CAMBRIDGE™ CONNECTION, INC

Greetings to all Cambridge Connection clients! Many of our "old timers" will remember periodic newsletters called "Quarterly Capsules". The format has been revised by the Alliance of Cambridge Advisors, and renamed "Financial Focus". Please enjoy the issue.

Bert Whitehead, MBA, JD
President, Cambridge Connection, Inc.

Staff
Bert Whitehead, President
  Serving Michigan/Arizona/California/Nevada/Florida/Georgia
Pamela Landy, Senior Advisor - Michigan
Chris Zehnder, Senior Advisor – Florida/Georgia
David King, Advisor - Arizona
Jason Moore, Senior Associate & Operations Manager
Christine Denham, Associate Paraplanner – Bert's Team
Damon Murphy, Associate Paraplanner – Pamela's Team
Carol Johnson, General Manager
Carrie El-Manaseer, Administrative Support

ARIZONA
4435 E. Calle del Conde
PO Box 65865
Tucson, Arizona 85718
Phone 520.529-9788
800.822.0944

FLORIDA
Also serving Georgia
The Danley Professional Building
2013 Live Oak Blvd, Suite L
St Cloud, FL 34772
407.957.0074

MICHIGAN
Also serving California & Nevada
26111 W Fourteen Mile Rd, Ste LL6
Franklin, Michigan 48025
Phone 248.737.7090
800.224.1040

www.cambridgeconnection.com

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Bert in the news! News on Bert!

2005 has been an interesting and creative year for Bert. With the office under the sturdy helm of Carol Johnson, General Manager and Jason Moore, Operations Manager, Bert has been able to focus his unique abilities on client meetings and creative endeavors within the financial planning industry.

As you may know, Bert's book *"Facing Financial Dysfunction, Why Smart People do Stupid Things with Money"* was released in its 2nd Edition. Bert has also been written up and/or quoted in *Consumers Reports, TheStreet.com, Investors.com, Financial Planning Magazine, The Christian Science Monitor, NAPFA Advisor, Kiplingers, & Investment News.* He's "shaking up the industry", making headway into the use of real estate as a portion of an individuals investment portfolio. He is also challenging the industry's use of "Assets Under Management" (AUM) as a method of compensation for financial advisors. There are a host of conflicts of interest with AUM and Bert is taking the high-ground promoting the Cambridge method of Retainer/Renewal fees, holistic & comprehensive planning -- where the Financial Advisor sits on ***your*** side of the table.

During January of 2005, Cambridge hosted the first "Family Financial Retreat". A small test-group of clients got together over a long weekend, with their children and/or parents. Educational seminars ranged from "Money Basics/Investing 101 to Ethical Wills (Pamela Landy, MBA, JD, CFP is highly specialized in ethical wills), to writing a will for your parents! The response was overwhelming and Cambridge is making this highly sensitive and edifying instructional conference an annual event.

Over the years Bert has addressed many issues and presented many topics of client interest. You've heard some of this material at a Client Appreciation Event or listened to a cassette tape. We've put together a new logo for Bert to publish under, and soon to be released is the first seven in the series entitled "Cambridge Classic Capsules". Available at a special discounted rate for clients this summer, each Capsule includes the booklet and an updated and re-recorded CD of the following presentations:

Volume 1 – The Big Lie: "Give Me Your Money and I'll Make You Rich"
Volume 2 – Creative Budgeting
Volume 3 – Fool's Gold: Today's Financial Fads
Volume 4 – Gambling to Win
Volume 5 – Financial Issues in Second Marriages
Volume 6 – Your Money Personality
Volume 7 – Bert Whitehead Live:
The Seven Simple Secrets to Financial Independence

financial focus

Spring 2005

ALLIANCE OF CAMBRIDGE ADVISORS INC

This issue of *Financial Focus* is provided by a member of the **Alliance of Cambridge Advisors**, fee-only advisors helping real people transform their lives through holistic financial planning. For more information, or to locate a Cambridge Advisor in your area, visit us on-line at ***http://www.cambridgeadvisors.com*** or call toll-free 888-834-6333.

SHOULD YOU TAKE A LOAN FROM YOUR 401(K) PLAN?

by John Einberger, CFP®

The benefits of taking a loan from your 401(k) account are easy to see: there's no credit check; there are few restrictions (you can borrow for any reason); you pay yourself back, not a bank; and the interest rate is generally lower than you would find elsewhere. Unfortunately, too often 401(k) plan participants do not consider the financial implications of taking a 401(k) loan. The following are reasons why borrowing from your 401(k) account may negatively affect your financial future.

■ Loss of Earnings Potential

When you withdraw money from your 401(k) account, you have less money invested. The money you have withdrawn no longer appreciates in value from interest, dividends, and/or capital gains. For example, if you take a $10,000 loan and over the next year the stock market returns 9 percent, you will have lost out on the profit your $10,000 could have earned ($900) and any future gains on that profit. Put simply, you should consider how much you could expect your money to earn in your account if you do not borrow the money.

■ Double Taxation of Loan Interest

Contributions to your 401(k) account are made before taxes are deducted from your pay. When you pay back a 401(k) loan, the payments are made with after-tax dollars. When you retire and begin to withdraw money from your account, the interest portion of the loan repayment will be taxed again.

■ Fees

Many 401(k) plans have a nonrefundable loan application fee that is deducted from your account.

. . . you should carefully consider how withdrawing a portion of your 401(k) account could affect your overall retirement plan.

■ Default

If you default on your loan (by missing any three payments), you will have to pay both federal and state income taxes on the defaulted loan amount. If you are younger than age $59^1/_2$, you will be assessed an additional 10% penalty. Many 401(k) plans will not allow you to take another loan if you have defaulted.

■ Repayment upon Death

Should you die (or leave your employer for any reason) before your loan is repaid in full, the outstanding balance is due in full immediately.

You should carefully consider how withdrawing a portion of your 401(k) account could affect your overall retirement plan. Money that is not in your 401(k) account cannot continue to grow to meet your retirement goals. ■■■

Alternatives to 401(k) Loans

So, you need cash and you're thinking about borrowing from your 401(k)?

Here are some alternatives:

1. If you've been considering an IRA rollover anyway, do it now and you'll get tax-free access to your cash for up to 60 days with no loss of qualification or tax-advantage. Contact your financial advisor to make sure you do this correctly.
2. Consider borrowing on the equity in your home through a second mortgage or a home equity line. Of course, this will cost you some interest payments, but you may get tax relief, since most home equity loan interest is deductible. Another positive for this alternative is that most home equity loans and/or refinancing deals are at relatively low interest rates at present.
3. Consider withdrawing from the cash value of an insurance policy that holds a variable investment. Such withdrawals are considered return of capital, need not be repaid, and do not create a taxable event.

Source: Barry J. Swaim, CFP®

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THE BIG LIE - Part 1 of a Two-Part Series

by Bert Whitehead, MBA, JD and Mark Stempel, EA, CFP®

Any article about finances or advertising from a financial services company will most likely focus on the securities market: stocks and bonds issued by large U.S. companies. The financial industry perpetuates the myth that whether the securities market is up or down is the single most important factor when it comes to your financial life. In fact, the financial industry has so dominated our way of thinking about investments that it even determines the kinds of questions we ask about investments. The financial industry would have us believe that our most important financial question is, "What return can we expect to get on our investments?" Each brokerage firm, financial planner, and investment advisor attempts to persuade us that we can get higher yields, better dividends, and higher long-term returns with lower risk from them than from any others. In this article we are going to show you why focusing only on buying and selling to maximize returns is ***"The Big Lie."***

. . . the financial industry has been so successful in promulgating "the big lie" that only 14% of individual investors use index funds.

To understand the claims of the financial industry from an economic standpoint, it is important to understand the difference between efficient and inefficient markets. Efficient markets, such as the stock market, are characterized by homogeneous items, sophisticated traders, accessible information, and high volume. Inefficient markets, like real estate, are characterized by uniqueness, unsophisticated buyers, low turnover, and information that's not easy to come by. In efficient markets, prices change rapidly to reflect the true value that others place on the item since information passes almost instantaneously between buyers and sellers. In the stock market, it is obvious that all of the brokers cannot do better than all of the other brokers because the end result of every stock transaction is one buyer and one seller, and one of them is wrong. A defining characteristic of an efficient market is that most trades will be made at a fair price since information flows so freely. Yet virtually every investment advisor in the financial industry asserts that he or she can beat the system and buy stocks "cheap" by timing the market.

The first problem with "market timing" systems is that information moves much too fast for accurate market timing by the average broker. It is generally recognized that 5% of all stock traders account for 95% of the stock transactions. These people have staffs of hundreds that come to work every day to analyze individual stocks. They trade in millions of shares, and new information is instantly reflected by share price changes in the market. This is not your local broker. The 5% of brokers doing most of the trading also pay for early access to information, such as the Consumer Confidence Index. They receive those monthly confidence figures one minute before the information is made public, and that new information affects the market within five to ten seconds after its release. So when a broker in Topeka, Kansas says he is watching the market for you and that he is going to outperform it by going to his Monday morning sales meeting, or reading his email everyday, he is way too late to predict trends.

The second problem with "market timing" systems is that if someone had a market timing system that worked, he or she wouldn't tell anyone else because once other people found out about it, it wouldn't work anymore. And the third nail in the coffin of "market timing" systems is that every single study that has been done by academia, pension funds, and foundations has consistently proven that market timing doesn't work. Despite their huge resources, the investment industry has never been able to produce any study that would indicate that their brand of market timing does work. Buying and holding stocks in an index that reflects the composition of the large-cap companies in the stock market is a more effective approach. Studies of data on large-cap stocks show that 85% of money managers do not perform as well as the S&P 500 Index over a 15-20 year time span.

Institutional investors, such as large pension funds, have discovered what individual investors have not: large-cap indexes outperform money managers in the long term, with much lower costs. As a result, two-thirds of pension funds and foundations now use large-cap indexes instead of money managers for their investments. But the financial industry has been so successful in promulgating "the big lie" that only 14% of individual investors use index funds. Some will say, "Well, then, from an investment standpoint what really counts?" We can say, after a combined 50 years of working with clients and witnessing numerous economic cycles, that a balanced portfolio – and not market timing – is paramount. ■ ■ ■

MORTGAGES: WHAT YOU DON'T KNOW CAN COST YOU

by W. Tedd Oyler, JD

You've made the offer to purchase the home of your dreams. The seller, after some haggling, has accepted your offer. The offer is contingent upon approval of your mortgage application. Are you concerned whether or not you'll get the mortgage? Will you get the best deal you can? Chances are that if you've waited until this point to learn about how mortgages work, you will NOT get the best deal available to you. It may be crucial to your financial well-being to understand this process, since the cost to you of the credit you are seeking will amount to thousands of dollars out of your pocket.

Lenders love to loan to those of us in the middle class for the purchase of our homes, for they assume that we will endeavor to pay our house payment even when we are having trouble paying other bills. This is a primary reason that interest rates charged to homebuyers are lower than the rate charged by banks for most other forms of credit. Of course, it also helps that there is federally-backed mortgage insurance protecting banks from our default.

However, not all borrowers are created equal. Each homeowner in your neighborhood may be paying a different interest rate. There are several reasons for this:

- Interest rates fluctuate, and the rate each of us is paying can vary depending upon the specific date we sign the loan paperwork. This sets the stage for all that refinancing of loans we hear about as interest rates decline.
- Lenders charge different rates for different "terms" or lengths of time: if you agree to pay off the mortgage in 15 years rather than 20 years, your rate will be lower.

. . . not all borrowers are created equal

- Many of us nowadays agree to "variable" rate loans, meaning that the interest rate charged can increase (or even decrease) annually. These can be attractive options because they tend to begin at a lower rate than fixed-rate loans, but they can backfire if we stay in the house long enough to see the rate surpass those same fixed rates.
- Some borrowers take advantage of offers by the lender to "buy down" to a lower interest rate; this is accomplished by paying points, which is simply a form of prepaid interest.
- Lenders may offer lower rates based upon some sort of affinity: for instance, if one has sufficient funds on deposit at a bank, he or she may be eligible for a nominally lower rate.
- Our willingness to shop our business around and to negotiate can affect the interest rate we will pay. The mortgage business is both competitive and increasingly impersonal, so I recommend that my clients obtain quotes regarding rates, fees, terms, and other related items from at least two potential lenders. If the lender considers you a fair credit risk and wants to compete for your business, then you are in a position to ask that certain fees be waived or even that the rate be lowered. Remember that you are usually dealing with a commissioned salesperson, somebody who has to get you to close the loan in order to make that commission, so ask for a better deal than the one offered to you.
- Finally, our credit ratings affect the interest rates we pay. This is an area where a minimal effort on your part can pay off handsomely - we will take a much closer look at credit ratings in our next issue.

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? ? ASK an Advisor ? ?

IS TAX PLANNING FOR ME?

by Linda Y. Leitz, CFP®, EA

Q. "Is it too late to do anything about cutting down last year's tax bill?"

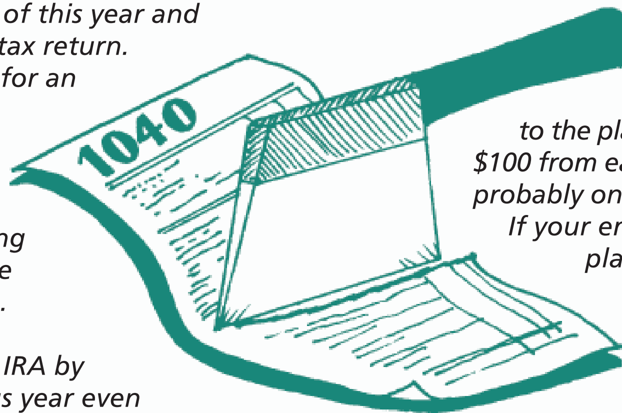
A. *For many people, it is too late to do much about last year's tax bill. But your financial advisor can tell you if one of these strategies would work for you. If you have earned income and aren't eligible to participate in an employer-sponsored retirement plan, you can make a contribution to an Individual Retirement Account (IRA) for up to $3,000 if you are under age 50 or up to $3,500 if you are 50 or older. This contribution can be made up to April 15 of this year and still apply to last year's tax return. Even if you are eligible for an employer-sponsored retirement plan, if your income is below specified levels for your income tax filing status, you might still be eligible for a deduction. And you can still make contributions into your IRA by April 15 for the previous year even if you don't need the deduction.*

If you are self-employed, you can fund a Simplified Employer Pension (SEP) for the previous year until the time that you file your final return. Given extension deadlines, this might be as late as October 15 of this year.

The government has also declared that cash donated to charitable institutions for the tsunami relief effort are deductible up through January 2005. So if you wrote a check on or before January 31, 2005, you can deduct it on your 2004 tax return.

Q. "If I've missed some opportunities for last year, what are some things that I can start doing for this year?"

A. *There are lots of opportunities if we plan ahead. Many people miss legitimate deductions every year because they don't know about them or just don't keep track of them.*



If you're still in the workforce, maximize what you put into your retirement plans. If your company provides a plan and they match a portion of your contribution, put in at least enough to get the company match. That's found money! Even if your employer doesn't match, put in what you feel you can afford. That will lower your taxable income while it's helping you save for retirement. In figuring what you can contribute to your retirement plan, don't subtract the entire amount you contribute from your cash flow estimate. Since the contribution isn't taxable this year, it saves most people between 20% and 30% of what they're contributing to the plan. So if you can start contributing $100 from each paycheck, your paycheck will probably only be lowered by $70 or $80.

If your employer doesn't offer a retirement plan, start contributing regularly to a traditional IRA. You can make a total tax-deductible contribution in 2005 of up to $4,000 ($333 a month) if you're younger than 50 or $4,500 ($375 a month) if you're 50 or older.

When you take items to charities that resell them, like Goodwill, Salvation Army, or a church thrift shop, you can actually take a deduction for what the charity can get when it sells the item. Most people will assume that a big garbage bag of outgrown clothes is only worth $25 or $50. If you make an inventory of the donated items and attach it to your receipt, you can then take the value of the actual items instead of a rough (low) guess. Your Cambridge Advisor can provide you with information about item values and the best way to keep track of your donations.

Your financial advisor can tell you some other strategies that are more specific to your situation. And remember, it's not about paying less tax than you should; it's about getting all the deductions to which you're entitled.