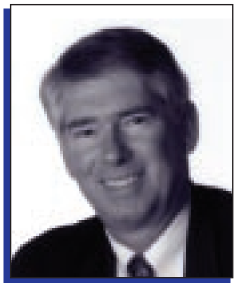
Summer 2004

BWFA Advisor

Baltimore–Washington Financial Advisors, Inc.

Fee-Only Retirement & Estate Planning, Investment Management, & Tax Services

Bonds Are No Safe Haven



By Bob Ray

Most investors view bonds as safe securities providing a fixed income until maturity. Especially after experiencing dramatic losses in the stock market, investors may look to bonds to provide a safe haven from the volatility of stocks. But the truth is a portfolio of bonds can be nearly as risky as stocks, and is certainly more risky than a blended portfolio of stocks and bonds.

Why Bonds Can Be Risky

One rule of investing is that as interest rates rise, the price of a bond falls. This is known as interest rate risk. To see this, imagine that you purchase a bond paying 6% and interest rates go up to 7%. Your bond is now less valuable in the marketplace. You may be asking yourself, "But, what if I hold my bond until maturity?" It is true that you will recoup your principal at maturity, but you will still have suffered years of portfolio value fluctuation and be locked into an interest rate below current market rates.

Bonds Are Especially Risky When Interest Rates Are Low

When interest rates are at their lowest, the potential for volatility in bonds is at its highest. This was demonstrated dramatically last summer. Interest rates had hit forty-year lows. Then investors became concerned that the Federal Reserve Bank would raise interest rates in response to strong economic growth. As a result, intermediate-term bonds lost 10% of their value in just two months. Fears faded last fall as economic growth slowed slightly and bonds recouped half of their losses. But, bonds were hit again in the second quarter of this year as inflation picked up and economic growth continued. Yields on intermediate-term bonds rose by 1.125%, and bonds lost another 9% of their value.

Bonds Still Have a Place in Diversified Portfolios

We include bonds as part of our conservative models for a reason. Over long periods of time, bonds do reduce the volatility or risk in a portfolio without substantially reducing the expected return. This is because bonds historically return about 5% to 6%, and have a low correlation to equities, meaning the prices of stocks and bonds often move in opposite directions. As interest rates rise due to strong economic growth, equities usually outperform bonds. But, when economic growth declines and stocks suffer, bonds are usually stellar performers. An allocation to bonds over the last three years would certainly have reduced overall portfolio risk. The Lehman Brothers Aggregate Bond Index returned 7.44% over the last three years while the S&P 500 Index returned -3.34%.

We expect that interest rates will continue to rise over the next few years. In this environment, bonds alone could be just as volatile as stocks. However, when included in moderate amounts in diversified portfolios, bonds will serve their intended purpose of reducing the overall volatility of the portfolio and helping to meet the required income needs of our clients.

What's Happening at BWFA

Delivering a Fee Reduction!

BWFA has a new arrangement with TD Waterhouse which reduces the amount our clients pay for trades. Under the previous arrangement, $7 of each $25 stock trade went to help us pay for independent research services. Because of our growth, we are now able to eliminate this $7 from the cost of a trade. The new fee for trades will be $15-$18, depending on whether we place a "market" or a "limit" order. This reduction will save our clients about $200 - $300 per year. We retain a 'soft dollars for research' arrangement with TD Waterhouse, but this new arrangement does not cause the cost of a trade to be higher than it would be in the absence of this arrangement. Please give us a call if you have any questions.

We Are Moving

BWFA is moving to Columbia. Beginning Monday, July 26, our new address and contact information will be:

Baltimore-Washington Financial Advisors
5950 Symphony Woods Rd.
Suite 600
Columbia, MD 21044
410-461-3900 local
888-461-3900 toll-free
443-539-0330 fax

Our offices will be closed Friday, July 23 in preparation for the move. We expect to be fully operational in our new location on Monday, July 26.

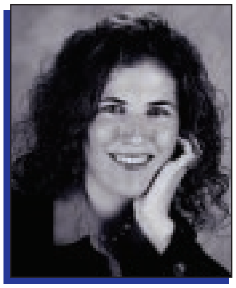
We Welcome Lisa Guyton to Our Staff

Chasity Crawley will be leaving us July 16 to have her baby. Lisa Guyton will be taking her place as Administrative Assistant. Lisa has over ten years of administrative and office management experience, most recently with a law firm in Columbia. Lisa lives in Columbia with her husband Joey and two kids, André and Nina.

Fee FO Only ™

Retirement & Estate Planning

Is Long-Term Care Insurance Worth the Price?



By Kim Anderson, CFP

Anyone who has ever looked into long-term care (LTC) insurance knows it is not cheap. Depending on your age and the policy you choose, this coverage can cost thousands of dollars per year. If you are retiring and want to make sure your nest egg lasts, you may be wondering if the coverage is really worth the price. While there is no easy answer, generally, LTC insurance makes sense if you wish to accomplish any one of these three things: protect your assets, protect the lifestyle of a spouse, or ensure choice in your care.

Protecting Assets

Many of the retirees we see today intend to spend their money and enjoy their retirement. If something is left over for their children, that will be fine, but leaving an inheritance is not necessary. However, if the happy and active retirement life you are anticipating is interrupted by a long-term illness, the question becomes: would you rather the assets you worked hard to accumulate go to your family or get consumed paying for medical care? Faced with that choice, many people opt to protect their assets with LTC insurance. Some simple calculations can help illustrate the situation. Suppose you purchased LTC insurance at age 55. For 20 years, you paid about $1,800 per year for this coverage. If you had invested that money instead and earned 6%, you would have accumulated about $70,000. At age 75, you began needing long-term care and the need lasted three years (the average length of stay at a long-term care facility). The total cost of care was about $217,000 ($180 per day or $65,700 per year, increasing at 5% per year). So, purchasing long-term care insurance protected $147,000 of your assets ($217,000 – $70,000).

Protecting a Spouse

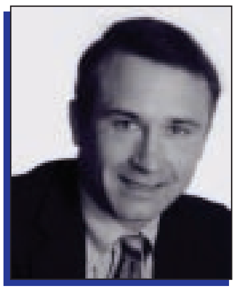
Even if you are not concerned about spending your money on long-term care, you will need to consider the impact paying for such care could have on your spouse. If we use the example above but increase your stay to six years and assume you have no insurance, the cost of your care would be over $469,000. Depleting that amount of your retirement assets over such a short period of a time would likely cause financial hardship for your spouse. He or she would likely have to greatly reduce his or her lifestyle or face the possibly of running out of assets. By purchasing long-term care insurance, you might increase the security of your spouse's retirement.

Ensuring Choice

If you are single and not concerned about spending your money on long-term care, there may still be one other reason to consider long-term care insurance—ensuring choice and quality of care. If the need for care arises, will you be able to afford the care of your choice? If someone else is making healthcare decisions for you, will they choose the same facility you would? Having long-term care insurance can make those decisions much easier. In addition, many people assume they will just spend down their assets and then qualify for Medicaid. However, Medicaid may not pay for the same care you expect. For example, Medicaid typically pays for a semi-private room in a nursing home. You may not be able to receive care at home or in an assisted living facility. Long-term care insurance can help ensure you have those options.

The primary purpose of all insurance is to reduce financial risks. By definition, a risk is something that is unpredictable and cannot be fully controlled. Thus, the decision to buy long-term care insurance should not be based on whether you think you will need it. You buy it precisely because you cannot know if you will need it. The way to determine if you should buy long-term care insurance is to evaluate the financial impact ***not*** having it would have on you and your family. If the impact on your assets, your spouse, or your choice of care is one that you can and are willing to absorb, then you do not need to purchase long-term care insurance. If the financial impact would be too great on any of these aspects of your life, then long-term care insurance may be worth the price.

Investment Management



Now That You Have Retired, How Much of Your Portfolio Should You Invest in Bonds?

By Rob Williams

Conventional wisdom says that investors should determine the percentage of their portfolio they invest in stocks by subtracting their age from 100. The rest of their portfolio should be spread between bonds and cash. According to this wisdom, a 30-year-old investor will have 70 percent of his assets in stocks and 30 percent in bonds and cash, and a 65-year-old investor will hold only 35 percent in stocks and the rest in bonds and cash.

This approach, which is used by many individuals and old-fashioned defined benefit retirement plans, emphasizes reducing investment risk and producing enough bond interest to pay benefit checks when workers retire. However, it has a problem. The interest earned on bonds and cash is not enough to support a comfortable lifestyle for the average retiree today.

The facts are that:

- Investment-grade bonds have averaged only 5.7% annual return over the last 70 years and are currently earning even less. After fees and expenses, the return can be quite small. And worse yet, money market funds are currently paying almost nothing.
- Retirees need to plan on their money lasting a long time. A person who retires at 62 today may be alive and well in 35 years and still have bills to pay.
- Inflation erodes the real value of the rate of return over time. Even a moderate inflation rate can cut the real earnings rate in half, so that 5.7% becomes less than 3%.
- Very few people have saved enough in their retirement accounts that they could support their lifestyle throughout retirement if they earned so little on their investments. When we prepare a financial plan, we assume that a retiree will earn at least 6% per year on their investments after all fees and expenses. You would need to be truly rich or extremely frugal to live on a portfolio predominantly invested in bonds if you retired today.

Our Approach

We think retirees should strive to earn a higher rate of return by holding more stocks and fewer bonds so that they can afford a comfortable retirement. We think that with reasonable safeguards a retiree can hold 60% to 70% of their portfolio in stocks, and be able to ride out the ups and downs of the stock market.

We note:

- Over the same 70-year period as noted above, stocks have earned an average annual rate of return of 11%.
- Only nine times in the last 74 years has the stock market been down over a five-year period. (Four of those were during the Great Depression and two were in the last three years.)
- Not since 1939 has the market been down for a 10-year holding period.

But what about the short term? Safeguards must be in place because investors retiring today cannot tolerate three to five years of negative returns while "living off of their investments." After five years of living off of their principal, they would have little money left to grow back once the stock market finally turned around.

To protect against this problem, we make sure that retirees do not need to draw heavily on their principals. We do this by making sure that 60% to 80% of the money retirees draws from their accounts comes from income earned in the form of interest and dividends. To earn this income, we invest in bonds, preferred stocks, stocks with higher-than-average dividends and real estate investment trusts, all of which have high yields. This approach allows the principal to ride through the troughs and the retiree to enjoy the long-term advantages of stocks over bonds.

Tax Services

The Advantages of Donor-Advised Funds

By Bob Cassel, EA,

CFP

Individuals who wish to make a commitment to philanthropy often consider establishing a private foundation. But Donor-Advised Funds offer significant advantages with no start-up costs, higher tax deduction limits, and less paperwork and expense. These funds are charitable organizations set up to receive your donations and administer your gifting plan. They have a structure that makes them efficient and inexpensive.

What are the advantages to you?

- **An immediate charitable donation –** With proper tax planning you will receive an immediate tax deduction for the total value of your gift.
- **Spread donations out over several years –** You are able to make a large gift in one year, but determine the charities you wish to benefit over time.
- **Avoid capital gains taxes –** When you gift appreciated assets (rather than sell them outright), you avoid paying capital gains tax. Examples of this kind of gift might include highly appreciated stock, mutual funds, and real estate.
- **Reduce estate taxes –** Your charitable donation reduces the value of your estate and lowers any potential estate tax consequences.

Who might use them?

We've identified some people who would benefit by making a gift to a Donor-Advised Fund. Do you see yourself in this group?

- **Planning a gift of $10,000 or more –** Most Donor-Advised Funds have minimums of at least $10,000. Obviously they will accept more, but you should be careful to contribute amounts that work with your income tax situation.
- **Expect to receive a large spike in income in one year –** It makes very good sense to make a large donation in a high-income year. The donation will reduce your tax bill at your highest tax rate.
- **Want a structured approach to charitable giving –** These funds create structure to your charitable giving. They remind you when it is time to recommend a charity and they handle the administrative details.
- **Direct your investment –** You may want to retain, or assign to your investment advisor, control of the way in which your gift is invested over time.

What are the Disadvantages?

The disadvantages of making a gift to a Donor-Advised Fund are:

- **You cannot *control* the decision about the charity –** The tax code requires that you give control of the gift to the Donor-Advised Fund, which retains the right to make the final decision about your designated charity. Normally, they follow your wishes, so this should not be a problem.
- **Limited investment options –** In some cases, the Donor-Advised Fund may offer limited investment choices or retain full control of the investment. Careful selection of the Donor-Advised Fund can prevent this problem and allow you to direct the investment management choices. BWFA can help you select the fund which best suits your needs.
- **Less flexibility than a private foundation –** Donor-Advised Funds do not allow the donor to use the gift for personal benefit. For those individuals gifting larger amounts of $1,000,000 or more, a private foundation will offer more flexibility, including the opportunity to put family members on the foundation's payroll.

A Donor-Advised Fund allows you to build a legacy of philanthropy. Planning for and recommending grants can be an activity you share with your family and pass on to your heirs. If you would like more information about this topic, please feel free to contact us.

Baltimore-Washington Financial Advisors, Inc.

3525 Ellicott Mills Drive, Suite G • Ellicott City, MD 21043

www.bwfa.com • (410) 461-3900 • (888) 461-3900 • Fax (410) 461-2127