

# The New Three-Legged Stool ....Update

March 2010

Volume 1 Issue 8

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## Twelve Months and Counting

March 2010 marked the first anniversary of the recent stock market low reached last year. At that time the stock market appeared to be in a free fall. The Dow Industrial Average had just broken through 7,000 in February and seemed to be on its way to 6,000? 5,000? Finally that Average closed at a 12-year low of 6,547 on March 9, 2009. The financial world was coming to an end. Investors pulled \$100s of billions out of stock mutual funds in an attempt to curb their losses.

Pundits predicted it would be years until the stock market recovered. Some predicted the economy was in a tail spin that would be worse than the Great Depression.

Instead of a Great Depression, the stock market used the March 9<sup>th</sup> low to launch a great recovery by jumping 20% over the next 10 trading days. As we passed the one year anniversary last week, the stock market had gained over 60% and created \$5.6 trillion in gains as

measured by the Dow Jones U.S Total Stock Market Index. And how have investors reacted to this recovery? They have continued to sell their stocks even as the market recovers. Only in the last three months have contributions started to exceed withdrawals. The Investment Company Institute reported that net cash flow for stock mutual funds has only totaled \$1.5 billion in this 12 month period. You might well ask what investors

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## What Can We Learn From This?

Neither you nor I will ever be able to predict the short-term direction of the stock market. If there was a way to do this consistently, someone would have discovered it by now. You will probably not see the next severe down turn coming. You will probably not be able to get out before the market drops like a stone. I have heard some people say they knew this crash was coming and were sitting in cash when the stock market spiraled downward. They are

probably still in cash waiting for the market to crash again because they missed the 60% advance of the last 12 months. Their money is sitting in money market funds earning on average less than ½%.

The good news is that you don't have to be able to predict the direction of the stock market to be a successful investor. You start by developing an investment strategy that divides your

investment dollars between fixed income investments and equities. The proper division, or allocation, is arrived at by looking at the historical returns for these classes of investments and combining them in a way that seeks to allow you to earn the return you need to reach your goals. Once you've formulated your strategy, you stick to it. Let the financial markets tell you when to buy and sell. As the stock market goes up, you become over

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## Twelve Months and Counting

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are doing with all the cash that was pulled from the stock market. With interest rates at historic lows, the average investor has put \$386 billion of his money into bond funds. They have sold their stocks low and are now buying bonds high. (Remember that as interest rates rise, the value of bonds generally declines.)

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### **What Can We Learn From This?**

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weighted in equities and must sell off a portion of them to buy fixed income to rebalance. When the stock market goes down, you are over weighted in fixed income because the equities have just shrunk. You adjust by selling off some of the fixed income assets to buy equities. Following this strategy simply forces you to sell high and buy low.

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## The New Three-Legged Stool

*A Tax Efficient Approach to Retirement Planning*  
By Rick Rodgers



Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

[www.thenewthreeleggedstool.com](http://www.thenewthreeleggedstool.com)

## How Does An Asset Allocation Strategy Work?

Bill and Karen are in their early 60s and are retiring in 2007. They have accumulated \$1 million in investment accounts. They calculate that they will need to draw \$40,000 per year from these accounts to maintain their lifestyle which represents a withdrawal rate of 4%. The withdrawals will need to increase each year to keep pace with inflation. At their ages, their joint life expectancy is more than 30 years. An investment return of 8% will allow them to withdraw 4% and still have their principle grow with inflation. Their allocation between fixed investment and equities will need to have a projected return of 8% to meet their goals.

Dimensional Fund Advisors, Inc. has done extensive research on returns for various classes of equities and fixed investments. Their research shows that the average annual return for the U.S. total stock market over the last 30 years is 9.8%. The Barclays Capital U.S. Government Intermediate Term Index has had a return of 6.5% for the same period. Although you cannot invest directly in an index, an allocation of 50% fixed and 50% equities would have produced a return of 8.2% over the past 30 years ( $9.8\% \times 50\% + 6.5\% \times 50\% = 8.2\%$ ) before deduction of fees. Although this is a fictional example, presume for purposes of this analysis, Bill and Karen begin their retirement with a 50/50 allocation on October 9, 2007 at the peak of the stock market.

By March 9, 2009, Bill and Karen are 16 months into retirement and have withdrawn \$53,000 from their investment accounts. The equity portion of their account is down 53% and has a current value of \$218,000. The fixed portion of their account is down 10% and it is worth \$426,000. Bill and Karen have watched their nest egg shrink to \$644,000. What should they do? Sell everything to stop the losses? No, we believe that they need to follow their strategy and rebalance. They sell \$104,000 of the fixed assets and buy equities to bring their portfolio back to 50/50.

It is now March 9, 2010 and Bill and Karen have taken another \$40,000 from their investments. The equity portion of their portfolio has recov-

ered to \$475,000 and their fixed income portion is now worth \$345,000. The total account value is back to \$820,000 but it is still down from the \$1 million they started with in 2007. Should they let it go until they get back to \$1 million before rebalancing? We believe that the correct course would be to rebalance now. Sell \$65,000 of equities and put the proceeds into fixed. Let the financial markets dictate the time to buy and sell. When your portfolio is over weighted in either equities or fixed income, you need to rebalance under this strategy. **Please keep in mind that this 16 month period is not representative of how markets perform over a market cycle. Equity markets during the past 16 months have experienced significant positive returns that are atypical. Past performance is not indicative of future results. Applying this strategy over other 16 month periods would not result in similar positive returns.**

Bill and Karen are only hypothetical examples but they illustrate how asset allocation is used to implement a strategy that keeps your investment portfolio on a possible right course. Without a strategy and the discipline to stand by it, you are guessing or following the guesses of some so-called expert. Your emotions take over and you end up making the classic mistake of buying high and selling low. It is a recipe for financial ruin. Better to follow the example Warren Buffet who is one of the most successful investors of all time. On October 17, 2008 he wrote an Op Ed piece for the New York Times titled "*Buy American, I Am.*" In the article he talks about the commitments he was making to buying equities in the middle of the financial crisis. Most investors were selling their stocks as fast as they could while Mr. Buffet was calmly buying. In the article he wrote "A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful." Just another way of saying buy low and sell high.

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## Rick's Tip - Borrowing Rules for Family Loans

"Neither a borrower nor lender be" wrote William Shakespeare in *Hamlet*. My son studied *Hamlet* last year in a college drama class. Apparently he thought Hamlet's advice was out of date. Either that or he only paid attention to the lender part.

Actually, intra-family loans do have a place in our financial lives, particularly in times of tight money or when estate transfer taxation becomes a problem. If properly used and structured, both borrower and lender can benefit from the transaction.

Today, younger generations forming households are faced with the onerous task of finding money to buy homes. Tight lending standards tend to delay home purchases, even when the younger buyers can support the debt and other homeowner-ship costs. This opens up the possibility of borrowing from the "Parents Bank & Trust."

For interest on a real estate loan to qualify as a tax deductible expense, the debt must be secured. If the amount borrowed does not exceed \$1,000,000, the interest will be tax deductible as an itemized tax deduction.

Interest paid to the Parents Bank should be reported as interest income on the parent's tax return. If the Parents Bank wishes to cut a sweetheart deal and extend a low interest rate to the family borrower, that interest rate must meet or exceed the Applicable Federal Rate for the loan term (published monthly in the IRS Bulletin); otherwise the IRS will consider the money a gift and subject to gift tax rules.

In our current low interest rate environment, minimum rates are reasonable. The March 2010 AFT for midterm (3 to 9 year loans) is 2.69 percent. For long term (greater than 9 years) the rate is 4.35 percent. These rates are recalculated monthly.

If the Parents Bank sweetens the deal by agreeing to defer payments, an imputed interest amount, even if not collected, is required to be reported on the tax return.

The Parents Bank could also just waive, or forgive, interest payments on the loan. In that case the lender is credited with the imputed interest amount, which qualifies as a gift, free of gift taxes, if less than \$13,000. Anything more than that requires the filing of a gift tax return for the excess.

Parents contemplating loans should consider the relative value of the property, the ability of the child to pay for upkeep and maintenance, who will be responsible for making payments and keeping up the property in the event the child loses his or her job, or ability to make payments, and under what circumstances a parent can step in and foreclose the position in order to protect the investment. Finally, the transaction, in order to qualify for deductibility of interest, should be secured by a deed of trust.

Those are the rules, now the reality: As Dr. Thomas Stanley pointed out in his book "*The Millionaire Next Door*" we may not do our kids any favor by giving them too much. Making money easily available for a child to buy a house that is beyond his/her means to maintain financially (upkeep, taxes, insurance, etc.) leads to a situation where the child may be forced to come back time and time again for more money. Further, loaning money to support a lifestyle leads to a situation where the child never learns to make choices and accept personal responsibility for the handling of his/her own finances.

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