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Calmly Reassess Your Portfolio

The recent market volatility has been more pronounced and of longer duration than many expected, making it difficult to determine how to adjust your portfolio. Should you leave it alone, hoping the market will quickly rebound to much higher levels? Or should you sell everything and stick your money in cash accounts? The appropriate answer probably lies somewhere between those two extremes. What you should do is thoroughly review your portfolio and make any necessary adjustments. Consider these tips when analyzing your portfolio:

✔ **Take another look at your financial goals.** Now it's time to face reality. If your portfolio declined substantially over the past couple of years, it will probably affect your financial goals. Recalculate how much you need to save on an annual basis to reach those goals, based on your portfolio's current value and a reasonable rate of return. Be prepared to readjust your goals. For many people, one of the most painful results of the market declines has been the realization that they are now going to have to delay retirement to ensure they have an adequate retirement portfolio.

✔ **Set an allocation strategy for the long term.** The most basic investment decision you'll make is how to allocate your portfolio among the various investment categories, such as cash, bonds, and stocks. You want to ensure your portfolio is diversified among a variety of investments, so when one category is declining, hopefully other categories will be increasing or at least not decreasing as much. To decide how to allocate your portfolio, you'll first need to come to terms with your risk tolerance. Factors like your time horizon for investing and return expectations will also impact your decision. Once you've decided on an asset allocation strategy, you'll need to adjust your current portfolio to get it in line with that allocation.

✔ **Thoroughly review each investment in your portfolio**

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Banking on Family and Friends

The next time you're tempted to loan money to a family member or friend, follow these tips:

✔ **Don't risk more than you can afford to lose.** Consider all loans to family or friends as high risk. If they weren't, the person who's asking for help would probably be approved by a bank.

✔ **Put it in writing.** Draw up an agreement that you and the borrower sign. Specify the amount that's being borrowed, the interest rate, the term, and a detailed repayment schedule.

✔ **Beware of interest-free loans.** If the borrower is unable to repay the loan, you may be able to declare a loss on your tax return, as long as you've charged interest.

✔ **Understand your tax responsibilities.** The interest payments you receive are considered income and must be declared on your income tax return. The tax code on loans between "related parties" lays out a number of rules for the tax liability of both the lender and the borrower. Before you become a party to this kind of loan, check out the ramifications. ❍❍❍

Start Budgeting

Almost no one enjoys the process of analyzing and budgeting expenditures, but inefficient and wasted expenditures can be major impediments to accomplishing your financial goals. It is difficult to manage your money if you don't know how much you have or where it is going. Consider these steps when developing your budget:

1. Identify how you are spending your income. Review an annual period so you determine regular monthly expenses as well as irregular, periodic expenses, such as insurance premiums, tuition, and gifts. Much of the information can be found by examining canceled checks, credit card receipts, and tax returns. Total expenses in categories that make sense for your lifestyle. If you can't account for more than 5% of your income, take a closer look at your cash purchases. Keep a journal tracking every penny you spend for at least a month.

2. Evaluate your expenditures. If you find it tough to find money to save, critically review your expenditures. Consider these tips:

✔ Find ways to save at least 10% of your income. Almost all expenditure categories offer potential for savings. For essential expenses with fixed amounts, such as your mortgage, taxes, and insurance, you may be able to refinance your mortgage, find strategies to help reduce taxes, or comparison shop your insurance to reduce premiums. Essential expenses that vary in amount, such as food, medical care, and utilities, can usually be reduced by altering your spending or living habits. For instance, you can actively shop for food with coupons, exercise to get in better health, or put energy-saving lightbulbs through your house. Discretionary expenses, such as entertainment, dining out, clothing, travel, and charitable contributions, typically offer the most potential for spending reductions. Dining out four times a week? Reduce it to two, go to less-expensive restaurants, and save the difference.

✔ Limit the use of your credit cards, especially if you're not paying the balance in full every month. Not only do credit card balances carry high interest charges, but credit cards tend to encourage impulse spending. Use cash or a debit card, which automatically deducts purchases from your bank account.

✔ Resolve not to purchase impulse items or items over a certain dollar amount on your first shopping trip. Go home, think about it for a couple days, and then go back to purchase the item. Often, you'll decide you don't really need it.

✔ Delay the purchase of large items. For example, instead of purchasing a new car every two or three years, keep your car for four or five years.

✔ If you're really serious about reducing expenses, consider moving to a less-expensive house. Not only will you reduce your mortgage payment, but you will save on other costs, such as property taxes, insurance, and utilities.

3. Prepare a budget to guide future spending. You may want to start by setting a budget for a couple of months, tracking your expenses closely over that time period. You can then fine-tune your budget for an annual period. Some tips to consider when preparing your budget include:

✔ Don't include income in your budget that is uncertain, such as year-end bonuses, tax refunds, or gains on investments. When you receive that money, just put it aside for saving.

✔ Set up enough expenditure categories to give you a good feel for your spending patterns, but not so many that it becomes difficult and time consuming to monitor your progress.

✔ Make your budget flexible enough to handle unforeseen expenditures. Nothing goes exactly as planned, and your budget should be able to deal with emergencies. Be sure to include large, periodic expenditures, such as insurance premiums or tuition.

✔ Don't be so rigid that your family is afraid to spend any money. Everyone in the family should have a reasonable allowance that can be spent without accounting for it.

✔ Find ways to make the savings component of your budget happen automatically. Get the money out of your bank account and into an investment account before you have a chance to spend it.

The money you have available for saving is a direct result of your spending habits. Use a budget to control your spending so you can maximize your savings. Please call if you need help with this process. ❍❍❍

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Calmly Reassess

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and decide whether you should continue to own it. Some stocks will rebound from the recent market declines, while others will probably never rebound. If you think an investment won't rebound or will take a long time to do so, sell it and reinvest in others with better prospects. It's a painful thing to do, since most investors have an aversion to selling at a loss. But it's an important step if you want to make sure your portfolio is on track going forward. Also make sure your remaining investments are all adding diversification benefits to your portfolio. Just because you own a number of investments doesn't mean that your portfolio is properly diversified. Often, investors keep purchasing investments that are similar in nature. That doesn't add much in the way of diversification, while making the portfolio more difficult to monitor.

✔ **Look for investments you'll be comfortable owning for the long term.** It's tempting to look for the biggest winners in investments and put your money there. In essence, however, you are chasing yesterday's winners rather than tomorrow's winners. You need to keep in mind that the best performing investment category will change from year to year. A better strategy may be to select a diversified portfolio of investments you'll be comfortable owning for the long term, so you have some money invested in each of the major investment categories.

✔ **Use dollar cost averaging to invest.** If you've been investing throughout the market declines, you have probably been purchasing at lower and lower prices, making you wonder whether it makes sense to keep putting money in the market. The point of dollar cost averaging is to invest a set amount of money in a certain investment on a periodic basis. When prices are lower, you will purchase more shares than when prices are higher, following half of the investment principle of "buy low and sell high." But the most important part of dollar cost averaging is that it forces you to continue investing when you really don't want to invest. In the long run, when and if the stock market rebounds, you will probably be glad you had the discipline to continue investing during the market downturn. *(Keep in mind that dollar cost averaging does not guarantee a profit or protect against losses. Because it involves continual investment regardless of fluctuating prices levels, you should consider your ability to continue investing through periods of low price levels.)*

✔ **Pay attention to taxes.** Taxes are probably your portfolio's most significant expense. Ordinary income taxes on short-term capital gains and interest income can go as high as 35%, while long-term capital gains and dividends are taxed at rates not exceeding 15% (0% if you are in the 10% or 15% tax bracket). Using strategies that defer income taxes for as long as possible can make a substantial difference in the ultimate size of your portfolio. Some strategies to consider include utilizing tax-deferred investment vehicles (such as 401(k) plans and individual retirement accounts), minimizing portfolio turnover, selling investments with losses to offset gains, and placing assets generating ordinary income or that you want to trade frequently in your tax-deferred accounts.

✔ **Review your portfolio at least annually.** You can't just adjust your portfolio now and then leave it on autopilot. You need to keep an eye on your portfolio, in case market or company situations require changes. By reviewing your portfolio annually, you'll have an opportunity to make adjustments on an ongoing basis, which should prevent major overhauls in the future.

If you'd like help getting your portfolio back on track, please call. ❍❍❍

Changes in Home-Equity Loans

If you are trying to obtain a home-equity loan, be aware of these likely changes:

✔ **The loan-to-value ratio will probably be lower.** In the past, it was not uncommon for a mortgage and home-equity loan to total 100% or more of the home's market value. Now, anything over 90% is rare, and that percentage may be much lower in markets with declining home values. Some areas have limits as low as 65% of the home's value.

✔ **Your credit score is more important.** In the past, it was fairly easy to obtain a home-equity loan. Now, lenders are more concerned with your ability to repay the loan, using your credit rating as an indication. If your credit score is less than 680, it will be difficult to find a lender willing to approve the loan. The higher your credit score, the more options available and typically the lower the interest rate you will have to pay.

✔ **You'll need a full appraisal of your home.** In the past, a simple review of home values in your area was often enough for a home-equity loan. Now, you'll probably need a full appraisal, including a walk through of your home.

Please call if you'd like to discuss home-equity loans in more detail. ❍❍❍

The Impact on Higher-Income Families

It's commonly believed that recessions impact lower-income families more than higher-income families. However, a recent study by economists at Northwestern University found that the relative income loss during recessions for the top 10% of the population is 26% greater than the average household, while it is double the average household for the top 1% of the population. It is still probably tougher for the average family to deal with income declines, but the impact on the economy is certainly greater when higher-income families lose income. Consider the following (Source: *Newsweek*, July 20, 2009):

✔ **A significant portion of consumption spending is made by higher-income families.** For instance, in 2009, households with over $200,000 of income represented 3.4% of the number of households, but generated almost 14% of consumer spending. Households with income between $100,000 and $200,000 represented 14% of the number of households and 34% of spending. Combined, these two groups generated almost half of all consumer consumption, while accounting for only a sixth of the total population.

✔ **Higher-income families pay a significant portion of all income taxes.** In 2006, taxpayers with the highest 1% of income paid 28% of all federal taxes, while the top 10% paid 55% of all federal taxes.

✔ **A substantial portion of charitable giving is made by higher-income families.** In 2004, the top 1.5% of American families based on net worth made approximately 27% of all charitable contributions, while the next 7% made 20% of all contributions. Thus, one tenth of all American families made nearly half of all charitable contributions.

Thus, when higher-income families are faced with a substantial income loss, it can seriously drag down the economy. For instance, from 2007 to 2008, families with income between $150,000 and $250,000 reduced spending by 8%, while families with incomes over $250,000 reduced spending by 15%. ❍❍❍

New Changes in Credit Card Laws

Starting August 2009, certain portions of the Credit Card Act of 2009 went into effect. The major provisions include mailing statements at least 21 days before the due date and providing at least 45 days notice before making significant changes to interest rates or fees. In the past, statements could be mailed 14 days before the due date and fees or interest rates could be changed with a 15-day notice. Also, consumers must now receive a warning before increasing fees or rates due to missing payments or exceeding credit limits.

However, the majority of the Credit Card Act of 2009 provisions will go into effect in February 2010, including limits on interest rate increases on existing balances.

Prior to the act going into effect, many credit card issuers converted credit cards from fixed rate to variable rate, so they could adjust rates based on market conditions without notifying credit card holders. Many banks are reinstituting annual credit card fees and reducing reward cards. ❍❍❍

Financial Thoughts

Approximately 73% of baby boomers who own IRAs have no intention of converting to a Roth IRA in 2010, despite the elimination of the $100,000 income limitation (Source: USAA, August 2009).

In response to a recent survey, two-thirds of small business owners indicated that they did not have an exit plan to transition their business in the event of death, disability, or retirement (Source: Principal Financial Group, August 2009).

The Federal Reserve projects a total average home price decline of 41% to 48%, with a housing bottom in 2010. Don't count on a quick recovery in prices. After the mild recession that ended in 1991, it took six years for housing prices to start rising again (Source: *U.S. News & World Report*, June 8, 2009).

At the end of the first quarter, 2009, approximately 27% of homeowners with mortgages had negative equity. By 2011, that percentage is estimated to increase to 48% (Source: Deutsche Bank, August 5, 2009).

The Congressional Budget Office predicts that the unemployment rate will drift down slowly and won't return to normal levels of 5% or less until 2016 (Source: Congressional Budget Office, 2009). ❍❍❍