

# WEALTH MANAGEMENT REPORT

*Investment Planning & Wealth Management for Business Owners*

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## Japan's Two Lost Decades: Can It Happen In The U.S.?

**T**wenty years after Japan's "economic miracle" collapsed, the Asian nation still has not recovered its once-vaunted economic clout. Japan's debacle involved a spectacular jump in stock and real estate prices followed by an equally spectacular fall as those bubbles burst, much like the twin "pop" that sent the United States into a recessionary spiral in December 2007.

Does that mean Americans are doomed to spend the next two decades struggling to get their economic lives back? And what lessons can investors learn from the Japanese experience?

**Echoes of a debacle in Japan.** The start of Japan's so-called "lost decade" in 1990—which has stretched to two decades since that phrase was coined to describe Japan's extended economic malaise—was triggered by a period of irrational exuberance in the 1980s. Loose monetary policy fueled a rapid rise in stock and real estate prices. Driven by speculation, leveraged assets, and investing excess, Japanese industrial production rose by 50% during the 1980s, and by 1989 Japanese banks had become the largest in the world. When the bubble burst in 1990 and the economy collapsed, investors belatedly realized that much of the growth had been illusory.

The same thing happened in the United States during the period 2002 to 2007, as "easy money" policies, consumer spending, and foreign

investment pushed real estate and stock prices ever upward—until the bubble burst, sending over-leveraged financial institutions to the brink of bankruptcy and the U.S. economy to the edge of systemic failure. Two years later, the U.S. jobless rate surpassed 10%, businesses have trouble obtaining credit, and government officials are weighing further intervention in the economy even as the national deficit soars to unprecedented levels.



From an investor's point of view, the story is illustrated vividly by looking at the most-quoted stock market averages in the two countries. Japan's Nikkei average hit an all-time high of 38,957.44 intraday Dec. 29, 1989, then fell off a cliff. In 2009, the Nikkei never exceeded 10,800, and it nearly fell below 7,000 in March. In the United States, the Dow Jones Industrial average soared to a record intraday high of 14,198.10 on Oct. 11, 2007, then plunged as the economy deteriorated, dropping as low as 6,547.05 in March 2009 before rallying back above 10,000 in the last few months of the year.

**Why the U.S. should fare better.** While the similarities between the countries' boom-and-bust debacles are striking, there are also fundamental differences. For instance, the U.S. crisis is unlikely to be as deep and long-lasting as the Japanese downturn largely because the U.S. boom period did not even approach the stupendous

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## When To Take Social Security Is An Important Decision

**Y**ou've been paying Social Security tax your entire career, so it's only natural to look forward to the promised "payoff" in retirement. But Social Security isn't like other promises from the government. The benefits you're entitled to receive are actually a unique asset and should be considered in your investment planning.

The full retirement age for those born from 1943 through 1954 is age 66. It gradually increases to age 67 for those born between 1954 and 1960. If you choose to start receiving Social Security benefits at age 62, you'll get your money sooner, but the monthly benefit will be reduced by 25%. On the other hand, if you wait until age 70 to start receiving benefits, the amount is increased by up to 8% per year, in addition to annual cost-of-living hikes.

Let's say your monthly benefit at the full retirement age of 66 is \$1,000. Taking early retirement benefits at age 62 results in a permanent decrease to \$750 a month. But waiting until age 70 would produce a monthly benefit of \$1,320, a 32% increase.

Waiting to begin benefits isn't the best approach for everyone. Whether you should or could do it depends on numerous factors, including your marital status, current and anticipated cash needs, your health status and family history, if you plan on working during retirement, other sources of retirement income, and the projected amount of your Social Security benefit. We'll consider all these factors and help you decide how best to utilize this asset.

# Do You Know Estate Planning Basics?

**W**ith the future of the estate tax up in the air, you may be tempted to neglect estate planning. The federal tax on inherited wealth is currently scheduled to be repealed in 2010, only to return in 2011 under less favorable terms. Congress will most assuredly resolve this issue before year-end, perhaps exempting all but the wealthiest families from estate tax liability. Yet whatever the fate of the law, having a thoughtful, effective estate plan will continue to be crucial.

At a minimum, you need a legally enforceable will that lays out how you want your assets to be distributed. An accompanying, non-binding letter of instruction could further spell out your wishes. You may also want to establish one or more trusts designed to minimize taxes, manage assets for minors, provide asset protection for heirs, implement philanthropic plans, or protect assets from creditors. And a living will (or health care proxy) could provide valuable direction on end-of-life health care.

Are you familiar with estate planning basics? Use this quiz to test your knowledge.

## 1. Which of the following is true?

- a) A will is legally valid only if drafted by an attorney.
- b) You can transfer jointly owned

- property through a will.
- c) A will may appoint a guardian for minor children.
- d) Your property must go through probate if you don't have a will.

## 2. When can a will be changed and remain legally enforceable?

- a) Only if the changes are recorded by an attorney
- b) Only when the heirs named in the will provide their consent
- c) Any time before your death or mental incompetence
- d) Never

## 3. In 2009, the federal estate tax exemption was:

- a) \$1 million
- b) \$2 million
- c) \$3.5 million
- d) Zero

## 4. In 2010, the annual gift tax exclusion shelters gifts to individuals of up to:

- a) \$10,000
- b) \$13,000
- c) \$1 million
- d) Zero

## 5. For estate tax purposes, the value of assets is based on:

- a) Their fair market value on the date of the owner's death (or six months from that date)
- b) The amount received from the sale

- of those assets
- c) The assets' original cost
- d) The value stated in the owner's will

## 6. A "power of attorney" is best described as:

- a) A bequest in a legally validated will
- b) A document authorizing an agent to act on your behalf
- c) A document allowing life support systems to be shut down
- d) The use of a lawyer in estate planning matters

## 7. Which of the following is not true?

- a) The value of your principal residence is excluded from your estate.
- b) The value of property transferred to your spouse is exempt from estate tax at your death.
- c) A testamentary trust takes effect when you die.
- d) A will normally determines who will care for minor children.

If you have questions about estate planning or need to refine your plan, please give us a call. We can work with you and your attorney to make sure all of your needs are met. ●

Answers: 1-c; 2-c; 3-c; 4-b; 5-a; 6-b; 7-a

# Do You Know Your Health Care Facts?

**R**eforming the nation's health care system was the biggest single political issue of the past two years, prompting an unprecedented level of interest and debate. Unfortunately, the level of misunderstanding, on both sides, remains nearly as high as the level of passion.

How informed are you when it comes to health care? Take this quiz to find out:

1) Where does the U.S. rank worldwide in terms of health care, according to the World Health Organization?\*

- a) 1st
- b) 5th
- c) 37th
- d) 56th

2) What percentage of the U.S. gross domestic product consists of health care expenditures?

- a) 8%
- b) 16%
- c) 24%
- d) 39%

3) Federal spending on Medicare and Medicaid is what percentage of U.S. gross domestic product?

- a) 4%
- b) 8%
- c) 12%
- d) 18%

4) What percentage of Americans under age 65 has health care insurance through their employer?

- a) 34%
- b) 63%
- c) 76%
- d) 88%

5) What percentage of Americans under age 65 purchases health care insurance privately, directly from an insurer?

- a) 1%
- b) 4%
- c) 8%
- d) 16%

6) What percentage of national health expenditures comes directly out of the consumers' pockets, through deductibles, co-payments, and payments for services not covered by insurance?

- a) 2%
- b) 7%
- c) 13%
- d) 18%

# Moving Abroad Is No Tax Holiday

**T**he top few percent of taxpayers already contribute the vast majority of personal income tax revenue, and the top tax rate, 35%, is scheduled to rise to 39.6% in 2011, when tax cuts from a decade ago expire. New legislation could target even more of your income, and recession-battered states and municipalities are also eyeing higher rates, particularly for the wealthiest residents. It's enough to make you feel like getting the heck out of Dodge—perhaps emigrating to Switzerland or to one of the Caribbean nations that offer incentives to attract American millionaires. But before you pull up stakes for good, consider all of the implications, some of which have nothing to do with taxes. The benefits for expatriates may not be as promising as you expect.

To avoid paying U.S. taxes, it's not enough simply to leave the country; you'll also have to renounce your U.S. citizenship through a formal declaration of renunciation to the U.S. State Department. That's a major step you might come to regret. Once you voluntarily renounce your citizenship, it won't be easy to reacquire it if you change your mind, and as a non-citizen, you'll no longer be able to seek help from the U.S. Embassy if you run into trouble abroad. And moving out of the U.S. is likely to involve a dramatic

change in lifestyle, culture, and customs. (If you do decide to make the change, be sure to acquire citizenship in another country before you give up your U.S. citizenship. Otherwise, you may not be able to travel freely.)

Meanwhile, leaving the country may bring fewer tax advantages than it did a few years ago. Changes included in a 2008 tax law for military personnel—the Heroes Earnings Assistance and Tax Relief Act (known as HEART, or the Heroes Act)—have diluted the savings wealthy expatriates might otherwise realize from leaving the country. Now, if you terminate your U.S. citizenship, you're generally treated as if you had sold all of your assets on the day before expatriation, and you'll owe taxes on those implied proceeds. This rule normally applies to anyone who meets one of the following three criteria (though people with dual citizenship in the U.S. and another country as well as those who relinquish U.S. citizenship before age 18½ may be exempt).

- During the five-year period preceding expatriation, you had an average annual U.S. tax liability of at least \$145,000. That cut-off, which applies for those who give up their citizenship in 2010, is indexed annually for inflation.

- Your net worth is at least \$2 million.

- You fail to certify that you have satisfied all applicable U.S. obligations during the five years before expatriation.

If you are subject to this tax on expatriates, you're allowed an exemption of \$626,000 in 2010 (the amount is indexed annually). Then you'll be taxed at a 35% rate for ordinary income and 15% for long-term capital gains. Considering that these levies apply to all of your assets, minus the exempt amount, the tax is likely to add up to a hefty penalty for leaving the country and could undercut future benefits.

And what if you later want to do something for family members back home? U.S. citizens and residents who receive gifts or bequests from expatriates may be assessed a special transfer tax of 45%. The tax applies to property directly or indirectly acquired as a gift from someone who is an expatriate at the time of the transfer, as well as to any property received, directly or indirectly, due to the death of an expatriate. However, the transfer tax may be reduced by foreign gift or estate taxes paid on the property.

Special rules also apply to deferred compensation (such as retirement plan benefits) that you receive after giving up your citizenship. In most cases, 30% of those payments must be withheld to cover U.S. income tax liability.

Finally, there could also be problems involving state taxes. In California, for example, expatriates may owe state tax on real estate they continue to hold in the state.

No matter how frustrating you find your current U.S. tax burden—and regardless of how much that burden may soon rise—choosing to emigrate and give up your citizenship isn't a move to make without carefully considering all that it could mean. ●

7) Which of the following statements about Health Savings Accounts is true?

- Contributions are made on a pre-tax basis.
- The funds roll over and accumulate year over year if not spent.
- The funds can be invested, similar to funds in an individual retirement account.
- All of the above
- None of the above

8) The Medicare Trustees recently announced that the Medicare system is likely to start running out of money in what year?

- 2012
- 2017
- 2025
- 2038

**\*The World Health Organization rankings are from 2000, when the group stopped compiling the data, citing the complexity of the task.**

# Should Retirees Carry A Mortgage?

Your home mortgage is likely to be the biggest debt you ever take on. And if you've moved or refinanced a few times since your first home loan, you may be years or even decades away from owning your house free and clear. But that begs the question: What about retirement? If you're getting ready to retire or already have stopped working, does it make financial sense to keep making monthly payments? Or should you use some of your savings to retire that debt?

Traditionally, paying off the mortgage was a pre-retirement objective, but the recent trend has been to carry the debt longer. A study by the Center for Retirement Research at Boston College found that in 2007, 41% of households with people in their 60s still had a mortgage, even though more than half owned sufficient assets to repay the loan.

Why would you hold a mortgage in retirement? Depending on your situation, you may value the tax benefits and liquidity. Consider these four critical factors.

**1. Investment returns.** Recently, the average 30-year fixed rate for

mortgages has been well below 5%. You might keep your mortgage if you think you can do better investing the money you would spend to retire it. But retirees who invest heavily in low-risk vehicles such as bank certificates of deposit (CDs) and Treasury securities are likely to come up short. And though stocks and mutual funds may provide higher rates of return, they carry greater risks.

**2. Tax breaks.** You can generally write off mortgage interest if you itemize deductions. But people who claim the standard deduction—and that's almost two out of every three taxpayers—receive no tax benefit from mortgage interest payments. So if you're not an itemizer, it may make sense to pay off the mortgage. Also keep in mind that the tax benefit of itemized deductions will be reduced if your income is high.

**3. Retirement accounts.** It's generally not a good idea to pay off your mortgage if you have to invade your retirement accounts to do it. The money you pull out of a 401(k) plan or an IRA will be reduced by taxes—at ordinary income rates of as high as 35%—plus you'll be hit with an additional 10% penalty if you're under age 59½. And you'll be left with fewer funds to draw upon during retirement.

**4. Refinancing.** One alternative to paying off the mortgage may be to refinance it at a lower interest rate. That can reduce your payments, or you could use the opportunity to pull out equity you've built. But the deep decline in real estate values has underscored the risks of financial strategies built around home loans.

Choosing what to do about your mortgage is a major financial decision. We can help you choose the best approach for your situation. ●



## Japan's Lost Decades

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price increases seen in 1980s Japan. During the 1990s, Japanese real estate lost an average two-thirds of its value. In contrast, U.S. real estate prices are expected to fall 30% to 40%, although some areas, including Las Vegas, Phoenix, and Miami, have seen steeper declines.

Moreover, the U.S. economic structure is more open and fluid than that of Japan, where banks and major industries had a tendency to sweep problems under the rug, due to dysfunctional incentives created by the Japanese system of cross ownership between banks and their borrowers. In the United States, major banks have quickly (with the push of the

government) written off billions in bad debt in an attempt to get a recovery going without unnecessary delay.

But the most basic difference between Japan in 1990 and the United States today lies in the speed in which interest rates were lowered.

American economists, most notably current U.S. Federal Reserve Chairman Ben Bernanke, have criticized Japan's central bank for failing to reduce interest rates quickly enough during the early 1990s, with the delay spawning rampant, long-lasting deflation. Eager to avoid that mistake, the Fed has taken

several steps to cut interest rates and keep money flowing. And both the Bush and Obama administrations have pumped billions of dollars into the U.S. economy in the form of corporate bailouts and economic stimulus plans.

The crisis in the United States seems unlikely to mirror the Japanese experience, but it's impossible to know what will happen to stocks, real estate, commodities, and currencies in the near term. That is why it makes sense continue to maintain sensible diversification, an adequate cash cushion, and make sure that you are comfortable with the level of risk in your portfolio. ●

