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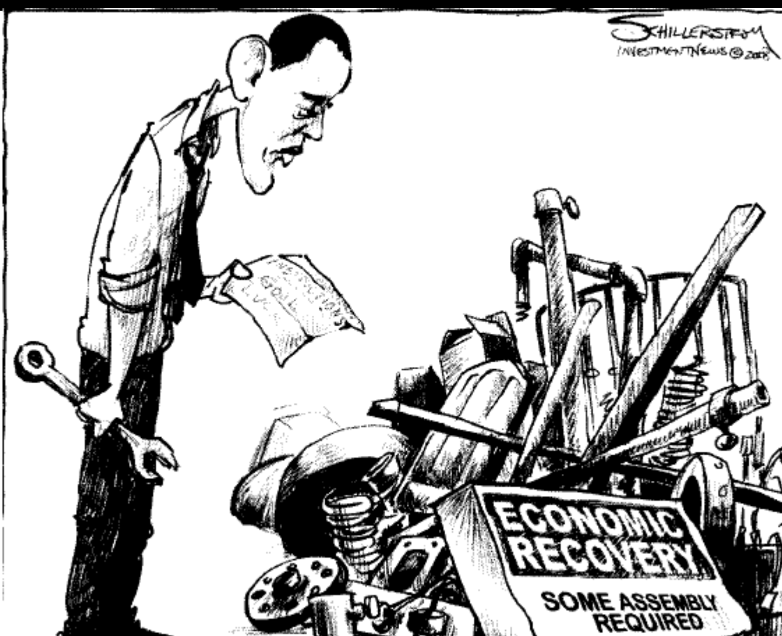
BFAS Money Line

When will the Pain Stop?

This question is on a lot of minds about now, along with, "**What do we do now?**" September and October's dramatic market drops surprised virtually everyone. (Yes, there were one or two commentators (out of hundreds) who are permanent bears and, like a stopped watch, happened to be right this time).

We seem to be in one of those periods when the market makes no progress over a period of years. By that, I'm referring to the period since the start of this decade. The market is down 17% from March of 2000 to this October. This is a very rare event since the market is rarely down over even a five year period (hence the common rule about not putting money into the market that you need to spend in the next five years).

Even though our market has lost ground, other markets have not over that same time. U.S. Treasuries and world bonds are up over 60% and commodities are up over 70% over the same time (foreign stocks are down 11%). Balanced portfolios of stocks and bonds are up over 10%.



Thus, **you can still make money in these periods of sideways market movement.** Now we've only had one such period in the last sixty years. That was 1966 – 1982. No one knows how long this one will last, but even within one of these periods, there are bull markets (like the one 2003 – 2007).

When the market turns around, it does so suddenly. After being down 34% during the year in 1987, it finished up 2%, followed by +12% in 1988 and +27% in 1989. Following **1994, the last time both stocks and bonds lost ground, the market gained 34% in 1995.**

Investors who held on through the last 12 bear markets gained an average of 32.5% in the first year after the market's recovery and recouped their losses 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 2007), the market produced 11.9% 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).**

During September, investors withdrew about $50 billion from the markets, $70 billion in October. Hedge funds receiving redemption requests from their investors are unwinding their complicated and leveraged trades. Estimates are they have withdrawn $600 billion from the markets with maybe another $200 billion to go.

This significant selling pressure has been one of the reasons for the late day sell-offs in the market. It is also responsible for stock valuations that bear no resemblance to their true value. For example, Exxon Mobile (XOM) is currently selling for 7.9 times past earnings (9 times forward earnings). Exxon Mobil is said to have 4 times earnings in cash on hand. In normal circumstances, a stock would be valued at 15 times earnings. IBM is currently valued at 10 times earnings, Microsoft 11 times,

The market appears to be oversold at this time. Can it be more oversold? Sure. When the scared money stops running and businesses seem to be turning the corner, the markets will respond. There are huge amounts of money on the sidelines to spur the recovery once conditions are right.

We are starting to see the credit tightening reverse as a result of last month's government actions. Lower oil and gas prices are helping. **Consensus opinion is that the economy will start to grow next quarter or the second quarter, no later than the third quarter**. The market, which anticipates the economy, should move higher months before.

One critical thing to remember is that you don't need all of your money now. At most, you "need" about 5% of it for living expenses. Some would ask, "5% of what I had last October or 5% of what I have now since it is 25% - 33% lower?" My analysis of long term 5% withdrawal rates assumes there will be times like these. So, I could still support 5% of the last October amount (about 7% of the current amount).

Having said that**, any prudent person would be wise to cut down on "want" expenses and focus on "need" expenses in a time such as this**. It is also a good time to review your goals and all your spending (charity and education included) to see if there are any areas you can pare down temporarily. Maybe revisit Niagara Falls instead of taking the family on an around-the-world cruise!

If you have sufficient cash for your needs and have dividends and capital gains coming in to refresh, you might only need to sell some bonds (sell high) to replenish your cash. You should have sufficient bonds that you would not have to touch your stocks for 8 – 9 years. Your stocks will certainly be much higher then than they are now and you will not have "lost" anything by selling low.

The current market value is just a number on the road to your long term (30 years + (including your retirement years)). Holding your stock positions over that time will always pay off. You will always remember these trying days (as I will), but **this is the time to let your advisor do the worrying, turn off the media and live your life. These times are when an advisor is most valuable by getting between your emotions and your money so that you don't become one of those investors who only earn 4.5% instead of 11.9%.**

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

Asset Class	1 Yr Rtn (10/31/08)
S & P 500	- 36.10%
NASDAQ	- 39.81%
Lg Cap Gwth	- 38.96%
Lg Cap Val	- 37.27%
Mid Cap Gwth	- 42.22%
Mid Cap Val	- 38.13%
Sml Cap Gwth	- 41.57%
Sml Cap Val	- 33.15%
Foreign	- 46.62%
Interm Corp Bds	- 8.37%
Foreign Bds	- 7.82%
Commodities (DJ – AIG)	- 26.61%

Odds and Ends

Taxes – Even before all of the current spending on re-energizing the economy, proposed spending by the incoming administration would have required higher taxes. Just letting the tax cuts enacted as a result of the last recession to expire will lead to one of the biggest tax increases in history.

Capital gains taxes will either be 20% or 28%. This 33% to 87% increase will

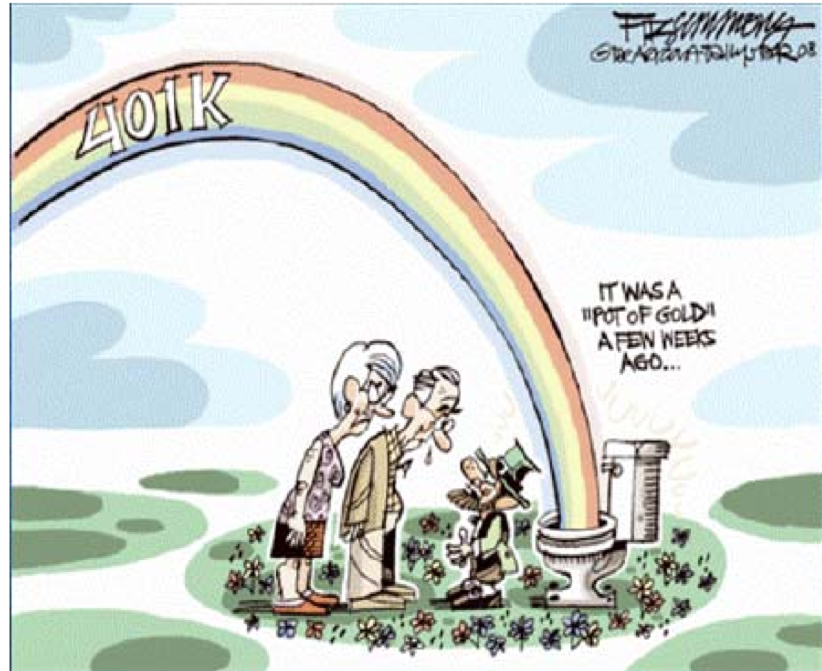
affect everyone holding a stock or mutual fund in a taxable account as well as those who finally are able to sell their home. This can especially affect seniors who are downsizing to smaller quarters and have significant equity built up in their homes.

This would be **a good time to "harvest" some tax losses. Not only will they offset any capital gains distributions this year (mainly from foreign, emerging market and commodities funds), but these losses could also offset next year's higher capital gains taxes**. I am reviewing every portfolio to sell funds that are down then purchasing a similar fund to maintain the investment allocation in that category. **If** you do this, be careful that you don't purchase a new fund that is also about to distribute capital gains!

If you own a business and plan to sell, you will probably keep more money if you sell this year rather than next year.

The recently signed (July) **housing bill changes the capital gains treatment on homes. Previously, if you owned a home for five years and you used it as your primary residence for at least two years, you could (jointly) pay no taxes on $500,000 of capital gains. As of January 1st, if you owned the house for five years and used it as a primary residence for two years, you can exempt only 2/5 or 40% of the first $500,000 in capital gains**.

Congress was trying to close a loophole where someone owning multiple vacation homes could live in each one for two years and



exempt $500,000 in capital gains on each one. That's no longer possible. You would have to live in each one for five years to get the maximum exemption. However, it also affects those with rental properties, who previously could move back to an area, live in their previous rental property for two years and claim the full $500,000 exemption.

Emergency Cash – The housing market crunch, rising energy and food prices and shaky jobs have left many families struggling to make ends meet. **Here in priority order are the most common places to get cash**:

1. Your Own Emergency Fund/Short term securities – should be in Money Market or CDs and should be large enough to cover 3 – 6 months' worth of expenses. If your job is shaky, expand it to twelve months of expenses.

2. Longer Term Assets in Taxable Accounts – next best source is your taxable stocks, stock funds, bonds or bond funds.

3. Roth IRA – you can withdraw your contributions (the amount you put in, not investment earnings) at any time with no penalties or taxes. However, earnings withdrawn before age 59 ½ are subject to taxes and penalties.

4. 401(k) Loan – it can be easy. Interest is paid back into your account. Must be repaid within five years. Downside is less money working towards your retirement. If you lose your job, the loan must be repaid immediately or you will pay taxes and penalties. You can reduce your contributions to your 401(k) but at least contribute the minimum amount to maximize your company match (almost 1/3 of workers fail to take advantage of this "free" money).

5. Home Equity Line of Credit – interest rates are reasonable and interest is tax deductible. However, some lenders have frozen these

lines of credit so it might not be available when you need it! Using your home equity increases the chances that a falling price will leave you owing more than your home is worth.

6. Traditional IRA – you will owe taxes and a penalty (unless you are over 59 ½).

7. Reverse Mortgage – must be over 62. High cost (twice that of a regular mortgage). Can make sense if you plan to stay in home over the long term (at least five years). Loan must be repaid when you leave the home.

8. Credit Cards – high interest rates, although some play card lotto switching from card to card to keep rates low. Credit cards are the single easiest way to ruin your credit. Minimum payments don't make a dent in your loan's principal.

9. 401(k) withdrawal – taxes will be due, and most of the time a 10% penalty. Depletes your retirement resources. Use only as a last resort!

Tips for the Homeowner in Crisis

1. **A Good Defense is the Best Offense** – Be careful before buying a house in today's market. It typically takes 4 – 5 years to break even on a home purchase in a "normal" market. Renting might be the best, and cheaper, option.
2. **Refinance Now** – If you have an adjustable rate mortgage that will adjust within the next year, and plan to stay in the home, consider a refi before the note adjusts.
3. **Renegotiate with the Bank** – many banks are offering to restructure loans. If you are slipping underwater, be proactive and contact your lender. It is easier to modify the mortgage before you reach crisis stage and the bank is more likely to work with you the quicker you get started. It may take time and effort to find the right person (loss mitigation) at the bank.
4. **Rent Your Unsellable Home, If Possible** – While being a landlord isn't for everyone, it beats foreclosure. Consider a lease-purchase agreement for slightly higher rent. Screen the renter's credit before completing the lease.
5. **Selling the Home with a Short Sale** – This is a negotiated sale where the lender agrees to accept less than the property is worth AND forgives the balance of the mortgage. This avoids expensive and time-consuming foreclosure and keeps your credit intact (Bank might ask for a note for the difference). However, at least it gets the monthly payment off your back!

Letter of Intent

I routinely talk to parents about the nuts and bolts of planning: qualification for benefits, helping create wills and Special Needs Trusts, and coordinating beneficiaries on retirement plans.

However, one of the key components of the overall plan is your Letter of Intent. It takes time out of your already busy lives to create one that covers all the areas of your child's life:

- **Family Information**
- **Medical History and Care**
- **Housing**
- **Daily Living Skills**
- **Education**
- **Day Program or Work**
- **Leisure and Recreation**
- **Religion**
- **Rights and Values**
- **Finances, Benefits and Services**

Think of yourself as an angel on the shoulder of the next caregiver. What would you want him/her to know about your child?

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