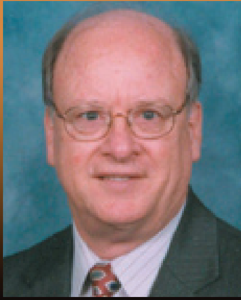


The THOUGHTFUL INVESTOR™

Morris E. Vickers, RFC®, President | A publication of Financial Security Advisors, Inc. | Third Quarter 2010

Two Keys to Portfolio Growth

Maybe you will be one of the lucky ones. You'll found a company offering the answer everyone wants and retire to easy street, the right horse will win, or a hundred other lucky combinations will happen.

But for the majority of us, retiring a millionaire – or a multi-millionaire – comes down to two actions everyone can take:

(1) Save throughout your life and

(2) let your savings compound.

Suppose you start with your first job at 16 by saving $500 for the year. Each subsequent year, you increase the amount you save by 10%. By the time you retire at 67, you will have saved more than $533,000. Add the impact of compounding and you are very likely a millionaire.

1. Lifetime Saving 2. Compound Savings

Compounding is the result of earning returns on prior earnings, as well as the initial investment.

continued on page 2

A Look at VIX, the Market Canary

One means of testing for bad gas in a coal mine is to lower a canary in a cage. If the canary dies, it's not a good sign.

The canary in the current stock market is volatility, commonly represented by VIX, the ticker symbol for the Chicago Board Options Exchange Volatility Index.

Volatility measures market uncertainty. When volatility is high, commentators like to call it a fear indicator. But when volatility falls, the same index becomes a greed indicator. Here's why.

Volatility at its most basic is the variation of an index or stock price over the short term. That variation may be a gain or a loss. It doesn't matter. What volatility measures is not market direction but market uncertainty. History shows us that volatility increases in times of financial turmoil.

VIX calculates the market's expectation for volatility over the next 30 days based on the options prices of the S&P 500 stock index. For example, a VIX of 15 represents an **annualized** change of 15% over the next 30 days. This means the index options markets expect the S&P 500 to move up or down less than 1.17% (remember the 15% is the annualized change) over

continued on page 3

Will the U.S. Be Another Greece?

It's easy to watch the financial turmoil in Europe and think, "It could never happen here. Our economy is too big, our resources too plentiful and our ability to create new businesses and products too great." The United States Government Accountability Office (GAO) however, reports we are well on our way to becoming a future Greece, it's just going to take a few years longer.

According to the GAO's **The Federal Government's Long-Term Fiscal Outlook: January 2010 Update** which was released on March 2, 2010, "absent changes to federal entitlement programs, spending on Social Security, Medicare, Medicaid, and interest on the federal debt will account for an ever-growing share of the economy. *… Assuming federal revenue remains constant at 20.2 percent of GDP–higher than the historical average–by 2030 there will be little room for "all other spending," which consists of what many think of as "government," including national defense, homeland security, investment in highways and mass transit and alternative energy sources, plus smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports."*

There are very few tools available to the federal government to avoid the problem, one of which is to increase taxes. This is already taking place and can be expected to accelerate. When the federal government starts looking for more money, it will look, as bank robber Willy Sutton once said, "where the money is."

Investment Strategies that Avoid Triggering Tax Consequences

With higher tax rates on the horizon, it's important to look at ways you can avoid triggering tax consequences in your investment portfolio. Any time you can reduce the tax bite, you have more money to invest, more money earning money, and ultimately, more money for your own needs.

- **Take capital gains in 2010 on assets you may want to sell in the next few years.**

  Given that taxes are headed up, 2010 may be the year to sell capital assets that have appreciated substantially, but that you don't want to hold forever. You may also want to look at long-term holdings where you have substantial gains, but intended to hold for a while yet. By selling now, you lock in current capital gains at the lower tax rate. You can then repurchase the investment establishing a higher tax basis.

- **Maximize contributions to tax advantaged retirement accounts.**

  Given the rapid phase-out of deductions and exemptions for reported income above $250,000 for couples and $200,000 for individuals, your goal should be to keep your income as low as possible by increasing 401(k), 403(b), IRA, SEP IRA, and other retirement plans that allow you to deduct contributions from income.

- **Fund a Roth IRA, and consider rolling over existing IRAs to a Roth format this year.**

  Everyone is eligible to rollover or fund a Roth IRA in 2010 regardless of income levels. Even if you have to pay taxes to roll over a traditional IRA, you may be paying taxes at the lowest level you will see for some time.

- **In higher tax environments, minimize realizing gains in taxable accounts unless you have offsetting losses.**

  This doesn't mean forgoing risk management. Instead find an adviser who understands the use of tools to protect asset values value in a down market.

- **Substitute perks for taxable paychecks.**

  This pretty much says it all, just check with your accountant first.

- **If self employed, consider forming a C-corporation.**

  Partnerships, LLCs or Subchapter S corporations are currently taxed on profits at the owners' individual income tax rates. A C corporation is a separate taxpayer with an initial tax rate of 15%, allowing business owners to hold profits in the corporation for growth and expansion with less eaten away by taxes. C corporations can deduct certain employee benefits that would otherwise be taxable income adding up to more tax savings.

The disadvantage to a C corp is that profits can end up taxed twice – first at the corporation's level and then at your personal level if not properly planned.

Before putting in place any of the strategies above, make certain and talk to your tax adviser. Everyone's personal financial situation is different and your tax adviser should be able to determine whether or not these strategies will have the benefits you want, or unintended side effects.

Two Keys to Portfolio Growth

continued from page 1

- Earn 5% a year compounded annually on your accumulated savings and the value of your portfolio increases to $1.1 million at the end of 50 years.
- Earn 8% compounded annually and your final portfolio value is $1.9 million at year 50.

Don't want to wait 50 years until you retire? You have two options. Increase the amount you save each year or increase the return on your investments. You have full control over the first option. The second option is going to depend on the return of your investment choices over the years. If you choose to invest for higher return, you need to accept the reality that the higher the return, the greater the risk. With that said… increase your savings to $5,000 that first year and continue to increase the amount you save by 10% each year and you will have $1 million by year 28 at 5% compounded annually and year 25 at 8% earnings.

Naturally, we have to add some disclaimers. There can be no guarantee that your account will earn a consistent 5 or 8% over 50 years. All investments have the potential for loss as well as gain. This example does not take into account the potential impact of taxes on earnings. So make certain your savings are invested in a Roth IRA where you can withdraw earnings tax free or a tax advantaged account that defers taxes on earnings (and contributions if in a qualified plan) until they are withdrawn.

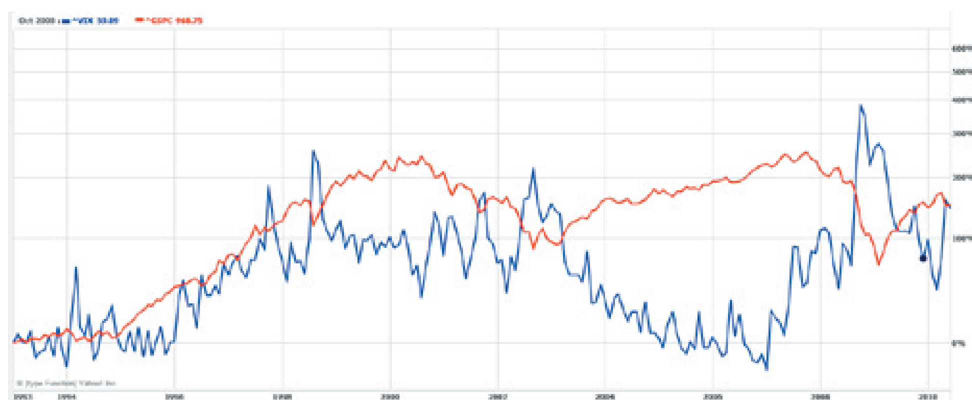
When it comes to achieving our financial goals, it can be easy to become discouraged. When you are struggling to save $5,000 a year, the idea of savings more than $500,000 may seem overwhelming. But small amounts add up over time. When you allow your savings to grow and let compounding take effect, wealth is very achievable.

A Look at VIX, the Market Canary *continued form page 1*

the next 30-day period. Most of us can live with the risk of a 1.7% change in 30 days. When the VIX reaches 60%, as it did in October of 2008, there is a 68% chance (one standard deviation) that the change for the 30-day period will be less than 4% up or down, and a 32% chance the move could be greater.

Historically, the value of VIX increases as investors become fearful of the direction of the market and decreases when they feel more confident of its future direction. A conservative investment approach avoids equities during periods of increasing volatility, reasoning that when investors as a whole are uncertain of market direction the sideline is the safe place to be. An opportunistic approach says when volatility is at its highest, the market is about to reverse direction. Periods of low volatility generally indicate a high degree of confidence with the market's direction indicating lower risk of a change in market direction. Thus, low volatility becomes a greed indicator.

VIX compared to the S&P 500 Index
1993 through June 2010



The S&P 500 is a capitalization-weighted index of the prices of 500 large-cap common stocks actively traded in the United States. An index cannot be invested in directly. VIX is a weighted blend of prices for a range of options on the S&P 500 index. Investors can buy or sell VIX contracts.

The one certainty about the VIX and other volatility indicators is that interpreting their meaning is an imprecise art, not a science. As with all investing, there is the potential for loss as well as gain when using volatility as an indicator.

Volatility's greatest value is as a caution sign. High volatility says be careful. There are factors we may not be aware of impacting the value of the investment. This is a time to put risk control in place. Don't get greedy. Remember it is always harder to make up a loss than to lose value.

Should You Buy the Market Because It Is on Sale?

Are market declines an invitation to buy equities?

One of the arguments made for buying in falling markets is the comparison of discounted stocks to discounted items at a store. If a 25% off sale on apparel or sporting goods makes items more attractive, the same should apply to the market when it is on sale, argue many traditional investment advisers.

At the risk of sounding cynical, buying long when the investment is falling in value is a great way to help generate fees for a stock broker or to keep a mutual fund manager – whose pay is based on assets under management – from suffering a drop in income. But it doesn't mean it's a good investment.

By that, we don't mean that you shouldn't invest during down markets. But you don't invest while values are falling. Wait until you see your investment of choice start to show gains, accompanied by respectable volume. Then you can invest. But not before.

Trading volume is an important requirement because rallies can be short-lived if they are not supported by volume. Without demand, prices can't continue to increase.

Comparing investments to apparel or sporting goods on sale is comparing apples to donuts. The same principles don't apply. When you buy an item on sale, you buy usability. You are purchasing something that has value to you. Something you can use, or eat, or enjoy. When you purchase an investment, you are buying its future value. *When* you purchase that item has a tremendous impact on its future value. If you buy a stock and it continues to fall another 15%, you will have to earn 18% to make up that loss. If you wait until after the stock falls 15%, recovers 5% and shows signs of continuing up to buy, you have a 13% advantage over buying too soon.

Contrarian investing – when everyone else is headed for the lifeboats – is one of the most difficult investment approaches. Even if you are right about the ultimate direction of the investment, markets rarely keep to the investor's schedule.

By all means continue to save and set aside money during falling markets, but set yourself a plan as to when you will invest that money that is based on logic beyond the idea of "It's on sale."

The Coming Tradeoff between Dividends and Appreciation

The 2003 tax cuts reduced the tax rate on most ordinary dividends from the taxpayer's personal income tax rate to a maximum of 15%, equalizing the tax treatment of dividends and long-term capital gains. One result of the change was renewed focus on income investing. Many public companies initiated dividend programs to attract stable investors.

Unless the 2003 tax rates are extended, or new rules are enacted before then, dividends will be taxed at ordinary income rates once again after December 31, 2010.

The question for investors is how will that impact dividend payouts or the number of firms paying regular dividends.

Studies of corporate behavior following the 2003 tax cut show total dividends reversing their recent downward trend and special dividends spiking. Perhaps more important was the increase in the number of firms paying regular dividends.

With the expiration of the 2003 tax cuts, dividends again will be taxed at a taxpayer's personal tax rate. This could be as high as 43.5% when the tax to pay for health care, imposed on couples who earn more than $250,000 a year, goes into effect in 2013. In addition to giving the U.S. one of the highest dividend tax rates in the industrialized world, the change in dividend tax treatment can also be expected to change investor behavior and corporate dividend plans.

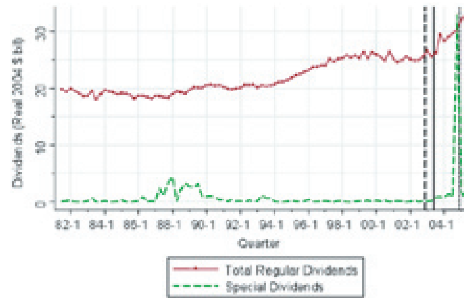
The reason is simple mathematics. A dividend of $10,000 will be worth $5,650 in after tax value at the highest income rates. A capital gain of $10,000 will have an after tax value of $8,000 based on the long-term capital gains tax rate of 20% effective 2011. The incentive to high income investors and corporations is to increase long-term capital gains and minimize dividends. Another advantage of long-term capital gains is that investors have greater ability to "schedule" the recognition of capital gains to offset losses.

For assets held in a tax-deferred retirement account, the tradeoff between dividend and long-term gain is a non-issue, because all withdrawals are taxed at the individual's personal income rate (with the exception of non-deductible IRA contributions where only gains are taxed).

The best approach for you to take with respect to dividends depends on your personal circumstance. Call today for an appointment on how to best position your portfolio.

Total Regular & Special Dividends

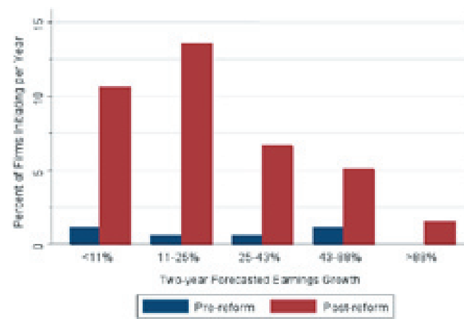
Non-Financial, Non-Utility & Non-Foreign Firms



The dashed vertical line is the start date of the dividend cut. The solid vertical line is the enactment date (end of May 2003) while the dotted line marks the reelection of George W. Bush.

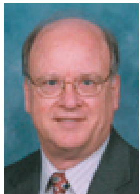
Effect of Tax Cut on Initiation of Dividends

Breakdown by Expected Earnings Growth



"The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting the Evidence," by Raj Chetty, Professor of Economics, University of California–Berkeley, and Emmanuel Saez, Professor of Economics, University of California - Berkeley, Quarterly Journal of Economics, 2005

RETURN SERVICE REQUESTED



Morris E. Vickers, D.Min, RFC®
Accredited Asset Management Specialist
17009 Heritage Bay Road
Rogers, AR 72756
800-396-0404
Fax 479-925-2938
fsamev@aol.com