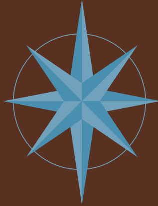
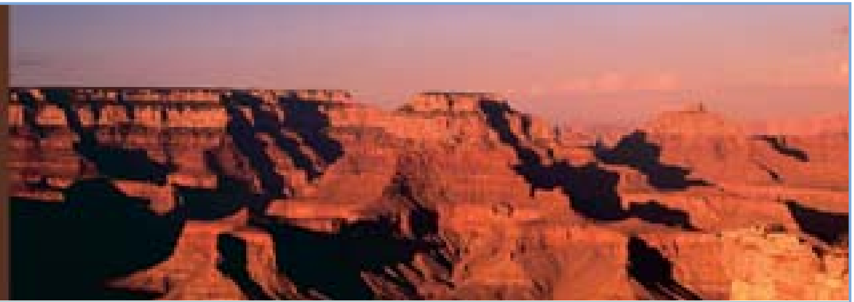

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Third Quarter 2007

The Dollar Is Weak And It Has Affected U.S. Investors

For many Americans, the dollar's decline during the past few years has sparked anxiety about the economy and international competitiveness. But for investors, the dollar's recent weakness has brought more good news than bad, serving to multiply the returns of investors in many foreign stock and bond funds. The likelihood that the greenback will continue to lose ground could be a reason to increase a portfolio's international exposure. Yet any bet on the future direction of currency markets is chancy at best.

What's behind the dollar's recent slide? A major factor is record U.S. trade and current account deficits that now exceed 6% of the U.S. gross domestic product (GDP). The U.S. is spending far more than it earns, and that increases the number of dollars in foreign hands. That trend, coupled with the impact of strengthening European economies, pushed the dollar down more than 11% against the euro in 2006, and by more than 55% since May 2001. Moreover, during the past five years, the dollar has fallen more than 25% against the Canadian dollar and 8% against the Japanese yen.

The dollar's future direction is tougher to gauge. In early 2007, robust U.S. economic data appeared to reduce the likelihood the Federal Reserve would cut short-term interest rates, and that led the dollar to gain value against other currencies. That early performance, along with other factors, led Neil Miller, a London-based currency analyst at Bank of New York, to revise his 2007 forecast for the dollar upward, though he expected any appreciation to be limited by the U.S. current account deficit. Barring any "exogenous shocks," such as new wars or sharply escalating oil prices, David Gilmore, of Connecticut research firm Foreign Exchange Analytics, expected the dollar to hold relatively steady for the time being. While Gilmore had thought a repeat of last year's 12% to 13% declines versus European currencies was "probably not in the cards," the dollar had indeed fallen about half that amount during the first five months of 2007.

Ongoing pressures on the dollar are significant. For one thing, though it continues to be the world's favored reserve currency, central banks have begun to diversify their holdings, according to Ashraf Laidi, currency analyst with CMC Markets. For example, China has reduced from 85% to less than 70% the proportion of its $1 trillion in foreign exchange reserves held in U.S. dollars, and Russia and Great Britain have followed similar strategies. Moreover, the European Central Bank and the Bank of England have been raising interest rates at a time when the U.S. Federal Reserve has been holding rates steady. Higher rates tend to attract currency investors and boost local currency values.

Whatever happens next, however, it's clear the dollar's recent weakness has been a boon for much of the U.S. economy. It has reduced prices of exports and drawn in bargain-hunting foreign tourists. It has also given record numbers of U.S. investors a good reason to look abroad for returns from international

(Continued on page 4)

Ranks Of Millionaires Skyrocketing Across The Globe

According to *World Wealth Report 2007*, from Merrill Lynch and Capgemini, 9.5 million people now have a net worth of at least $1 million—excluding their residence. That's 8.3% more than could claim that distinction a year earlier. The aggregate wealth of the world's millionaires grew to $37.2 trillion, nearly three times the U.S. gross domestic product.

Country	% Increase In Millionaires
Singapore	21.2%
India	20.2%
Indonesia	18.0%
Russia	15.5%
United Arab Emirates	15.4%
South Korea	14.1%
United States	9.2%

Asia's millionaire ranks swelled particularly fast. Singapore now has 21.2% more millionaires than in 2005, and India and Indonesia posted 20.2% and 18% gains, respectively. Russia, the United Arab Emirates, and South Korea also coined plenty of new millionaires, adding 15.5%, 15.4%, and 14.1%, respectively. In the U.S., the number grew by 9.2%.

By this gauge, North America is the wealthiest continent, with 11.3% of the world's millionaires. Europe and Asia-Pacific follow with 10.1% and 8.4%, respectively. Latin America, though it has just 5.1% of the global allotment, grew most, expanding by 23.2% from 2005. Moreover, Latin America has the highest proportion (2.4%) "ultra-high net worth" individuals, with a minimum wealth of $30 million. Africa is next with 2% in that category, and North America has 1.2%.

The rich are getting richer, and they have more company than ever before.

College Inflation Boosts Prepaid Plans

Which do you think will increase faster: the value of an investment portfolio or the cost of college? If you expect the two to rise more or less in tandem, you may want to consider investing in a prepaid 529 college savings plan for your child or grandchild. By letting you prepay tuition at today's prices for an education that may be decades away, you take college inflation off your list of financial worries.

Most prepaid 529 plans are administered by the states and cover tuition at state schools only. But a private alternative, the Independent 529, set up in 2003, lets you prepay costs for hundreds of private colleges.

Suppose you open a prepaid 529 plan for your newborn granddaughter in 2006, and contribute $1,000. Assume that the current tuition at the college your grandchild will eventually attend is $30,000. By investing now, you're purchasing a tuition credit worth one-thirtieth of a year's tuition.

Now, let's say tuition rises by an average of 8% a year. That's the annual average for the past 30 years, according to the College Board. In 2024, when your granddaughter enters her freshman year of college, tuition would be $111,001—almost four times what it is today—and your credit, for one-thirtieth of a year's tuition, would also have nearly quadrupled, to $3,700. You'll have gotten an 8% annual return, but even more important, you'll have kept up with college inflation. (This hypothetical example doesn't represent the performance of any product.)

How does that compare with a 529 college savings plan in which you invest in savings vehicles offered by a plan? It depends, of course, on the investment option you choose and the return it achieves. But for the sake of comparison, suppose you've invested in a bond mutual fund that matches the performance of the Lehman Brothers Aggregate Bond Index. For the 15 years ended December 31, 2006, the index achieved an average annual return of 6.5%—much less than the hypothetical 8% earned in a prepaid plan. Stocks, meanwhile, have done better historically, with the Standard & Poor's 500 stock index gaining an average of 10.64% annually in the same period. These returns assume reinvestment of dividends and don't reflect fees, expenses, and taxes you'd pay. (Also, keep in mind that you cannot invest directly in an index.)

The Rising Cost Of College
Average annual increases in tuition, 1990-2006

Year	% increase
2006	5.9
2005	5.94
2004	5.97
2003	5.99
2002	5.80
2001	5.48
2000	5.25
1999	4.56
1998	5.24
1997	5.16
1996	5.05
1995	5.32
1994	5.44
1993	5.99
1992	5.79
1991	7.61
1990	7.83

Source: The College Board

Because it's impossible to know how stocks or bonds will perform during the next 20 years—or how much tuition will rise—you can't be certain which kind of plan will give you the better return. Choosing a prepaid plan, however, ensures you won't lose ground to college inflation (assuming, of course, that the state or Independent 529 plan makes good on its promise).

However, prepaid plans restrict student choices. Your child or grandchild may not be inclined to attend any of the schools covered by the prepaid plan you've chosen. Worse still, if you opt to not attend a college covered by your prepaid plan, some plans pay you a below-market return. So even a prepaid 529 can be a gamble.

It's wise to consider a plan's investment objectives, risks, charges and expenses carefully before you invest. A plan's official statement contains this and other information and should be read carefully before investing. You should also consider whether your home state—or your beneficiary's—offers any state tax or other benefits available only to residents. We're here to help you with any of this. ●

A Defined Benefit Plan Lets You Sock Away Large Amounts If

Is your 401(k) not enough? With a Defined Benefit (DB) plan, you can sock away around $2 million for retirement over a relatively short period of time while deferring taxation. Plus, you can still contribute to a 401(k), SEP, or other personal retirement account. If you've gotten a late start on retirement saving, a DB plan could help you quickly catch up. But it won't have much effect unless you can afford to fund it generously—for yourself and your employees.

Unlike a Defined Contribution plan, such as a 401(k), which is built around what goes into it, a DB plan is based on what comes out during retirement. A fully funded plan could guarantee that you'll receive as much as $2 million, either in a lump sum or as annuitized payments. To make sure you get there, actuarial calculations determine how much you must contribute each year. The size of that annual contribution is influenced by many factors, including the number of employees participating, their age and salary, and performance of the plan's investments. In good years for the market, your contribution may be smaller, while a weakmarket could require you to write a larger check.

A DB plan lets you receive an annual benefit equal to 100% of your company salary, up to $180,000 a year, until your benefit reaches the $2 million limit. With no limit on the annual contribution, a DB plan can be the ultimate catch-up tool for retirement for a small business owner with few employees and who is nearing retirement. Assuming you have the cash to make the maximum contributions allowed, you could accumulate $2 million in as little as a decade, depending on the return on plan investments. Meanwhile, you can

Retirement Spending Just Isn't The Same

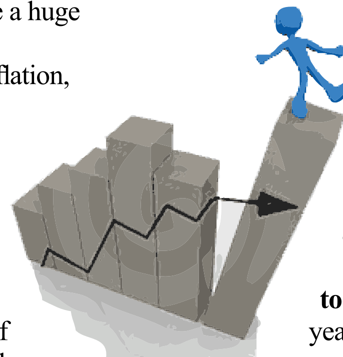
Since the Depression, most Americans have been guided by a simple retirement spending strategy: Don't touch your principal, and sell stocks only as a last resort. The approach worked well for many generations, when retirement seldom lasted more than a decade and people could live comfortably on bond interest, stock dividends, and a monthly pension payment. But times have changed. Today's retirees live longer and bear much more of the responsibility of paying for retirement, and simply depending on income spun off by investments may not work.

"Dividends, Social Security checks, and clipping coupons aren't enough for most people," says Moshe A. Milevsky, who teaches retirement income planning and risk management at York University in Toronto. "It's unavoidable that you're going to have to consume capital. The question then becomes how to do it intelligently." Finding a way to use your nest egg wisely—drawing it down gradually without depleting it during your lifetime—means taking into account many facts of retirement life.

Inflation can be a game-breaker. "Most people don't understand inflation," observes Mitch Anthony, author of The New Retirementality. "But to see what it will do in the future, look backwards. Consider the cost of a gallon of gas or a postage stamp 30 years ago. Remember your first paycheck? What kind of life would you have living on that paycheck today? Well, that's what you'll be facing 30 years from now. If you don't get your arms around inflation, you're in trouble."

Retirement spending needs may be higher than you expect. Future levels of spending, too, may be hard to gauge. It's easy to underestimate what you'll need. Health care costs are rising faster than the general inflation rate. Your family could experience an unexpected problem, such as a child needing support. Separating your expenses into discrete goals with specific timelines and then factoring in the appropriate inflation rate is wise. You can't take one lump sum and inflate it for 30 years. Do it in pieces, because different costs rise at different rates. That didn't matter when people lived just five or 10 years after retirement. But it can make a huge difference today.

Taxes matter. Like inflation, taxes eat into retirement income, and it's essential to have a retirement plan that minimizes their impact. One major tax-related question involves which source of capital to tap first. The general rule of thumb is to sell from taxable accounts first, tax-deferred accounts next, and tax-free accounts last. Redeeming investments in taxable accounts may result in capital gains, but those are taxed at a much lower rate than income from a 401(k) or IRA. "There's a delicate balance between trying to keep assets tax sheltered and the risk of pushing yourself into a higher tax bracket and losing more of your Social Security benefits," warns Milevsky.



Risk isn't always a four-letter word. Living into your 90s means taking investment risks. But longer retirement time spans also mean weighing different kinds of risk. Bonds, long a favorite retirement asset, generate income and tend to be less risky than stocks. Over three decades or more, however, bonds have barely kept up with inflation, and that poses another risk—of running out of money. "The whole 'don't tap the principal' idea can be damaging if it leads you to hold the wrong assets," says Milevsky. "If you're 57, say, and have 30 years to live, you can afford the risk of owning stocks."

Real estate is an asset, too. "During the past 10 to 15 years, our homes have been excellent investments, and our income planning should reflect that, says Bob Curtis, whose company makes MoneyGuidePro, software for wealth managers. Today, real estate is part of your overall available assets." You don't want to treat your home like other investments, but tapping your home's equity through a home equity loan, reverse mortgage or by downsizing to a smaller house is worthy of consideration.

A cash cushion creates comfort. Whereas during your working years you may need to set aside enough cash to cover six months of expenses, during retirement a cushion of one to two years may be better. "This is about meeting emotional needs," Curtis says. "Cash gives you an anchor. If the market turns bad, you'll be more comfortable sticking with your financial plan if you know you have that cash buffer." ●

You Can Overcome Some Obstacles

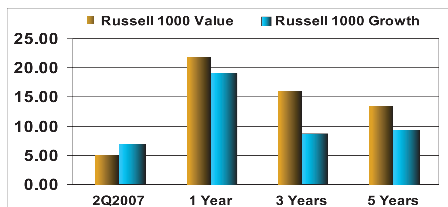
continue to fund your own Defined Contribution plan, deferring taxation on another $45,000 in income each year.

The chief drawback to a DB plan is that if you have employees, you'll have to fund their retirement benefit, too. That may not be a huge burden if your workers are mostly young and earning low salaries. But if you're paying into the plan for well-paid employees nearing retirement age, the total contribution required could amount to a substantial drain. In general, any employee who is at least 21 and has worked for the company for a year or more must be covered by your plan.

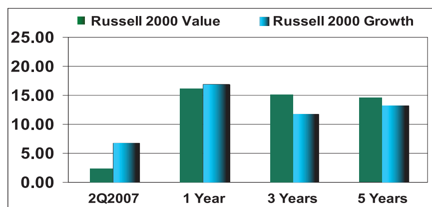
Of course, making contributions for employees won't be an issue if yours is a one-person business. In fact, even those without a corporate structure may establish a DB plan.

DB plans offer estate planning advantages. If your plan is set up to continue payments to a surviving spouse after your death, the ongoing income won't be taxed as part of your estate, though your spouse will pay income tax on the payouts. In contrast, an inherited IRA or 401(k) could be subject to estate tax. ●

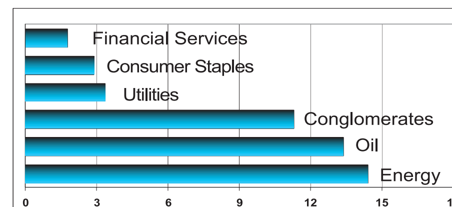
Market Data Bank: 2nd Quarter 2007



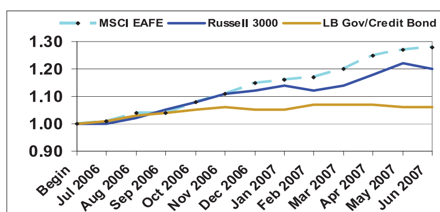
LARGE VALUE VS. LARGE GROWTH
While large-cap shares remained dominant in 2Q07, signs of a brewing economic expansion shifted investors' focus to growth. Large growth gained 6.9%, versus large value's 4.9% return.



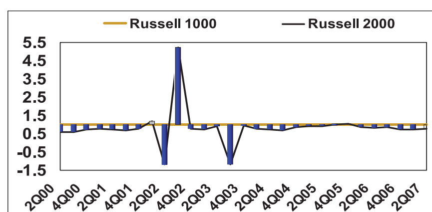
SMALL VALUE VS. SMALL GROWTH
The quarter's growth bias was more pronounced at the smaller end of the market, where companies with growth potential outperformed their value-oriented counterparts 6.7% to 2.3%.



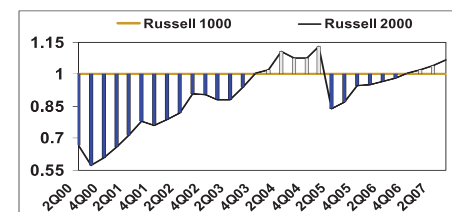
THREE BEST AND WORST SECTORS
All 11 Russell sectors delivered positive returns in 2Q2007. High fuel prices helped push diversified energy companies and oil producers to the top, but interest-sensitive financial services firms lagged.



FOREIGN, US STOCKS & US BONDS
From July 1, 2006 to June 30, 2007, U.S. U.S. stocks and bonds respectively returned 20% and 6%. Foreign Stock markets, meanwhile, outperformed both of those classes, garnering a 28% return.



LARGE VS. SMALL STOCK EARNINGS
U.S. businesses continued to find new ways to increase their profits in 2Q07. Year over year, large companies boosted their earnings by 16% in the quarter, while small-cap profits climbed 12.3%.



PRICE-TO-EARNINGS RATIO
Small-cap shares stayed relatively rich on an earnings basis. Investors paid $17.70 per $1 of small-cap profit in 2Q07, compared to $16.60 for that same $1 of income from larger companies.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do not represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Weak Dollar Affects Investors

(Continued from page 1)

stock and bond funds. According to the Investment Company Institute, a trade group for mutual funds, more than $12 billion flowed from investors to international funds in 2006, while funds that invest mostly in the U.S. saw an outflow of $169 million.

"Currency factors were a big reason for the gains of international funds in 2006," says Greg Wolper, a senior analyst at Chicago-based Morningstar. A weak dollar puffs up international fund returns for U.S. investors, Wolper says. For example, Britain's blue-chip FTSE 100 index gained 12.5% in 2006 if measured in pounds sterling. But in U.S. dollar terms, it jumped 27%. Similarly, the Morgan Stanley Capital International Europe index rose 15.9% in local currencies compared with 33.7% in U.S. dollar terms.

To take advantage of such discrepancies, you need to invest in funds that don't use hedging strategies to minimize the differences. Most international stock funds are unhedged, Wolper says, while most international bond funds do hedge currency exposures. Read the fine print in fund prospectuses to gauge their currency policies, Wolper suggests. "Some funds may hedge only occasionally," he notes.

But Wolper also cautions against investing based solely on how you expect currencies to perform. "Because it's so difficult to know what the dollar's direction will be, it doesn't make sense for a guess about currencies to be the deciding factor when choosing a fund," Wolper says.

Of course, if the U.S. dollar is in a permanent tailspin, that could threaten the long-term value of retirement savings concentrated in dollar investments. But Laidi is one of many currency experts who doesn't expect the dollar to collapse. More likely, he says, is that the U.S. currency will eventually strengthen, and overseas equity markets, which have been hot for several years, may decline. If that happens, U.S. investors with portfolios tilted too much toward international funds could miss out on domestic returns. So the wise course, as always, is to diversify holdings. ●

Past performance is not a guarantee of future returns, and currency changes will not affect portfolios the same way they have in the recent past. Investments in the markets and indexes mentioned in this article will differ from your portfolio's performance. International investment involves additional risks beyond currency fluctuations and is not suitable for all investors.

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