

Investment Implications Of The Federal Bailout

As one market-shaking event followed another in the fall of 2008, it became harder and harder to stay abreast of the changes. This or that move by the government would be greeted as the key to economic survival only to be discarded as irrelevant or wrong-headed just days later. And the most ballyhooed effort, the near-trillion-dollar rescue package that finally made it through Congress and was signed into law October 3, has proven equally difficult to fathom.

The best-known provision of the Emergency Economic Stabilization Act of 2008 is \$700 billion initially intended to fund purchases of “toxic” mortgage-backed securities from cash-strapped banks. Shortly after the bill passed, however, U.S. Treasury Secretary Henry Paulson announced a new plan—taking equity stakes in banks in return for direct injections of capital.

The bailout also has \$100 billion in tax breaks, including a “patch” to save millions of taxpayers from the alternative minimum tax (AMT), and a temporary rise, from \$100,000 to \$250,000 per account, in the limit on Federal Deposit Insurance Corporation guarantees for bank deposits.

These and other provisions may have implications for investors, who could consider several possible

responses.

Keep an eye on inflation.

There’s widespread disagreement about where prices are headed. Initial concerns that the bailout would fuel inflation have more recently been supplanted by worries about deflation, with the price spike of the summer and fall seeming to be reversed by a slumping economy, soft demand, and collapsing commodity prices. Meanwhile, traditional inflation hedges such as gold and other precious



metals experienced their own bubble and could fall back. If you expect inflation to return, a better idea might be to invest in Treasury inflation protection securities (TIPS) and inflation-adjusted Savings Bonds (I Bonds) that adjust upward with the Consumer Price Index.

Think globally but invest cautiously. The recent troubles have shown just how closely the world’s financial fortunes are intertwined. Yet while most investors should be internationally diversified, U.S. markets may have an edge in coming months. The mortgage crisis began here before spreading globally, and a recovery could start here, too. And though both foreign developed and developing economies were initially faring better than the U.S., a deep global slump now seems to be

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A Year Investors Would Like To Forget

I know of no one who was not anxious for 2008 to be over—at least from a financial perspective. As if a global liquidity crisis, a severe economic recession, and the worst market returns in more than 75 years weren’t enough, the year ended with the revelation of the largest Ponzi scheme in history: Bernie Madoff and his “alleged” \$50 billion fraud. Yes, goodbye and good riddance to 2008.

But I hope that we can take some memories (or at least some lessons) from the year. First, regardless of your political stripes, the election of Barack Obama was historic and has engendered hope that a change at the top will move the country and our fragile economy in a new and better direction. Are hopes too high for him? Perhaps, but the national psyche suffered a mighty blow in the fourth quarter of 2008, so having high hopes is far better than having no hope at all!

Will 2009 look better than 2008? Probably. That said, investment portfolios must be designed to survive in both good times and bad. The most dangerous investing philosophy is the desire to “get back” market losses—this urge focuses on where we were, not where we are going. And so, we enter 2009 with newfound hope, armed with the lessons of 2008 and prepared for whatever the new year brings.

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Gold Decouples From Oil, Sparking Buzz

One measure financial analysts use to gauge the health of the economy is the ratio of gold prices to oil prices. This ratio may also help predict where gold prices are headed. Of course, gold's value is ultimately unpredictable, and recent trends could be reversed. Still, the connections between these two commodities could have important implications, particularly in today's volatile investing environment.

Gold is attractive in times of crisis, because of its intrinsic value. Unlike stocks or bonds, which could end up worthless if a company fails, gold should always have a market, and many investment portfolios devote a small percentage of assets to the precious metal. Today, the case for gold is stronger than usual, in light of the Federal Reserve's intervention in the U.S. economy. Analysts say the cost of paying for the Wall Street bailout and buying up troubled mortgages will be paid in inflated dollars, possibly weakening the dollar and strengthening the value of gold.

It's important to note that gold already has had a strong run-up in price. From March 2007 to March 2008, the price of gold soared from

\$660 an ounce to more than \$1,000 an ounce. Since then, as economic troubles grew, gold prices retreated and have fluctuated between \$730 and \$980.

Prices of gold and oil tend to rise and fall together, in part because major purchases of oil once were paid for with gold, and even today much

surplus oil revenue gets invested in gold. So, rising oil prices tend to boost demand for gold and its price. Also, higher oil prices encourage inflation, and that also increases demand for gold, a time-tested hedge against inflation.

In recent months, however, oil prices have declined while gold prices have risen, a situation that analysts refer to as "decoupling." If oil prices were going up and gold prices falling, it would signal a surging economy and potential inflation. But between July 2008,

when oil prices peaked, and October, when the price of a barrel of crude had fallen nearly by half, the oil-to-gold ratio climbed from 5.8 to 10.15, signaling the approach of recessionary conditions. For investors, this may also forecast a continued rise in the price of gold because a flagging economy usually pushes up the demand for gold.

Indeed, Morningstar Inc.

predicted in early October that gold prices could reach \$1,250 an ounce within a year. Citing gold's decoupling from oil prices, Morningstar asserted "bullion has significant room for further appreciation on its own as an asset class in times of financial crisis." Still, Morningstar recommended using gold only as a hedge against inflation and keeping "a small portion" of a portfolio in gold.

If you'd like to review the possible role of gold in your portfolio, please give us a call. ●



Ensuring A Smooth, Smart IRA Rollover

When retirement finally beckons and you begin to tap the funds in your 401(k) or other retirement plan, you can expect to give the IRS its share—at ordinary income tax rates as high as 35% of any withdrawal. But if you don't need the cash immediately, a better option may be to transfer the money to an individual retirement plan, or IRA.

A properly executed rollover to an IRA postpones current tax on the funds you transfer and keeps the money growing tax-deferred. (You can do this when changing employers as well as at retirement.) Eventually, you must make taxable withdrawals, but not until

the year after the year in which you turn age 70½. It's also possible to transfer money from an existing IRA to another IRA, to get a better menu of investments, say, or to consolidate accounts.

Though making a successful rollover isn't difficult, several pitfalls could lead to unnecessary taxes. Avoid these six common mistakes.

1. Not meeting the rollover deadline. The tax law requires you to complete a rollover within 60 days of receiving funds from your cashed-out retirement plan. Otherwise, the distribution is fully taxable on the current year's return, and you could

face a 10% penalty for a premature withdrawal if you're under age 59½. That could get pretty expensive—50% or more of the value of your account when you consider federal and state taxes along with the 10% federal penalty and possible state penalties.

2. Not arranging a trustee-to-trustee transfer. Unless you make other arrangements, your company's retirement plan administrator will impose 20% income tax withholding on a payout, even if you intend to meet the 60-day deadline. Though you may recoup the money when you file your taxes, you'll have to come up with the cash before then to complete a tax-free

The Importance Of Year-Round Tax Planning

Chances are, you prefer to think about taxes as little as possible. But just avoiding the subject won't keep the Internal Revenue Service at bay. And paying attention long before tax season gives you time to implement strategies that could save you money. "You can't plan backwards," says Victoria Serles, partner and director of the Private Client Wealth Management Practice with the Seattle office of BDO Seidman, a national accounting firm. "But people who consider their taxes months ahead of time tend to be very satisfied with the results."

You could put these strategies into effect at any time (and sooner is almost always better than later):

Profit from tax losses. Call this the silver lining of a dark cloud. With markets struggling recently, you may be sitting on investment losses. But there could also be unrealized gains in your long-term holdings, and if you had planned to sell appreciated assets—but feared the tax bite—now could be the time to act.

You can offset gains with losses dollar for dollar. So a \$50,000 loss will negate a \$50,000 gain. If you sell a stock or fund at a loss, the loss is disallowed for tax purposes, however, if you buy the same investment again 30 days before or after the date of sale. This "wash sale rule" is meant to discourage people from selling shares for tax purposes and then immediately repurchasing them.

rollover. To avoid the issue, instruct your plan to send funds directly to the new IRA.

3. Not rolling over sufficient funds. If you don't use a trustee-to-trustee transfer—say, you need to use the funds for 60 days—you must deposit the exact amount in the IRA that you received as a distribution. Any shortfall is subject to tax (plus a possible early withdrawal penalty).

4. Making this an all-or-nothing proposition. You don't have to roll over your entire retirement account balance. If you need cash now, you could take a partial taxable distribution and transfer the rest to your IRA. Alternatively, to better manage the tax implications, you could transfer the entire amount and do

You can jump right back into a similar investment—a stock in the same industry or another fund that tracks the same index, for example. If you sell, as a loss, a mutual fund of one investment objective, you could purchase a different fund with the same objective—therefore harvesting the tax loss without changing your overall allocation.

If your losses exceed your gains, you can use up to \$3,000 in losses to offset ordinary income each year, and you can save leftover losses for future years.

Maximize retirement savings. In 2007 and 2008, annual contribution ceilings for retirement plans edged up to a maximum of \$15,500 in pre-tax dollars going into a 401(k) and \$5,000 for an individual retirement account. Catch-up contributions for savers 50 or older extend those limits by \$5,000 a year for 401(k)s and \$1,000 for IRAs. Any deductible contributions you divert into these accounts come off the top of your income, immediately reducing your taxes. So if you're saving less than the maximum, consider boosting your contributions now to spread the increase over the rest of the tax year. Wait until year-end and "you might not have the cash flow available to maximize that opportunity," says Serles.

Minimize the alternative minimum tax. The alternative minimum tax, or AMT, was designed to ensure that the very wealthy couldn't avoid taxes by taking

a separate distribution from the IRA.

5. Rolling over to the wrong IRA. You can make a tax-free rollover only to an IRA you own. Mistakenly transfer the funds to your spouse's IRA or another account, and the distribution is taxable.

6. Making too many rollovers. A "rollover" is when you take possession of the funds before re-depositing them in an IRA. While you are allowed multiple "transfers" per year, you are only allowed one "rollover." Subsequent rollovers within the same year will be treated as a taxable distribution.

If you'd like our help in arranging a safe, tax-free rollover or transfer to an IRA, please give us a call.●

advantage of abundant tax loopholes. These days, though, almost anyone can get snared by the AMT. For non-business owners, several things can trigger AMT liability: claiming personal exemptions, paying state and local taxes, taking miscellaneous deductions, deducting medical expenses, or exercising incentive stock options. Any combination of these could push you into AMT territory.

Sitting down early with your tax professional to run an AMT projection could help you see if you'll pay the AMT this year. It could also give you a chance to head off some of your liability. "If you are going to fall into the AMT area, you want to be thinking about timing some of your deductions," Serles says.

For example, if it looks like you'll have to pay the AMT this year, but not next year, you might push some of your state and local tax deductions into next year, when you'll be able to use them to full effect. Or you could think about delaying the exercise of your incentive stock options, or bunching charitable deductions in years that you won't have to pay AMT and will receive the full benefit of the deduction.

Manage your business taxes. If you're self-employed or receive income from a side business, mid-year is a good time to make sure you're on track with your estimated taxes. Check with your tax specialist to see whether you're sending the government the correct amount each quarter. The longer you wait, the shorter the time you'll have to pay what you owe, and if you end up underpaying estimated taxes, you could be hit with a penalty. To reduce business taxes, consider employing your children. "That provides a deduction to you, and their income is taxed in a lower bracket," say Serles. Or you could increase the tax-deductible benefits you provide to your employees or yourself. Acting well before the end of the year will let you maximize the amount you deduct.

Other tax planning strategies include Roth IRA conversions and the use of charitable trusts. However, many of these strategies are complicated, so you should seek the guidance of your financial advisor and tax professional.●

Is It Time To Buy Municipal Bonds?

Municipal bonds don't normally make news. But the past year's credit crisis dragged even the most staid investments through the mud, and munis were no exception. The good news is that the rap on these bonds' reputation has led to the best muni buying opportunities in a long, long time.

The problem wasn't the municipal bonds themselves, which are used to finance public projects such as bridges and roads, but the bond insurance that many bond issuers purchase. Provided by companies such as Ambac and MBIA, this insurance gives any muni bond, regardless of underlying credit quality, an AAA rating. Investors like insurance because it adds another layer of protection against default; issuers like it because using it reduces borrowing costs. (Higher-rated bonds can offer lower interest rates.) At one point, about half of the municipal market was insured.

If bond insurers had insured only munis, there would have been no problems, because municipal bonds

have miniscule default rates—just 0.1% from 1970 through 2006, according to a Moody's Investors Service study. (Corporate bonds, in contrast, have a 9.7% default rate.) But it turned out bond insurers had gone beyond the municipal bond market to insure collateralized debt obligations built around dubious subprime mortgages, and subsequent losses put the companies on unstable financial footing. Municipal bond prices plummeted and their yields rose after Ambac was downgraded by one rating service and put on notice by two others.

At one point, AAA-rated munis yielded about 0.5 percentage points more than comparable Treasury bonds. Ordinarily, munis' yields are lower than Treasuries', because municipal bond interest is exempt from federal income taxes. "It was clearly an anomaly for munis to yield more," says Thomas Doe, chief executive officer of Municipal Market Advisors, a municipal bond strategy firm.

While the muni crisis may have passed—and that screaming buying

opportunity with it—municipal bonds still are attractive to many investors, particularly those in high tax brackets.

When muni yields approach those of Treasuries, muni investors come out ahead, keeping more income after taxes. The advantage can be even greater on bonds that are also exempt from state and local taxes. The higher an investor's tax bracket, the higher the value of the bonds' yields. "Munis are still attractive on a relative basis," says Doe. "They give you more yield than should be available for a particular level of risk." If the government raises income tax rates in the future, tax-free municipal bonds will become even more attractive.

Contact our office if you would like to discuss whether this might be an opportune time to add municipal bonds to your portfolio. ●

The information provided is not specific financial advice or a recommendation to buy or sell. We must review your profile, needs, and accounts specifically to determine what is right for you.

Implications of Bailout

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underway. While foreign stocks may falter, European bonds could gain as investors seek safe havens.

Small could be beautiful (but large might be, too). When the economy abroad slows and growth in the U.S. returns, small-cap stocks—which tend to have a domestic focus—may be preferable to giant multinationals and exporters. Still, many experts believe any U.S. recovery may first benefit safer, dividend-paying large-cap stocks.

Stay nimble. In today's chaotic markets, it's more crucial than ever to maintain a thoughtfully diversified portfolio with a long-term focus. But tactical adjustments

involving small changes in exposure to asset classes, sectors, or national markets may occasionally be needed.

We are continuing to monitor the extraordinary developments in the economy and investment markets, and we would be happy to discuss the potential impact of the bailout and other government initiatives on your portfolio and financial plan. ●

These views represent an appraisal of possible events. Outcomes and performances are not guaranteed. The investments discussed may go up or down in value and are not suitable for all investors. The information provided is not specific financial advice or a recommendation to buy or sell. We must review your profile, needs, and accounts specifically

to determine what is right for you.

You should consider any investments objectives, risks, charges, and expenses carefully before you invest. Information regarding potential investments, including a fund's prospectus, contains this and other information and should be read carefully before investing. Prospectuses and information may be obtained from our office.

Investing in stocks of small companies involves additional risks. Smaller companies typically have a higher risk of failure, and are not as well established as larger blue-chip companies. Historically, smaller-company stocks have experienced a greater degree of market volatility than the overall market average.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards.