The Thoughtful Investor

Will the Election Year Cycle Play Out Once Again?

Among a series of cycles that seem to recur time after time is the Presidential Cycle. According to the theory, the stock market goes up for the last two years of the Presidential term and then falls for two years. The rationale is that prior to an election, the party in control pumps money into the economy to make conditions look good. After the election, the artificial stimulus goes away and the market falls in response.

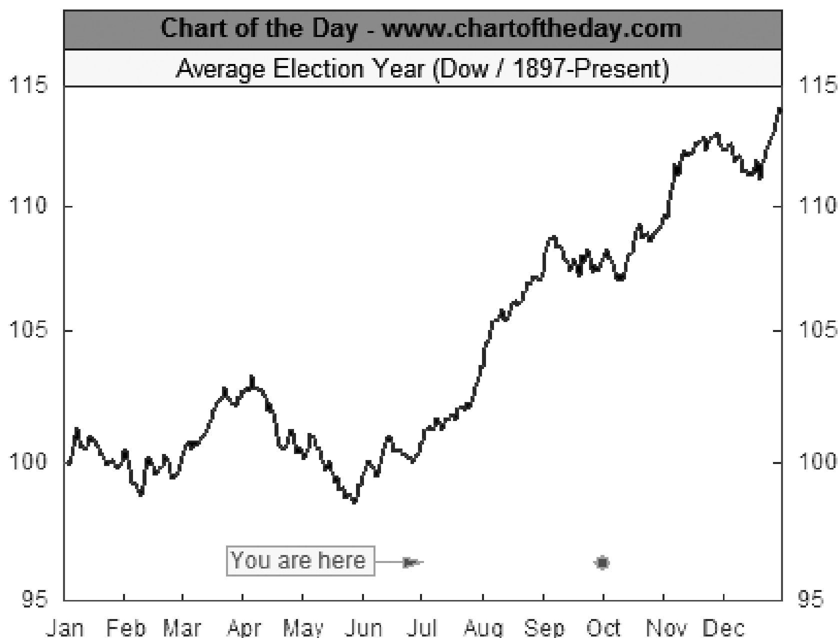
While the fourth year of the cycle – the election year – is typically an up year, it often starts on an uncertain note and the rally doesn't really get underway until mid-year. The chart below is from Chart of the Day – www.chartoftheday – and shows how the Dow Jones Industrial Average has performed in the average election year from 1897 to the present.

The uncertain start of the election year has certainly been true for 2004. It remains to be seen if the trend for the second half plays out as it has in the past.

But while prior years would indicate a rosy scenario for the next three months, investors need to remember that past performance is not indicative of future returns. History never repeats itself exactly and mixed in with the averages are down years.

There are a number of factors that could negatively impact the financial markets prior to the election, from terrorism to inflation and interest rate increases. Looking to the past gives us ideas of how the future might unfold, but what really matters is the day-to-day action of the financial markets.

That's why continuous review of the financial markets and your portfolio positions is essential to manage risk and minimize drawdowns. Uncertainty gives the market the potential for rallies that build portfolio value, but unexpected declines can also occur. Our objective is to help you take advantage of the rallies and limit the impact of declines on your portfolio.



Don't Take the Phisher's Bait

One of the biggest Internet scams is a tactic termed "phishing" (fishing) – redirection scams which use realistic-looking emails to trick recipients into disclosing their credit card numbers, bank account information, Social Security numbers, user names, passwords and other sensitive information to unknown individuals.

The typical phishing bait is an email purporting to be from your bank or a merchant where you have a credit account claiming that verification is needed regarding the account. Phishing emails have claimed to come from Visa, CitiBank, eBay, Amazon.com and many other financial institutions as well as the Internal Revenue Service. The email message might say a fraudulent transaction is suspected, or the account is in danger of being closed, or information is missing to process a request and immediate action is required on your part. A link is provided for you to respond. Often the site the link leads to looks very much like your bank or merchant's site.

An estimated 20% of people receiving phishing emails take the bait. Don't be one of them. Never respond to emails requesting credit card or account numbers, passwords, or other sensitive information. Login directly to your bank, credit card or other merchants' web sites to access your accounts. Never provide sensitive information via links included in emails.

If you ever receive an email that appears to be from our firm requesting sensitive information, please contact our office prior to responding.

Taxes Are Only One Consideration When It Comes to Investing Lump-Sum Distributions

Lump-sum distributions have a number of sources. You may have been laid off, retired and cashed out your 401k or retirement plan, sold your home, won the lottery, or received an inheritance or insurance settlement. What you do with that lump sum depends a great deal on your current financial situation and future plans.

If the lump sum is from a qualified plan, such as a 401(k) or company retirement plan, you have four choices:

1. Pay income taxes (plus a 9½% tax penalty if you are under age 55) on the lump sum when you file your tax return.
2. Roll over the lump sum into an IRA roll over account and continue deferring taxes.
3. If you qualify, pay income taxes and roll over the lump sum into a Roth IRA from which you will be able to later withdraw funds free of taxes,
4. Roll over the lump sum into your new employer's retirement plan.

Timing matters. In the case of a qualified retirement plan distribution, you have just 60 days from constructive receipt of the funds to roll it over into an IRA to avoid tax consequences. If you don't roll it over within the 60-day window, you lose forever the right to roll over the distribution.

As a general rule of thumb, when in doubt, roll over. You can always decide to take money out of a rollover account later and pay taxes.

There is a disadvantage to tax-deferred vehicles, such as an IRA Rollover, however. When money is withdrawn from a tax-deferred account, it is taxed as personal income, not capital gains. If your income is such at the time of withdrawal that the Alternative Minimum Tax applies, the tax bite can be hefty. Capital gains from investments held more than 12 months are currently taxed at up to 15%.

More important over the long term, however, is the investment decision. Too many people spend too much time agonizing over the tax decision and not nearly enough time on the investment decision, regardless of whether or not they elect a roll over.

If you want to use your lump sum distribution to fund your retirement, a roll over typically makes the best sense. By deferring taxes, you have more to invest and earn income on it. If you are invested in interest-producing investments, such as Certificates of Deposit or debt securities, or you anticipate short-term capital gains, you will be taxed at your personal income tax rate anyway.

If you decide to pay taxes on the lump-sum distribution and not roll it over, there are some ways to obtain favorable tax treatment on the distribution. If your distribution meets several conditions, you may be able to take advantage of special income averaging tax breaks, including ten-year and five-year forward averaging. You must pay ordinary income tax if you decide to roll over a portion of your distribution. Take the time to consult with your financial or tax advisor to see if you meet those conditions and what the final tax impact will be.

The most important issue is that you don't get so bogged down in the tax decision that you lose sight of the investment decision. You need to look at what you would like to do with that money and how it fits your long-term financial goals. Make a plan and stick with it. What return will your money need to earn to achieve your plan? What will it take to achieve that level of return and what safeguards can you put in place to control risk and assure that you will meet your goals?

Lump-sum distributions can mean financial independence later in life or short-term pleasure. Give us a call today about your lump sum distribution and what is really important to you.

To Accumulate Wealth, Pay Yourself First

All too often, people put off saving with the idea that it will be easier to set aside money for retirement in a few years when their salaries are higher or perhaps expenses are lower with the offsprings off on their own. When later arrives, however, a variation of Parkinson's Law has typically taken place: "Expenses rise to meet income."

The best way to accumulate wealth is to *pay yourself first* in the form of automatic, regular contributions to your retirement plan or savings account. When income increases, increase your automatic contribution.

Your first priority should be to fully fund tax-deferred accounts, such as 401(k) or Individual Retirement Accounts. The tax-deferred nature of these accounts gives additional earning power to your investments. If you qualify for a Roth IRA, make certain you maximize contributions to this account as well because earnings can be withdrawn tax-free in retirement.

The earlier you start to pay yourself first, the better off you will be when it comes time to retire. A small contribution in one's 30s for example, can be worth far more than a large contribution in your 50s due to the power of compounding. For example, to equal a $1,500 contribution made 25 years earlier that earned an average 8% annually tax deferred, you would have to contribute $10,272 today. Naturally, there is no guarantee that an investment would earn an average of 8% over the 25-year period and you could lose money, but the power of compounding over time clearly impacts the growth of an investment.

Long ago, the government figured out the best way to make sure people paid their taxes was to make certain the government was paid first through payroll withholdings. The same approach works when it comes to funding your retirement. Don't take a chance on spending your income before you have a chance to invest. Pay yourself first.

Time Makes a Big Difference

To accumulate $1 million by retirement at an 8% annual rate of return compounded yearly, you would need to invest the following each year:

Years prior to Retirement	Annual Investment	Total Investment
40	$4,000	$60,000
35	$5,500	$92,500
30	$8,700	$261,000
25	$14,000	$350,000
20	$24,000	$480,000
10	$74,000	$740,000

This is a hypothetical example, only and is not representative of any specific investment or investment style. There can be no guarantee that an investment will achieve an annual rate of return of 8%. Investments can lose value as well as appreciate.

When Variable Annuities Make Sense

Variable annuities are a very useful tool for growing a portfolio on a tax-deferred basis. But before you invest in a variable annuity, you need to understand the advantages and drawbacks of the securities and how they fit in a portfolio.

In many ways, variable annuities resemble mutual funds with the exception of three basic features not found in mutual funds:

(1) Tax-deferred treatment of earnings.

(2) A death benefit, which is one reason the investment is an insurance product.

(3) Payout options that can provide guaranteed income for life. If payments are delayed to the future, it is a "deferred" annuity. If payments start immediately, the annuity is called an "immediate" annuity.

These features are the reason an investor might chose a variable annuity over a mutual fund; however, they do not come without cost, as we will explain. Because of the costs associated with variable annuities, it is always best to max out other forms of tax-deferred investing such as 401(k) plans and other qualified retirement plans, before investing in a variable annuity. Unlike 401(k) and other before-tax retirement plans, contributions to a variable annuity are not tax deductible, but there is also no cap on the amount you can invest in an annuity.

The Tax-Deferred Advantage

A variable annuity's tax-deferred treatment of earnings postpones the payment of taxes, allowing earnings that might otherwise be lost to taxes to continue to grow. However, when gains are withdrawn from a variable annuity, they are treated as personal income, not long-term capital gains.

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The Death Benefit

A primary insurance aspect of a variable annuity is the death benefit. This insures that if the holder of the annuity dies before the insurance company begins making payouts, the beneficiary will receive the greater of all the money in the account or some guaranteed minimum (such as all purchase payments less prior withdrawals). Some annuities allow you to "step-up" the guaranteed minimum as the value of the account increases. The death benefit can be a nice feature if the annuity holder is concerned that a bear market or poor investment choice could erode the amount invested in the annuity, adversely impacting the beneficiary.

Payout Options

Variable annuities typically offer an assortment of payout options including lump sum, scheduled payments or guaranteed income for life. The last lets the contract holder receive periodic payments for the rest of his or her life or the life of a spouse or other designated beneficiary. This feature offers protection against the possibility that an individual outlives his/her assets. The amount of the payments, however, is determined by the account value and the life expectancy of the beneficiary at the time the payout schedule is determined.

Evaluating Variable Annuities

Deferred variable annuities must be considered long-term investments. Typically, variable annuities have sales or surrender charges that apply if you decide to terminate an annuity early. These charges generally decline the longer you hold your shares, eventually disappearing. Withdrawals prior to an investor reaching age 59½ are generally subject to a 10% tax penalty as well as ordinary income taxes on gains.

In addition to sales and surrender charges, other fees and expenses may apply such as:

- Mortality and expense risk charges for the insurance to cover guaranteed death benefits, annuity payout options that can provide income for life or guaranteed caps on administrative charges;
- Administrative fees;
- Underlying fund expenses relating to the sub accounts; and
- Charges for special features such as stepped up death benefits, long-term health insurance and guaranteed minimum income benefits.

According to Morningstar.com, the average variable annuity costs 2.12% a year. The average U.S. stock fund, by comparison, costs 1.4%.

As the name applies, a variable annuity's rate of return is not stable. Without an active investment approach that strives to minimize the impact of market downturns, variable annuities are vulnerable to bear markets and periodic declines just as any stock or bond investment.

The insurance features of the annuity are only as good as the insurance company that underwrites them. Should a variable annuity issuer begin to get financially shaky, it is possible to move assets held in the annuity to another annuity provider without any tax consequences through a 1035 exchange, but there are certain conditions to be met. The new annuity will also have different conditions and fees that you need to understand before making the change. You don't want to make an unwarranted exchange, so make certain a change is really in your best interest before doing so.

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The big advantage of a variable annuity is the deferral of taxes on gains, particularly if those gains are short-term gains that would be taxed at ordinary income levels. But before you invest you need to understand the tradeoffs you accept for that tax deferral. Make certain you understand the liquidity of your investment, sales and surrender charges, fees and expenses and the tax impact, and don't hesitate to ask questions. Variable annuities are not appropriate for all investors.

If you have been approached to purchase a variable annuity or would like to discuss how they can benefit your portfolio, please give us a call.

For a Richer Retirement, Invest in Your Health

"If I had known I was going to live this long, I would have taken better care of myself." — Mickey Mantle

The first wealth is health. — Emerson 1860

A good friend eats beef with relish, explaining that when he dies, he would rather it be quickly from a heart attack. While there's a certain logic to his statement, our modern medical system has made death a lengthier experience that it once was. You just can't count on just keeling over anymore. And the costs of a medical problem can quickly erode your retirement savings even with health insurance.

Medicare covers only short-term and rehabilitative skilled care received in an approved facility. Chronic illnesses and custodial care that require help with the activities of daily living are not covered by Medicare. Medicaid does provide help with medical expenses — but only for the poor. To qualify for assistance, you must already be poor or deliberately impoverish yourself, depleting all non-house assets.

Long-term care protection insurance is one option, but because premiums increase rapidly with age, it is best to purchase such coverage while in your 50s or early 60s.

Another option is to invest in your health by establishing a regular exercise program, seeing your doctor before minor problems become major issues, eating wisely and taking the right supplements and medications for your current state of health.

Above all, don't neglect making appointments with your doctor on a regular basis, even if you are feeling fine. The current generation of retirees grew up in a period of self-sufficiency, when you toughed it out and didn't complain about minor issues. But that can all too easily lead to not catching major problems — such as prostrate cancer — early when treatments are most effective.

One of the greatest dangers for women as they age comes from calcium loss, which weakens bones. A broken hip all too often leads to more serious complications. In addition to calcium supplements, regular weight bearing exercise helps maintain bone strength. This means setting aside time for walks every day and upper body strengthening activities.

Exercise is equally important for men. In addition to benefiting heart and lung functions and giving you more energy, exercise helps guard men from bone loss as well. It is possible to rebuild muscle strength and endurance at any age, although you definitely want to talk with your doctor before dramatically changing your activity level.

While there are no guarantees you can completely avoid financially debilitating health problems in the future, investing in your health can improve your odds of "dying young as late in life as possible" and you benefit from feeling better today.