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# Funeral Monitor

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Subscribers may receive the Funeral Monitor early via email at no extra charge. Details at [www.funeralmonitor.com](http://www.funeralmonitor.com).

January 24, 2005

Volume 14, Number 4

## Zeroing In On The Important Things

Despite his Midwestern work ethic, my husband would be the first to admit retirement has never been far from his mind since he punched in at his first job washing dishes at 16. Working toward his goal of comfortable sloth, he paid \$7,500 for \$58,000 worth of zero coupon bonds for his IRA in 1985. The beauty, of course, was the compounding 12.5 percent interest rate leading to a seven-fold increase of nontaxable growth after 20 years; the tough part was mentally putting the funds in a lock box as we bought a new house, a couple of cars, and college tuitions and weddings came and went for our two daughters. Only God and maybe Greenspan knew what he'd lose if he cashed the zeroes out before their time. So he didn't. He was notified last week the bonds mature at the end of the month.

Unlike most municipal bonds, zeroes pay no periodic interest during their life. "Instead," explains the Securities and Exchange Commission, "investors buy zero coupon bonds at a deep discount from their face value, which is the amount a bond will be worth when it matures." The investor receives one lump sum equal to the principal invested plus interest earned, compounded semiannually, at the original interest rate.

"Because zero coupon bonds pay no interest until maturity, their prices fluctuate more than other types of bonds in the secondary market," the SEC goes on. "In addition, although zero coupon bonds do not pay any interest, investors may still have to pay federal, state, and local income tax on the imputed or 'phantom' interest that accrues each year."

Zero coupon bonds are also known as "STRIPS" because their interest and repayment

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of principal are separated and sold individually. "STRIPS" is an acronym for Separate Trading of Registered Interest and Principal Securities. The Treasury does not issue or sell STRIPS directly to investors; they can be purchased and held only through financial institutions and government securities brokers and dealers. While STRIPS may be issued by the U.S. Treasury, corporations, and state and local governments, the Treasury STRIPS are considered the safest of the three because they're backed by the ever-popular "full faith and credit" of the U.S. government. They're fabulous investments if you don't need the money, but not so hot if you're looking for interest income or are forced to sell in a down market.

"STRIPS are popular with investors who want to receive a known payment at a specific future date," says the Treasury Department's Bureau of the Public Debt. [Whoever *knew* public debt even had its own *bureau*?] For example, some state lotteries invest the present value of large lottery prizes in STRIPS to be sure that funds are available when needed to meet annual payment obligations that result from the prizes. Pension funds invest in STRIPS to match the payment flows of their assets with those of their liabilities..."

So what does this have to do with the funding of a funeral? The **Cooperative**

**Funeral Fund (CFF)**, a Massachusetts corporation headquartered in Madison, Connecticut, invests in STRIPS exclusively, at least for the \$22-plus million in the "Massachusetts Funeral Services Escrow Account," only part of its \$115 million of discretionary assets under management as of May 2002. (Now, \$30.5 million in Massachusetts and \$180 million overall.) Not that there's anything wrong with that; unless it turns out there is.

### Brilliant, but prudent?

Compared to the 10-year-old cheese sandwich with the vision of the Virgin Mary toasted into its side that sold on eBay in November for \$28,000, investing in zeroes looks like a safe bet. But a portfolio of all eggs in one basket is not necessarily what financial fortune-tellers recommend.

Yet there's much to admire about this strategy: The returns are better than average, the investments are safe and secure, and nobody has to worry about buying or selling – in fact, when you look at CFF's bookkeeping, there are no discernible transactions going on. It's money in and money out. A fan might say the plan is beautiful in its simplicity and safety, while critics warn against a possible Ponzi scheme. Without a full-fledged audit, however, neither opinion is provable.

According to CFF: "The objective of

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this program is to provide maximum security to the principal and to pace inflation (or the rising cost of funerals) as best possible. In that the funds of an individual escrow account exist, on average, seven years before being withdrawn, the investment philosophy is one of passive management. Financial instruments are bought and held for long durations not actively traded.”

Which is good if the bonds are precisely laddered to mature in conjunction with the fund’s liquidity needs, but possibly dangerous if too many contract-holders die premature deaths according to actuarial assumptions and bonds need to be sold before maturity.

There might be a few other flies in this ointment as well. The fund’s statements are “reviewed” but unaudited; there are some possible loosey-goosey discretionary over- and under-allocations of earnings going on (at least in Massachusetts) in an effort “to avoid annual distortions”; CFF’s fees sound relatively high at 1.25 percent plus expenses; and no one claims fiduciary responsibility – not Wachovia Bank, the trustee, nor Mark Mannix, the fund’s founder and president.

We’ve submitted a number of questions to Mr. Mannix about oversight and regulation of CFF, its reporting practices, and investment philosophies; and expect detailed explanations for next week’s issue. Yet the fact that the parameters of funeral trust investing and reporting are as hazy as who bears fiduciary and regulatory responsibility, points up a bigger and far more important problem: State boards are fiddling while funeral service burns.

“The regulatory scheme we operate under has been on the books for 50 or 60 or 70 years,” says New Jersey State FDA exec Wilson Beebe. “We have to open up our practice acts in a big way. What issues

require government oversight?” And is anyone doing anything about them?

### **Misplaced priorities**

In Oklahoma, some folks are getting their underwear in a bundle over who should be permitted to sell caskets. California FDs have been given reason to worry over how to display their framed licenses in a places of prominence while the interior walls of their FHs get a fresh coat of paint. Wisconsin FDs fret about the threat of combination operations. FDs’ business cards in New Jersey must list their license number – making them look a lot like a plumber’s. Massachusetts and Connecticut owners agonize over competitors who manage to get around a prohibition against refreshments in the FH. Advertising in Oregon must carry a funeral home’s physical address on everything from newspaper ads to calendars, rain hats, and combs.

State budgets are shrinking and bureaucracies are on life-support. Licensing agencies remain responsible for delivering the cash cows of revenue. State boards are stuffed and staffed by practitioners more concerned with self-protection than the public. Complaints are often generated by competitors, not consumers. Legal counsels are spread between eight, ten, fifteen, or more occupational categories. The relatively few inspectors who remain are often inexperienced and more inclined to measure the square footage of the prep room (which they understand) than examine a random sample of preneed contracts (which they don’t).

There’s enough money in the deathcare business to attract opportunists bent on mischief, but not enough to attract attention from the regulators – until there’s a problem; and then it’s too late. While the industry contemplates its navel, bad things

might well be happening to good but naïve people – FDs and consumers alike.

It is not against the law to sell a cheese sandwich for \$28,000, or for a preneed

trust to be unaudited, under-regulated, and all but ignored. But it is illegal in some states to curse in the presence of a dead body. It's all a question of priorities.

## The Skinny on STRIPS/ Zero Coupon Bonds

*STRIPS, or zero coupon bonds, have been around for about 20 years and while they are not a universally popular fixed-income investment, they're also not as mysterious as one might imagine. Their suitability as a funding mechanism for preneed contracts, however, remains largely unexamined by state regulators and even the SEC. The Bureau of Public Debt has this to say:*

- When a Treasury fixed-principal note or bond is stripped, each interest payment and the principal payment becomes a separate zero-coupon security. Each component has its own identifying number and can be held or traded separately. For example, a regular Treasury note with 10 years remaining to maturity consists of a single principal payment at the end and 20 interest payments, one every six months, for 10 years. When this note is converted to STRIPS form, each of the 20 interest payments and the principal payment becomes a separate security. STRIPS are also called zero-coupon securities because they have no periodic interest “coupons,” and the only time an investor receives a payment during the life of a STRIP is when it matures.
- Market prices of STRIPS fluctuate more than the prices of fully constituted securities of the same maturity. The market price of a STRIP reflects the fact that there is only one payment on a specific date in the future...The longer the maturity of STRIPS, the greater is the potential market price fluctuation.
- STRIPS sell at a discount because there are no periodic interest payments. An investor's income on a STRIP that is held to maturity is the difference between the purchase price and the amount received at maturity.
- The total income from a STRIPS security is fixed at the time of purchase as long as the security is held to maturity. When STRIPS are sold before maturity, however, the investor could realize a gain or loss because the market price could be more or less than the purchase price plus the amount of interest that is accrued between the time the security was purchased and the date it is sold.
- While the liquidity of particular issues may vary from time to time, in general a busy market exists for STRIPS with maturities from a few months to 30 years.
- Generally, for Federal income tax purposes, an investor must report the interest earned on STRIPS as income in the year in which it is earned – even though it is not received until maturity or the STRIPS are sold.

- Every investor in STRIPS receives a report each year displaying the amount of STRIPS interest income from the financial institution, government securities broker, or government securities dealer that maintains the account in which the STRIPS are held. This statement is known as IRS Form 1099 – OID, the acronym for original issue discount. The income-reporting requirement has meant that STRIPS are attractive investments for tax-deferred accounts, such as individual retirement accounts and 401(k) plans, and for nontaxable accounts, which

include pension funds.

- The income tax treatment of STRIPS also takes into account market discount and capital gains or losses, if any. Therefore, an investor would be well advised to review possible income tax implications before investing in STRIPS.

*I'd say STRIPS' volatility, maturity requirements, and tax implications would pretty much negate their utility as the sole funding mechanism for preneed; an opinion that will no doubt be challenged by Mark Mannix next week.*

## Monitoring.....

### FCA Files Brief in OK Casket Monopoly Case

Funeral Consumers Alliance, the nation's oldest and largest funeral watchdog group (and to some, biggest pain-in-the-neck to business-as-usual for FDs), has filed a friend-of-the-court brief with the US Supreme Court in support of a challenge to an Oklahoma law that gives funeral directors the sole right to sell caskets. FCA hopes the high court will hear this case and rule that the law is invalid, which would overturn similarly restrictive laws in several states around the nation.

On August 23, 2004, a three-judge panel for the 10th Circuit of the Federal Court of Appeals in Oklahoma upheld the state's ban on the sale of caskets by anyone but licensed FDs. The FTC had filed an amicus brief criticizing the law, and despite the court's opinion that the law "may extract a needless, wasteful requirement in many cases," it upheld the ban anyway, on the grounds that it was up to the legislature, not the judiciary, to change the laws.

In 2002, an opposite decision was

reached by the 6th Circuit Court of Appeals, overturning a similar casket sales ban in Tennessee. In that ruling, the court noted that the state's justification for the ban, "came close to striking us with the 'force of a five-week-old, unrefrigerated dead fish.' " [They were, apparently, neither swayed nor convinced by the argument that *only licensed* FDs are uniquely suited to sell single-use boxes of varying beauty.]

The Institute for Justice, the Washington, DC-based law firm that successfully litigated the case in Tennessee, has asked the Supreme Court to overturn the 10th Circuit's decision upholding Oklahoma's law.

### Damiano Trial, Take Two

The Association of Independent FDs of Florida reports in its January newsletter: "A mistrial was declared in a civil case against a former crematorium operator accused of delivering cadavers to Lynn University without family consent.

"The family of Madeline Post, who