



Is Residential Real Estate In The Midst Of A Bubble?

During the past several years, your home has been a great investment. Housing prices have been rising across most of the country, and the return on the money you've actually put into your home likely rivals anything you've earned in the stock market. But have things gotten a little too good? Will home values go the way of technology stock prices, which plunged when the bubble of the late 1990s finally burst?

According to Federal Reserve Chairman Alan Greenspan, concerns about a housing bubble may be overblown. The monetary guru believes much of the appreciation in the residential real estate market has been limited to a handful of geographic areas, leaving most of the country with relatively modest gains during the past few years. Still, that assessment may provide little comfort if prices in your area have skyrocketed. A housing market "correction" could still lop off a painful chunk of the value of your home.

In exploring whether home values are likely to plunge—nationally, regionally, or not at all—it's important to consider why housing prices have increased in the first place. If the rise has been fueled by legitimate, sustainable forces, then a precipitous fall may be less likely. "Why Have Housing Prices Gone Up?"—a recent working paper from the National Bureau of Economic Research—considers key elements behind the widespread appreciation in home prices. The authors believe both supply and demand have played a role. They see demand being fueled by low interest rates and relatively stable,

growing wages, which together have made home ownership more accessible across the board. But there have also been important crimps in supply, the researchers say. Government zoning restrictions and limits on construction permits have slowed the pace of new housing construction and put upward pressure on prices, with bidding wars erupting in some markets.

Real Estate's Hottest Markets		
State	1 Year % Increase	5 Year % Increase
Nevada	32.38	79.22
Hawaii	24.56	77.67
California	23.44	102.35
D.C.	22.97	112.13
Florida	18.79	75.01
Maryland	18.63	73.55
Rhode Island	16.76	99.42
Virginia	16.44	63.15
Delaware	15.19	59.31
Arizona	14.46	47.27
New Jersey	13.67	74.40
New York	12.56	68.89
Vermont	12.28	56.15
Maine	12.26	64.75
Connecticut	11.80	59.57
National Avg.	11.17	49.67

Source: Office of Federal Housing Enterprise Oversight Ending December 31, 2004

Such relatively normal economic forces aren't likely to create a housing bubble. Bubbles happen only when investors buy solely because they think prices will rise. Many economists attribute most of the big run-up in housing prices from 1999 through 2004 to fundamentals—interest rates, per capita income growth, and economic

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News You Can Use: Why I Became A Loan Officer

It's certainly been a hectic 90 days since our last update. For compliance purposes, I've become a loan officer at a bank! This is to support our increased focus on managing both sides of the balance sheet: not only making recommendations on the asset side, but finding ways to use debt to enhance our clients' wealth accumulation. You'll hear more about this in the near future, but if you have an immediate concern about your situation, please don't hesitate to call. I'd be more than happy to discuss it with you.

On December 1st, I will be giving a presentation at the Wealth Advisor Summit in West Palm Beach, Florida. The topic is simply how to make your retirement money last through 30 years of inflationary pressure. Think about it: Your next car will cost more than your first house! That, my friends, is inflation in a nutshell. We have discovered a program called "Income For Life" (created by a company called Wealth2k) and have begun implementing their strategy in our practice. If you are in or near retirement and are concerned about outliving your income, give me a call or visit our website to see a 15-minute video that explains the program very nicely.

Have a happy holiday season!

Warmest regards,

Martin V. Higgins

Funds Squander The Dividend Tax Break



As if the mutual fund scandals were not enough to give funds a black eye, you also could get shortchanged if you invest in a fund to capitalize on the new tax treatment accorded dividends. Funds treat dividends in a strange way.

Until the 2003 tax law, dividends were taxed at your income tax rate, which could run as high as 35%. Under new rules, from 2003 through 2008, dividends will be taxed at 15% if you're in the 25% tax bracket or higher, and at 5% if you're in the 10% or 15% bracket. In 2008, taxpayers in the lowest two brackets will pay no tax on dividends.

Now, if Congress doesn't extend this tax break beyond 2008, it will vanish, and dividends will again be taxed as ordinary income. But in the

meantime, you have an opportunity for big tax savings on dividends.

To take advantage of this opportunity, some mutual funds have loaded up on dividend-paying stocks. But look closely before you leap. You may get less than you expect.

One problem is the way funds pay portfolio management fees and operating expenses. In the average fund, those cost you 1.4% a year. Mutual funds generally deduct these fees from income received from stocks and bonds—including dividend income. Otherwise, these fees would have to be paid from investors' capital.

However, with the average dividend yield on the Standard & Poor's 500 below 2%, that doesn't leave much dividend income to be taxed—most of it goes to pay fund fees. So the tax benefit is reduced. That was true before the tax cut, and is still true. Moreover, before the dividend tax rate was lowered to 15%, you were paying fund expenses with income that would have been taxed at 35% or higher. Now, you're paying the fund expenses with income that would only be taxed at the 15% rate. So the tax break on that income is less valuable than you might expect.

The situation is even worse if you hold dividend-heavy funds in tax-

deferred accounts, such as an IRA or 401(k). The puny dividends the fund does pay out don't qualify for the new favorable 15% rate. All income from such accounts, including dividends, is taxed at ordinary income rates when withdrawn. In holding dividend-paying funds in tax-deferred accounts, you actually turn low-tax dividends into higher-tax ordinary income.

So what should a fund investor do? First, consider holding high dividend-yielding funds in taxable accounts, and reserving your tax-deferred retirement accounts for funds that generate large amounts of ordinary income—for example, those that invest in REITs, bonds, convertible bonds, or preferred stock. A tax-deferred account is also a good place for funds that trade a lot. Remember, too, that low-expense funds may work best with dividends.

Keep in mind, though, that for a stock dividend to qualify for the lower tax rate, investors—including mutual fund managers—must own the stock for 60 days during a 120-day time period starting 60 days before the ex-dividend date. And because fund managers tend to be judged by their pre-tax returns, don't expect most of them to be too concerned about the tax issue and that mandated time frame. ●

The Federal Medicare Drug Coverage Program Is Coming, But

How much do you spend each year for prescription drugs? It's a question millions of older Americans will be asking themselves during the months leading up to the January 2006 launch of Medicare's drug benefit. (Sign-up starts November 15.) According to the New York-based Medicare Rights Center, opting for the new program could make sense if you don't already have drug coverage and pay more than \$810 annually for your prescriptions. But that's only a broad rule of thumb, and the Medicare drug plan, mandated by legislation signed into law in late 2003, is dauntingly complex. Here are several

factors to consider:

All drug coverage, like all politics, is local. In most areas, the drug benefit will be purchased from private insurance companies. (If there are no participating private insurers where you live, the federal government will fund your coverage.) You'll pay a monthly premium of about \$35 a month to Medicare for what will be known as Part D coverage, but the private insurers offering the benefit in your area may tack on an additional cost. Different plans may charge different fees and pay for different drugs. If you take a particular medicine routinely, check to see which insurers

in your area include it in their lists of covered drugs.

What do you get for your money? In addition to annual premium costs—likely at least \$420, and perhaps significantly more, depending on private insurers' fees—you'll be responsible for a \$250 annual deductible. Then there's a copayment of 25% for the next \$2,000 you spend on drugs covered by the plan you choose. You're on the hook for 100% of expenses from \$2,251 through \$5,100; above that threshold, you'll pay 5% of costs.

So what's the cost, and what's your benefit? It all depends on

Taking Too Much From Your Nest Egg?

The recent three-year bear market was full of investment lessons. Chief among them: start out slowly when drawing down on your retirement savings if you want your money to keep up with inflation and last longer.

If you retired at the height of the long bull market, you could be excused for thinking that, because stocks historically returned 11% a year, you could safely withdraw 7% or 8% a year and be confident your nest egg would last as long as you live. You could be excused, but you could also be on your way to being broke.

Suppose you had a \$1 million portfolio and retired at the beginning of 2000, just months before the start of the bear market. Say you withdrew 7% from your nest egg in the first year and increased the dollar amount of withdrawals by 3% each year thereafter, to keep pace with inflation. Within 13 years, your savings would be gone.

That, according to data from T. Rowe Price Associates in Baltimore, Maryland, assumes a 60%-30%-10% split respectively among stocks, bonds, and cash, and that your portfolio lost 1.26%, 4.32%, and 9.84%, respectively, in

2000, 2001, and 2002. It also assumes you went on to earn 8% a year after that. How could a millionaire like you go broke so fast? Here's what happened.

In 2000, say you withdrew 7%, or \$70,000. In 2001, you withdrew 3% more to cover inflation, for a total of \$72,100, and \$74,263 in the third year. Your withdrawals, coupled with portfolio losses in the bear market, already devoured a third of your savings, leaving you with just \$663,004 at the end of 2002. Not a good start. And, when the market recovered, far fewer assets were left to benefit from it. In the withdrawal phase of retirement, an early sequence of poor returns really hurts.

In contrast, suppose you began retirement in 2000 with a more conservative withdrawal rate of 4% from your \$1 million portfolio. Starting with a distribution of \$40,000 and making the same 3% annual adjustment for inflation—an essential part of the formula to help maintain your standard of living. Making the same return assumptions as we did previously, your portfolio would be worth \$840,066 in 2013, according to the T. Rowe Price study, and you would be able to take

inflation-adjusted withdrawals for another 34 years before depleting your portfolio.

The study estimated the impact of hundreds of hypothetical economic and investment scenarios to find withdrawal strategies with a high probability of success—that is, of not running out of money before today's retiree dies. While these assumptions are hypothetical and your portfolio could perform better or worse, the study indicated that initial withdrawals of 3% to 5% of the initial value of your portfolio would allow you to be secure and maintain your standard of living.

Research by three professors at Trinity University in San Antonio has found that a nominal 7% initial withdrawal rate is sustainable in most cases. However, after inflation adjustments, the sustainable rate falls back to 3% to 5%.

At a 4% withdrawal rate, almost any combination of stocks and bonds should enable the portfolio to last 25 years. However, if you want to have money left over when you die—to fund a legacy for your kids or a charitable organization—or if you anticipate a retirement of 30 years or longer, you'll want to consider placing more of your assets in stocks.

That allocation should be at least 30% to 40%, suggests the T. Rowe Price study, and you may want to limit allocation to low-yielding money markets to less than 30%.

Of course, everyone's situation is different, and if the stock market is booming when you retire, you may be able to bump up your withdrawals. Similarly, if you delay retirement and shorten the amount of time the portfolio has to last, a more aggressive withdrawal rate could be sustainable. Yet given the uncertainty in the markets and longer average life span, it's probably better to be safe than sorry. ●

Will It Be Worth The Cost To You?

your prescription expenses. Consider three scenarios:

1. If your drug costs average \$50 a month (\$600 a year), you'll pay at least \$420 in premiums, the \$250 deductible, and \$87.50 in copays—or total out-of-pocket expenses of more than \$750. A losing proposition.

2. With costs of \$100 a month (\$1,200 annually), the same premium and deductible added to \$237.50 in copays makes a total of \$907.50. You save \$292.50.

3. And if you spend \$2,400 a year on prescriptions? Opting for the drug benefit could save you \$1,080.

Other options could be a better

deal. Stand-alone drug coverage is an optional Medicare benefit for those enrolled in "Original Medicare"—traditional, fee-for-service coverage. Medicare's managed care options—HMOs and PPOs—will also pay for prescription drugs, and if you can live with those plans' restricted physician and hospital choices, you could cut your overall outlays. In addition, insurers providing stand-alone coverage may offer supplemental plans to defray your out-of-pocket costs, or you could stick with a cheaper drug plan from a former employer. ●

Setting Up Your Own Foundation

Building on a long tradition of philanthropy, Americans in recent years have contributed an astonishing \$240 billion a year to charitable groups, according to the American Association of Fundraising Counsel. While much of that comes as checks written directly to favorite causes, many charitably inclined individuals prefer a more systematic approach: establishing private foundations.

Today, the foundation route is more popular than ever. You no longer have to be a “Ford” to have a foundation, and wealthy families can now start a foundation with as little as \$500,000. Thanks largely to declining set-up and operating costs and a growing interest in actively managing charitable giving, Americans have now established more than 66,000 private foundations.

Private foundations have become more popular because they allow families with charitable plans to make their donations strategically. Here’s why:

- **Control.** A foundation gives donors more influence and control than conventional giving. Instead of simply making donations annually to favored charities, a foundation allows you to

establish a going concern whose chief objective is funding your charitable passion, whether it is education, religion, politics, medicine—you name it.

- **Influence.** To remain operative, the foundation must satisfy IRS rules requiring that at least 5% of the previous year’s net average assets annually go to fund charitable causes and pay the fees associated with the foundation, including legal, accounting and administrative fees. But as long as your foundation annually earns more than the required 5% outlays, it can continue year after year to fund the causes you wish to support.

- **Freedom.** Your foundation can establish scholarships, sponsor research, and make grants to needy individuals as well as make donations to charitable organizations that qualify for tax-exempt status under Internal Revenue Section 501(c)(3).

Keep in mind, IRS rules regarding administration of a foundation are strict to prevent abuses, but the tax benefits can be significant.

- If you fund your foundation with cash, your deduction may not exceed 30% of your adjusted gross

income (AGI).

- Contributions of securities are deductible against up to 20% of your adjusted gross income.

- Excess contributions made beyond the deduction limitations may be carried over for deduction for up to five years.

- Assets donated to your foundation are removed from your estate, possibly providing significant reduction of death taxes.

- To the extent you donate appreciated securities at their current market value, you avoid triggering capital gains taxes. You could thus move appreciated assets out of your estate.

Leveraging technology to reduce overhead expenses, companies such as the Fairfield, Connecticut-based Foundation Source have streamlined the process of running a foundation. Foundation Source focuses on state and federal filings, compliance monitoring and grant-related paperwork. Its fee is \$4,000 per year, plus 0.30% of foundation assets. This does not include the fees for managing the assets in your foundation, an area where our firm can help you. ●

Residential Real Estate

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growth, and believe only a small part of the run-up is attributable to supply conditions in specific high-demand geographic areas.

Where are those areas? In the latest report by the Office of Federal Housing Enterprise Oversight, home prices in Las Vegas increased a whopping 36.23% in 2004, topping the list of big gainers. Though some of the advance may be due to supply restrictions, part of it is likely linked to speculative investments that anticipate both a growing tourist trade and an expected influx of retiring baby boomers. (See box for the 15 states that have the most rapidly appreciating home prices.)

One trend that could support the

bubble theory, at least where prices are most buoyant, is the increasing use of adjustable rate mortgages (ARMs) and interest-only ARMs to purchase homes. According to the Mortgage Bankers Association, 32% of mortgages in 2004 were ARMs, up from 19% in 2003. Because some ARMs require a balloon payment after a few years, these borrowers may be betting that prices will continue to go up, enabling them to sell at a profit before the balloon payment is due, often after five years. Moreover, buyers who use ARMs may be buying higher-priced houses than they could otherwise afford—and thus could be particularly vulnerable if prices level off or decline. For example, if interest rates rose sharply, leading to a decrease in demand and lower prices, highly leveraged

homeowners with ARMs might have to sell quickly, adding to the downward price spiral.

Still, interest rates have been low for several years, and with many homeowners having already locked in attractive fixed rates for their home loans, the upsurge in ARMs in 2004 may represent more of a blip than a trend. And even in the worst-case scenario, in which a frenzy of selling leads to significantly lower real estate prices in many parts of the country, the decline would be unlikely to mirror tech stocks’ plunge. That’s because for most people, an investment in residential real estate is also the place where they live. Rather than selling out if prices slump, a large proportion of homeowners would probably just stay put. ●