

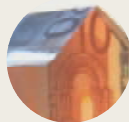


# NAPFA

## *Planning Perspectives*



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## Housing Issues Remain in Focus

Mortgages and housing have been in the news lately—and for all the wrong reasons. Home owners across the country are over-extended, with mortgage expenses taking up an uncomfortable share of their monthly income. Many home owners are facing the prospect of foreclosure.

This issue of *Planning Perspectives* opens with an essay on this very timely topic. NAPFA member Ronald Rogé considers the reverberations for individual home owners and the overall U.S. economy of the current mortgage crunch.

We follow with a look at mortgages from another angle—reverse mortgages. NAPFA member Christopher Parr provides insights about these increasingly popular financial vehicles.

From there, *Planning Perspectives* turns to three other NAPFA members for analysis of additional financial and personal issues.

First, Christopher Van Slyke explains the many ways that investment brokers disguise the often outlandish expenses that they charge their clients. Then, Fred Amrein shows parents how to help their children learn to face adult responsibility of paying their own bills.

Finally, this issue concludes with a suggestion by Stacy Francis about how to make New Year's resolutions that stick.

Thank you for reading NAPFA's electronic newsletter, *Planning Perspectives*.

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## NAPFA Provides Small-Business Advice Through Partnership with Wall St. Journal and Land Rover USA

NAPFA is pleased to announce an expansion of its consumer outreach efforts through a new, free Website developed in conjunction with the *Wall Street Journal*. The Website, <http://online.wsj.com/ad/landrover>, answers questions from small-business owners and provides financial information especially aimed at this vibrant sector of the U.S. economy. It is co-sponsored by automaker Land Rover USA, a division of Ford Motor Co.

Topics covered on the Website include taxes, estate planning, financing, health and life insurance, and transfer of ownership. "The site is freely available to everyone," said Ellen

Turf, NAPFA CEO. "Small-business owners have some unique financial issues, but as more and more people become independent contractors, the issues take on general importance, too."

Consumer education is one of NAPFA's primary missions, added Tom Orecchio, NAPFA chairman. "Whether it's managing investments, selecting insurance, or saving for retirement, the benefits of getting objective information from an unbiased source is crucial. NAPFA members are eager to share their knowledge with hundreds of thousands, or even millions, of Website visitors," he said.



# Finances

## Your Home is No Longer Your Savings Account

By Ronald W. Rogé, MS, CFP® [www.rwroge.com](http://www.rwroge.com)

The rapid rise in housing prices over the past few decades allowed many people, especially Baby Boomers, to think of their houses as a type of savings account. It was a good pretext for rationalizing meager retirement savings or the absence of a meaningful reserve for college costs.

That worked for Boomers' parents, who purchased their 1,200-square-foot homes in the 1950s and sold them at much appreciated values, and then used the proceeds to buy a much less expensive condo in Florida and deposited the balance into a savings account or investment portfolio. That portfolio produced income to supplement pensions and Social Security.

Now, America's mortgage and mortgage derivative markets are in a liquidity crisis. The extent of the fallout is uncertain, but it will be significant. Foreclosures could affect well over a million households.

I believe the credit crisis is the watershed event that will create a fundamental decline in real estate values that could last for up to a decade. American families' net worth exploded to \$54 trillion from \$10.8 trillion between 1982 and 2006. However, from 1965 to 1982, U.S. families experienced a net-worth reduction, and it could happen again.

### Increase of Wealth No Longer Automatic

In the next economic cycle, wealth appreciation will not come from the increase in the value of real estate. Wealth appreciation will have to come from saving. But the collective American savings rate was negative in 2005 and much of 2006, something not seen since the Great Depression.

However, I'm an optimist. I believe that once Americans realize that their housing wealth is shrinking, they will rediscover the virtues of saving and spending in a disciplined manner. Very likely, many people will need to delay retirement in order to build savings.

But those decisions will affect the market in other ways, too. When workers decide to work longer, the supply of labor will rise. If demand for the services of this labor pool does not increase, wages will fall. And that will have a further deflationary effect.

Increased demand for geriatric services to Boomers will create some new labor demand. However, that labor will be provided by a younger work force, perhaps composed largely of immigrant labor. Demand in real estate will be for geriatric care facilities to house the Boomers and lower-cost housing for the generation of new immigrants who come here to provide services to Boomers.

Not all is negative in this scenario. The weaker U.S. dollar will allow us to pay down our deficit more easily with devalued dollars. In addition, increased savings will stoke investment in stocks, bonds, and other assets that promote economic growth. That will increase the value of stocks and reduce the yields on bonds and cash longer-term. Lower rates will start a new credit cycle and perhaps a new real estate boom.

These developments are many years away. The job of a financial advisor is to think about the pressures on the economy and the trends that are being generated. Our job is to assess clients' portfolios to mitigate the negative impacts and take advantage of the opportunities they create.

### Foreclosures on the Rise

#### Properties in US

2005 Q1 – 188,000

2005 Q2 – 201,000

2005 Q3 – 223,000

2005 Q4 – 234,000

2006 Q1 – 323,000

2006 Q2 – 272,000

2006 Q3 – 318,000

2006 Q4 – 345,000

2007 Q1 – 437,000

2007 Q2 – 489,000

(Foreclosures defined as "any foreclosure activity" by Realtytrac.com.)

Source: Realtytrac.com



# Finances

## Reverse Mortgages: Deal Or No Deal?

By Christopher P. Parr, CFP®, [www.FinancialAdvantageInc.com](http://www.FinancialAdvantageInc.com)

Reverse mortgages have been positioned as a Holy Grail for cash-strapped seniors facing escalating healthcare costs in retirement. Reverse mortgages also can provide liquidity for homeowners for neglected home repairs and maintenance. In fact, reverse mortgage loans can be used for almost any expense. This differs markedly from conventional loans where purpose, proof of income, employment verification, and a sufficient credit score are required before approval.

But when do reverse mortgages really make sense?

To review for a moment, reverse mortgages are available to homeowners age 62 or older who have no or low outstanding mortgage balances. The home owner borrows against the equity in his or her home and receives payments from the lending institution; it's the reverse of a typical mortgage.

The reverse mortgage loan is repaid to the lender with interest at the time when the borrower sells the home, moves, or dies. The amount owed on the reverse mortgage can never exceed the value of the property. There is no need for the homeowner to repay the debt while living in the home.

The maximum loan amount is calculated based on age of the youngest borrower, the location of the home, the market value of the home, and current interest rates.

### Deal or No Deal?

While the opportunity to use the equity in a home and remain in the home truly is attractive, reverse mortgages come with drawbacks. First, the fees to process a reverse

mortgage range from 7 percent to 11 percent of a home's market value, or the lower program lending limit. Ultimately, the loan and the fees must be paid back with interest. These fees make a reverse mortgage a very costly short-term financial solution.

Second, reverse mortgage interest rates are variable. Current interest rates indexed to one-year Treasury Bonds are not high by historical standards. But imagine what happens if interest rates rise considerably, which has happened in the past.

### Questions to Consider

For many retirees, selling or downsizing a home might be a more cost-effective solution than a reverse mortgage. To help decide if a reverse mortgage is right for you or a family member, consider these questions:

- How long can the homeowner reasonably be expected to live in the home? Given the fees, a reverse mortgage probably doesn't make sense for a person staying in a home less than about seven years.
- Does the home offer the healthiest environment, both mentally and physically, for this person?
- What home improvements or renovations are necessary to allow the homeowner to continue to live in the home safely?

The good news for consumers is that as reverse mortgage products become more established, increased competition by lenders probably will drive costs lower for borrowers.

### Reverse Mortgages Are Up 5x Since 2003

#### Year                      Federally insured reverse mortgages

FY 2007	107,558
FY 2006	76,351
FY 2005	43,131
FY 2004	37,829
FY 2003	18,097

Source: National Reverse Mortgage Lenders Association



# Finances

## The Portfolio Assassin: Undisclosed Fees

By Christopher P. Van Slyke, CFP®, [www.cfafeeonly.com](http://www.cfafeeonly.com)

After a great meal, we generously tip the waiter. The dentist soothes our toothache, and we happily pay for the relief. We don't mind paying for services when the benefits justify the cost.

Similarly, we don't mind paying investment fees if performance warrants the expense. However, there are two reasons why brokerage fees are rarely defensible:

- Historical evidence indicates that the markets are so efficient that beating a simple index fund is next to impossible over time.
- The brokerage industry is so adept at camouflaging its fees that most investors have no idea what they are paying for portfolio management.

It's logical to conclude that reducing expenses will increase returns. But how do you do that when most of the expenses are buried deeper than an Egyptian pharaoh?

In my years as an advisor, I have frequently performed forensic examinations of investment accounts for attorneys suing brokerage firms on behalf of investors. I also have evaluated hundreds of brokerage accounts at the request of investors seeking to identify expense sources. The results of these investigations shocked even the most sophisticated investors and attorneys.

In the past decade, the brokerage community gave itself a cosmetic makeover when it converted to "fee-based" accounts. It sounds equitable, but in actuality brokers are masquerading as independent investment advisors.

The brokerage contract contains the broker-

dealer's stated advisory fee; it's also the key to determining whether a firm is a fiduciary, as are all Registered Investment Advisors, or a sales operation, as are all broker representatives. If the firm is a fiduciary, the contract will disclose the fees and conflicts of interest. In contrast, brokers must specify if they are not a fiduciary, in which case they are not legally required to disclose fee and conflict information. And that's where the odyssey of unearthing the hidden expenses — the portfolio assassins — begins.

Investors attempting to navigate this maze should review their previous 12 months of account data, not just to see what their account looks like today, but to see how it arrived at this point. The enemy of high returns is high transaction costs, but transaction costs are how brokerage firms make money.

### Hidden Costs in Bonds

Bonds have become more popular in the past year or two because the stock market has been so volatile. Many investors have been told by brokers that bonds are not only safer than stocks—which is often true, depending on the bond—but also that bonds are less costly to purchase than stocks. The latter assertion is often untrue.

My assessments of brokerage accounts typically reveal excessive bond allocations and individual bond holdings, frequently in municipals.

Why so many bonds? Investors are unaware of the fees hidden in bonds' bid/ask spreads, which are significantly higher than in stocks. The bid/ask spread is the difference between the asking price of the seller and the bidding price of the buyer. Brokers make their money on this

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# Finances

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differential, as they buy bonds at one price and then sell them to their clients at a higher price.

Investors see bonds in their accounts and assume they paid the market price. Wrong. What they really paid was the price plus a markup. *Money* magazine estimates the typical bid/ask spread on bonds is 3 percent to 8 percent of the principal. That's on top of the advisory fee!

I recently had the unhappy task of telling an investor with a \$2-million bond portfolio that he paid his brokerage firm somewhere between \$60,000 and \$160,000 up front to own it. (The disparity between those two figures is one indication of how difficult it is to resolve brokerage fees.) Given recent bonds returns in the 3 percent to 4 percent range, it was not a pleasant revelation.

## **Costs Can Be Hidden in Individual Stocks and Mutual Funds, Too**

Bonds aren't the only place where true costs are hard to discover.

In examining portfolios, I often find individual stocks rather than mutual funds. There are inherent economies of scale in investing, and the cheapest way to buy and sell equities and bonds is in large quantities (i.e., funds).

But brokers regularly convince investors they should own individual small lots of companies in "separate accounts," in which we see a great deal of trading in small lots, which translates into high costs. Investors are unaware of these costs because they have been told they have a fee account and that the

brokerage is picking up the expenses. What the brokerage picks up are the commissions, but not the bid/ask spreads; that's where the big profits reside.

When portfolios do contain mutual funds, they are usually high-expense, actively managed funds that pay 12b-1 fees. These are marketing fees levied on shareholders, ostensibly to pay for advertising and distribution costs, but typically kicked back to the brokerage firm.

Portfolios might also hold funds where the brokerage does not participate in the 12b-1 fees, but these are hardly pure, either. Often, these funds are distributed by the brokerage, so the brokerage participates in management fees instead.

And here's another way that brokers increase their fees at investors' expense. When brokers use a third-party money manager or mutual fund, something called "direct brokerage" funnels all the fund's trades through the broker that holds the account, rather than seeking best execution in the market (that is, trying to buy as cheaply as possible). Investors are stuck trading through a single brokerage where the profit margins can be as high as the broker wants them to be.

Whatever subterfuge is employed, the fees — although concealed — are there. The whole brokerage universe is constructed on a foundation of hidden fees. These are some of the most egregious examples, but investors need to be wary every step of the way. Read your statements, and ask questions. Better yet, work with a fiduciary, Fee-Only advisor who you can be assured is working in your best interests all the time.

**FOCUS**onFiduciary™

*Fiduciary - fi·du·ci·ar·y*  
*adj.:* An individual, company or institution that has a legal duty to put the interests of their clients above their own.



# Finances

## Getting a Handle on Young Adult Expenses

*By Fred Amrein, ChFC, MBA, CCPS, [www.amreinfinancial.com](http://www.amreinfinancial.com)*

Part of our job as parents is to teach our children independence, both emotionally and financially. In today's society, we often protect our children from some of these realities or hope they will learn it themselves. Unfortunately, in most cases, our children do not obtain this knowledge soon enough.

One of the harsh realities that our children will face eventually is the cost of living on their own and covering their own expenses. Listed below are some basic living expenses our children will be facing after they complete their educations, whether or not that includes college/grad school.

From these expense figures, we can make an estimate of a salary that will be necessary for breakeven status. (Note that taxes are estimated based on the salary at breakeven.)

These figures should lead to a good discussion regarding a child's financial independence and what it means.

To be sure, these figures are estimates, and many decisions can change the costs significantly. Sharing a group home or apartment can reduce rent below \$1,000/month, at least in many parts of the country. On the other hand, entertainment and miscellaneous expenses can be much higher than estimated. And the basic breakeven budget shown here makes no allowance for savings, even in an employer-sponsored 401(k) or a personal IRA.

The point is that as parents, we have a responsibility to educate our children. We want our children to pursue their dreams, but we must also prepare them for the real world. They must understand the consequences of their decisions.

### **Starting Out: Typical Expenses for a Young Adult**

- Housing: \$1,000 (rent or \$120,000 mortgage for 30 years, plus property taxes)
  - Utilities/Cable: \$150
  - Student Loans (if applicable): \$275 (\$24,000 @ 6.8%, 10 years)
  - Car Payment: \$300
  - Auto and health insurance: \$400
  - Food/gas/cell phone: \$340
  - Entertainment and miscellaneous: \$300
- Basic Expenses Subtotal: \$2,765**
- Income Taxes: \$690 (based on breakeven salary of \$41,460/year)

**Total Basic Expenses: \$3,455**

**Breakeven Monthly Salary: \$3,455**

**Breakeven Annual Salary: \$41,460**



# Planning and You

## The Other New Year's Resolutions

By Stacy Francis, CFP®, CDFP

Now that we have enjoyed our Thanksgiving break, the holiday season has officially arrived. We can look forward to more than a month of parties and get-togethers, topped off with a New Year's celebration.

New Year's usually makes people think about eating, drinking, celebrating, and, of course... New Year's resolutions. Generally, we have little trouble enjoying the first three things. But the last one—resolutions—is typically easier to make than to live by.

Financial resolutions are among the most difficult to follow. Yet, they are as important as any others we may make. So this year, try to set some attainable goals for yourself that will survive past January 31st.

One of the best ways to set realistic goals is to know where you stand financially. Rutgers University developed a Financial Fitness Quiz that asks you fairly basic questions about your finances. Though many questions may initially seem obvious, they are critical to your financial well-being. Here are some of the questions:

- Have you drawn up a will?
- Do you pay your bills on time?
- Do you have credit card balances?
- Do you have at least three months' earnings saved in case of sudden job loss?
- Do you have a financial savings goal with an actual dollar amount and date you would like to reach it by?

The truth is that many people have not taken the time to really work on these basic aspects of a healthy financial life.

Creating resolutions to address these issues is not burdensome. In fact, many of the changes you need to make to get your financial goals on track can be established with just a few hours of planning.

So step up to the plate and hit a financial home run this year. Use these personalized suggestions now to become financially stable. That way, you will not only feel more comfortable about your finances, but by this time next year you will be glowing as you realize that you don't need to make any financial resolutions for 2008!

