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PERSONAL FINANCIAL MANAGEMENT

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Making The Best Of A Bad Time For The Economy

During the first few weeks of 2008, the stock market continued on the downward path of the previous quarter, and financial news seemed to worsen almost daily. By mid-January, most experts seemed to believe the U.S. economy was headed for either a recession or growth so weak that the gross domestic product (GDP) might as well be declining. With unemployment rising and billions more in worthless mortgage-backed investments being written off by Wall Street firms, Federal Reserve chair Ben Bernanke practically promised aggressive interest rate reductions and Washington began debating economic stimulus. Yet while portfolio pressures seemed certain to increase in 2008, this year's troubles need not set back your long-term plans.

Keep in mind that a recession, if it happens, may not spell doom for stocks. Sometimes the fallout is severe. During the brutal recession of 1973-75, for example, the Standard & Poor's 500 stock index dropped almost 25%—and a total of 48% in the accompanying bear market. Similarly, the S&P retreated 8.1% during the brief 2001 recession and 49% all told in a stock swoon that didn't end until 2002. Yet the stock market is considered a leading economic indicator, and while it almost invariably drops in anticipation of an economic downturn, it may also move up before GDP rebounds. During the recession of 1990-91, the S&P gained about 3% and tacked on another 8% in the six months that followed.

Based on these divergent history lessons, anything could happen this time around. Moreover, if a recession develops, we won't know until months after the fact, and by then stocks may or may not have begun to recover. So rather than try to time the market or forecast when it might start its next surge, consider these strategies:

Be prepared for personal setbacks. Sometimes, tough economic times come home to roost. And if, for example, yours is one of the raft of jobs cut during a recession, the performance of the stock market will be the least of your worries. So be sure to set aside a rainy day cash fund that can cover at least six months of living expenses. That may help you avoid selling investment assets when markets are down.

Keep investing, and look for bargains. If you're investing for the long haul, buying stocks when markets are down could pay off down the road. Dollar-cost averaging, the practice of periodically investing a fixed dollar amount regardless of what's going on in the markets, lets fund investors buy comparatively more when values are depressed. Purchasing solid companies caught in a general market downdraft also may give you more for your money. Relatively recession-proof sectors such as health care and consumer staples could hold up better than most.

Don't ignore dividends. Historically, much of the total return of the stock market has come in the form of dividends rather than share appreciation, and steady investment income can stabilize a portfolio when markets are volatile. But companies may cut dividends when times get tough, and financial stocks, in particular, whose sunken share prices translate into high

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Financial Spring Cleaning!

A few notes now that tax season is behind us:

I. This may be the time for you to set up folders to organize the paperwork you used in filing last year's tax return.

II. We anticipate major revisions of the estate tax by 2010. It makes sense to review the basics of your estate planning before you need to adjust to any Congressionally mandated changes. If you need help, please call.

III. Reviewing your beneficiary designations can help avoid unnecessary probate issues. It is common to set up financial accounts over the years, but forget to review the beneficiary designations you originally established. Primary and contingent beneficiaries are usually listed and attached to your retirement accounts (IRA, 401(k), 403(b), 457, etc.), pension and profit-sharing plans, and life insurance policies, and are mentioned in your will and other estate planning documents.

IV. If you set up any accounts with a "payable/transferable on death" instruction, these should also be reviewed to be sure they are still appropriate. Making someone a "joint owner" on one of your accounts also has serious tax and estate implications. It's time to look at how your assets are titled and make changes as needed

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Some Home Loans May Not Be Deductible

Have you refinanced, taken out a second mortgage, or used a home-equity line of credit? If you're subject to the alternative minimum tax (AMT), you may not be able to take a tax deduction for all of the interest on such loans.

All taxpayers must calculate their taxes under two sets of rules, for normal income tax and the AMT. You pay the higher tax. Even if you're not subject to AMT rules now, you could be soon. The number of AMT taxpayers soared from about 3 million in 2004 to over 20 million in 2006, and will likely continue to rise throughout the decade.

One deduction not allowed under AMT rules is for interest paid on home-equity loans. Forget what lenders mean by that term—as far as the Internal Revenue Service is concerned, home-equity debt is any loan secured by your residence but used for something other than buying or improving the home. Suppose you've been approved for a line of credit based on your equity in the property, and you draw out money to cover tuition at your daughter's private college. Or you take a second mortgage at today's reasonable interest rates and use the cash to pay down more expensive credit card debt. In both cases, if you pay AMT, you can't deduct the interest, because you didn't use the money to purchase or fix your home. In contrast, the regular rules permit writing off the interest charged on up to $100,000 of home-equity debt, assuming the loan was made after October 13, 1987. All interest on older mortgages is fully deductible for both regular and alternative tax purposes.

Don't set yourself up for a nasty surprise—disallowance of part or all of the tax deduction for a home equity loan

The waters become muddier when refinancing is involved. Suppose you and your spouse borrowed $200,000 several years ago to buy your home. You still owe $160,000, but the property has appreciated substantially and interest rates have fallen. So you decide to refinance $240,000. The first $160,000 of your new loan replaces the remaining debt on your purchase, and interest on that amount is deductible under AMT rules. But what about the other $80,000, which accounts for a third of the refinanced amount? Use it to pay for non-home-related expenses say, a luxury cruise and new automobiles—and a third of your interest won't be deductible in years you pay AMT.

Even if you refinance only what you owe on your original loan, closing costs could pose a problem. Suppose you take a new loan for the $160,000 balance on your old $200,000 mortgage, and the lender charges $5,000 to process the transaction. If you pay the closing costs out of pocket, you can deduct all of the interest on the new loan, even under AMT. But if you finance those costs, and thus borrow $165,000, AMT rules stipulate you can deduct only the interest on $160,000—because the other money didn't pay for a home purchase or renovation. ●

When Your Financial Advisor Accepts The Role Of Fiduciary,

In the world of financial advisors there are myriad labels, certifications, registrations, and other terms that tend to be meaningful only to industry insiders. But one distinction could be crucial: An advisor bound by contract or law to serve as a "fiduciary" is obligated to act solely in your best interest. That's different from others who may seem to work for you but in fact owe primary allegiance to the companies that pay them.

With other professionals, such as lawyers and CPAs, there's typically a fiduciary responsibility that requires them to act in clients' best interests. But for financial advisors, fiduciary status is not yet standardized or guaranteed. So while you may think your stockbroker offers unbiased advice, he or she is probably receiving a commission for selling you products. To complicate matters, even a fee-based advisor who charges for advice may not be acting solely in your interest.

Not surprisingly, there's widespread confusion among consumers on this point. According to a recent survey by a major financial services firm:

- More than half of the investors interviewed believed both stockbrokers and Registered Investment Advisors (RIAs) have an obligation to act in the client's best interests.
- Three out of four investors didn't realize that only independent RIAs have a fiduciary duty to their clients.

RIAs must inform clients of potential conflicts of interest, and they're legally obligated to act as a fiduciary. They have a fiduciary duty to act in their clients' interest at all times. Stockbrokers don't have the same obligation. Brokers must make recommendations that are suitable but are not required to adhere to the higher standard of care—to always do what's in your best interest—as a fiduciary.

Nine Estate Planning Mistakes To Avoid

Thanks to increased home values, well-funded retirement accounts, and hefty life insurance policies, many retirees today not only have enough money to live comfortably but are also likely to have wealth to distribute at the end of their lives. But it can be tricky making sure your bequest gets where you want it to go. Here are nine common mistakes to avoid.

Assuming you don't need an estate plan because you don't owe estate tax. With estate tax laws currently in flux, whether your estate is large enough to owe estate taxes may depend on when you die. But even if taxes aren't an issue, estate planning can ensure your assets are controlled according to your wishes if you're incapacitated and parceled out appropriately at your death. It can also help to avoid the cost and delay of probate and minimize emotional and financial burdens on your beneficiaries.

Not having a will. Without a will, state law will govern the disposition of your probate estate, with the government deciding who gets what. Depending on your state of residence, if you are survived by a spouse and children, your estate will typically be divided among them even if you had something else in mind. Moreover, assets could be poorly managed and your estate could end up paying more than it should in taxes and legal fees. A will lets you specify who gets what and could help minimize estate taxes.

Not having a letter of instruction. What happens if you change your mind about who gets your favorite jewelry or whether you want to be buried or cremated? You can note these wishes in an addendum to your will called a "letter of instruction." Though not legally binding in all states, this document will at least give your heirs an idea what you want and help them avoid needless conflicts.

Leaving your entire estate to your spouse. While many couples leave all assets to one another, that's not always the best strategy. You may want some property to pass directly to children from a previous marriage, or to go into a trust to make use of both spouses' estate tax exemptions. Trusts, which come in many varieties, may help you fine-tune your estate plan, are typically less vulnerable than wills to legal challenges, and can provide asset protection.

Owning all assets jointly. Most couples own property jointly, with rights of survivorship—meaning that upon the death of one spouse, the jointly owned property automatically passes to the surviving spouse, avoiding probate. But this may not be the best choice in all situations. For example, owning property separately could make it possible to fund a trust and take better advantage of the estate tax exemption.

Not considering annual gifts. Using yearly gifts to distribute your estate while you're living can be immensely satisfying, and it takes advantage of an annual gift tax exclusion that allows you to make tax-free gifts each year of up to $12,000 each to an unlimited number of recipients. (If you give with your spouse, the limit is $24,000.) You can use your $1 million lifetime gift tax exclusion to make even larger gifts. And any gift now avoids potential estate taxes later.

Failing to consider the benefits of charitable contributions. Fulfilling your philanthropic goals can also have many tax benefits. Your estate can take a deduction for gifts—including cash, personal property, real estate, and certain investments—made to charitable organizations upon your death. (Charitable gifts during your lifetime are also deductible, and reduce the size of your taxable estate.) Other options to consider are a charitable remainder trust that pays a lifetime income to you and distributes remaining assets to a charity at your death, or a charitable lead trust, which reverses the equation, paying the charity now and your heirs when you die. And you might use life insurance to "compensate" family members for the part of their inheritance that goes to charity, if you are insurable and inclined to do so.

Keeping life insurance in your taxable estate. Life insurance benefits aren't taxed as income but they do go into your estate and could increase your heirs' estate taxes. A better option may be to have your policy owned by an irrevocable life insurance trust that can pass along proceeds without tax liability.

Failing to update estate strategies periodically. Everyone's circumstances change. Your wealth may increase or decrease, new children may be born while others reach adulthood, and you could be widowed or divorced and remarry, adding the complications of a second family. Regular reviews can make sure your estate plan keeps up. ●

You Have A Foundation For Trust

The distinction between an advisor who is a fiduciary and one who is not could be critical when weighing an advisor's recommendations. There may be a hidden agenda—for example, if an advisor is receiving better commissions for selling you one mutual fund instead of another.

Rules recently clarified by the Securities & Exchange Commission permit brokers to give you investment advice on a fee basis and not act as a fiduciary. In these instances, a broker can only give you advice about one or two issues—such as your retirement plan or investing. If a broker wishes to give you comprehensive financial advice that spans insurance, taxation, college planning and estate planning as well as investing and retirement planning, the broker must accept his or her role as a fiduciary to you. He must disclose that he will begin giving you advice as a fiduciary and then tell you when he has stopped acting as a fiduciary and reverted back to his role as your stockbroker.

Working with someone who is a fiduciary, or will sign an agreement to act as a fiduciary, doesn't guarantee you'll profit from the advisor's recommendations. But it does give you a greater assurance that you're both sitting on the same side of the table.●

Coping With Estate Tax Uncertainties

It has been said that the two things you can count on are death and taxes. But what about the tax that may come due upon your death? Under current law, the federal estate tax is being whittled down until it expires in 2010. But unless Congress acts, the tax will return with a vengeance just one year later. And although this political football has been kicked around in our nation's capital for most of this decade, there is no clear-cut outcome in sight. That leaves those whose assets might be subject to the tax in estate planning limbo.

The most practical approach for now is to know the existing law and prepare for pending changes as if they will definitely occur. The massive Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) completely revamped federal estate tax law, and under EGTRRA, these changes are being implemented:

- The individual estate tax exemption, which shelters an estate from tax liability through a special tax credit, is gradually increasing from $675,000 for those who died in 2001 to $3.5 million for anyone who dies in 2009. In 2008, the exemption is $2 million.
- The top federal estate tax rate of 55% has been gradually decreasing during the same time period. It is 45% in 2008 and will remain there until the estate tax is repealed.
- The individual exemption from gift taxes stopped rising in 2004 and will remain at $1 million. So the estate and gift tax credits, once identical—and sometimes referred to as the "unified" credit—are unified no more. But the gift tax rate has continued to fall with the estate tax rate and is currently also at 45%. After 2009, the gift tax rate will be pegged to the top individual income tax rate (currently 35%).
- The generation-skipping transfer tax (GSTT), which generally applies to transfers of property to grandchildren, will also be repealed after 2009 and revived in 2011. The GST exemption is $2 million in 2008 and $3.5 million in 2009.
- After 2009, heirs will no longer benefit from a "step-up" in cost basis on inherited assets. Suppose you own 10,000 shares of stock that you purchased years ago for $10 a share but that is worth $100 a share at the time of your death. Under current rules, your heirs could "step up" the per-share basis to $100, potentially avoiding capital gains tax on $900,000. Under the new rules, heirs will inherit the deceased owner's basis, though non-spouse inheritors will be able to increase the basis by $1.3 million, and spouses can take advantage of an additional $3 million bump, for a total of $4.3 million.

Most provisions of EGTRRA will "sunset" after 2010, with exemption amounts and tax rates essentially reverting to pre-EGTRRA levels. So an estate plan that assumes there will be a $3.5 million exemption, for example, may be of little use if the exemption is actually only $1 million when you die. While Congress doesn't favor lowering exemptions, this could change with a new president. We can work with you and your estate attorney to develop a plan that is flexible enough to adapt to the law as it changes. ●

Estate Tax Ups And Downs

Tax Year	Individual Exemption	Maximum Tax Rate
2001	$675,000	55%
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007-2008	$2 million	45%
2009	$3.5 million	45%
2010	-----	-----
2011	$1 million	55%

Making The Best Of Bad

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percentage yields (calculated by dividing a stock's annual dividend by its current share price), seem likely to reduce payments to shareholders. So look for companies with solid balance sheets and a history of raising dividends.

Choose bonds carefully. On the fixed-income side, yields on Treasuries are likely to decline as the Fed continues to cut interest rates, and investors may get better returns from highly rated corporate bonds. Meanwhile, yields on many municipal bonds are nearly as high as those on Treasuries, and that's before factoring in the municipal bonds' federal tax-free status. But many local governments and agencies that issue municipal bonds face rising financial pressures, increasing the risk of default. High-yield (junk) corporate bonds may also suffer. Treasury inflation-protected bonds (TIPs) could help insulate your portfolio if rate cuts boost inflationary pressures.

Look overseas, but don't overdo it. Most well diversified portfolios need an international component, and at a time when the U.S. economy and markets are under pressure, foreign stocks could provide some relief. But much of international stocks' recent outperformance has been attributable to the declining U.S. dollar, which inflates foreign profits when they're converted back into greenbacks. And while the dollar's woes could well continue, that's hardly guaranteed. Moreover, although the economic outlook for much of Europe and Asia may be brighter than for the U.S.—and while emerging markets could continue to lead developed markets—loading up on foreign stocks could add risk to your portfolio just when it makes sense to try to minimize volatility. Some of your international exposure can come via U.S. multinationals that get significant income from overseas operations. Indeed, those blue chip companies may also provide relatively high, dependable dividends.

Your response to the U.S. economic downturn could range from standing pat to making judicious adjustments. We can discuss the current economic and market environments with you, review your portfolio, and help you decide what needs to be done to keep you moving toward your long-term financial goals. ●

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