

The Cause Is Found

Good news. Federal Reserve Chairman Alan Greenspan believes he has identified the culprit that has caused the stock market's decline. The bad news is that it appears to be you and me and all of the other investors out there that he is blaming. According to Greenspan, and in a twist that is gaining popularity among the blame-placers, bubbles happen because the majority of the people expect good markets and the good life to go on forever. Because they see nothing but blue skies ahead, they bid up prices to levels that cannot rationally be supported, at which point the bubble bursts.

Greenspan maintains there's nothing government policy or anything else can do about it. (*Although, ironically he is on record for criticizing central government policy in the 1970s for not taking the proper steps to prevent that bubble from bursting.*)

So, now that we know it's all our fault (*actually we would place a*

higher level of blame on the Federal Reserves' role in the credit expansion in the United States over the last three years, which has been running at an annual rate of around \$2 trillion, accounting for about 20% of GDP), what's to be done? Our recommendation is that you cultivate a

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healthy level of paranoia in your life that recognizes bad things can happen and builds in a safety net.

A healthy level of paranoia is a level that doesn't cripple you with fear, or take the pleasure out of your accomplishments. But rather keeps you from betting the farm, tossing out the baby with the bathwater and all those

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Beyond Bathtub Bubbles

Bubbles used to be relatively innocent. They added modesty and pleasure to a bathtub and, blown on the wind, caught sunlight like iridescent jewels.

But bubbles have turned scary. The new bugaboo bubble is the housing market. Should you panic? Not really. There's more to housing than just another overpriced stock. With that said, housing prices could be headed for a downturn. But it is unlikely to be comparable to the Nasdaq's 70% downturn, if history is any guide.

Historically, homes have appreciated at right about the rate of inflation. There's a certain logic to that. If your

home were destroyed by a fire, inflation means it would cost more to rebuild it. For a period shortly after World War II, the decision to buy or rent a home had to take into account how much the home might depreciate in value. The last seven years, however, home purchase prices have risen nearly 30% more than the rate of inflation.

One of the primary factors behind that increase could well have been falling interest rates. Unlike the 70s and 80s, when home buyers were willing to spend a larger percentage of their income on housing, mortgage

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Asking the "What If" Question

What if" is one of the greatest questions you can ask yourself.

Before you make an investment, you need to ask, "What if markets decline or the company does not perform as expected?" How will you limit potential losses? "What if your employer runs into financial trouble?" How will it impact your job, your retirement plan and your benefits? Before you incur more debt ask yourself, "What if I lose my job or my savings?" How will I be able to pay this debt?

Asking "What if" helps us not only make better decisions but also be more comfortable with the possibility of negative outcomes. By understanding the risk, you choose to either accept it or not, or look for ways to control the risk, building a safety net.

Active investment management asks "What if" and then strives to position your assets to take advantage of the outcome perceived to be most likely. We are optimists and believe that the long-term direction of the financial markets is up and that there are opportunities to capitalize on that trend. But we also understand that there are no guarantees. Losses can happen and we need to have in place a strategy that strives to limit those losses and to recognize when the trend turns against us.

Holiday Gift Ideas for Children

As store displays will soon remind us, the holidays are just around the corner. If you are wondering what you can give a child or grandchild that will have lasting impact, consider the gift of education. There are a number of excellent ways to help fund a child's education including the **Coverdell education savings account** and **529 plans**.

Coverdell education savings accounts are juiced-up education IRAs that can be funded to the tune of up to \$2,000 per child per year. In addition to college costs, Coverdell funds can be used for elementary and secondary school expenses. Earnings grow tax-free and remain tax-free if used for educational purposes, however, the account must be fully withdrawn by the time the beneficiary reaches age 30 or it will be subject to tax and penalties. Because Coverdell accounts are considered an asset of the student, they may adversely affect a student's financial aid eligibility. If not used for college expenses, the account will eventually go to the child.

A strong positive for the Coverdell compared to 529 plans is the level of control you maintain over how the money is invested. While the contribution limit restricts how fast the account can grow, you can add professional management and move funds between investment options as desired.

A **529 plan** is an investment plan operated by a state designed to help families save for future college costs. 529 plans fall into two categories: pre-

paid programs and savings programs. Prepaid tuition contracts cover in-state tuition but often allow the value of the contract to be transferred to private and out-of-state schools. The full value of a 529 savings program can be used at any accredited college or university in the country.

Investments grow tax-free for as long as the money stays in the 529 plan. Distributions to pay the beneficiary's college costs are currently federal tax-free in the years 2002 through 2010. The donor stays in control of the account and with few exceptions the named beneficiary has no rights to the funds. In fact, the donor can opt to reclaim funds (there may be a penalty tax) or change a named recipient. The amounts you can put in are substantial (over \$200,000 per beneficiary in many state plans). Contributions qualify for the annual gift tax exclusion and you can elect to treat a contribution between \$10,000 and \$50,000 as if made over a five calendar-year period.

The catch is that you have little control over how the funds are invested and your ability to move out of a poorly performing 529 plan is limited.

The rules for these accounts can be somewhat confusing and this is a very sketchy overview. If the concept of giving children the financial ability to obtain a good education appeals to you, talk to your financial advisor and find out what works best for your circumstances.

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great old sayings which really come down to promoting a level of caution in your finances and in your investing.

The human race is by and large made up of optimists. And that is a good thing! We want tomorrow to be a better day, for the good times to roll on. But tomorrow is far more likely to be a better day if we realize that bad days could happen as well.

We are very fortunate in this country. We have been blessed with a relatively stable economy, with access to excellent education and the chance to continually change our lives for the better. Our lifestyles are the envy of

much of the world, even those of the lowest income levels of our society. Many immigrants who came here did so because they faced starvation in their homeland. The idea that we could starve to death is incomprehensible to the vast majority of Americans today.

But past performance is not a guarantee of future results in far more than just the financial markets. The American public is not solely responsible for today's bear market. But we are responsible for learning from this debacle and avoiding excesses in our lives that can lead to devastating financial losses.

Beyond Bathtub Bubbles

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payment to income ratios didn't see much increase in the 90s. Lower interest rates meant buyers could afford significantly larger mortgages without substantially increasing their payments, creating more demand for higher priced homes.

If housing prices come back to their trend over time, it will mean either falling home values, or no rise in home prices as the trend in inflation catches up to current home prices.

Unlike other investments, most homeowners can't opt to simply cash out their gains and stash them in a bank. They need somewhere to live. As a result, one would expect housing prices to see modest declines while homeowners by and large opt to wait it out.

Naturally, there's a "What if." What if many marginal loans begin to go into default, pushing foreclosed homes onto the market? According to the Mortgage Bankers Association, about 1.23% of all U.S. mortgages were somewhere in the foreclosure process during April, May and June, the highest rate since the group began tracking the data in 1972. About 4.7% of Federal Housing Administration borrowers are at least 90 days late on their loan payments, nearly twice the default rate of 1995, the agency says.



Too many foreclosed properties on the market could put downward pressure on existing home values. As a homeowner, you have to ask yourself the "what if" question and decide how this will influence your personal situation and what, if anything, you should do.

To Lend or Not to Lend

Often one of the hardest decisions is what to do when a family member or good friend asks for a loan. Before you make that decision, we would suggest that you ask yourself the following:

- 1) What is the likelihood the loan will be repaid, and if it is not, can you afford to lose the money? If you choose to make the loan, you have to accept that you may not get the money back. In addition, you will lose the earning power of that money. \$15,000 today may be worth \$30,000 in ten years. What impact will that have on your future?
- 2) What is the money for? Are you assisting in a genuine emergency situation or just enabling a person to continue imprudent spending? If the loan is to fund a business, what are the prospects of the business succeeding and will you be compensated fairly if it does?
- 3) Is it possible that the individual could obtain the funding elsewhere, but is just looking for a cheaper loan? Are you comfortable assuming the risk of non-payment if the borrower has alternatives?
- 4) Will lending the money cause problems in your family? Not everyone will see the loan as deserved. Some family members may think you are playing favorites. In addition, sometimes the inability to repay a loan will result in a family member avoiding you and family gatherings.

Charity Gone Astray

Check out charities before you give! Some charitable gift annuities are popping up on the radar screen of possible scams. These annuities transfer money or property to a charitable organization but provide the giver with a steady stream of income. The value of the annuity is generally less than the value of the money or property with the difference creating the charitable donation. There is nothing wrong with the concept of a charitable annuity, it's a question of who is offering the annuity.

Ironically, people are often less careful about checking out charity-based programs than they are other

If you decide to say yes, put the agreement in writing with the loan amount, interest rate, repayment schedule and penalties for late payments clearly stated. Make certain both you and the borrower sign the agreement and keep a copy. If you are talking about a substantial loan, have a lawyer review the agreement. Don't leave repayments to chance and the potential of a faulty memory. Keep a record of every payment and give the borrower a signed receipt each time.

Remember the tax man is involved, even in a loan within the family. Any interest you receive is taxable. The IRS even has a minimum interest rate it expects you to receive and bases your taxable income on that rate. Known as the applicable federal rate, the rate is published monthly in the [Internal Revenue Bulletin](#). If the loan is viewed as a gift in disguise, you may find yourself subject to gift taxes.

Remember that you are under no obligation to assist a family member in a financial fix simply because you have more money than that individual. Lending money may make the situation worse by allowing the individual to simply postpone the consequences of poor financial decisions. If you were in the same situation, would you feel justified asking another person to loan you money? With that said, every situation is different and you have to do the best you can, but be careful that

investments. Mid-America Foundation based in Arizona created a \$54 million charitable annuity Ponzi scheme that took 430 investors nationwide for an average of \$133,000 before regulators shut it down.

Before you invest, always find out who you are dealing with. There are several credit rating sources, non-profit agencies and government resources you can check to find out if a business or individual is on the up and up. The investment of a little bit of time upfront can be worth hundreds of thousands of dollars in the long run. If you don't know where to start, give us a call.

you do not jeopardize the future that you have worked hard to achieve by lending money.

Before you decide to loan money to a family member or friend, it's also a good idea to talk to your financial adviser or accountant and make sure you understand all of the ramifications of this decision.

Use Automatic Payments to Save

A major profit center for credit card issuers is the late fee, imposed if payments are received after a statement's due date. Citibank, MBNA America, and Discover customers have to pay \$35 late fees on balances over \$1,000; \$25 for balances between \$100 and \$1,000; and \$15 on balances below \$100. Other card issuers have somewhat similar late fee structures that vary based on the balance owed.

If you've run into difficulty lately getting your credit card payment in on time, due either to time speeding up or delivery of your statement slowing down, consider automatically paying the minimum balance on your card each month. Automatic payments are drawn from your designated account on the payment due date, assuring that you will never be charged a late fee. By setting the automatic payment at the monthly minimum, you retain the flexibility to pay your bill in full by the due date, or carry a balance over into the next month. If you have other payments where you have run into late fees, query them as well about the ability to automatically pay your bills on the due date. The savings in late fees can be substantial.

To establish an automatic payment, contact your credit card issuer or other creditors. One caution, if you change your bank account or designated account, you will need to change your automatic payment agreements as well.

Of course, the best policy is to pay off your credit card in full every month, and never incur their exorbitantly high interest charges or late fees.

Was 1987 a Tipping Point?

Throughout history there are “tipping points.” Points at which things changed. Markets, wars, public opinions, social trends. 1987 was one of those points of change for the financial markets and investor behavior, according to financial historian Peter Bernstein. Bernstein has been in the investment world since the 1950s and heads an investment advisory firm. He helped launch the *Journal of Portfolio Management* and is the author of Capital Ideas and Against the Gods.

The following is an excerpt from an interview with Bernstein, posted on www.PBS.org *Betting on the Market* column.

“1987 is important to the modern investor. It’s a symbol. It’s a syndrome, because here we had, for a single day, probably the biggest drop we’ve ever had in market history and enormous volume and panic and everything, and the next couple of days also. And nothing happened. And, in time and really not so long, the stock market got back to where it was at the 1987 top.

“So the lesson from that, or the lesson that people believe they learned, was the 1987 crash didn’t cause anything else to happen. Other crashes had caused bank failures, corporate failures, business failures, New York City almost failing. The 1987 crash didn’t cause anything bad. And so, “Why worry? If the stock market goes down, by the time I retire, it will be back up.” And if you look back at the long history — history that goes

back to 1920 — there are a lot of ups and downs, but in the long run, the trend is up. So even if I bought here, the 1929 high, by the time I retire, it’s going to be higher.

“My philosophy is that that’s history and that we really do not know. Other countries had histories like that and Germany and Italy had no stock market after World War II. The Russians had a gorgeous stock market until 1920.

“We don’t know what’s gonna happen in the next 50 years.”

The moral of this story: While wise individuals invest according to the historical probabilities, investing is not a cinch. It takes savvy, disciplined, experienced monitoring of the economy and the markets full time to give you the best opportunity for future success.

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