

BFAS Money Line

INVESTMENTS

Is There an Upside?

After a promising start, the market has given up its gains this year. Earlier, the uncertainty of the Presidential election and Iraq troubled the market. Now, it seems to be high oil prices and possible terrorist attacks. **Historically, presidential election years have ended up 9 – 11% with all the gains in the last half of the year.**

While the **economy is doing well** (companies earning record returns, jobs being created although slower, interest rates low and inflation low), we seem to be in a **transition period between a consumer driven economy and a business driven one.**

Businesses have been slow to spend on plant and equipment. They have been using higher productivity to increase production rather than building and hiring. Quick productivity gains have been exhausted. **Future production increases will require spending and hiring, which should carry the economy forward.**

Even though the economy is doing well, higher than normal Price-to-Earnings ratios lead most



prognosticators to believe that stock returns will be modest (5 – 7%) in the near term. With U. S. bonds likely to lose ground due to rising interest rates, **those looking for 8 – 10% returns from their portfolios in the next five years could be disappointed.**

So, should you resign yourself to modest returns? Where's the best place for your money? There are many greener pastures out there. Should you jump into them?

Foreign stocks have significantly out-performed domestic stocks over the last three years. Emerging market stocks have done even better. On the domestic front, value stocks have significantly out-performed growth stocks during the last three years.

Portfolios with 30 – 40% bond holdings along with exposure to foreign stocks and over-weighted in value stocks have tended to match S & P 500 returns recently with 30 – 50% less risk. **Risk is often ignored in the stampede for higher returns.**

As this decade nears the midway point, **the S & P 500 is still down about 20% since January 1, 2000.** With the natural human tendency to project the past into the future, we tend to have a gloomy view of the future based upon the recent past. That is just as wrong as the euphoria many felt in 1999 towards the end of the Internet boom.

The natural response to this period of no/slow growth is to listen to the siren song of higher returns elsewhere. For

some, that means finding a successful stock picker or market timer.

Others are looking at hedge funds, private equity or separate accounts. Some are looking at hard assets, like oil-and-gas or real estate. They see oil prices rising and think that's the place to be. Or, **they have watched their home value increase substantially (and consistently) over the last fifteen years and wonder why they should bother with volatile stocks and bonds.**

Big bets on one sector or another are risky since the various **sectors tend to rotate between top and bottom performance. Market timing** has gotten even more bad press recently as a result of Elliot Spitzer's indictments of mutual fund companies who facilitated market-timing activities. Mark Hulbert, who tracks the performance of hundreds of investment newsletters says fewer than 20% of market timing newsletters beat the market.

My own experience with market timing is limited to two clients who lost 30 – 40% of their portfolios in 2000 with a market timer. Both were moderate risk investors who believed market timing would reduce their risk. Their portfolios were in and out of the NASDAQ and S & P 500 all year. Since the NASDAQ lost 39% and the S & P 500 lost 9%, equal investments in both all year would have resulted in a loss of only 25%. In addition, the timer charged 3% annually for this service.

Hedge funds are all the rage today. They generally have high minimum

investments (which gives them cachet) and promise returns of 10 – 12% in both up and down markets. These funds have high costs, virtually no regulation or oversight and spotty track records. I've looked at them and I'm not yet convinced they belong in client portfolios. Only time will tell whether or not hedge funds are just the ticket or the next dot.bomb.

Similarly, **separate accounts** have high minimum investments and promise access to top investment gurus for only \$100k - \$250k. Expenses are generally higher than mutual funds, but promoters say returns are higher because they can be more tax efficient than mutual funds.

I have not done a widespread analysis of separate account performance (performance information is not readily available), but where I have analyzed the performance of the same manager using the same style in both a mutual fund and a separate account, he had better performance in the mutual fund.

Tax efficiency is important, but can be overrated since it's relatively easy to sell a mutual fund to harvest losses (a separate account manager can sell individual stocks to generate losses). Separate accounts are not as liquid as mutual funds, but it's sexier to be in something not available to everyone.

Most separate account portfolios I see are not sufficiently diversified since the high minimums drive them to use only two or three accounts. Rarely is the separate account investor aware of the higher risk

of his concentrated portfolio. When your separate account manger is in one of the hot sectors of the market, it does well (just like a mutual fund). When the market turns, they fall just as well, without the cushion of a widely diversified portfolio.

Private equity and oil-and-gas are relatively high risk and only appropriate for investors who are both comfortable with the risk and can meet the minimum investment without tying up a large percentage of their portfolios.

Exchange-traded-funds (ETFs) are one category of new investments that have a role in many portfolios. While they trade on the exchanges like stocks, they provide the diversification of holding all the stocks of whatever indexes they track.

Costs are very low and taxable distributions are virtually nil. While I believe active mutual fund managers will out-perform indexes in a sideways market, the tax efficiency and low cost make ETFs **very attractive in the taxable portfolios of high-income investors.**

A sidebar on costs: I **have seen high cost** (see the market timing comments) **portfolios do poorly and I have seen low cost portfolios do poorly.** Some low cost funds, like Vanguard, that I have tracked have significantly under-performed actively managed, higher cost funds.

Sure, I've read Vanguard-founder John Bogle's book (even had a beer with him once) that says indexes beat

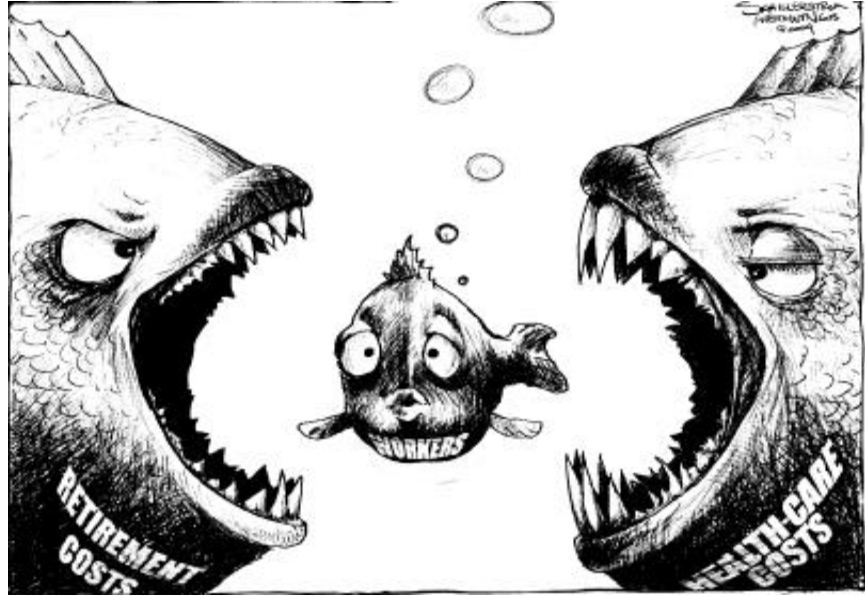
their active rivals 80% of the time, so low costs means higher performance. I have to say that I can't agree with the **basic premise of all these cost comparisons: performance is the same, thus cost is the only difference in performance.** I find that performance is not the same. Thus, I look for **performance after costs.** If some manager can provide top performance even after incurring higher than normal costs, more power to him or her!

Real estate is one investment most people are familiar with since many are homeowners. The recent (fifteen year) trend has been up and, thus, we tend to assume that trend will continue unabated.

Most people see no problem with maximum loans, sometimes interest only. Equity value will only increase right? Not necessarily. Although many have forgotten, and the danger is probably worse in other parts of the country than Hampton Roads, **real estate values can go down, and steeply (25%).**

Most people already have ¼ to ½ of their net worth tied up in real estate; their home. Some are wondering if they should put their money into a vacation property where they could enjoy themselves while receiving rental income. This seems less risky than the stock market.

While real estate has averaged a **3% increase in value over the long term,** it seems like everyone knows someone who bought a vacation rental that doubled in



value in four years while providing sufficient cash flow to pay the mortgage. It's not unlike five years ago when everyone knew a Dell, or Microsoft, or Intel or Yahoo millionaire. They assumed they could do the same in Enron, Worldcom, etc.

What happened in real estate the last few years probably won't be repeated in the near-term. Some will find their equity declining below their maxed out mortgage while their variable interest rate is increasing. They will be trapped with high payments on a house they can't afford to sell.

Real estate has a role in everyone's financial assets. However, **it should neither be the sole asset, nor even the majority.** Real estate is not a liquid asset available to you whenever you need it. Sometimes, people damage your property, sometimes its empty. **Stocks and bonds and mutual funds never call on Friday night to tell you the air conditioning broke**

and must be fixed in the next ten minutes!

The table below shows what the various markets did in the last year:

Asset Class	1 Yr Rtn (07/30/04)
S & P 500	+13.16%
NASDAQ	+08.78%
Lg Cap Gwth	+08.48%
Lg Cap Val	+16.63%
Mid Cap Gwth	+14.84%
Mid Cap Val	+24.03%
Sml Cap Gwth	+13.20%
Sml Cap Val	+23.36%
Foreign	+25.05%
Interm Corp Bds	+4.67%
Foreign Bds	+ 6.62%

Mortgage Options

As I said in the opening article, I am **concerned about those who**

chose interest only and/or Adjustable Rate Mortgages (ARMs). I am well aware that a 4% mortgage, especially interest only can dramatically reduce your monthly payments. However, if that's the only way you can afford your home, you could be putting yourself in jeopardy.

I would be less concerned if you had that 4% ARM locked for five years and plans to move within that time. I know many have said, if interest rates go up, I'll just refinance. Think about it. It costs about 2 – 3% of your loan to refinance and interest rates will likely be higher than today.

For example take an ARM based upon 1-month LIBOR rates plus 3%. Today, that rate would be about 4.5% and you'd only pay about \$375 per month interest only. Principal and interest on a fixed 6% thirty-year loan would be \$605 per month. That \$230/month savings (\$13,821 over five years) can be enticing.

If that savings is being put into retirement accounts or used to pay down the mortgage principal, this strategy could make sense. If, however, the savings just covers normal household expenses, a day of reckoning could be coming. Five years ago, the 1-month LIBOR was 5.2%. If your interest only payment five years hence is 8.2% (5.2% + 3%), you would pay \$683/month. Fifteen years ago, the 1-month LIBOR was 10% and this would present you with a \$1,083 monthly payment!

ARMs have a role in mortgage planning if used

correctly. Used incorrectly, they put your financial house at risk!

Roth IRA vs. 529 Savings

Since Roth IRA money can be withdrawn penalty free for college, some wonder whether to contribute to a Roth IRA or a 529 College Savings plan. **My answer is both!**

If you can contribute to one or the other, the **Roth IRA is first choice. Your child can borrow to pay for college; you can't borrow for retirement.**

The advantage of Roth IRAs is the tax free compounding and tax free withdrawal after 59 ½ . You can also withdraw money from a Roth IRA before 59 ½ for qualified higher education expenses for yourself, your spouse, your children or your grandchildren.

If your qualified withdrawal before 59 ½ is less than your total contributions, you pay no tax or penalty. If you dip into your Roth IRA earnings for college expenses, you will pay ordinary income tax but no penalty on the earnings.

Medicaid Waiver Criteria

This year, Virginia funded 860 new Medicaid

waivers, more than the last three years combined. These waivers are important to families of Mentally Retarded children because they **offer day services, respite care and, when needed, a group home for their child.**

This wonderful increase still does not meet the need of the **1,388 people on the urgent-care waiting list plus the thousands more on the non-urgent-care waiting list.**

Thus, it is important to meet the **criteria to get on the urgent-care waiting list.** Those criteria include:

1. **Primary caregiver age 55 or older.**
2. **Child is living with caregiver who can no longer lift or bath the child.**
3. **There is a clear risk of abuse, neglect or exploitation.**
4. **The caregiver has a chronic or long-term physical or psychiatric condition that significantly limits his abilities.**
5. **The child might become homeless.**

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