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Spring 2007 Newsletter

Overwrought and Overbought

There are a couple major themes in the process of developing around the broad topics of real estate and inflation. The impending real estate bubble has been underway for at least a year in many portions of the U.S. The National Association of Realtors reports that overall home prices have declined by 2% over the past year. In many areas the value decline is much greater and overall it would appear that prices may fall further before leveling off. The reaction in the credit markets to several years of extremely easy mortgage money has led to a significant tightening of lending standards, just as the overhang of real estate supply is at a peak in many areas. That is not a recipe for a happy ending.

The equilibrium point where demand and supply are roughly aligned may require either a more sizeable drop in overall real estate prices or lower borrowing rates. For now it would appear that prices may decline further as a number of factors are working against sharply lower mortgage rates. For most areas 5-15% price reductions may be in the reasonable range while certain overbought areas may witness even larger declines. While this falls far short of a "bubble" or "contagion" it will have an impact on the economy.

The second major theme at work in the background is the possibility of an increase in the rate of inflation caused largely by productivity declines and increases in foreign goods prices. In March, the year over year increase in imported goods prices rose at the highest rate in 11 years. Just a couple weeks later the Commerce Department reported that the primary measure of aggregate economic growth (Gross Domestic Product) grew at its lowest rate in over 4 years. None of this absolutely portends that "stagflation", the old term to describe slowing growth and rising prices, is inevitable but just that it is on the radar. The eventual cyclical unwinding of the excesses in the housing market may hold the key to how all of this unfolds.

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All the Rage

Sometimes it pays *not* to bite the hook of the newest/fanciest/complex strategy or product. Exchange Traded Funds, Hedge Funds, Roth Conversions, Long Term Care Insurance and many other products fit well within this hot product category. While we are generally positive on the intended design of Exchange Traded Funds (ETF's are mutual funds that opt to trade on the stock exchange), the very fact

that investors can trade intra-day has attracted the fast-money crowd (Hedge Funds and Wall Street traders). The basic idea of most ETF's is to track a particular index but some of these funds have an incredibly narrow focus which tends to look more like old-timey sector funds (funds that invest in a particular sector or industry such as healthcare or technology). Because of this sometime overly-narrow focus and heavy intra-day trading

Beneficiary Designations

All of you know the importance that we place on both selecting and maintaining proper beneficiary designations on IRA, 401-k and other similar accounts. In most cases what is on these seemingly simple forms trumps what is in the will and sometimes has unintended consequences for everyone concerned. Ideally the beneficiary designations of these accounts should coordinate with not dismantle the intentions expressed via your estate planning documents. In all but the rarest cases, natural people should be named as at least the primary beneficiaries (because of more favorable withdrawal provisions) and the accounts should contain contingent beneficiaries as well.

the prices of ETF's can often wander away from the underlying index that it seeks to track. To some extent, ETF's appear to be undermining the very "buy and hold" approach that they were created to promote.

Hedge Funds are mutual fund like investments that are aimed at very wealthy investors and avoid much of the regulatory oversight of traditional funds. They tend to trade at a far greater frequency than even the most active of the actively managed (read- stock picking) mutual funds. They also almost always come complete with significantly higher costs due first to the trading and secondarily due to sometimes outrageously high management fees. Because many of the super-wealthy are attracted to the high risk/high reward investment tableau they have been popular, but there is almost no evidence that the popularity is justified by any type of long term returns.



The headline of a story in the April 1, 2007 *Wall Street Journal* read "The year 2010 offers a unique way to fund a Roth IRA-but is "unique" better?" This is well put and fairly well describes how we view many of these possible conversions. Starting next year (2008) some company plans will be eligible for Roth conversion assuming both the plan and you qualify. Starting in 2010, however, everyone qualifies for a Roth IRA conversion.

Roth IRA's have been around since 1998 and have several possible advantages over traditional IRA's. First, all earnings in retirement are withdrawn tax free; there are no required minimum distributions after age 70 1/2; and your heirs may be able to enjoy tax free withdrawals as well. Those are the plusses. The negatives are the contributions aren't deductible; higher income individuals aren't eligible; and tax must be paid on the contributions up-front rather than at a later date. For conversions in 2010 the tax due can be spread over a two year period.

J.E. Wilson Advisors, LLC

2431 Devine Street
Columbia, SC 29205

Phone:

(803) 799-9203 / Toll Free: (888) 799-9203

Fax:

(803) 254-4474

www.jewilson.com

There are some issues that have yet to be fully addressed regarding Roth conversions that are highly problematic. First, something called the "pro-rata rule" will grab many investors who think that they may be able to convert the whole of their non-deductible IRA contributions into a Roth. This rule basically requires that you add up all IRA's, SEP's Simple IRA's and create a ratio of your non-deductible contributions to this sum. The result will provide the percentage of the conversion that's tax free. Of course, you also need to be able to pay the pesky taxes due from outside retirement plan sources. Finally, the vagaries of tax policy within the current political landscape, some or all of these provisions could well be changed by time 2010 rolls around. Our advice is to take a deep breath and let's see what the next year or two brings in terms of possibilities and alternatives.

Long Term Care Insurance has been around for about 20 years and the sales tactics have changed over time. Our general advice has been that investment/financial assets of greater than \$1 million make LTC a poor purchase strictly from a financial viewpoint. The new marketing strategies of insurance companies however focus on leaving your inheritance intact by purchasing LTC insurance. The average purchase age is about 60 with an average annual premium of just under \$2800 per person. The highest payout on record is about \$800k and an average of about \$100k. For most of our clients this continues to be a poor financial purchase.



Keeping Wealth Intact

One of our largest responsibilities is to assist our clients, not only with building wealth, but ***maintaining*** it for the long term. Many factors can go into this equation and we are always searching for new and better ways to look at the impact of "highly improbable consequential events" that could occur. Toward that end, a new book, (*The Black Swan*), by Nassim Nicholas Taleb (who you may remember wrote *Fooled by Randomness*) provides some valuable insights into this question. Taleb is a great storyteller and wraps his often deep and provoking thoughts around stories that enable the reader to comprehend what otherwise might be gibberish. It is a bit of a tough read even with the stories, however, given the depth of the topic. If you like to read and think, you probably can't do much better than this one.

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