



- ▶ INVESTMENTS.....2,3
- ▶ COMPREHENSIVE FINANCIAL PLANNING.....4,5
- ▶ INSURANCE.....6

○ ISSUE 2 | ○ VOLUME 1 | ○ MAY 2005

NAPFA

Planning Perspectives

The Long-Term Approach

Financial matters continue to generate headlines today, and the average investor can be confused by the conflicting opinions offered by investment experts. The stock market performed fairly well in the first quarter of 2005, and then fell rapidly in April. Oil prices remain stubbornly high. But real estate is hot, and interest rates are staying low.

NAPFA members repeatedly counsel their clients to ignore all of these short-term developments – as difficult as that may be. Long-term interests are satisfied only by taking a long-term approach and sticking with it.

In this issue of *NAPFA Planning Perspectives*, we explain why long-term investing and diversification work. We also look at the pros and cons of annuities; how to purchase life insurance; and financial planning before a divorce.



NAPFA Criticizes SEC for Inadequate Protection of Consumers

NAPFA’s guiding principle since its inception in 1983 has been to improve protection of consumers who are seeking financial advice. This principle is at the heart of our commitment to Fee-Only planning, full disclosure, and consumer education.

So NAPFA is disappointed that the Securities and Exchange Commission (SEC) decided in April 2005 to go only part of the way towards ensuring that consumers get honest information and fair treatment from their financial advisors. In April, the SEC issued a

new regulation for financial professionals, known as “Certain Broker-Dealers Deemed Not To Be Investment Advisors.”

The new rule leaves in place two different regulatory systems for two different types of financial professionals: broker-dealers and Registered Investment Advisors (RIAs). Historically, broker-dealers have been assumed by the SEC to primarily be performing a transactional service for their clients, i.e., making investments that their clients have requested. Thus, broker-dealers have

less comprehensive regulations governing their actions. RIAs are assumed to be giving financial advice, and so they are held to a higher standard. Most NAPFA members are Registered Investment Advisors, and all NAPFA members adhere to a Code of Ethics that matches standards placed on RIAs.

The problem is that the investment world has changed, and the old distinctions do not reflect today’s reality. Today, the largest financial service firms (broker-dealers) employ thousands of registered reps. These firms publicize their services as

Continued on page 6



Investments

Don't Let the Media Distract You from Sticking with a Good Investment Program

By David B. Jacobs, NAPFA-Registered Financial Advisor. President, Pathfinder Financial Services, www.pathfinderfs.com.

In January 2001, CNN reported that seven cows, born and raised in Germany, were diagnosed with mad cow disease. Within six weeks, beef consumption in Germany dropped in half. Yet only 150 deaths have been attributed to Mad Cow disease since its discovery in the 1980s.

In contrast, the U.S. Centers for Disease Control and Prevention estimates that salmonella poisoning kills 600 people in the U.S. every year and makes an additional 1.4 million Americans sick. But the popularity of chicken, the main source of salmonella poisoning, continues to increase.

This discrepancy in behavior arises because of how we process new information. We give the most weight to our personal experiences, then to experiences relayed to us by our friends, then to media reporting, and in last place, to statistical facts. So while most of us have had enough experience with food poisoning to put the salmonella statistics in context, Mad Cow disease, being an unknown, makes a larger-than-life impression.

Consider how this affects investment decisions. For the last few years, most pundits have been saying, "Don't invest in medium- or long-term bonds because long-term interest rates are going up." If you watched or read the financial press regularly, you heard this so many times that you probably became convinced the pundits were right.

The facts say otherwise. The facts say that long-term interest rates today already reflect our best guess of what they will be tomorrow. So, as unintuitive as it seems, they are just as likely to go down as they are to go up. And, in fact, those who waited for rates to go up are still waiting.

My advice: To improve your financial health, stop checking your portfolio's value every day and stop watching and reading the financial news on a regular basis. Once you have built a sound investment strategy, changes should only occur when your goals and needs change. Reading the

financial news just motivates you to make unnecessary changes that are often mistakes.

The other area in which our odds-making ability betrays us is when the sample size is large. For example, if you were in a room with 22 other people, what would be the odds of two of you having the same birthday (same month and day)? Most people guess around a 10 percent chance or less; in fact, the odds are just over 50 percent (really, they are).

This is why people are poor judges of when success is due to chance or expertise. When evaluating mutual funds, a performance history of better-than-average returns for each of the last five years would lead most people to infer the fund manager has some investment expertise. However, random chance suggests that around 3 percent of mutual funds should have this kind of track record. With a pool of 10,000 mutual funds, 300 funds could have this positive track record without any need for skill-based explanations. Actually, fewer than 3 percent of all mutual funds beat their benchmark index 5 years in a row.

To further muddy the waters, the investment industry creates thousands of new funds every year, while killing off the ones that perform poorly. Since the performance numbers of the failed funds are erased, the illusion of skill is enhanced.

When you add to this that studies have shown virtually no predictive power of how a mutual fund will do in the future based on its history, you understand why every prospectus includes the words "past performance does not guarantee future results."

My advice: To improve your financial health, stop trying to find the outperforming funds. Focus on taking the appropriate risk for your needs and ensuring your portfolio is well diversified. Stop chasing returns, and use low-expense, passive funds to capture economic growth.

To improve your financial health, stop checking your portfolio's value every day and stop watching and reading the financial news on a regular basis.





Investments

Natural Resources Investments Can Help Inflation-Proof Your Portfolio

By Stephen Craffen, NAPFA-Registered Financial Advisor, BE, MBA, MS, CFA, ChFC, CLU. Principal, Baron Financial Group www.baron-financial.com

We've all heard that we need equities in our portfolio so our assets grow enough to match or surpass inflation. But many people don't realize that stocks (and, in many cases, bonds) usually perform very badly in times of high inflation and do not begin to do well again until inflation subsides. A case in point was the late 1970s, when the average price-to-earnings ratio for the stock market fell to as low as 6. Only when inflation fell in the 1980s did equities regain their footing and begin to provide the performance that makes them a great long-term bet against inflation.

So how do you maintain your portfolio's returns during times of high inflation? We suggest investing in real estate mutual funds and natural resources funds. Both asset classes provide good performance in times of high inflation, and both improve long-term risk vs. return characteristics because they tend to "zig" when the market "zags."

Let's look more closely at natural resources. We consider natural resources to include oil, gas, precious metals, and also agricultural products. If natural resources only provided superior returns in times of high inflation, we might not recommend that it be a core holding for a diversified portfolio. But they have been a good investment for the long run, too. The Goldman Sachs Commodities Index returned

11.6% per year, on average, from 1970 through 2002. Remember, you also get the benefits of the assets' low correlation to equities, which balances your portfolio's performance as equities go up and down.

How much should you invest in natural resources? We tell our clients to allocate from 3 percent to 7 percent of their investable assets, depending on other, individual factors. Because this is a volatile asset class, we do not suggest overweighting.

How should you invest? First we do not suggest actually attempting to purchase futures on commodities, nor do we recommend purchasing a commodity such as gold outright. We recommend purchasing a mutual fund that specializes in natural resources, such as the Oppenheimer Real Asset N and the PIMCO CommRealRtStrA. We prefer these funds to many others in this category since they model themselves after commodities indices (the Goldman Sachs and Dow Jones Commodities indices, respectively), and do not have an active manager deciding which commodity will be "hot." We do not care for funds that buy the stocks of companies that deal in commodities such as mining companies or oil and gas companies since those tend to have a greater linkage to the performance of equities.

"Financial planners who take a commission have a built-in conflict of interest...even with disclosure, my choice would be a Fee-Only planner."

-- Jane Bryan Quinn, financial advice columnist and author

Performance of Two Natural Resources Funds

Name	Symbol	Performance (Average)		
		One Year	Three Year	Five Year
Oppenheimer Real Asset N	QRANX	25.22%	27.76%	12.86%
PIMCO CommRealRtStrA	PCRAX	11.4%	N/A	N/A

¹ As of February 28, 2005. ¹ Fund inception November 2002.



Financial Planning

Uses and Abuses of Annuities

By Dennis Houlihan, NAPFA-Registered Financial Advisor. President, Houlihan Asset Management, LLC,

www.houlihan.biz

My firm has been inundated for the past six months with questions from clients and friends about fixed and variable annuities. It's time to address this vexing product – both its uses and potential abuses.

An annuity is an investment product sold (primarily) by insurance companies. It is a contractual relationship that has two basic properties: a payout that is either immediate or deferred; and rate of return that is either fixed or variable. First, some definitions:

Immediate payout occurs when the initial investment (or series of investments) is deposited and the insurance company commences payout for the “annuitant” (the recipient). This payment can be a certain period of years or for the rest of the annuitant’s life, which is known as “annuitization.”

Deferred payouts are more common. After the initial investment is deposited, the annuitant delays receipt of the funds until a future date – usually retirement. Payout options can be customized for the annuitant’s needs.

Fixed rate annuities reference the underlying investment. Funds are invested in safe, low-interest assets. Usually the yield is slightly more than certificates of deposit and money market funds.

Variable rate annuities are similar to mutual funds. The annuity owner is given an investment menu of “sub-accounts” to choose from. The investment options can range from money markets or bond funds to more aggressive stock funds. The risk of the investments is transferred from the insurance company to the annuity owner.

Next, let's examine the main characteristics of all annuities:

Tax deferral. Annuities are afforded special treatment under the tax code to allow deferral of federal/state income taxes on income and gains generated until the money is withdrawn. This is their main selling point.

Death benefit. If you die before the insurance company has started making payments to you, your beneficiary is guaranteed to receive a specified amount. Typically, this is at least the amount of your surrender value. This can be comforting, but if you already have an insurance policy, the annuity benefit is not as important as it might seem to be.

Surrender charges. If the annuity owner withdraws money from a variable or fixed annuity before a certain contractual time period (usually 5-8 years), the insurance company will assess a surrender charge. This surrender charge is a percentage of the withdrawn amount, and declines gradually over the term of the contract. The surrender charge is assessed to recover the front-end selling costs (a fancy phrase for commissions to the sales agent). However, contracts will often allow the owner to withdraw 10-15% of the contract’s value annually without charge.

Expenses and charges. Layered annual expenses can add up to about 2%-4% annually. Expenses matter a lot, especially over a long period of time.

IRS penalty. If monies are withdrawn before age 59½, a 10% penalty will be levied on the amount withdrawn, subject to limited exceptions.

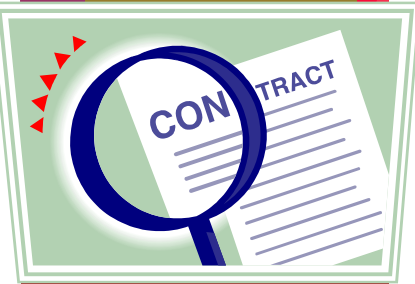
Uses and Abuses

Sales of annuities, unfortunately, are driven by high sales commissions. They are inappropriate for IRA or 401(k) accounts because those accounts already are tax-deferred. **There is no benefit to putting tax-deferred investments into a tax-deferred annuity.**

Therefore, if you have maximized all of your IRA and other tax-deferred retirement contributions, it might be worth speaking with your financial advisor about an annuity. But even in those circumstances, you need to look carefully at the marginal tax rate you face and the expenses of the annuity you are interested in purchasing.

Fixed annuities may make sense if you wish to generate steady monthly income and are concerned about preservation of principal. Variable annuities, on the other hand, rarely benefit the investor because they have high expenses and mediocre investment fund performance.

Vanguard and T. Rowe Price have recently developed fixed and variable annuities that offer improved investment options with lower annual expenses than products from traditional insurance companies. The Vanguard and T. Rowe Price annuities are no-load (no commission).



An annuity is an investment product sold (primarily) by insurance companies. It is a contractual relationship that has two basic properties: a payout that is either immediate or deferred; and rate of return that is either fixed or variable.



Financial Planning

Hints for Making a Divorce Less Financially Traumatic

Submitted by Morris Armstrong, NAFPFA-Registered Financial Advisor.

President, Armstrong Financial Strategies, www.armstrong-financial.com

When divorces occur, former spouses might face financial uncertainties. Three issues that should be addressed are life insurance, disability insurance, and division of retirement assets.

Life insurance. If you will be dependent on an ex-spouse for alimony, child support, and contributions to a college fund, you should take steps to ensure that the money will be there if anything happens to your ex-spouse. Depending on the age of the insured and state of residence, it is possible to obtain affordable coverage where the rates are guaranteed to remain level for 20 years.

Make sure your spouse applies for life insurance *before* the divorce. You should be both the owner and beneficiary of the policy, and it should be sufficient to provide a lump sum of money approximating the discounted value of future alimony payments. Why should you be the owner of the policy? If you are the owner you will know if the policy is in force, and if the ex-spouse has made his/her payments. Note: The premiums may be considered alimony in this situation.

Disability insurance. Disability insurance is more expensive and more difficult to obtain, but it's desirable. Disability insurance replaces a portion of a person's income if he/she are unable to work due to accident or sickness. The same recommendations apply as for life insurance.

Retirement assets. The division of retirement assets in a divorce is very often misunderstood. Retirement assets include IRAs and company-sponsored retirement accounts such as a 401(k), 403(b), 457 plan, or a traditional defined-benefit pension plan.

First, your divorce decree should identify in detail how a retirement asset will be divided. When that is resolved, you need to contact the custodian of the retirement account (i.e., the company that holds your assets) and ask the firm what it requires in order to accommodate your decision.

A bank, brokerage, or insurance company probably is the custodian of an IRA. Each custodian has different requirements. I am familiar with one situation in which four IRAs were being split. One

custodian asked only for a letter from the person who was losing 50% of the IRA, requesting that it be transferred to the ex-spouse. Another custodian required complete paperwork, plus an original, certified copy of the divorce decree. The other two custodians asked for the same paperwork but accepted photocopies of the decree.

Transfers can only be made after the divorce, but you can have much of the paperwork completed prior to the divorce so that when the divorce papers are signed by the judge and the copies of the decree are available, they can be submitted to the custodians in a timely manner.

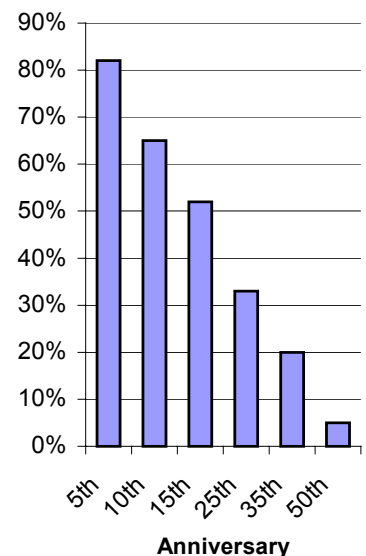
Corporate-sponsored pension plans are more complicated. Let's assume that we have a 50%-50% split of a retirement plan, and it clearly says so in the decree. While this is satisfactory paperwork for an IRA, it means absolutely nothing for a qualified plan. You will need a Qualified Domestic Relations Order, or QDRO, to be signed by the divorce judge that orders the plan administrators to divide the participant's plan into two portions. There is no alternative to obtaining a QDRO.

To simplify this process, you should obtain a "summary plan description" from the plan from which you are receiving the money. It will disclose the plan's features and the payout options. This is critical because if a QDRO contains payout instructions that are not allowed by the plan, the QDRO will not be accepted by the plan sponsor.

Ask the plan sponsor if it has either its own QDRO form or a checklist. Your attorney should review that form to see if it provides you with sufficient protection; if it doesn't, have your attorney write a QDRO. Lastly, when the QDRO is prepared and before it is signed by the judge, you may be able to submit it to the company for review, and it will confirm that it will or will not accept the document.

For the military or governmental employees, a document similar to a QDRO will have to be prepared.

Percentage of married Americans who reach significant wedding anniversaries.





Insurance

Use the A-B-C Technique to Compare Insurance Proposals

By John Sestina, NAPFA-Registered Financial Advisor,
President, John E. Sestina and Company, www.sestina.com

I suggest using the "A-B-C Technique" to determine which insurance policy to select for your family coverage. This method will help you learn the details of different proposals that agents will offer from different companies.

Here's how it works. After Agent A submits a proposal, ask him/her to take a look at Agent B's submission. In turn, ask Agent B to examine Agent C's proposal and evaluate it. Then, show Agent C the original recommendation from Agent A.

In this A-B-C triangle, you are not trying to embarrass anyone, but you are taking advantage of a person's expertise in a competitive marketplace.

This detective strategy works especially well in evaluating disability insurance plans because "the fine print" is crucial in determining which proposal best meets your particular needs. For example, the A-B-C system can help you determine which disability coverage is non-cancelable. Or which policy has a guaranteed renewable feature at the time of renewal. The agents also will probably quickly spot if the policy has an inflation rider and whether it has a "partial/residual benefit," since some plans call for a period of total disability for qualification.

Further, this process should reveal how the proposal handles a situation in which a policyholder is unable to perform the individual's own occupation but does generate some income from a different occupation.

Keep in mind that in disability insurance, expensive is often better. Shop by benefits offered, not premium price.

NAPFA Criticizes SEC... Continued from page 1

comprehensive financial advice. In other words, they claim that their services are indistinguishable from the services provided by RIAs. But they're not RIAs.

RIAs are held to higher standards of disclosure of how they are compensated, whether through payments from clients or commissions on products they recommend. RIAs also are fiduciaries, which means that they are legally bound to act in the client's interest first and foremost. Broker-dealers, by contrast, are legally bound to act in their employer's interest first.

Which would you rather work with? An investment advisor who works in your interest, or a broker-dealer whose loyalty is to his or her employer? NAPFA believes that federal regulations should make the distinctions between the two types of professionals clear. And then consumers can decide who they want to hire.

NAPFA will continue to work with other leading organizations and financial services firms to highlight the bright line between broker-dealers and Registered Investment Advisors. Our Web site has several publications that can help consumers find out if their advisor is truly working in their best interest. Go to www.napfa.org for more information.

"The most important matter is how the planner is compensated. Hire the planner who has no financial stake in [your] investments."

**-- Forbes magazine,
May 2002**