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## Market Update

The state of the current markets can only be described as topsy-turvy. While the Federal Reserve (the Fed) has been raising short term rates, long term rates fell in the second quarter. The Dow Jones Industrial Average dropped in the quarter yet the S&P 500 rose. One would think higher gasoline prices would depress consumer attitudes but consumer sentiment actually rose in June.

## Economy

Despite the relentless march of rising short rates, the economy stays healthy. Government income tax collections are up 20% compared to last year, reflecting higher personal and business income. This in turn helps reduce the US budget deficit.

The manufacturing sector just completed its 25<sup>th</sup> consecutive month of expansion. This represents the longest period of continuous growth in the past sixteen years. Dollar for dollar, consumer income has grown faster than personal gas expenditures. As a result, families and individuals have not felt overwhelmed by \$2.25 a gallon gasoline. In fact, more people are taking summer vacations than ever. The economy continues to grow at a pace just less than 4%.

## Interest Rates

Much discussion has occurred recently on the subject of when the Fed will be finished raising the Federal Funds rate, which now stands at 3.25%. Some say we are in the 8<sup>th</sup> inning, while others say we

will go into extra innings. While no one knows for sure when the Fed will be done, we do know we are close to the end.

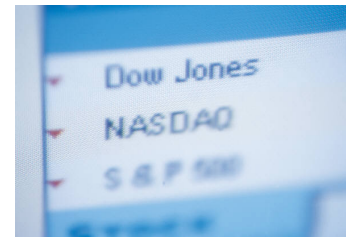
One signal to watch is the pace of manufacturing growth mentioned earlier. Any sign that growth is slowing would not be positive for the economy and the Fed may stop hiking rates. Another measure to keep an eye on is the real Federal Funds rate - the Fed funds rate less the rate of inflation, currently, 0.45%. Since 1954, this rate has averaged 1.8%. It is generally perceived that a rate above 0% is restrictive and below is accommodative. In order to help ease the economy out of a recession in 2001, the Fed lowered rates, driving the real rate below 0%. The Fed may now be applying pressure to the economy for the first time in years. The question remains how much the Fed will raise rates.

## Stock Market

When the Fed stops raising rates, the stock market should rally. Why? Because the uncertainty of when will be removed and the market strongly dislikes the unknown.

As long as the consensus feels that the Fed stopped before any harm was done to the economy, then business will be able to continue to operate in a favorable environment.

The second quarter of the year provided stock investors with lackluster results. While most markets were up mildly in the

Year to Date Returns  
As of 6/30/05

DOW	-3.65%
S&P 500	-0.81%
NASDAQ	-5.45%
Russell 2000	-1.25%
Mid Cap 400	3.85%
MSCI EAFE	-2.75%
Lehman US Agg.	2.48%
Lehman Muni.	2.73%
10 Year Treasury Yield	3.94%

second quarter, large cap and international stocks are still down for the year. Mid and small cap stocks have turned the corner and are generating positive results.

## Is Your Social Security Secure?

**“Depending on the actuarial assumptions used and the political slant, Social Security has been described as a program in need of only minor adjustments or one in crisis, requiring immediate drastic reform.”**



If you're retired or close to being retired, then you've probably got nothing to worry about - your Social Security benefits will likely be paid to you in the amount you've planned on (at least that's what many of the politicians say). But what about the rest of us?

### The media onslaught

Watching the news, listening to the radio, or reading the newspaper over the past few months, you've probably come across story after story on the health of Social Security. And, depending on the actuarial assumptions used and the political slant, Social Security has been described as a program in need of only minor adjustments or one in crisis, requiring immediate, drastic reform. Obviously, the underlying assumptions used can skew one's perception of the health of Social Security, and even experts

disagree. So let's look at what we do know.

### Just the facts, ma'am

Social Security is a pay-as-you-go system, with today's current workers paying the benefits of today's retirees. Currently, more than 47 million Americans collect some sort of Social Security retirement, disability, or death benefit. How much do today's workers pay? Well, the first \$90,000 of an individual's annual wages is subject to a 12.4% Social Security payroll tax, with half being paid by the employee and half by the employer (self-employed individuals pay all of it). This money is put into a big holding tank - the Social Security trust fund - and used to pay out current benefits. The amount of benefits an individual is entitled to is complex and depends on a number of factors like age at retirement, work history, and

earnings record. Currently, the full retirement age is in the process of rising from 65 to 67 in two-month increments, based on year of birth.

### Demographic trends

Even those on opposite sides of the political spectrum can agree that demographic factors are exacerbating Social Security's problems; namely, life expectancy is increasing and the birth rate is decreasing. This means that over time, fewer workers will have to support more retirees. According to the Social Security Administration, in 2018, Social Security will begin paying out more money than it takes in. However, by drawing on the trust fund that, on paper, is supposed, to receive today's payroll surpluses, Social Security should be able to pay promised benefits until 2041. The caveat is that money in the trust fund

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## Equity-Linked Notes

**“Incorporating ELNs into an investor's investment strategy may be appropriate for risk-averse equity investors or fixed income investors who desire equity exposure with controlled risk.”**

An Equity-Linked Note (ELN) is an investment instrument that provides investors fixed income-like principal protection together with equity market upside potential.

An ELN is structured by combining the economics of an equity call option with a zero coupon bond. It is a debt instrument generally designed to return 100% of the original investment at maturity, but differs from a standard fixed income secu-

rity in that the coupon or final payment at maturity is based on the return of a single stock, basket of stocks or equity index. An ELN typically has a maturity of anywhere between two and nine years.

The performance of an ELN is affected by changes in the underlying equity price, volatility, interest rates, time to expiration, dividend yield and issuer credit rating. Most investments that offer a significant upside opportunity

also involve significantly more risk. ELNs allow investors to avoid falling into either too-risky or too-low return investments. Incorporating ELNs into an investor's investment strategy may be appropriate for risk-averse equity investors or fixed income investors who desire equity exposure with controlled risk.

ELNs are flexible securities that can be structured to match the investor's risk/reward objectives.

## ILITs - Keeping Life Insurance Proceeds Out of Your Taxable Estate

While life insurance proceeds generally pass to beneficiaries free from federal income tax, they can be subject to estate taxes at your death. If your estate is valued in excess of \$1.5 million, this means that as much as half of your life insurance proceeds could go to Uncle Sam instead of to your loved ones. Fortunately, proper planning can help protect your family's financial security.

### Irrevocable life insurance trust (ILIT)

An ILIT (pronounced "eye-lit") is a trust primarily set up to hold a life insurance policy.

The main purpose of an ILIT is to remove life insurance proceeds from your taxable estate and avoid estate taxes. If the trust is drafted and funded properly, the proceeds should not be included in your taxable estate, and your beneficiaries should receive the entire amount, undiminished by estate taxes.

### Is Your Social Security Secure? *Continued from page 2*

isn't exactly like money in your pocket - various administrations have used the money to pay for general government spending, leaving the trust fund with only a legal obligation to be paid back. To do so, the government would need to reduce other spending, borrow, or raise taxes - a hurdle that might factor into the final solution.

### Be on the lookout for these fixes

Here's how an ILIT works:

#### Creating the trust

Your first step is to draft and execute an ILIT trust agreement. Because precise drafting is essential, you'll have to hire an experienced attorney for this. Although you'll have to pay the attorney's fee, the potential estate tax savings should more than outweigh this cost.

#### Naming the trustee

The trustee is the person named in the trust agreement who is responsible for administering the trust. You should select the trustee carefully. The trustee should be someone other than yourself or your spouse who can understand the purpose of the trust and perform his or her duties as trustee as defined in the trust agreement.

#### Funding the trust

Funding the trust can be accomplished in one of two ways:

While no one can say for sure what will happen, here are some solutions that might make the final cut:

- 1) Allow individuals to invest some of their current Social Security taxes in private accounts.
- 2) Raise the current 12.4% payroll tax.
- 3) Raise the current \$90,000 ceiling on wages subject to the payroll tax.
- 4) Raise the retirement age beyond 67.
- 5) Reduce future benefits, especially for wealthy retirees.
- 6) Tie initial

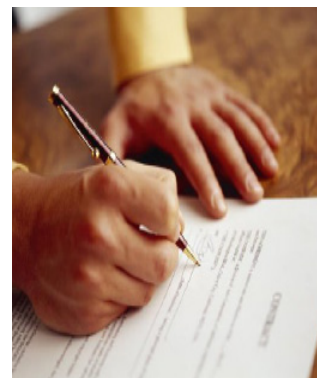
#### *Transferring an existing policy*

You can transfer your existing policy to the trust, but be forewarned that, under federal tax rules, you'll have to wait three years for the ILIT to be effective. That means if you die within three years of the transfer, the proceeds will be included in your taxable estate and subject to estate taxes. Your age and health should be considered when deciding whether to take this risk.

#### *Buying a new policy*

To avoid the three-year rule, you can have the trustee, on behalf of the trust, buy a new policy on your life. You can't make this purchase yourself. You transfer money to the trust and the trustee pays the initial premium. As future annual premiums come due, you continue to make transfers to the trust, and the trustee continues to make the payments to the insurance company to keep the policy in force.

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**“The main purpose of an ILIT is to remove life insurance proceeds from your taxable estate and avoid estate taxes.”**

benefit levels to a more modest price index instead of the current wage index. 7) Allow the Social Security program itself to invest in assets other than government bonds.

Just keep in mind that the final outcome for this decades - old program may be months, or even years, away.



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Key Statistics: MCD

Price	\$28.00
EPS	\$1.79
Estimated EPS	\$1.96
P/E Ratio	14.50x
PEG Ratio	1.60x
Dividend	\$0.55
Market Cap	\$38.0B
52 Week High	\$34.56
52 Week Low	\$25.64
Beta	0.81
Expected Annual Growth Rate	9.00%
ROE	17.4%

*At Financial Solutions Advisory Group, you'll find a fee-only Registered Investment Advisor (RIA) committed to putting your interests and your needs first, eliminating the commissions and self-serving incentives that get in the way of solid, successful financial planning and investment management.*

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## Stocks in the News: McDonald's (MCD)

Ronald McDonald is smiling again. After years of poor service, old stores and the same old food, Oakbrook, IL based McDonald's is back on a roll. As the largest fast food restaurant company in the world, management believed the easiest way to increase revenues was to build and franchise more restaurants. And grow, did it ever! While McDonald's has always been huge in the US, about 53% of its 30,000 restaurants now are located internationally. But while the company concentrated its efforts outside, domestic stores sales were declining. Customers were tired of waiting for its meals at a fast food restaurant. Stores were allowed to get tired looking. Finally, not enough new menu items were added to keep older customers interested in returning to the stores. Instead, the company tried to experiment with new foods by purchasing other restaurants such as Donati's Pizza, Boston Chicken and Chipolte.

Management regrouped and its efforts have paid off. First, in a risky move, McDonald's entirely overhauled the flow of their kitchens into a "make to

order" model. While food may not reach the diners much quicker, it allows for custom orders, which were previously frowned upon. This model also increases order accuracy. Patrons viewed this change in service positively. Next, McDonald's took the Atkins diet craze and spun it in its favor by totally revamping its salad offerings. A larger assortment of bigger, fresher salads were created and aimed at adults. This ensures that parents are now more likely to return when the kids scream that they want to go to Micky D's. These more expensive salads not only help to increase revenue, but also have served to increase margins. McDonald's is now addressing its physical space. Rather than spending capital on new stores, the company has committed to refurbishing 2,800 stores by the end of next year. The company has found that stores with more comfortable surroundings and large flat screen TVs increase sales 5% on average.

Fundamentally, McDonald's is in very solid shape. It has \$1.3 billion in cash on its books which could be used to in-

crease its current dividend yield of 1.9%. The debt to equity ratio has declined to 38% as interest expenses have fallen as well. Its unusually low price earnings ratio of 14.5 on next years earnings places the company below the market and well beneath the company's historical average of 24. While McDonald's long term predicted growth has slowed to 9%, its more volatile growth is becoming more predictable which should move its shares forward.

The restaurant industry continues to flourish. Consumers keep finding excuses to dine outside the home. Everyone knows they are pressed for time and "going out" is easier. But interestingly, it is the younger generation, who has been raised on fast food, that keeps the industry moving. Once on their own, the 20 something's budget does not include a line item for groceries and one for dining out, instead it includes one entry for food. This phenomenon should not only keep Ronald smiling, but it should make Wendy and the Colonel happy too!

## ILITs Continued from page 3

As future annual premiums come due, you continue to make transfers to the trust, and the trustee continues to make the payments to the insurance company to keep the policy in force. Whether you transfer an existing policy or have the trustee buy a new policy, the trust will own the policy and will be the named beneficiary of the proceeds. (Your heirs will ultimately receive the proceeds because they will be the named beneficiaries of the trust.) Because you will not own the policy

and your estate will not be the beneficiary of the proceeds, your life insurance will escape estate taxation.

### Gift tax consequences

Because the trust must be irrevocable (i.e., you'll be unable to change the terms of the trust, or end it earlier than the time stated in the trust agreement), the cash transfers you make to the trust are considered taxable gifts. However, if the trust is created and administered appropriately, transfers of \$11,000 or less per trust

beneficiary will be free from federal gift tax under the annual gift tax exclusion. Further, transfers that do not fall under the annual gift tax exclusion will be free from gift tax to the extent of your available lifetime federal gift tax exemption (\$1 million in total). Note: ILITs are extremely complex - this article is only a brief overview. You'll need to consult an experienced financial professional for more information.