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Inside this Issue

1 New Self-Employed Retirement Plans

1 Market Update May 2003

2 Individual 401k's - socking it away

3 Are you between jobs and wondering what to do about your 401k?

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New Self-Employed Retirement Plans Can Guarantee up to a 55% Investment Return

By Daniel R. Sharp, Ph.D

In the 2000 census, over 200,000 adult Oregonians were identified as self-employed, which is nearly 10% of the working population and considerably higher than the national average. Eight percent of Oregon's metro workers are self-employed, and 11% of its rural workers.

With self-employment come special problems. Outside of the risk of entrepreneurship, the self-employed will pay both the employer and employee taxes. As a result, many incorporated self-employed search for ways to lower their w-2 income given the approximately 15% social security, Medicare, and local taxes on top of their normal personal tax rate. Sole proprietors face the same problem. An Oregon entrepreneur in the 27% personal bracket pays 15% + federal tax of 27% plus Oregon state tax of about 9%, meaning that they keep less than 50 cents for every dollar they are paid.

One-way to mitigate the nearly 50% tax rate is to contribute heavily to one of the small business retirement plans available to the self-employed, such as SIMPLEs, which work well for businesses with employees (see Note at end of article). However, many Oregon self-employed have no employees other than themselves or family members such as a spouse, parent, or child. Entrepreneurs in this situation can drastically reduce business taxes via a new streamlined type of plan under the 401(k) code commonly known as an **Individual 401k**. The new Individual(k) plan is a type of 401(k) plan that is different from the conventional

continued on page 2

Market Update May 2003

This quarter marked what we believe is the bottom of the three-year bear market (March 11th: Dow 7568, S&P 807), a decline of more than 45% from three years prior. The average investor did far worse during the last three years given their concentration on technology and growth stocks. The three-year bear has served an important purpose in that most of the excesses of the prior mania are now purged

continued on page 3

Retirement Plans.. cont. from page 1

401(k) plan typically sponsored by companies with multiple employees. The Individual(k) plan is - by design - made to fit owner-only businesses and businesses with employees that can be excluded under federal laws governing plan coverage requirements.

If you are self-employed and your business makes a profit that puts you in the 15-31% Federal Tax bracket**, contributing to an Individual(k) plan can generate an instant investment return on the tax savings anywhere from 38-55%.** Not taking advantage of this plan, if eligible, is passing up one of the main benefits the government provides to small business entrepreneurs.

Because the Individual(k) plan is designed for owner-only coverage, when compared to conventional 401(k) plans, the Individual(k) plan is less complex, less burdensome to administer, and less costly to maintain than its big brother. In most cases, opening an Individual(k) plan at a discount broker is as simple as opening any other type of account, whether an IRA or taxable account. There are virtually no reporting requirements until the plan assets exceed $100,000 and then only an annual 5500 report is required, which can be filed by any CPA when doing your business taxes. This almost completely removes the high administrative costs that made a regular 401k too expensive for most small businesses.

Lower administrative costs are only the start of the benefits. The Individual 401k allows each participant to put away a maximum of $40,000 per year in a retirement plan. A self-employed Oregonian in the 27% Federal tax bracket could realize up to $20,000 in instant tax savings – an instant return on your investment of 50%!

Here's how it works: As long as you earn at least $12,000, you can make a contribution of the entire $12,000 plus an additional 25% of your compensation up to the maximum of $40,000 in any contribution year.

Example: An Oregon entrepreneur has a small business in which her husband is also involved on a part-time basis. She earns $30,000 and he earns $16,000 for 2003. From previous tax filings they know they are likely to end up in the 27% Federal tax bracket. Their goal is to tax shelter as much of their income as possible, so they wish to make the maximum contribution allowed to each of their Individual(k) plans. The husband can make a contribution of $12,000 + 25%($16,000) for a total of $16,000 – or 100% of his compensation. The entrepreneur is allowed $12,000 + 25%($30,000) = $19,500, which is 65% of her income.

By fully-funding their Individual(k)'s, this couple has reduced their 2003 tax bill by over $23,000! This is over a 50% instant investment return on every dollar put in the 401k as opposed to paying taxes of over 50% on compensation. In addition, they are now starting a nest egg for retirement that will grow tax-deferred in their account until they reach at least age 59.5.

This example assumes several things. The couple has to have enough cash to fund the Individual(k), or has other sources of income to live on

continued on page 3…

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Retirement Plans ..cont. from page 2

given that they are socking away nearly all their business income into the retirement plan. The couple may not access this money once contributed without taxes and penalties until age 59.5, although they can take out loans on the their Individual(k)'s, just like the full-fledged 401k. The other assumption is that since the Individual(k) is a self-directed plan, the business owner bears the risk and responsibility of investing the retirement plan. Plan assets may be invested in stocks, bonds, real estate, or any other asset allowed by the plan custodian (deep discount brokers such as Bidwell or TD Waterhouse offer no-cost Individual(k) plans).

You can give 50 cents of each dollar to Uncle Sam, or, with the Individual 401K, you can give yourself an instant 50% investment return and save for your own future.

NOTE: The most popular plans over the past several years have been SIMPLEs, which can be thought of as business IRA's, with contribution limits of up to $7,000 per employee plus an additional 3% of salary contributed by the employer. This is still the best plan for the self-employed with plan-eligible employees since the employer's maximum obligation to them is the 3% match. Contribution limits will rise to $10,000 by 2008 and then will be indexed to inflation thereafter.

Market Update… cont. from page 1

and fear of stock market risk has been firmly reintroduced into the human psyche. Historically this has always been a necessary component to starting the next bull market. There are no more "new era" valuations and investors have returned to investment basics such as company fundamentals, earnings, and historical levels of valuation. Although additional testing of the low point is possible, we believe that the risk/reward ratio favors the development of the next cyclical bull market going forward.

Stock prices began and ended the quarter at similar levels, but by far the most significant event was the removal of uncertainty over the Iraq situation. In the beginning of the quarter the market faced the uncertainty of war and sagged as expected. Since then, the most probably outcome did indeed occur, a very quick, clean victory by coalition forces and the removal of the Iraqi regime – all in about thirty days. From a geopolitical standpoint, things could not have gone much better. With the conclusion of the war (as far as the market is concerned) stock prices made the roundtrip back to January levels and finished the quarter virtually unchanged, again as expected. The market was treading water while the war diverted investor focus away from the economy to the geopolitical. Now, back to the same levels we were at in January but without the uncertainty of war, investors again are focusing on the economy.

Pre-war economic indicators reflected both consumer and business uncertainty and reluctance to commit to spending, hiring, and

continued on page 4

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

Market Update …continued from page 3

other economic activity. Many of these lagging economic indicators are reflecting pre-war economic attitudes. As a result, GNP growth, manufacturing growth, hiring trends, and other measurements are still showing anemic economic growth at best. However, the leading economic indicators are much brighter. April consumer confidence jumped from a level of 62.5 in March to 81.0 in April, far above the expectation of 70 and the third largest rise in confidence ever. Corporate earnings are coming in very solid as most companies have grown so lean and mean during the past several years of economic difficulty that they are showing profit growth even though many still have stagnant revenues. The technology industry, which led the way into the recession, is showing signs of rapid improvement, as sectors from chips to telecom are starting to see some demand again. Energy prices are under control and starting to come down to pre-war levels. Alan Greenspan is also now saying that the economy is poised for a rebound.

Over the last two years this economy has weathered a huge bear market, terrorism, corporate scandal, and war and only briefly dipped into recession. Under the assumption that these hopefully one-time events cease for a time, we have an outstanding backdrop for economic growth.

Extremely accommodative monetary policy, an administration that knows that reelection depends on economic growth, record low interest rates, and a lean and mean corporate structure should all contribute to robust economic activity within six to twelve months. The market historically anticipates strong economic activity by about six months, meaning that stock prices could very well take off at any time over that period. We are confident that the worst is behind us and that investors can expect the next bull market to take hold this year.