



## INVESTMENT OUTLOOK

March 2004

One of the subjects that is implicit in every newsletter we've ever written is "**Risk.**" Precisely what is "Risk" and how does it affect you? From a financial standpoint, we've all heard of the relationship between "Risk" and "Reward". Simply stated, the theory goes that the more risk you take on, the more reward you should earn. But from an emotional side, just how much risk are you willing to assume in order to achieve the rewards that you desire? A psychologist might ask you to take the proverbial pad of paper, divide it into two columns labeled "Advantages" and "Disadvantages", and then write down all the good and bad things you can think of before you commit money to any investment that has any type of risk. If the good outweighs the bad by a sufficient amount, the chances are that you would be willing to take on the risk.

Let's use a simple example. We are told that deposits of up to \$100,000 at banks have no risk because the FDIC insures them. And so you will find that deposits that permit you open access to your money without penalty pay a nominal interest rate currently less than 1% at most banks. If you are willing to lock up your money for up to five years, and to take on the risk of paying a premature withdrawal penalty, you might be able to get a little over 4%. Your risk is not the loss of any money. Your risk is the potential inconvenience of having your money tied up and subject to penalties if you withdraw too soon. Bonds issued by the U.S. Government are considered to be the most risk free investments. The rate on a 91-Day T-Bill is 0.93% while you could earn 3.72% on a 10-year T-Note or 4.67% on a 30-Year T-Bond.

You cannot consider pure interest rates, however, without considering the rate of and the risk of **Inflation**. For the 10-year period ending 12/31/03, the average Rate of Inflation was 2.44%. If you look at only the past four years, the average rate was 2.50%. When you subtract the inflation rate from the bank and bond interest rates listed above, you will see that inflation took more out of your earning power than the interest rate paid to you unless you took on the risk of tying up your money for longer periods of time. In other words, with all the safety associated with banks and government savings vehicles, you were barely breaking even and possibly even losing money.

It has been and remains our belief that the only way you can cover the cost of inflation and still earn enough of a return to be able to withdraw a meaningful income is to invest your money in some form of equity based investment. It has long been quoted that the long-term growth rate of stocks is somewhere around 11%. That includes all stocks over all winning and losing years. Over the past 75 to 80 years, we've come to learn that stocks go down in value about once every 3½ years. Over the past 25 years, stocks went down six times... and up 19 times. The down years were 1981, 1990, 1994, 2000, 2001 and 2002. All the other years were winners. These statistics also tell us that over the past ten years, stocks went down four times, went up six times, and still averaged 8.83% (using the S&P 500 index) over those ten years which gave us a 6.39% edge over the rate of inflation. The risk with equities is getting caught in a down cycle. I think of one of my favorite clients, a lovely lady from Brooklyn who had seen the stock market go up for five years in a row. She invested significant money in December 1999, just in time to catch a three-year free-fall. While stocks rose over 26% in 2003, her four-year results are an average loss of almost 7% per year. Her safety net is that with equities, one must think long term and four years is far too short a period of time in which to judge one's long term results.

I had a long conversation with a good friend last Sunday who is a savvy and experienced investor. He is almost 80-years old and has been actively investing most of his life. He remains very much committed to keeping his money in equities. His current favorite is to use a variety of indexed investments so that his money is broadly diversified among a large spectrum of investments. If you are a client of mine in a Variable Annuity or Variable Life Insurance product and if you followed my advice of diversifying among a broad class of investments using eight to twelve fund accounts, you are using that same philosophy. You took a hit during the three years from 2000-2002, but your long-term prospects remain bright.

And then there is the 81-year old client who at one time saw \$500,000 of his money increase to \$800,000, only to watch it drop to under \$400,000. Of course he had taken out over \$200,000 so the drop in value wasn't all because the market had gone down. But although he is also a sophisticated and experienced investor, he came to my office and asked a simple question, "Isn't there some way that I can continue to participate in the up side of the market, but never take any losses when the market goes down? And if there is, shouldn't some of my money be invested in that sort of thing?"

The answer I gave him was "Yes" and "Yes." We've written about Equity Index Annuities. The more we use them, the more convinced we are that they belong in portfolios as an asset class just as one would use Stocks, Cash, Bonds, etc. Since these annuities typically run for ten or twelve years, persons who use them should be at least 50-years old. While these annuities permit annual withdrawals of 10% with no penalties, persons who are under the age of 59½ are subject to a 10% tax on premature withdrawals.

Indexed annuities give you a participation rate in the up-side of the market with no participation in the down-side. The most common designs are:

**Annually Capped Annuities:** A 12% Cap gives you the first 12% gain in any year. These annuities normally lock in your gain on every policy anniversary. But over the past 25 years, of the 19 years that the market went up, the gain was over 20% in nine of them and between 12% and 20% in six. So, does a 12% cap give you enough of the gain?

**Monthly Capped Annuities:** The best we have right now allows you the first 4.15% gain in any month. To put that into perspective, over the past 25 years (300 months) there were 64 months in which the market went up by more than 4.15%. You got the first 4.15%. You didn't get the rest. In theory, 4.15% could create 49.8% total growth per year. In fact, the downside to this product is that it resets only once every two years. In that environment, where the market went down 23% in 2002 and up 26% in 2003, the combination of the two years resulted in a net loss so the annuity kept you even. In a 12% Annually Capped annuity, you would have gotten 12% for 2003.

**70% Participation Rate Annuity:** These annuities give you 70% of the market gain with no cap but most of them do not re-set annually. They tend to be seven-year plans and you actually have to wait until the end of the seventh year to see how you will end up doing.

For the ten years ending 12/31/03, the designs shown above returned between 7% and 8.35% per year. Did the typical S&P 500 Index Fund do better? Yes ... but only slightly. The index funds subject you to roller coaster rides. Equity Index Annuities are guaranteed products and offer an excellent substitute for CDs and Bonds. When interest rates start to go up, your bond values will go down. With Equity Index Annuities, unless you withdraw funds beyond the limits that are clearly stated by each product, your values can only go up.

Many Equity Index Annuities pay bonuses as high as 4% just for investing your money. That bonus would cover your cost of any early withdrawal fees from a CD and the linkage to the S&P Index gives you a chance to earn a higher interest rate than a CD or Bond based upon stock market performance.

*NOTE: THERE ARE NO EQUITY INDEX ANNUITIES APPROVED FOR SALE IN THE STATE OF NEW YORK. NEW YORK HAS APPROVED EQUITY INDEX LIFE INSURANCE SO WE SUSPECT ANNUITIES MAY BE NEXT. READERS WHO LIVE AND WORK IN NEW YORK SHOULD KEEP THIS INFORMATION AND BE READY IF AND WHEN NEW YORK APPROVES EQUITY INDEX ANNUITIES.*

If you have questions on any of these ideas, please give me a call.

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