interm Corp Bds	+14.26%
Foreign Bds	+9.22%

There are economists whose views support just about any bull or bear theory you might have. Generally, I believe we will see modest growth for the near and intermediate future.

Anchoring

One thing I have observed as the markets have rebounded is a **lack of enthusiasm for recent gains**. This is typically due to a phenomenon called anchoring.

Investors remember with great clarity the amount of their portfolios at the peak of the technology bubble. They feel the losses since then quite personally. Since the market "bottom" on September 21st, the NASDAQ is up 16% and the S & P 500 is up over 10%. Yet, no one is cheering!

As an example, take someone who had a $100,000 portfolio at the peak of the bubble, saw it drop to $70,000 then rebound to $80,000. They are not happy. They discount the gain because they are measuring everything against the peak.

This anchoring is a natural human phenomenon, but it prolongs the bad feelings long after the portfolio has started to recover. **Take a look at how you are relating to your portfolio in light of the above and see if you can feel a little better about how you are doing!**

Where to Get Income?

In an effort to stimulate the economy, the Federal Reserve continues to lower interest rates. This is great if you are looking for a new car; but not so great for those who live off the interest from their principal.

Money markets are paying up to about 2.6%. A one year CD pays 2.9%, three year CD pays 4.1% and a five year CD pays about 4.75%. Treasury's are paying less, 3.6% for 5 years and 4.35% for 10 years.

So what's a person depending upon interest income to do? **I am concerned that people will be swayed by the siren song of higher returns in much riskier investment vehicles.**

I once checked out an advertisement that touted a **safe and secure 12% return**. My investigation found that the investment was a preferred stock in a company that used the money to purchase public telephones. The **12% return was dependent upon revenues from these telephones**.

You remember what public telephones are, don't you? That's those things people used in the dark days before cell phones. How do you think those revenues are doing today? **Do you think the investors are getting their 12%? Not likely!!**

Other options sometimes seen are **senior promissory notes and prime banknotes**. **Senior promissory notes are often touted as safe, yet their quality is not rated by the normal rating agencies**.

While the rating agencies are not perfect (debt rated investment grade has defaulted on occasion), I would much rather have an informed opinion on debt before I trust someone with my money.

Prime banknotes are issued by foreign banks. Again, you may get swayed by an attractive interest rate, but the **opportunity for fraud is high**.

Yet, time after time, people will fall prey to the words safe and secure, focus on the interest rate and invest without understanding what they are putting their money into.

Another option for those looking for income is the **annuity**. If you have a bank account, no doubt you will be accosted by a bank salesperson wanting to talk to you about an annuity.

An immediate fixed **annuity can pay 5.5% to 6.5% annually for your life**. Annuities are relatively safe since they are guaranteed by the insurance company that issues it. However, you should know how financially strong that insurance company is, since that is critical to your long-term payment safety.

Some annuities will offer a **teaser rate the first year of 7%, then drop down**. While annuities can be a partial solution, you can't take out a lump sum if you need to replace your air conditioning or other emergency need.

In addition, **when you die the annuity stops**. Sometimes they may offer payments for a minimum of 10 or 20 years, so that your spouse or your heirs will receive some return on your money if you die early.

As an alternative to a balanced and diversified portfolio, annuity returns are generally inferior. However, as an alternative to money in the mattress or CDs, it has significant advantages.

Thus, if you have good genes and can expect to live a long life, an annuity can be useful for a portion of your money. If you are in poor health, make sure to obtain a term certain payout option (10 – 20 years). Always keep some money outside the annuity to cover rainy-day situations.

BUDGET

Refinance?

Another thing you should be thinking about in this low interest rate environment is **refinancing your mortgage.** Mortgage rates are lower than in many years. In some cases the old thumb rule of needing a 2% decrease in interest rate to justify changing does not apply.

There are a **number of factors** to consider in choosing to obtain a new mortgage. First is your **current rate** and second is **your plans**.

Will you be staying in the home forever, 10 years, 5 years, 1 year? Is your job situation stable? Could you be laid off and have to relocate?

The **longer you will be in your home, the longer you have to pay back the closing costs of a new loan**. For example, a person with 7.5% mortgage might recoup the costs of **refinancing a new loan at 6.25% over 24 months**. This loan would not be appropriate for those with job uncertainty or who plan to move within 2 or 3 years.

"You must be the fellow who asked to see one of the clowns who runs our fund's research department."

On the other hand, those who are permanently in their home might want to **pay points to lower the interest rate to 5.5%**. This might push the breakeven point out to 4 – 6 years, but would save substantial money over the life of the loan.

When you look for low cost loans, **make it a point to find out all the costs**. **Internet rankings of loans typically use interest rate, points and loan origination fees to determine rankings**.

Understanding how to "game" the system, some mortgage lenders will **quote zero points and zero loan origination fees**; but further digging shows that the **document preparation fee**, which is not counted in the rankings and **usually runs $300 - $400 can be as high as $1,800.** Obviously, they are "hiding" their loan origination fee in the document fee.

There are a number of other fees as well. I provide the following list of sample fees to give you an idea of what to expect:

Appraisal	$300
Credit Report	$55
Recording	$300
Escrow	Varies[1]
Title Insurance	$300[2]
Attorney	$350
Tax Service	$90
Document Prep	$300

1. This varies with the amount of taxes and insurance.

2. Based upon a percentage of the home value.

Note: These fees are in addition to Points and Loan Origination Fees.

One option for those who don't want to pay closing costs: **sometimes your current lender will allow you to "reset" your loan to the prevailing rate plus about .5% with no closing costs**. Not all lenders do it, but it could be worth the phone call to find out!

TAXES

Harvesting Losses

This is the season to **review your portfolio for potential tax losses**. Last year, most equity mutual funds lost value, yet distributed dividends and large amounts of capital gains.

Thus, many people not only suffered the indignity of watching their portfolios drop 10% - 15%, but also paying thousands of dollars in income taxes on the distributions.

How can a mutual fund have gains to distribute, you say, when they lost money? Here's how. Say a mutual fund manager bought Cisco stock years ago at 10, then watched it go to 80.

Last year the manager watched the stock drop faster than the market and sold some at 60, either because they lost faith in the stock or to generate cash to pay those people who redeemed their mutual fund shares.

Although the stock inside the mutual fund had dropped 25% and helped cause the mutual fund to drop 10% - 15%, the sale generated a capital gain of $50 per share. At the end of the year, **this gain must be distributed to shareholders, whether or not the mutual fund itself increased or decreased in value during the year**.

Thus, this time of the year is a **good time to look at your portfolio to identify those funds where you have losses to be harvested or to identify those funds that may be getting ready in December to distribute a large gain**.

If you find a fund that can generate a tax loss and is expected to distribute capital gains, you can have a twofer by selling the fund before the distribution date. The distribution date is the date the fund uses to determine who the shareholders are and how many shares they have. If shares are sold before the distribution date, you don't receive the distribution and don't pay the taxes.

If the fund is a great fund and you want to retain it in your portfolio, you may want to sell it before the distribution date, wait 31 days, then repurchase it. This eliminates the taxable distribution and the 31 day wait avoids IRS's "wash sale" rules.

I can tell you that most funds I have contacted this year say they plan no, or very small, distributions. Most of the imbedded gains were distributed last year.

Thus, you have **two things to consider, selling to harvest capital losses and/or selling to avoid possible capital gains distributions**. Take a look at your situation!

RETIREMENT

Thrift Savings Plan

Military members currently have a window until the end of December to choose to have **up to 7% of their pay withheld starting in January and invested in the Thrift Savings Plan (TSP).** Virtually identical to the Civil Service TSP, this plan has five options: **Govt. Securities (G Fund), Fixed Income (F), Common Stocks (C), Small Cap (S) and International Stock (I).**

These funds have very low costs and are a very good option for most members. I **strongly recommend they take advantage of this new retirement planning opportunity!**

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