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BFAS Money Line

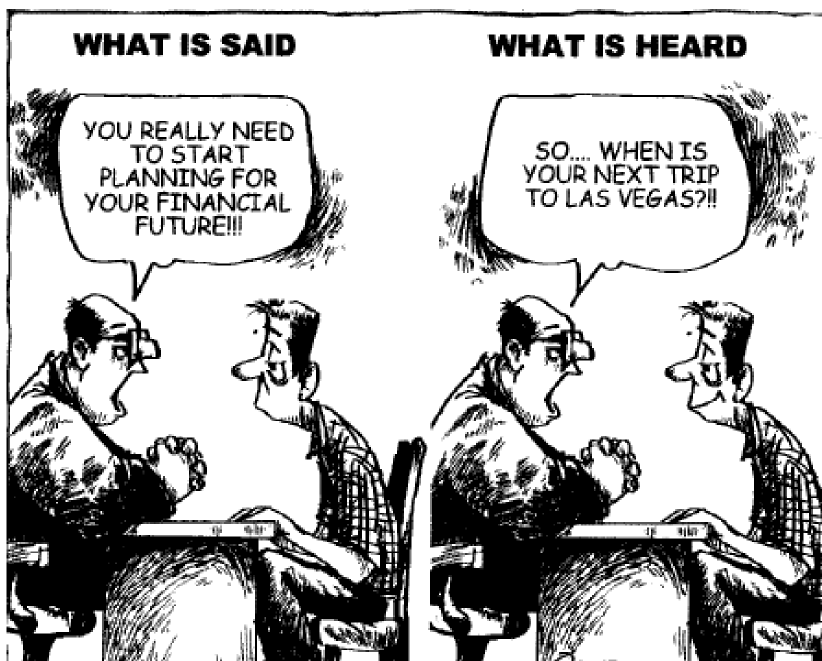
Silver Lining?

After a small rally in August/September, October stole all of this year's gains in the U. S. market. Thankfully **foreign stocks (especially emerging market and small company foreign stocks) have had a very good year**.

The market's laggard performance has a silver lining. In **early 2000** the **Price/Earnings (P/E) ratio of our market was about 29** versus a **long-term average of 14 – 16.** In those days the concerns of conservative investors were shouted down by pundits who trumpeted, **"It's different this time"**. Since January 2000, the "P" in P/E has hardly budged, while the "E" has almost doubled. Thus, the **market's current P/E is down to about 16**.

Having earnings growth help the market to revert back to a more normal market P/E is much preferable to a sharp drop in the market's price. Just think back to 2002. The market dropped 22% and that was much more painful than this year's flat price with rising earnings.

Hey Ron, you may say, I can't spend that earnings increase! While that's true, your current holdings are much more likely to hold their value than a year ago. There are much better earnings backing up current prices than a year ago.



Some will complain that past retrenchments in P/E ratios have continued until the P/E ratio undershot to about 7. Such a scenario would either lead to lower prices (by half) or flat prices while earnings doubled again. Even if that happened, it should be temporary (a year?) and the market would again revert to the mean of 14 – 16 P/E.

To summarize, **from where we are today** (barring the usual unforeseen circumstances), **we should see moderate market growth (roughly equal to earnings growth plus inflation**). That doesn't mean the ride will be smooth. As always, there will be bumps in the road.

One of the impacts of the rioting in France is continued downward pressure on the Euro. Even though, we have significant government and trade deficits, the world seems to feel the dollar is a safer place to put their money than the Euro. Hence, the dollar (against all odds) has strengthened this year versus the Euro. For you travelers, that means you'll pay a little less for your European vacations!

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

Asset Class	1 Yr Rtn (10/31/05)
S & P 500	+ 8.72%
NASDAQ	+ 7.36%
Lg Cap Gwth	+ 6.23%
Lg Cap Val	+12.23%
Mid Cap Gwth	+16.40%
Mid Cap Val	+19.12%
Sml Cap Gwth	+12.26%
Sml Cap Val	+16.05%
Foreign	+18.09%
Interm Corp Bds	+ 1.28%
Foreign Bds	+ 0.62%

Equity Indexed Annuities

One of the hottest products on the market these days, the **equity indexed annuity (EIA) is an insurance product that is often touted to protect against losses while providing market-like returns**. While it does protect against losses, it's the "providing market-like returns" that is in doubt.

Who wouldn't love to have a product that would perform much better than a CD or Treasury Bill, yet provide similar protection against loss? As an annuity, it is protected by the security of the insurance company against loss.

On the upside, there are a myriad of methods by which an EIA can track the market. Most investors (and salespeople) have no clue what an EIA will provide in the way of returns. When asked what return their EIA would provide if the market was up 10%, most people would say either 10% or 10% minus the usual 1.5% EIA expense.

In fact, many EIA's cap the gain in any one year at a level (7% for example, or limit your participation in the growth of the market (say 55%) so that **your actual return if the market goes up 10% might be 4% - 5.5%.** Also, **remember that the 10% return in a market index fund would be taxed at a maximum rate of 15% upon sale, whereas returns on your EIA are taxed as ordinary income (often twice as high as your capital gains tax rate).**

Note: Yes, there is an exclusion ratio that limits the amount of your taxable income from an annuity in the early years because some of your annuity payment is a return of your principal, but over the long term you are still paying ordinary income tax rates on all your gains.

Currently, there is very little regulation of the marketing of EIAs because they are insurance products. However, since they are widely advertised as investment vehicles, the NASD and the SEC are seriously considering regulating them as investment products. This could reduce the amount of unrealistic and inflated claims made about EIAs.

Often, EIAs are advertised as providing a safe 9% return. This hardly seems possible since the market's long-term return of 11% includes 2% of dividends (which EIAs don't count). Thus, an EIA would need 100% participation and have no expenses to even approach a 9% return.

A recent study of EIAs (*Exploring the Equity Indexed Annuity: An In Depth Look for Financial Advisors by Mitchell M. Maynard, November 3, 2005*) and their various crediting methods showed dramatic differences in overall returns. **Back testing various EIA crediting methods over the 1965 – 2005 timeframe showed returns from 3.5% to 6.34%**.

Only about 5% of EIAs use the crediting method that provided returns over 6%. The majority earned about 4%. This 2% difference in returns really adds up over ten-to-fifteen years. However, you can see how the high commissions (and the promised but elusive higher returns) make them such a popular product.

Just don't fall for the pitch of "stock market returns without the risk". It's not true and repeating it often enough and long enough will never make it true!

College Savings

(*The following article was written by David John Marotta of Marrota Asset Management*)

A lot of money has been pouring into 529 college savings plans since their inception in 1994. Like the Gold Rush the benefits seem too good to pass up. As of 2004 over $54 billion has been invested. We've surveyed your options and can steer you clear of the fool's gold of 529 plans.

There are two kinds of 529 plans: college saving plans and prepaid tuition programs. We recommend college savings plans to maximize both flexibility and growth.

All college savings plans offer growth exempt from federal taxes. Some states also offer a full or partial state tax exemption. Withdrawals can be made for any required college expense such as tuition, room and board, and books. Funds can be used to pay for costs at most public or private, in-state or out-of-state colleges and universities. Although your principle investment is not guaranteed against losses, we believe the risk is worth the return if you child has at least five years before college.

Prepaid tuition programs are very different. They allow you to contract for a set amount of future education benefit from your state. They allow you to lock-in tomorrow's tuition costs at reduced tuition rates. But what you gain in stability, you lose in flexibility.

Prepaid Tuition Programs

Many are attracted to the stability and guarantee offered by prepaid tuition programs. Virginia residents may enroll in the Virginia Prepaid Education Program (VPEP). VPEP provides a quick solution to the problem of rising tuition costs but like other prepaid plans, the numbers don't add up.

Prepaid tuition programs limit your growth and spending opportunities. While your prepaid investment is guaranteed to increase at the rate of rising tuition costs,

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

it will never exceed the average rate of tuition increases. Unlike savings plans, prepaid programs cover tuition only and cannot be applied to cover the costs of the other 65% of college expenses such as room, board, books or supplies.

Prepaid tuition programs also dramatically reduce your financial aid eligibility. They are considered a "resource" (instead of an asset). Therefore, funds in a prepaid program are assessed at 100% their value. For every dollar invested in a prepaid tuition program, your financial aid eligibility will be reduced by a dollar.

Transferring your prepaid tuition benefit out of state may cost you much of your investment. To transfer your education benefit out of state, Virginia's prepaid program will pay either the average Virginia in-state tuition cost or your principal investment plus a small amount of interest, whichever is less.

Take for example one of our client's children whose grandparents bought him a prepaid Virginia plan. Purchased for $15,268 in April of 1997, the child is now a high school senior applying to colleges. If he decides to go to a Virginia public college, his in-state tuition costs will be covered. Today, four years of tuition benefit is worth, on average, $24,260 or a maximum of $34,664 at the most expensive Virginia public university. This represents an annualized gain of between 6.5% and 10%. The prepaid tuition plan is a good deal only if he attends the most expensive public college in Virginia.

However, to attend a Virginia private school, the VPEP will pay a total of $26,175 which represents an annual 6.4% gain. While these rates of return aren't as good as the 8% you would expect in other 529 plans, they aren't bad. But the real risk of the prepaid tuition option lies in limiting your student to in-state schools only.

If he decides to attend an out-of-state school, the payments drop off sharply. VPEP will only pay $19,966, a mere 3.2% annual gain. Even if the money had been in the volatile S&P 500 during some of the worst years in the markets, the accounts still would have made 5.4% annually and be worth $24,076. Prepaid programs are not safe. They just assume a different type of risk. Your choice is which risk you want to take: The risk of your child not wanting to go (or not being accepted) to an in state school or the risk that your diversified college savings investments won't average a 6% return.

We prefer trusting in a diversified portfolio and having the flexibility of cash.

College Savings Plans

Of the college savings plans, we recommend Virginia's CollegeAmerica both for residents and non-residents of Virginia alike. The best plans offer low fees, high quality investment options, and flexible asset allocation models. Many also offer state tax benefits for residents.

Still among the best plans is the Utah Education Savings Plan Trust. Utah's image took a hit when former executive director Dale Hatch was recently convicted on fraud charges for channeling a half million dollars to secret bank accounts. But, Utah's funds are still some of the finest college investments. Sometimes the safest place to put your money is in the bank that was just robbed! Security and checks and balances couldn't be tighter in the wake of this scandal.

529 funds are classified as municipal funds because they are state-run. The SEC does not police municipal funds as it does other securities. This lack of SEC oversight may have contributed to the recent turn of events in Utah. Lack of SEC oversight has also contributed to the confusion caused by non-standard fee disclosures.

We've listed some of the best and worst 529 plans according to Morningstar and Forbes magazine. If you aren't in the best plan, it is easy to change. Savings plan owners are allowed one tax-free rollover each year. If you are invested in a prepaid tuition program, you may be able to roll over your investment into a savings plan. Before investing in a 529 plan or rolling over your account, seek advice from a fee-only financial planner.

Best and Worst Savings Plans From Morningstar and Forbes

Best

Virginia CollegeAmerica
Utah Education Savings Plan Trust
Nevada Vanguard 529 College Savings Plan
Michigan Education Savings Program
Alaska T. Rowe Price College Savings Plan
Colorado Scholars Choice College
Kansas Learning Quest Education

Worst

Wisconsin EdVest College Savings
Arizona Waddell & Reed InvestEd Plan
Arizona Family College Savings Program
Wyoming 529 College Achievement Plan
Ohio Putnam CollegeAdvantage
Alabama Higher Education 529 Fund
Maine NextGen College Investing Plan
Tennessee BEST Savings Plan

Trusts

In reviewing regular and Special Needs Trusts (SNT), I often see language that can cause problems in the future. **One of the biggest problems is creating a conflict-of-interest**. This is usually not a lawyer-drafting problem, it's a client-driven problem.

For example, a client will be concerned about the cost and impersonal control of using a corporate trustee. Thus, they will direct that a family member be trustee. This can be beneficial in SNTs because the family member may look out for the beneficiary, amounts may be small and it can keep costs down. However, what if the ultimate beneficiary of the SNT is the trustee's children? The more money the trustee spent on the beneficiary, the less would be ultimately available for the trustee's children when the beneficiary dies.

I have personally witnessed the **distrust of motives (and subsequent legal costs) that creating a conflict-of-interest can cause**. **Please think through all of these issues when giving guidance to your attorney!**

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