the Investment ADVISOR

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What History Tells Us to Expect in 2004

Recent surveys of investor expectations show that overall investors are still optimistic about future market returns despite the recent bear market. Forty percent believe that a reasonable average long-term return from a broadly diversified mutual fund will be 10%. Six percent of those surveyed thought that 20% or more was a reasonable expectation, and 15% thought that 15% was reasonable. That adds up to 61% who think the markets will give them 10% or more over the long term.

Are they right? Only time will tell. But near term, it may pay to have much more conservative expectations and to build risk management into any investment strategy.

John Templeton, one of the greatest investors of our time and founder of the Templeton fund family, is among those still in the bearish camp. He says, "It would be unlikely that the bear market is over when the American stock market is only down about 30%; when in the biggest boom ever, it had been up 10 times over where it had been years earlier... Following such a large increase, a 30% decrease is small."

The most common phrase in any financial ad or brochure is undoubtedly a variation of *"Past performance is not predictive of future values."* But when it comes to trying to anticipate the future, we have no better guide

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Problems with Proposed Mutual Fund Reform Solutions

Since New York Attorney General Eliot Spitzer's first release of charges filed against hedge fund Canary Capital for improper mutual fund trading in September 2003, new revelations of mutual fund misdoings seem to hit the newspapers daily. The issues have revolved around three key problems:

- Late trading - Buying or selling mutual fund shares after the official 4:00 p.m. close of the stock market — an outright illegal act.
- Overnight arbitrage, particularly in international funds — this has involved quickly trading in and out of mutual fund shares in an attempt to make a fast profit based on pricing discrepancies. While legal, it has been under attacked by fund companies who maintain it hurts returns for long-term investors.
- Individual violations — Wrongful behavior or criminal acts by individuals inside and outside the mutual fund industry.

A number of regulatory solutions have been proposed to prevent these issues in the future; however, some of the early concepts have the potential to hurt the innocent without resolving the issues. The two areas of greatest concern are (1) a proposed 4 p.m. hard close on all mutual fund transactions and (2) mandatory redemption fees of a minimum of 2% on transactions occurring within a minimum of five days.

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Optimize Tax-Deferred Investments Before April 15

Whether it's a retirement plan offered by your employer — a 401(k), 403(b) or 457 plan, for instance — or an individual retirement account (IRA), it makes sense to maximize your contributions each year. The benefits of doing so include an immediate tax deduction in most cases and increased earning power. Because investments in these plans compound tax deferred, the value of the account at retirement will be substantially higher than if taxes had been paid each year.

With the Roth IRA and Coverdell Education Savings Accounts (CESA), contributions are nondeductible but money can be withdrawn tax free for the account purpose (i.e., retirement or education).

Any plans that offer employer matching are priorities for maximizing contributions. For 2003, a 401(k) plan participant under age 50 can save up to $12,000 of salary pretax. If, for example, the employer matches the pre-tax savings at 4% of salary, that's an immediate return on the contribution, and it can be a substantial return based on salary levels.

Even if you participate in a company-sponsored retirement plan, you may be able to contribute to a regular Individual Retirement Account, a Roth IRA, or a CESA, formerly called an Education IRA.

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A Will Can Make All the Difference

***Where there's a will,** there's an opportunity to see that your heirs are treated fairly, that estate taxes and legal fees are minimized and that the capital you leave behind benefits others.* Yet, more than half of adult Americans don't have wills.[1] If you are one of those individuals, or if it has been a long time since you looked at your will, please read on.

A will is a legal document ensuring that, after you die, your assets will be given to family members or other beneficiaries that you designate. Having a will is critical if you have underage children because it allows you to designate a guardian for them in the event of your death. Without a will, the court will appoint a guardian for your children and distribute your assets according to the laws of your state.

Usually, wills can be written by any person over the age of 18 who is "of sound mind and memory." If you plan to draft your own will, you can find information on how to do this on the Internet, in bookstores, in various types of software, and you can always find a form will in a stationery store.

While there are obvious savings in legal fees by using form wills and trusts, there may also be risks involved. One risk is that problems, such as defective forms, violations of state law, or improper witnessing, will not be apparent when the documents are signed, and may be only discovered after death. At that point it is too late to revise the will or trust. In most cases, you should consider using a professional to help with preparation of a will.

What Your Will Should Cover

There are some basic elements that most wills should include, such as:

- Your name and place of residence.
- A brief description of your assets (property, furnishings, liquid assets, etc.).
- Names of your spouse, children and other beneficiaries, such as friends or charitable organizations.
- Names of alternate beneficiaries, in case a beneficiary dies before you do (or else you can state that the bequest will lapse if a beneficiary precedes you in death).
- Any specific gifts, such as a car, furniture or residence, that you wish to bequeath.
- The name of an executor who will manage your estate.
- The establishment of trusts, if you desire.
- Cancellation of any debts owed to you, if you desire.
- The name of a guardian for minor children.
- The name of an alternative guardian, in the event your first choice is unable or unwilling to act.

When naming beneficiaries, be clear and specific (i.e., state the person's full name as well as his or her relationship to you so your executor will know exactly who you mean). The more specific you are, the less chance that there will be any challenges to your will.

In addition, the document must expressly state that it is your will. You must sign and date the will, and it must be signed by at least two (or in some states, three) witnesses. In most states, your witnesses must be people who won't inherit anything under the will.

Updating a Will

Old wills may become out of date or inappropriate. You will probably need to update your will several times during the course of your life. If you change your marital or financial status, move to a new state, have a baby or adopt a child, you should review your will. If your beneficiaries change, you will want to change your will accordingly. Most people choose to create a new will that supersedes the old one.

After signing and witnessing the new will, be sure to destroy the old one. Store the new will in a safe place that is accessible to others after your death. Make sure a close friend or relative knows the location of your will. If you had an attorney prepare your will, have him or her retain a copy with a note stating where the original can be found.

Wills are not just for the rich. How much you have is irrelevant. Everyone should have a will to guarantee that their assets and dependents are taken care of according to their wishes. The more money you will leave behind, however, or the more divisive your family situation is, the more it makes sense to consult an attorney.

The preceding is not intended as legal advice, but rather a general overview of the process and importance of establishing a will.

[1] Results from a September, 2003 survey by Findlaw.com showed that only 41% of adult Americans currently have a will.

New Protection Against Identity Theft

In an effort to provide new protections for consumers against identity theft, a new federal law – the Fair and Accurate Credit Transactions Act of 2003 – was passed in December. The law gives consumers access to free credit reports at least once a year from each of the three credit bureaus (Experian, TransUnion and Equifax), requires merchants to notify consumers if they plan to report something negative on their credit, and allows consumers to restrict credit bureaus from sharing sensitive credit information with businesses. Businesses will also need to verify that consumers actually ran up the bills before turning their cases over to collectors.

Optimize 2004 Tax-Deferred Investments Before April 15

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Thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001, the amounts plan participants can defer each year continue to increase. In addition, there are catch-up provisions for investors age 50 or older. The table here shows the maximum investments and catch up provisions for 2003 contributions. There are IRA, Roth IRA and Coverdell income eligibility requirements, particularly for individuals also covered by employer sponsored plans, so check with your tax adviser prior to opening these accounts.

The foregoing information is from generally reliable sources; however, we are not tax accountants or attorneys. Please check with your tax profession before you make any decisions.

2003 Contribution Limits

	Maximum Contribution	Additional Catch-Up Contribution for Individuals over 50
IRA*	$3,000	$500
Roth IRA**	$3,000	$500
Non-Deductible IRA	$3,000	$500
Cloverdell Education Savings Accounts***	$2,000	NA
SEP-IRA - Employer contribution	25% of the compensation not to exceed $40,000	
SEP IRA - Participant Elective contribution	25% of the participant's compensation up to $12,000	
SIMPLE IRA - Employee contribution	$8,000	$1,000
SIMPLE IRA - Employer contribution	1-3% of the participant's compensation up to the limit depending upon whether elective of non-elective.	
Defined benefit plans	Lesser of $160,000 or 100% of the average compensation for an employee over his or her highest consecutive three-year period, subject to annual compensation limit of $200,000.	
Defined contribution plans	$40,000 or 100% of compensation, also subject to an annual compensation limit of $200,000.	
401(k) - Participant contribution	Lesser of $12,000 or 100% of compensation	$2,000
401(k) - Employer Contribution	Combined with participant contributions cannot exceed $40,000 per year.	

* *In tax-year 2003, eligibility phases out for individuals with Maximum Adjusted Gross Income (MAGI) between $40,000 and $50,000 and for married couples with MAGI between $60,000 and $70,000* (for 2004, between $45,000 and $55,000 for singles, between $65,000 and $75,000 for couples). No income cap for individuals not covered by an employer-sponsored retirement plan or for married couples when neither participates in such a plan. If only one spouse participates in an employer-sponsored plan, IRA eligibility phases out between MAGI of $150,000 and $160,000 for uncovered spouse, between $60,000 and $70,000 for covered spouse ($65,000 and $75,000 in 2004). If covered spouse files separately, phase out is between $0 and $10,000.*

** *Eligibility phases out between MAGI of $95,000 and $110,000 for singles, and $150,000 and $160,000 for married couples*

*** *If you're unmarried, your ability to make CESA contributions is phased out between adjusted gross income of $95,000 and $110,000. For joint filers, the phase-out range is $190,000 to $220,000.*

What History Tells Us to Expect in 2004

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than to look at the past and how the market has played out in similar times. This provides a framework in which one attempts to understand what could happen in the near future. And, while history tends to rhyme rather than repeat, certain themes and trends have played out over and over.

Many believe that financial markets should go up during the presidential election year, as the political party holding the presidency does whatever it takes to keep investors happy and its grip on the presidency. In reality, according to the "Presidential Cycle," a pattern that has shown some consistency, the stock market typically performs better in the years prior to election years. The third year is historically the best of the four-year cycle. This appears to be the case in 2003. Election years are often times of uncertainty, reflected by little growth in the market.

Another indicator is the economic cycle. According to Mark Hulbert, editor of *Hulbert Financial Digest*, since 1897, the Dow has risen an average of 22% over the 12 months following the end of a recession, then fell to returns between 2 and 3% for the next two years. Since economists have pegged November of 2001 as the end of our current recession, the market should have risen dramatically in 2002 and then slowed. If the reaction was delayed by factors such as September 11, 2001, then the gain in 2003 might have been the post-recession run-up in stocks.

So what's an investor to do? Realizing that past performance is not predictive of future values, it still seems reasonable to expect the long-term trend of the market to continue to be up. As we saw during 2000-2002, however, there can be extensive periods of painful market declines. Therefore, for most of the investing public, there needs to be a plan that limits losses and keeps us willing to stay committed to equities over the long haul. That's where active management comes in!

While there is no perfect investment strategy and investors can lose money as well as profit, by knowing a system is in place to control risk, active managers are more willing to be invested during uncertain periods. That creates the ability to potentially profit from upturns in the midst of bear markets and limit losses during bull market corrections.

Problems with Proposed Mutual Fund Reform Solutions

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Hard 4 p.m. close

The hard 4 p.m. close proposed by the Securities and Exchange Commission would require that all buy and sell orders reach the mutual fund, its transfer agent or securities clearing agency by 4 p.m. market close or else receive next day pricing. To meet this deadline, financial intermediaries, such as brokerage firms, trust companies, retirement plan administrators and others, which handle 85-90% of all mutual fund transactions, would need to establish an earlier cutoff for investors. Investors on the West Coast would have an early morning cutoff.

This means the average investor would not be able to buy or sell after the cutoff, but institutional investors and insiders who trade directly with the mutual fund would still have some four hours to react to afternoon news — news such as Federal Reserve policy statements and rate changes which occur at 2:00 p.m. These investors would have a tremendous advantage over the vast majority of individual investors when market moving news happens.

Mandatory and Higher Redemption Fees

The second proposed solution of allowing mutual funds to increase redemption fees and mandating holding periods again threatens to penalize individual investors without solving the problem. Currently mutual funds can impose redemption fees up to 2% for whatever time period they choose. In response to the recent mutual fund scandal, many funds have imposed new redemption fees for periods ranging from 30-120 days, far in excess of what would be considered necessary to stop overnight price arbitrage.

Institutions, wealthy investors, professional money managers and other investors have the tools and ability to manage portfolio risk outside of the mutual fund framework. Redemption fees will have little impact upon them. But for the vast majority of Americans who have come to depend on mutual funds for retirement savings and building financial security, the rules will have changed. The decision to liquidate fund assets to meet an unforeseen emergency, take advantage of a better investment opportunity, limit damage from collapsing market values and even poor performance by the fund manager, could easily cost a fund investor hundreds and even thousands of dollars in redemption fee penalties.

We encourage you to write to your congressional representatives and urge them to make certain that actions to remedy the mutual fund industry's ills do not penalize individual investors and create an even more uneven playing field. The 4 p.m. close and mandatory redemption fees are the wrong answers to the problems revealed in the fund industry during the last few months. Web sites for the United States Senate and House of Representatives contact information are:
http://www.senate.gov/ and
http://www.house.gov/

I would like more information about:

- ❐ Retirement planning
- ❐ Investing lump sum distributions from retirement plans
- ❐ Risk management of mutual funds
- ❐ Investment options offered by your firm
- ❐ Past performance for your investment programs
- ❐ Tactics used by your firm to avoid market declines
- ❐ Information on your firm's history
- ❐ The following topics discussed in the newsletter ________________________

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