



# Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON

NICK LEVINSON

## SEPTEMBER 2005 COMMENTS

### IMPORTANT NOTICES:

#### **THOUGHT for the MONTH**

From the New York Times (10/1/05, pg. B1), Joseph Nocera's article discussed Nassim Nicholas Taleb's book "Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets" (a book we wrote about in our January 2003 Comments). Nocera describes how Taleb is highly critical of Wall Street's efforts to forecast the future (a point of view we share), and quotes Taleb as follows: "When a 9/11 happens, it counts. When a forecaster says that nobody could predict it, well, that's the whole point, isn't it."

#### **PARK PIEDMONT ADV and PRIVACY STATEMENT:**

As a Registered Investment Advisor with the SEC, Park Piedmont Advisors LLC (PPA) has provided each client with a copy of its required SEC Disclosure Document, ADV Part II, which, among other matters, describes PPA's advisory services, fees, and the business and educational backgrounds of its advisors. To request a copy of our ADV, please contact Lynette Carmelli at 212-391-2323 or by email to [LynetteC@parkpiedmont.com](mailto:LynetteC@parkpiedmont.com), or you can access it at our website, [www.parkpiedmont.com](http://www.parkpiedmont.com). Our PRIVACY STATEMENT, which is required to be delivered once each year, is enclosed with this month's Comments.

#### **TAX COST BASIS INFORMATION:**

We plan to resume our work that will incorporate in your monthly statements tax cost basis information for all presently owned positions in your taxable accounts. We hope to finish all client accounts by year end. You will be receiving an explanatory letter from us, and a completed cost basis information form that calls for your signature, prior to this information appearing on your statement(s).

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

**COMMENTS: INDEX RESULTS, period ending SEPTEMBER, 2005**

<u>STOCKS</u>	<u>YEAR 1999</u>	<u>YEAR 2000</u>	<u>YEAR 2001</u>	<u>YEAR 2002</u>	<u>YEAR 2003</u>	<u>YEAR 2004</u>	<u>YTD 2005</u>	<u>CURR. MONTH</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	3.7%	0.8%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	1.4%	0.7%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	2.0%	0.3%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	5.4%	1.5%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(2.0)%	0.8%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	(1.1)%	0.0%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	10.5%	1.4%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	6.1 %	0.7%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	10.8%	5.0%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	10.0%	0.6%
<b><u>BONDS</u></b>								
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	1.8%	( 1.1)%
Vanguard Interm. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	1.7%	( 0.5)%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	0.8%	( 0.5)%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.3%	0.3%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	1.6%	( 0.4)%

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.  
 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
<b>NASDAQ</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
<b>BONDS</b>	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
Interm. Tax.															
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
<b>NASDAQ</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
<b>BONDS</b>	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
Interm. Tax.															
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
<b>S&amp;P 500</b>	(2.6)	0.9%	3.1%												
<b>NASDAQ</b>	(8.1)	2.6%	4.4%												
<b>BONDS</b>	(0.5)	3.0%	(0.7%)												
Interm. Tax.															

## SEPTEMBER 2005 COMMENTS

**STOCK** index prices posted modest gains in September, with the S&P 500 and the Dow Industrials increasing by 0.7% and 0.8%, respectively, and the NASDAQ Composite remaining unchanged. The Midcap, Smallcap, and REIT indexes also gained, while the international index continued its outperformance. For 2005 year to date (YTD), the S&P 500 is up 1.4%, while the Dow and NASDAQ are down  $-(2.0\%)$  and  $-(1.1\%)$ , respectively. By contrast, the Midcap, Smallcap, REIT and international indexes are all up between 6% and 11%, substantially outperforming the Largecap indexes. The Total Stock Market index is up 3.7%, benefiting from the Midcap and Smallcap performance. See page 2 for the monthly and YTD figures.

**BOND** returns (price change plus interest) declined significantly during September, completely reversing their gains of August and reverting back to the price and yield levels reached in July. The Federal Reserve continued to raise the short term interest rates it controls, and in doing so determined that even Hurricane Katrina was unlikely to slow the US economy. The benchmark 10-year US Treasury yield closed the month at 4.33%, far above August's close of 4.02% and even higher than July's 4.28% close, which in turn was significantly higher than June's close of 3.92%. Despite the monthly declines, all YTD figures for bonds continue positive, although these returns are now lower than corresponding money market yields, which benefit from increases in short term interest rates. Bond results for the month and YTD are reported on page 2.

The stock market rally that began decisively in March 2003 has raised the S&P 500 by 58% from the October 2002 low. While these gains have made investors believe again that stocks do not go down in perpetuity (a widely-held view during the depths of the 2000-02 bear market), the question of whether this recovery will continue is, as always, dependent on unknown, unpredictable future events (like the recent hurricanes; and remember Nick Taleb's quote from page 1). Indeed, this year's Largecap stock indexes, over the first nine months, are essentially break-even. (Note also that after a 50% price decline, it takes a 100% gain to return to the previous level. Since the S&P 500 reached its high of 1,527 in Q1 2000, and then declined by almost half to 777 during Q4 2002, the current level of 1,229 is 58% higher than the low but still another 298 points, or 38%, from the prior high).

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (also see the figures on page 12). Note that the three indexes have positive average annual returns ranging from 9.6% to 10.3% for the ten-year, nine-month period from the end of 1994 through September 2005, very much in line with long-term stock returns going back to 1926. Further, as these returns converge more and more, the idea of "regression to the mean" seems quite applicable.

**The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.**

	<u>S&amp;P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 10, 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
September 30, 2005	1,229	(19)%	10,569	(10)%	2,152	(57)%

**Context: Prior Five-Year Gains in Bull Market of 1995 - 1999**

	<u>S&amp;P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
September 2005	1,229	10,569	2,152
Gain	770	6,735	1,400
Avg. Ann. % Gain: '95-09/05; 10.75 yrs	9.6%	9.9%	10.3%

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

## I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth. Further, we believe that even if you could accurately predict any number of actual economic figures, the market's reaction to those figures is essentially unpredictable. In any event, an understanding of the direction of current economic trends may at times be useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators. (Certain of these reports will have been impacted by Hurricanes Katrina and Rita.)

- (1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the US economy. (GDP figures are inflation-adjusted, annualized growth rates. See the August 2005 Comments for reference to a NY Times (NYT) article "Economic View" (7/31/05, Financial section, pg. 4), listing the major components of GDP). The final figure for Q2 2005 GDP was a 3.3% increase (Vanguard Economic Week in Review [VEWR], 9/26-30/05), slower than the 3.8% growth in Q1 2005. "Consumer spending, business investment and exports rose, while business inventory investment fell" (Wall Street Journal [WSJ], 9/1/05, pg. A2).
- (2) Employment for September will not be reported until Friday, October 7<sup>th</sup>, which will provide the first look at the hurricanes' impact on employment. August jobs grew by 169,000, "less than Wall Street forecasters had expected, but the Labor Department also calculated that the nation generated 44,000 more jobs in June and July than it had estimated. Taken together the new data showed that companies expanded their work forces an average of 195,000 jobs a month over the last three months – a pace that suggested that the economy was not slowed much by the sharp increase in gasoline prices earlier this summer" (NYT, 9/3/05, pg. B1).
- (3) Interest Rates increased sharply in September. The benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 4.33%, far above August's level of 4.02%, and even above July's 4.28% close. During September, the Federal Reserve raised the short-term rates it controls for the eleventh time since June 2004, bringing the short-term rate to 3.75%, up from 1% fifteen months earlier. In its front page story reporting the latest increase, the WSJ stated that "the Fed acknowledged Katrina's 'tragic toll,' but predicted it wouldn't derail the economy's expansion, and may aggravate inflation" (WSJ, 9/21/05, pg. A1).
- (4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, increased a modest 0.1% in August, but overall CPI was up a much higher 0.5%, mostly because of higher gasoline and energy costs. "Compared with August 2004, prices rose 3.6% overall and 2.1% excluding food and energy" (NYT, 9/16/05, pg C4). The Producer Price Index (PPI) core rate was unchanged in August, and up 0.6% with food and energy included (VEWR, 9/12-16/05). (Note: the CPI measures prices of goods and services; the PPI, only goods).

- (5) Sector Economic Activity was Mixed (Later Reports, impacted by Katrina, were Worse than Earlier Reports Covering August Activity)
- (a) Durable goods orders (industrial and consumer) rose 3.3% in August, a rebound from July's decline, "indicating that business spending had accelerated before Katrina, and that business conditions are strong enough to overcome a Katrina-led slowdown in the months ahead" (WSJ, 9/29/05, pg. A2).
  - (b) Industrial production rose 0.1% in August, "despite including some preliminary effects of Katrina, and would have been up an estimated 0.4% without Katrina's impact" (VEWR, 9/12-16/05).
  - (c) Retail Sales declined 2.1% in August, primarily from declining auto sales; excluding auto sales, all other retail sales rose 1.0%. (All of these figures are from before Katrina.) (WSJ, 9/15/05, pg. A2). (Retail sales are not adjusted for inflation, and include disparate categories such as gasoline sales, auto sales, and non-store retailers such as the Internet.)
  - (d) Housing sales for existing homes rose 2.0% in August. New home sales declined 9.9%, but were still 6.2% ahead of August 2004 (VEWR, 9/26-30/05).
  - (e) Personal Income declined 0.1% in August, while consumer spending declined by 0.5%, impacted in part by Katrina, declining auto and truck sales, and soaring energy costs. Personal savings remained negative (VEWR, 9/26-30/05).
- (6) Consumer Confidence, as measured by the Conference Board's Index, "skidded to a nearly two year low in September...due to rising gasoline prices, Hurricane Katrina, and a weaker job-market outlook" (WSJ, 9/28/05, pg. A2). The University of Michigan's report on consumer sentiment mirrored this result, "raising the prospect that consumer spending- a pillar of the economy- could slow in the months ahead" (WSJ, 9/17-18/05, pg. A2).
- (7) Corporate Profits for Q2 2005 "rose a sharp 6.9% from the first quarter, and were up 11.5% after-tax from the second quarter of 2004" (WSJ, 9/1/05, pg. A2). Profits for Q3 will not begin to be reported until October. While corporate profits are a major driver of stock prices, it is important to note that over extended periods of time the rate of profit growth is closely related to the rate of overall economic growth.

Overall, the economic news reported in September for the first few weeks of August was positive; towards the end of the month, when factoring in Katrina, the news turned negative. Nine months into 2005, the broadly diversified liquid investment markets have produced meager returns. As for the future, prices will, as always, be determined by unpredictable, unknowable future events. This constant conclusion of ours has been reinforced by the recent hurricanes.

## II. ANNUITIES

(Note: The first paragraph, and first sentence of the second paragraph, are repeated from last month's Comments. The remainder of this section is new material).

Annuities are not an alternative asset class, but rather a specialized kind of account within which investments in stock funds, bond funds, and other fixed income funds, can be made. Annuities are issued by insurance companies in return for funds contributed by the investor. They promise a flow of money for as long as one (or more) people live, or for some other agreed-upon time period. The idea of a guaranteed flow of money is one key advantage of annuities. A second key advantage is that the investment earnings accumulate income tax-free until such time as money is withdrawn.

Annuities have several offsetting disadvantages, chief among which are: (a) the high cost, and severe premature withdrawal charges, typically associated with these products, and (b) the fact that when money is withdrawn, the investment earnings component is taxed as ordinary income with no opportunity for favorable capital gain treatment. Also, depending on the way money is withdrawn, the income tax consequence comes before, or coincident with, the tax free invested capital component. Amounts invested are made with after-tax dollars, and receive no income tax benefit. Investors should therefore generally fund all tax deductible retirement programs before considering any annuity investment, since a tax deduction is available for the retirement plan investment, and all other income tax treatment is the same. (Note: Roth IRAs involve different tax treatment, which is beyond the scope of this discussion of annuities.)

The key economic question for investors is whether, given the above mentioned advantages and disadvantages, it is better to accumulate money inside an annuity or in a regular taxable account. The following provides a detailed financial analysis relating to this question, along with a discussion of other issues raised in recent media articles regarding annuities.

This analysis compares the use of an ANNUITY with the use of an INDIVIDUAL TAXABLE INVESTMENT ACCOUNT, for both the ACCUMULATION and DISTRIBUTION of money.

### **ACCUMULATION Phase:**

Assumptions: Married couple, both age 53  
\$1 million starting value  
Average Annual Investment returns, net of fees and before taxes  
(assumes straight-line annual returns):  
Stocks: 8%, Bonds: 4% taxable; 3% tax-exempt (i.e., "Munis")  
Asset Allocation: 50% Stocks, 50% Bonds

### Investment results:

(1) Within an Annuity, using stocks and taxable bonds (the income from which are not taxed on a current basis when held in the annuity), and an average annual investment return of 6%, the \$1 million of starting principal increases to \$2 million after twelve years.

(2) In a Taxable Account, using an after-tax figure of 7% for stocks (to account for current taxation of dividends and capital gains distributions) Muni bonds at 3%, for an average annual investment return of 5%, the \$1 million of starting principal increases to \$1.8 million after the same twelve years

### **DISTRIBUTION Phase:**

(1) From the Annuity, the analysis assumes that the husband and wife, now both age 65, annuitize the \$2 million, with payments guaranteed for life and a minimum of twenty years. Annuitizing in the case of the married couple means the insurance company pays a set amount of money each month until both spouses have died. The monthly amount paid includes a portion attributable to the original \$1 million invested, another portion attributable to the investment gain of \$1 million, and yet another portion attributable to the ongoing earnings on the remaining amounts in the annuity.

Using a New York Life Insurance Co. illustration, the monthly payment would be \$10,700, of which 30% is attributable to the tax-free return of the original \$1 million, and the remaining 70% is taxable, ALL at ORDINARY INCOME TAX rates. The result is that \$3,217 per month is tax-free, and \$7,483 per month is taxable. Assuming a 28% Federal rate (but no State tax), the result is a tax of \$2,100. This leaves a total \$8,600 per month, or \$103,200 annually, payable for as long as the "second-to-die", or "survivor", lives, and guaranteed for a minimum of twenty years.

(2) For the Taxable Account, the relevant questions are: 1) how much needs to be generated after-tax to equal the \$8,600 monthly payment from the annuity; and 2) given that monthly withdrawal from the Taxable Account, how long would the accumulated \$1.8 million last, compared to the lifetime/20-year minimum payments the annuity provides.

This account would have accumulated approximately \$700,000, or 40%, in Muni bonds and \$1.1 million, or 60%, in stocks, based on the after-tax average annual investment return assumptions mentioned above (i.e., 3% for Munis and 7% for stocks). The Muni bond portion can be distributed with no taxes, while the stock portion would incur a 15% Federal capital gains tax on the gain component. Of the \$1.1 million, \$500,000 consists of "cost basis" that is not subject to tax, and \$600,000 is capital gain subject to tax. Therefore, only 55% of the stock investment is subject to the 15% cap gains tax, which equates to 8.25% in tax on each distribution attributable to stocks.

Based on the above information, a monthly distribution of \$9,100 will net \$8,600 per month after taxes from the Taxable Account<sup>1</sup>, which would equal the monthly after-tax distribution from an Annuity. On an annual basis, the \$9,100 per month figure requires that \$109,200 be distributed from a Taxable Account each year to equate to the \$103,200 per year generated by an Annuity.

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<sup>1</sup> The general calculations are as follows:

40% of \$9,100 = \$3,640, attributable to the Muni bond portion that is not subject to tax; and  
60% of \$9,100 = \$5,460, attributable to the stock portion and subject to capital gains taxes.

Using the 8.25% capital gains tax figure calculated above for each distribution from stocks, the tax is \$450, leaving approximately \$5,000

The END RESULT of this analysis is that it would take 36 YEARS of \$109,200 distributions to use up the \$1.8 million of starting capital, assuming the 5% annual investment return continues. In summary, even though the Annuity accumulates \$2 million compared to \$1.8 million in the Taxable Account, the taxation of the distributions from the Annuity is so unfavorable that the lifetime/20-year minimum payment guarantees for two 65-year olds compare to a 36-year distribution of the same after-tax annual amount from the Taxable Account. In other words, one of the annuity investors would have to live beyond age 101 for the annuity to be the preferable investment vehicle.

Perhaps the future will bring either lower annuity costs or other product improvements, but for now, this analysis clearly favors the taxable account. We welcome your comments and questions regarding this analysis.

To continue this discussion of annuities, we now turn to some recent newspaper articles. WSJ columnist Jonathan Clements discussed annuities in his 9/14/05 "Getting Going" column (pg. D1) under the title "When Income, Not Wealth Accumulation, Becomes the Goal of Your Investments." He wrote that "in pitching tax deferred variable annuities, insurers emphasize 'living benefits,' such as guaranteeing a minimum annual withdrawal or promising a minimum payment if you eventually convert your variable annuity into a stream of income." The column discusses a Vanguard inflation-adjusted lifetime-income annuity, setting out examples of amounts of "income" that would be paid based on the amounts invested and the age withdrawals begin.

While we believe Clements is often right on target in his columns, particularly since he favors investment portfolios using low cost indexed investments, we think the way he uses the term "income" is incorrect. The reason is that the amount of money that is withdrawn from the annuity is a combination of the original contribution made and the investment earnings obtained on that original contribution. Only the investment earnings should be characterized as income; the portion of the withdrawal amount attributable to the original contribution is nothing more than the return of the investor's own money. Using the term income can lead to the erroneous idea that when withdrawals are made, the original contribution remains intact. This is not correct. The original contribution is being consumed, along with the investment earnings, as monies are withdrawn.

There are new annuities from which you can withdraw only the investment earnings and leave the original investment intact, but to do so would not maximize the amounts withdrawn, and the examples used in the Clements article definitely assume annuitization (that is, including the original investment in the periodic withdrawals). We intend to send our financial analysis of annuities to Mr. Clements for his response as to whether the guarantees that come from using annuities are worth the amount of money given up in the process.

In an earlier "Getting Going" column (WSJ, 3/30/05, pg. D1) written by Jeff Opdyke under the title "Figuring Out When Putting a Nest Egg Into an Annuity Makes Sense for Seniors," the article begins: "State and Federal regulators are clamping down on the sales practices of annuities, specifically the 'variable' and 'fixed deferred' varieties that insurers and banks constantly pitch to retirees." It goes on to state that "the tax consequences and long holding periods necessary to make a variable annuity attractive don't make sense for retirees." A Vanguard retiree services executive says that "there are only very narrow situations where it makes sense for a 65 year old, and I (he) can't contemplate a situation when it makes sense for someone 75 or 85."

The article then refers to immediate annuities, into which "you put in a sum of money now for monthly payments that begin immediately and last for as long as you live," commenting that those might make sense. We believe our financial analysis casts doubt on this conclusion even for the immediate annuity, but we note with approval that the author refers to the withdrawals as "monthly payments" (which they are), and not "income" (which they are not).

The Opdyke column continues by discussing the adverse tax consequences of the variable annuity. Even if the investments do well, "when you start drawing on the account, you've turned capital gains into ordinary income, which is taxed at higher rates, meaning the annuity ultimately provides less money." (Our note: this was exactly the point of our financial analysis, which quantifies just how much less the investor receives as the price of the lifetime guarantees). Further, the article notes that if you die before the money is withdrawn, there is no stepped-up basis for your heirs to minimize future income taxes. Investments held in taxable accounts rather than annuities do receive this treatment when the assets pass to heirs at death. The article concludes by discussing the practice that some issuers employ of offering high interest rates for a year or two, and then lowering the rates they pay over the remaining contract period, while the investor is locked into the contract. "It is like signing up for a 10-year CD without knowing what the bank will pay you. That doesn't make any sense," says the Vanguard retiree services executive quoted earlier in the article.

Another article by Jeff Opdyke (WSJ, 8/4/05, pg. D1) was headlined, "Annuity Sales Face Crackdown by Regulators." The article begins by stating that "the annuity business long has been criticized by regulators and consumer advocates for misrepresenting its products and preying on senior citizens." It goes on to say that regulators are placing "special emphasis on provisions that limit the amount of time annuity sellers can impose penalties – so called surrender charges – for canceling an annuity contract early, and imposing additional requirements on companies to make sure they are selling annuities only to 'suitable' investors." The article states that these efforts underscore increasing frustration among government officials, regulators, and consumers about the aggressive ways many financial service companies sell annuities, particularly to seniors, whose life savings may be jeopardized by unsuitable annuities. Specific problems cited in the article are: (a) seniors are often sold annuities ill-suited to their needs; (b) seniors often do not understand the nuances of the contract; (c) seniors are often promised the annuity is as safe as a CD, even though many are not; (d) long-term lockups of money are often not in the senior's best interests; and (e) seniors are encouraged to switch from one annuity to another, racking up big charges.

A final WSJ article worth discussing appeared in the special report section "Your Money Matters" (8/15/05, pg. R5), titled "Annuities, Meet 401(k)s." The article cites a growing number of 401(k) plans that offer an annuity as an investment choice, or are tailored to receive 401(k) money at the time a person retires. It then discusses a number of the companies involved, noting that it was difficult to determine the fees involved with these products. In our view this is extremely important, because we believe the costs associated with these products will determine their effectiveness. Our reasoning here is that 401(k) plans are retirement plans, and the contributions that are made into them, along with all investment earnings, will be subject to ordinary income taxation at the time of distribution. This is true whether the money is distributed from the 401(k) plan investments not including any annuity, or from an annuity within the plan. Since there is no after-tax investment being made into the annuity within the 401(k) plan, there would be no component of the distributions that would be received as a tax-free return of principal. The alternative to using the annuity would be for 401(k) participants to set up an IRA Rollover account for the money, make their own investment decisions, and withdraw money using their own time frames, subject only to the Required Minimum Distribution rules for taxable distributions which begin at age 70   . All distributions from Rollovers would also be taxed as ordinary income. So whether the annuity makes sense would hinge on how much you would be paid from the annuity compared to what would be paid from the IRA Rollover, assuming comparable investment results and comparable taxation. This in turn boils down to the costs and fees that come with the annuity contract guarantees, compared to those associated with the IRA Rollover account.

### III. HOUSING

As the boom in housing prices continues, conventional wisdom tells us that housing is, will be, and has been a superior investment to the stock market. The facts and figures indicate otherwise. In a front page NY Times article titled, "In The Long Run, Sleep at Home and Invest in the Stock Market" (8/19/05), the authors present the following chart under the heading, "Housing Prices have done better than Stocks recently, but not over longer periods."

	<u>Average Annual Change 2000-05 (5 years)</u>	<u>1980-2005 (25 years)</u>
S&P 500; Stocks	- (2.7)%	+ 10.2%
Housing: New York	+ 12.0%	+ 7.7%
Los Angeles	+ 15.5%	+ 6.7%
Chicago	+ 7.7%	+ 5.5%

The article states that “In fact, by a wide margin over time, stock prices have risen more quickly than home values, even on the East and West Coasts, where home values have appreciated most.” The article continues that “much of the gain in home prices came from simple price inflation, the same force that has made a gallon of milk more expensive today than it was decades ago.” It then discusses the fact that many homeowners make costly investments in their home over time, adding to the eventual resale value. The authors cite an example of a home purchased in 1970 for \$110,000 and sold in 2005 for \$900,000. Factoring in inflation and the cost of additions, the profit came to 10% over the 35 years, while the stock market gained over 200%, even accounting for inflation.

The authors state that “the main benefit is what it has always been: you can live in the house you own,” and “despite the fact that home values usually appreciate over time, most of the value of a house actually comes from the ability to use it.” They go on to say that “whenever people sell one house, they must immediately pay to live elsewhere, meaning that they never wholly cash out of a home’s value.” (Our note: at least not while still living.) The article elaborates on this value of living in a house by stating that “homes in New York have returned more than 15% a year since 1980, but only 5% of the return comes from sheer price appreciation as opposed to the value of the shelter.” The analysis cited in the article took account of property taxes, spending on renovations, interest payments and the tax deductions on these payments, and the fact that most purchases are made with mortgages.

In discussing why investors currently see housing as a less risky investment these days than the stock market, the authors cite the recent stock market declines of 2000-02 as being still fresh in investors’ minds, while the housing price declines of the early 1990s are dim memories. They also note the fact that because stock prices are reported each day, home prices appear more stable.

Further, the fact that most homes are purchased with mortgages works well when prices are rising, but can create real problems in a declining market. The article observes that a 30% decline in the value of a home with a large mortgage can put a person into bankruptcy if they can’t make the mortgage payments, whereas a decline of 30% in a stock portfolio is unlikely to have the same result. And finally, in a point that we believe carries real insight, the article states: “Beyond the shelter it provides, the biggest advantage of real estate might be that it protects people from their worst investment instincts. Most people do not sell their house out of frustration after a few months of declining values, as they might with a stock. Instead, they are almost forced to be long-run investors who do not try to time the market.”

The importance of housing in our current economy was highlighted in recent comments made by Fed Chairman Alan Greenspan, as reported in the WSJ (9/27/05, pg. A1) and NYT (9/27/05, pg. C1). The WSJ article was headlined “Greenspan Warns of Reliance on Housing Loans”, while the NYT article was headlined “Most Homeowners Not Overly in Debt, Fed Chief Says.”

The WSJ article begins: "Fed Chairman Greenspan, drawing on new research he has personally supervised, said American consumers have become enormously dependent on borrowing against their homes to fuel their spending, and that a rise in mortgage rates could trigger a spending pullback." Low interest rates were cited as a key factor that has spurred the trend. The Fed Chairman said that rising rates would reduce borrowing and slow consumer spending, a reversal that he said need not be "disruptive" and might even be welcome, as it would result in rising saving and a narrower trade deficit. Greenspan's remarks also included his view that "there is 'froth' in some local markets where home prices have risen to unsustainable levels," but that it was "too soon to tell whether that froth would widen to the national market or whether recent indications of some easing of speculative pressures signal the onset of a moderating trend." The rising number of second home purchases and the use of "exotic" mortgages were cited as factors fueling a speculative housing market.

The NYT article, with its more optimistic headline, begins: "With new evidence that the housing market remained red hot last month, Alan Greenspan said that the vast majority of homeowners are not yet stretched too thin." Supporting this view are figures that "only about 5% of families have borrowed more than 90% of the value of their houses." The article discusses Greenspan's concerns about interest-only and other exotic mortgages that "provide ways for marginally qualified buyers to borrow heavily and buy homes at inflated prices. In the event of widespread cooling in home prices, these borrowers, and the institutions that service them, could be exposed to significant losses." So the messages are twofold: (a) "exotic mortgages can be aggravating the run up in prices and inducing some families to take on too much risk;" and (b) "finances of most houses are still on solid ground." (Our comment: it appears that both headlines, this time, are accurate).

S&P 500 (1)                      DOW JONES (1)                      NASDAQ (1)

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

**I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)**

Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
Sept. 21, 2001 <u>Low</u>	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
End of 2001	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
Oct. 9, 2002 <u>Low</u>	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
End of 2002	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
End of 2003	1,112	(24.3)%	10,454	(9.1)%	2,003	(50.8)%
End of 2004	1,212	(17.5)%	10,783	(6.2)%	2,175	(46.5)%
September 30, 2005	1,229	(16.4)%	10,569	(8.1)%	2,152	(47.1)%

**II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)**

Start of 1995	459		3,834		752	
End of 1999	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	<u>1,112</u>		<u>10,454</u>		<u>2,003</u>	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5%
End of 2004	<u>1,212</u>		<u>10,783</u>		<u>2,175</u>	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
September 30, 2005	<u>1,229</u>		<u>10,569</u>		<u>2,152</u>	
10.75 Yr Gain; Annualized %	770	9.6%	6,735	9.9%	1,400	10.3%



Victor Levinson



Nicholas Levinson