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This is the February 2005 monthly Wealth Management newsletter from Hoffman, White & Kaelber Financial Services, LLC. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular monthly basis by sending their name and email address to info@hwkfs.com. Feel free to forward this to any of your friends who may find it useful. Thanks for your interest and I hope you enjoy the letter.

Managing Health Care Costs

According to health care studies conducted by the Cato Institute and National Coalition of Health Care, health care costs have increased dramatically over the last few decades and spending in 2003 was estimated at five times the rate of inflation. What's more, health insurance premiums in 2002 experienced the largest single year increase in more than a decade at reportedly eight times the general inflation rate.

Sound alarming? It should! In a July 2003 Health Poll Report, by the Kaiser Family Foundation, "Thirty-four percent of Americans said they were very worried about increased out-of-pocket costs for health care or insurance. That was more than twice the proportion of people who were worried about not being able to pay their mortgage, or about losing money in the stock market, or of being a victim of a terrorist attack or about losing their job."

Also, the Kaiser Foundation reports, "economists have found that rising health care costs correlate to drops in health insurance coverage" and job losses. Apparently, since 2000, Americans have experienced economic circumstances in which the likelihood of employer-sponsored coverage was lower and the probability of being uninsured increased. With large decreases in the number of workers in larger firms being partially offset by small firm and self-employment opportunities, much of the workforce moved to employment arrangements in which the likelihood of employer-sponsored insurance was lower or non-existent.

University of Texas economics professor, Stan Liebowitz, suggests: "The cure for the present problems is straightforward: the patient must once again be made the central actor in the medical marketplace. Patients need to be given the same motivations to economize on medical care that they have to economize in other markets. Tax laws need to be rewritten. The use of medical savings accounts needs to be promoted. High-deductible health insurance should be encouraged."

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's letter will review health savings accounts and other tax-favored health plans. The US Congress enacted these plans with hopes of creating a constituency for future reforms based on choice and competition, rather than rationing and controls. And, with alarming increases in health care costs, employers are already looking to consumer driven health plans to help rein in expenses. Unfortunately, many consumers and employers are confused about which approach is best. Hopefully, this letter will help you understand how to save hard earned health care dollars and, maybe build an additional nest egg you can use in retirement. Lastly, and as always, we will finish with an update on our investment activities.

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FSA, MSAs, HRAs and HSAs

Flexible Spending Arrangements. Health FSAs are employer established benefit plans that may be offered in conjunction with other employer provided benefits as part of a “cafeteria” plan. A cafeteria plan (sometimes called a flexible benefit or Section 125 plan) is a benefit plan that allows an employee to have some choice in designing his or her own benefit package by selecting different types and/or levels of benefits that are funded with nontaxable employer dollars. Authorized under the Revenue Act of 1978, FSAs were Congress’ first attempt at health care reform.

An FSA allows employees to be reimbursed for qualified medical expenses. The word “qualified” may seem limiting, however, the scope of what qualifies is not very restrictive. You can use funds to pay any covered out-of-pocket medical expenses not paid by your health insurance. Plus, you can use these funds to pay for things like dental and vision care, chiropractors, non-prescription medicines and even bandages. FSAs are usually funded through voluntary salary reduction agreements and employer contributions are permitted as well. Also, contributed amounts are free from both employment and income taxes. The entire benefit can be completely tax-free!

At year’s end, however, unused funds are forfeited. This means that amounts carried at the end of the year cannot be paid out to the employee or carried over to the next year. This use-it-or-lose-it feature often encourages people to engage in wasteful year-end spending.

Employers, be advised that in order to maintain tax-qualified status, the FSA must comply with certain requirements that apply to cafeteria plans. There are restrictions for highly compensated and key employees and the plan must also comply with rules applicable to other accident and health plans.

Lastly, “self-employed” persons are not eligible for an FSA. The definition of “self-employed” includes sole proprietors, partners in a partnership, LLC and LLP members, and 2% or greater shareholders in an S Corporation.

Medical Savings Accounts. A MSA is a tax-exempt trust or custodial account – much like an IRA – that you set up with a US institution that allows saving money exclusively for future medical expenses. Congress, in an effort to expand health care reform to a larger part of the population, authorized MSAs under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). MSAs were created to help the self-employed; employees of certain small firms; and persons eligible for Medicare in meeting the growing burden of medical care costs.

Like the FSA, an employee or employer can make contributions to the MSA free from employment and income taxes. Plus, any earned income or capital gains earned on funds in your MSA accumulate tax-free. Unlike the FSA, however, the contributions remain in your MSA from year to year until you use them. And, the MSA is “portable” so it can stay with you if you change employers or leave the work force. Once funded, distributions taken from the account are tax free if used to pay or reimburse qualified medical expenses. But beware, money taken out for anything other than qualified medical expenses is deemed taxable income and you’ll pay an additional 15% penalty on top.

To qualify for an MSA, you need: (a) to be eligible for Medicare, or be an employee of a small firm, or be self-employed – spouses may also qualify; and, (b) to obtain and be covered by a

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high deductible health plan (HDHP). While the terminology for HDHP sounds self-explanatory, the IRS has specific criteria for what qualifies and it is best to check this with your tax advisor.

Despite Congress' efforts, very few insurers, employers and employees have found MSAs very attractive. The main problem often cited for this lack of interest is that they enacted too many rules for determining who qualifies, what type of health insurance must be purchased, and so on. In addition, the rules restricted MSA contributions to a fraction of the required HDHP insurance deductible. Perhaps, the administrative burden for smaller taxpayers and their advisors just didn't seem worth the trouble to gain the benefit.

Health Reimbursement Arrangements. In June 2002, the IRS provided guidance in the form of Revenue Ruling 2002-41 and Notice 2002-45 with respect to what are now referred to as "health reimbursement arrangements" (HRAs). A HRA is an employer-funded plan, reimbursing employees only for eligible and substantiated health care expenses, and may not under any circumstances allow employees to contribute on any pre-tax basis.

Employers have complete flexibility with the plan and it can be offered in conjunction with other health benefit plans, including a FSA. There is no limit on the amount of money an employer can contribute to the accounts and unspent HRA balances may accumulate from year to year. Since it is the employer's money, there is no requirement to provide departing employees access to the balances after they have left the company.

Only current and former employees (including retired employees), their spouses and dependents are eligible to participate in an HRA. Like a FSA, "self-employed" individuals are not eligible to participate in an HRA.

Health Savings Accounts. The newest "kid" on the block – the Medicare Prescription Drug, Improvement and Modernization Act of 2003 authorized the establishment of health savings accounts (HSAs) effective January 1, 2004. Make no mistake. The HSA is a new and improved version of the MSA, which the government is presently seeking to phase out, with less restrictions and limitations. In fact, the new HSAs are much better and worth looking at.

Now, almost everyone is eligible for HSA enrollment. And, like the MSA, if you change insurance plans, providers or even jobs, the HSA remains yours.

Remember, similar to the MSA, a HSA is a tax-exempt trust or custodial account that you set up with a qualified trustee to pay or reimburse "qualified medical expenses" you incur. To qualify, you must pair the account with a HDHP (high deductible health plan). The minimum deductible that qualifies is \$1,000 for an individual and \$2,000 for a family. You can't be eligible for Medicare, nor can you be claimed as a dependent on someone else's tax return. Also, the insurance policy you choose must have a provision that limits out-of-pocket expenses to a maximum of \$5,000 for an individual and \$10,000 for a family. There are some lenient exceptions to consider, so check with your tax advisor.

The amount you can contribute to your HSA depends on the type of HDHP coverage you have and your age. For 2004, if you have self-only coverage, you can contribute up to the amount of your annual health plan deductible, but not more than \$2,600 (\$3,100 if aged 55 or older). If you have family coverage, you are again limited to the lesser of the HDHP deductible or \$5,150 (\$5,650 if 55 or older). Given how the limits are worded in the IRS

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publications, I expect these amounts may be indexed each year. The limits are also impacted by many how many months out of the tax year you are covered under an HDHP.

When it comes to the insurance plan, remember, the higher the deductible, the lower your monthly premium. Most insurance providers will offer a range of deductible options so you can choose what might best fit your situation.

Some Concluding Thoughts

As I mentioned in the beginning of this letter, Congress enacted these plans with the hope of creating a constituency for future reforms based on choice and competition, rather than rationing and controls. They did this upon the belief that private health accounts will be a crucial component of health care and Medicare reform.

Health-policy experts have been universally critical of these plans. They don't refute the cost savings, but their concern is with the effect on public health. They point out that the best way to prevent sickness and high medical costs is through regular preventative examinations. Since preventative maintenance costs are paid from funds in the HSA custodial account until the (high) deductible has been met, the concern is that people will put off the exams until they are already sick. While this is certainly a risk for the public in general, it is definitely appears a manageable risk for those who are informed.

Don't skimp on your regular check-ups and health screenings. Sure, you'll pay a few more dollars out-of-pocket for a visit to the doctor, but the lower premiums should more than make up for these costs. In healthy years, the low premiums will allow you to increase your savings – on a pre-tax basis. In years with high medical costs, you are no worse off than you would have been under a traditional plan.

We're At Your Service

At Hoffman, White & Kaelber Financial Services, our focus is to help our clients achieve a more certain future. As such, our wealth management clients gain comfort in knowing that they've hired disciplined decision makers whose objective favors consistency of returns and capital preservation rather than magnitude of returns. And, we're always thinking of ways to help our clients keep what they've earned!

Hoffman, White & Kaelber Financial Services Investment Performance Update

There seemed to be a lot of selling by traders prior to the elections in Iraq at the end of January. Not only did the market's ups and downs provide us some indication of this, but I've been reading reports that as much money flowed out of mutual funds in the first three weeks of January as had flowed in during all of November and December combined. This selling seemed to impact most of the equity markets we follow, including REITs. To provide you some gauge of how US equity markets fared in January: the S&P 500 (large cap stocks) was off better than 2.5% for the month; the Russell 2000 (small cap stocks) was off almost 4.25%; and, the Dow Jones REIT Index (real estate) was off more than 9.0%. Despite these losses, our defensive strategy managed to protect value in our client portfolios.

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For the month ended January 31, 2005, our one-month performance is off 0.08% (yes, 0.08%), our three-month return is up 1.60%, our one-year return is off 1.98%, and our average annualized return since inception is up 9.49%. This may sound like a broken record, but volatility (risk) steadily continues to increase and our (since inception) risk profile has crept downward further to +/- 6.31%. With our expectation that this statistic gains increasing importance, our Sharpe Ratio remains a very respectable 1.30.

As a side note, using history as a guide, volatility numbers are generally lower in up markets and begin to increase – often dramatically – in down markets.

About Measuring Risk and Sharpe Ratios

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the *range* of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

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