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BFAS Money Line

How Long Will the “R” Word be Around?

No, the “R” does not stand for Republican! **Looks like we are in a recession** although it will be a year or two before the economists will confirm it. By then, the recession will be long past. We normally have a recession about every four years (doesn’t have anything to do with the other thing that happens every four years). We **just finished the second longest period in our history without a recession**!

Much ink and airtime will be used dissecting why we are having this recession. When times get tough, we always want a scapegoat, err.. reason. Last recession followed the **Internet Bubble**, this one followed the **Real Estate Bubble**. Last time, your hair dresser talked about making a killing in Internet stocks, this time real estate. Guess you could say, when the hair dresser starts touting an investment, run for the hills!

"Buy low, sell high. Stay Diversified. That's it?"

Typically, a recession lasts about 8 – 12 months during which the stock market will lose 20% - 30% and will recover all that loss within another 18 months. During the drop, you’ll feel poor and, since you will anchor your expectations at the highest amount you had (on Oct. 9th), you will feel poor until that high water mark is breached by the subsequent bull market. Economists believe the economy will recover towards the end of 2008.

So, where are the “safe havens” for your money in a down market? Bonds and cash. In the past, value stocks have lost less and bounced back quicker in recessions. However, with the credit crisis playing out, value stocks like financial companies and banks are hardly a safe haven.

If I was so sure about how long the recession would be, **why not just stick with bonds and cash until we’re sure the market has recovered?** Because, averages are not certainty. Remember the old adage about drowning in a river that averages one foot deep? Same with markets. **If we take our chips off the table until we’re sure it is going to go up, we’ll miss some of the downside (which may already be mostly behind us) and might miss a significant amount of the upside. That will dramatically reduce your overall returns.**

January was especially difficult. Our market lost 6% and foreign stocks lost 10%. Since October 9th, the S & P 500 is down about 16%, the NASDAQ over 20%.

With the Dow at about 12,000, you could say it is “on sale” right now. “On Sale” because we know it will be higher than the last peak of $14,164 sometime. I, for one, would rather be buying at 12,000 than 14,000. Yes, the market might go "more" on sale; but, again, that is a temporary situation.

Selling equity mutual funds when the market is down is dollar-cost-averaging in reverse. It really hurts. That's why **I recommend that retirees have sufficient cash on hand (or projected income) to make ends meet for two years without having to sell something at just the wrong time.** A two year period gives the markets time to drop and mostly recover from the routine recessions that come along.

The S & P 500 was only up 5.5% last year, but that looks pretty good to those who watched their real estate holdings decline in value. Locally, ODU says our real estate values were up about 4.5% last year, but Virginia Beach's increase of 6% obscures some losses in other cities in the area. ODU thinks that our housing is over-priced by 10%, yet, doesn't expect to see sharp declines in prices. More likely, reduced building will allow normal demand to soak up a surplus of 20,000+ houses within the next two years. Prices are likely to be flat with the possible exception of some high-end homes.

Nationally, home prices are down about 7% with Florida, California, Arizona, Nevada, and Michigan hurting the worst. Home building nationally is below normal demand levels, but prices may drop another 5 – 15% before they stabilize. Lower interest rates will allow many people to refinance from their Adjustable Rate Loans to fixed rate loans of 5.5% or less. Lower rates will also support more buying, but tighter credit requirements will keep some people renting.

Last year was one of those years when bonds beat stocks and a balanced 60% stock/40% bond portfolio out-performed the S & P 500. **As the market declines in this recession, a balanced portfolio will decline less and regain its former level quicker than an all stock portfolio.** Remember that it takes much higher gains to recover from losses (i.e. a 20% loss requires a 25% gain to get back to your starting point). **Minimizing losses by maintaining a balanced portfolio is critical to long term success!**

As the following chart shows, most every category of investment has swung to the negative in just the last quarter:

Asset Class	**1 Yr Rtn (01/31/08)**
S & P 500	**- 2.31%**
NASDAQ	**- 3.01%**
Lg Cap Gwth	**+ .98%**
Lg Cap Val	**- 4.75%**
Mid Cap Gwth	**+ 1.46%**
Mid Cap Val	**- 6.17%**
Sml Cap Gwth	**- 4.87%**
Sml Cap Val	**- 11.89%**
Foreign	**+ .22%**
Interm Corp Bds	**+ 5.68%**
Foreign Bds	**+10.87%**

Tax Issues

Starting in 2007, if you purchase a new mortgage and your Adjusted Gross Income is less than $100,000, **you can deduct the cost of your mortgage insurance.** This can be **on your primary home or a vacation home**. It applies to private mortgage insurance as well as to VA, FHA or RHA mortgage insurance. I generally recommend that you structure your purchase to avoid mortgage insurance, but at least now you can get a deduction for it!

Starting in 2008, **those in the 10% and 15% tax brackets will pay no taxes on long term capital gains**. This can be a significant advantage if you are in the two lowest tax brackets. Thus, if your income is below the magic number ($65,100 joint, $32,550 single) and you need some cash, you might sell enough to stay below those numbers with no tax consequences.

This also works if you want to give money to children (beware the Kiddie Tax I spoke of in my last newsletter) who might be in a lower tax bracket. Alternatively, you might want to give some stock/mutual funds to parents or grandparents who need income. They could possibly sell it with no taxes!

Did you remember to increase your 2008 contributions to your Roth IRAs and IRAs? This year **you can contribute $5,000 to IRAs or Roth IRAs ($6,000 for those over 50**). **For a SIMPLE IRA, you can contribute $10,500 ($13,000 if over 50).** Finally, contribution limits on 401(k) remain the same, $15,500 ($20,500 if over 50).

Real Estate: Sell or Not?

Some of you want or need to sell your home, but have seen the price drop and don't want to "sell low". Bert Whitehead, in the January 28, 2008 issue of *Investment News*, discusses the **costs of moving and carrying vacant real estate as well as how emotions can lead to more losses than just "selling low".**

He uses an example of a person who had moved out of their $750,000 home into a new home in another city. Since their old mortgage was "just' $2,500 per month, they figured they could hold onto their old home until values recovered. They had upgraded the old home and had about $650,000 invested in it. The felt they needed to get back at least what they had invested and didn't want to sell for $100,000 below the two year old appraisal of $750,000. Due to the costs of purchasing the new home, they felt they could not afford to bring money to a closing just to get the old house off their expenses. They were initially asking $725,000 for the old house with no buyers.

The owner was not counting several things in their carrying costs: **$300/month in home insurance on the vacant house, $600/month for utilities and landscaping**, etc. In fact, they were incurring **over**

"We've been selling the hell out of this stuff lately. Have somebody in legal check it out and see if it's on the level."

$50,000 a year in carrying costs. In addition, values in their old neighborhood were dropping by 5% - 10% annually adding another $40,000 in carrying costs. It was quite possible that the value of their home could drop another $150,000 before going back up.

By using the normal technique of slowing dropping the price to get a sale, the market price drops could be lowering the floor under the asking price. Thus, if they don't want to drop the price now to say, $625,000 (and losing $25,000), they may end up selling in two years for $550,000 having paid $100,000 in carrying costs. **Getting past the emotional issues, and getting the house sold now could end up saving a substantial amount of money versus holding on and hoping to break even!**

Paperwork

As the year ends and taxes are wrapped up, it is a good time to asses what paperwork you can throw out. We all get inundated with financial clutter. **Here are some things you can throw out:**

- Cancelled checks (except those supporting tax deductions or cost basis).
- Proxy paperwork
- Stuffers in bank an brokerage statements
- Annual reports
- Credit card receipts
- Utility bills (unless you are deducting them)

Here is what you need to keep:

- Bank statements after one year

- Tax returns for seven years
- Birth certificates, death certificates, marriage certificates
- Deeds
- Car titles
- Insurance policies
- Estate documents (wills, trusts, powers of attorney)
- Contracts
- Medical records
- Prospectuses
- Investment confirmations for buys and sells
- Year-end brokerage statements
- Monthly credit card statements (especially if they list items you deduct on taxes)
- Property tax bills

For identity theft reasons, I recommend you use a shredder for those items you throw away.

Savings for Children with Disabilities

The House of Representatives is considering new legislation called the **Financial Security Accounts for Individuals with Disabilities Act of 2007**. This proposal would **allow contributions of up to $500,000 to these special savings accounts where the money would grow tax-free for the life of the beneficiary**.

The **money could be used to pay for education, medical and dental care, community services, employment training, assistive technology, housing and transportation**. **Distributions would be excluded from the beneficiary's gross income so as to maintain the beneficiary's eligibility for government benefits.**

Some of the thinking behind this effort is that we already have such savings vehicles for families to save for education or health care (Education Savings Accounts and 529 plans). But, the child with a disability has no similar account.

Special Needs Trusts, which are commonly used, are taxed at trust tax rates which hit the 35% tax rate with only $10,450 in earnings. Thus, it is difficult to grow money in a special needs trust. On the other hand, these new proposed accounts could significantly improve the quality of life for our children with disabilities.

With government benefits being squeezed by budget deficits, it is more important than ever to encourage parents to save for their children with disabilities. Currently, families use Special Needs Trusts which are often tied to the deaths of the parents or funded by life insurance. Aggressive advocacy by parents and other interested parties could help make this proposed legislation a reality!

Even if this legislation is passed, you need to give great thought to who will manage this money and who will be allowed to spend it. This issue also affects Special Needs Trusts. Should the money be in a checking account or should it be invested in CDs, stocks, bonds, mutual funds, etc.?

How much of the money can reasonably be expected to be used annually to meet the child's needs while preserving the long-term viability of the fund/trust? As a trustee of the Virginia Beach Community Trust, our guideline is **no more than 5% should be used in any one year unless there are special circumstances**. Special circumstances might include not using any money for several years, then asking for a 10% withdrawal to fix a car or take a special trip.

Many times the person who is a close friend/family member of the person with a disability would be a perfect choice to request money, but not the right choice to manage the money. For amounts less than $100,000, you should consider having one of the free Community Trusts (Virginia Beach, Chesapeake, Norfolk, etc.) manage the money. For larger amounts, check out the Commonwealth Community Trust in Richmond (888-241-6039).

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