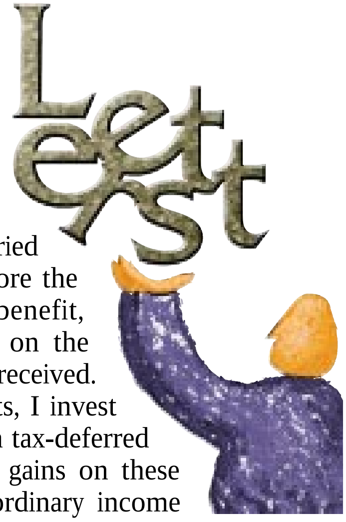
Letters to the Editors



To the Editors:

I have been using James Cloonan's November 2002 *AAII Journal* article ["Asset Allocation and Risk: How to Build Your Own Portfolio] as a basis for investing in Vanguard index funds. The price-to-book ratio of the small-cap value index fund is above 1.5. Should I wait to invest further, screen for other index funds, or use this as a guide to take some profits in the retirement part of my portfolio?

Steve Hammer
Via E-mail

James Cloonan Responds:

In the same article, I pointed out that value as applied to index funds refers to the top-half of a value continuum. In Vanguard's case, it is the top half of the Barra 600 small-cap fund. Less than half of these holdings are truly value stocks and so you get a higher price-to-book ratio than I like to see. While I can't give specific advice, I personally would prefer some of the small-cap value funds mentioned in my September 2003 AAII Journal column ["New From AAII: Specific Guidance on Stock and Fund Selection]. Historically, between December and the end of January is the strongest period for small-cap stock performance. This period often runs into February, so if you change funds do so simultaneously; don't be out of small caps early in the year, even for a few days.

To the Editors:

In "A Full Financial Planning Plate: Kids, Parents and Retirement" [October 2003 *AAII Journal*], Karen Altfest states in the Kids' Education section that "Since it's your state plan, contributions would be tax-deductible on your state tax return as well as on your federal return."

Please note that contributions to 529 plans are not tax deductible for federal income taxes. However, earnings are tax free if used for higher education. Also, not all states allow deductions for contributions to 529 plans.

Joseph A. Zielinski, CPA, CFP
Via E-mail

To the Editors:

Annette Thau's article on bonds in the October 2003 *AAII Journal* ["Are Junk Bonds for You? A Look at High-Yield Bonds] did not discuss an important tax issue for individual investors who consider investing in high-yield bonds.

The market sets the prices of these bonds at low levels, resulting in high yields, because investors anticipate a high level of defaults. If the bond issuer does default, the investor realizes a capital loss—a loss that must be offset against any capital gains before reducing the investor's taxable ordinary income. The offset against ordinary income is limited to $3,000 per year. This means that in a best-case scenario, the capital losses create a tax savings at the capital gains rate, while the added coupon income is taxed at the higher ordinary income rate. In the worst case, if the capital losses are high enough, they might have to be carried forward for many years before the investor realizes any tax benefit, meanwhile having paid tax on the coupon income in the year received.

For my own investments, I invest in high-yield bonds only in a tax-deferred account. Since the ultimate gains on these accounts will be taxed as ordinary income when withdrawn, the capital losses and high coupon have offsetting tax effects.

Donald F. Behan
Via E-mail

To the Editors:

The October 2003 *AAII Journal* contained a great article about ETFs ("The Individual Investor's Guide to Exchange-Traded Funds"), but no mention that Vanguard came out with several new VIPERS last fall.

Craig Bell
Via E-mail

The Editors Respond:

We only reported exchange-traded funds that were listed at the time of printing. Vanguard VIPERS will be included in next year's listing.

To the Editors:

I am unable to find any reference to medical deductions pertaining to over-the-counter non-prescription drugs in your tax planning guide. I was under the impression that the law had been changed to now allow this deduction. Is that actually the case?

G. Fischer, MD
Via E-mail

The Editors Respond:

For further information on specific deductions, visit the IRS Web site at www.irs.gov. Medical and dental expenses are covered by Topic 502, according to which "The cost of drugs is deductible only for drugs that require a prescription, except for insulin." Go to www.irs.gov/taxtopics/index.html and click on Itemized Deductions (Topic 500) and then Medical and Dental Expenses (Topic 502). For further details, a link to Publication 502 is included within the Topic area. The IRS notes that this rule applies only to deduction of medical expenses and does not limit reimbursements from health plans.