CREATIVE Wealth Maximization Strategies

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What do I do *now*?

Remember the optimism of the new millennium? Remember the "new economy," led by 25-year-old dot-com millionaires and venture capitalists? Remember how double-digit returns in the stock market were just there for the taking? Somehow the math never met the expectations.

In fact, the numbers are ugly, almost unbelievable. In recent memory, there hasn't been a stretch in which investment results have been so persistently bad. According to a 2002 Investment Scorecard published in the January 3, 2003 edition of the *Wall Street Journal*:

- The Dow Jones Industrial Average dropped 6.2% in 2000, another 5.44% in 2001, and then plummeted 15.01% in 2002.
- The S & P 500 index showed even worse numbers, dropping 9.1%, 11.9% and 22.1% over the same three-year period.
- As for mutual funds, Lipper's Growth Fund Index showed a decline of 10.88% in 2000, followed by a 17.98% drop in 2001, made even worse by a 24.2% free-fall in 2002. By our calculation, a $100,000 balance invested in the index on January 1, 2000 had decreased in value to $55,406 by December 31, 2002.

Of course, you could have sold out of the market as things started to go south, but where would you have put the money?

- According to the Bankrate.com National Index, a one-year Certificate of Deposit (CD) would have yielded, on average, a 5.46% annual return in 2000. By 2001, the annual rate dropped to 3.6%, and in 2002, was even lower – just 1.98%.
- Money Market accounts showed the same trend, dropping from 5.83% in 2000 to 3.66%, then 1.27% over the next two years. *1.27%....?* Are you kidding?

What happened?

How did the "irrational exuberance" of just a few years ago become *so* dispirited that John Bebow's headline in a February 23, 2003 *Detroit News* front-page article reads "Millennium sparkle fades into darkness?" Why is everyone so grim?

Well, let's see.

There's Enron, and Worldcom, and related accounting scandals.

There's September 11.

And anthrax.

And as retirement accounts are knocked down by tumbling markets, the dream of a projected retirement slips further back on the horizon.

Big old-line companies like Bethlehem Steel announce they intend to discontinue retirement and health insurance benefits for all 95,000 retirees.

The personal financial magazines have stopped touting stocks to "buy now," and instead are talking about how to maximize the inheritance from your parents.

And by the time you read this, the United States may be at war with Iraq.

It's enough to make even die-hard optimists say, "Hey, while I bet there's a silver lining in all this (I hope), things seem a little rough right now."

So…when it comes to financial planning, the question everyone seems to have is:

What do I do now?

First, try to get some perspective. Although it's probably the first time for many of us, this isn't the first time the economy has been in the dumper and other troubles have loomed large. Remember the Great Depression? (Or the Dark Ages?) Based on previous history, it's reasonable to say, "this too shall pass." It sounds hokey, but good plans start with good attitudes.

That's not to say that all your financial issues can be solved by saying "don't worry, be happy." Success comes from action. There are some general financial principles that have a proven track record – in good times and bad – but to be effective, they need to be implemented.

(Of course, every situation is different, so your specific plan of action may require some unique adjustments, but that's what your financial advisors are for, right?) Here are a few essential thoughts.

Stick with the basics. Keep saving. Somewhere in the middle of the last bull market, "financial planning" became "how to invest in the stock market." Every company, every advisor, every broker jumped on the bandwagon with portfolio models and statistical analyses that held the key to unlocking a stock market bonanza. Just add money, let simmer for 15 or 20

years, and "poof," you have a golden retirement. Nobody ever said the "poof" would be your investment shrinking.

At the core, financial planning is really about saving. It's not about the stock market. It's about setting aside some of today's earnings for tomorrow.

Whatever you do, keep saving. Not sure where to put it right now? Then leave it in the bank, or even in your mattress. But don't use "not knowing where to put your savings" as an excuse to not save.

At this basic level, some aspects of saving are boring. There's no sex appeal in setting aside savings for an emergency fund, or for life insurance. But both items are critical "saving" elements in a well-structured long-term financial plan. And now may be a good time to review and reinforce these pieces of your saving program.

Continuing to lay a solid saving foundation today makes it more likely that you will be able to participate in future opportunities. Keep saving.

On a related note, remember that paying down debt is not the same as saving. Someone might say, "If I use my savings to pay off my 15% credit cards, it's like earning 15%." We understand the math, but disagree with the conclusion. When you save, you have more money under your control. When you repay, you reduce the control your creditors have on you. These two statements are not the same.

If paying debt were savings, you would be able to access this "savings" just like the money in an account at the bank. But if you want your savings back from the credit card company or your mortgage holder, it means running up your limit, and paying interest all over again – provided your credit is good, or the bank gives its approval. This is saving? No.

Paying down debt is a good thing. But keep saving.

Don't project today's situation too far into the future. It's a whacked-out analogy, but the financial planning canoe was paddled into the fast-rushing stream of stock market investing by the personal computer.

With a laptop and some simple spreadsheet software, anyone could prepare a market analysis and project future returns, right at the kitchen table. Add an Internet connection, and the only difference between you and Warren Buffet was that Buffet lived in Nebraska. With so much data at your fingertips, you could generate a plan to guide your finances for the rest of your life.

But while the information may have been historically accurate, and the number-crunching options beyond imagination, statistical input from the past has, more often than not, proven worthless for the purposes of accurately projecting the future.

Admittedly, there are trends, and most markets (stocks, bonds, housing, etc.) do seem to move in recognizable cycles. There are times to buy and times to sell. It makes sense to make adjustments in response to definite shifts in investment cycles.

But even though history may repeat itself in recognizable ways, it does so irregularly. This "random-ness" makes long-term projection – and long-term commitments – a dicey proposition. A good financial plan has flexibility built into it. You don't try to predict the future, you adjust to it.

Participation in a qualified retirement plan is a common instance of optimistic projections leading to unexpected results.

The principle value of a qualified plan is the up-front tax deduction, for which the participant agrees to not touch the money until retirement. At that time, tax will be due, presumably in a lower tax bracket than when the funds were deposited.

Making a decision about participating in such a plan involves several long-term assumptions that cannot be certified as probable. First, the participant has no way to be sure that the rate of taxation on distribution will be lower than the deduction received on the deposit. Second, the participant cannot guarantee that he/she will be able to leave the account untouched until retirement, and many changes (such as partial withdrawals) require additional tax penalties. Third, the participant cannot be certain that the government will not change the plan rules, and by doing so, change the desirability of participation.

Re-emphasize the intangible value of control. During the infatuation with the stock market, the dominant factor was total rate of return – every investment decision focused on it. But there are other facets of financial planning that matter as well, and not all of them can be quantified on a spreadsheet.

Among the intangible factors in a financial plan, one of the biggest is how much control the participant has over his/her money. Control gives the individual the ability to arrange (and rearrange) things to one's personal advantage, instead of accepting the arrangements of others.

With a controlling interest, an owner of real estate can adjust his profits by changing lease rates or altering his sale prices. With a controlling interest, a business owner can decide to increase or decrease production, enter a new market, or reduce workers. Not every decision will be profitable, but having control over the decisions at least affords the owner a better chance at achieving his/her profit objectives.

In contrast, mutual fund investing removes most of the financial control from the investor. The decisions are made by the fund manager, according to the terms of the prospectus, without the shareholder's knowledge or approval. Even with the best resources, most shareholders do not have the ability or expertise to track or understand a fund's holdings and trading activities. Furthermore, tracking the fund to this degree would be a full-time job. (If you are going to put this much effort into the process, you might as well run your own fund.)

It may sound a little snarky, but this lack of control is why some say, "Mutual fund shareholders aren't really investors. They are simply savers with risk."

This is not to say that one should avoid the stock market altogether. Noted investor Bernard Baruch said, "Don't speculate unless you can make it a full-time job," but there are ways to maintain a "little control," even in "saver-with-risk" vehicles. For example, stocks or funds that provide income and dividends (such as preferred shares) allow the individual to transfer some of the gains from the holding without selling the shares. In the stock market boom, income and dividends didn't matter, but having a way to siphon some "profit" from a stock whose share price has dropped may justify keeping it long enough for it to have a chance to rebound.

We've said it before, and it's worth asking again: Who do you know that says, "I made my fortune in my 401(k)?" Overwhelmingly, the wealthiest and most prosperous people attained their wealth through control – of a business, or property, or some unique skill.

It also must be emphasized that taking control means taking responsibility. It means more work. The mutual fund was supposed to be a "set it and forget it" vehicle, and it went south, you could always blame the fund manager (even if you didn't know his name). You were a passive spectator. But you can't be passive and have control.

As you continue to save, continue to be vigilant, to keep some control over your accumulation. A great opportunity is nothing if you can't access your account to take advantage of it.

Continue to maintain a balanced approach. The adage about not putting all of your eggs in one basket? It's an old adage because it's true. And it's not just true for stock portfolios. There's a broader application.

The preoccupation with the stock market during the previous decade resulted in some unbalanced balance sheets. There were lots of stock holdings – in the 401(k), in the variable annuity, in the life insurance cash values, in the kids' UGMA or 529 – and not much else. In short, a lot of paper assets.

Paper assets don't have real value, they have representative value. As a piece of paper, a ten-dollar bill and a hundred-dollar bill are identical. They burn just as fast, or make the same paper airplane. But the piece of paper with a picture of Ben Franklin has a representative value that's ten times greater than the bill with Alexander Hamilton's picture on it. Paper assets get their value from what they represent.

So just owning a big stack of currency bills or stock certificates doesn't make you wealthy. The key determinant is what you can buy with the stack, and the purchase power of paper assets changes all the time. Currencies, stocks, bonds, all fluctuate in value daily.

By contrast, a real asset has some value in and of itself, not representative value. A bag of shredded dollar bills is just trash, but a gold coin could be melted to form a ring. A million-dollar home, disassembled brick by brick, or an automobile, stripped down to scrap metal, would still be worth something. All of these things, to some extent, would continue to have value.

There are some interesting differences between real and paper assets. In general, real assets don't fluctuate much in their worth relative to other real assets, and real assets retain their value in proportion to economic forces like inflation. A century ago, a one-ounce U.S. gold coin would have purchased an evening's lodging in the finest hotel in New York City, or a quality suit of men's clothing. Today, one ounce of gold still has roughly the same purchasing power – if used as money, it would still afford you a stay in the nice hotel, or buy the suit. Gold fluctuates in terms of how many paper dollars it will buy, but its value has stayed fairly stable in relation to other real assets.

On the other hand, real assets can be rendered worthless by new technologies. Other than as a collector's item, no one wants an eight-track tape player, and even the materials from the tape player aren't worth enough to salvage. It's the same way with old computers. Would anyone be willing to exchange anything of value for a Compaq 286? You probably couldn't even buy a candy bar with it.

Because paper assets (like currency, stocks and bonds) have value only by the agreement of buyers and sellers, their values can fluctuate wildly, depending on the variables of the times. But paper assets have some positives that real assets lack.

Usually, paper assets are much more portable and exchangeable. Your home may be a storehouse of real value, but you can't take a brick from the house and plunk it down in the checkout to pay for your groceries. Getting value out of the home usually requires selling it, or taking a home equity loan, which means your home is not exactly an ATM machine.

On the other hand, most businesses still take U.S. currency for almost any transaction. And while it would take a Brink's truck a week to haul a ton of gold from Los Angeles to New York, the same representative value on paper can be transferred instantly via electronic wire. Paper assets are a great convenience, and make it possible for us to buy and sell with minimum limitations.

Considering the advantages and drawbacks of both real and paper assets, it should be obvious that a solid financial program should consider a mix of real and paper assets. But all too often, we meet people who have all their savings (and future) in one type of asset or another. It's not that what they are doing is "bad." It's just a little unbalanced.

Holding a steady course

Using these basic principles, with some knowledgeable input from your advisors, you will probably find items that need some adjustment. And you can be confident that continuing to stick with these basic principles will help you move forward financially – regardless of what happens next week, next month, or next year.

And hopefully, the next time you face the question, "What do I do now?" your answer will be: "The same thing I've been doing."

THINGS THAT MAKE YOU GO "HMM…"

"PUNXSUTAWNEY PHIL" – THE NEXT STOCK MARKET FORECASTER

Now that Peter Lynch and some of the other stock-market gurus of the booming 80s and 90s have retired, is it time to turn to Punxsutawney Phil?

Perhaps you've seen or read an article about how certain regular events seem to have a statistical correlation to the performance of the stock market. For example, there appears to be a strong connection, (say 80% of the time) between a National Football Conference team wining the Super Bowl and stocks going up. Conversely, stocks tend to drop in the years when an American Conference team wins. It's probably pure coincidence, but statistics show a connection between the two events, and it makes for interesting reading. Not that anyone would take the idea seriously, right?

Well maybe they would.

Punxsutawney Phil is the name of the groundhog that emerges from his burrow in northwestern Pennsylvania each year on February 2 – Groundhog Day. If Phil sees his shadow, folklore says it means six more weeks of winter are still to come. How does one know if Phil has seen his shadow? The Inner Circle of the Groundhog Club of Punxsutawney makes the decision.

Using the Inner Circle's data for the past 62 years, Bloomberg, the financial news company, found that in the 52 years that the groundhog saw his shadow, the Dow Jones Industrial Average dropped an average of 0.1% in the six weeks following Groundhog Day. In contrast, in the 10 years the groundhog didn't see his shadow, stocks rose an average of 5.8% over the same six-week period.

So far this is just another warped piece of trivia. But here's the thing that should raise eyebrows: At least one economist sees Phil's shadow as a plausible stock forecasting method. In a February 10, 2003 *Bloomberg News* article, David Littman, chief economist at Comerica Inc., a large Midwest bank, says a prediction based on a shadow is "not so farfetched. Expecting six more weeks of winter can be kind of depressing to investors."

Hmm…The old joke says that if you asked four economists a question you would get five different answers, and all of them would be wrong. So an economist who tries to make sense of Punxsutawney Phil is probably a harmless diversion. But the prospect of having your investment decisions made by someone who believes a groundhog's shadow is a market indicator is just a little unsettling.

NEWS DIGEST – ***(Snippets from stuff we've read, including differing points of view, not all of which we agree with. Want to know more? Give us a call and we can provide you the complete article.)***

MORTGAGE RATES HIT ANOTHER LOW

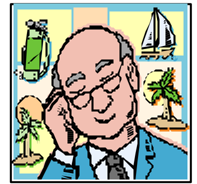
"Mortgage rates this week set new lows, and economists said that means more good news for the housing industry.

The average interest rate on a 30-year fixed-rate mortgages dipped to 5.84%, down from 5.86% last week, the mortgage company Freddie Mac reported Thursday in its latest nationwide survey.

That was the lowest since Freddie Mac began tracking 30-year mortgage rates in 1971. Records earlier than Freddie Mac's indicate that rate is the lowest since the early 1960s."

Martin Crutsinger, Associated Press, February 21, 2003.

WILL YOU HAVE ENOUGH TO RETIRE?



"Despite all the warnings about the need to save, many Americans still believe that the cost of retirement will be only 35% of their current income. The majority of the 80,000 adults I surveyed are dangerously underestimating their needs.

Reality: Middle- and upper-income Americans require at least 80% of their pre-retirement income during retirement. You won't be paying payroll taxes, such as Social Security, or job-related expenses. And, of course, you won't have to save for retirement. But these reductions are often offset by medical or travel expenses. If you have a big mortgage, your expenses could even exceed 80%."

Jonathan Pond, Bottom Line Personal, March 1, 2003.

INVESTORS LOSING INTEREST IN STOCK MARKET

"While the threat of war with Iraq has sent stocks falling sharply for more than a month, it is trading volume, not prices, that has taken the biggest hit and poses the biggest risk to the market.

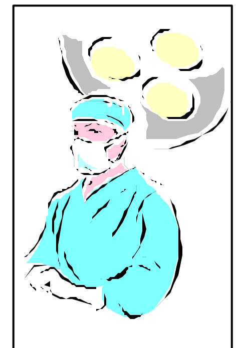
Most investors aren't selling – they aren't trading at all, and that has given Wall Street extremely low volume and, in turn, big price swings that are becoming routine.

'Light trading volume means there is not interest on the part of retail investors and on some institutions as well. We have a market in which no one is open for business,' said Peter Cardillo, president and chief strategist of Global Partner Securities, Inc.

With fewer shares changing hands, stocks are much more vulnerable to big declines. With few, if any, buyers, sellers have to drop their prices in hopes of attracting takers."

Amy Baldwin, *Associated Press*, February 23, 2003.

COSMETIC SURGERY – A RECESSION-PROOF INDUSTRY



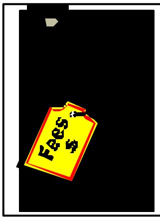
"Despite a sagging economy and the threat of war, spending on elective cosmetic surgery is up as much as 48%, making it the one true recession-proof industry.

The number of cosmetic procedures rose 48% between 2000 and 2001, according to the American Society for Aesthetic Plastic Surgery. Dr. Malcom D. Paul, a cosmetic surgeon in Newport Beach, Calif., and a past president of the ASAPS, said in the past 100 years there haven't been lasting dips in business during economic downturns.

Also, many cosmetic procedures are now done on an out-patient basis or don't require as long of a hospital stay, so they cost less."

Michelle Franzen Martin and Jeff Swiatek, *Detroit News*, Feb. 19, 2003.

MUTUAL FUND FEES CLIMB



"Mutual fund fees may seem miniscule, but they're spiraling upward – and taking a big chunk out of your investment.

To the injury of ruined investment portfolios, the mutual fund industry is adding the insult of higher expenses. And what's really insulting is that hordes of individual investors don't seem to mind.

'I think investors are a little naïve,' says Sheridan Titman, professor of finance at the University of Texas. They ignore expenses because they seem so tiny – less than 1.5% at the typical growth fund.

'But if you're 42 years old, and you're going to retire in 25 years, compounding 1.5% produces a pretty sizable number.'

In the last five years, the average growth fund has boosted its annual expense levy 11.8%, from 1.27% to 1.42%, according to Lipper, Inc."

Timothy Middleton, *MSN Money*, February 23, 2003.

"IF YOU WOULD LIKE TO BE FRUSTRATED, PRESS 1…"

"An IRS reorganization that was supposed to make the agency more taxpayer-friendly may be having the opposite effect. Taxpayers and accountants complain of unanswered letters, missed faxes and confusion over whom to contact.

The new (IRS) regime makes heavier use of computerized call centers and automated voice-mail systems. The result: Tax professionals say it's more difficult to find the right person, or even a live person at all, when corresponding with the IRS."

Rob Wells, *Tax Report*, February 13, 2003.

RSAs and LSAs – THE FUTURE OF TAX-ADVANTAGED SAVINGS PLANS?

On January 31, 2003, President Bush announced his intention to introduce several new government-regulated tax-advantaged savings accounts as part of his proposed budget. While most of the proposed new accounts appear to be variations on the existing Roth IRA format, some commentators characterized the ideas as radical, ones that could fundamentally change the way individuals save, not only for retirement, but also for personal purchases, such as automobiles.

Here are some of the details, at least as they have been presented. The proposed new accounts are subject to legislative approval, which may also mean some modifications.

According to articles written by *CBSMarketWatch*'s Deborah Adamson, one of the proposed new accounts is simply called a Retirement Savings Account (RSA). This account is similar to a Roth IRA in that the contributions would not be tax-deductible, but the earnings may accumulate tax-free. The maximum contribution would be $7,500 a year, and there would be no income limits to prevent high-income individuals

from participating. Contributions could be withdrawn from the account after age 58.

RSAs would replace Roth IRAs, and existing Roth accounts would automatically be "grandfathered" as RSA accounts.

An even bolder proposal is the Lifetime Savings Account (LSA). Per Adamson, "Anyone, regardless of age or income, could save up to $7,500 a year in after-tax dollars for any use, and take the money out at any time without taxes or penalty." Whoa. That is radical.

In theory, LSAs would replace a variety of other government-sponsored savings plans, such as Archer Medical Savings Accounts (MSAs), Coverdell Education Savings Accounts and state 529 plans. But LSAs could also be used for general savings, for such things as emergency funds, house down payments, and vacations.

John McKinnon of the *Wall Street Journal* reports that these new accounts will also mean changes to existing programs: "There could be a phaseout of the rules for traditional IRAs," a move that would eventually stop the establishment of new IRA accounts.

What to think? Do these proposals represent a "new and improved" approach to saving? Why does the government want to change the rules for qualified savings plans? Is it just a matter of political philosophy, or is it something deeper?

Since the proposal came from Washington, political response has been immediate. Some see the proposed changes as a political ploy to mute criticism of the Bush Administration's desire to eliminate or drastically reduce the tax on capital gains and dividends. RSAs and LSAs are accounts for everyone, not just "the rich." One think-tank director called the proposed changes "the biggest single budget gimmick I have ever seen."

But others see the new approach as a recognition that IRAs and similar qualified accounts (TSAs, SEPs and 401(k)s) with tax-deductible contributions and full taxation at distribution aren't practical – for either the individual or the government.

Participation in IRA-type plans requires the individual to anticipate the future tax cost and determine if the deduction today is worth the tax due tomorrow. Ironically, those who have saved the best in qualified plans often end up with the least tax advantage on their contributions. These diligent savers have larger account balances, and consequently draw larger

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retirement incomes, while having fewer deductions (no mortgage payment, for example). Thus, these super-savers often find a greater percentage of their retirement income fully taxable.

Used correctly, current IRA plans expect the money to be untouched until after age 59½. For many reasons, a large percentage of qualified plan users don't do that. They either take loans against the account, or cash out early and pay penalties. These drawbacks discourage participation, and as a result, some individuals don't save at all. According to Barbara Roper, the Director of Investor Protection at the Consumer Federation of America, half of all American households save only $1,000 a year on average.

Further, all of these transactions require on-going reporting to, and supervision by the government. Accounting for the future tax on distributions is a gigantic administrative task, for the individual, the institutions that hold the funds, and for the government. Switching to RSAs and LSAs would make the paperwork easier for everyone.

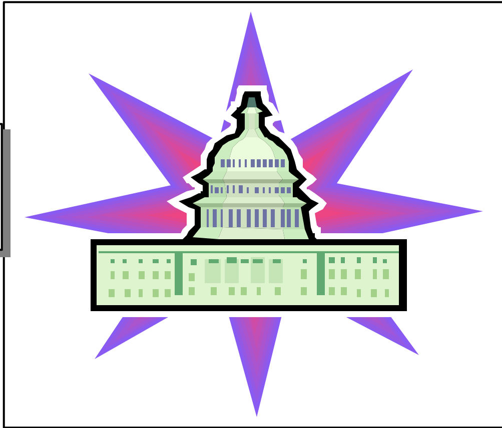
In a strange twist, other commentators believe the changes are a way to increase current tax revenues. Since none of the proposed accounts offer a tax deduction on contributions, more of the money is taxable today. Several critics have expressed concern over this approach, saying it is a short-sighted way to increase tax revenues today that comes at the expense of future revenues.

If these proposed savings plans were approved, it would represent a startling shift in U.S. tax policy. Even before the establishment of a federal income tax in 1913, the government attempted to tax income, which was defined as "earnings from capital," i.e., interest from principal, rents from properties, sale of goods for profit, etc. Income was differentiated from "wages," which meant money given in exchange for service. Obviously, the thought was that wealthier citizens had income and could "afford" the tax, while the rest of the populace – the wage earners - had little income, only wages, and were less likely to be "rich." This idea of making the "rich" pay their "fair share" is one of the core features of the progressive tax format the United States uses.

LSAs and RSAs turn this idea upside down. Now those with "income" can actually accumulate it and use it tax-free, while the tax system relies even more on revenue from wage earners.

Whatever the reasons for the proposed change, and regardless of the benefits that may be offered, this news provides another reminder: ***what the government gives, it can also take away.*** Those who choose to participate in such plans must also acknowledge the government's control over them, and the distinct possibility that the rules governing such plans are always subject to change.

"What the government gives, it can also take away"



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