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VALUE BUILDING

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INVESTMENT OUTLOOK

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Last week's drop in the Dow Jones Industrial Average, caused by another spike in the price of oil and gasoline, gives us pause to look at precisely where our economy and investment markets are positioned. Oil reached \$136 per barrel while gas at the pump went over \$4.00 per gallon. Basically, the DJIA has returned to where it was in October 2006, after reaching a high point in October 2007. In like manner, the S&P 500, the Russell 2000 (small cap) and the NASDAQ all returned to where they were between August and October 2006 after reaching their own highs in the fall of 2007. It's a tough way to make money.

The U.S. inflation rate, which had averaged 2.78% since 2000 jumped to over 4% for the first four months of 2008. That means that fixed income investments paying 4% or less are actually losing purchasing power for you. The Euro now costs us \$1.56. When I was in Europe in 2001, the Euro was brand new and very close to equaling the dollar and so purchases of foreign goods now cost us 56% more than seven years ago. My mother retired in 1977 and most of her money was in Municipal Bonds paying rates of 10% and more on a tax-free basis. That was great. But the national average yield to maturity on 20 to 30 year AAA Municipals is running just over 4%. Unless your total assets are large enough, a 4% return, even if it is tax-free, that is locked in until the bond matures, doesn't do much for you. If interest rates go up, the market value of your bond will go down, and that will inhibit you from selling. If interest rates go down, then your 4% will look good. The 10-year U.S. Government Bond Yield has fallen to under 4%. AAA rated Corporate bonds are yielding under 4% for 10-years to 4.7% for 30-years. And so if equity markets aren't giving you the growth you want, and bond yields are too low to be of interest, then what are your options?

If you are still working and investing money into your various portfolios, the current news is not all bad. Given the principle that buying low is the right time to buy, then now is the time to maximize contributions into your retirement plans. All this bad news will change. We are seven months away from a major leadership change in Washington and both of the presumed candidates have distanced themselves from enough current policies so that we can feel comfort in good things happening in the future. Since the stock market normally discounts the future by reacting to expectations some six months early, I would not be surprised to see a post Labor-Day run-up in the stock market, with a surge following Election Day, no matter who wins. If you find that view as inevitable as I do, then now just might be the time to buy.

But for those of you who will be retiring soon or already are retired, you face a different set of issues. Your issue is that you do not wish to delay your retirement or reduce your income during retirement. Most important, with life expectancies continually rising, the greatest fear becomes that of running out of money.

The Problem:

The issue with which we are dealing is primarily triggered by the incredible increases in longevity that we are now seeing. It is not unusual for people to live into their 90's and persons who are 100 years of age or older are now the largest growing segment of our population. The medical profession has done a wonderful job in keeping us healthy and curing those of us who have problems. But as we live longer and healthier lives, we also must realize it is becoming more expensive to pay for basic necessities. I was at a meeting yesterday where a speaker noted that medical insurance is not expensive. It is medical care that goes up in cost driven primarily by all the new medical technology that has been invented.

When I started working in the retirement planning business some 40 years ago, people worked for large corporations and anticipated pensions that guaranteed an income for life. For a person retiring at 65, life expectancy was about ten years. My father died just short of his 70th birthday. My father-in-law died just before reaching 68. They did not have long retirements to pay for. But today, people are retiring in their sixties, some in their fifties, and then living into their nineties. And so the first problem we need to concern ourselves with is "**longevity risk**." The longer you live, the greater the chance that your money might not last as long as you do. At one time, we could expect pensions that would assume the risk of us living long. Today, our money appears in 401(k) or other cash accumulation plans and the management of that

money, its rate of investment return and income payout is left totally to us.

Many financial organizations distribute charts showing the probability of an income-producing portfolio lasting for 25, 30 or 35 years. If you limit your draw to 3%, the prospect of running out of money is negligible. But if you take out 4% or 5%, a true risk appears that you will run out of money. The charts tell you that this risk is lessened if you invest greater amounts into equities. Even then, the probability of the money lasting 30 years is between 60% and 90%. No matter how good an investment manager you might be, running out of money while you are alive and healthy would not be acceptable to you.

Framework for a Solution:

Mutual Funds and Investment Managers cannot guarantee an income for life. There are all forms of asset allocations designed to protect you in a myriad of economic cycles, but you cannot escape the result of a bad "Sequence of Investments." If you had retired at the end of 1994 and enjoyed five spectacular years in your equity portfolio before experiencing any bumps, the chances are you will be just fine. But if you retired at the end of 1999, and had to deal first with 2000, 2001 and 2002, your equity investments would have become a disaster, and you would most certainly run out of money far earlier than you ever intended.

As such, the insurance industry began to realize that it could serve the public better by acting like an insurance company rather than trying to emulate Mutual Funds. Do you recall the old fixed annuities? That's where you turned your money over to an insurance company and they gave you an income that was guaranteed for life. The income used up your principal and interest but the cash flow was in the 6% to 8% range, or possibly higher if you were older. Your principal was gone... but you had a guaranteed income stream to replace it... Those forms of contracts went out of favor as people began to feel they could manage their money to get better returns on their own and still leave something for the kids. Those old contracts educated the insurance industry on how to price longevity risk. They began to attach lifetime income guarantees to their variable annuities. With these plans, however, the money remained under the client's control and projections showed that money would be left for the heirs. It is the inherent claims paying ability of each insurance company that determines its ability to pay any claims on these guarantees.

The Solution:

The Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB) was invented. The cash value of the annuity equals the sum of your investments minus your withdrawals plus or minus market return. That is the amount that you can cash out (subject to withdrawal fees in the early years) and that is what will go to your heirs following your death. For an additional fee, the Insurance Company will now guarantee income for as long as you or your spouse lives. This income can only go up (driven by equity returns) and the income can never decrease (the insurance company assumes the risk of a down market).

Variable Annuities with GMWBs create an account they label as the "Income Account." I called it the "Phantom Account" in my April 2007 newsletter. That account represents the amount of money on which your income will be based. That account can never go down. For the first ten years, so long as you do not initiate any withdrawals, the account is guaranteed to increase either from market gains or by a factor guaranteed to be 7% with most companies. You get the better of the two. Some companies use simple interest while others use compound interest. A client knows that irrespective of market performance, his Income Account is guaranteed to increase by at least a 7% compound rate. If the true value of a \$500,000 investment were to fall over the next three years to any amount you select, the guaranteed life income would still be based on \$612,500, that being the third year guaranteed value of the Income Account.

The rate of income is based upon the age of the younger spouse when income begins. In your 60's, figure on a 5% rate. At age 72 or 75, depending upon the carrier, the rate increases to 6%. Some carriers will pay out at 7% if you begin after Age 80. The market is measured every year. If it goes up, your income goes up. One carrier measures the market quarterly. Any high points in the market as of a quarter-end are locked into the Income Account and result in an immediate increase in income. Remember the catch phrase that "Your income can only go up, can never go down, and is guaranteed for as long as you and your spouse may live." For complete information, give me a call.

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