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

Twenty 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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Moderation Is Wise In A Time Of Financial Upheaval

With nerves still frayed over the near-collapse of the world economic order in 2008, it's difficult to be optimistic. But it may be helpful to put the bad news about the American economy in perspective.

According to the World Bank, U.S. gross domestic product in 2009 totaled $14.25 trillion. That represented nearly a fifth of the world's total output of goods and services, even though we have less than one-twentieth of the world's population. Whatever its current troubles, the U.S. economy remains the world's mightiest. And though much of the financial and economic news has been bleak—with some respected economists suggesting that recent signs of growth could yet be supplanted by a new downturn—stock prices have continued the strong recovery that began during the spring of 2009. Just as the world was caught off guard by the suddenness and scope of the 2008 collapse, the months ahead could surprise to the upside.

Stocks' resurgence could make this an excellent time to reassess your risk profile. If you learned during the meltdown that you can't tolerate as much investment risk as you had thought, please make an appointment so we can consider changes to your portfolio. In general, we continue to counsel moderation and a broadly diversified approach to investments during this time of upheaval.

Beware Of Homeowner's Insurance Gaps

Disaster may strike your home when you least expect it. There could be damage from flooding, an earthquake, termites, or even mold—just to name a few possibilities. And though you probably assume repairs will be covered by your homeowner's insurance policy, they may not be. Your policy may exclude more events than you realize. Even when you are covered—for, say, flood damage—there may be "gaps" in your coverage that limit the amount you can recover.

The good news is that a typical homeowner's policy covers losses resulting from fires, tornadoes, and severe storms. But the list of what it normally doesn't cover may surprise you. For instance, coverage may not extend to floods and earthquakes, although you can usually add a policy rider for such events. The rider's cost will vary based on whether you reside in a high-risk area.

Similarly, if you have to clean up a mess created by a water or sewage backup, the expense won't be covered by standard homeowner's insurance. But here, too, you can purchase a special rider to avoid this headache, often for less than $100 a year.

The list of other types of damage that usually aren't covered range from mold to insect and termite infestations to acts of terrorism, war, and nuclear attack. Dig your policy out of your files and take a few minutes to assess your risk exposure for these events.

Even if you're covered for damage—through standard insurance or a rider—payments from the insurance company are based on the property's replacement cost, not its fair market value. Also, if your home is destroyed and it's insured for less than the replacement value, you'll have to pay some of the rebuilding cost. In addition, deductibles and maximum dollar caps may affect reimbursements for possessions that are destroyed or stolen.

In terms of liability exposure, one way to avoid dire consequences is to supplement your current coverage with an umbrella liability policy. As the name implies, the umbrella policy sits on top of your homeowner's and auto insurance policies to provide additional protection. For instance, if a neighbor slips and is injured on your icy sidewalk or a tree topples onto a car parked in front of your home, an umbrella policy may pick up the slack.

Just like other forms of insurance, you'll need to shop around for the best umbrella policy. And keep in mind that umbrella coverage kicks in only after other insurance is exhausted, and umbrella policies usually carry deductibles equal to the required underlying limits for the auto and homeowners policies. Still, the cost of umbrella coverage usually isn't prohibitively expensive. You may be able to obtain $1 million in liability coverage for $200 to $300 a year. And you may get a discount for using the same carrier. That could prove a small price to pay for plugging the gaps in policies. ●

Whole Life Or Term? It's A Tough Choice

If you're shopping for life insurance, you'll find myriad policies with innumerable options and riders. But individuals often face a choice between two common types of life insurance: whole life or term. While whole life provides permanent coverage and some cash value, it's normally much more expensive than a term policy that merely promises a death benefit if you die within a specified length of time. After years of steadily declining, the premiums for some term insurance policies have recently started to creep up. That could lead you to rethink your options.

Consider these differences between the two types of policies.

Whole life insurance. This is the traditional form of permanent life insurance. (Variations include "universal" life insurance and other cash-value policies.) The annual premiums are generally fixed when you buy the policy, which remains in effect for as long as you live if you continue to pay the premiums. In addition to providing a death benefit, the policy builds up a cash value on a tax-free basis. Typically, you're able to borrow against that value, or take the cash with you if you surrender the policy. If you decide to surrender the policy, you will receive the accumulated cash value less any surrender charges or fees. But the premiums for whole life insurance are sharply higher than those of a term policy, particularly when you're younger and term insurance is relatively cheap.

Term life insurance. As the name implies, you can buy term insurance covering a specified term, usually 10 years or longer. You could tailor the length of a policy to the amount of time you project that you will need coverage, perhaps choosing to have it expire at your expected retirement date, when replacing your income becomes less of an issue. Most term

Annuity Ladder Can Cut Retirement Risk

Annuities are forever, or at least they can be, and that's both their strength and their weakness. It's a strength because, at a time when almost everyone is concerned about market volatility and the prospect of outliving retirement savings, annuities can provide predictable payments that will last as long as you do. It's a weakness because, in the case of fixed annuities, the amount of your perpetual payout is determined when you buy an annuity, and if you sign up when interest rates are low, you'll receive less than if you purchase an annuity when rates are higher. Also, fixed annuities don't protect you against inflation unless you pay extra for an inflation-adjustment feature.

But what if you spread out annuity purchases, much as you would build a bond ladder or use dollar cost averaging to add to a stock portfolio over time? In a recent study, "Variable Payout Annuities and Dynamic Portfolio Choice in Retirement," in the *Journal of Pension Economics and Finance*, Olivia Mitchell, professor of insurance and risk management at the University of Pennsylvania's Wharton School, and three German academics found that laddering annuities can reduce the risks of saving for retirement and increase the likelihood of reaching long-term financial goals.

Particularly in today's unsettled investment markets, annuities have an undeniable appeal. You pay a sum of money to an insurance company or other financial firm, and the company promises to make specified monthly payments for a fixed term or life. There are many variations on the annuity theme, but for simplicity, consider a fixed, immediate annuity for a 60-year-old male living in New York. Annuity payouts are based on interest rates and life expectancy, and according to an estimator on ImmediateAnnuities.com, if he had invested $50,000 in late June 2009, he could have received lifetime monthly payments of $311.

Viewed on the surface, that's a very good deal. It amounts to $3,732 a year, or an annual return of about 7.5% on that $50,000 investment. Compare that with a typical withdrawal strategy that calls for taking 4% annually from an investment portfolio during retirement—which would provide only $167 a month during the first year—and the annuity seems clearly preferable, at least for a time. But with the lifetime annuity there's a risk you'll die prematurely, thus ending the payments and greatly reducing the investment's value, as well as the risk of locking in returns based on lower-than-usual interest rates.

Laddering annuities could minimize both those risks. Purchasing an annuity each year for a decade, for example, means that each investment will be based on a different interest rate and averages out the impact of annual variations. It also reduces mortality risk—if you die early, the purchases end—and can often provide slightly higher payouts with each new annuity, because the buyer is one year older and his life expectancy one year less. To return to the earlier example, the $311 monthly payment would have been $328 for a 63-year-old male, or $342 if he were age 65.

The results of the *Pension Economics and Finance* study echo those of a 2007 report from MassMutual Financial Group that looked at how three investment strategies would have fared during 181 different 27-year periods beginning monthly from 1965 through 1980 and ending in 1991 through 2006. Comparing a half-stocks, half-bonds portfolio to alternatives that replaced some bonds with either a single annuity bought at the outset or with several purchased in a laddering strategy, the illustrations showed both annuity methods outperforming the traditional stock-and-bond portfolio, and the laddered approach doing better than the single annuity through all of the back-tested periods and many economic ups and downs.

One approach to laddering would be to keep adding annuities until you've met most of your basic retirement income needs. If that 60-year-old knows he'll need at least $10,000 a month and plans to retire in seven years, the first year he might buy a $200,000 annuity that pays about $1,250 a month, then purchase another annuity the next year that adds another $1,250 in monthly income, and so on until, after seven years, he has almost $9,000 in guaranteed monthly income. He may use social security or a pension to fill the rest of his retirement income needs, while keeping any remaining assets in stocks to provide discretionary retirement income and build an inheritance for his children.

Annuities themselves and laddering approaches are complex, with many variables to consider including credit risk of the issuing institutions. We can work with you to see whether an annuity ladder might reduce your retirement risk and help you achieve your long-term goals. ●

policies let you continue coverage at a higher rate. One main reason why term premiums are lower than those for whole life policies with the same death benefit is that term insurance doesn't have to divert part of what you pay to fund a cash build-up.

The bottom line. The standard financial advice on life insurance has been to buy a term policy and invest the difference between that cost and what you would pay for a whole life policy. Of course, every situation is different. For instance, with the cost of term insurance rising, you may prefer the peace of mind of having permanent insurance. But your choice doesn't have to be either/or; you could combine both kinds of insurance as part of an overall financial plan.

Major life events such as the birth of a child or grandchild, the start of a new business venture, or a change in your personal health are important times review your life insurance coverage. We are happy to help you evaluate the right mix of insurance for your unique situation. Please feel free to give us a call. ●

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. 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.

Even though the crisis in the United States seems unlikely to mirror the Japanese experience, it's impossible to know what will happen to stocks, real estate, commodities, and currencies in the near term. That's why we advise you to continue protecting yourself from the vicissitudes of the stock market and the world economy by remaining broadly diversified in your investments. That's the best way to ensure you are in a good position to benefit when the economy starts coming back to life. ●

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Horace C. Gordon, IV, CPA/PFS, CFP®
Gordon & Associates Financial Advisors, Inc.
2907 W. Bay to Bay Blvd, Suite 104B
Tampa, FL 33629
www.gafainc.com

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