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## Capital Blueprints for the Future

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# Whoa, Dollar!

Falling greenback reveals a global imbalance.

(1) A trade gap arises when the U.S. imports more goods than it exports. This results in a net outflow of dollars, which reduces the greenback's value overseas. The U.S. financial markets must attract more foreign capital to offset this outflow, which requires higher interest rates and more attractive investment returns. The federal budget deficit compounds this challenge by requiring even more government borrowing. The current account deficit, which reflects the net outflow of goods and services, reached a record 5.7% of GDP in 2004 and is expected to exceed 6% in 2005. ("The Makings of a Meltdown", *BusinessWeek*, 13 Dec. 2004, p 53)

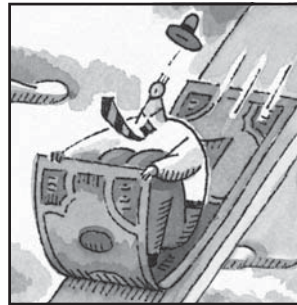
(2) "Behind Big Drop in Currency: Imbalance in Global Economy", *The Wall Street Journal*, 2 Dec. 2004, A1.

(3) Foreign capital now supplies about 75% of U.S. net investment. ("Could Trade Imbalances Topple the Greenback?", *BusinessWeek*, 29 Nov. 2004, p31)

(4) The trade deficit doesn't imply a structural weakness in the U.S. Rather, it confirms that the economy and markets reflect the most attractive, growth oriented environment for money to work. If the U.S. financial market were not the choice destination for foreign capital, a capital surplus would not exist and maintaining a trade deficit would not be possible. ("Destination U.S.A.", *The Wall Street Journal*, 3 Jan. 2005, A 15)

SINCE 2002, the dollar has fallen against the euro, yen and other currencies. The decline has worsened in recent months, prompting economists, financial managers and the Federal Reserve to issue warnings about the dangers of a plummeting dollar.

The popular view blames the "twin deficits" of foreign trade and federal spending for eroding the dollar's value.<sup>(1)</sup> But history offers scant evidence that deficit spending affects exchange rates. In the late 1970s, the U.S. had modest deficits and a depreciating dollar—and in the 1980s, large deficits and a strong dollar. Clearly, other factors are involved, including the balance of trade and monetary policy.



### Global enablers

A more insightful argument is that a global economic imbalance has weakened the dollar.<sup>(2)</sup> The U.S. economy has been expanding much faster than the economies of its major Asian and European trading partners. Consequently, Americans are consuming more and foreigners are consuming less. The exporting nations of the world have depended on strong U.S. demand to keep their economies growing—and have loaned surplus capital needed to finance America's growing trade deficit.

This arrangement has provided mutual benefits. Net exporters have supported the dollar to keep their currencies competitive.<sup>(3)</sup> Their lending and investment capital has kept U.S. interest rates low while enabling the federal government to cut taxes, prolong the economic rebound and fight a war. Also, the U.S. financial markets have offered for-

foreign capital a stable environment and higher expected return.<sup>(4)</sup>

According to conventional wisdom, the dollar will continue dropping until foreigners are compelled to buy cheaper U.S. goods, relocate business and send more capital to our shores. On the other side of the equation, American demand for imports will fall as foreign goods and services become more expensive relative to domestic alternatives. A gradual dollar decline results in an orderly reversal of the trade trend. As foreign markets demand more dollars to buy our products, the greenback gains value in the currency markets. This is a classical "weak dollar fix". But this conventional model may not work. Here's why:

- **Foreign exporters don't want a competitive dollar.** A weakening dollar would stunt growth in Asia and Europe by opening their markets to more competitive U.S. goods.<sup>(5)</sup> China is perhaps most vulnerable, which is why it maintains a fixed exchange rate with the dollar. This ensures that the yuan will not rise and Chinese goods will stay competitive in the U.S. market. The smaller Asian economies also compete with China for exports. They will support the dollar to prevent their currencies from rising against the yuan.

- **Trading partners may not boost demand for U.S. exports.** The Eurozone has averaged a recessionary 1% annual growth in recent years, while the U.S. economy has averaged 3.5%. And if the Bush Administration and Congress implement more pro-growth policies in 2005, the performance

*Continued on back*

# Tax Reform: Bush II

## What's ahead, based on campaign promises.

(1) These changes were implemented through the Economic Growth and Tax Relief Reconciliation Act of 2000 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

(2) The AMT disallows deductions for state and local taxes and personal exemptions, then levies a 26% or 28% rate. If the Bush tax cuts are extended beyond 2010 or made permanent, even more people will be forced into the AMT net. In that case, repealing the tax may cost over \$1 trillion over 10 years. ("Tax Reform May Take Center Stage", The Wall Street Journal, 2 Sept. 2004, A6)

(3) "Bush vs. Kerry On Your Tax Bill", The Wall Street Journal, 26 Aug. 2004, D1.

(4) "Corporate Tax Reform: Kerry, Bush, Congress Fall Short", Tax & Budget Bulletin, CATO Institute, No. 21, Sept. 2004.

(5) It is estimated that making the 2003 tax cuts permanent would lower federal collections by about \$2.3 billion through 2014.

(6) For the plan to be revenue neutral, any rate cuts or new deductions must be offset by tax increases in other areas. ("Questions for the President on Tax Reform", The Wall Street Journal, 11 Nov. 2004, A2)

(7) Regarding Social Security privatization: A popular notion is to enable workers to divert a portion of their payroll taxes to individual accounts which they would own, control and bequeath to heirs. Investment planning, asset allocation and risk management would be their responsibility. ("Bush Sets Plans to Revamp Taxes, Social Security", The Wall Street Journal, 5 Nov. 2004, A1)

Regarding the proposed retirement savings vehicles: These include the Lifetime Savings Account (\$5,000 maximum per year), the Retirement Savings Account, which would replace Roth and Individual IRAs (\$5,000 per year), and the Employer Retirement Savings Account, which is designed to consolidate the 401(k) and other employer-sponsored plans. ("What to Expect in Bush Part II", The Wall Street Journal, 4 Nov. 2004, D1)

**P**RESIDENT BUSH and Congress have used tax policy to help the economy recover from recession, declining financial markets and war.<sup>(1)</sup> With the election over, the focus shifts to overhauling the federal income and estate tax system.

These possible changes could impact your income, investments and wealth—and the resulting policies will affect economic growth. In the coming year, these issues may take center stage. Here's a summary of current rules and potential changes:

• **Personal income tax rates.** The 2003 tax bill set current marginal tax rates at 10%, 15%, 25%, 33% and 35%. President Bush pledged to make the current rates permanent and floated the idea of replacing the current income tax system with a national sales tax, flat tax, value added tax, or other type of consumption tax.

• **Capital gains and dividend rates.** Since 2003, long-term capital gains and most types of dividends have been taxed at 15%. Both of these new provisions are scheduled to sunset in 2008. President Bush wants to make these rates permanent.

• **The Alternative Minimum Tax (AMT).** This is the parallel tax system designed to prevent the wealthiest taxpayers from using hefty deductions to zero-out their tax bill. Since inception in 1969, the AMT has not been adjusted for inflation. It is now creeping into the middle class, projected to trap about 12 million taxpayers in 2005 and 33 million by 2010. By then it could raise more revenue than the standard federal tax system.<sup>(2)</sup> President Bush has asked Treasury officials to "study the AMT and propose a long-term solution".<sup>(3)</sup>

• **Estate taxes.** The current \$1.5 million exemption will climb to \$3.5 million by 2009. The tax vanishes in 2010, only to be reinstated in 2011 at rates and exemptions in effect before tax reform. President Bush has stated that he wants to fully eliminate the estate tax system. Advocates say that Congress could now deliver the votes to achieve this and other tax reforms.

• **Corporate tax rates.** Today, the U.S. corporate tax rate stands at 40%. Next to Japan's 42% rate, this assessment on business earnings is the highest of any developed nation. President Bush has not proposed corporate tax reform, but has promised to consider it in a second term.<sup>(4)</sup>

Several current tax rules—including the child tax credit, expansion of the 10% bracket, marriage penalty relief and the AMT relief provision—expire this year. Congress is expected to extend

these in 2005 and possibly make all of the 2003 tax changes permanent.<sup>(5)</sup>

### System overhaul?

The Bush Administration has pledged to revamp the federal tax system in the second term. Their guiding principles include simplifying the tax code, restructuring policy to better reward business risk

taking and encourage personal saving and investment, and making the code fair and revenue neutral.<sup>(6)</sup> There's also interest in retaining the deductions for mortgage interest expense and charitable contributions, while closing lesser known loopholes. The president also wants to overhaul Social Security and reignite interest in the retirement saving vehicles proposed in 2003.<sup>(7)</sup>

That's an ambitious agenda—and one that will prove fiscally complex and politically hazardous. The swelling budget and special interest lobbies are two major hurdles. Proponents say tax cuts don't have to be immediately self-funding because the right changes will fuel economic growth and boost federal revenues over time. But many lawmakers will insist on revenue neutrality. Moreover, the U.S. tax code offers breaks to almost every industry, special interest group and social cause. Although polls routinely show most Americans in favor of tax simplification, people defend their own perks when the debate starts.

Financial gravity will force hard choices upon taxpayers at some point. The decisions will center on determining how much government taxpayers can afford, preserving a culture of self-reliance and promoting a business environment that rewards innovation, risk taking and entrepreneurship. Without these ideals and behaviors driving the economy, Americans won't maintain the high living standard they now enjoy and expect. ■

Who Pays For Government		
Income Rank*	Starts At	% of Receipts
Top 1%	\$ 285,424	33.71%
Top 5%	\$ 126,525	53.80%
Top 10%	\$ 92,663	65.73%
Top 25%	\$ 56,401	83.90%
Top 50%	\$ 28,654	96.50%
Bottom 50%	< \$ 28,654	3.50%

\* Adjusted Gross Income (AGI) Source: IRS

# Rising Interest Rates

A Fed rate hike can imply good news, too.

**R**ISING INTEREST RATES bring thoughts of hyperinflation, eroding bond values and a teetering stock market. Some in the financial media have touted defensive actions, such as moving to cash, holding inflation-adjusted bonds (such as TIPs) or buying instruments with lower credit quality. Be warned: These remedies may inflict more risk and potential damage on a portfolio than the negative effects of higher rates would.

Everyone has enjoyed the enhanced borrowing power and investment benefits of cheap money. But in truth, higher interest rates bring advantages over time. If your investment portfolio is well diversified—and you have a long-term time horizon—you might even welcome a period of rising rates. Consider these positive aspects:

• **Higher rates boost income.** The 23-year bull market in bonds has conditioned investors to focus on capital growth. But income generation is an equally essential component of return—and to many people, the more important feature. A consistent cash stream generated in both up and down markets helps stabilize portfolio return while providing real money to spend or reinvest.

As the Fed tightens its monetary policy and rates rise, the economic advantage will shift from borrowers to lenders. Retirees and other fixed income investors will realize immediately better returns on their cash, and increasing income and better yields over time. Thus, investors with a diversified portfolio that models their risk sensitivity and time horizon should not worry too much about the impact of higher rates or feel compelled to take drastic actions to avoid capital loss in their fixed income component. Over time, their bond mix can be adjusted to maintain a moderate average duration. This results in higher-interest bonds entering the portfolio to generate higher income. If the income is reinvested, the enhanced yields can make up for the earlier erosion of market price.

• **A robust economy has spurred the Fed rate hikes.** The Fed increases rates to keep a robust economy from overheating or to fight surging inflation. A strong economy is the preferred rationale. During 2003-04, the Fed kept rates lower than fundamentals could justify to keep the expansion alive. And now, the modest rate increases send a message that the economy has gained sustainable momentum.

The Fed has begun to lightly apply the brakes to keep inflation in check, reduce business and consumer debt levels, avoid market bubbles, and manage other effects of the business cycle. This is occurring amidst good news, such as rising corporate profits, a rebounding stock market and moderate inflation.

• **Stocks typically follow interest rates upward.** History shows that initial rate increases are, more often than not, a bullish indicator for stocks in the early stages of the upward cycle. In fact, strong economic indicators bring about the rate increase.<sup>(1)</sup> In six of the last 10 rate-tightening cycles since 1950, the Standard & Poor's 500 index delivered double-digit returns in the 12 months following the initial rate jump.<sup>(2)</sup> Longer-term market scrutiny also supports this pattern. In the 78 years since 1926, interest rates have risen and fallen the same number of years (39 each). In the years when interest rates increased, the stock market produced gains in 31 of the total 39 performance periods—or about 80% of the time<sup>(3)</sup>

• **Higher rates make room for the next cycle.** Modest rate increases alone should not inflict much pain on either the economy or diversified investors. In fact, since the U.S. household savings rate may be higher than reported, rising rates could help families more than the higher cost of borrowing might hurt them.<sup>(4)</sup> With inflation appearing to be under control, savers and retirees won't have to surrender their higher rates to rising consumer prices. Moreover, higher rates provide a cushion for the Fed to respond with rate cuts when the expansion has run its course. ■

## Life Planning

### A Time To Explore Your Potential

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Because of increasing longevity and healthier, more active lifestyles, many individuals are viewing retirement as an opportunity to switch careers, start a business, return to school, or get involved in a good cause. Others use retirement to return to an activity they enjoyed in their youth or to pursue latent interests.

It is important to consider retirement as a time to explore your potential. Do you want to contribute through a leadership role in your church or non-profit organization? Would you like to take the skills and experiences developed in your career and apply them in a whole new way? Have you always dreamed of owning your own business?

On the other hand, have you longed to try your hand at painting or immerse yourself in writing? Do you aspire to becoming a master gardener? Did you set aside a musical instrument years ago and have longed to start playing it again?

Consider your skills, interests, values, and preferences when designing your retirement life. These items are your real assets—a set of characteristics that defines who you are as an individual and influences the life choices you make.

Combining the information of “who I am” and “what I want” will help you form your unique definition of “quality of life” and form a solid foundation for planning for your future.

In addition, taking stock of your skills, interests, values, and preferences will help to strengthen your identity apart from the world of work. In their book *Comfort Zones*, authors Elwood Chapman and Marion Haynes wrote:

“What you do for a living is often the topic of casual conversations. Facing your identity, beyond your career, will be one of the major challenges you face in retirement. How will you answer the question, ‘What do you do?’ after you retire?” ■

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(1) In the 31 years when stocks advanced during a rate hike, most business indicators were strong. Inflation averaged 3.7%, corporate profit growth averaged 12.8% and real GDP averaged 3.8%. (Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bernstein Investment Research and Management, 2004.) (2) “How to React to the Fed's Move”, The Wall Street Journal, 1 July 2004, D2. (3) “Will Rising Interest Rates Lead to a Lasting Stock Market Downturn?”, Bernstein Investment Research and Management, www.berstein.com, 24 May 2004. (4) “Surviving Rate Hikes Will Be Easier Than You Think”, Fortune, 8 March 2004, p74.

## Whoa, Dollar! (Continued)

gap might widen. To stimulate demand in their economies, Europe and Japan must cut social spending, reduce taxes and excessive regulation, reform their pension system and implement expansionary monetary policy. These fiscal and structural reforms will not come easily.

• **Cross-border trade is more complex now.** About 20% of U.S. import activity involves foreign trade among companies that purchase components and services from overseas partners or subsidiaries. Since corporate strategy drives this activity, a falling dollar may not alter commerce as expected. Also, if foreign companies find the American market more lucrative and stable relative to other economic regions, they may choose to give up profits rather than lose U.S. market share.<sup>(5)</sup> So, as the dollar falls, they may cut prices to counteract the effect of their rising currency.

• **The U.S. economy has moved on.** Lowering the dollar won't bring back low-margin industries or low-wage factory jobs to our shores. The economy has retooled for higher-margin industries and higher-paying knowledge and design work. As the "intellectual property economy" advances, U.S. wealth is built on exporting profitable designs—such as advanced medical technology, new wireless networks, advanced drugs, digital content and iPods—and importing finished goods. Rising corporate earnings, higher salaries and a climbing stock market balance this out as dollars flow back into the financial markets.<sup>(7)</sup> A strong dollar benefits this economic model. ■

(5) To make their exported goods attractive to U.S. buyers, China, Hong Kong and Malaysia peg their currencies to the dollar, and Japan, Korea and Taiwan support the dollar as necessary through aggressive buying. Europe relies on exports to Asia to maintain its growth, while the Asian economies are mostly tied to the U.S. dollar. So, a drop in the dollar hits Europe particularly hard. ("Europe's Dollar Problem", The Wall Street Journal, 2 Dec. 2004, A10.)

(6) "Europe's Dollar Problem", The Wall Street Journal, 2 Dec. 2004, A10.

(7) "We Think, They Sweat", The Wall Street Journal, 23 Dec. 2004, A10.

## In My Opinion...

Robert J. Cole, Jr., CLU, ChFC, CFP®

### Like A Rock...

*"Twenty years now, where'd they go? Twenty years now, I don't know."*

— Bob Seger, "Like a Rock"

As I write this, the last column of Financial Architects, Inc.'s, twentieth year in business, I thought it might be a good time to reflect upon what I have seen over that span of time.

In August of 1984 I returned to Louisville to open a fee-based financial planning practice. This was a new idea that had little support from the financial services industry. The concept was that having your compensation come directly from your client allowed the client to judge the value of the services they were receiving. This was in direct contrast to the commission-based platform of the industry, which at that time was charging as much as an 8% fee on a mutual fund account. At that point, I had over fifteen years experience in financial services; so I was confident that this revolutionary idea was based on sound thinking. I had a concept (and still do) that if I *always* placed the client's needs first and addressed those needs with the highest level of professional competence, we would have plenty of potential people to work with. Pricing this new service turned out to be a problem since there was very little information on how to do that. However, after some trial and error, we were able to build a business model that served both the need to make a profit and to assist our clients in the services that they wanted.

As our business began to grow, I watched the first wave of "financial planners" disappear when the Tax Reform Act of 1986 destroyed the real estate tax shelter industry. Most of these people were really selling tax shelters—not doing planning. I then witnessed the banking industry's first attempt to repackage their services into "financial plans". Later, they quietly left when they saw how labor intensive it was. Next on the band wagon was the brokerage industry. Overnight, the reps were no longer stockbrokers but "financial advisors". Most recently, the CPA profession has expanded into "financial planning". All the while, the regulatory bodies were trying to make sense of all of this. What makes all of this so difficult for the average consumer is that today, after twenty years of confusion, there still is no common definition of what "financial planning" is or who is qualified to do it.

As I enter my thirty-fifth year in the financial services industry, I feel qualified to add my two cents worth to the conversation. First, *real* financial planning involves a deep understanding of what a client is trying to accomplish. This process of understanding takes a great deal of time and effort to accomplish; but it is the foundation of all the other parts. Without it, there can be no meaningful commitment to "stay the course" when the normal disruptions of life occur. Second, planning is a separate function from implementation. Those who start a financial plan by recommending solutions before they thoroughly analyze the client's problems and goals are putting the cart before the horse. Third, a planner must attain a high level of knowledge to be effective. At a minimum, he or she should be a Certified Financial Planner or a Chartered Financial Consultant and be registered as an Investment Advisor with the appropriate regulatory agency. Finally, and this is *strictly* my opinion, his or her business platform should be an *independent* one that frees them from the influences of anyone who would place their interests in front of the client's.

As easy as these statements are to make, it has taken twenty years of effort and fighting to reach my vision. Today, we are seen as the innovators that we are and others regularly seek me out to see how our business model might fit them. As we face the next twenty years of business, I am committed to maintaining the high level of integrity and professionalism that our success has been built on. I look forward to serving the many friendships that we have developed with our clients and their families. Above all, like a rock, we will be there for our clients in their time of need and to help them enjoy this wonderful gift we have been given called life.

Until next time, that's my opinion...

Robert J. Cole, Jr., CLU, ChFC, CFP®  
President