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FOURTH QUARTER 2005

CHANGE YOUR PERSPECTIVE, NOT YOUR GLASSES

by Ralph Weil

Most of the major news sources would have us believing that the U.S. economy is in a shambles. We know better than that, as economic activity here in the U.S. is so strong that not even two major hurricanes could derail that growth. Our economy continues to grow at a solid 3.5% to 4%, on a year-over-year basis, while at the same time price pressures remain moderate. Inflation, while up from previous levels, has slipped back below 2% in the most recent quarter as measured by the Personal Consumption Deflator. Real GDP grew at a revised 4.3% rate in the third quarter, which was an increase from the preliminary estimate of 3.8%. Most areas of the GDP rose strongly. Upward revisions in consumer spending and nondurable goods and services accounted for most of the positive trend. The third quarter performance marked the tenth consecutive period of 3% or better growth.

The employment picture continued to improve and recovered nicely from the sharp drop associated with the hurricanes in the South. During the month of November more than 215,000 new jobs were created which was up from 17,000 in September and 44,000 in October. The overall unemployment rate held at 5%. Apparently the creation of new jobs in this cycle has been below the rate in previous recoveries, mostly due to fewer new entrants into the labor market. Real personal income is up a meager 1.8% on a year-over-year basis but that was caused mostly by the huge increase in energy costs. As those increases moderate, we expect real personal income to return to the 3.5% to 4% growth of earlier in 2005. It is currently estimated that Proforma Operating Earnings for businesses should rise at a double digit rate (11.6%) for all of the year 2005. The largest increase is in the energy sector. The current estimate for 2006 is a rise in the area of 6% to 7%.

The rise in the price of energy did have a negative impact on equity prices during the year. This was reflected mostly in lower price earnings ratios (P/E) because of higher inflation expectations and some downward revisions in earnings estimates. Clearly the beneficiaries of this price increase were the energy-related companies. The biggest gainers were the weakest and most speculative energy issues.

While we do not want to seem Pollyannaish, there appear to be only two areas that could upset the proverbial apple cart going forward. The first of these would be the price of energy and the second would be the value of existing housing. It is a certainty that the cost of home heating is going to rise this year. We have heard estimates that the cost, in many areas of the country, could more than double. The consumer's cost is a function of use (outside temperature) and the price of energy. In this country most residences are

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heated with natural gas and the price of this commodity has more than doubled in the last year. The increased price will be passed on to the consumer during this heating season. So now we have another reason to hope for a warm winter, because the added spending could have a negative impact on the consumer segment of the economy. The second area of possible concern is house values. We do not believe that home prices will collapse over the next twelve to eighteen months. Interest rates will continue to rise but will not get to a level that would stop buying activity completely.

This all translates into a positive outlook for the economy and equity market during 2006. In terms of real Gross Domestic Product (GDP), we are forecasting growth of about 3% for the year. The slower growth on a year-over-year basis results from higher interest rates, moderation in house prices and just a general slowing caused by a pull back of the consumer. We believe that short-term interest rates will continue to rise in the early part of the year which should continue to put upward pressure on longer term rates. This pattern might continue into the second quarter. The rising interest rates along with the slowing economy should have an impact on equity prices (related to P/E's) during the first half of the year. This effect should moderate in the second half and earnings growth will be reflected more in stock prices as we progress through the year. Our portfolio strategy for this scenario, where it is appropriate, will be to extend maturities in the fixed income portion of the account. In the equity segment we will hold close to our targets early on with perhaps increased exposure in the second half of the year. When we look at equity market segments, we do not see any one portion dominating performance as we saw in 2005 (energy and utilities) so our more balanced style should pay off handsomely. §

A 529 SAVINGS PLAN PRIMER

by David Andrew

The Tax Relief Act of 2001 enhanced Section 529 state college savings plans to help families prepare for the rising costs of a college education. Since then, each state has formed at least one plan and the assets in these accounts have grown to over $70 billion. These 529 plan assets are expected to at least triple by the year 2010. Along with this growth has also come a considerable amount of confusion.

ARGUMENTS AGAINST 529 PLANS

Despite the growing popularity of 529 plans, there are a number of significant concerns that challenge some of the widely accepted benefits. Most of the concerns involve high fees and expenses, poor investment performance, lack of investment flexibility, and the impact on obtaining financial aid. Some feel that the high costs and limitations of certain plans can outweigh their tax benefits.

Probably the most common concern in using 529 plans involves the costs, performance and flexibility of the specific state plan. Generally, 529 plans are more expensive than similar mutual funds – sometimes dramatically so. One can often avoid sales fees by setting up the account directly with the state sponsor. A reasonably priced plan should have management fees no higher than the average mutual fund. Not only do fees vary widely from state to state, but the names some states use for certain fees can be different from other states. Efforts are underway to make it easier for consumers to understand these charges. Since many people tend to blindly chase tax advantages, parents need to realize that these higher fees can erase any tax savings. Also, one needs to compare the benefits of any state tax deduction to using another state's cheaper plan. Although many 529 plans have only existed since 2002, the performance of most plans has failed to keep pace with rising college costs.

The cost of a college education continues to rise. In just one year (2005 vs. 2004) the average tuition and fees rose 5.9% at private schools and 7.1% at public schools. There are many state 529 plans that have performed relatively poorly. Some of the poor performance is related to the lack of investment options available. Parents must remember that a 529 plan is simply a mutual fund in another dress. The commissions, fees and other expenses can have a significant effect on the long-term performance. One must carefully select a mix of funds that produce relatively good overall performance in both good and bad markets. Meanwhile, only a few 529 plans allow investors to fine-tune their investment mix. There are restrictions on how often funds can be changed, so they may be a bad choice for active investors and those needing continuous investment counsel.

There are substantial tax penalties if the assets in a 529 plan are not used for educational purposes. The distributions from a 529 plan also do not cover all student expenses. Some costs of attending college which might not be considered educational costs are transportation, automobile expenses, social club dues, clothes and spending money. Some parents need to be careful not to have more assets in the plan than expected college expenses. An over-funded plan can incur tax penalties unless parents re-direct the assets to another student.

The assets in a 529 plan might hurt a family's chance of getting financial aid. Currently, 529 plan accounts are counted the same as other investment accounts held by parents. These 529 plan assets are therefore included in most financial aid formulas. Some colleges look at the federal financial aid form (Free Application for Federal Student Aid or FASFA) and significantly lower potential awards because of 529 plan assets. Other schools will follow

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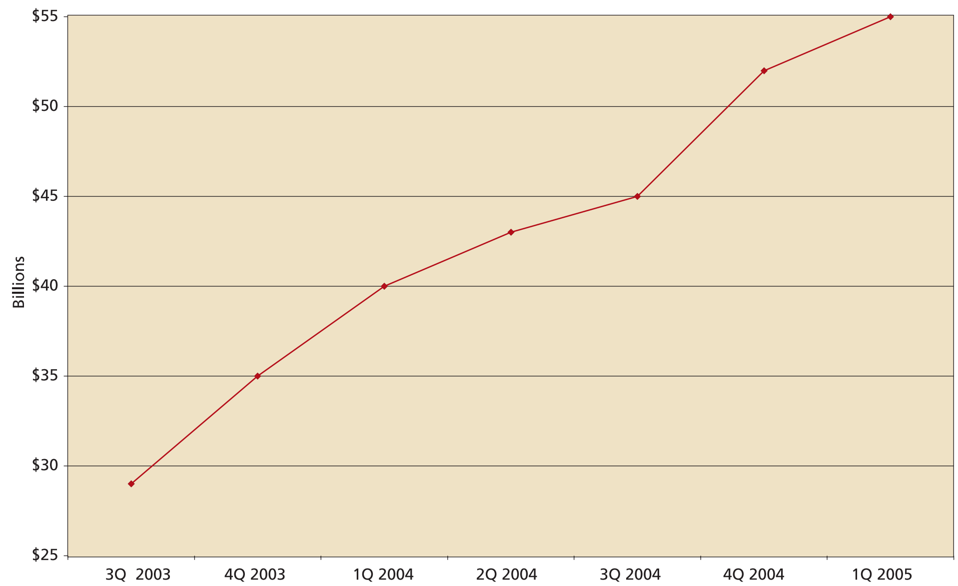
federal rules with their own financial aid funds. There is actually no way to know how funds in a 529 plan will be treated for financial aid except to ask the school. If financial aid is necessary, parents should find out which potential school treats 529 assets more favorably. Families can also simply ignore obtaining outside financial aid and pursue other scholarships or available savings. There is considerable due diligence required by parents and students in making these decisions.

Lastly, one of the major concerns about using 529 plans involves their continued tax benefits after the end of 2010. Unless Congress agrees to extend the exclusion of investment gains, these benefits will sunset in 5 years. However, it is likely that the 529 plan provisions will be extended past 2010. There are bills to this effect in both houses of Congress. In addition, there is considerable bi-partisan support for making the 529 plan exclusion permanent. While the general expectation is that Congress will extend the favorable tax treatment of 529 plans, there is no guarantee. If the benefits are not extended beyond 2010, distributions from 529 plans could be taxed at the beneficiary's tax rate.

Learning Curve

Assets of 529 college-savings plans soared 90% over the 18 months through March 31, 2005.



Source: College Savings Foundation: Financial Research Corp.

ARGUMENTS FOR 529 PLANS

Many families are unprepared for the cost of a college education. Over the past five years, total annual borrowing through student loans has soared, easily outpacing the 41% rise in public-college costs and the 28% increase at private schools. Among students graduating last year from private non-profit four-year colleges, 73% had taken out loans. At the present time, 529 plans are one of the best ways that families can save for college. While these plans have several major advantages over other available options, all college saving plans are unique and deserve consideration. In most cases, the best solution involves utilizing more than just one savings option. From the standpoint of the donor, the advantages of using 529 plans involve 1) Control of the assets; 2) Removing assets from the estate; 3) Accelerated contribution limits; 4) Tax-deferred savings and tax-free withdrawals; and 5) State tax breaks in certain states.

The donor to a 529 plan retains control over the assets in the account. Although these assets are considered a gift, the beneficiary of the assets can be changed to suit the circumstances. The rules allow a change in the beneficiary to a fairly broad group of family members, including grandchildren, cousins, and in-laws. This benefit adds considerable flexibility to families whose children are different ages and have different educational aspirations. Some students may attend a community college while others may attend a prestigious private university. The rules even allow the donor to be named as the beneficiary if the children elect not to attend college. Also, if the donor is named as the beneficiary and pays the additional taxes, the funds in a 529 plan can be distributed back to the donor.

If the donor's main objective is to create a fund for college and remove assets from an estate below the $2 million exclusion limit, then a 529 plan is ideal. As the cost of college keeps rising, the ideal educational fund must be large enough to sustain future schooling expenses. This means either starting to fund the account while the children are young or using an accelerated method. All of the current college savings plans use after-tax dollars for contributions.

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Another option is a Coverdell Education Savings Account (ESA). One problem with an ESA account is that the total annual contribution per beneficiary is limited to $2,000. At that rate, it would take years to accumulate a college fund of sufficient size for most schools. In addition, there are limitations on the amount of contributions based on the donor's income. A custodial account (UGMA/UTMA) is another vehicle often used for a college fund. The contributions to a custodial account are irrevocable and allow the minor complete access to the funds upon reaching majority. One advantage custodial accounts have over Coverdell accounts involves the higher contribution limits. Contributions are eligible for the annual gift tax exclusion, which is currently $11,000 for a contribution from an individual (or $22,000 for a married couple electing gift splitting). Since 529 plans are classified as qualified tuition programs, a donor may elect to treat up to $55,000 of the contribution (or $110,000 for a married couple electing gift splitting) as if it were made ratably over a five year period. However, if the donor dies during this five year period, a pro-rated amount goes back into the estate's taxable books. The higher contribution limits of a 529 plan are ideal for families who have started later in forming a college fund. Also, the cumulative limits of multiple 529 plans for a single beneficiary are quite generous, ranging from about $100,000 to $300,000, depending on the state.

For a single beneficiary, a 529 plan is an excellent savings vehicle from a tax standpoint. While many states offer tax breaks for residents using their own state plans, California currently provides no tax benefits. The main advantage of a 529 plan is that all investment gains (dividends, interest and capital gains) accumulate tax-free. Also, provided the funds are used for qualified higher education costs (including graduate school), all distributions are tax-free. According to the rules, qualified education costs include tuition, fees, books, supplies and equipment required for enrollment at an eligible educational institution. The designated beneficiary must be at least a half-time student to qualify.

There are special rules that determine how qualified distributions from a 529 plan are treated for income taxes. A special IRS form is required from the plan paying the distribution. To this extent, there might be some additional accounting costs involved. A family may also want to track the total fund assets and distributions to ensure that the funds are not depleted by the oldest student. But aside from this, there is no separate tax return or tax preparation costs required for the beneficiary.

There are many options to consider when evaluating 529 plans. But like other important opportunities, it would be a mistake to ignore these plans due to their initial complexity. As with most difficult decisions, one can usually narrow down the list of criteria to several different variables for comparison purposes. In general, it does make sense for people to start their investigation with their own state's plan because many states offer special benefits such as tax breaks and matching contributions. California residents should compare the state's plans to other state plans. Since you can contribute to virtually any state's plan, it pays to shop around. Also, keep in mind that a state's plan can change in regard to management, fee structure, investment options and performance – the main criteria a donor should consider.

THE BEST 529 PLANS FOR CALIFORNIA RESIDENTS

The 529 plan for California is called the Golden State Scholarship Fund. Unfortunately, this plan has higher expenses, fewer investment options and inferior performance when compared to many other states. At this time, the three best state plans are Nevada, Alaska and Utah. Each of these state plans allows one to set up an account directly with the sponsor, thus avoiding a sales commission. This is one particular type of expense which has seen considerable abuse. Once an account has been established, it can only be funded with cash. The list of available investment options should include age-based options (which automatically adjust asset allocations based on beneficiary's age) as well as both stock and bond index funds. All investment options need to be evaluated based on one's own risk tolerance and the length of time until distributions will be required.

A family's decision about starting a 529 plan requires considerable thought and analysis. These plans are not for everyone! As part of our ongoing counseling, we feel we can offer valuable assistance to our clients in evaluating these important college savings plans. §