



QUARTERLY CAPSULE

Newsletter of the Alliance of Cambridge Advisors, Inc.

Winter/Spring 2003

Dollar Cost Averaging: A Second Look



Bert Whitehead, MBA ©2003

"I don't want to keep putting money in the stock market!" a client recently exclaimed. "It seems like my monthly savings gets wiped out in the next month..." Bill was determined to buy bonds; at least his money would still be there next month, plus a little interest. So the question looms: is it time to stop Dollar Cost Averaging (DCA)?

DCA is a strategy of investing a certain amount of money regularly, usually on a monthly basis. This strategy protects an investor from a sudden drop in the market. It is advantageous because when the market drops, each monthly investment buys more shares. When the market turns around, the portfolio rebounds quickly. DCA is an alternative to 'market timing' but it takes discipline.

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As a result of completing our reorganization, Cambridge Connection, Inc is pleased to announce the staff who are now available to service our clients:

Senior Advisors: Bert Whitehead, MBA, JD (MI), Kelly Adams, EA, CFP (MI)

Team Advisors: Chris Zehnder, CFP (MI), Pam Landy, JD (AZ & MI), Janet Campbell, CFP (CA)

Paraplanners: Jason Moore (MI), Monika Logan (MI), Nicki Kuznicki (AZ)

We have appreciated our client's support in the past, and are now sufficiently staffed to be able to accept new clients. If you are pleased with your financial progress, with us as your advisors, please pass it on to others. If you have suggestions on how we can improve our image, marketing method, or professional demeanor, please email Bert (bertw@cambridgeconnection.com) or Kelly (kellya@cambridgeconnection.com) and let us know your suggestions.

Cambridge Connection, Inc's ADV Part II is available from the Michigan office upon request.

Why Hire Your Children?

Do you want to inspire a good work ethic in your child? Teach her skills that could serve her lifelong? Jump-start her retirement nest egg? Or maybe just show her what you do all day and make her more productive (because no one else is hiring her!).

As a business or rental property owner, you have the perfect opportunity to take advantage of the numerous tax and savings benefits available by hiring family members. You simply need to find work your child can perform in your unincorporated business. Even younger children can be hired to empty trash, or stuff and stamp envelopes for example.

If you hire your children who are under the age of 18, their wages are exempt from Social Security, Medicare, and Federal Unemployment Taxes. In addition, you can pay your child up to \$7,750 income tax free. If your child files her own tax return, she can take both a standard deduction of \$4,750 (for

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\$7,750 income tax free.*

2003) and fund a deductible IRA for \$3,000. If you are in the 27% federal tax bracket, pay 15% self-employment tax, and 4% state tax, you will save \$46 in taxes for every \$100 you pay your child. If you pay her \$7,750, you save \$3,565! This tax savings doesn't include the benefits of the IRA account that could grow tax-deferred in her name – for decades!

Remember, to enjoy these benefits, you must *formally* employ your child. The child must be paid for the work done, and the wages must be reasonable for the services rendered. So, what's the catch? It will be necessary to prepare all the normal paperwork, such as federal and state W-4s and to keep good records. Track your child's completed work hours with a timecard to substantiate wages paid. At year-end you must report these wages on a W-2 and report the earnings and withholdings to the Social Security Administration.

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Since Bill was a gambling man, he bet me \$100 that if he invested \$10,000 regularly each year during a recession into bonds paying 5% a year, at the end of 10 years he would be better off than if he Dollar Cost Averaged the same amount into the stock market during the whole recession. I took him up on the bet.

We agreed that the recession from 1972-1982 would be a good test. The Dow Jones Industrial Average closed above 1000 for the first time in 1972. Over the next few years it dropped about 40%, and then slowly rebounded and finally closed over 1000 again ten years later in 1982. Jason Moore, my trusty Senior Paraplanner, did the analysis for us. His results are shown in the graph below. Using DCA into the Dow or S&P index during that period would result in a portfolio of 42% more than a bond portfolio at the end of the 10 years, even though the economy was in a recession

The reason DCA beats bonds during a recession is that, even though the stocks bought the first year are worth the same at the end of the 10 years, the remaining stocks were purchased at lower costs. Indeed the stock purchased at the nadir of the recession (1974) increased over 60% in the next seven years!

Alternatively, if the whole \$100,000 had been invested in bonds in 1972, instead of \$10,000 per year, the bonds would show superior performance. The bonds would have increased at a 5% rate (compounded) to about \$175,000 in 1982. The \$100,000 invested in

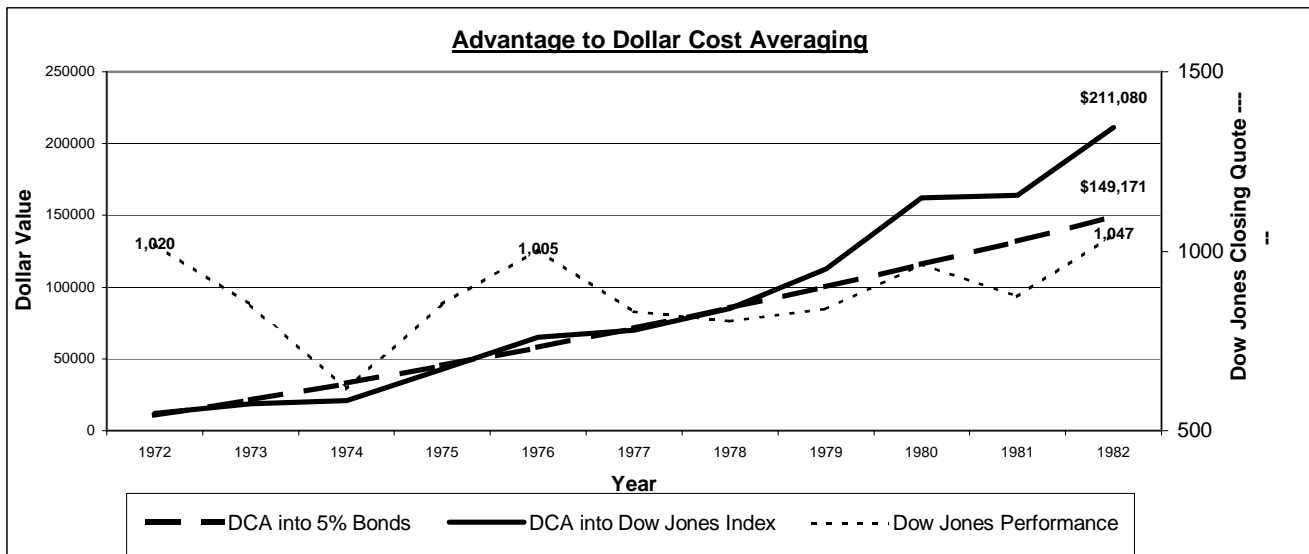
stocks in 1972 would still be worth \$100,000 (plus perhaps some dividends) in 1982.

As proponents of Functional Asset Allocation we eschew market timing – it’s the equivalent of gambling with investments. To protect an investor against deflation as well as inflation, and to participate in prosperous times as well, it is important to have assets properly balanced. Dollar cost averaging into a properly balanced investment portfolio of both stocks and bonds is a disciplined alternative to market timing.

In scary economic times, it is more important than ever to continue a DCA program, even though your instincts may scream in protest. Many younger clients are using DCA as they contribute to their 401-k or 403-b tax deferred savings plan at work. It is tempting to switch all contributions into safe interest-earning investments, but this is not an effective response to protect a portfolio in a declining market.

Your Cambridge Advisor can make sure that your portfolio is rebalanced regularly, and when you look back five or ten years from now you will be glad that you had an advisor to keep your portfolio on track. It is difficult to maintain that kind of discipline without a trusted, unbiased personal financial advisor. Bill was grateful enough to pay up on his \$100 bet with me, but still hasn’t started DCA...yet. This “second look” is an assurance that DCA is still appropriate.

Stay the course!



Bert Whitehead is the founder of the Alliance of Cambridge Advisors, and has been a practicing fee-only planner since 1972. He is author of the recent controversial book, “Facing Financial Dysfunction: Why Smart People Do Stupid Things With Money.” available through Amazon.com. This article can be quoted if the author is notified and appropriate attribution is noted in the text. Comments or questions about this article can be directed to: Bert@BertWhitehead.com.

You will need to apply for a Federal Identification number on a Form SS-4. This is a relatively simple form and can be found on the IRS Forms website at <http://www.irs.ustreas.gov/pub/> or by calling the IRS at (866) 816-2065. Once you hold a Federal ID number, each quarter the IRS will send you Form 941 which employers use to report employee wages and withholding. If your only employee is your child under the age of 18, there is a place on the form to indicate this.

It's important to remember that the value of employing your children is not purely financial. The lesson of what it takes to earn a dollar is a must for every parent today. If you have children and are self-employed, talk with your Cambridge Advisor about how you can take advantage of these strategies.

Sheryl Clark, EA, ATP Tucson, Arizona

What is your Real Hourly Wage?

Do you ever feel like the harder you work, the more it costs you to live? In a workshop based on the book, Your Money Or Your Life, Transforming Your Relationship with Money and Achieving Financial Independence, by Joe Dominguez and Vicki Robin, I learned about a useful way to take a hard look at where our money goes. Consider that every decision we make, whether it is where we live, what car we drive, what we read, or whether we save, should be based on what we value most in our lives. Think of money as something we trade our life energy for.

1. Identify your hidden job costs

- How much time and money does it cost to get to work? Whether you drive your own car or take the bus, it costs money to get to and from work. What about the time you spend commuting?
- Does your job require special clothes? Nurses' uniforms are obvious, but also consider suits, ties, nylons, briefcase, and time spent shopping for work clothing.
- Are your meals affected by your job? Do you stand in line to buy coffee every morning and at coffee break, lunch at the local restaurant, use expensive convenience foods for dinner because there is no time to plan and cook? How many extra dollars are spent?
- What other job/stress related expenses do you have? What activities must you do in order to relax after a hectic day at work, how often do you need a weekend getaway to escape the rat race, what are your day care costs so you can work, do you need a gardener, a housekeeper or a handyman?

2. Calculate your Real Hourly Wage

Use the answers to these questions to establish the actual costs in time and money required to maintain your job in addition to the hours you work, and then

compute *your real hourly wage*. After adding all these hidden costs you may find that the \$25 hourly wage you are paid is really worth about \$8 an hour.

3. Keep track

Track all the money that comes in and goes out of your life. Then convert the "dollars" spent into how many "hours of energy" you have given up.

HOW TO CALCULATE YOUR REAL HOURLY WAGE

PAY PER WEEK: _____ (A)

MONEY: Costs per week related to maintaining your job

TOTAL COST: _____ (B)

TIME: Hours per week worked **plus** hours related to maintaining your job

TOTAL HOURS: _____ (C)

Subtract your Total Costs (B) from your Pay Per Week (A) then divide by Total Hours (C) for your Real Hourly Wage

REAL HOURLY WAGE: _____

4. Ask yourself three key questions

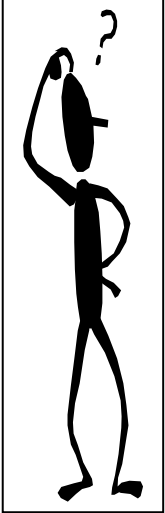
- Did I receive fulfillment, satisfaction and value in proportion to life energy spent?
- Is this expenditure of life energy in alignment with my values and life purpose?
- How might this expenditure change if I didn't have to work for a living?

5. Repeat

Do this exercise every month and keep asking the questions. Did you receive satisfaction from the things you did or bought? Does your spending relate to your priorities? If not, take the time to re-evaluate what you are doing. Remember, we only have 24 hours in a day and one life to live!

Patricia Konetzny, CFP® Maynard, Massachusetts

Ask An Advisor: This market is driving me crazy! When is it going to get back to normal? And what is a “normal” market?



Are you waiting for 1999 to return so that your investments see “normal” growth? As my kids say, “NOT!”

In the 45 years between 1950 and 1995, the stock market delivered average annual returns of 11% (with many booms and busts in those years). Much of the return came from dividends and corporate earnings. During the boom years of 1996-1999, annual returns zoomed to more than double their historical 45-year average. Why? Corporate earnings stayed about the same and dividends actually decreased. The change came from rising expectations on the part of investors. Price to Earnings Ratios (P/Es) skyrocketed as investors bet on the “New Economy” and paid a much higher price for each dollar of company earnings. From 1996 through 1999, P/E valuation added 18.1% to investors’ annual return. In contrast, during the prior 45 years, P/E valuation added 1.5% to annual return.

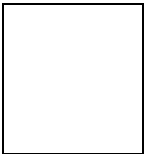
Macroeconomists believe that earnings grow at about the same rate as real gross domestic product (GDP) plus inflation. If real GDP grows at its historical rate of 3.5% annually and inflation stays low at 1.5%, we can expect to see earnings growth of 5-6% annually. Add on the current average dividend yield of 1.5% plus historical P/E addition of 1.5% and we’re looking at an average annual return for stocks in the 8-9% range. How about P/E valuations – should we factor in a rise for them? Do you think that they will rise above the current market P/E of 25, when the historical P/E average is 15? Unlikely.

Stocks *are* likely to revert to their mean average annual return of about 12% in the long run and stocks will continue to provide a higher return over time than bonds and real estate. However, we all need to adjust our sights to make sure that we are planning with realistic returns; basing our plans on a 4-year boom period just doesn’t make sense.

The basic strategy for a successful retirement remains: live within your means, save at least 10% of your income in permanent savings for retirement, diversify your investments, and plan to maintain your lifestyle in retirement.

*Rebecca Preston, CFP® Providence, Rhode Island
Statistics were taken from an article by Martin Barnes of The Bank Credit Analyst.*

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ADDRESS CORRECTION REQUESTED

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