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Money Matter$

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Variable Annuities Are Sold, Not Purchased

by Harry Maurer

Variable annuities—just like loaded mutual funds discussed last quarter—offer you a way to transfer a significant portion of your wealth into someone else's pocket.

The Seduction:

This is what a *slick* advisor may say, in order to sell you product that I feel should be illegal but isn't: If you buy a fixed annuity, then you'll receive equal payments for the rest of your life, but your purchasing power will decline, as inflation continues. Just take a look at how much it cost to buy a car ten years ago. For your purchasing power to climb with inflation, you want to buy a variable annuity. That way, a portion of your premium goes into investments, and you can participate in the growth of the economy. Furthermore, the growth of your investment is tax-deferred. That means you benefit from the compounding of your investment growth, without paying taxes on that growth until some time in the future when you're ready to take payments. Just sign here.

The Reality:

What makes this line of reasoning so compelling is that it states nothing that's untrue. What makes it deceptive is the fact that it is incomplete. **Which is worse: Your advisor telling you overt lies or omitting essential information, so that you believe something that is false?** If your advisor were hypothetically forced to tell the whole truth in clear terms, this is what she would say:

"I'm a broker who wants you to buy a variable annuity, so that I can put a down payment on a BMW. You will need to keep your money in place with my company for seven to ten years. If you try to get out early, we'll charge you an enormous exit fee, to compensate us for our lost chance to squeeze our inflated annual fee out of you. Yes, we already dinged you for a 10 percent commission, but we want more. Do you think my bank wants only the down payment on my BMW? They want me to make monthly payments, too. And you're going to help me.

"Furthermore, I won't guarantee that the variable portion of your premium payments will grow at my insurance company's projected rate of return. That rate is projected, not guaranteed. You can't hold us to it. Your money in a variable annuity is at risk, and is not FDIC insured. And if the insurance company goes bankrupt, the 'death benefit' (your original investment) may be significantly reduced, or even eliminated.

"When you finally do take payments, any **profits from your annuity will be taxed as ordinary income, at rates up to 35%. Ouch!** Oh yeah, and if the value of your annuity declines, you can't deduct your losses from your taxable income. You should probably invest in stocks, bonds, and real estate, because **long-term capital gains are taxed at a maximum of only 15%,** and—just in case—losses are tax deductible and can offset other capital gains. It's too bad you don't have an advisor who wants to educate you as to what's in ***your* best interest**. I want you to do what's best for me and my company.

"I want to cause economic pain not only to you, but to your heirs as well. They will pay tax on the growth of the annuity, upon your death. If you had bought equities instead of an annuity, your heirs would pay no tax on the growth of those equities. But you don't care about your heirs, right? Besides, I really want a BMW."

Naturally, most who sell variable annuities will never voluntarily give you this information, except as it may be hidden in a 250 page prospectus. ***Now you wear annuity armor. Congrats!***

One Year Returns

- **Dow Jones Industrial 30 Average :** **8.6 %**
- **Standard & Poor's 500 Index:** **5.8 %**
- **Nasdaq Composite Index:** **5.6 %**
- **Russell 2000 Small Company Index:** **13.3 %**
- **Sommers Finanical Management's "MODEL 25" PORTFOLIO** *(see next page for an update)*: **17.3 %**

Sommers Financial Management's "MODEL 25" PORTFOLIO Update

Wow—what a ride in the second quarter of 2006! Emerging Markets were down 5%, after plunging 25% in one month; commodities ended up 3%, after dropping 19% from May 15th to June 15th. Despite the weakness in our portfolio's heavily weighted sectors: including homebuilding, energy, and commodity stocks—not to mention the market in general—the Model Portfolio's long-term track record continues to outshine alternative investments with a simple buy-and-hold strategy of the 25 most attractive equities, arrived at utilizing Sommers Financial Management's proprietary formula.

This quarter, the Model Portfolio basically doubled the drop in the S&P 500 Index, continuing to have a higher beta (volatility) than the general market, as we would predict from a non-diversified portfolio. This past quarter is precisely why we shy away from placing client funds into a mirror image of the Model Portfolio, **advising instead to diversify and allocate each account based on time horizon, *risk-tolerance* (read: strength of stomach for drops like these), and tax implications.**

OUTGOING stocks from the portfolio during the second quarter of 2006 include:

- **Bank of America, US Bank & Washington Mutual—** These three banks are great long term holdings, but gave way to the more aggressive ranks in the Model.
- **Burlington Resources—**Acquired by ConocoPhillips
- **Harley Davidson—**Harley has been in the model for all but less than 6 months over the past 3 years
- **Intel & Microsoft—**No catalysts until '07
- **Innovative Solutions—**Unprofitable so far in 2006
- **J2 Global—**Still a growing company, just not top 25
- **Johnson & Johnson—**JNJ has been in the model since it's inception—and has grown 26% during that period.
- **Linear Technology—**Moving Linear out of the portfolio will help lighten our over-weighting in semiconductors
- **Shanda Interactive—**This Chinese internet entertainer was not profitable in 2005. So long, Shanda; hello, Hooray!

INCOMING stocks to the portfolio this quarter include:

- **Aspreva Pharmaceuticals—**Possible joint venture with a big pharmaceutical company on the horizon
- **Citigroup—**Replaces 4% bank yields of BAC, USB, & WM
- **China National Drilling & PetroChina—**These Chinese oil conglomerates are back in top 25

Company Name	Symbol	SFM Rank	% Gain since purchased
Actions Semiconductor	ACTS	13	48.6
Aspreva Pharma	ASPV	10	(6.5)
Citigroup	C	12	(1.2)
CompuCredit	CCRT	9	(0.2)
China National Offshore	CEO	17	2.5
Calamos Management	CLMS	7	(9.4)
DR Horton	DHI	6	(18.6)
Dow Chemical	DOW	24	(1.8)
Syneron Medical	ELOS	18	6.9
Eagle Materials	EXP	22	15.2
First Marblehead	FMD	15	149.3
Grey Wolf	GW	14	9.4
Hooray! Holdings	HRAY	8	(38.5)
Ipsco	IPS	16	2.2
K-Swiss	KSWS	20	(2.2)
Moody's	MCO	19	1.2
NetEase.com	NTES	3	4.8
NVR, Inc.	NVR	1	23.1
Southern Copper	PCU	2	60.0
Patterson Energy	PTEN	5	(1.2)
PetroChina	PTR	25	(0.6)
Q Logic	QLGC	23	10.6
Toll Brothers	TOL	11	(31.7)
Taiwan Semiconductor	TSM	21	26.3
Virpharma	VPHM	4	(52.5)

- **Calamos Asset Management—**A well respected mutual fund company with loads of cash, yielding 1.3%
- **DR Horton—**Starter-home community builder with a sub-5 P/E and 27% return on equity, yielding 1.7%
- **Dow Chemical—**4% dividend yield, and P/E ratio of 8
- **Eagle Materials—**Cement and gypsum wallboard maker with a P/E of 8 and return on equity of 35%
- **Grey Wolf—**Contract driller for oil and natural gas
- **Hooray! Holdings—**Chinese wireless entertainment company trading at 1.5 times cash
- **Ipsco—**This steel pipe manufacturer is back. P/E: 9
- **Moody's—**Debt rating agency with only one competitor

Returns for our Model Portfolio versus the S&P 500 Index

	Model Portfolio	S&P 500
Three Months	**-4.0 %**	-1.9 %
One Year	**17.3 %**	5.8 %
Three Year Annual Avg.	**26.8 %**	10.2 %
Annual ROR Since Inception	**30.9 %**	10.3 %