



## Is It Different This Time Or Will The Gloom Subside?

If the financial news has you hanging your head, thinking about hiding your money under the mattress, turn off the TV, and take a deep breath. We've been here before.

Breathless talk of bank bailouts, the collapsing dollar, record oil prices, and mounting foreclosures has many investors nervously eyeing the safe haven of CDs, gold, and low-yielding Treasury bonds. Yet while a well-diversified portfolio might include some of those assets, overemphasizing them could carry a high cost in terms of lost opportunities and long-term losses.

It's hardly a secret that our current economic woes are linked to what had been a phenomenal rise in home prices that started during the late 1990s and gained momentum after the Sept. 11, 2001, terrorist attacks. Spurred by historically low interest rates and other factors, inflation-adjusted home prices rose 85% between 1997 and 2006, according to Yale University economist Robert Shiller, who developed the S&P/Case-Shiller Home Price Indices in the 1980s. It was the biggest national housing boom in U.S. history, and historic booms tend to be followed by historic busts. According to the S&P/Case-Shiller Home Price Indices, median home prices fell 8.9% nationwide in 2007, and that has sparked an explosion in foreclosures, a pervasive credit crunch, a slump in earnings for financial institutions, and plunging consumer confidence.

Financial stocks, now volatile and significantly off their highs, had been

roaring ahead for years, helped along by the popularity of mortgage-backed securities. As home prices rose, mortgage activity soared, and banks repackaged bundles of home loans to sell to other investors.



By December 2006, the stock of financial companies had bubbled up to account for a record 22.3% share of the Standard & Poor's 500 stock index—almost 10 percentage points higher than in December 1999. But many of the bundled mortgages were of the notorious subprime variety. When the housing market cooled, defaults on those loans began, and soon financial institutions were swallowing huge losses. Their share prices plunged, and by April 2008, financial stocks were back down to a 17.2% share of the S&P.

As often happens when a bubble bursts, many investors found themselves over-concentrated in the hardest-hit sectors. Their financial holdings, which had been growing rapidly for years—and thus came to represent a disproportionate share of their portfolios—suddenly fell off the table. But the broader market has also suffered. The Dow Jones Industrial Average, after reaching an all-time high of 14,279.96 on Oct. 11, 2007, fell as low as 10,731.96 on July 15, 2008.

A similar chain of events occurred during the early 1980s. Energy stocks, which had comprised only 15.7% of the S&P in 1970, surged to a 28.2% weighting by 1980—and then fell to 11.6% in 1985.

That rise and fall was mirrored by

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## Homeowner's Capital Gain Exclusion – Change to the Law

A new clause, recently signed into law, significantly reduces the amount of capital gains you can exclude upon the sale of your principal residence. Under current law, you enjoy tax-free capital gains of up to \$500,000 for a married couple (\$250,000 for a single filer) if your home served as your principal residence for at least two of the last five years. The new rule, effective January 1, 2009, only allows you to exclude capital gains for the years it is your principal residence. For example, if your home was your principal residence in only two of the last five years, you will only receive a two-fifths capital gain exclusion and will have to pay capital gains taxes on the other three-fifths of the gain. Anyone who purchases a home and lives in it by January 1, 2009 will not be subject to the new rule and instead will enjoy the more lenient current rule. The bottom line – if you own a home, but don't live in it, yet would like to live in it at some point to take advantage of the Maximum Exclusion of Capital Gains – either move into it prior to December 31, 2008 or plan to live in it for at least five years before selling it.

**Sharkey, Howes & Javer, Inc.**

# Do The Math Before Refinancing

**W**ith interest rates relatively low, some homeowners are moving to refinance their mortgages. The logic seems obvious. If you can get a loan with a lower rate, you'll pay less interest and reduce your monthly payments. What could be simpler?

Unfortunately, it's all too easy to lose in the refinancing game even when it seems to save you money. In fact, refinancings have contributed to the recent mortgage crisis in the country. By trading in your old mortgage, you may well end up paying more interest, not less. The trouble is, each time you restart the clock on your debt, you return to the earliest years of a repayment schedule, when the lion's share of every payment is applied to interest, not principal. Unless you're refinancing to improve your cash flow, you'll often be better off continuing to pay off your old mortgage, even at its higher rate.

To see how this works, consider the case of a homeowner who began making payments on a 30-year, \$300,000 mortgage in January 1999. At an 8.25% rate, the homeowner would pay \$2,254 a month for 30 years and a grand total of \$511,368 in interest.

But suppose that on January 1,

2008, the homeowner refinanced, trading in his old mortgage for a new 30-year loan with a 7.25% rate. The principal of the refinanced mortgage would be \$272,995, reflecting the \$27,005 of the original \$300,000 mortgage that had been paid off

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*Even when it seems like you'll be saving money, it's all too easy to lose in the refinancing game*

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during the preceding eight years.

With the smaller principal and the new, lower rate, monthly payments on the refinanced mortgage would be only \$1,862, instead of \$2,254. However, the new mortgage wouldn't be paid off until the end of 2037, eight years later than the retirement date on the original loan. And even though the new loan rate was a full percentage point lower than the old one, the homeowner would end up

paying a total of \$587,911 in interest to own the home outright—\$76,543 more than if he had simply continued to pay off the original loan.

Refinancing would be financially shrewd, however, if the homeowner chose to make the same payment on the new loan as he had on the original mortgage. Paying \$2,254 a month at the lower rate would retire the mortgage by 2023, and the total interest paid would drop to \$404,520—\$106,874 less than would have been paid on the original mortgage.

The standard rule of thumb for deciding when to refinance a mortgage is that it makes sense any time you can find a loan rate that's at least one percentage point lower than your current rate. But if you look at the bigger picture and do the math, you may find that it takes a two-percentage-point reduction to make the new loan pay off. Any less, and you'll generally be better off keeping your old loan, unless you plan to make your usual mortgage payments at the new, lower rate.

Keep this in mind the next time you're tempted by a bargain-rate mortgage. Reducing your nominal mortgage interest rate is only one chapter of a larger story. ●

## Marriage Doesn't Mean Owning All Your Assets Jointly

**M**arriage is all about togetherness. Yet when it comes to owning assets, too much togetherness may not be financially healthy.

Owning assets jointly is more convenient than individual ownership, and it's the simplest way to avoid probate after a spouse's death. But couples often should consider separating their assets. Here's why:

**Estate tax implications.** Estate rules let spouses leave unlimited property to each other tax free. That's okay when the first spouse to die leaves everything to the second,

but the second death could result in a whopping tax bill. Couples likely to have estate tax issues could acquire property individually to help maximize the value of each other's estate tax exclusion. While owning a house jointly is important for giving both spouses equal claim if they divorce, other assets can and should be held separately in roughly equal shares.

**Dividing jointly owned property.** How you take title also affects who can inherit your property. If you own it individually or jointly as "tenants in common," each of you may specify in your will that

you want a particular asset or share of an asset to go to a designated heir. However, if you take title as "joint tenants" (with rights of survivorship) or "tenants by the entirety"—the most common form of ownership for married couples—you won't be able to say how assets are split. That may work if you and your spouse share the same beneficiaries. But it could be a problem if, for example, you're in a second marriage and want to divide assets among children from different marriages.

Consider John and Mary. Because they own their property as tenants in common, each holds 50%, and John

# Credit Crunch Places Focus On Rating Agencies

The names are familiar to every investor: Standard & Poor's, Moody's Investors Service, Fitch Ratings. They're the nation's premier credit rating companies, and they're supposed to provide investors with credible, independent information to help evaluate investment risk. All three are now under fire, accused of conflicts of interest that may have contributed to the agencies' failure to warn of the credit crisis sparked by the subprime mortgage fiasco.

A group of federal regulators led by Treasury Secretary Henry Paulson has demanded the credit agencies change the way they do business, warning that if they don't act quickly they will face stringent new rules. The Treasury Department and other financial regulatory agencies want the credit rating agencies to rate complex structured products differently than they do conventional bonds. The agencies routinely assigned top ratings to securities that bundled mortgages issued to borrowers with questionable creditworthiness. When those homeowners began to miss payments, the defaults had a domino effect on the whole credit system. Regulators now also want the credit agencies to toughen standards for companies that originate complex loans wrapped in securities, to disclose conflicts of interest, and to release more details of their work.

Those were among the recommendations of the President's

Working Group on Financial Markets, which includes the heads of the Federal Reserve Board, the Federal Reserve Bank of New York, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission. The reforms are intended to ensure that credit ratings are more accurate, timely, and understandable, and that rating agencies are objective and not beholden to the companies they rate.

The current scrutiny of these agencies was triggered by their late reaction to the nation's burgeoning credit crisis. Moody's, S&P, and Fitch all failed to downgrade the investment ratings of securities backed by subprime mortgage loans until July 2007, despite warnings raised months earlier by major banks. The rating agencies had also been widely criticized in 2001 and 2002, when they failed to downgrade bonds issued by Enron and WorldCom until after those companies imploded.

At the heart of the problem are potential conflicts of interest. The credit agencies rate securities while providing advice, for a fee, to Wall Street firms on how to package those securities to obtain the highest possible credit rating. In addition, the top three firms have a virtual monopoly on providing investment banks and brokerages with the risk evaluations the SEC requires. "Lack of competition has lowered the quality of ratings, inflated prices, stifled innovation, and allowed abusive industry practices and conflicts of

interest to go unchecked," says Rep. Michael Fitzpatrick, Republican of Pennsylvania.

In 2006, Congress passed the Credit Rating Reform Act, which Fitzpatrick co-sponsored. It requires rating agencies to disclose their procedures and largest clients, and it was supposed to make it easier for competitors to get into the ratings business. But critics say the law doesn't go far enough, and now the President's Working Group on Financial Markets is pushing the agencies to clean up their methods, with the threat of tighter regulation looming. "Regulation needs to catch up with innovation and help restore investor confidence but not go so far as to create new problems, make our markets less efficient, or cut off credit to those who need it," Paulson said in a recent speech at the National Press Club.

The Working Group issued recommendations for other members of the financial community as well. For instance, the panel called on issuers of mortgage-backed securities to disclose whether they "shopped" for ratings, meaning they approached more than one credit rating agency before being rated. The group stopped short of calling for Wall Street firms to be held liable for creating mortgage-backed securities that they should have known carried excessive risks, but Paulson did fire a warning shot in that direction, suggesting that simply receiving a high rating for a particular product didn't absolve investment banks and brokerages. "The idea that [the packagers of risky investments] can abdicate their responsibility and be overly reliant on ratings is something that really didn't wash in the past and won't wash in the future," Paulson said. "They need to do independent analysis, and they need a better understanding of risk. There is not a free lunch."

Questions about the integrity leading credit rating agencies reinforces the importance of investors to do their own research before making investment decisions or to enlist a trusted financial advisor to act in their best interest. Managing investment risk on your own isn't easy. Call our office and we'll help you review and rebalance your investment portfolio. ●

can bequeath his share to children from a prior marriage. Mary won't automatically inherit John's interest.

But if they hold their assets as joint tenants or tenants by the entirety, the surviving spouse becomes the sole owner of everything the couple owned together. It won't matter that John's will names his children as beneficiaries; if he dies first, the title documents will govern, and Mary will decide how assets are divided when she dies.

**Other considerations.** Owning assets separately is especially important if your combined net worth is at or above the IRS estate tax

exemption—\$2 million in 2008 and \$3.5 million in 2009. Once you approach those levels, it pays to consider ways to separate assets. Also, since joint-tenancy assets can be taken by creditors or lost in lawsuits once an individual's assets are exhausted, doctors or others who can be sued easily will want at least half of their assets in their spouse's name.

Deciding how to hold title to your assets is not a simple decision, as state laws differ and each situation is unique. We can work with your attorney to help decide what's best for you and your spouse. ●

# Workers Can Sue Employers On 401(k)s

**A** unanimous decision handed down by the U.S. Supreme Court means potential trouble for business owners who provide retirement plans for their workers. According to the ruling, participants in a defined-contribution plan such as a 401(k) may sue the plan sponsor if they suffer losses in their personal accounts because the sponsor has breached its fiduciary duty. Considering that there are now about 70 million people holding some \$3 trillion in 401(k) accounts, this ruling could lead to a rash of new lawsuits. But businesses can do much to limit their liability.

In the case that prompted the Supreme Court decision, a former employee of a Dallas consulting firm sued the company, alleging that it had failed to follow his directions to switch to a more conservative mix of mutual funds in his 401(k). Subsequently, the employee lost \$150,000.

The employee claimed the company breached its fiduciary duty under ERISA, the Employee Security Income Retirement Act of

1974. However, both a U.S. district court and the Fourth Circuit Court of Appeals ruled against the employee. They held that an individual couldn't pursue a legal remedy for an ERISA-based violation affecting a participant's individual account. These rulings relied on a 1985 Supreme Court case involving losses by a participant in a traditional defined-benefit pension plan.

Disagreeing with the lower courts, the Supreme Court recognized the inherent differences between traditional defined-benefit plans, which companies manage on behalf of employees as a group, and defined-contribution plans. Old-style pension plans don't have individual accounts, and payouts don't depend on plan participants' investment choices. But in a 401(k), participants do face potential losses in their personal accounts, and the high court ruled a plan sponsor may be held liable for violating its fiduciary responsibility to manage, administer,

and invest plan assets on employees' behalf.

Where does this ruling leave your company? To avoid potential problems, consider these measures:

- Review your plan's investment policies and its procedures for following participants' directions on a timely basis
- Impose controls that reduce the potential for error
- Ensure that your plan provider fully educates participants about their investment options
- Elect the ERISA 404(c) Safe Harbor and follow all the requirements to ensure compliance
- Make sure your plan has adequate liability insurance coverage

Your plan's participants need broad investment options, easy, timely access to their accounts, and an understanding of how to make prudent investment choices. We can work with your legal advisors to safeguard your and your workers' interests. ●



## Will The Gloom Subside?

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the boom and bust of technology shares in the late 1990s. By August 2000, information technology stocks had risen to account for one-third of the S&P 500. When that bubble burst, that sector's weighting fell to 14.3% within a year.

While many investors suffered losses when these bubbles popped, the economy soon recovered, and it will happen this time, too. There's no way to know exactly when that will occur, but the point is to remain invested and diversified. That lets you take advantage of lower prices and puts you in position to benefit when the market inevitably turns upward.

Think about which investors had the best results during past bubbles. Was it

those who panicked and fled the markets after the bubble burst—or those who made short-term adjustments but stayed invested and bought more while prices were low?

We're now in a transition from a market where growth and revenue reigned supreme to an era when a strong balance sheet will be most important to investors. When the economy is shaky and the market is well off its highs, it

often makes sense to turn toward solid companies in steady industry sectors, such as consumer durables, and put less emphasis on high-flying prospects.

Sure, the stock market probably will remain choppy for a while, as the economy continues to recover from the nation's house-happy hangover. But savvy investors will see the situation as just another great, post-bubble buying opportunity. ●

## Bubbles That Went Bust

Sector	Boom	Bust
Energy stocks	28.2% of S&P 500 in 1980	11.6% of S&P 500 in 1985
Internet-related stocks	33.6% of S&P 500 in 2000	14.3% of S&P 500 in 2001
Financial stocks	22.3% of S&P 500 in 2006	17.2% of S&P 500 in 2008

*Source: Standard & Poor's*