



By Scot Millen,
MBA

Improving Your Finances in a Low-Interest-Rate Environment

Who hasn't noticed how low interest rates have fallen? If you haven't refinanced your mortgage several times over the last few years, I'd be surprised.

The average rate for a new 30-year fixed-rate mortgage fell to 4.36% at the end of

August. The Prime Rate, the rate at which banks lend to their best commercial customers, dropped to 3.25%. That's the good news.

The bad news is that the 10-year U.S. Treasury bond currently yields just 2.5%. If you're counting on bonds for your retirement income, it's going to be difficult to make it on those returns.

We've dedicated this newsletter issue to ways to help you prosper in a low-interest-rate environment. We have identified opportunities for increasing your pension distributions and reducing college costs—plus, we think that dividend-paying stocks look especially attractive in the current environment. We'll also tell you how to avoid a tax "surprise" in April.

But first, an update about our firm.

BWFA has expanded in 2010

It's been a year of growth for BWFA. We have added about 600 square feet of office space in the back, creating a sunny open space for six new work stations. We also have created a new office along the back windows. Ask for the "tour" next time you're in our office.

The physical expansion accommodates staff members and interns who have joined us in 2010. Here are quick introductions to people who will soon be familiar faces to you:

- **Lila Washington, CFP®, financial planner.** An experienced planner who previously worked with Schwab and TD Waterhouse, Lila joins Mark Stinson, CFP®, in our planning group. Lila will support preparation of financial plans, and she will be a resource for all of our advisors.
- **Victoria Hansard, operations manager.** Victoria is your contact point for account opening, distributions, and all TD

Ameritrade paperwork. She also reviews trades and reconciles our records with TD Ameritrade's reports on a daily basis.

- **Meghan Manas, front desk.** Our new smiling face greets you at the door and on the phone, and keeps many things working smoothly. If you need help with anything at all, but aren't sure where to start, Meghan is a great resource.
- **Susan Bailey** joins Meghan as a part-time member of our administrative team. By the way, she's been a BWFA client since 2003.

Our intern program supports higher education in the area and helps BWFA identify and train potential junior staff members. We are pleased to recently have added **Danny Phelan** (UMBC) and **Mitch Smallwood** (Towson University) to assist us with research, marketing, and operations.

Stop by soon and say hello!

Save the Date

BWFA Retirement Investing Workshop

Wednesday, November 3, 2010, 7 – 9 p.m.

Parsons Auditorium at the Applied Physics
Laboratory in Laurel, MD 20723

Come and learn about creating a "retirement paycheck" from your investments. The workshop features Saxon Birdsong, president of Baltimore-Washington Financial Advisors. BWFA has been serving local investors and retirees since 1986. The workshop will also feature Gary Belsky, an award-winning author in the emerging field of "behavioral economics" that explains why we are not as successful with money as we could be. Mr. Belsky will explore topics from his book: *Why Smart People Make Big Money Mistakes And How To Correct Them: Lessons From The New Science Of Behavioral Economics*.

Register now on BWFA.com!



Retirement & Estate Planning



By Mark Stinson, MBA



Pensions, Loans and Trusts in a Low-Interest-Rate Environment

Before becoming a comedian, Jeffrey Jena worked as a grade-school teacher. "Children are stupid," he says. "That's why they're in school. I'd lecture for an hour about percentages and interest rates, and at the end I'd ask one simple question: You put ten grand in the bank for one year at five and a half percent, and what do you get? Some kid would always yell out, 'A toaster.'"

With money market, CD, and savings account interest rates at all-time lows, the toaster sounds good these days. However, low interest rates do create planning opportunities.

Pensions

If you have a defined benefit plan (better-known as a pension), a low-interest-rate environment can improve your lump-sum pension payout. If you are eligible for a pension, now is a good time to consider a lump-sum payout because your employer or former employer will offer a larger lump sum than when interest rates are higher.

Here's why. When you have a pension, often you have the option to take your pension in a one-time, lump-sum payout or as a guaranteed lifetime monthly payout. To calculate the lump-sum pension benefit, companies use a standard interest rate, a mortality table, and your years of service. The amount of the lump sum, invested at the standard interest rate, is supposed to equal the amount you would have received in annuity payments over your expected lifetime. The interest rate that companies use is now typically based on high-quality corporate bond rates. Since these rates are low, a larger lump sum would be needed to give you that monthly payment.

Applicable Federal Rates

Every month, the IRS publishes the Applicable Funds Rates (AFR). When interest rates are low, the AFR is low—and that's potentially good for you.

- **Intra-Family Loan.** Clients occasionally want to make a loan to a family member to help him or her purchase a house, buy a car, pay off high-interest debt, or start a business. The IRS generally treats an interest-free loan (or any loan below market interest rates) as a gift, which makes the loans subject to gift tax rules. The AFR determines the interest rate that will avoid gift status. In September 2010, the AFR for a mid-term (3- to 9-year) loan was 1.94%. Therefore, you can loan family members money and charge them interest as low as 1.94%, without the loan being deemed a gift.
- **GRAT and CLAT.** A Grantor Retained Annuity Trust (GRAT) or a Charitable Lead Annuity Trust (CLAT) allow you to transfer wealth to family members and charities during your lifetime without paying large taxes. Because these also are based on the AFR, low interest rates provide a greater opportunity to transfer additional assets to your heirs and to charities.

Student Loans

With mortgage, home equity, and home equity line of credit (HELOC) loans at low interest rates, it is possible to use these loans to pay off student loans. However, you should talk with your advisor about the tax implications of using a HELOC, as well as the matter of using your house as collateral for a loan.

My grandmother actually told me, "When life gives you a lemon, make lemonade." Low interest rates are lemons in terms of your investments, but with a little work, you can make lemonade.

If you have questions or comments or would like assistance using one of these techniques, please contact me at mstinson@bwfa.com or 410-461-3900.

Baltimore-Washington Financial Advisors

Investment Management



By Robert F. Ray

Stocks vs. Bonds in a Low-Interest Rate Environment

It's no secret that bond portfolios have outperformed stock portfolios through August of this year. Stocks have performed poorly as the economy weakened in the second and third quarters, while bonds have benefitted

from investors reaching for yield and safety.

But what do you do today, when the 10-year U.S. Treasury bond is yielding only 2.5% per annum? I think that you favor equities and avoid long bonds like the plague.

Most client portfolios managed by BWFA are diversified among stocks, bonds, and other investments. The percentages of each are a function of the individual client's risk tolerance and income needs. BWFA has different "risk models" that address these needs.

Our risk models assume that there is a negative correlation between stocks and bonds. As bond yields fall, the price of the bond rises, which helps to offset the potential decline in the value of the equities in the portfolio. But in a low-rate environment, this might not be the case. The closer that bond yields get to zero, the less protection the bond portion of the portfolio provides to offset potential losses in equities. (Yields will not go below zero, unless you are willing to pay someone to hold your money!)

To put it another way, the more yields fall, the more that risk becomes asymmetrical. The investor has a greater risk of losing money on his bonds as interest rates rise than he has potential gains if interest rates fall even further or the economy goes back into a recession.

For BWFA, the question comes to this: If you are going to take on this risk of losing 10% to 15% of your bond investments if rates rise, shouldn't you be willing to take on the risk of owning equities, where you can participate in the upside if the economy improves?

Other Reasons to Favor Stocks

- *Stock yields are high.* The dividend yield on a conservative portfolio of stocks is approximately 3%, as compared to 2.5% for 10-year Treasuries or less than 3% for short-term corporate bonds.
- *Bonds are the past year's trade.* Over the past 20 years, fixed-income securities have not outperformed equities two years in a row. Don't bet on it happening now.
- *Corporations are buying equities.* Cash-rich corporations with strong profits are either buying back their own stock or buying other companies.
- *Exogenous events that have hurt equities are being resolved.* The markets have been beaten down by worries about the European (or developed world) debt crisis, the currency crisis, the BP oil spill, financial reform regulation, North Korean and Iranian nuclear ambitions, wars in Iraq and Afghanistan, and the expiration of the Bush tax cuts. As these issues are resolved (slowly) and the future becomes more certain, capital spending should pick up and spur economic growth.
- *Worldwide economic growth is stronger than in the U.S.* Emerging markets, led by China, India, and Brazil, with growth rates of 5% to 8%, will help keep developed economies out of recession.
- *Stock dividends are taxed at a lower rate than bond interest.* With the aim of keeping more after taxes, you really need to take a hard look at stock dividends.

A final note. BWFA is not recommending that you sell all of the bonds that you hold in a well-crafted portfolio of stocks and bonds. Most of the yields on bonds held in your portfolio are higher than current yields, and your bond portfolio will gradually mature over time. Therefore, if rates rise, you will have ample opportunities to invest at higher rates. But now is not the time to add to your bond portfolios. That opportunity is behind us.

If you would like to check your portfolio's suitability for a low-interest-rate environment, please contact your investment advisor at BWFA.

Baltimore-Washington Financial Advisors



Tax Services



By Bob Cassel, EA



Lower Mortgage Interest Rates Could Mean Higher Taxes for You

Lower mortgage interest rates are good news for homeowners who are seeking to refinance and for those who are looking to purchase a home. Lower rates add flexibility to the negotiation of loan terms, mortgage interest, points, financed amount, and term of the loan. But

refinancing an existing mortgage can raise your taxes, too.

Typically, in a refinance, you pay a lower rate of interest, and you pay less interest over the remaining course of the loan. While this is desirable, lower mortgage payments will likely also result in a lower mortgage-interest tax deduction:

Example:

Reduction in mortgage interest (and tax deduction):	\$6,000
Federal tax rate:	28%
State tax rate (Maryland):	8%
<hr/> Total tax rate	<hr/> 36%

Multiply total tax rate times the reduction to mortgage interest: $36\% \times \$6,000 = \$2,160$ tax increase

Total savings from refinance: $\$6,000 - \$2,160 = \$3,840$

You still come out way ahead, but be prepared in your 2011 tax return to cover the additional taxes.

Attention Students: You Might Need to File a Tax Return

Alert to college and high school students working a summer job. If your total income goes over \$5,700 for the year, you'll need to file a tax return for 2010. If you earn less than \$5,700 but also have investment income (interest, dividends, capital gains, etc.) greater than \$300, you'll have to file tax returns. If your employer didn't withhold any federal or state taxes, you'll need to be prepared to pay taxes with your return by April 15, 2011.

Need help? Give BWFA a call at 410-461-3900.

Watch Out: Sometimes, Mortgage Interest Is Not Tax Deductible

There is another aspect to the tax deduction for mortgage interest that you'll want to consider: how the IRS classifies mortgage interest. The IRS categorizes mortgage interest into acquisition indebtedness and home-equity indebtedness. Home acquisition indebtedness is defined as a mortgage to purchase, construct, and/or improve your home. Home-equity indebtedness is defined as any other debt (secured by your home) not used as acquisition indebtedness.

Tax deductions on each type of interest have upper limits. For acquisitions, it's \$1 million. For home-equity, it's \$100,000.

Example:

Assume that you refinance and take extra cash (equity) out of your home.

Current mortgage balance is \$200,000.

Refinance and borrow \$320,000 (extra cash for home renovations and down payment on vacation property).

Based on IRS rules, \$200,000 of the \$300,000 is classified as acquisition indebtedness (it replaces the balance on the original loan). The interest on the remaining \$120,000 is classified as home-equity indebtedness. The interest on the first \$100,000 of home-equity indebtedness is fully deductible as mortgage interest. But the other \$20,000 would be deductible only under certain circumstances related to the use of that money.

You may need to plan for this change to your taxes. You can increase tax withholding from your salary, or make quarterly payments. BWFA can help you with this calculation; please call our tax department at 410-461-3900.

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