

# *Financial Security by Design*

*Investment and Estate Planning*

Thanksgiving 2001

Dear Customers and Friends,

I hope that you were able to share this holiday with family and friends.

While I mourn the loss of so many on September 11<sup>th</sup>, I am grateful that the death toll was not higher, that the Anthrax mailer apparently ran out of stamps, that the Afghanistan campaign has avoided disaster and that, finally, it may be time to re-enter the stock market.

**Is It Time To Buy Stocks?** The investment class that I am teaching this semester is forcing me to reexamine my investment biases. As regular readers know, I am a buy-and-hold investor in large measure because I doubt my ability to "time" the market - to sell near the market top and to buy back near the market bottom. Many prefer a more active strategy. So, I will stick my neck out and make a market predication.

On the plus side, the Federal Reserve Board and the Treasury forced interest rates down by cutting the "Fed Funds Rate" and by announcing the demise of the 30-year bond. Lower rates in the past always presaged a market recovery.

Lower interest rates improve the economic climate by making it cheaper for businesses to invest and by reducing the cost of consumer debt. Lower interest rates also improve the stock market's prospects by making "safe" investments less attractive. A year ago, the conservative investor could have earned \$60,000 a year on a million dollars of ultra safe Treasury bonds. Today, they would earn \$20,000 a year less.

The Federal Reserve made a casual reference, several years ago, to their observation that the average stock price adjusts to changes in interest rates such that the yield on stocks (the ratio of forward earnings to current price) is comparable to the yield on Treasury securities<sup>1</sup>. This relationship, assuming that it is a relationship rather than simply an accidental correlation, allows us to predict stock market prices from interest rates.

This correlation and current interest rates suggest that the current stock market is fairly priced. The implication is that the downside is limited.

---

<sup>1</sup> Edward Yardeni and Amalia Quintana "Asset Allocation & Allocation Models," Deutsche Banc Alex, Brown, October 16, 2001. Available at [www.yardeni.com/public/val.pdf](http://www.yardeni.com/public/val.pdf).

---

Certified Financial Planner - Enrolled Agent - Registered Investment Advisor

852 Acampo Drive, Lafayette, CA 94549-5040

(925) 299 - 0472    FAX (925) 299 - 0473    [lingane@post.harvard.edu](mailto:lingane@post.harvard.edu)    [www.lingane.com/tax](http://www.lingane.com/tax)

Congress is spending like a drunken sailor. First there were the rebate checks and then, following September 11<sup>th</sup>, \$40 billion in emergency aid with a big stimulus bill likely before year's end. The Supply Siders criticize this spending as not being focused on measures, like marginal tax rates, that will stimulate economic activity and they warn that indiscriminate spending carries the risk of inflation. But however you slice it, it seems to me that some of this spending will hasten the end to the current recession.

"Leading indicators" give a hint as to future economic activity. The Conference Board's Leading Economic Indicators index rose a better-than-expected 0.3 percent in October, meaning that we might find better economic conditions three or six or nine months from now. The skillful (or lucky!) investor moves into the market when he or she decides that the elements are in place for an economic recovery. Those who wait until the economic recovery is in full swing forfeit much of the market rise.

There is about \$2 trillion dollars of cash on the sidelines in money market funds. This tells me that investors are worried. Since investors are notoriously poor at judging the market's direction, investor worry suggests that the market outlook is better than it may appear. This also tells me that there is a lot of money to fund a stock buying spree when confidence returns.

Academics commonly disparage the idea that it is possible to exploit stock price patterns but this negativism may be overstated<sup>2</sup>. As illustrated by the chart on the next page, a simple moving average technique flashed a sell signal in early October a year ago. You would be feeling pretty smug if you had reduced your stock holdings at that time.

While it is tempting to buy back into the market on the assumption that the market bottomed on September 21<sup>st</sup>, the current trend might be only a temporary bounce, like the one last April and May. It is more prudent to wait until stock prices move above the moving average. If the current upward trend is sustained, such a buy signal would occur in mid December.

A timing strategy based on a 200-day moving average could have added an extra \$150,000 after-tax to the growth of a million dollar pension over the past

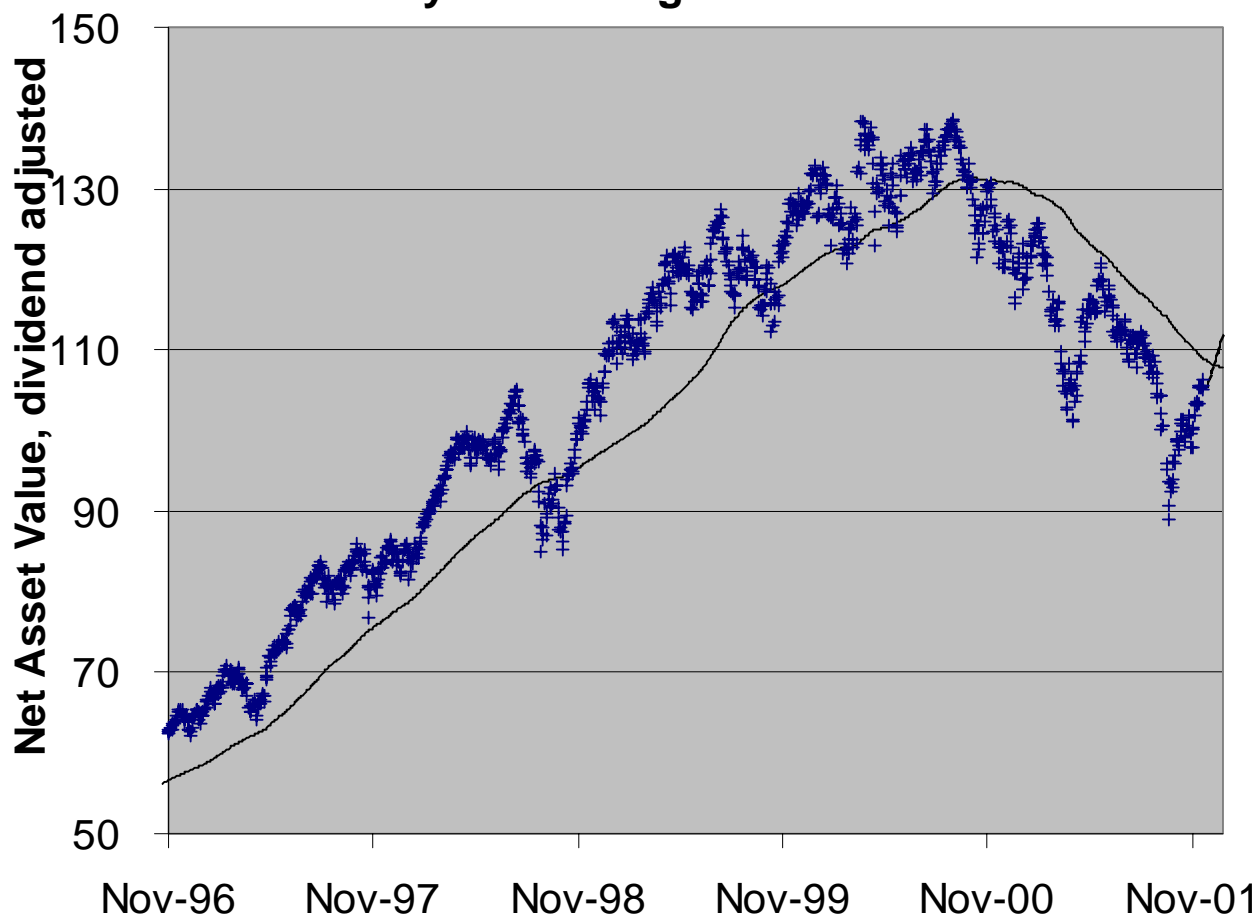
---

<sup>2</sup> As an indication of the formidable problems facing pattern seekers, Professor Jeremy Siegel of the Wharton School ("Stocks for the Long Run, 2<sup>nd</sup> Ed.," McGraw-Hill 1998, Chapter 17) prepared a series of graphs, half of which reflected historical market prices while the other half were random computer generated simulations. Professionals could not distinguish the real from the random patterns.

Siegel goes on to illustrate the potential of technical analysis. He concludes that a 200-day moving average would have allowed an investor to avoid the largest down movements of the twentieth century. A timing strategy did not increase wealth in Siegel's analysis because of transaction costs and false or late signals but it did reduce volatility. Putting Siegel's conclusion another way, adjusting a portfolio's stock allocation in response to a 200-day moving average signal provides the psychological benefit of being able to "do something" without serious risk to the long term portfolio return.

five years as compared to a buy-and-hold strategy<sup>3</sup>. The potential gain was about \$30,000 after-tax in a taxable account; the gain is smaller because switching accelerates income tax. Reduce these potential gains by a factor of four for a real portfolio since most of us would decrease our stock allocation rather than sell our entire stock portfolio in response to a technical signal.

### Vanguard Index 500 & 200-day Moving Average 5-years ending 11/21/2001



<sup>3</sup> The moving average signaled the sale of Vanguard's Index 500 Fund, which tracks the S&P 500 Index, at a price of about 130 in October 2000. My extrapolation of the current trend suggests a buy signal at a price of about 110 in December 2001. Had an investor used moving average signals to switch between Vanguard's Index 500 fund and Vanguard's Intermediate Bond Index Fund in tax deferred account over the past five years, they would have seen a million dollars grow to \$2.2 million, before tax. This is about \$250,000 more than the growth of a buy-and-hold portfolio, before-tax.

The extra gain is less in a taxable account where switching accelerates income tax. Assuming gains are taxed currently at 35% when timing, this is the combined marginal tax rate for a married couple with a taxable income of between \$50,000 and \$100,000, and that gains are deferred and taxed at 27% when buying-and-holding, the after-tax benefit from timing is about \$30,000 after-tax over these five years.

If the moving average signal triggered an allocation change from 75% to 50% stocks, and via versa, the potential gains would be one fourth the numbers shown above.

Details can be found in an Excel file at [www.lingane.com/ohlone/handouts/hw112001.xls](http://www.lingane.com/ohlone/handouts/hw112001.xls).

I'm not enthusiastic about future returns in the immediate term because the market is already up twenty percent from the September lows. Since twenty percent for a whole year would be above average, I don't see how the explosive gains of recent weeks can continue much longer.

There are only two reasons for the market to go up: earnings growth and speculative pressures. Earnings have grown at a remarkably stable 7% over the past forty years. This should propel the market upwards at about 7% annually, for a total return of 8 -9% including dividends. Anything more than this means investors are bidding stocks above fundamental cash flow valuations.

In summary, the weight of the evidence is that the worst of the market decline is behind us and it will be time, in the next couple of weeks, to increase stock allocations or to become less fearful if you are a buy-and-hold investor. While the sun may be rising, I suspect that the dawn will be overcast and that future market returns will be below the historical averages for the foreseeable future.

**What Does This Forecast Mean For Your Investment Strategy?** Everyone needs an adequate rainy day fund and adequate life and disability insurance. Near term savings for a car or home should be in stable investments like CDs and bonds (not bond funds) where the maturity can be matched to when the money is needed. Longer term savings for education should emphasize the ScholarShare program<sup>4</sup> since distributions for education are free of federal tax and large amounts of money can be socked away.

Retirement money for younger individuals should be in a diversified stock portfolio because the potential for long term appreciation is greater with stocks. And, if you are younger, you can afford to take on the additional risk that a growth portfolio implies because you can compensate for market declines by adjusting your retirement date or other action.

If you are being supported by your investments and you are truly wealthy, buy enough TIPS to support your lifestyle and put the rest in a diversified portfolio.

Retirees of more modest means should review their allocation to stocks in light of my prediction that returns for the next couple of years are likely to be less than historical averages would suggest. It turns out, historically, that allocating half of a retirement portfolio to stocks and half to bonds makes your portfolio less sensitive to the ups and downs of the stock market without risk to your financial security<sup>5</sup>.

---

<sup>4</sup> California's 529 plan. [www.scholarshare.org](http://www.scholarshare.org) has not been updated to reflect the fact that qualified distributions are free of federal tax beginning in 2002.

<sup>5</sup> See [www.lingane.com/tax/risk.htm#part2](http://www.lingane.com/tax/risk.htm#part2). While bonds do not increase the downside risk, bonds do decrease the upside potential and an all stock portfolio will probably produce a larger estate than a more balanced portfolio. If your objective is to make your children rich or to endow a building at your alma mater, you should probably overweight stocks.

**TIPS Update.** I like Treasury Inflation Protection Securities or TIPS. They represent impeccable quality since they are direct obligations of the US government, they shift the inflation risk to the government, portfolio values fluctuate less than for comparable securities and, after figuring in inflation, they tend to return a bit more than comparable securities.

Like original issue discount bonds, one must pay income tax on the annual inflation increment even though the increment is not paid out until maturity. If cash flow is an issue<sup>6</sup>, TIPS can be held in a retirement account.

**Year End Actions.** Regular readers know that mutual fund purchases should be delayed until after the year end capital gain distributions. Year end distributions will be small this year with most funds because they have been able, consciously or not, to offset realized gains with realized losses. Funds usually post distribution dates posted on their web sites or you can call the fund for this information.

Marginal income tax rates go down slightly next year because of the changes wrought by the 2001 Act. This provides an extra incentive to accelerate deductions into the current year and to delay income to next year.

If your home is paid off, you may not have enough deductions to benefit from itemizing. Consider making your charitable contributions and state tax payments in January and December of alternate years. You might save a couple of hundred dollars on your taxes by bunching deductions in this way.

When you sell at a gain, the government wants a share of your profit. When you sell at a loss, you can use this loss to offset gains and you can even use this loss to offset a modest amount of interest and dividends and wage and pension income. Harvesting losses by selective selling towards year end lets you make some lemonade in an otherwise down year.

Selling to harvest losses is most effective if you use the specific lot method for calculating the loss. (You can't use the specific lot method if you have used the average cost method with prior sales of the same security.) You are supposed to identify the specific lot at the time of the sale.

Identifying the specific lot is a challenge when dealing with a mutual fund. My practice is to say "Sell 404.102 shares purchased in July and August of 1997." Since conversations are recorded, I reason that the recording would be evidence of intent should the tax authorities challenge my loss calculation.

When you sell at a loss, you don't gain an immediate tax benefit if you buy the same security within the sixty-one day interval surrounding the sale date. This "wash sale" rule often pops up if you automatically reinvest dividends.

---

<sup>6</sup> Total returns (yield plus inflation adjustment plus price changes) were 13.3% for the year ended 10/10/01. However, cash flow after taxes could be as little as \$6,000 a year after taxes, based on current 3.2% yields and 3.3% inflation, if a million dollar TIPS portfolio were owned in a non pension account. For more information, see [www.lingane.com/tax/tips.pdf](http://www.lingane.com/tax/tips.pdf).

Typically, we base this year's estimated payments on last year's tax liability. If you have less capital gains this year, you may be able to reduce your last estimated tax payments. If you will owe state tax in April, it can make sense to prepay this tax in December. But before reducing tax payments or prepaying state tax, test things out (last year's tax software will probably provide an adequate result) to be sure that you don't run afoul of AMT or other issues. If the tax payments are large, seek professional assistance.

Call if you need help with the amount of your required pension distribution.

**The Liberalized Federal Pension Rules** were discussed in June<sup>7</sup>. Time has tempered my enthusiasm since California has not yet conformed. The difficulty is that you will not get a California tax deduction if you increase your pension contribution or if you take advantage of the new rollover opportunities. You might have to pay state tax again when the "excess contribution" is distributed and your employer might be denied state tax deductions if they change a pension plan to accommodate the liberalized federal rules.

I have expressed my concerns to senior staffers on both California tax writing committees and urged consideration of pension conformity when the legislature reconvenes in January. I am also working with my professional organizations to raise awareness of this issue.

Revenue is especially tight in California. My hope is that the legislature will nonetheless ensure that employers get a full tax deduction for pension contributions and that employees are not taxed twice on excess contributions and rollovers. These proposals are revenue neutral in the immediate term.

**The Estate Tax Exemption** rises to \$1 million effective in January 2002. This welcome news means that substantial numbers will be relieved of the burden of filing an estate tax return. However, the increased exemption does not eliminate the need for careful estate planning.

For example, I encourage every married couple to review the assets which will be used to fund a by-pass trust if one spouse were to die. Funding a million dollar trust should be straightforward if you own two million dollars of securities as community property but the securities are not available for funding if you own them in joint tenancy. You may also find that you can't use a large IRA to fund the by-pass trust because you did not consider this possibility when preparing the beneficiary designation.

I hope that these periodic communications are useful to you. If something sparks your interest, please call.

Sincerely,

Peter James Lingane

---

<sup>7</sup> See [www.lingane.com/tax/newsletr.htm](http://www.lingane.com/tax/newsletr.htm). My current views are summarized in "Pensions, State Taxes and the 2001 Act" at [www.lingane.com/tax/seminars/conformity.pdf](http://www.lingane.com/tax/seminars/conformity.pdf).