

Is It Time To Change Your Investment Approach?

It seems as though many investors are unusually edgy right now. Granted, so far this year the market hasn't gone far in a positive direction. But it also hasn't gone far in a negative direction either; in fact, "directionless" is an apt description of the stock market year to date. Certainly the market is not nearly as bad as it was in 2000, 2001 and 2002. So why do investors who managed to weather the worst market since the Great Depression seem more concerned now than they were in the midst of the terrible markets of a couple years ago?

Personally, I think it is the "Oh no, not again" syndrome. April 2000 through March 2003 was tough to stomach. Even if you performed in line with the market during that period – as most investors doing things on their own do not – you still lost quite a bit of value in the stock portion of your portfolio. If you are like the many investors who underperform the market by several percentage points, your losses were steeper

yet. In the meantime, you heard of people making a lot of money in real estate. The returns of April 2003 through February 2004 helped remind you why you invest in stocks, but since it appears we are heading for yet another poor year in stocks, it is easy to lose patience.

Don't. If your strategy is right for you, stick to it through thick and thin and you will achieve success. If you aren't sure your strategy is right, then double check that. But changing strategy should only be undertaken if you are severely wayward in your current approach. Consider this:

1. An individual recently came to me with a portfolio of \$1 million. This was down from \$2 million at the beginning of 2000, mostly due to investment performance. As we looked at it, the portfolio's drop in value from \$2 million at the beginning of 2000 to about \$1.1 million at the beginning of 2003 wasn't great; market returns over that period would have taken the \$2 million down to \$1.25 million, so this performance was quite a bit less than the market. But the real killer was that this investor decided at the beginning of 2003 that enough was enough – and switched all to bonds! So instead of participating in the market rally that would have taken portfolio values back up to about \$1.4 million, the portfolio value remained flat at \$1.1 million during 2003! Then, seeing the market recovery of 2003, what did the investor do? Switched back to stocks, just in time to see the \$1.1 million eroded to \$1 million when by the time we saw them. If this investor had achieved just market returns over the past four years and had not switched strategies,

they would have \$1.65 million today instead of \$1 million. That is the serious, significant damage you can do to your long term returns by losing faith and making an ill-advised switch in your strategy.



2. So many investors have looked at very low interest rates and an uninspiring stock market and, impatient for something that will provide them a return more than zero, have said to themselves "Real estate has been a great investment. Why don't I just take my money out of the markets and invest in real estate?" Certainly real estate values have climbed sharply over the past few years as demand has been spurred by low interest rates. While there will always be dynamics that make certain pieces of real estate perform well and while every investor should have some real estate investments in addition to stock and bond investments, investing in an asset class that has performed so well for so long is usually a recipe for financial disaster. To me, real estate values look like they are in the same "bubble" that tech stock prices were in back in 1999 and early 2000. I hear lots of discussion about how real estate values will always increase and all kinds of well-reasoned arguments why real estate will out perform stocks. It all reminds me of what I heard about the stock market in general, and the tech

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sector in particular, back in 1999 and 2000. “Pay no attention to the fact that these companies have no earnings.” “We are in a new frontier for the stock market; current long-term return expectations of 12% per year are grossly understated for the market going forward.” “The equity risk premium is disappearing, which will continue to drive stock prices higher.” And on and on. We all know what happened to the stock market after all that. Today I am starting to hear grumbling from realtors who say that they can't sell homes for anywhere near appraisal values that banks have used as the basis for a mortgage. Real estate, to me, bears all of the indications of being an overheated market right now, much like tech stocks in 1999 and 2000. If we are headed for a precipitous drop in real estate prices similar to what happened in the stock market as interest rates head higher and demand for real estate diminishes correspondingly, you can't say you weren't warned after reading this. So does it really make good sense to sell out of stocks and bonds to buy real estate right now?

It is football season, and I love football. And successfully managing your financial affairs requires many of the same attributes that contribute to success on the football field – solid fundamentals, patience and avoid mistakes. If your financial plan is right for you, have the patience to stick with it. That is how you will succeed in the long run. If you question whether the plan is right, then double check that. But don't go jumping to alternatives because you are becoming impatient or because the grass “seems greener” doing something else. That is almost a certain recipe for disaster. 



Tom Batterman
President
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Paying a Fair Price for Bonds

Purchasing an individual bond or CD is the best method for timing a specific income or money need with an individual situation. You can match the maturity and income needed almost exactly. However, purchasing bonds at a fair price requires careful attention to detail and some research.


Unlike mutual funds or stocks, determining the costs associated with a bond purchase is not easily discernable. Bond costs are hidden in the “spread.” The term “bond spread” or “spread” refers to the interest rate differential between two bonds. Mathematically, a bond spread is the simple subtraction of one bond yield from another. Bond spreads are the common way that market participants compare the value of one bond to another; much like “price-earnings ratios” are used for equities.

Unfortunately for the consumer, bond spreads are almost impossible to calculate. In part, this is because spread data is notoriously difficult to find since there is not a widely recognized corporate bond index like the S&P or Dow. So, without careful attention to detail and research, the consumer will not know if they are buying and selling bonds at prices that represent a reasonable commission.

Of course, careful attention to detail and research takes time and effort. Some financial advisors side-step this issue and avoid the extra effort by advising clients to use bond mutual funds only. Taking this approach deprives clients of the obvious advantages of individual bonds—controllable maturities, laddering opportunities, and quality control, to name a few. Individuals handling their own investments might have the time to devote to this research but probably won't have the right resources. Paying a fair price for bonds requires a high level of knowledge about the bond market including relationships with individual bond brokers and clearinghouses, familiarity with

internet resources that assist with the frugal selection of bonds, and awareness of market conditions.

At Vigil, we purchase large lots of bonds and then allocate the bonds among client accounts as needed. This allows us to leverage our research for the benefit of all clients and secure the best possible interest rate for a client. As you might imagine, the interest rate for a \$25,000 bond can be quite different than a rate quoted for a \$250,000 bond with the same maturity. Since we are fee-only advocates, we are happy to help our clients locate the best possible bond at the lowest price. Of course, if you are purchasing bonds through someone whose livelihood depends on bond commissions chances are that you will not be able to take advantage of having your assets leveraged with other like minded clients. After all, that would seriously reduce the commission paid.

We have seen all sorts of situations where clients have overpaid on bond investments placed with former advisors. In one scenario, a group of physicians was charged close to \$20,000 in commissions on a \$250,000 bond purchase! What a pay day for that advisor. Fortunately, they came to us soon after the purchase and we were able to help them reverse the sale and get a refund of their money. If they had waited longer before seeing us the outcome would not have been so favorable. More commonly, we see situations where individuals are sold bonds of poor quality or maturities that don't match their objectives. If you have bonds in your portfolio and would like an assessment of their worth and suitability in your portfolio, we are here to help. Contact us to schedule a no obligation review of your portfolio. You might be surprised to learn what you really have in your portfolio. 



Keep it SIMPLE or Play it Safe Harbor?

With predictions that the market is in recovery and the economy getting stronger, many closely held business owners are considering adopting a new retirement plan or making changes to an existing plan. For small business owners who want the most cost effective and easiest approach with minimal monitoring throughout the year—the Savings Incentive Match Plan for Employees (SIMPLE) or Safe harbor 401K plan may fit the bill.

Keep it SIMPLE—SIMPLEs, covered under IRC Section 408(p) are employer sponsored plans for businesses with 100 or fewer employees. Employers and employees can make plan contributions to a participating employee's IRA. To participate, employees must have earned at least \$5,000 in each of the two preceding years and must be expected to earn \$5,000 in the current year.

Contributions—Employees can make elective pre-tax contributions of up to \$9,000. Plan participants who turn 50 before the end of the year can contribute an additional \$1,000 to a SIMPLE. Employers can match employee contributions in one of two ways—a dollar for dollar matching contribution up to 3% of the employee's compensation or a 2% non-elective compensation for all eligible employees.

An employer may not do both. For example, if ABC company elects the matching contribution then 3% is the maximum match ABC can make, and non-elective contributions are not allowed. If ABC elects the non-elective compensation then the 2% contribution is the maximum and matching contributions are not allowed.

Direct employer contributions are not subject to Social Security (FICA) or federal unemployment (FUTA) taxes. However, employee salary reduction contributions are subject to FICA and FUTA. SIMPLE plans started after 2001 may be eligible for a business tax credit of up to \$500 for qualified start-up expenses. Also, employers can make contributions for their employees past age 70½ but employees cannot make SIMPLE contributions on their own behalf past this age.

Distributions—Since the plan cannot limit

participant withdrawals, all distributions are taxed at ordinary income rates and charged a 10% penalty for pre-59½ withdrawals. If participants choose to withdraw their money during the first two years they are charged a 25% penalty tax. Since participants are vested 100% at all times, participants can roll the money into their own IRAs.

When to use—Small business owners should consider SIMPLEs when the amount of self-employment income they make is limited. For example, an individual who runs a part-time business in addition to working full-time would be an excellent candidate for a SIMPLE. For example, if a client earned \$9,000 or less in a part-time business she could contribute the entire amount to the account, which would effectively reduce income to \$0.

Playing it Safe harbor—Safe harbor 401(k)s are not actually a separate type of retirement plan. Rather, it is a traditional 401(k) plan that includes several safe harbor provisions. As with any 401(k), employees may contribute a portion of their salaries to the plan on a pre-tax basis. However, with Safe harbor plans the employer is required to make certain contributions on behalf of the employee. These required contributions exempt the plan from many of the complex rules that apply to traditional 401(k) plans.

Contributions—Employees may elect to contribute, on a pre-tax basis, the same amount that could be deferred under a traditional 401(k) plan (2004—\$13,000, 2005—\$14,000, 2006—\$15,000; also employees over 50 years old may contribute an additional \$3,000 in 2004, \$4,000 in 2005, \$5,000 in 2006 with additional \$500/yr increments in years following 2006). In addition, because the Safe harbor plan is not subject to certain non-discrimination tests, the highly compensated employees will be able to defer the maximum amount permitted based upon their salary level, regardless of what the non-highly compensated employees defer.

Employer contributions are only required to be made to nonhighly compensated employees. However, if desired, contributions

can be made on behalf of highly compensated employees as well as nonhighly compensated employees. There are three different safe harbor contribution options.

The first two options are matching contributions based upon an employee's pre-tax deferrals. The more an employee contributes on a pre-tax basis, the larger the employer's required contribution generally is. An employer using the basic matching contribution option would make a contribution of 100% of the first 3% of each participating employee's pre-tax deferral, plus an additional 50% matching contribution for pre-tax deferrals that exceed 3% but do not exceed 5% of the employee's compensation. Alternatively, an employer could use the enhanced safe harbor matching contribution option. Here the employer designs a matching formula which equals or exceeds the safe harbor matching formula at each level of elective deferrals. For example, an employer could offer a 100% match not in excess of 4% of compensation.

The third option is not based on the employee's pre-tax deferrals. Here, the employer must make a contribution of 3% of pay for each eligible employee who has worked for the employer during the year, even if that employee has not deferred into the plan.

Distributions—Employees are immediately vested 100% in both pre-tax deferrals and in the employer safe harbor contributions. Additional matching or profit sharing contributions may be subject to a vesting schedule. Safe harbor contributions are distributable only upon employee's separation from service, death, disability, or attainment of age 50½. Safe harbor contributions are not eligible for hardship withdrawal.

When to use—With safe harbor plans employers may maintain other retirement plans in addition to the safe harbor 401(k) plan. Accordingly, safe harbor plans are ideal for employers who wish to maximize their pre-tax retirement savings options.

Distinctions between SIMPLE and safe harbor plans—First, the limit on employee pre-tax deferrals is less for a SIMPLE plan. For



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instance, in 2004, a SIMPLE plan participant can only defer \$9,000 versus \$13,000 with a safe harbor plan. But, the employer contribution requirement is less with the SIMPLE plan. Second, under the SIMPLE plan, the employer may not make any additional contribution other than the 2% employer contribution or matching contribution. Lastly, an employer with a SIMPLE can not make additional contributions to other retirement plans other than the SIMPLE whereas employers with safe harbor plans may.

Both SIMPLEs and safe harbors are appropriate plans for small business owners. Safe harbors work best for employers that generate more income because of the higher contribution limits. SIMPLEs work best for employers who earn extra money on the side. If this is something you are interested in make sure you ask your financial advocate for help selecting the plan right for you. Small business owners are in the unique position to be able to stash away considerable pre-tax savings in investments of their choosing. Don't squander this opportunity! Your fee-only financial advocate will work with you to make sure that your retirement plan isn't being whittled away by commissions and other unnecessary expenses. ✓

Mature Bonds No Longer Earning Interest

The United States Treasury estimates that nearly \$9 BILLION in matured U.S. Savings bonds are sitting in safe deposit boxes, desk drawers or filing cabinets. Since these matured bonds can no longer earn interest they should be redeemed. While rolling these bonds over to a HH bond was once an option, this option no longer exists and bond holders will be forced to pay taxes on accrued interest. Not sure what to do with these bonds? Consider using them to fund a charitable trust. You end up with an immediate income tax deduction, lifetime income, and the ability to give your favorite charity future funds. Contact Vigil Trust if you would like to discuss this further. ✓



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