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BFAS Money Line

Is Bottom Behind Us?

The **market bottom of 752 for the S & P 500 on November 20th seems to be holding**. After an up December, January produced the worst January loss in history.

Why is the market bottom important? Because in the last ten bear markets, the market gained 23% - 53% in the twelve months after the market bottom!

Good news that could boost the market has been hard to come by. In this economy, a retail sales increase of 1% over December is a big deal. So also is news that local foreclosures are down, even as job losses continue.

The stimulus package is the government's attempt to help make up for a lack of consumer spending. It won't fully make up for the loss of consumer spending but it should reduce the drop in Gross Domestic Product (GDP). Sadly, the much ballyhooed infrastructure spending amounts to less than $50 billion of the nearly $800 billion total.

The magnitude of the current crisis isn't unprecedented – we've had worse - but how we got here is unique. There has never been a recession in modern history

that has been triggered by such a severe financial crisis – one that froze credit markets worldwide and led to the biggest surge in stock market volatility ever. Although the financial panic seems to be ebbing, borrowers are less willing to borrow and lenders less willing to lend, twin trends that will impede any economic recovery.

Last year's exodus from stock mutual funds was ten times higher than in 2002 (when the market tumbled 22%). With hedge funds and banks scrambling for cash, there were too many sellers and too few buyers and this accelerated the downward push far more than economic fundamentals would explain.

The **best case scenario going forward has the economy growing by the second quarter**. Unemployment would continue up to over 8% and inflation would start out negative, and then turn positive later in the year. In the **worst case scenario, the economy falls throughout the year** and unemployment tops 9% (it was 10% in the '82 recession).

Either way, the **economy will rebound and the market will bounce back**. Here are some of the positive signs I am seeing:

- market volatility has declined from the highs of Oct/Nov
- bank lending is improving (4th qtr 5% higher than 3rd qtr)
- positively shaped yield curve allows banks to make money by taking deposits at low

- interest rates and lending at higher long term rates
- housing is much more affordable after a 25% decline in price and mortgage rates are at or below 5%
- there is now $8 trillion sitting in cash waiting to flow back into the market when sentiment improves

I will repeat something from my last newsletter because it is so important. When the market turns around, it does so suddenly. **One year returns after the market bottom average 32.5%. On average, the market recovered to its previous high in 1.5 years.**

Waiting too late to get back into the market by only one week reduced the first year return to 24.3% and delayed recovery to 2.5 years. If you missed the first three months of the recovery, you only gained 14.8% and took 3 years to recover.

Over the last 20 years (through end of 2008), the market produced 8.4% returns. However, the average investor only earned 4.5%. Why the disparity? Simply that the average investor gets whipsawed by greed and fear emotions. **They buy when the market is up and sell when the market goes down (just the reverse of what they should be doing).**

Over the last 25 years, the market earned 9.8%. However, if you missed the best 25 days out of 25 years, you only earned 3.5%. How confident are you that you pick when to be in or out of the market?

As with all recessions, the decline in stocks has caused many to move money to bonds. The difference this time was that the credit crisis scared investors away from any bonds other than Treasury bonds. Thus, Treasury bonds did well last year, while all other bonds lost value.

Commodities peaked in July after gaining 25%, then went into freefall to finish the year down 40%. Typically, when raw materials are cheap, companies make higher profits and their stock value goes up. Clearly, this did not happen!

In previous recessions, foreign stocks didn't lose as much as domestic stocks; however this recession is global and the downturn is even worse in Europe this time. Thus, **there were no safe havens anywhere in typical diversified portfolios.** With the S & P 500 off 37% last year, **even a balanced (60% stock/40% bond) portfolio lost 26%**. Similarly, Yale lost 25% of their endowment and the Virginia Retirement system lost 25% of its value.

As the following chart shows, all asset categories are negative over the last twelve months:

Asset Class	1 Yr Rtn (01/31/09)
S & P 500	- 38.63%
NASDAQ	- 38.22%
Lg Cap Gwth	- 38.21%
Lg Cap Val	- 39.97%
Mid Cap Gwth	- 41.26%
Mid Cap Val	- 39.35%
Sml Cap Gwth	- 40.10%
Sml Cap Val	- 37.11%
Foreign	- 43.74%
Interm Corp Bds	- 7.48%
Foreign Bds	- 8.30%
Commodities (DJ – AIG)	- 41.58%

Odds and Ends

Government-Speak – Do you know what **OASDI** is? It's **Old Age, Survivors and Disability Insurance, known by the more common name, Social Security, today**. Since it's inception in 1935, everyone paid "premiums" in accordance with the **Federal Insurance Contributions Act** (FICA). Currently, employees pay 6.2% and employers pay 6.2% in FICA tax (self-employed pay the whole 12.4%).

The "**Making Work Pay" Tax Credit just passed in the stimulus package includes $400 per person refundable tax credits for those with adjusted gross income below $75,000 ($150,000 for married filing jointly)**. This credit also applies to those who pay no income taxes.

The **purpose of this tax credit is to eliminate the requirement for people to pay their share of the OASDI insurance premium.** Thus, after 74 years, **we have changed OASDI from an insurance program to which everyone pays premiums into a wealth transfer program where those who pay income taxes will be subsidizing those who no longer have to pay their insurance premiums**. In government-speak, not paying your premiums becomes a "tax cut". This one change will cost $116 billion over the next 10 years.

To "pay" for this wealth transfer, Congress plans to raise taxes on those making higher incomes (some say greater than $250,000). This tax increase may be delayed until after the recession is over, but it is coming.

There is no doubt that payroll taxes represent a large burden on the working poor. However, this burden cannot be viewed in a short-term context because payroll taxes represent future benefits for workers. The Social Security system is an insurance program into which workers pay so that they can receive benefits when they retire.

Social Security was designed to provide higher rates of return for those with the greatest financial need. Accordingly, the system already **redistributed a substantial amount of money from mid- and high-income workers to low-income workers**.

A Congressional study showed that low-wage workers could expect to receive Social Security benefits which exceeded the value of their payroll tax contributions (roughly a 2% return). In contrast, middle- and high- wage workers were expected to pay substantially more into the system than they would receive in benefits. Middle- and high-wage couples were expected to suffer net losses throughout their lifetimes as large as $120,000 and $200,000 respectively.

Thus, the original Social Security program was, in part, a wealth transfer to low

income workers. This new "tax cut" further increases the wealth transfer.

IRA/401k Contributions – Maximum IRA contributions in 2009 remain at $5000 plus $1,000 catch-up for those over 50. Maximum 401k deferral is $16,500 plus $5,500 for those over 50. Maximum SIMPLE IRA deferral is $11,500 plus $2,500 catch-up.

IRA Distributions – to allow your IRA to recover some of last year's losses, **no one is required to take a mandatory IRA distribution in 2009!**

State Taxes and Retirement – Lots of people like to move to sunnier states in retirement. Seven states (including Florida, Nevada and Texas) have no income taxes. The lack of income tax would seem to make these states attractive for retirees.

However, the states have a wide variety of taxes and loopholes from taxes that could easily trump the lack of income tax. Some states tax Social Security, some don't. Some don't tax federal or state pensions. Sales taxes vary greatly from state-to-state. Some states offer property tax relief for seniors. There are big differences in treatment of inheritances and tax breaks for college 529 plan contributions.

A recent paper in the Journal of Financial Planning, "Survey of Total State Taxes and Planning Implications for Retirees", showed that the total state tax burden was least in Alaska (6.4% of income). The next four were Nevada 6.6%, Wyoming 7%, Florida 7.4% and New Hampshire 7.6% (for my Texas readers, it was 8.4%). Highest tax burden was New Jersey at 11.8% followed by New York 11.7%, Connecticut 11.1%, Maryland 10.8% and Hawaii 10.6%. Virginia is right up there at 9.8%!

So, **take the time to investigate all your proposed retirement location's tax policies. It could make a 2% -- 5% difference in spendable income during retirement**!

Estate Taxes and Planning -- - We are very likely to see estate tax legislation this year. Current law gives each person a $3.5 million exemption on estate taxes. Next year estate taxes are eliminated and in 2011 the exemption goes to $1 million and stays there.

Congress is expected to freeze the exemption at $3.5 million and maintain the step-up in tax basis upon death as is currently in place. Previous estate tax elimination proposals would have done away with the step-up. That would have led to nightmares as heirs tried to figure out the tax basis of stocks held for decades.

As this issue comes up and Congress makes the new rules, this year will be a great time to review your estate plan. One issue is not having an estate plan (70% of you don't have one). Next biggest is having an estate plan that has not been completed.

Even if you have a will, it may not be enough. The probate process can be expensive. If you own property in more than one state, you must go through probate in each state plus having to hire an attorney in states where you are not a resident. This is one of the many situations where a trust (with all assets held in trust name) might make more sense.

If your heirs have problem marriages, poor financial skills or disabilities, a trust might be the best solution. Even joint ownership of a home can be problematic. If one of the joint owners becomes mentally incapacitated, the home is in legal limbo because the incapacitated owner is incapable of conveying legal title or signing legally binding documents.

College Savings – The stimulus plan includes a provision that makes **computers and computer technology qualify as qualified education expenses**. However, with many 529 plans having suffered losses last year, this would be a good year to minimize withdrawals. Rising tuitions and losses in 529 plans have made Virginia's Prepaid Tuition plan more attractive to many people. But, the Prepaid Tuition plan's limitations if your student goes to an out-of-state college severely limit its usefulness.

Special Needs Trusts

As of today, military survivor benefits can not be directed to a Special Needs Trust (SNT) so that a beneficiary may continue receiving SSI/Medicaid benefits. However, I am working this issue with the Center for Medicare & Medicaid Services to get a legislative change. In addition, the National Military Family Association is working the issue. Stay tuned!

Here is a partial list of what SNT funds can pay for:

- **Purchase of a home, with rent paid by occupants**
- **Household goods**
- **Weatherization assistance (insulation, storm doors, storm windows**
- **Tools for home improvements**
- **Furniture**
- **Handicap van or regular car**
- **Durable medical equipment, wheelchairs**
- **TV, radio, cable service**
- **Stereo**
- **Telephone, answering machine**
- **Recreational equipment, games, crafts**
- **Musical instruments**
- **Travel and education**
- **Recreation and entertainment**
- **Insurance**
- **Vacations**
- **Travel costs of relative to accompany on vacation**
- **Dental care**
- **Personal services: lawn mowing, house cleaning, grocery shopping, babysitting**
- **Movies**
- **Care manager services**

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