



# The THOUGHTFUL INVESTOR™

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## Winning by Not Losing

Given a choice of (1) participating in the best days of the market or (2) missing them altogether along with the worst days of the market, which would you choose?

In a study conducted over 25 years of S&P 500 index history, the answer is surprisingly consistent. Investors don't need to participate in the best days of the market if they can miss the worst days. Missing both the best and worst 10, 20, 30 or 40 days of the S&P 500 returns outperforms the index by more than 1% annually. Over the 25-year history of the study, that 1% is the difference between a \$100,000

investment turning into \$673,836 versus \$846,624 – a \$172,788 or 25% increase in value.

With that said, keep in mind this is a hypothetical example and there's never been an investment strategy that missed just the best and worst days of the market. This study also doesn't take into account management or trading

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S&P 500 – 25 Years Ending Dec. 31, 2009 Average Annual Return 7.93%			
	Miss the Best	Miss the Worst	Miss Both Best and Worst
10 days	4.83%	12.14%	8.92%
20 days	2.79%	14.74%	9.28%
30 days	1.12%	16.93%	9.56%
40 days	(.46%)	18.86%	9.67%

Source: Hepburn Capital Management 2009 Study

## The Search for Stable Income Investment Options

Shell shocked by the volatility of the market over the last ten years, many retirees are asking where they can invest for stable income. "Forget appreciation and gains. I just need to know that I will have steady income in the years ahead," has become a common comment.

In January 2010, the White House's Middle Class Task Force recommended immediate annuities\* as a way to reduce "the risks that retirees will outlive their savings." Before you take that advice, however, we have some different recommendations.

An immediate annuity makes income payments immediately, or very soon after purchase. The problem with an immediate annuity is that you are locking in today's ultra-low interest rates forever. If you buy a bond, you collect interest for the term of the bond and then get your principal back. With an annuity, you get a higher payout, but your purchase price is gone forever. Your bet is that you will outlive the repayment of your original investment and interest, upping the long-term return from your invest-

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## Estate Tax Consequences Still Exist

So far, Congress has failed to reenact estate taxes for 2010, but that doesn't necessarily mean no tax consequences for heirs in 2010.

Yes, estate taxes and generation-skipping transfer taxes were repealed at the end of 2009. Without Congressional action, they will be back in 2011 at rates from a decade ago of \$1 million exempt from taxes and 55% taxes on the remainder. While Congress could pass estate taxes retroactive to January 1, 2010, the more time that passes from the start of the year, the messier that becomes to implement.

Barring new legislation, where taxes still come into play for a 2010 estate is cashing out an inheritance. Items sold from a 2010 estate will be taxable based on their original price. Inherit 1,000 shares of Amazon purchased in 1997 for \$18 and sell them today for \$130 per share, and you will have taxable gains of \$112,000. As a result, individuals who might not pay estate taxes under even a \$1 million exemption, may find themselves with a taxable inheritance.

The real problem for estates in 2010 will be wills designed to pass as much of the estate through tax free as possible. For example, a will might state that 100% of the estate that could be passed on tax-free be distributed to a designated charity while the remainder goes to the surviving spouse. Today, that could mean nothing for the surviving spouse.

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## The Search for Stable Income Investment Options *continued from page 1*

ment. Die early and the annuity issuer wins the bet.

### Other Alternatives for Stable Income

The most conservative, safest, stable income investments are found in U.S. treasury market issues. The catch is that these are your lowest yield options. If you believe, as we do, that interest rates will not stay this low forever, purchasing short-term issues will allow you to roll over your investment into higher yields in the future.

The next step up the yield curve is the purchase of corporate bonds and municipal bonds. Corporate bonds are debt issues from businesses. Municipal bonds are offered by local government agencies. Municipal bonds typically pay interest every six months and are often tax free. They have a slightly higher market risk than federal or state government issues, resulting in a slightly higher interest rate. In addition to a respectable yield, look for a good rating and whether or not the bond is insured.

The catch with both corporate and municipal bonds is that you have to commit for a long time. Typically, the further out the maturity (at which point you will receive the face value of the bond), the better the yield. If you need access to your funds before the bond matures, depending on where interest rates are at the time, you could receive less than the face value for your bond if you sell before maturity.

Bond funds offer corporate and municipal bond interest income with access to your funds. Your options include a wide array of corporate bond money market funds, corporate bond funds, floating rate bonds funds and tax-free bond funds. Buying a bond fund also provides individual security diversification, which can reduce volatility if a bond issue does go bad. But a bond fund still leaves investors vulnerable to interest rate risk. If interest rates increase, the value of the bond

portfolio will decline.

Another stable income option typically encountered in 401k plans is a stable-value fund or guaranteed investment contract, or GIC.s. These funds generally offer returns that are a few percentage points higher than the average money-market fund by means of contracts between insurance firms and a company's retirement plan guaranteeing investors a fixed rate of return. The catch is that the "guarantee" is only as good as the guarantor. In a stable income fund or contract, short- to intermediate-term bonds are bound by insurance "wrappers." If a stable-value portfolio falls below the rate of return set by the wrapper, the insurer pays the difference, keeping the fund stable. On the other hand, if the portfolio gains beyond the wrapper's set return, the fund pays the insurer the difference. Fees and redemption restrictions can adversely affect the attractiveness of these investments.

Other options for individuals who understand and are willing to accept more investment risk include utilities and master limited partnerships that are structured to generate regular income payments.

### Build Flexibility into Your Portfolio

The time to lock in a long-term, stable income investment is when you feel returns are optimal and unlikely to improve substantially over the time period in which you plan to invest. If that time isn't now, look to short-term options or stagger your investments over time. Keeping flexibility in your portfolio is essential if you are to take advantage of future opportunities for profit.

If stable income is your investment priority, let's review your options together. Remember, it doesn't take long for even a modest level of inflation to eat away at the value of a fixed income payout, leaving you without sufficient funds for your lifestyle.

*\* Past performance is not indicative of future returns. All investments have the potential for loss as well as gain. Make certain you understand an investment's objectives, past performance, and risk factors before investing, as well as what management, sales, distribution, transaction, and administrative fees are involved in the purchase, ownership, and sale of investments.*

*An annuity is a long-term, tax-deferred investment designed for retirement that allows you to create a fixed or variable stream of income through a process called annuitization. An annuity contains guarantees and protections that are subject to the issuing insurance company's ability to pay for them. An annuity is sold by prospectus, which describes risks, fees and charges that may apply to you. Individuals selling these products must be licensed insurance agents and registered representatives.*

*Money market funds are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although they seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in money market funds.*

*The values of government bonds funds, which invest primarily in the securities of the U.S. government and its agencies, are not guaranteed by these entities.*

*Bond funds have the same interest rate, inflation and credit risks associated with the underlying bonds owned by the fund.*

*Read the prospectus thoroughly and understand the risks and expenses before investing in any limited partnership or non-registered security.*

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## Winning by Not Losing

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fees that might be incurred in implementing such a strategy. Nor can you invest directly in the S&P 500 index.

What this example does demonstrate is how important not losing can be to an investor.

2008-2009 was a perfect example. The average mutual fund was up 34.9% in 2009 according to Morningstar. Unfortunately the average loss in 2008 was -40.5%, again according to Morningstar data. At the end of 2009, despite one of the best years for the S&P 500, the average mutual fund was still down -19.7% from where it started in 2008. If that doesn't seem to add up, you need to do the mathematics of gains and losses. A 40.5% loss needs a 68% gain to make it back to breakeven because you are starting from a much small balance.

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## Another Look at the Numbers

*‘There are three kinds of lies: lies, damned lies, and statistics.’ — Mark Twain<sup>1</sup>*

**H**ow bad is the housing market? Last fall, First American CoreLogic reported that 23% of all mortgage borrowers owed more than the actual value of their home while another 5% were near negative equity share. However, according to *The Wall Street Journal*, some 24 million Americans own their homes outright. When that number is taken into account, the number of homeowners in danger of defaulting on underwater mortgages drops to 15%. Still a problem, but much less of one.

Unemployment, on the other hand, looks considerably worse when you look at what’s behind the numbers. Widely reported is the official unemployment rate of 9.7% or 14.9 million unemployed for February 2010. The U.S. Dept. of Labor, Bureau of Labor Statistics has another number that looks at a wider population of those individuals who would like to be employed full time, but for one reason or another are not. It ranges from 17-18%, nearly double the official number. Converted to people, that’s 26 million people.

The U.S. federal government deficit has become too big to grasp as a single number. One way to put it in perspective is to look at the deficit per person, based on an estimated population of 308,000,000. Each citizen’s share of this debt is \$40,790. Then there’s a nasty little oversight called unfunded liabilities. The federal and state governments have made a lot of promises to retirees and federal and state employees with respect to retirement benefits. Unlike businesses, they are not required to carry those promises on their books as future liabilities.

Unfunded promises by state and federal governments are in excess of \$59.1 trillion, an amount equal to \$516,348 for every U.S. household. Medicare, Social Security and federal retirement programs account for 85%

of taxpayer liabilities. State and local government retirement plans account for much of the rest, reported *USA Today* in 2007<sup>2</sup>. The number has not gotten smaller.

What should you do? If it’s not too late, you might want to look for a job in the federal government. While state governments have made many of the same promises, their inability to print money tends to put a ceiling on over-spending.

On a more serious note, the financial stresses on state and local governments are forcing the public sector to become more efficient, to cut staffs and re-examine unsustainable benefits in light of declining tax revenues. Just as corporations are forced to undergo periods of self-examination and rethink the best way to do the job

and compensate employees, state and municipal governments are now doing the same. This is a very positive result of a difficult economic period and one that could have a lasting impact on local government. Whether or not the federal government follows suit remains to be seen. Its ability to borrow on a global scale is unmatched at the state level, where tax revenues shape budgets.

But at some point, even the federal government has to pay its debts. President Obama has suggested doing so by taxing the rich. Here again, you need to look at the numbers. According to the Tax Policy Center, there are an estimated three million taxpayers with annual income in excess of \$250,000. With respect to combined household

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## Learn to Detect On-Site ATM Scams

**A**ny time you withdraw money or enter a transaction on an Automated Teller Machine (ATM), you need to be alert to scams designed to steal your account and pin numbers. And, there’s some pretty ingenious technology in place to do so.

The most common means of capturing data from the magnetic stripe on the card is a device fastened in close proximity or over the top of an ATM’s factory-installed card reader.

The device reads and stores the data on the magnetic stripe. Capturing a pin number is often by means of micro cameras or imaging devices attached to the ATM. Touch sensitive plates have also been placed over the keyboard to record keystrokes.

Before using an ATM, check for any unusual or non-

standard features. Most ATM’s are single surface construction. They don’t have add on panels or overlays. Look for signs of tampering; pay particular attention to the touch and action points. Anything that looks like a camera should not be considered just security monitoring. If you have any concerns about an ATM, don’t use it. It’s much easier to find another ATM than it is to fight fraudulent charges to your account.

### Where to spot a card skimming or pin capturing device on an ATM?



## What's Different Today?

In the last year, the U.S. financial market has rallied nearly 70% and the prognosis for 2010 is increasingly bullish. But before you decide it's time to throw yourself head first into equities without a safety net, you need to answer the question – What's different today to give the market reason to continue its upward move?

We would hazard to say that the biggest difference between October of 2007 when the market started its last drop and today is that we have a better idea of the extent of the problem facing the U.S. and global economies. But that knowledge doesn't give us greater confidence in the staying power of the current rally.

Rose colored glasses say the economy is fixed and we just have to wait for growth to kick in. Low interest rates, bank bailouts, stimulus spending, and actions of the federal government are working. Unemployment is a lagging indicator, so nothing to worry about. And if there is a problem in sight it's the specter of inflation, which tends to be good for the stock market.

That's not a scenario we are comfortable with.

The problems that caused the market slide that began in 2007 are still with us. Commercial and residential lending

has not noticeably increased. New company formations and stock offerings are still at all time lows. Uncertainty in the business community over future regulations, costs and taxes has not been resolved. The continuing constriction of tax revenues at the local, state and federal level is forcing changes in government budgets, services and unfunded programs. California is a bell weather state once again but this time on how to avoid bankruptcy.

There has rarely been a more important time to have risk management a part of your investment approach. As our cover story shows, minimizing losses is essential in preserving portfolio values. There are no guarantees how long it will take to recover from a market decline. And, this is not a good time to be poor.

We would be the first to admit that there is no perfect investment approach. Investing always carries risk. But there is also the risk of inflation and of not having the financial ability to retire when you want. Our job is to balance those risks; to invest with a strategy designed to limit losses, but still participate in the market when we see opportunities. We welcome the opportunity to review our approach to investing with you at any time.

Fulfilling Life Goals Through Responsible Investing

## Another Look at the Numbers

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income, some 2% of U.S. households are estimated to report adjusted gross income of more than \$250,000 to the IRS. They currently pay 43.6% of all personal federal income taxes.

To generate sufficient dollars from these taxpayers to pay down a deficit estimated at \$9 trillion over the next ten years, would require boosting the average federal income tax rate for households earning over \$250,000 to 69%, says the *Wall Street Journal*. Add on state income taxes from 5-15% and top earners would take home 26-15¢ of every dollar in income. For an individual earning \$250,000, take home pay would fall to \$65,000 to \$37,500. At that point, one would be much better off earning less and paying taxes at a lower rate.

Numbers can be used to blur the truth as well as clarify facts. Before you accept an argument based on statistics, take another look at the numbers.

1 Mark Twain (1906-09-07). "Chapters from My Autobiography". North American Review 186. Project Gutenberg. <http://www.gutenberg.org/files/19987/19987.txt>. Retrieved 2007-05-23.[1]

2 Taxpayers on the hook for \$59 trillion," USA Today, Updated 5/29/2007.

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