BWFA

Retirement & Estate Planning,
Investment Management
& Tax Services

Advisor

JANUARY 2012

Baltimore-Washington Financial Advisors

# It's Been a Lost Decade for Most Equity Investors, But it Didn't Have to Be

*By Saxon Birdsong, MBA*

Back about 10 years ago, I spent a lot of time trying to explain to folks why just buying the S&P 500 index was a bad idea. I remember vividly how some of our clients and prospects at the time felt that we were just making excuses for not keeping our performance up to S&P, which was soaring. Our explanation was simple: we were not going to buy investments that were clearly overvalued. But I could tell that our explanation seemed like a lame excuse for poor performance. Now, after more than 10 years, we can conclusively demonstrate that our reasoning was right. Here is an explanation and the facts.

One of the problems with trying to match the S&P 500's returns is that the index is market-cap weighted. This means that larger companies influence the movement of the index more than smaller companies in the index. A $1 change in the price of Exxon (the largest stock in the S&P 500 and currently selling for about $80/share) causes the index to move twice as much as a $1 change in the price of a company also selling at $80/share but half as big as Exxon. This means that if your investments are "benchmarked" to the S&P 500, your investment results (i.e., performance) will mirror the results of the index. The problem is, it simply does not make sense to buy twice as much of a stock just because it's twice as big as another stock. Bigger companies simply do not outperform smaller companies just because they are bigger; the evidence is to the contrary.

Here are the facts. The S&P 500 index is still down about 19% from its dot-com high in March of 2000. But if you ignored size and owned an equal dollar amount of each stock in the index, your portfolio would be up about 66% from March 24, 2000 through December 2, 2011.

The difference in performance is remarkable. And, according to S&P, most equity investors ($5.8 trillion) are still benchmarked to the S&P 500 index, mostly through mutual funds. Owners of stocks in the largest companies, represented by the S&P 100 index, suffered the most; this index fell 33%, driven by declines in the largest companies at the time, Cisco Systems, General Electric and Microsoft.

These past 10 years have seen the 9/11 attacks, the dot-com bubble, the collapse of real estate values, the worst financial crisis in the U.S. since the Great Depression, multiple wars, a tsunami in Japan, and serious problems throughout Europe. Yet, if you invested intelligently in stocks over that time, you did fine. It's unfortunate that most investors didn't.

## What's Happening at BWFA

### BWFA Welcomes Two New Staff Members

**Sunil Reddy** joined BWFA's Investment team on September 6. Sunil is a CFA charterholder, a Certified Public Accountant (CPA), and earned a Master's degree in accounting with a concentration in taxation. Sunil has worked at major accounting firms, including KPMG and Ernst and Young, at a healthcare company, and most recently as a Senior Financial Analyst for federal agencies dealing with housing issues. Sunil will have responsibility for monitoring investments and making recommendations to the firm's investment committee.

**Tanya Blakely** joined BWFA in July as the firm's Investment Operations Manager. Tanya gained her experience working with investment firms Morgan Stanley, Merrill Lynch, and Bank of America. Tanya studied International Business in Wurzburg, Germany, providing her with a background in international business affairs, as well as fluency in German.

### Client Satisfaction Survey – 3rd Quarter 2011

We sent our client satisfaction survey to 170 current clients in October, and we received a 41% response rate. Here are the scores:

| | May | July | October |
|---|---|---|---|
| Financial Planning | 48% | 66% | 30% |
| Investment Management | 55% | 59% | 41% |
| Tax Services | 32% | 38% | 33% |

Our plan is to survey one-fourth of our clients each quarter, so we can track our results toward continual improvement. Your feedback is essential to us. Thanks to those who participated.

Fee FO Only ™

# Retirement & Estate *Planning*

## The Real Estate Elephant

*By Mark Stinson, CPA, MBA*

*New York Mayor David Dinkins was once urged by his advisors to buy some property in Manhattan. Despite claims that the proposed deal presented an "extraordinary opportunity" for the city, Dinkins declined. "If they're selling elephants two for a quarter, that's a great bargain," he explained. "But only if you have a quarter — and only if you need elephants."*

Stocks are down. Real estate is down even more. With the recent stock market swoon, residential real estate looks inviting: low interest rates, bargain prices. But do you need this elephant?

Assuming you already have a primary residence, there are two reasons to "invest" in a second home. The first reason is that you want a second property (seriously). Many people buy a vacation or rental property; looking at an ocean view or a mountain vista is much more satisfying than looking at a stock certificate. Other people plan to eventually retire to another location. For these types of buyers, real estate may not match the returns of the stock market, but it sure is nice to sit on the deck. In addition, it is potentially an appreciating asset (unlike an expensive car) and provides diversification when owned along with stocks.

The second reason to purchase real estate is to save on estate and inheritance taxes. In our April 2011 newsletter ("The State of Estate Taxes"), we discussed Maryland's low estate tax exemption of $1 million. Due to this low exemption, some retirees move from Maryland to states with no estate tax or a higher estate tax exemption. If you can afford it, now is a great time to purchase that retirement home for your future change in residency. For a discussion of which states provide income, property, and sales tax breaks, see "Considering Taxes in Retirement Location" in our July 2011 newsletter.

### Stock Market vs. Real Estate

What about residential real estate as a true investment? Generally, stocks outperform real estate. Over long periods, the stock market returns about 10% annually, while real estate returns 3%.

But pick your period, and the picture can change dramatically. In the 1990s, the stock market clobbered real estate. From 2000 through 2007, real estate clobbered the stock market. Sounds like market timing doesn't it?

However, the 10% vs. 3% argument leaves out real estate's biggest advantage: leverage, or the ability to borrow money (mortgage) to make the investment. If you have $100,000 to invest, you can invest it in the stock market. Alternately, you can purchase a $500,000 home ($100,000 cash down payment and a $400,000 mortgage). At the end of one year of historical gains, your real estate investment would be worth $115,000 ($100,000 + ($500,000 x 3%)), and your stock market would be worth $110,000 ($100,000 + 10%). That's the argument made by those late-night infomercial guys who urge you to invest in real estate.

But the leverage argument leaves out one of real estate's biggest disadvantages: transaction and holding costs. Owning real estate generates purchasing and selling expenses (taxes, fees, and commissions), mortgage interest, property taxes, insurance, maintenance, and repair bills.

### Well…?

When it comes to investments, there is usually less risk and higher returns with stocks. We like stock investing because it's inexpensive (most trades cost less than $20) and easy to diversify, and easier to turn into cash. By the way, stocks don't wake you up in the middle of the night with a leaky toilet.

When we want to invest in real estate, we sometimes use Real Estate Investment Trusts (REITs). We have used REITs for many years to help diversify our clients' portfolios. REITs are similar to stocks in that they are easily traded and relatively inexpensive investments. In other words, they are liquid assets, but they give you access to real estate, when the outlook for real estate returns is positive.

So, do you want to own a real estate elephant? If you buy a vacation, rental, or retirement home, it should be because you're going to use it in some way. If you want to invest in real estate but not be an owner, then let's talk about REITs. Contact me at 410-461-3900 or mstinson@bwfa.com.

# What to do About Market Volatility

*By Rob Williams*

Investors are upset by the recent big increase in the number of wild days in the stock market. After any volatile period, some investors react emotionally—and they suffer real harm. Some investors settle for safe investments that offer rates of return so low that they will have a hard time achieving their goals, while other investors become spooked and sell at the bottom. What can we do to avoid the high costs of this excessive volatility?

BWFA can help investors alleviate a portion of these choppy waters by selecting an appropriate investment model designed for the investors' needs. BWFA can't control the market's volatility, but we can help them keep on track by making the day-to-day decisions that avoid costly strategic mistakes.

However, many economists and market experts think there are steps we can take that would reduce market swings. BWFA supports efforts to find better ways to run our financial markets that allow investors to earn good rates of return while sleeping at night. However, we must be careful to avoid regulations that interfere with necessary parts of an efficient, free-market system, and thus cripple the goose that lays the golden eggs.

Let's take a look at some of the proposals floating around Washington, DC, these days to reduce market volatility.

- **Limit "black box" high-frequency computer trading** – Computer trading systems using complex algorithms were heavily involved in the infamous "Flash Crash" on May 6, 2010, when the Dow Jones Industrial Average dropped 900 points in less than 30 minutes. Computer trading does push the stock market around, sometimes in damaging ways. Yet, these firms provide a valuable service to all buyers and sellers of stocks by providing liquidity. In other words, they buy whenever we want to sell, so we can always sell stocks quickly.
- **Limit short selling** – Short selling is selling a stock now with the hope of buying it later at a lower price. Thus, the investor makes money when a stock goes down in value. Many experts claim short selling can push down stock prices further than necessary, thus increasing volatility on the downside. It's probably true, but short-sellers provide crucial discipline on stocks, too. In addition, why should we restrict an investor's profit if that investor believes that a stock or the stock market is overvalued?
- **Prohibit investment banks from trading for their own account** – Paul Volcker, chairman of the Federal Reserve from 1979 to 1987, is an advocate of limiting investment banks' ability to trade for their own accounts. Investment banks provide market liquidity, and they help big companies raise money to build their businesses. However, the biggest investment banks, such as Goldman Sachs and JP Morgan Chase, make most of their money by buying and selling securities solely to make money. Since these big banks are in the middle of the action, they appear to have an advantage over regular investors and can make money whether the markets go up or down. They also make more money when the markets are more volatile, which gives them an incentive to cause excessive volatility.
- **Impose a small fee on purchases and sales of stock** – A 5-cents-per-share charge on every stock transaction would be a big disincentive for rapid buying and selling. Unfortunately, even long-term investors would have to pay the fee as well.
- **Prohibit leveraged and short-position Exchange Traded Funds (ETFs)** – Originally developed as inexpensive ways to match indexes, ETF managers have branched out into much more specialized investment strategies, including leveraging (borrowing) and taking short positions. These ETFs operate by borrowing money, so they can earn or lose two or three times the rate of return earned by the bundle of stocks they hold. Think of these as ETFs on steroids—and some experts argue that they can increase market volatility.

## What Do We Think?

None of the ideas discussed above are close to being implemented today, but they will surely gain traction if the market continues to be very volatile. We don't believe that any of the ideas would have a big impact on volatility, and they might produce unintended consequences that would create new problems. That's why we at BWFA focus on what we can control: maintaining our clients' portfolios for long-term, steady returns.

# Tax Services

# Can I Use My IRA to Loan Money?

*By Bob Cassel, EA*

From time to time clients ask, "How can I use my IRA to help my children or others? Can I use my IRA to loan money to my children to buy a home or start a business?"

Unfortunately, the short answer is that you can't loan money from your IRA to your children for the purchase of a home or to start a business. More accurately, you can't do it without severe tax consequences, because any money you lend to a lineal family member is considered a withdrawal by you, and you will be taxed on it.

It can be frustrating to owners of large IRAs not to be able to use their IRAs how they want. But in exchange for the tax benefits of IRAs, you have to follow the rules. Given the depressed real estate markets, some believe that this is a good time to buy real estate (see Mark Stinson's article in the Planning section of this newsletter).

Let's look at the IRA rules in more detail and see whether it makes sense to use IRA loans to family members to purchase real estate.

## Who are lineal descendants?

IRA rules distinguish between "lineal descendants," who are not eligible for non-taxable loans, and "non-lineal descendants," who can be given non-taxable loans. Examples of lineal descendants include (and may not be limited to): spouses, parents, children, and grandchildren. This list pretty much rules out non-taxable loans from your IRA to your family.

Notice that the list does not include brothers, sisters (including in-laws), and friends. You can make loans to them from your IRA, tax-free, under some circumstances.

Here are the types of loans that are permitted from your IRA:

1. Loans to brothers and sisters, including in-laws
2. Loans to non-family members who are not employed in your business
3. Loans secured by the purchase of rental real estate property (this is best done from a Roth IRA).

Specific loans and other activities that are not permitted from your IRA include:

1. Using your retirement plan to buy a home for you to live in now
2. Pledging assets of your retirement as collateral for a loan
3. Selling personal investment property to your IRA
4. Buying collectibles such as rugs or gems
5. Loaning money to your child
6. Owning/purchasing stock in an S Corporation
7. Paying yourself fees from cash flow (i.e., rental income) derived from your plan's investments
8. Purchasing life insurance with IRA funds.

## Why is a Roth IRA the preferred vehicle for purchasing a rental property?

Owners of Roth IRAs might consider using them for a loan. Here's why. First, we assume that you want to eventually move into and live in the real estate you are purchasing in the Roth IRA, but you are renting it to tenants now. In order for you to convert the rental activity to personal use, you distribute the rental property from the Roth IRA to yourself. Because you're distributing from a Roth IRA, you pay no tax. (Remember that distributions from a Roth IRA are not taxable.) You are then free to move into the real estate property and use it as your personal residence.

## How should you set up your IRA to lend money tax free?

You will need to set up a "self-directed" IRA. There are only a few nationwide vendors who provide the necessary custody services. The fees they charge are much higher than you would pay for a traditional IRA. Our preferred custodian, TD Ameritrade, does not offer self-directed IRAs. If you would like more information about these types of IRAs, please call your BWFA advisor.

## Final Words

IRAs are intended to be used for your retirement. For the most part, laws prevent owners of such accounts from investing in collectibles, making loans to family members, and supporting their own businesses. If you want to use your IRA for a purpose other than saving for retirement, talk to us about the financial and tax consequences.

**Baltimore-Washington Financial Advisors**

5950 Symphony Woods Road, Suite 600 • Columbia, MD 21044 • (410) 461-3900 • (888) 461-3900 • Fax (443) 539-0330 • www.bwfa.com

311504 12/11 VI
Printed on recycled paper with soy ink