The
FINANCIAL UPDATE

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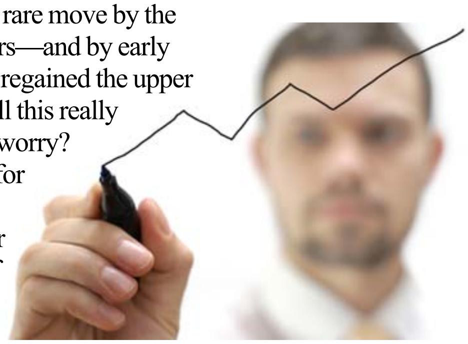
Volatility Is Back, But That's Not Necessarily Bad

Wall Street traders who were looking forward to another boring summer got a rude awakening this year. After a few jolts in the spring, financial markets around the world got downright stormy in July and August as investors worried about the subprime mortgage collapse and a credit crunch. Make no mistake about it, volatility was back with a vengeance. The ride got so intense that the Federal Reserve Board felt compelled to ease credit by reducing the bank discount rate—a rare move by the nation's central bankers—and by early October, the bulls had regained the upper hand. But what does all this really mean and should you worry?

One explanation for the summer's market turbulence is that, after repeatedly shaking off bad news during the past few years, stocks were simply overdue for a correction. Despite soaring oil prices and military setbacks in Iraq, share prices had pushed steadily higher, and in mid-July the Dow and Standard & Poor's 500 stock indexes hit record highs. And it had been a very smooth ride. From May 2003 through January 2007, the Dow never dropped more than 2% in a day. That was a period of stock market stability unmatched in more than a century, but it couldn't last forever. Finally, "the past few years' speculative excesses were pulled from the market," says Doug Roberts, chief investment strategist at Channel Capital Research.

But the summer stock market was also buffeted by a sudden credit crunch. When the economy is on the upswing, things often get a little out of hand, and this time that took the form of easy credit being offered to poorly qualified homebuyers in the form of subprime mortgages. When those homeowners couldn't keep up with their payments, foreclosures began to rise. And because those mortgages had been repackaged into complex, illiquid securities bought by hedge funds and other institutional investors, it was those sophisticated professional investors who suffered the worst losses. With these rarely traded securities still buried in some portfolios, the full extent of the damage may not yet be known.



But much of the devastation has been on public view. For example, in June 2007, Merrill Lynch seized $800 million in assets from two hedge funds managed by a venerable Wall Street firm, Bear Stearns & Company. The hedge funds suffered huge losses and became insolvent because of the plunge in value of the mortgage-backed securities they owned.

Although it was debt and not equities that triggered the summer stock sell-off, stocks couldn't avoid the fallout. Hedge funds tend to be highly leveraged—they borrow money hoping to increase the impact of their strategies—and many of those holding subprime mortgage-based bonds had to sell stock to meet demands by lenders that they come up with more cash. That onslaught of selling helped push down prices. Lenders, meanwhile, fearing widespread defaults, stopped lending.

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Longevity: The Impact Of Stress And Financial Peace Of Mind

When you consider the best ways to extend your life, you probably think of good physical health habits—diet, exercise, medical screening. But moves that keep you financially healthy also help, relieving stress that can lead to disease and a premature death. And good financial planning puts you in position to enjoy all those extra years.

Getting older is inherently stressful. Major lifestyle changes such as retiring, watching kids leave the nest, and downsizing to a smaller residence inevitably generate anxiety. If you're also taking financial responsibility for aging parents or for adult children who need help getting started, it only adds to the psychological toll.

Getting your financial house in order can help lighten the load. Knowing your retirement account is well funded, say, or that you have established a trust to take care of children from your first marriage, can help ease your mind. But if others around you are concerned about the future, their anxiety will inevitably affect you, too. So sit down now with your spouse, your children, and your parents to discuss what's ahead.

And talk with us. It's our job to help you achieve financial peace of mind, and the more we know about your goals and your stress, the better we can work with you to relieve your anxiety. Getting comfortable with your financial future just might give you more of it to enjoy.

When To Consider A Safe Harbor 401(k)

For owners of small businesses, traditional 401(k) plans are a mixed blessing. They let you offer workers tax-deferred retirement saving, an attractive employee benefit. But administering such a plan can be costly, and anti-discrimination rules could prevent you and other highly compensated executives from fully participating. A variation on the 401(k) theme, the safe harbor 401(k), has simpler rules, lower administrative costs, and is not off-limits to even the highest-paid worker.

Safe harbor 401(k)s are designed for smaller businesses that want to offer a flexible retirement savings vehicle while avoiding the administrative hassle of standard 401(k)s. They work especially well for a small business where owners, along with a few key employees, earn considerably more than most other employees.

Like traditional plans, safe harbor 401(k)s allow employees to make tax-deductible contributions to a retirement account; plan participants are taxed only when they withdraw money from their account during retirement. Participants also benefit from employer contributions—optional for companies offering traditional plans but required for safe harbor 401(k)s.

With a standard 401(k), annual non-discrimination testing is used to ensure that the plan isn't skewed in favor of high-paid workers. If too few employees at the low end of the salary scale participate, the plan may be forced to limit contributions by owners and managers. That testing is an administrative burden and potential roadblock for tax-deferred saving. A chief virtue of safe harbor plans is that they don't require yearly tests.

The government lets safe harbor

plans off the hook because they require employers to contribute to workers' accounts. This can happen in one of two ways. The first is to match, dollar for dollar, the first 3% of salary any employee directs to the plan. Under this scenario, you may also provide a partial match, at 50 cents on the dollar, of contributions up to 5% of salary. So if a worker makes $50,000 and contributes $2,500 (5% of salary) to your safe harbor plan, you'd be obligated to kick in $1,500 (3% of salary) and could contribute an additional $500 (a 50% match of the next 2% of salary), perhaps as part of another defined contribution plan.

The second option for a safe harbor plan is to provide an across-the-board 3% contribution on behalf of all eligible employees, even those who don't put any of their own money into the plan. You would contribute $1,500 for a worker who makes $50,000, $600 for someone earning $20,000, and $3,000 for someone grossing $100,000. Employer contributions vest immediately, meaning the money you provide belongs to the workers even if they leave the company immediately.

If business conditions leave you short of cash, you can suspend contributions for a year, but only if you provide written notice to your employees 30 to 90 days before the end of the plan's year. To participate in the program, employees must be at least 21 years old and have performed 1,000 hours of service for the company during the previous year. Pre-tax contribution limits for safe harbor plans are the same as for traditional 401(k)s—$15,500 in 2007 (and 2008), plus an extra $5,000 for workers 50 and older.This allows a highly-paid owner or employee to put away significant sums toward retirement annually. ●

With Today's Stock Market Volatility, An Investment

As mentioned in the article on page one, stock market volatility is back with a vengeance. It's in times like these that an investment policy statement (IPS) is most valuable.

An investment policy statement commits to writing the details of your financial situation—what you want to accomplish, a plan for achieving it, and how much risk you're willing to take to get there. It can save you from your own worst instincts, helping you resist the temptation to reach too far when times are good or panic when the market plunges. Suppose, for example, that the Nasdaq Composite has had a great run, skyrocketing 15% in the most recent quarter. With your portfolio ahead just 5% during the period, you might feel frustrated, and tempted to grab some of Nasdaq's big gainers to try to catch up. A glance at your IPS, however, would remind you why that's a bad idea. The diversification strategy you've committed to is designed to keep your portfolio on a relatively even keel, with judicious allocations to bonds and dividend-paying blue chip stocks. It has the potential to produce steady gains over the long haul to fund your financial goals. And though it may not take off during a market surge, it's also less likely to go into free fall when the investment climate gets stormy.

While there's no hard-and-fast format for an investment policy statement, most combine the same basic component parts. First, there's usually an executive summary that lays out where you are now in your investing life. It describes your current portfolio and may include your target asset allocation, how much new money you'll invest each month or year, and what index benchmarks are used to gauge your progress. The executive summary also considers risk, often in terms of how

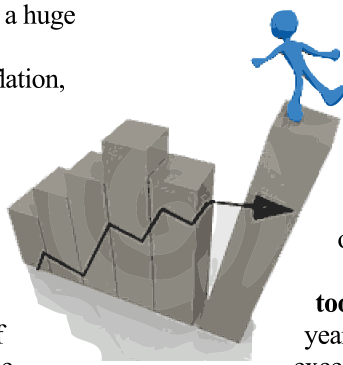
Retirement Spending Just Isn't The Same

Since the Depression, most Americans have been guided by a simple retirement spending strategy: Don't touch your principal, and sell stocks only as a last resort. The approach worked well for many generations, when retirement seldom lasted more than a decade and people could live comfortably on bond interest, stock dividends, and a monthly pension payment. But times have changed. Today's retirees live longer and bear much more of the responsibility of paying for retirement, and simply depending on income spun off by investments may not work.

"Dividends, Social Security checks, and clipping coupons aren't enough for most people," says Moshe A. Milevsky, who teaches retirement income planning and risk management at York University in Toronto. "It's unavoidable that you're going to have to consume capital. The question then becomes how to do it intelligently." Finding a way to use your nest egg wisely—drawing it down gradually without depleting it during your lifetime—means taking into account many facts of retirement life.

Inflation can be a game-breaker. "Most people don't understand inflation," observes Mitch Anthony, author of The New Retirementality. "But to see what it will do in the future, look backwards. Consider the cost of a gallon of gas or a postage stamp 30 years ago. Remember your first paycheck? What kind of life would you have living on that paycheck today? Well, that's what you'll be facing 30 years from now. If you don't get your arms around inflation, you're in trouble."

Retirement spending needs may be higher than you expect. Future levels of spending, too, may be hard to gauge. It's easy to underestimate what you'll need. Health care costs are rising faster than the general inflation rate. Your family could experience an unexpected problem, such as a child needing support. Separating your expenses into discrete goals with specific timelines and then factoring in the appropriate inflation rate is wise. You can't take one lump sum and inflate it for 30 years. Do it in pieces, because different costs rise at different rates. That didn't matter when people lived just five or 10 years after retirement. But it can make a huge difference today.



Taxes matter. Like inflation, taxes eat into retirement income, and it's essential to have a retirement plan that minimizes their impact. One major tax-related question involves which source of capital to tap first. The general rule of thumb is to sell from taxable accounts first, tax-deferred accounts next, and tax-free accounts last. Redeeming investments in taxable accounts may result in capital gains, but those are taxed at a much lower rate than income from a 401(k) or IRA. "There's a delicate balance between trying to keep assets tax sheltered and the risk of pushing yourself into a higher tax bracket and losing more of your Social Security benefits," warns Milevsky.

Risk isn't always a four-letter word. Living into your 90s means taking investment risks. But longer retirement time spans also mean weighing different kinds of risk. Bonds, long a favorite retirement asset, generate income and tend to be less risky than stocks. Over three decades or more, however, bonds have barely kept up with inflation, and that poses another risk—of running out of money. "The whole 'don't tap the principal' idea can be damaging if it leads you to hold the wrong assets," says Milevsky. "If you're 57, say, and have 30 years to live, you can afford the risk of owning stocks."

Real estate is an asset, too. "During the past 10 to 15 years, our homes have been excellent investments, and our income planning should reflect that, says Bob Curtis, whose company makes MoneyGuidePro, software for wealth managers. Today, real estate is part of your overall available assets." You don't want to treat your home like other investments, but tapping your home's equity through a home equity loan, reverse mortgage or by downsizing to a smaller house is worthy of consideration.

A cash cushion creates comfort. Whereas during your working years you may need to set aside enough cash to cover six months of expenses, during retirement a cushion of one to two years may be better. "This is about meeting emotional needs," Curtis says. "Cash gives you an anchor. If the market turns bad, you'll be more comfortable sticking with your financial plan if you know you have that cash buffer." ●

Policy Statement Is Key

much of a loss you could tolerate during specified time periods.

Next, your IPS may detail your **investment objectives**—for example, that you and your spouse plan to retire in 15 years, and you'll need income of $200,000 a year, inflation adjusted, for three decades. Your **investment philosophy** sets out your investing rules to live by. How do you feel about risk, diversification, frequency of trading, investment costs, and taxes? Answering these questions in a formal IPS provides a philosophical underpinning for specific **investment selection criteria** that translate your beliefs into action. Finally, the IPS may outline **monitoring procedures** for gauging your progress.

If you don't already have an investment policy statement, please let us help you create one. Simply going through the process can be invaluable; answering our questions about your goals and risk tolerance may focus your thinking in a new, beneficial way. And with your IPS in hand, we'll know how to serve your needs whatever the market climate. ●

Treating Your Retirement As A Liability

You already pay your bills on time. So why not add one more really important obligation to your monthly budget. If you begin treating your retirement needs as a future liability that you must fund now, you'll likely put away more money than if you pretend retirement saving is optional.

It's easy to fund your retirement account last. You know you should save, but there are competing priorities. The kids want to go to college, and you would like a new boat. And often, retirement saving loses out. But if you treat your retirement saving as another bill you have to pay, it will stay at the front of your mind. You won't miss payments, because—just as when you're paying the mortgage or the electric bill—getting behind has consequences.

While this solution to retirement planning sounds pretty simple, it comes from the sophisticated world of institutional investing. Pension fund managers, for example, have to treat future obligations—payments to pensioneers—as liabilities, and that forces them to deal now with something that may be years or decades off. Using actuarial tables, they calculate the cost of future obligations to determine what return they require on their investments and whether the pension fund is adequate.

While you may not use actuarial tables, you can manage your retirement account like a pension fund. The first step is to determine the savings you need to support the lifestyle you want during retirement, keeping in mind that you probably want to fund retirement through age 90 or 95. Next, determine how many years you have to reach your savings goal. If you are 45 and plan to retire at 62, for example, you have 17 years to fund your retirement account. Finally, determine how much you must save each year and make projections about returns on your investments.

If you're already funding your retirement goal by contributing to a 401(k) or other plan at work, treating that money along with all of your other retirement savings as a liability, may provide you with a more realistic picture about how much you need to put away and the retirement you should expect. It may make you save more.

A simple way to establish a monthly liability for your retirement obligation is to divide your goal into equal installments. So if you have 17 years to save $500,000, you can divide that obligation into 204 monthly payments of just over $2,450 apiece. Given the expected growth of your investments, you're likely to "over-fund" your retirement obligation.

If you would like us to calculate your payments more precisely, we will estimate the impact of inflation, investment returns, and taxes. That may give you a realistic number for your monthly liability. By thinking of your retirement account as a liability, you're paying yourself along with your other debts. It's a great way of funding retirement. Of course, making calculations about how much you need to save today to fund a debt in the future, while also making judgments about inflation and taxes and selecting the right investments, requires the help of a professional. We're here to assist you with any aspect of this and help you create a disciplined system for planning your retirement. ●

Volatility Is Back

(Continued from page 1)

The sudden credit crunch spurred the Fed on August 17 to lower the discount rate—the rate at which the U.S. central bank lends to commercial banks—a full half percentage point. Little money is actually borrowed from the Fed at the discount rate, but this largely symbolic move demonstrated that the Fed, which had been thought more likely to raise interest rates than to lower them, had suddenly changed direction. The Fed followed up by reducing other key rates.

Even before this market correction, however, stocks were not wildly overpriced by historic standards. One key measure of stock value is the market's price-to-earnings multiple. Since 1935, investors have been willing to pay an average of $15.80 for every dollar of profit on stocks in the Standard & Poor's 500 stock index—in other words, the ratio of stock prices to corporate earnings was 15.8. When the stock market peaked on July 20, its price-to-earnings ratio was above average, at 18.3, but relatively low compared with other recent bull market highs. For instance, during the bull market that ended in 2000, the p-e ratio of the S&P 500 topped out at 34. Investors seven years ago were willing to pay almost twice as much for every dollar of corporate profit as they were this summer.

As worrisome as volatile markets may be, they're nothing new. Some research speculates that ancient Babylon suffered through a rough stretch between 1740 and 1700 BCE, when costs more than tripled, and a run on donkeys in Roman Egypt around 200 AD pushed up the price of the animals eightfold.

These days, the markets are still jumpier than they were a year ago. There's less mystery about what the Federal Reserve and other central banks will do, p-e ratios have retreated a bit (making stocks seem cheaper on an earnings basis), and some of the most irrational exuberance has gotten a dose of reality as investors remember just what risk means.

Hopefully, dissecting the summer and fall decline calms any fears you may have. As long as your investment portfolio remains aligned with your long-term financial goals and attitude toward risk, you're likely not too upset about the stock market correction. But if you are still concerned, please give us a call. ●

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