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THE KELEMEN-WAY FINANCIAL PERSPECTIVE

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Should You Revise Your Strategy Because Of The New Tax Law?

Other than the stock market recovery, the other big financial news this summer has been the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Whether you agree with it or not, this is one of the largest tax cuts in history. Most of our readers have already received a special supplement outlining the basic provisions and some investment implications. Since then, we've had more time to research it and think about it in depth, so here are some additional thoughts, mostly from an investment portfolio perspective.

JGTRRA affects investments through reductions in income tax rates, capital gains and corporate dividends. We're already hearing comments that one should switch portfolios to dividend paying stocks, or that tax-deductible retirement plans aren't as good a deal now. We're also seeing headlines such as "Portfolio Actions To Take Now" on magazine covers at the newsstands.

Asset Allocation

Stocks now have an additional tax advantage over other alternatives in this low interest rate environment because of the 15% rate on dividends and a maximum 15% rate on capital gains. However, we believe that **nothing in the tax bill requires immediate action on your portfolio. The key to your asset allocation should not be taxes, but rather your goals and risk tolerance. The mixture of stocks to bonds before the tax bill should be the same mixture you have now.** If anything, the new law gives an additional advantage to buy and hold, as opposed to short-term trading strategies and market timing. For those who look at their assets in a unified way, it makes sense to allocate more of the taxable bonds and REITs into tax-deferred retirement plans, and allocate more stocks to the taxable accounts. But, except for dividend-paying stocks, this has always been our advice.

Retirement Plans

Many of JGTRRA's changes are temporary. Some provisions expire as soon as 2004; others extend out to 2011. This makes long range financial planning difficult. For example, do we run retirement planning scenarios with or without the sunset provisions? And if so, which ones? How much portfolio return should we assume would be capital gains and dividends?

Logic would say that it makes sense to save more in taxable accounts at lower tax rates and at a lower tax on dividends and capital gains, rather saving in a tax-deductible retirement plan and paying taxes later at a possibly higher tax bracket at ordinary income rates on everything. However, the numbers we have looked at under a variety of scenarios just don't pencil out. **Never underestimate the power of the time value of money from a tax deduction today and tax-deferred growth.** This is especially true with employer matches and the higher amounts those over age 50 can put into retirement plans. The money in your pocket from the tax deduction is a sure thing. The promise of a lower capital gain rate or income tax rate later is not.

Action

If you already have a well-structured portfolio, you don't need to immediately do anything with it. Keep funding your tax-deductible retirement plans, Roth IRAs, and 529 College Savings Plans. **There are a lot of other provisions in the new law that have nothing to do with investments, so we do urge you to meet with your tax professional soon to adjust your quarterly estimates and to learn how those other provisions may affect you.**

Eliminating Roadblocks to a Secure Retirement

The first rule of retirement planning is that nothing works out exactly as projected. You could say that about a lot of things, including vacations, a recipe, a home remodel, or a given day. So to have a secure retirement that comes close to resembling your projections, you need to anticipate roadblocks and have a contingency plan to address them. Here are four major roadblocks that could undermine your retirement, and some ways to deal with them.

1. A catastrophic casualty claim.

In this litigious society, asset protection is more than just keeping enough insurance. It's also about how you own your assets. You generally shouldn't own everything in your name, or jointly with your spouse. Careful estate and insurance planning can help protect your assets through proper ownership. Some assets, such as your home, IRA, retirement plans, life insurance, 529 plans and annuities are more protected than others. Remember, though, that no plan is "bullet proof." Seek competent legal advice **before** you have a claim.

2. Death, disability, and long-term care

One of your most important assets is your ability to produce an income. Without your earnings, saving for retirement becomes a moot point. Therefore, make sure your disability insurance comes close to matching your net income and that you have adequate life insurance.

We have seen how people hate to see their portfolios drop, and we have seen how the distant threat of needing long-term care affects the way people reduce their retirement opportunities by protecting their capital for the possibility of needing long-term care. Long-term care coverage is very inexpensive for those under 50, very reasonably priced for those under age 60, and still a bargain for those under 70.

3. Poor investment results

Prudent investment planning using asset allocation can go a long way toward reducing investment risk. We can help you with this, and free your time to do what you do best. Remember, sometimes it's not always about poor results, as much as it is about unrealistic return assumptions. More about this in a future article.

4. Boomerang children

We have seen several retirements derailed by children who either didn't/couldn't leave the nest, or who returned, often with grandchildren in hand. And it happens to some of the best families. Other than moving to a smaller home to discourage that, we honestly don't know what to advise. However, if you think it may happen to you, then make the boomerang scenario part of your retirement planning assumptions and set aside funds to cover it. And remember that aging and infirm parents can also boomerang on you, too.

The "Hot Strategy Approach" to planning

Unfortunately, the typical "planning" approach these days is to start out with an investment recommendation or a planning strategy, as shown in Figure #1. Without covering the bases first, it doesn't take much to jeopardize your financial security and wipe out your investments. (Figure #2). This would be analogous to asking your doctor to prescribe the latest advertised lifestyle drug without a proper diagnosis first, ignoring your blood pressure, weight, cholesterol, and other health preservation issues until later, if at all.

A true financial planning approach (Figure #3) helps reduce the danger of these roadblocks by addressing them early in the planning process. So start by 1) protecting what you already have, 2) address liquidity and short-term goals, 3) build a solid long-term investment core, and only then 4) take advantage of hot strategies and the "fun stuff."

FIGURE #1

Typical "Planning"Approaches

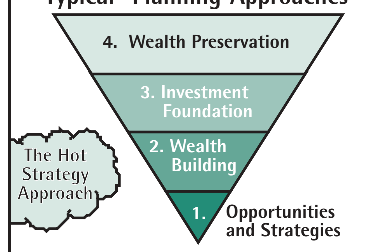

FIGURE #2

The Pitfalls of Typical "Planning"

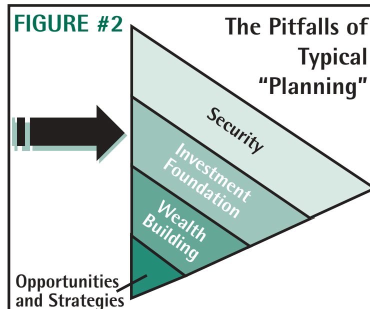

FIGURE #3

A True Planning Approach

Savor the Moment and Learn From It

Summers in Oregon are special, and something to be savored. By the time you read this, it will be early to mid August. The local produce stands are bountiful, the back-to-school ads are in the paper, the days are getting shorter, and your July investment account statements are in the mail.

Hopefully at this time, your portfolio values are close to where they were the first of July. If they are, you should savor the moment. We've had a very good year during the past three months. We have all come through the worst bear market in decades. **If you "stayed the course", congratulate yourself. And whether or not you held tight, promise to remember this recovery when we have our next bear market.**

Try to remember how you felt last October 9 at the market bottom and for many days earlier this year as we almost hit that bottom again. It felt lousy, and it took fortitude to hang in there. Few could imagine the markets turning around so fast and going up so far so quickly.

Continued on back page.

Beware Of The Hedge Fund Craze

We've seen a lot of investment fads come and go during our collective 31 years in the business. Limited partnerships, oil stocks, no-money down real estate, market timing, dot.com stocks, hot sector funds, and day trading, just to name a few. Some of them worked well in the early days before they became popular. Then nearly everybody, including inexperienced managers and novices, got into the act. That's when it became risky and the vehicle either crashed or dramatically slowed. It's happening now with today's latest fad—hedge funds.

A hedge fund is a large pool of money that has the ability to use a wide variety of investment strategies in global financial markets to make money in any environment. Many of them are highly leveraged. They use options to anticipate a rising or falling market, and they often try to take advantage of minute swings in interest rates or the prices of certain securities. They are open only to accredited investors and require a high minimum account size. However, newer versions have smaller minimum account size requirements, some as little as $25,000. (See the table for a comparison against mutual funds.)

The April 9 issue of the *Wall Street Journal* reports that there are 6,000 hedge funds run by everyone from proven money managers to failed stockbrokers. Some posted gains of more than 100% last year; others lost everything. It notes in the April 8 issue that hedge-fund holdings represent only about 4% of the stock market's value, but they account for about 25% of its volatility because of leverage, borrowing, and bets in volatile sectors such as technology.

According to CSFB Tremont LLC, a hedge fund tracking service, "the three-year market decline has ripped the $600 billion industry to shreds. Across the board, funds of all sizes and styles are having trouble." Over 73% earned no performance fees last year because they failed to reach their previous years' "high water mark".

For some funds, 2002 might have marked the third consecutive year of losses, which can add up to a deep hole that has to be filled before a performance fee can be charged. A hedge fund manager can just decide to close the fund down and start a new one, thus making it easier to earn a performance fee in a new fund. Of the 2,000 tracked by CSFB Tremont, 220 closed in 2002, and that could reach 400 by mid 2003. The handwriting was already on the wall as the SEC began fact-gathering hearings in mid May. **Don't be left holding the bag! The lesson that should be learned from hedge funds and all the other fads is that they may be good at first, but too good to be true for very long.**

MUTUAL FUNDS VS. HEDGE FUNDS

	Mutual Funds	Hedge Funds
Regulation	Heavy. Fund directors required to represent investor's interests	Light. No SEC registration required. Open only to wealthy investors
Diversification & risk	Usually hold broad mix of investments, lowering risk and likely gains	Holdings may be highly concentrated, raising risk and potential gains
Fees	Relatively low, but managers get paid even if they lose money for investors	High, but managers don't get paid paid biggest fees if they don't make money
Portfolio disclosure	Semiannual reports are required	No disclosure is required
Performance disclosure	Usually reported every trading day and published	Usually reported monthly only to investors
Investment methods	Mostly publicly traded securities. Little use of leverage or short selling	Widespread use of leverage and short sales. Purchases of nonpublic securities, currencies, & commodities
Share buybacks	Usually done daily after market close	Often limited to a few times a year
Tax liability	Varies, but investors may face taxes even in years that fund loses money.	Frequent trading can generate large tax bills.

Source: Wall Street Journal, March 3, 2003.

THE KELEMEN-WAY ADVANTAGE

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants and jointly serve their clients as a team. Their fee-based practice focuses on wealth planning and management for professionals, business owners, and retirees. Together, they have developed The Planning Vision Process®, and several other unique processes. They are both advisory associates of The H Group, Inc., one of the largest independent fee-based registered investment advisory firms in Oregon with 18 professionals and over $260 million under active management. They are also registered with Financial Network Investment Corporation, member SIPC, a national broker-dealer with offices throughout the United States. The H Group, Inc. and Financial Network Investment Corporation are unaffiliated.

About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP®**, is a contributing author of the definitive book on retirement planning: *Ways and Means: Practical Answers from America's Foremost Financial Advisors and Retirement Planning Attorneys*. His other contributory book, *Strictly Business—Planning Strategies for Privately Owned Businesses*, is now available from Ron or Quantum Press. He is a Board Member of the Willamette Valley Estate Planning Council, active in several local charities, and is frequently quoted in the press.

About Mary Way, CFP®, CPA

Mary Way, CFP®, CPA is a professional team member on Ron's team for over eight years. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She is active in Salem Rotary, the Financial Planning Section of the Oregon Society of CPAs, The Oregon Financial Planning Association, and The Willamette Valley Estate Planning Council.

Team Update

This has been our busiest summer in many years. Some of it is because of meetings with new and existing clients. But we spent a lot of time getting up to speed on the new tax law. We are also getting organized to scan documents with the hope of someday soon becoming a paperless office. (Yeah, right!)

Lani Moore has been kept busy juggling all the scheduling for our activities, plus a lot of personal things. Her son, Caleb had nerve surgery for his hands, and her youngest daughter was recently married—the fourth child in the past year! She and husband Jim became grandparents for the first time. They are now busy finishing off the basement of the home they recently built to accommodate those boomerang children mentioned elsewhere in this newsletter.

Debbie Renggli has been doing all the organizing for our scanning project. She and husband Bob are looking forward to moving into their home in August after spending 11 months in an apartment. Son and daughter, Pete and Gretchen will be able to enjoy the house for a couple weeks before going back for college in Arizona and San Francisco in late August.

Mary Way participated in the Oregon CPA Society's conference on estate planning in June. After her Australia vacation with husband Steve in the spring, she has settled down to enjoying her home and garden this summer. She's been busy picking out furniture and installing more landscaping. She continues her 25-year practice of yoga, and faithfully goes to Jazzercise several times a week at the Courthouse.

Ron Kelemen provided background information to *On Wall Street* on using a statistical method called "Monte Carlo simulations" to model retirement projections. He is giving his hamstring a break from competing in any running or triathlon events this summer, but **Kathy** is on a roll with several tennis tournaments. He and Kathy traveled to Italy and Austria the last two weeks of May, eating very well along the way, but keeping it calorie neutral with lots of walking and hiking. Skyler is now home from her high school exchange year in Italy, their exchange student Feruza is home in Uzbekistan for the summer, and Shanti is teaching gymnastics and diving at a summer camp in Vermont, returning to Boston University in late August.

The Kelemen-Way Financial Perspective Is In The News

Originally called *Kelemen's Financial Perspectives,* The *Kelemen-Way Financial Perspective* is now in its 12th year of publication. Some issues come easy; others are a struggle. But all are labors of love. The July 14 issue of the *Statesman-Journal* newspaper ran a feature on this newsletter and two other local businesses that also write their own newsletters. Contrary to what the article stated, we gladly take on new clients from sources other than referrals if the fit is right.

To see the article go to: **http://news.statesmanjournal.com/article.cfm?i=64623.**

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Savor the Moment and Learn From It . . . continued from page 2

DALBAR, a financial services industry research organization, conducted a study in 2001 on investor behavior from January 1984 to December 2000. During that period, the average diversified stock mutual fund returned 13.3%, but the average mutual fund <u>investor</u> only earned 5.3%. Put another way, the study concluded that $1,000 invested in the average diversified stock mutual fund in January 1984, would have grown to $8,300 17 years later. But the average <u>investor's</u> account grew to only $2,400. This was less than could have been earned in money market funds over this period. Why? DALBAR concluded that many investors either let greed pull them toward chasing the hottest mutual funds (after they'd run up) or they let fear push them out of the market during difficult periods.

These statistics are not yet available for the period from December of 2000 to now. However, we suspect the average investor fared far worse than the average diversified mutual fund. Those who got out of the market will eventually get back in when it **feels** better/safer. When does it feel safer? After it has risen for a while, of course! Since that October 9 low, all the major stock market indexes are up 25%. **Those that moved to cash will literally need <u>years</u> at today's interest rates to get to where those who stayed invested are today.**

Yes, there are still problems to be worked out, just like there were always positives during even the darkest days of the market decline. Not everything will go smoothly. There are still international tensions, terrorists, high unemployment, the trade deficit, the weaker dollar, corporate governance issues, and other economic ills to overcome. **So savor your gains and be patient if we have a minor correction.**

In spite of recent market returns, many portfolios are still below their 1999 levels. Losses are still available to offset the gains. This makes it easier to make changes without incurring capital gains taxes. So, use this opportunity to develop a more balanced portfolio before the next leg of the bull market. And enjoy what's left of your summer, too.