



OCTOBER 2001

# BWFA Advisor

FINANCIAL PLANNING ♦ INVESTMENT PLANNING ♦ TAX PLANNING

Baltimore–Washington Financial Advisors, Inc.

## A Note to Our Clients

Like everyone, we have found it difficult to focus on anything but the tragedies which occurred on September 11. The depth of our sorrow and fears was felt in our hearts, our living rooms and in our offices.

Events far less dramatic than those of September 11 cause us to reassess our lives and help us to refocus on what's really important. As we tried to give hope and support to many of our clients during this time of uncertainty, so too did our clients provide us with encouragement and a sense of how

important we are to them through their numerous emails and notes.

We are glad, and proud, that you have chosen us to help you with some aspects of your lives.

We are also confident that our lives and our financial markets will soon return to "normal". Even though our economy has slowed, it remains strong. Our government is showing strength and cooperation that it has not exhibited in a long time. And, most importantly, the will of our citizens is stronger than ever.



### INSIDE...

**New Educational IRA for 2002** *by Bob Cassel*

**Determining if Markets Are Overvalued or Undervalued: The Fed Model**  
*by Saxon Birdsong*

**BWFA and APLFCU: Financial Planning Services Complemented by the Benefits of Credit Union Membership** *by Kevin Condon*

### FREE FINANCIAL PLANNING SEMINAR SERIES

Kossiakoff Center  
JHU APL Campus, Laurel

October 30  
November 6  
November 13

For more information and to register call 410-461-3900

or online at

[bwfa.com/aplfcu.asp](http://bwfa.com/aplfcu.asp)

# Taxes & Tax

## Planning



By Bob Cassel, EA 

## New Educational IRA for 2002

We have a new model for the education IRA. The old model—let's call it the Yugo—is gone. You may remember the Yugo—it was a college savings vehicle with more faulty engineering than practical uses. It had very low horsepower; only a yearly maximum contribution of \$500. In

addition, we were not permitted to take any of the other education credits in a year in which we used money from the education IRA to pay for education expenses. The education expenses that qualified were only for secondary education expenses. Well, let's take a look at the new 2002 model. We'll call it the Saturn.

The Saturn model benefits from the latest upgrades in technology, corrects past mistakes and is much more consumer-friendly. Let's kick the tires:

1. The horsepower has increased to an annual maximum contribution of \$2,000 per individual. (We still are not permitted to put more than \$2,000 into any education IRA for the same individual in a given year.)
2. The income limits have been expanded to \$95,000 for individuals and \$190,000 for married couples. More people will qualify to make the contribution. If your income still prevents you from making the contribution, consider gifting the contribution money to another person who will then open their own Educational IRA.
3. The definition of what qualifies as an education expense has been greatly expanded. Tuition, fees and expenses for kindergarten through twelfth grade now qualify. Also allowed are uniforms, transportation and supplementary items or services. This includes expenses at public, private and religious schools. (This is as close as we may get to a voucher system.)
4. And listen to this. The Saturn model allows us to use the money from the Education IRA to buy computers, peripheral and technology equipment, and Internet-related services while the student is in school.
5. The Saturn model also allows us to put money in both an Education IRA and a qualified tuition program or a qualified college savings program in the same year. Because of the expanded definition of qualified expenses,

you may want to make contributions to both of these types of plans in order to achieve the maximum benefit.

6. The Saturn model also allows us to make a distribution from an education IRA and still take either the Hope or Lifetime Learning credits in the same year. In the past, we could not take advantage of more than one education tax incentive in any given year.
7. The Saturn model allows us the flexibility of making our education IRA contributions until the April 15 tax filing deadline.
8. For people with special needs, the life of the education IRA can be extended beyond the time when the beneficiary reaches age 30. The law also provides that contributions can be made beyond the age of 18 for a person with special needs. This is a fantastic opportunity to put money in a tax-free vehicle for persons who will need additional time to complete their education because of a physical, mental or emotional condition.

Because of the greatly expanded definition of qualified education expenses, many of us should open an education IRA account for ourselves, our kids and our grandkids. (Remember that each person can only put a maximum of \$2,000 in the education IRA each year.) It now makes sense to start the education IRA immediately upon the birth of a child or grandchild. By the time the child is ready for elementary school they will be able to pay for uniforms, tuition, computers, Internet access and even transportation to school with tax-free earnings from the account.

If you would like us to open an education IRA for you, your spouse, children or grandchildren at TD Waterhouse, please let us know.



# Investment Management



By Saxon Birdsong, MBA

## Determining if Markets Are Overvalued or Undervalued: The Fed Model

Market analysts use various quantitative measurements to assess where the market is and where it might be going. While none of these measurements is accurate all the time, one of them has gained wide support among analysts, and even some support from Federal Reserve officials. In this article I will try to explain how many analysts view whether the equity markets are overvalued or undervalued.

According to an article dated August 25, 1997 in Barron's, Ed Yardeni, then economist at Deutsche Morgan Grenfell, said that Alan Greenspan at one time instructed his staff to devise a model to help him gauge the stock market. Yardeni says he found the model buried in the Fed's semiannual monetary report to Congress. The model is simple, and compares the current yield on the 10-year Treasury note with the earnings yield on stocks. The earnings yield is the inverse of the P/E ratio.

The model works like this:

Calculate the earnings yield on stocks. (Earnings yield on stocks = Total of next 12 months of earnings per share of all companies in the S&P 500/S&P 500 Index.)

Then compare the yield on 10-Year Treasury with the earnings yield on stocks (yield on Treasury/earnings yield on stocks) - 1

Now let's supply some real numbers, and see what the model says.

The mean estimate for the earnings of companies in the S&P 500 in the coming 12 months provided by Zack's Investment Research is \$55.37/share.

The S&P Index stands at 1007.77. The earnings yield is therefore 5.49% ( $\$55.37/1007.77$ ). The reciprocal ( $1/0.0549$ ) is the P/E of the S&P 500, 18.21 (a bit high by historical standards).

Using data from the same day (9/24), Bloomberg tells us that the current yield on the 10-year Treasury was 4.69%. Applying the numbers we get  $(4.69/5.49) - 1 = -14.1\%$ . The formula is telling us that stocks are undervalued relative to bonds by 14.1%.

To see if any of this makes sense, it would be good to look at the results of these calculations over a period of years.

### MODEL BEHAVIOR

The so-called Fed Model indicates that the stock market is undervalued by more than 14%. That's a greater discount than at any time since 1996. In the past, undervaluation readings of 10%-20% have represented good buying opportunities.

### FED STOCK MARKET VALUATION MODEL



Source: yardeni.com

As you can see, over the past 10 years the relationship between stock earnings and bond yields has bottomed out at its current level just four times. Does this really mean that stock prices are going to go up? No, but it does tell us that the current relationship between bond yields and stock earnings is uncommon. Several things could happen to change the relationship and bring it back into the "normal" range:

Bond yields could go up 15% above current levels to 5.49 before stocks become overvalued.	Not likely; Fed acting to lower interest rates; yields could rise.
Bond yields could go down.	Would push the stock/bond relationship into unprecedented level on the chart. By historical standards, not too likely.
Stock earnings could go down.	If earnings are \$50 rather than \$55, lower by 10%, stocks would still be undervalued by 5%.
Stock prices (the Index) could go up.	If stock prices go up by 10% they would still be undervalued by 6%.

So, of the four possibilities, two appear more likely. It therefore seems that we might see money flowing back into stocks rather soon.



# Financial Planning

## BWFA and APLFCU: Financial Planning Services Complemented by the Benefits of Credit Union Membership



By Kevin Condon 

BWFA has recently announced a new collaborative relationship with APL

Federal Credit Union (APLFCU), located on Johns Hopkins Road in Laurel.

This relationship will help both parties market their services. For years, BWFA has served as personal financial advisor to many APLers. We believe that this collaboration will bring us even more APLers as clients. When APLFCU decided to market its services to the larger community by expanding its charter definition to attract Howard County residents, they selected us to offer financial planning, investment and tax services. Our fee-only status and our established reputation at APL was the starting point. APLFCU believes that the new venture with BWFA will attract more new members from outside the APL community. Both companies are excited about this alliance.

Without reservation, we would encourage BWFA clients and friends to look at the benefits of credit union membership at APLFCU. APLFCU membership is available to anyone who works, lives, goes to school or worships in Howard County, as well as members of their immediate families. APLFCU members can usually lower the costs associated with everyday banking needs.

Many of you may not be familiar with what credit unions offer. If you meet the eligibility requirements above, here are a few examples of what they can offer your family:

1. Credit unions are not-for-profit financial institutions. As a member, you are also an owner, and all profits are returned to you in the form of lower loan rates, higher savings rates, and low or no fees for services.
2. Opening a savings account (the minimum deposit is only \$50) establishes your membership and entitles you to use all the credit union's services.

3. Free checking—They'll even pay to print your checks in a basic design if you have direct deposit of your pay or retirement check.
4. Free Visa check cards.
5. Low-cost loans—New and used vehicles, personal loans, a Visa credit card and more.
6. Home equity loans at Prime plus 0%—No-closing-cost options are available.
7. State-of-the art Internet access—Enjoy free access to your accounts for managing your money in the easiest possible way. This award-winning Web site has many informational and interactive features (and will soon add even more). But don't take our word for it, ask current members — APLFCU has the highest percentage of members using its Web site in the industry.
8. Internet Bill Payment—For only \$1.50 per month (less than the cost of postage for most), APLFCU can pay an unlimited number of bills. You can schedule recurring payments, schedule payments in advance or pay as you go.
9. Real estate loans and mortgage lending.
10. Discounts on all new first-year BWFA services for APLFCU members.
11. This institution will last. It has the highest possible rating and a sound financial footing. It does not seek consolidation or any other profit-oriented instability.
12. The members of the board of directors are volunteer co-owners with you. The institution is run for the benefit of its members only.

We look forward to using this new relationship to benefit all of our clients. APLFCU's phone numbers are 443-778-5250 and 240-228-5250. Its Web address is [www.bwfa.com/aplfcu.asp](http://www.bwfa.com/aplfcu.asp).