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BWFA Advisor

FINANCIAL PLANNING ◆ INVESTMENT PLANNING ◆ TAX PLANNING

Baltimore–Washington Financial Advisors, Inc.

College Savings with Tax Deductions

By Annette Simon, MBA

Section 529 College Savings Plans allow parents and grandparents to set aside significant amounts of money for the higher education expenses of their children and grandchildren. They were authorized by a 1997 federal bill but are run by the individual states. Money contributed to a 529 plan grows tax-free and is never subject to state or federal income tax if used for qualified higher education expenses.

In mid-July, the state of Maryland announced that T. Rowe Price will manage its new 529 plan. The plan, which will begin operation this fall, will offer 10 different investment options. While it is open to investors in all states, Maryland residents will receive an added benefit—the opportunity to deduct as much as $2,500 for contributions to each account under the plan. These deductions can be carried forward for 10 years if necessary to use them up and offset one's Maryland income tax liability.

For a more detailed explanation of 529 plans and their benefits, see my recent article on the WorldWIT Web site at www.worldwit.org/simon_says/simonsays062101.html. (Or call us and ask for a copy!)

How can BWFA help me with a 529 plan?

Because every state has either established a plan or expects to launch a plan in the near future, choosing the plan that is right for you can be a complex and confusing task. Plans vary in a number of ways, and the best plan for you will depend upon numerous factors, including your planning horizon, risk tolerance, state of residence, tax sensitivity, and overall savings needs.

Even more significantly, your BWFA advisor can guide you in integrating a 529 plan with your current college, retirement, and estate planning goals. Funds within a 529 plan are not subject to estate taxes and (if used for qualified education expenses) are exempt from federal and state income tax as well. Parents, and even more so grandparents, now have an opportunity to transfer sizable funds to children and grandchildren in an extremely tax efficient manner.

Call today to set up a 529 consultation. We're excited about this new planning vehicle and ready to help you make the most of it!

Welcome, Chasity Crawley

As the firm's Investment Operations Manager, Chasity is here to serve you. Some of her responsibilities include fielding client questions, maintaining the accuracy of client accounts at Waterhouse, and supporting Rob and Sax in the daily functions of the investment department. Do not hesitate to call her for assistance or to just say hi. There is no problem too big or too small for her to handle.

Chasity comes to us from a diverse and rather intriguing background. She has worked in a small D.C. law firm specializing in special education and child welfare issues, she has been the intern to the Deputy Chief of Staff for Operations in the District of Columbia Mayor's office, and she worked as a mutual funds specialist in one of Dallas's leading regional brokerage firms.

Chasity graduated magna cum laude from The George Washington University in Washington, D.C. Besides achieving high academic excellence, she also helped steer the women's basketball team at GW to many years of success, including an NCAA Elite Eight appearance.

Chasity and her husband, Dwayne Crawley, live in Baltimore, with their handsome, energetic, almost two-year-old son Caleb. Welcome, Chasity.

Taxes&Tax Planning

Tax Law Changes: How Can They Benefit You?

By Bob Cassel, EA

We have another new tax act: The Economic Growth and Tax Relief Reconciliation Act of 2001. It appears as though we are never going to see the tax simplification that everybody wants. The new act is a positive piece of tax legislation with lots of incentives built in for families, education, and retirement. We want to help you understand what you should do about the latest tax law changes. There are a few things that you can do now and lots of things that you will want to do over the next two to three years. The new tax law is phased in over a rather long period of time. Full implementation of all aspects of the new tax law does not occur until the year 2010.

Let's begin with a look at the changes that will affect you in the year 2001.

1. Your marginal tax rate will go down by 0.5%. All of the tax brackets have been lowered, and your employer has received new payroll tax withholding tables that reflect the change.

2. A new 10% tax bracket has been created. This new rate will apply to the first $6,000 of taxable income for single persons, $11,000 for heads of household and $12,000 for married couples.

3. An advance refund check will come to you in the mail later this year. Single filers will receive $300; married filers, $600.

What should you do about these changes?

1. Monitor your federal tax withholding during July and verify that your withholding has actually decreased. The amount of the decrease will vary based on your marginal tax bracket, your income level, and the number of withholding exemptions you have claimed.

2. As a result of the lowering of tax rates, you should be able to decrease your federal estimated tax payments. Call us and ask us to prepare a revision of your estimated tax workup.

3. Has your address changed since you filed your income tax returns? If so, be sure to file a change of address notice, form 8822, with the IRS. That way the IRS will send your advance refund to your new address.

4. You can also visit our Web site at www.bwfa.com and click on the Tax Planning link to get a quick idea of your federal tax savings over the next ten years.

There are some exciting changes that take effect in 2002. Here we list the ones which we thought would interest you and which might require you to design a multiyear tax planning strategy.

1. You can now deduct education expenses (up to $3,000) without itemizing deductions.

2. Contribution limits for IRAs will increase to $3,000 in 2002.

3. Taxpayers over the age of 49 may make "catch up" contributions to their IRAs. The catch-up amount for 2002 is $500.

4. You can also make a catch-up contribution of up to $1,000 to your 401(k) and other employer retirement plans.

5. A surviving spouse can roll over a distribution from a deceased spouse's retirement plan.

6. Rollovers will also now be permitted from IRAs back into 401(k)s and government sponsored retirement plans.

7. You will be able to contribute up to $2,000 into an Education IRA, as opposed to $500.

It is impossible for us to cover all of the rules and exceptions that apply to these changes. We suggest that you call us for a tax strategizing session. Let us help you be at the front of the line when it comes to getting your share of tax savings.

Investment Management

By Saxon Birdsong, MBA

Beware: Brokers Offer New Program

We believe that it is important for investors to understand how and *how much* they are paying for investment advisory services. In many cases, the fees investors pay are deliberately obscured, and hidden from view. It is in this regard that we want to explain two important and highly significant trends which will impact investors' decisions for investment advisory services.

The first change is the push by large brokerage houses to sell investors on the use of individually managed accounts rather than the brokerage's own mutual funds; and the second is how investors are being asked to pay for their brokerage fees. While these two things - separate accounts and changes in brokerage fees - are very much related, the relationship will not be apparent to most investors.

Individually managed accounts differ from mutual funds in that the managed account investor actually owns the individual securities chosen by the money manager rather than owning an interest in a large investment pool through a publicly traded mutual fund. Individually managed accounts have distinct advantages over mutual funds. Mostly, the advantages include 1) being able to invest all of your money without holding some cash on the side to honor redemptions, 2) being able to control your tax liability, 3) qualifying for reductions in fees when you have over $500 thousand or $1 million invested, 4) knowing which investments you own, 5) tailoring your investments to accomplish your goals more precisely, and 6) and managing your income stream better.

An article in the August 6, 2001 edition of The Wall Street Journal (which we are enclosing with this newsletter) described how investors increasingly prefer individually managed accounts over mutual funds, pointing out that assets in individually managed accounts grew at 20% in 2000 while assets in mutual funds declined -2.3%. The article also points out that for years, Merrill Lynch focused its representatives on promoting its mutual funds - but not any more. Along with other large brokerage houses, Merrill is now making a big push for separately managed accounts.

And in addition, Merrill is following the trend at other large brokerage houses to change its fees from transaction based commissions to fees based on asset values.

To understand how these two trends are related, it is necessary to note the decline in brokerage fees in recent years. Instead of paying $100-$200 to trade a stock, thanks to technology and competition, investors can now easily trade stocks at fees ranging from $10-$25. This dramatic reduction in fees caused an important source of revenue for brokerage houses to dry up, and they needed to replace it. Hence the shift from commissions to asset based fees.

But just changing from sales commissions to asset fees wouldn't do it for Merrill. Charging asset fees on accounts which were already heavily invested in their mutual funds would have represented such a severe conflict in interest that the SEC would not have been able to overlook it.

Without changing the way it was doing business Merrill would be collecting three fees; 1) a fee for underwriting the stock of the corporation it has as an investment banking client, 2) a fee for managing the mutual fund the stock might be held in (the normal way mutual funds get their fees), and 3) a fee based on the market value of its mutual funds held in its investors accounts. In effect, Merrill would be getting paid once by the corporate client and twice by the retail client.

So, to remove some of this conflict, Merrill had to redirect its clients from mutual funds to individually managed accounts. While Merrill and others will have declining revenue in their mutual funds, they will make up for it by charging their newly converted individually managed accounts. The article points out that, after discounts, the average managed account fee is still 1.8% of assets.

But clients of brokerage houses must still come to grips with the inherent conflict of interest present in the brokerage business - raising cash for their corporate clients by underwriting their stocks and simultaneously investing their retail clients in the same stocks. The only way an investor can be sure that an advisor is serving their best interests is if the advisor's sole source of revenue is from its clients. For a hint as to who provides this service, call 410-461-3900.

APL FCU and BWFA Team Up

BWFA is happy to announce a co-marketing agreement and service collaboration with the APL Federal Credit Union to begin immediately. APL FCU's expanded charter makes credit union membership available to anyone who lives, works, worships or goes to school in Howard County. APL FCU was established originally to serve the employees of Johns Hopkins University Applied Physics Lab, the county's largest employer. With a large new headquarters building with drive-through capability they have now developed into a major service provider of competitively priced mortgage, auto loans, and integrated banking services. APL FCU has been recognized as one of the most forward-looking credit unions in the country. Their web site has won awards for design and for attracting more of its members to its use than any other credit union. If you meet the criteria for membership, we heartily recommend our friends at APL FCU. Stop by their web site, their headquarters, or their main branch for a tour soon.

Financial *Planning*

Monte Carlo (Mount Charles?) Sensitivity Analysis: A New Tool at BWFA

By Kevin Condon CFP

The purple graph on this page is a simulation showing the potential outcomes of 125 financial plans for the same person using randomly differing rather than static rates of return, inflation rates, mortality, and so forth. The rates used to project these futures are selected within limits by something called a Monte Carlo simulation program and then displayed in this graphic form. If this graph were showing your financial plan, it would tell you that an estimated 90% of the time your plan is expected to work and, contrarily, 10% of the time it may fall short and require substantive adjustments or intervention to meet your needs for cash in the future.

A 90% chance may seem poor to some of you. In our example, some of the graphed futures result in a positive, growing net worth. Others tail off into early asset depletion and financial failure. In reality, neither of the extremes shown on the chart would take place. No one would drive an unsuccessful spending plan that far into the ground without police intervention. Conversely, plans that produced much wealth would result in increased spending. But also remember, none of these outcomes lead to becoming broke or rich quickly. Also notice that if a simulation predicted 100% success, it would tell you that you already have every penny you will need and that your retirement will work even in very adverse circumstances without your lifestyle changing one whit. We recommend Monte Carlo simulation to help you make decisions about retirement, job change, expense reduction, and how realistic your goals are. For example, can you really afford that boat? Can you retire early? Can you send your children to an Ivy League college, or will they have to go to a less expensive school? Can you make a big gift to your church now?

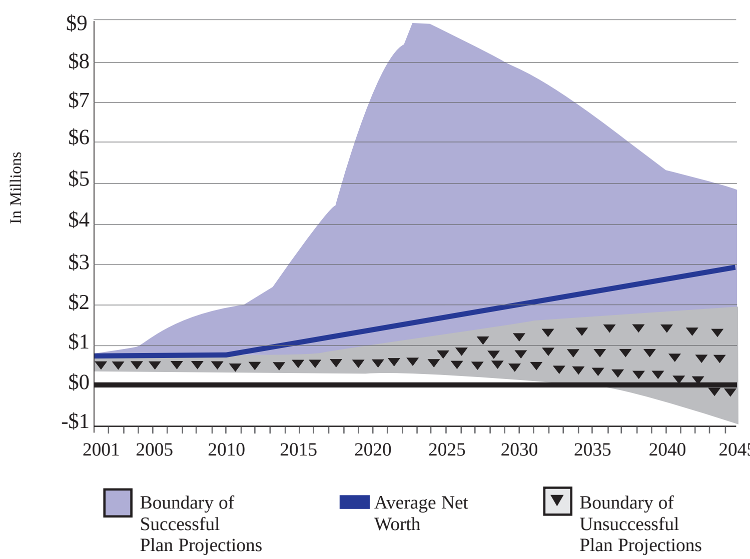
Our last article on this subject (Spring 2000) told you of our concern that the public may think that Monte Carlo simulation might be a substitute for close annual review and revision. If things go wrong financially, most of us will survive and prosper if we just adjust our expenses and cash flow needs in a timely manner. With early warning and decisive action, abrupt negative changes in lifestyle may be avoided. Continued comfort and security requires projection and planning. If you have developed the discipline of regular annual review, you know the truth of this statement. Making adjustments to changing conditions is part of the implementation of every good financial plan.

Next time you call to set up a review, let's discuss whether a Monte Carlo simulation can help you adjust to changes in your finances. Our new simulation tool is part of new software which includes all provisions of the new tax law.

Curious? Call for a review.

Monte Carlo Simulation Results

Success Rate: 112 out of 125 (90%)



Assumptions

Life Expectancy Randomized	Yes
Surplus/Deficit Success Tolerance	-$10,000
Number of Projections	125

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