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The Importance of Compounding

Assume you have a choice between two investments. Option A would provide you with $1,000 per day for 30 days. Option B would provide you with a penny per day and double your account balance every day for 30 days. Which would you choose?

At the end of 30 days, option A would have accumulated $30,000. Option B would have grown to $10,747,418. By day 15, the individual who chose Option B might have been feeling a bit discouraged. Only $327 would have accumulated in his account. But compounding takes time to work. As the account balance grows, the rate of growth snowballs. The same principle applies to investing.

Compounding is simply the result of earning returns on earned returns, i.e. reinvesting your gains. It is one of the most overlooked elements of successful investing. The chart on page 2 shows the value of a $10,000 investment earning 8 percent annually when (1) gains are allowed to compound or (2) earnings are withdrawn each year and set aside. By year 20, allowing gains to compound would have resulted in an account balance of $46,609. If gains had been withdrawn each year, the investor would still have the original $10,000 investment and would have received $16,000 in earnings for a total account value of $26,000.

Here again, at year 10, the difference doesn't seem that significant. In fact, the compounding account is ahead by only $3,590. But the longer funds are allowed to compound, the more impact it has on the value of the investment. Another 10 years, and the difference has increased to $20,600.

The morale of this story is if anyone offers to pay you a penny a day and double your account value every day, take the offer. And remember that

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Passive Asset Allocations Fall Short

In 1997, many financial planners thought that they had discovered the holy grail of investing in the most comprehensive, objective study ever done of historical returns in the U.S. capital market — **Stocks, Bonds, Bills and Inflation: Historical Returns (1925-1996)**. The authors, Roger Ibbotson and Rex Sinquefeld, analyzed the indicated asset classes, their total returns and their volatility over extended time periods.

Their conclusion was that small stocks can be expected to return an average 12.5 percent annually, while large cap stocks, represented by the Dow Jones Industrial Average, would average 10.0 percent. Bonds were pegged at an average annual return of 5.2 percent while treasury bills could be expected to average 3.7 percent annually.[1]

The Securities and Exchange Commission has long required money managers and investment advisors to warn clients that past performance is no guarantee of future returns. But that didn't stop the planning industry from trotting out historical returns as a basis for designing passive allocation investment portfolios. Some planners implied that all investors needed to do was to establish their required rate of return and risk tolerance based on existing savings and intended future savings, have a passive asset allocation prescribed, and then build a portfolio of mutual funds to meet that allocation.

The idea that large cap stocks gain 10 percent per year on the average

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Nobel Laureate Discovers Investors Are Irrational

The Efficient Market Theory just took another blow to its validity with the 2002 Nobel Prize in economics going to a psychologist who proved that investors are irrational.

In a series of studies, Daniel Kahneman, a professor with the Department of Psychology at Princeton University – in collaboration with the late Amos Tversky – showed that most people are incapable of fully analyzing complex decision situations when the future consequences are uncertain. Under such circumstances, they rely instead on rules of thumb.

Faced with uncertainty, people exploit rules of thumb which systematically contradict basic logic (or as the paper summary states – fundamental propositions in probability theory). An investor who recognizes that a fund manager beat the index two years in a row may conclude that the manager is systematically more competent than the average investor, whereas the true statistical implication is much weaker.

Kahneman concluded most individuals seem to be more averse to losses, relative to a reference level, than partial to gains of the same size. Kahneman takes his theory further to explain the propensity to sign up for costly small-scale insurance for appliances; willingness to drive many miles for a few dollars' discount on a minor purchase, but reluctance to do so in order to save the same amount on a more expensive good; or resistance to lowering consumption in response to bad news about lifetime income.

529 College Savings Plan Cautions

529 plans have become increasingly popular for saving for college expenses in recent years, but before you invest you need to understand the shortcomings as well as the advantages of the plans.

529 plans were created in 1996 by federal legislation to help families meet the increasing costs of a college education. While federal legislation authorized the accounts and established a federal income tax exemption on earnings, the plans are administered by the individual states.

Today all 50 states have one or more 529 offerings. The key benefit of using a 529 plan is that earnings accumulate on a tax-deferred basis and are (currently) exempt from federal income taxes if used to pay for qualified higher education expenses. Most states offer a similar favorable tax treatment and some allow contributions to be deductible on state income tax.

How 529 Plans Differ

Unlike Cloverdell accounts, a 529 plan remains in the name of the individual who establishes the account, not the student. This can be beneficial when applying for financial aid because the federal financial aid formula assesses student assets at a flat rate of 35 percent while parent assets are assessed on a bracketed scale with a maximum rate of 5.64 percent. The annual contribution limits for 529 plans are set by the states and can be as high as $200,000, while the Cloverdell is limited to $2,000 per year with income restrictions for eligible contributors.

With any state plan, if the account is canceled or funds exceed those used for educational expenses, resulting in a refund, federal and state income taxes must be paid on the earnings and there is a possibility of a 10 percent tax penalty.

So what's the catch?

The account holder has no say in how the funds are managed, who is selected for the manager, management fees, the length of a management agreement, or changes in how the plans are administered. While many states offer a choice of portfolios based on how long it will be before the funds might be needed for educational purposes, the account holder has no control over the investment approaches used.

Because 529 plans are run by the individual states, the plans are subject to political manipulation and rule changes. To manage a state plan, fund companies contract with the individual states, typically offering the states a small percentage of the assets under management. However, contracts can include agreements such as the *Wall Street Journal* reports exist in Illinois, where a substantial ad budget is under the control of the state treasurer's office and must prominently mention the treasurer in ads. In addition, the treasurer's office receives a minimum of $350,000 to cover expenses related to the plan and is entitled to any unused ad monies. These types of agreements increase the fee burden on a 529 plan, directly impacting return.

Penalties for Using Out-of-State Plans

The states are compensated by the plan managers based on assets under management and they have a strong incentive to keep residents from investing in plans offered by other states. This can impact account holders who move to another state prior to accessing the funds for educational purposes, and limit the ability of account holders to move assets from a poorly performing 529 plan to one offered by another state.

The number of states imposing penalties on residents investing in out-of-state plans is on the increase. These penalties range from recapturing tax deductions given on investments that subsequently transferred to other states, to taxing withdrawals from out-of-state 529 plans and even requiring annual income tax payments on interest and dividends earned in an out-of-state plan.

All of these factors add up to considerable concern over the long-term advantages of 529 plans. What was intended to benefit families trying to meet the costs of a college education has turned into a "you pay your money and you take your chances," as to whether or not you will end up coming out ahead of simply investing in a taxable account.

Before you invest in a 529 plan, read the plan documents carefully and consider the political and economic climate of the state offering the plan and your home state.

The Importance of Compounding

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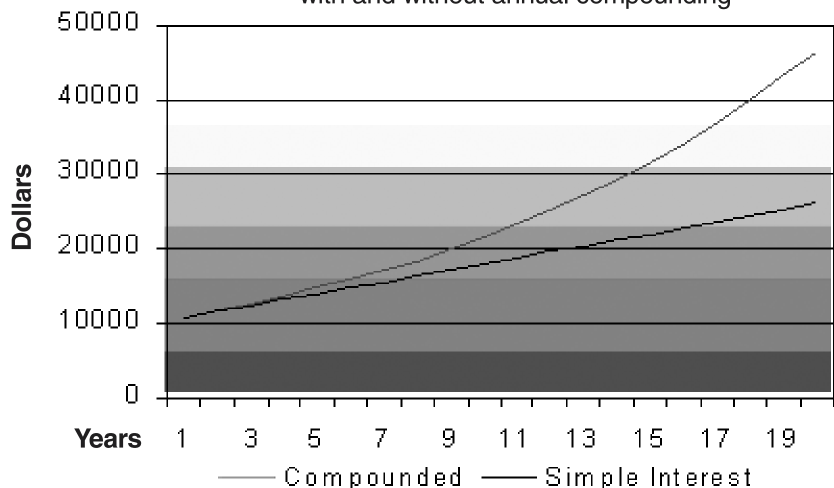
investing early and reinvesting earnings is one of the most effective paths to accumulating wealth. The longer your investment has to grow, the greater the impact of compounding.

Growth of $10,000 at 8% Interest

with and without annual compounding



The data presented here is hypothetical and used for illustrative purposes only. It does not represent the past or future performance of any investment. In any investment, the possibility of loss always exists.

Behind the Small Cap Rally

Not too long ago, large cap funds were the only way to go and the S&P 500 was easily outpacing the Russell 2000. Today, the Russell 2000 is the hot market segment. Why the difference? It's hard to say. The market will do what the market will do, and in the short run, rationality has nothing to do with it. With that said, there are some rational reasons that some investment pros like small caps.

The Russell 2000, which represents the small capitalization stocks, moved in tandem with the Dow Jones Industrial Index until late April, when small caps performance began to exceed large cap stocks.

(1) **The mathematics of growth.** It is a lot easier to increase sales and earnings 100 percent when you start with a base of $50 million versus $50 billion.

(2) **Growth potential.** Small cap companies are often found in the fastest growth segments of the industry where the market is wide open for new technologies and new ideas. These companies as a group tend to grow faster in economic recoveries

(3) **Valuation.** The S&P 500 companies by and large are still considerably above historic earnings per share ratios. If the market reverts to mean, as many analysts believe it will, these companies could still drop considerably in value. Small caps are relatively cheap in comparison with price/earnings (PE) ratios ranging from 10-18 percent. According to the Leuthold Group, an investment research firm, the price/earnings ratio for small-caps has fallen to an all-time low compared with that of large-caps.

(4) **Low interest rates.** Small cap companies tend to be more dependent on borrowing than large cap companies, which have greater ability to raising capital through equities. Low interest rates have a considerable impact on profitability and the ability of the smaller companies to fund growth.

(5) **Financial clarity**. With the recent accounting frauds and earnings reclassifications at many large cap companies, the relative simplicity of a smaller company's accounting records appeals to many investors.

As with any investment area, you need to investigate the risks of small cap investing as well as the potential rewards. Small cap stocks are often subject to the risks associated with investments in newly emerging companies, such as erratic earnings patterns, competitive conditions, limited earnings history and a reliance on one or a limited number of products.

Passive Asset Allocations Fall Short

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also formed the basis of arguments against trying to "time" the market, or actively manage portfolios.

But times have changed. Roger Ibbotson, head of Ibbotson Associates and co-author of the Ibbotson-Sinquefeld study that ingrained the 10 percent concept, now says the next quarter century will not live up to the past 75 years. Why? Conditions are different, says Ibbotson.

Fidelity Investments recently lowered to 7 percent its annual return target for its in-house pension plan. The Vanguard Group's *Plain Talk About Realistic Expectations For Stock Market Returns* has been removed from the fund family's web site. Likewise data on historical returns (up to 50 years) from T. Rowe Price are gone from that firm's web site.

We don't know what returns will be for the next year, or the next 20 years. Nor do we know which market sectors will prove the most profitable. In fact, the most accurate prediction of market behavior may well be simply that stocks will go up and go down. What we do know is that fluctuations create opportunities for profit if investors are willing to take an active approach.

Financial markets tend to establish trends, some short, some longer. The active manager strives to be positioned on the right side of the trend. To quote Will Rogers, "…if it don't go up, don't buy it." Because we are not limiting ourselves to a fixed allocation, investment positions can be flexible to take advantage of different sectors. As a result, returns are not limited to those achieved by the major market indices.

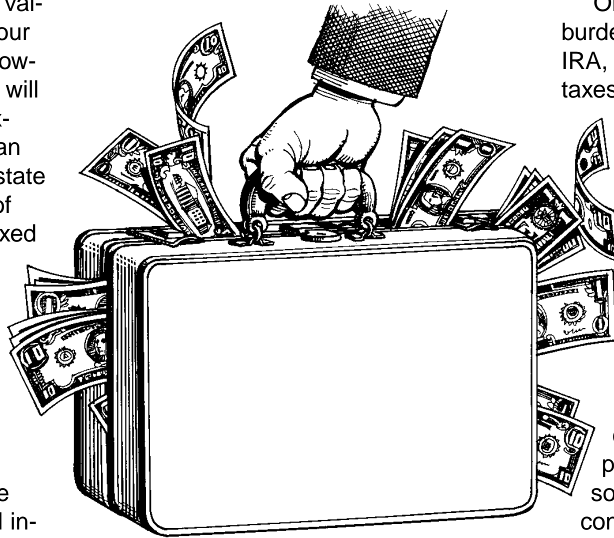
While the possiblity for loss as well as gain exists for any investment, active management doesn't need to be 100 percent accurate because many short-term moves are continually taking place in the financial markets, providing opportunities to recapture losses from trades that don't work out as hoped. To achieve Ibbotson's once forecast average annual return of 10 percent annually, an active management strategy would need to realize 0.8 percent a month and let it compound.

1 Returns are from indexes selected by Ibbotson and Sinquefeld as representative of the asset classes. One cannot invest directly in an index. No consideration of fees that might be incurred trying to mirror the performance of an index has been considered. While all investing involves risk, stocks tend to experience greater volatility and carry greater risks than bonds. The Dow Jones Industrials is a price weighted average of 30 industrial stocks listed on the New York Stock Exchange. The small company index represents the performance of the Dimensional Fund Advisors Small Company Fund. Small cap stocks have higher risk than the stocks of larger, more established companies and have significant short-term price volatility. Bond returns are represented by the Salmon Brothers Long-term High-Grade Corporate Bond Index. Risks associated with investment grade corporate bonds include higher interest rates, economic recession, deterioration of the investment grade bond market or investors perception thereof, possible downgrades and defaults of interest and/or principal. The U.S. Treasury Bill index is based on data from the Wall Street Journal. Both corporate bonds and treasury bills may fluctuate in market value prior to maturity.

Estate Taxes and IRAs

If you expect your estate to be valued well below $1 million at your death, feel free to skip the following information. But if your estate will exceed the current per-person exemption of $1 million (a couple can exempt $2 million with minimal estate planning) you need to be aware of how tax deferred accounts are taxed and plan ahead.

For example, an IRA rolled over at the death of the holder to a spouse typically qualifies for an unlimited estate tax deduction on qualified property. But if the beneficiary is other than a spouse, the IRA balance may be subject to state and federal estate taxes as well as state and federal income taxes. The nasty part is that the estate taxes would be paid prior to income taxes. As a result the beneficiary pays estate taxes on funds that later must be handed over for income taxes.



If the IRA balance feeds into the overall estate, when the estate is probated there is often a credit to estate taxes for income taxes that are later due, moderating the impact of taxes.

One strategy to minimize the tax burden on an IRA is to cash out your IRA, paying federal and state income taxes on the balance and then having the remaining funds pass on to your beneficiary at your death. If your IRA balance is $500,000, and combined state and federal income taxes are 40%, estate taxes would apply to only $300,000 if you cash out. Depending upon the size of your estate that can be a sizable savings.

Depending upon your circumstances, early withdrawal penalties of 10% could also apply, so talk to your tax and financial consultant prior to making the decision to cash out your IRA.

Even if you think your estate will be less than $1 million, we recommend sitting down with an experienced estate planner to make certain your heirs don't incur unnecessary taxes. Often individuals underestimate their net worth.

Thanks to Investment Advisor magazine for this tip.

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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PHONE ________________________ BEST TIME TO CALL ________________________