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The Thoughtful Investor

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Our Take on "Is It Safe to Invest in Stocks Again?"

The most frequent question we hear from investors is whether the market decline is over and it's safe to invest in equities again.

Our response is a bit different than most. We don't know if the declines are over or if the market has settled into a long-term uptrend. But we also don't need to know. That is the beauty of active management.

When it comes to investing, it's very important to realize that financial markets rarely advance smoothly from point A to point B. Rallies followed by retreats are common in bear markets, as are pull backs in bull markets. Even if you were to precisely pinpoint the bottom of a market decline, history shows it won't be all uphill from there.

If you are a buy-and-hold investor, "when is it safe" is looking for a long-term forecast. If you are willing to take an active approach to the financial markets, it doesn't matter if the absolute bottom has been reached, or if the market may decide to take back its gains. What you are looking for is whether or not the market appears to have established a trend with a little staying power.

While the S&P 500 was declining in 2001, ending the year with a loss of -11.9%, there were two periods

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Forecasting is an Uncertain Art

Most forecasts interpret the present based on the past. By looking back we know that the average recession has lasted 10 months with the longest excluding the Great Depression, coming in at 16 months.

But a number of factors make this recession different. Will government intervention spur a recovery? What will the burden of a tripling of the federal debt over the next decade have on the recovery? How with the new debt plus legacy programs such as Social Security and Medicare impact the economy? How will economic interventions by other countries that are major trade partners alter the recovery? These are all uncertainties that impact consumer confidence, which is ultimately at the root of any market recovery.

Another problem with forecasts is that there are so many of them, and the rationale behind the forecasts varies by the training of the individual. It's like going to a doctor for a headache. The orthodontist will tell you it's the result of temporomandibular joint (TMJ) disorder, the oncologist will suspect cancer, an immunologist will look to allergies, the chiropractor will target misalignment, and so on. While the medical profession has clinical tests they can use to pin down the potential cause, the only effective proof for an economic forecast is time.

With investing, however, we don't necessarily have the benefit of time.

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Save the Economy or Your Future?

"Since consumer spending accounts for about 70% of total economic activity, the economy will not rebound until consumers reopen their pocketbooks."
March 2, 2009, *The Huffington Post*.

Feeling guilty because you are not doing your bit to save the economy? While saving the economy may be a good excuse to spend money, over the long run increasing your personal savings offers the greatest benefit.

In the 1980s, the consumer savings rate was 12%. By 2005, Americans were spending more than they made.

When the safety net of savings is missing stress increases, particularly among women. Interest payments begin taking up a larger share of each paycheck, actually decreasing the amount of money available to consumers. Savings also give you the ability to cope with setbacks such as the loss of a job of an unexpected expense. With savings, you have options that don't exist if your net worth is tied up in liquid assets. A lack of retirement savings means many Americans working much longer.

Increasing our savings rate isn't painless but it is necessary for the health of families and individuals and ultimately our nation. With that said, up with savings! And let's put them to work.

Forecasting is an Uncertain Art

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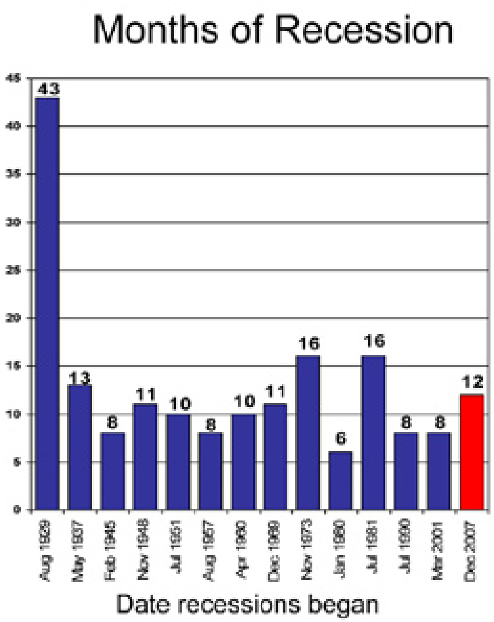
Staying out of the market until we have proof of a recovery foregoes opportunities for profit. Which is why we come back to our major premise — what matters in the market is what is happening right now. We don't know the future and past performance is not a guarantee of future returns.



SOURCE: Bureau of Economic Research

Market truisms we believe in:

• Markets are not random. There is a reason for price changes. That reason may be more emotional than logical at times, but there is still a reason.

• While there will always be short-term volatility, there is also a phenomenon known as persistence of performance in which market trends develop and continue for a period of time as the reasons for price changes are accepted and acted upon.

• Market behavior is not always rational based on our perceptions and trying to force our view of what should happen on the market will have little effect. *"The market can stay irrational longer than you can stay solvent,"* said John Maynard Keye. The wisdom of that statement has been proven over and over.

"Is It Safe to Invest in Stocks Again?"

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in which it rallied in excess of 15% and 13%. Capturing those gains did not require answering the question of whether or not the market had reached bottom, but rather whether or not an up trend appeared to be in place and when a reverse occurred.

With active management, if a trend reverses, you take your gains and exit the position. There will also be times when you will need to cut short your losses and exit, accepting that every investment approach has the potential for gains or losses.

Knowing that we can exit a position and cut our losses short if it turns against us is very liberating. By establishing a definitive sell point, such as 3% drop in value, you limit the risk you are willing to accept and also build in a methodology to preserve gains.

Another benefit to active management is that you can invest beyond the "evergreen" indexes or stocks. For example, if your investment time frame is 10 to 20 years, investing in cyclical assets such as gold, which tend to move counter to the overall market, may not be your best strategy. But there are points in the economic cycle when gold tends to shine. Active management allows you to pick and chose sectors with the potential for outperformance in the current market environment. Even in the midst of a bear market environment, we still have opportunities for profit, but they are not the same opportunities as during a bull market.

While actively managed accounts pursue strategies that are intended to outperform passive investing, there can be no assurance that the strategies or their use will be successful. All investments have the potential for loss as well as gain. Past performance is not an indication of future returns. The S&P 500 is an index and as such cannot be invested in directly. Before purchasing an index fund, request a prospectus and read it carefully to understand the fund's investment directive, fees and risks. This information is found in the prospectus.

"Teach your children well"

"Teach your children well, Their father's hell did slowly go by."

Crosby Stills and Nash

It's easy to give our children what they want. It's harder to make them earn it. But earning something changes the way we view our possessions and how we care for them. It also helps build lifelong habits that can keep children out of trouble as they grow up.

Next time your child asks for a new toy, a computer or clothing above and beyond what might be considered necessary, rather than to saying "No, we can't afford that," or purchasing it for the child against your better judgment, take a moment to walk through the following exercise:

1. Ask them to determine exactly how much that purchase will cost.

• Many times, children have little perception of what something actually costs.

• Don't forget to include taxes and shipping. (I still remember how furious my then six-year-old daughter was to find out she would have to pay $14 to the government on a purchase.)

2. Once they have a cost, have them check other sources, such as EBay, to see if they can find a less expensive option.

• Often children are surprised to find there is more than one price for

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Coping with a Variable Annuity that's Under Water

While variable annuitie are a valid investment tool for many people, they can be expensive and have been sold inappropriately. With each abuse, has come another disclosure requirement. So please bear with us as we tackle this very important subject.

You may be holding a variable annuity that has seen substantial losses over the last 18 months. In some cases, these accounts may be "under water" … worth less than their purchase price. As you look for ways to rebuild your financial security, what should be done with such an annuity needs to be considered.

In general your choices are to:

(1) Leave the annuity where it is. Look for any ways you might be able to adjust its investment options to reflect your expectations for future growth.

(2) Terminate the annuity contract and claim a loss on your taxes.

(3) Effect a 1035 exchange into a new annuity product that has better terms and/or investment options or allows active management by your financial adviser.

(4) Withdraw a portion of the annuity to reinvest elsewhere, leaving sufficient funds in the original annuity to keep the death benefit intact.

There are costs and consequences to each of these choices that you must consider. To do so, you need to pull out your purchase contract and read it. Also, consult your financial or tax adviser to make certain your decision is in your best interest.

Understand the variable annuity

The appeal of variable annuities is largely two fold. The first is their ability to defer taxes on gains. The second is the insurance guarantees built into the annuity contract.

A variable annuity is a combination of mutual fund and insurance policy designed primarily for long-term investors who want another way to save for retirement. Variable annuity contracts have limitations, will fluctuate in value and are subject to market risk, including the possibility of loss of principal. The annuity offers investment options (sub-accounts) that are structured much like mutual funds. Gains from these investment options are packaged within the variable annuity on a tax-deferred basis, allowing assets to grow without the drag of taxes. When withdrawn, gains (and there is no guarantee there will be gains) are taxed at the individual's personal income tax rate.

The typical variable annuity has two key insurance features. The first is the ability to annuitize payouts over the life of beneficiary rather than accepting a lump sum at payout. The second is the death benefit, which guarantees that either the initial investment or a value locked in during the contract (less withdrawals) will be paid directly to a named beneficiary on the account holder's death.

Costs and restrictions

Variable annuities are typically sold on a commission basis, which makes it essential that you understand how much the commission is and how it will be billed. The average variable annuity annual expense, including fund and insurance expenses, currently stands at 2.44% of assets, according to Morningstar, compared to 1.32% for the average open-ended mutual fund. Remember this is an average. Fees can be both lower and higher depending on the variable annuity company. The more features the annuity offers, the higher the cost. Many annuities, but not all, have surrender fees to withdraw funds during the early years of a contract. These fees typically decrease over time. You might incur a 7% surrender fee the first year, but only 1% in the 7th year of the contract. Withdraw funds before age 59 1/2, and you will also have a 10% early withdrawal tax penalty unless your withdrawals conform to Section 72-q of the Internal Revenue Code.

Know your death benefit

If your goal for your variable annuity is to leave a nice nest egg for your beneficiaries make certain you know what your death benefit is before you make any changes. The death benefit is typically the greater of: (i) all the money in your account, (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals), or (iii) a stepped-up value set at some point during the annuity contract, less withdrawals.

It is possible given recent market declines for the death benefit to substantially exceed the cash value of the annuity. For example, suppose you purchased a variable annuity for $250,000, locked in the death benefit after five years when the account reached $475,000, and then saw the cash value of the annuity fall 55% $213,750. The death benefit is still $475,000.

Do you need the money, or could you do better invested elsewhere? You may be able to withdraw or transfer $210,000 from the variable annuity, leaving $3,750 very conservatively invested to keep the contract in effect. This would reduce your death benefit to $265,000 and free up $210,000 to invest elsewhere. Be careful to take into account any termination fees, surrender fees, etc. If your account value goes to zero, the contract will terminate.

Here again, before you do anything, read your contract and talk to your financial professional or tax adviser. Make certain you understand any surrender periods, minimum account values or any other restrictions on the annuity before you take action.

Tax-free 1035 exchanges

Section 1035 of the U.S. tax code allows you to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the gains in your current variable annuity account. You may still have to pay surrender charges on the old annuity if you are still in the surrender period. A new surrender charge period may begin with the new annu-

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Variable Annuity

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ity limiting your access to your funds without paying a surrender fee. Evaluate the investment options, annual fees, charges and features of the new annuity carefully to make certain the exchange is to your advantage.

You don't want to surrender the old annuity for cash and then buy a new annuity, because taxes will be due on the surrender. Here again, talk to your financial professional or tax adviser to make sure the exchange will be tax-free. If you have an underwater annuity that you need help with, please give us a call and let's discuss.

Annuities are long-term financial products designed for retirement purposes. In essence, annuities are contractual agreements in which payment(s) are made to an insurance company, which agrees to pay out an income or a lump sum amount at a later date. There are contract limitations and fees and charges associated with annuities, administrative fees, and charges for optional benefits. A financial professional can provide cost information and complete details.

Withdrawals from annuities are subject to normal income tax treatment and if taken prior to age 59½, may be subject to an additional 10% federal income tax penalty. Withdrawals may also be subject to a contractual withdrawal charge.

Consider the charges, risk, expenses, and investment objectives carefully before purchasing a variable annuity. For a prospectus containing this and other information, contact a financial professional. Read it carefully before you invest or send money.

"Teach your children well"

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an item and that shopping around can save them money or help them find a better product.

3. Ask them how they would like to pay that cost.

- Savings
- Deductions from allowance
- Work around the home or for others

4. If they do not have sufficient funds in savings, put together a budget with your child outlining what it will take to raise the funds necessary.

- How many weeks of allowance will they need to forego?
- How many hours of babysitting, mowing the lawn or other chores will it take to earn the required funds? What is a realistic time frame in which that will happen?
- Don't' discourage your child with this information. In fact, bend over backwards to help them put together a plan. This is an important ability that they will need all of their lives.

5. If you are expected to advance the funds for the purchase of the item, which will then be deducted from subsequent allowances or pay, charge interest.

- Walk your child through how interest will be calculated and how it will increase the cost of the item the longer it takes your child to pay off the advance.
- Offer to pay your child interest if he or she would prefer to save their funds until they have enough money to buy the item. The catch is that they need to deposit the money with you regularly. An attractive rate of interest, where they can clearly see the benefit of saving, helps teach the positives of delayed gratification.
- Put together a side by side comparison of how much of the child's money will be required to 1) buy now and pay later or 2) save and buy later.

Then, let your child make the decision. Now your job is to stick with that decision. No forgiving loans, no dropping interest charges. Because children are pretty canny little manipulators, it may make good sense to put your agreement in writing with very straightforward financial calculations.

Now if only we had a realistic action plan from the federal government on how those trillions of dollars will be repaid.

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RETURN SERVICE REQUESTED


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