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Investing In China: Weigh The Risk Against Rewards

With the Chinese stock market plummeting 9% in a single day this past February, is it time for bargain hunting? Maybe, but proceed with caution. China, as it has always been, is intriguing but shadowy, alluring but risky.

"China's economic fundamentals are tremendous," says Arijit Dutta, a mutual fund analyst at Morningstar, the Chicago-based research firm. However, making money from China's surge requires judgment, caution, and a limitation on what you'll put at risk.

In 2006, China's economy expanded an astounding 10.7%, about triple the rate of U.S. economic growth. The Hang Seng index—the benchmark for Hong Kong's stock exchange—soared, as did stock prices on China's two mainland exchanges, where values nearly doubled in 2006, according to the MSCI China Index.* This performance suggested that, after years of speculation and hope, China's potential as a global economic giant was beginning to be realized.

China's middle class, 150-million to 200-million strong, still represents only a fraction of the country's total population of 1.3 billion. But it's expected to double in size in the next five years, creating more new consumers than the world economy has ever seen from one country. Already, China's retail sales rank third in the world behind only the U.S. and Japan. And China is the globe's fastest-growing technology market, with record sales of computers and cell phones. Spending on homes, cars, and vacations is also growing quickly.

The global investment community is taking notice. Many professional investors remain cautious, having been burned in China's boom of the early 1990s, which went bust largely because of tight government controls. Since then, however, Beijing has moved from socialism toward capitalism, says Richard Gao of Matthews International Capital Management, advisor to several Asian mutual funds. While the political system remains under single-party Communist rule, a wave of privatization resulted in several huge initial public offerings in 2006. The Bank of China's IPO in Hong Kong in mid-summer 2006, for example, raised $11 billion.

"Reforms in state-owned enterprises, the banking sector, and housing have made the whole economy more efficient and productive," says Gao.

Against this backdrop, Zhiwu Chen, professor of finance at Yale University and a China expert, favors a broad array of sectors including retail, financial, travel, technology, energy, and alternative energy. "The window of opportunity is large," he says. Despite this, Chen warns investors to limit their exposure, allocating only a small portion of a portfolio to China.

One problem is China's confusing mix of share classes and rules of ownership. Class A shares, traded exclusively on exchanges in Shanghai and Shenzhen, are mostly inaccessible to foreign investors, who tend to own Class H shares, listed in Hong Kong, or American depositary receipts traded in New York. Foreigners must pay a steep premium on their shares.

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Retirement Is No Longer What It Used To Be, So Plan For That

Four years from now, one in seven Americans will be old enough to retire. For members of the Baby Boom generation who are approaching the traditional retirement age of 65, retirement is unlikely to follow the pattern of our parents and grandparents.

For one thing, advances in medicine mean tomorrow's retirees will live longer. A 65-year-old today has a better-than-even chance of living another 20 years; one in three will live to age 90. As the length of the typical retirement stretches out, retirement assets will have to stretch with it to ensure that you don't outlive your money just when you might need it the most.

Meanwhile, the very definition of retirement is changing. Today's seniors are enjoying lifestyles that break the sedentary mold of previous generations. Instead of sitting at home—not that there's anything wrong with that!—reflecting on memories of past exploits, they're making new memories through travel, active hobbies, and philanthropic work. Naturally, all these pursuits cost money, but many members of the 65-plus crowd are staying in the job market as well, some to earn the extra income, but plenty simply find the work rewarding in itself.

Retirement planning isn't about retirement anymore. It means planning to keep busy with leisure activities and maybe even planning to work through your 60s and 70s. We're here to help you plan that kind of retirement.

John R Day Bill Ennis

A Skeptical View Of Variable Annuities

Variable annuities (VAs) soared from obscurity a decade ago to have $1.3 trillion in total assets in late 2006, according to the National Association for Variable Annuities. However, many skeptics say VAs are popular not because they're great for investors, but because they're usually great for the people selling them. VAs are often laden with punishing fees that can drain the value of your account.

VAs are not all bad. Indeed, some individuals can benefit from a VA. It provides tax-deferral for investments, just as a 401(k) or IRA does. Unlike an IRA, there's no limit on contributions and no mandatory withdrawals. You can put your money in a wide range of professionally managed subaccounts, very much like mutual funds. And if you happen to lose money and die while the account is down, your beneficiaries could receive a death benefit. In addition, many VAs offer a "living benefit" rider that promises minimum lifetime income regardless of investment performance. With all these benefits, VAs make for a great sales pitch, and that makes it especially important to be aware of the drawbacks.

Bells and whistles can make a VA seem complicated, but the basic structure is simple. An insurance component provides a benefit upon your death and allows a VA its tax-deferred status under U.S. tax law. You decide how you want your account invested, dividing money among a menu of mutual fund-like subaccounts. Like other tax-deferred accounts, VAs permit penalty-free withdrawals after age 59½. Before that, there's a 10% tax penalty on your policy earnings. All withdrawals of earnings, whenever they're made, are taxed as regular income.

The biggest problem with VAs is that fees tend to be extremely high. They impose insurance and administrative expenses on top of management fees for the subaccounts. Fees can be in excess of 2% of your assets annually. There may also be annual contract charges and sales loads on investment subaccounts.

Meanwhile, the death benefit isn't likely to be much. There are scenarios in which it would be valuable—for example, if you died shortly after making a large investment and the market had dropped sharply. But that just doesn't happen very often. According to LIMRA International, an insurance research group, only three of every 1,000 VA contracts are surrendered because of death or disability.

Taxes are another shortcoming. When money comes out, it is taxed as income at rates of up to 35%. Compare that with the top rate of 15% on most long-term capital gains and qualified dividends in taxable accounts. Several states also impose additional taxes on VAs. And while the tax advantage for mutual funds may be partially offset by tax-deferred compounding within a VA, it could take many years of tax-deferral for a VA to come out ahead.

There's also the tax treatment of inherited VAs. Heirs, like any other account owner, are subject to tax at income rates on withdrawals. In contrast, the tax basis of an inherited mutual fund is stepped up to its value when it passes to your heirs, so that gains you earned during your lifetime aren't taxed at all.

The final indignity? If you experience buyer's remorse after purchasing a VA, you'll probably have to pay a surrender charge of as much as 7% to get your money back. While VAs may be right in some circumstances, we are here to serve as your trusted advisor in evaluating such sales pitches. ●

As Exchange Traded Funds Become More Sophisticated,

In their early incarnations, exchange-traded funds (ETFs) were the soul of simplicity. Like index mutual funds, ETFs typically track market benchmarks, giving self-directed investors a low-cost way to achieve returns in line with the performance of, say, the Standard & Poor's 500 stock index. Yet an ETF built around a broad index is usually more tax efficient and has lower expenses than a similar index mutual fund; moreover, because ETFs trade like stocks, they can be bought or sold whenever markets are open. As more ETFs become available, however, they've become increasingly complex and expensive, making it more difficult to integrate them into a portfolio.

Much of the problem involves so-called specialty ETFs based on newly designed or exotic indices. Typically, an ETF packager will come up with specific screening criteria—to be included in an index, for example, a stock might need to pay dividends or meet certain capitalization requirements. In launching the new fund, the investment company will present the results of "back-testing" showing that such an index would have had an outstanding record during a specified historical period. While in some cases that may continue to be a winning formula, great (and theoretical) past performance could also reflect developments unlikely to be repeated.

Some indices may be too narrow or esoteric to serve as the source of a stable, well-diversified ETF. One private equity ETF, for example, is based on an index with less than three dozen components—a far cry from the hundreds in the S&P or another broad-based, well-established benchmark. And low trading volume of relatively illiquid shares can lead to wide spreads between the bid and asking price of an underlying security in the ETF and to performance that deviates significantly from the index.

Meanwhile, creating specialty indices and finding component companies can be costly, and annual

Five Financial Ideas For Grandparents

Spoiling your grandchildren with extravagant gifts may be fun, but you're not really doing them—or yourself—any favors. Instead, it may be wise to look for ways that help grandchildren but that also make financial sense for all of you.

Your long experience handling money matters is one invaluable gift you can pass along. Sharing your savvy not only helps grandkids develop healthy financial habits but also to understand family and cultural values. So tell them about your first job, how you started a business, and financial goofs you've made, such as spending too much or getting suckered into bad investments. "There's a big legacy gap," says Nathan Dungan, author of *Prodigal Sons and Material Girls: How Not to Be Your Child's ATM*. "Grandparents aren't having these conversations with the grandkids."

But don't leave your own children out of the loop. Make sure your advice and giving strategies don't conflict with their plans or guidance for your grandchildren. Here are several ways you might help:

Leverage your gifts. A grandparent can now give as much as $12,000 a year tax-free to each child and grandchild. If you have a large family and make such gifts for several years, you could substantially reduce your taxable estate. But rather than simply putting cash in the grandchildren's pockets, consider creative alternatives. For example, you might open a custodial savings account for a grandson and match what he saves. Or you could establish a brokerage account and use your contributions to help your granddaughter learn about investing. But stick to broad mutual funds rather than individual stocks. Choosing the wrong stock could lead to deep losses and discourage your would-be Warren Buffett.

Take care of college. Setting up a state-sponsored 529 college savings plan for your grandchild brings benefits for both of you. Start early and kick in the annual gift-tax-free maximum, and your grandson or granddaughter should be in fine shape when tuition comes due. Money in 529 plans grow tax free and withdrawals for qualified college expenses aren't taxed, either. And, if you want to accelerate giving, you can make five years' gifts—a maximum of $60,000—all at once. Moreover, because you control the plan, you don't have to worry about a spendthrift scion squandering the money. And, if you didn't get around to starting a 529? Consider sending a tuition check directly to your grandchild's college. It won't count against your $12,000 annual gift-tax exemption.

Put a roof over their heads. First-time homebuyers often earn enough to qualify for a mortgage but lack cash for a down payment and closing costs. Your gift could make up the shortfall. But there are other options, too. You could make a low-interest or interest-free loan, though that may raise complicated tax issues. Or, if qualifying for a home loan is a problem for your grandchildren, you could co-sign a mortgage. Some financial companies offer programs allowing grandparents to pledge securities as collateral for a grandchild's mortgage, so you can lend a helping hand without the expense and taxes of liquidating personal holdings.

Guide with your gifts. One alternative to direct giving is to fund one or more type of trusts, which can be customized to fit many financial and personal situations. An incentive trust, for example, could be instructed to distribute funds to your grandchildren in installments, at specified points in their lives, and may tie payouts to your grandchild's accomplishments—reaching a certain income level, for example, or getting a college or graduate degree. But tread carefully, warns Dungan. "You need to help a grandchild develop healthy financial habits before trust distributions start," he says. And be careful about the kinds of hurdles you set up. "You want your grandchildren to be connected to their life passions, not yours, so don't strive for too much control," he suggests.

Encourage philanthropy. There are several options for helping your grandchildren learn the value of charitable giving, and many of these vehicles also offer estate tax advantages. For example, you could transfer assets from your estate into your own family foundation, though to be effective, a family foundation needs an initial commitment of as much as $1 million. Your grandkids could get involved by helping screen grant applications or serving on the foundation's board. A less expensive alternative is a donor-advised fund, which also lets grandparents and grandchildren confer about what charities to support. "This is like having your own foundation to support causes you believe in, but without the hassles and paperwork that go along with operating one," Dungan says. ●

Managing Them Requires More Care

expense ratios for some new ETFs are 70 basis points (0.7%) or more, compared with less than 10 basis points for many broad-market ETFs. And ETFs bring another cost—trading commissions. The smaller your investment in a particular ETF—and by their nature, specialty ETFs should make up only a sliver of your overall portfolio—the more significant trading costs become.

These caveats don't mean a particular specialty ETF doesn't deserve a place in your portfolio. Depending on your goals, risk tolerance, and timetable, using an ETF to invest in, say, private equity might be appropriate. Money is flooding into private companies, and because private equity tends not to track the performance of public markets, adding this asset class to a portfolio could enhance diversification. But making a call on a specialty ETF means considering many factors about the fund and your portfolio.

It's wise to understand an ETF's investment objectives, risks, and expenses before you invest, and to read the fund's prospectus. We're here to help you make sense of all this, provide you prospectuses and give any you information you need to understand these increasingly complex instruments and our recommendations about how to use them in your portfolio. ●

State, City Fiscal Woes Hurt Muni Bonds

America's cities and states have a problem—and so could anyone who invests in them by holding municipal bonds. But careful planning could help you continue to enjoy munis' tax-free income while minimizing your exposure to potential losses.

To understand the dimensions of the current trouble, consider New York City. Though New York has said its pension fund will have all the money it needs to meet future obligations—and has enhanced city workers' benefits—the calculations it uses don't comply with accepted government accounting rules. Gauged by other accounting methods, New York's pension fund could be as much as $49 billion short, according to the city's chief actuary, and dozens of other major cities and state governments are in similar situations. The stock market plunge of 2000 through 2002 knocked a big hole in many public pension plans, and years of low interest rates have exacerbated the situation. Add in the expense of health care for future state and municipal retirees and matters get considerably worse. How bad is the problem?

- According to estimates by Standard & Poor's, the pension shortfall for U.S. states, cities and counties totals more than $280 billion.
- Also looking at Standard & Poor's data but applying different accounting methods, a report by Lord, Abbett & Co. of Jersey City, New Jersey, comes up with a much higher estimate: $700 billion.

Meanwhile, other benefit costs are also putting pressure on state and local governments. Currently, they can simply pay health and other non-pension benefits as costs are incurred. But that will change in June 2008, when all states and most cities must begin to factor future costs into annual budgets. With the price of health care and other retiree costs expected to skyrocket, this shift could endanger the fiscal health of state and local governments.

How will these trends affect your municipal bond holdings? It depends on how officials respond. They could raise taxes or cut services. But neither of those moves are popular with voters, so state and local governments are more likely to flood the market with new debt, using higher yields to spur demand. That could hurt the prices of existing bonds paying lower rates. Several states, including California, Illinois, and Kansas, have already issued new bonds to close gaps in pension funding.

Meanwhile, as the balance sheets of state and local governments begin to look less solid, bond rating agencies may downgrade some municipal bonds. That, too, generally hurts bond prices, as investors shy away from increased credit risks.

If you're buying the newly issued municipal bonds, you could benefit from higher yields. But not all new bonds are created equal.

- Bonds tied to specific projects, such as building roads, sewers, or a new stadium, may fare better than general obligation bonds issued to cover pension or health care shortfalls.
- Geographic diversity in a municipal bond portfolio can temper risks, particularly if it includes regions where growth is strong and government finances healthy.

If you're concerned about how state and city fiscal troubles might affect your muni portfolio, we would be happy to review your situation with you and see whether adjustments are needed. ●

Investing In China

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The Communist government maintains majority interests in most Chinese companies, and "minority shareholders' rights are not always a priority," says Gao. Chen says Chinese companies still have a long way to go in terms of improving corporate governance and disclosure, as well as abiding by international laws and accounting standards. "Transparency is key for foreign investors," Chen says. "And transparency for the most part is lacking in China."

Still, with one-fifth of the world's population being Chinese and the rapid growth of the economy, this is not a market to be ignored. More than 1,100 U.S.-based mutual funds, out of a universe of some 6,500, have exposure to Chinese assets, according to Morningstar. But only a dozen or so funds focus exclusively on China or invest more than 10% of assets in Chinese holdings, mostly because risks are great and the pickings slim, says Morningstar's Dutta. "There just aren't that many Chinese stocks a fund could own, because of restrictions on foreign ownership and the difficulty of conducting adequate due diligence," he says.

Rather than investing in a fund that holds only Chinese stocks, it may make more sense to buy a diversified emerging markets fund, whose manager isn't restricted to Chinese companies. Placing a small portion of a portfolio in emerging markets stocks often is a sensible approach. But you should expect setbacks now and then.

The potential for political unrest is likely to grow as China's closed Communist-controlled political system increasingly comes under pressure to open up. Meanwhile, with a banking system not open to public scrutiny, corruption and secretive corporate dealings are bound to be exposed as this economic giant makes its shift toward capitalism. Currency risk, therefore, is another significant risk.

Despite its risk, China remains an intriguing market. But you'll need a long-term perspective and strong stomach when your investment tumbles, as it is likely to do from time to time. ●

*** The MSCI China Index is an unmanaged index of Chinese stocks only available to foreign investors, and the Hang Seng index is an unmanaged index comprised of stocks representing the 33 largest companies in China. You cannot invest directly in an index. Your return in an investment that attempts to mimic an index's performance may be worse than an index's.**

Before making any investments in a mutual fund or ETF, always read the fund's prospectus, which can be obtained by calling our office or from the fund company directly.

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