

Cycles and the Investor

When it comes to investment planning, there's considerable misinformation out there. Read the typical story in the news media on structuring a portfolio and you will learn to expect an average annual return based on historical data of 11% for large company stocks. You'll also discover the last five years of the 1990s were an aberration, that returns don't normally exceed 20%.

Neither is true. Markets cycle. There are periods of strength and times of underperformance. The size of today's market, however, tends to minimize market cycles in prior periods. To put the cycles back into perspective, in the chart to the right we've taken Ibbotson's Large Company Stocks Total Returns data to show periods of strength and weakness based on average annual returns.¹

Time Period Jan.-Dec.	Number of Years	Average Annual Return
1929-1932	4	-21%
1933-1938	6	22%
1939-1941	3	-10%
1942-1945	4	26%
1946-1948	3	1%
1949-1955	7	25%
1956-1957	2	-2%
1958-1968	11	14%
1969-1970	2	-2%
1971-1972	2	17%
1973-1974	2	-21%
1975-1976	2	31%
1977-1978	5	0%
1979-1980	2	25%
1981	1	-5%
1982-1989	8	19%
1990-1994	5	9%
1995-1999	5	29%
2000-2001	2	-11%

continued on page 2

Creating an Investment Plan

There are some lucky people out there who like to plan. A questionnaire full of blanks that requires digging into files and crunching numbers is their idea of a great evening. The rest wonder what the use of all that planning is when life tends to hand out the unexpected,

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putting the best-laid plans to waste. Or else we fear the results of those plans. What if we learn we will never have our heart's desire? Do we really want to know?

The answer is yes, we should want to know, because where there's a will

there tends to be a way. But before you start with the numbers side of your financial plan, start with the "want to's." Make a list of 100 things you would love to do if you had the time. What are your goals? What would make you happy? An investment plan is about achieving goals that go beyond a balance sheet number. It's about having the money to make it easier to enjoy the things you want to do.

Once you've thought about what you would like to do, start your timetable. By a timetable, we don't mean just "Buy a second home by 55." What are you going to do with the next 20, 30 or even 40 years of your life? After all, you could live to 100 years of age. Don't forget to include your spouse or partner in the planning process. Or, you might end up as Henry Higgins

continued on page 2

Retirement Contribution Limits Are Up

To take full advantage of time and compounding, it's best to make your retirement plan contributions at the start of the investment year, not immediately before you file your taxes. An earlier contribution gains a year longer to compound and is in position for upturns in the market. And over the long run, those few months can make a significant difference.

The good news for retirement investors is increased contribution caps and catch-up provisions. Contributions maximums for IRAs increased to \$3,000 in 2002, with further increases scheduled through 2008 to a maximum of \$5,000. IRA owners age 50 and older, making deductible IRA contributions, are also able to make additional annual catch-up contributions of \$500, increasing ultimately to \$1,000 in 2006.

The annual contribution cap on 401(k) plans has increased to \$11,000 this year. If you are 50 or older, you can take advantage of catch-up provisions to put up to \$1,000 extra in your account. The catch-up amount rises by \$1,000 each year until it hits \$5,000 in 2006. The basic yearly cap on 401(k) contributions increases by \$1,000 a year. Further increases to both will be indexed for inflation. By 2006, 401(k) account holders will be able to kick in a total of \$20,000 annually. Since employers can match the catch-up provisions that can translate to a total annual contribution of \$40,000.

(see page 4)

Creating an Investment Plan

continued from page 1

put it so well in the musical *My Fair Lady*, "Make a plan and you will find she has something else in mind, and so rather than do either you do something else that neither likes at all."

Forget that nonsense about needing 70% of your current spending level once you retire. You will need to know how much it's going to take to make your "want to's" happen. It's



much easier to save and do without today if you have a pleasant consequence to look forward to achieving.

Even if you think you have plenty of money, that plan is still essential. How many lottery winners start out feeling rich, loaning money to friends and family, buying presents and expensive toys only to find out the money's gone and no one's repaying the loans? If your life goal is to start a foundation to change the world, then go for it. But you don't need to give or loan relatives and or charities your money. Your greatest value is as a happy, productive person.

The best part of having a plan is that you may find you don't have to wait until you're retired to start putting it in action. Life is uncertain. The things we take for granted such as good health, friends and family could be snatched away. What is important is that we don't waste the time we have now and will have tomorrow. So start planning!

Cycles and the Investor

continued from page 1

The most important reason to include an active component in your investment portfolio is because markets do cycle. History has repeatedly shown us periods of exceptional appreciation — times when returns easily exceeded 20% for periods of one to seven years.

When averaged over a longer period of time, 20%+ returns are watered down by the years of poor performance. Active management recognizes that markets cycle. There are times when it is best to sit on the sidelines making money market returns.

What history really shows us is that the opportunities for gains have always come again. While past performance is no guarantee of future results, it provides a perspective by which we can better understand cycles and portfolio performance.

¹**Source:** Stocks, Bonds, Bills and Inflation 2001 Yearbook, Ibbotson Associates, Pages 200-2001

Mutual Fund Expenses, Tax Inefficiency Drag Down Returns in Slow Markets

When mutual funds were experiencing double-digit returns and performance ads dominated the media, it was easy to overlook the impact of the fund's expense ratio or how much short-term taxable income a fund generated. What did 1.5, 2 or even 3 percentage points in expenses matter? And, while having gains taxed as short-term income definitely paled next to long-term taxation rates, the end result still looked pretty good.

Economies of scale have been relatively meaningless words when discussing expense fees at mutual funds. While it would seem that expenses would drop as assets under management increased, very few funds reduced expense ratios as assets increased. In fact, according to Morningstar, the average expense ratio for a diversified U.S. mutual fund is now 1.43 percent, up from 1.31 per-

cent in 1993. Take out the three most cost-efficient funds, which collectively hold a substantial 32% share of the total assets in U.S. mutual funds, and the expense ratios are even higher.

But with returns down, high expenses and taxes dramatically impact fund performance. Investors are becoming cost conscious, forcing fund groups to tighten up expense ratios and look for more tax efficient investing strategies. Plus, there's some new competition in the fund arena with ultra low fees, putting more pressure on fund expenses.

Mutual funds are facing competition in their two greatest areas of weakness — expense ratios and tax efficiency. Exchange-traded funds (ETFs) are gaining popularity for their user-friendly format, tax efficiencies and low management expenses. ETFs are index funds that can be bought and sold like stocks through-

out the trading day. One of the first ETFs was the Standard & Poor's Depository Receipts (SPY) or Spiders, traded on the American Stock Exchange. Management fees are 0.18 percent. Barclays Global Investors S&P 500 clone (IVV) has even thinner expenses of 0.0945 percent. Diamonds (DIA), which track the 30 stocks in the Dow Jones Industrial Average, carry an expense ratio of 0.18 percent, as do Qubes (QQQ), which mirror the Nasdaq-100 Index.

The new instruments are good news for investors because they promise to have mutual fund companies taking a second look at their own expense ratios and tax-efficiency and looking for ways to better serve investors. As mutual funds rethink their businesses in the face of new competition, investors stand to gain.

Tough Markets Leave Investors Vulnerable to Scams

The last two years have put many retirement plans on hold. And with the market still faltering between a lingering bear and the promise of an upturn, it's tempting to look for investment returns in non-traditional arenas. One result has been a proliferation of "prime bank" scams. According to state securities regulators, losses from "prime bank" scams were well over \$1.5 billion last year and are rising dramatically.

Over the last three years, regulators at the Securities and Exchange Commission have shut down roughly three dozen prime bank scams, with losses totaling hundreds of millions of dollars. One reason prime bank scam artists are able to mislead people is because the instruments they claim to be using – standby letters of credit, bank debentures and bank-secured trading programs, to name a few – mimic legitimate financial instruments closely enough to deceive people outside the specialized world of international banking.

In a typical pitch, increasingly made over the Internet, investors are promised access to secret, high-yield investments made through trades between the world's top or "prime" banks. The claim is often falsely made that the investments are guaranteed

or secured by some sort of collateral or insurance. Sophisticated sounding but fictitious investment products are described that mimic the hundreds of new, legitimate products. Promoters claim that prime bank trading programs can yield huge returns with no risk. In reality securities regulators say, neither prime banks nor the instruments they claim to trade exist.

The instruments they claim to be using – standby letters of credit, bank debentures and bank-secured trading programs, to name a few – mimic legitimate financial instruments.

The desire for above-market returns tends to erode investors' judgment. When promised returns fail to materialize, con artists often use promises of ever-higher returns – in some cases upwards of 1,000 percent annually – to persuade their victims to "reinvest."

"In prime bank schemes like these, investors should ask themselves 'Why me?'" says Joseph Borg, president of the North American Securities Administrators Association (NASAA). "If this scheme really works, why is some

stranger in a hotel meeting room or on the telephone or the Internet offering to cut me in on it? Prime bank trading programs don't pass the smell test."

Before making any investment, ask the following questions:

- Are the seller and investment licensed and registered in your state? Call your state securities regulator to find out. If they aren't, they may be operating illegally.
- Has the seller given you written information that fully explains the investment? Make sure you get proper written information, such as a prospectus or offering circular, before you buy. The documentation should contain enough clear and accurate information to allow you or your financial adviser to evaluate and verify the particulars of the investment. Watch for jargon that sounds sophisticated but makes no sense.
- Are claims made for the investment realistic? Some things really are too good to be true. Use common sense and get a professional, third party opinion when presented with investment opportunities that seem to offer unusually high returns in comparison to other investment options. Pie-in-the-sky promises often signal investment fraud.

For After-Tax Investing, Variable Annuities Offer Benefits

There are two key reasons to invest in variable annuities – (1) to defer taxes and (2) to take advantage of the insurance benefits of a variable annuity to provide a guaranteed, but possibly variable, income throughout your life, or to assure your heirs of receiving the principal you have invested. Total assets invested in variable annuities according to the Variable Annuity Research Data Service are nearing \$800 billion. Boston-based research and consulting firm Cerulli Associates expects that participation in variable annuities will continue to grow by 10-15% per year through 2002.

Because gains in variable annuities are deferred from taxes until withdrawn, there are definite advantages in terms of compounding. Tax deferred, your assets can grow faster, offsetting the eventual impact of

taxes. The insurance aspects of a variable annuity allow the account holder to annuitize payments over their lifetime, as one distribution choice. If they live longer than their account balance, the insurance company is obligated to continue the scheduled payments. If the account holder dies before the account is exhausted, the insurer benefits, although most annuities include options to pay out principal to the heirs.

The death benefit common to most variable annuities assures that if the account holder dies, the insurer will pay out contributed principal (less of course withdrawals according to a schedule determined by the annuity contract) to the account holder's heirs. If the account is down at the moment due to market conditions, the insurer is still obligated to return the principal.

The downside of variable annuities is several fees that hamper investment performance, including management fees and operating expenses, insurance and contract fees and surrender charges. Total expenses average 2.15% per year, according to *Mutual Funds* magazine, which is about one percentage point more than a typical mutual fund. In addition, if money is withdrawn before age 59½, there is a 10% penalty on top of income taxes.

With Americans living longer than ever before, an increasing concern to families is the threat of outliving the retirement nest egg. While participants in variable annuities today may be looking for more protection from investment risk, the next generation may turn to variable annuities to help protect them from poverty if they live to extreme old age.

When Savings Bonds Turn Bad

U.S. savings bonds are one of the most widely held securities in the world and after the last two years, they're looking like pretty smart investments. But before you congratulate yourself on astute investing, make certain your bonds are still paying interest. According to Daniel Pederson, author of "Savings Bonds: When to Hold, When to Fold and Everything In-Between," there are

approximately \$7 billion in matured savings bonds – bonds earning no interest.

The government keeps track of bond serial numbers; the bonds are not tracked by a person's name. As a result, no statements are sent to bondholders, as is the case with most other investments. Very few bondholders are ever notified when their bonds reach maturity.

If you hold Treasury bonds or have given bonds as presents, you might want to check their maturity dates. The following chart from the U.S. Bureau of the Public Debt shows which bonds are no longer earning interest. Once bonds stopped earning interest, holders should cash them in or exchange them.

For more information on your savings bonds, visit:
www.publicdebt.treas.gov.

U.S. Savings Bonds No Longer Earning Interest

SERIES	ISSUE DATE
E _____	May 1941 through March 1962 <i>and</i> December 1965 through March 1972
H _____	June 1952 through March 1972
HH _____	January 1980 through March 1982
Savings Notes _____	May 1967 through October 1970
A, B, C, D, F, G, J, K _____	All issues

Retirement Contribution Limits Are Up

continued from page 1

403(b) and 457 contribution limits have also changed dramatically to permit increased contribution levels and catch-up provisions. Coverdell education savings account (529 plan) contribution limits are up from \$500 per year to \$2,000 per year. Take advantage of these new limits with an early contribution to add further impetus to your investment returns.

I would like more information about:

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| <input type="checkbox"/> Retirement planning | <input type="checkbox"/> Past performance for your investment programs |
| <input type="checkbox"/> Investing lump sum distributions from retirement plans | <input type="checkbox"/> Tactics used by your firm to avoid market declines |
| <input type="checkbox"/> Risk management of mutual funds | <input type="checkbox"/> Information on your firm's history |
| <input type="checkbox"/> Investment options offered by your firm | <input type="checkbox"/> The following topics discussed in the newsletter _____ |

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