

# QUARTERLY REPORT

VOLUME 1, ISSUE 2 JULY 2003

## PROFITIOUS START

Well, we are off to a good start! These past few months have been invigorating as we have worked to put in place our research and all of our systems. We feel rewarded not only by the support of friends and clients but by renewed strength in the financial markets.

While it is encouraging to see an improved tone to the market, navigating these waters requires a disciplined approach and a steady hand that we are committed to providing.



We are taking a hard look at each account in light of the current economic environment and recent tax changes and will suggest adjustments as necessary.



...navigating these waters requires a disciplined approach and a steady hand

Karin Dreyer, Vice President of Portfolio Administration has been a great addition to our team. We are so pleased that she decided to join us.

Cordially,

Kathy Wimmer, CFA  
President

### KEY FACTS FOR 2003

- *Annual gift exclusion*  
\$11,000
- *Estate tax exemption*  
\$1 million in 2003 and  
\$1.5 million in 2004
- *IRA contribution limits*  
\$3,000 plus another \$500  
for those over fifty
- *401k contribution limits*  
\$12,000 plus another  
\$2,000 for those over fifty
- *SEP IRA contribution limits*  
25% of compensation or  
maximum of \$40,000

## OUTLOOK FOR THE THIRD QUARTER OF 2003

In our last quarterly report, we stated, “we see improved prospects in the stock market upon the conclusion of hostilities in Iraq”. Indeed, a sense of relief and optimism about the future course of the economy propelled the stock market up 14.9%, as measured by the S&P 500 Index, in the second quarter of 2003. This rally followed a 3.2% drop in the first quarter.

The stock market is a “leading indicator” and the recent upswing bodes well for the overall economy. Supported by the June 25<sup>th</sup> reduction in the Federal Funds Rate to 1% (a forty-year low), the economy, in our

opinion, is on course for improved growth. Our enthusiasm is tempered slightly by persistently high unemployment levels, but as unemployment is a “lagging indicator”, we expect demand for labor will eventually firm as business activity recovers.

The stronger economy may not translate into higher stock prices over the third quarter as the market may need some time to digest recent market gains. We are optimistic that technology spending is due for a cyclical upturn, although not necessarily back to the halcyon days of technology

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## OUTLOOK FOR THE THIRD QUARTER OF 2003

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growth. (Try not to wince recalling Y2K fears and the "irrational exuberance" of the internet bubble!) Energy prices continue to be a concern as ongoing sabotage is limiting Iraq's ability to bring oil back onto the market. President Bush has taken note of our limited natural gas supply and has instructed the Energy Secretary to put together a study to increase gas production in the States.

We believe the earnings prospects for natural gas companies are favorable. Energy intensive companies will continue to be challenged in the near term but will prosper from strong restructuring efforts in the long run. Low interest rates and consumer liquidity from home refinancings should

support consumer cyclicals and pharmaceuticals. Financial stocks have already benefited from the drop in interest rates but may receive a boost from new mergers and acquisitions as part of the continuing industry consolidation.

As we move into the second half of the year, investors will be looking for evidence of improved company profits, new signs of stability in the Middle East, especially Iraq, and better economic reports to confirm continued optimism in the markets. In our view, increased consumer liquidity from low interest rates, home refinancings and tax relief, as well as a cyclical upswing from a three-year downturn will set the stage for gradual recovery.

### INTERNET2 BY DAVE NIEBUHR, CFA

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Imagine transmitting an entire feature length film over 4000 miles (from Geneva to Chicago) in only 36 seconds! A team of scientists, including some from right here in Pasadena, recently demonstrated this capability. They are part of **Internet2**, a research consortium formed in 1996 by a couple dozen universities, several private corporations and a few government agencies. **Internet2's** mission is to "create a leading edge network capability for the national research community" -- the purpose for which the Internet was originally formed and the role it filled admirably for over a decade before being overwhelmed by millions of users sending emails, accessing multimedia websites and chat rooms and downloading petabytes of music.

Today, the **Internet2** consortium has grown to include over 200 universities and 60 corporations (Microsoft, Intel, Cisco, IBM, etc. - all the usual suspects) and a variety of affiliates ranging from JPL to the New World Symphony. Despite its name, **Internet2** is

not a 'new' Internet. Instead, its goals, in addition to providing academic researchers with a high-speed network unencumbered by commercial users, is to " ... enable revolutionary Internet applications [and] ensure the rapid transfer of new network services and applications to the broader Internet community."

**Internet2** is not separate from the 'traditional' Internet. However, in addition to using high-speed devices and interconnections to ensure that their signals travel over the fastest segments of the existing "net", the consortium has its own high-speed optical fiber backbone called Abilene. The first segment of this thousands-of-miles-long network was constructed in 1998/1999 by Qwest and Nortel using switching equipment from Cisco Systems and Juniper Networks. Abilene's current goal is to deliver 100 megabits per second of transmission capability to every desktop on its system

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## INTERNET2 BY DAVE NIEBUHR, CFA

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(that's about 100 times the speed of a typical cable modem or DSL connection.) The backbone is up and running; if you go to the web site <http://abilene.internet2.edu> you can view a 'weather-map' of the traffic currently flowing on the system. (Despite its name, Abilene is not headquartered in Kansas; it's at Indiana University. The name Abilene refers to the Kansas city that was the railroad's gateway to the west -- the New Frontier.)

In addition to using **Internet2** for research in data intensive areas such as bioinformatics, nuclear physics, meteorology and 'immersive VR' (Virtual Reality -- imagine being able to 'feel' a piece of fabric from thousands of miles away!), the consortium is eager to have **Internet2** used by libraries and schools throughout the country. To this end, a number of universities have become Sponsored Education Group Participants (SEGPs) -- if your local library or school is interested in gaining access, they should contact a local SEGP which can be found at <http://k20.internet2.edu>.



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## SAVING FOR COLLEGE WITH 529 PLANS BY ANNE WIMMER, CFA

In recent years, the financial press has extolled the virtues of 529 Plans for college savings. But just what is a 529 Plan, and what are its benefits as well as its shortcomings?

Section 529 of the Internal Revenue Code allows each individual state to sponsor a college savings program that provides certain tax benefits to the plan participants. Key features of state 529 Plans include:

- Assets grow tax-free, and qualified withdrawals are exempt from federal taxes.\* Qualified withdrawals refer to college-related expenses such as tuition, books and room and board costs at *any* accredited college or university in the U.S., as well as at some vocational schools and foreign institutions.
- Anyone may contribute to a plan, regardless of age or income. Investors can establish a 529 Plan for a child, grandchild, other relative, friend or even themselves.
- The account owner maintains control of the account, not the beneficiary. The account owner determines the amounts and timing of withdrawals, may change the beneficiary to a different family member, or can even reclaim the funds (although subject to taxes and penalties.)
- Favorable gift and estate tax treatment allows one to move sums of money from an

estate without paying taxes, yet still exercise control over the assets. An individual may gift up to \$55,000\*\*, or a couple may gift up to \$110,000\*\* to each beneficiary without incurring gift taxes. Accelerated gifting is an especially popular feature for affluent parents and grandparents who wish to reduce their estates through gifting, but still maintain ownership and control over the accounts, neither of which is possible with UTMA (Uniform Transfer to Minors Act) accounts.

Although the benefits of 529 Plans are compelling, there are some issues that do bear noting. First, each state program typically has limited investment choices, not unlike a corporate 401k plan that offers a handful of mutual fund choices. In addition, the account owner is restricted on how often he or she can move assets among investment options. Finally, the federal tax exemption for qualified withdrawals is set to expire after the year 2010. If this "sunset provision" isn't repealed or modified by Congress, then the earnings portion of withdrawals would be taxed at the beneficiary's income tax rate.

Despite these issues, 529 Plans remain an attractive vehicle for college savings. As the cost of a college education continues to spiral upward, it makes sense to plan ahead.

\* Through the year 2010, unless Congress revokes the sunset provision of the 2001 Tax Act.

\*\* A special election treats the lump sum as a gift spread over a five-year period.

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PERSONAL SERVICE AND  
OBJECTIVE ADVICE

We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

## RECENT TAX CHANGES

For the third time in as many years, Congress has passed a tax cut package, the Jobs and Growth Tax Relief Reconciliation Act of 2003. Most taxpayers will pay less in taxes, with investors, high-income earners and married couples with children among the main beneficiaries.

### **Lower individual income tax rates**

Marginal income tax rate cuts previously scheduled for 2004 and 2006 have been accelerated. The highest rate of 38.6% has been trimmed to 35%, and the old 35%, 30% and 27% rates have each declined by two percentage points. The 10% and 15% tax rates remain unchanged, but the income brackets have been expanded for many filers. All income tax rate cuts are retroactive to January 1, 2003.

**Reduced dividends and capital gains rates** Until now, dividends have been treated as ordinary income, which

meant individuals were taxed at their regular tax rate. With the new tax changes, qualified dividend income will be taxed at a 15% rate for most taxpayers. (Individuals making less than \$28,400, or married \$56,800, will be taxed at a 5% rate.) Retroactive from January 1, 2003, the lower rates apply to dividends distributed by tax-paying domestic corporations and qualified foreign corporations. A dividend-paying stock must be held for more than half of the 120-day period surrounding the ex-dividend date to be eligible for the 15% rate.

The maximum tax rate for long-term capital gains has been cut five percentage points from 20% to 15%, effective for transactions on or after May 6, 2003. Taxpayers making less than \$28,400 (married \$56,800) will pay a 5% rate for long-term capital gains.

**Other features** The 2003 Tax Act in-

creases the child tax credit for eligible taxpayers, provides some marriage penalty relief and raises the alternate minimum tax (AMT) exemption to \$40,250 for single taxpayers (married \$58,000). Businesses and corporations also receive benefits, in the form of enhanced small business expenses and expanded bonus depreciation.

The tax cuts span eight years and have a variety of start and ending dates through 2010. Unless Congress takes further action to extend or repeal the sunset provisions, the new tax breaks will revert back to their old levels over a several year period.

