

Spring 2006

The Pluses, Pitfalls and Performance of Hedge Funds

By: Matthew L. Roop, CFP®

During 1996 to 1999, the mean return on the S&P 500 was over 26 percent. To quote an old Toyota commercial, "Who could ask for anything more?" The 2000-2002 bear market, however, was one of the worst in the history of the United States. The numbers tell it all—the S&P 500 Index declined 9.73 percent, 11.80 percent and 21.53 percent in 2000, 2001 and 2002, respectively. Up until that period, hedge funds (private and unregistered investment pools that employ sophisticated investment techniques) were a relatively unknown quantity to the investing public. But after the bubble burst, investors sought hedge funds aggressively, hoping these

"alternative investments" could act like a tourniquet and stop the hemorrhaging of their portfolios.

Fueled by increased demand for hedge funds, the industry grew tremendously. Conservative estimates place the number of hedge funds operating in the U.S. in 1999 at 500-900. By the end of 2005, that number had increased to 8,500, with some estimates as high as 10,000. Since hedge funds are not required to register with the Securities Exchange Commission (SEC), it is sometimes difficult to get accurate data on them.

As money flew into the coffers of hedge funds during the bear market, many mutual fund managers left their posts to start their own hedge funds. Spurred by frequent reports of compensation in the tens of millions and the allure of managing money without regulatory oversight, these mutual fund managers hoped to cash in on the skyrocketing demand.

However, as is usually the case when some form of mania sets in, the peak of the interest in hedge funds coincided with the resurgence of the stock market. In 2003 the S&P 500 was up over 28 percent. The market's performance in 2004 was also strong, rising more than 10 percent. This made life more difficult for many hedge fund managers, as their performance relative to the broader market began to lose its luster. Many hedge funds closed their doors after unhappy clients pulled their money.

Much of the success of hedge funds in the early part of the decade lay in their ability to take advantage of inefficiencies in the markets. However, as the popularity and number of hedge funds rose, so did the amount of money chasing those inefficiencies. This eliminated many opportunities, making it

more difficult for managers to deliver good performance.

Poor performance and/or litigation issues caused the demise of many hedge funds. Spotty to non-existent reporting make historical performance statistics particularly susceptible to inaccuracies, as these reports do not always include funds that performed so poorly they no longer exist.

Finally, fees alone caused many people to reconsider investment in a hedge fund. Most hedge funds charge a standard two-percent annual fee. Moreover, they also charge performance-based fees, such as 20 percent of the fund's profits. To illustrate the impact of these fees, let us assume the S&P 500 increases eight percent in a given year. To deliver the same return to investors as a mutual fund, a hedge fund would have to improve by 12 percent before the fees are levied. (If the total gross return is 12 percent, the annual expense of two percent would reduce the return to 10 percent; then a 20-percent reduction of that number would reduce the total return to investors to eight percent.) In essence, the fund would need to beat the market by 50 percent to deliver similar returns.

While there are still many well-performing hedge funds, they seem to be fewer and farther between. We have yet to find a viable hedge fund option for our clients, although we continue to monitor this area for opportunities. Ultimately, we are looking for investments that can complement our clients' portfolios through low correlations with existing investments and deliver good risk-adjusted returns. We will continue to keep you apprised of our efforts.

Contact Matt if you have questions or would like additional information regarding this topic.

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From Elaine

Changing with the Seasons



There is nothing more beautiful than spring in Indiana—flowering dogwood and lilac trees, vibrant daffodils, tulips and fragrant hyacinths. This year all the colors seemed to

converge at the same time. What a refreshing uplift this season brings.

This year I also was able to experience springtime in Vancouver, Canada, where the Financial Planning Standards Board met in April. During this meeting, China became an Affiliate, which means it can issue the Certified Financial Planner™ designation to individuals who meet the standards, and Indonesia was accepted as an Associate member and will begin final preparations to allow its organization to certify individuals. With each meeting, it becomes more evident that international momentum is growing stronger.

One thing that remains strong on the home front is clients' concerns about

financial security in retirement. We hear these questions year round: Do I have enough money to retire? How much do I need to save before retirement to meet my goals? How much money can I safely spend from my investment portfolio? How long will my money last if I continue to spend at my current level? These are important questions that generally spark an even deeper discussion regarding lifetime goals.

Fortunately we have developed a program that can answer these questions and evaluate your progress toward your retirement goals. Using analytical software, we can run a thousand different scenarios, based on historical returns of different investment markets in combination with varying market cycles, and tailor the analysis to reflect changes in inflation rates, asset allocation and aspects unique to each client.

For example, a 45-year-old has \$500,000 in various savings accounts. Let us assume 75-percent stock market exposure until retirement, declining to 50 percent after retirement and a three-

percent inflation rate. If he wants to spend \$100,000 in retirement, beginning at age 60, he will need to add approximately \$70,000 per year of new money (personal savings, employer contributions to benefit plans, or other sources, such as inheritance) into his investments. This rate of investment will result in an 85-percent probability of funding his need through age 95. If you would like us to evaluate your progress toward your retirement goals, just let us know.

You will find information regarding hedge funds, family financial discussion forums, Roth Conversions, "1031 Exchanges" and changing ownership titles in this issue of our newsletter. We hope you find the information helpful. We will be happy to assist you with these issues and any other financial needs and concerns.

Sincerely,

Elaine E. Bedel, CFP®

Industry News

IRAs: Should I Stay Traditional or Convert to a Roth?

By: Dawn E. Morley, MBA

One of my favorite uses of the IRA is the Roth Conversion. Why? With a Roth Conversion, you take money or assets from your Traditional IRA and transfer them to a Roth IRA. Any amount, partial or total, can be converted. At tax time, you will be taxed at your ordinary income rate on the amount withdrawn from the Traditional IRA, but, once you meet the holding and age requirements for Roth IRAs, all income is distributed tax-free.

You can convert any Traditional IRA to a Roth IRA as long as your modified adjusted gross income is under \$100,000, without factoring in the conversion amount. You will owe income tax on the converted amounts, with the exception of funds representing non-deductible contributions previously made.

The benefits of a Roth IRA are highest if you are in a low tax bracket. For

example, if you are between jobs, your income drops and potentially your tax bracket drops also. This situation may be ideal for converting all or a part of your Traditional IRA to a Roth IRA, because the tax due on the converted amount will be relatively low. You might even consider rolling your inactive employer-sponsored 401(k) or 403(b), your Keogh or SEP IRA into a Traditional IRA and then converting it. A word of caution: If you withdraw money from a retirement plan but do not convert it to a Roth, you may be subject to a penalty if you are not yet 59 ½ years of age. Even if you are not penalized, the whole idea of a Roth Conversion is to let your money grow over a period of time.

A Roth Conversion may also be a good strategy in a year in which you incur high medical expenses. Medical expenses are tax-deductible as long as they exceed a percentage of your adjusted gross income. Deductible

medical expenses can significantly reduce your taxable income and make the Roth Conversion more beneficial. Retirees living from accumulated wealth have an opportunity to convert Traditional IRA assets to Roth IRAs at a low marginal tax rate. Entrepreneurs should also consider a Roth Conversion. Typically small business owners have at least a couple years of relatively low income before their businesses start turning a profit.

When making a new contribution to a Roth IRA, you have until April 15th of the year following the tax year in question. A Roth Conversion, however, must be completed by December 31st. It is important to be aware of all tax issues when using this strategy because there are complications and limitations and tax laws do change. Before converting your IRA, consult with us so we can assist you in determining whether this strategy is the best one for attaining your financial goals.

Client Dream — Client Reality

Family Discussion Forums

By: Kathy Hower, CFP®

You have worked hard to put together a financial plan, and now you are working toward your financial goals. But are your adult children aware of the resources you have accumulated for retirement and your plans and wishes for the future? If not, they should be.

Family meetings are a great way to pass this kind of information along to your children in an environment that is relaxed and non-threatening. You may prefer to have your financial advisor facilitate the meeting to help articulate your desires.

Besides providing a forum for discussing financial, estate and healthcare issues, family meetings can be used to communicate family values. These meetings also provide a venue for discussing future responsibilities of family members and for helping them prepare financially and emotionally for the future.

Possible discussion topics

The needs of each family are different, but here are some discussion ideas to consider for your family meetings.

- Your monetary values and educating your children about the importance of incorporating good monetary values through financial planning
- Your present and projected personal financial condition
- Your intentions for assisting with the needs of grandchildren
- The provisions of your estate plan
- Your personal representative and/or trustee of estate assets and the responsibilities associated with each
- Your wishes for the disposition of real estate, personal property and family heirlooms
- The location of your estate documents and list of financial advisors
- Your desires for your healthcare provisions and the responsibilities of those named as healthcare representatives
- Your funeral and burial wishes
- Your desire for the continuity of the family-owned business

Discussing your financial, healthcare and estate issues with family members



may be difficult at first. Therefore, we recommend holding a family meeting only when you are comfortable with sharing your personal information and only when you feel that your children will be able to understand the impact of the topics discussed. It may be necessary to conduct meetings on a routine basis, depending on the complexity of the issues and any changes that may occur.

Preparing for your family meeting

Once you decide to hold a family meeting, it is important to come prepared and to provide reference material for family members. The following information should be considered:

- A meeting agenda
- A list of all of your assets that have financial or sentimental value
- Copies of estate documents, account statements, insurance policies, etc.
- A spreadsheet of the contact information for all your financial advisors (estate attorney, accountant, insurance professional, investment advisor, financial advisor, etc.)
- A balance sheet reflecting your assets and liabilities (for reference during estate distribution discussion)

Remember, it is your responsibility to educate your family about your personal wishes and the resources you have put in place for their financial security. You may want to have your financial advisor assist with planning and conducting your family meeting. To learn more about organizing a meeting for your family, please contact us.

Contact Kathy if you have questions or would like additional information regarding this topic.

Your Questions

Taking Care of Your Assets

By: Julie Scheers, CFP®

Q: *Is there any way I can avoid capital gains taxes when I sell my investment property?*

A: Yes, you can do what is referred to as a “1031 Exchange.” The name comes from the Internal Revenue code section that created it. Effectively, you can sell a qualified existing property, purchase a “like-kind” replacement property and roll the capital gain into the new property. As long as you *exchange* one qualified property for another, you will not recognize the gain for tax purposes. Once you *sell* the replacement property, the original deferred gain and any subsequent gains from the replacement property are subject to capital gains taxes. Very specific rules and timelines must be followed for this transaction to work, but the option is fairly flexible, as the definition of “like-kind” property is rather wide. Real property encompasses property that has been held for investment or used for business purposes—generally land and, buildings. As long as you exchange your property for other property under this same definition, you have an appropriate exchange. For example, you could exchange a rental home for a warehouse, or a strip mall for an apartment building. Because the rules regarding 1031 exchange transactions are quite detailed, it is important to work with an advisor who is familiar with the process.

Q: *You advised me that my spouse and I should change the ownership titles of some of our assets for estate planning reasons. How do I do this?*

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Your Questions

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A: Here are some people or places to contact to get you started on the process. If you are changing titles on investment accounts, we can help you accomplish that. If you want to change a real estate title, your attorney must prepare a Quitclaim Deed for you to sign. This process will remove your name and allow the property to be titled to your spouse. Car titles need to be

changed at the Bureau of Motor Vehicles, which will issue a new title in the new name for the vehicle(s). Life insurance ownership can be changed through your insurance company, which will provide the appropriate forms upon request.

Contact Julie if you have questions or would like additional information regarding these topics.

New Addition to the Family

The Wendling family that is! Samuel David Wendling arrived April 4th to the tune of eight pounds, 15 ounces and 21 inches! Congratulations to proud parents Bill and Maurya and brother Calvin. Needless to say, Bill has already set up Samuel's college fund!

Quarterly Corporate Calendar

Bedel Financial Consulting will be closed for business on the following days:

May 29 - Memorial Day
July 3 - Day before Independence Day
July 4 - Independence Day

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