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Intro

2009 seems to have started just as 2008 ended… with confusion, uncertainty, and a very ugly result both on Wall St. and on Main St. Just as the dust begins to settle on the credit crisis, more uncertainty is being introduced in the area of politics and taxation. One thing is certain, change is rippling through our financial lives. We're moving from a world dominated by credit-based spending to one where individuals, businesses, and even the government will be forced to start saving money and planning in advance in order to achieve their goals. Joe the plumber can't just wake up one morning, decide he wants to buy a $300k house, and obtain two mortgages (one for 80% of the purchase and one for 20% of the purchase) to get the money he needs. Now, he is expected to put some skin in the game if a bank is going to loan him several hundred thousand dollars (which makes a lot more sense for the bank!). That means bringing at least 20% of the home's value to the table. How does Joe, who has lived paycheck to paycheck for most of his life come up with $60,000?!? The answer is probably daunting for Joe. He can't buy the house today. He has to find a way to save $10,000 / year for the next 5-6 years and then he can buy the house. He has to plan and execute, rather than living in the moment. This is not a new way of thinking. It's just new for Joe who has the memories of the lavish, unsustainable, credit-driven world he lived in for the past 10 years fresh in his head. Suddenly Joe understands why the housing market is in its current condition. No one can afford a downpayment on a house!

At A Glance

Segment*	2008	YTD 2009 (Thru 2/28)
US Large Cap Stocks	-36.8%	-18.1%
US Small Cap Stocks	-36.1%	-21.0%
Foreign Developed Stocks	-41.4%	-21.9%
Foreign Emerging Market Stocks	-50.0%	-13.1%
US Treasury Bills	1.8%	0.0%
US Med Term Treasuries	18.0%	-4.6%
US Long Term Treasuries	33.8%	-14.5%
US Aggregate Bond Index	5.2%	-1.1%
US Corporate Bonds	0.3%	-4.3%
US High Yield Bonds	-23.9%	1.0%
US REITs	-37.0%	-34.5%
Gold	3.0%	10.0%
Oil	-54.7%	-20.2%
Aggregate Commodities	-36.7%	-10.0%
US Home Prices	-18.6%	TBD
GDP Growth Y/Y	-6.2%	TBD
Unemployment Rate	7.2%	8.1%
Inflation (CPI) Y/Y	0.1%	TBD

We can extend this story to funding for a new or expanding small business, new machinery for larger businesses, and eventually, the story may even pertain to Joe's favorite Uncle Sam as well. We have to get used to having money before we spend it. It's a hard reality, especially at a time of pay cuts, layoffs, and other cost cutting measures. If the average person is making less money, has less credit, and has the realization that he/she needs to save in order to make large purchases in the future, then where does today's spending that fuels economic growth come from? If this argument makes sense to you, you now understand why we're in what will probably be one of the worst recessions of our lifetimes.

As always, the PWA Q1 newsletter will be almost entirely economy and market focused since it's these very markets that we use to help us achieve our goals. I've heard many questions asked recently by clients, friends, and especially in the press. In this newsletter I'd like to take the opportunity to answer some of those questions with a simple and straight-forward response that I hope helps you understand more of what's going on in the economy and financial markets.

Q. "How did we get into this mess?"

A. I've answered this one before, but for those who didn't get a chance to read it, please see my Special Market Update from October 12 which can be found at www.perpetualwealthadvisors.com/A/MarketUpdateDet20081012.htm. In short, we saw a lot of greed on the part of borrowers, lenders, and investors, combined with new tools spawned by financial engineering, artificially lift the economy and its assets to a place where they never should have been. When reality hit, it hit hard.

Q. "If the value of everything is falling, where do I put my money?"

A. While it may feel like the value of everything is falling because the high profile investment instruments (stocks, real estate, etc.) are losing value, not everything is in that same situation. The bond market actually performed very well in 2008. One of the most watched aggregate bond indexes was up 5.2% in 2008 and long-term U.S. Treasuries were up a whopping 33.8% in 2008.[1] The reason for this is that especially when asset values are falling, people rush to the safety of fixed-income, interest paying securities. This pushes interest rates down and the demand for those instruments with pre-existing, fixed higher interest rates pushes their price up. As a result, owners get not only the interest payments, but also the capital gains. The safety of bonds, especially in volatile economic times, is the reason we recommend that funding for short-term goals be in bonds and not stocks.

So, rather than trying to predict the market, we recommend that clients focus on dividing their money into segments that are allocated according to when the money will be needed. This means planning and determining your short, medium, and long-term goals, something that is a necessity in this new economic environment. Long-term money for things like retirement or education, if you're far from retirement or if you have a young child, can be invested in things like the stock market. The long-term returns of those vehicles will likely be higher than that of bonds. But, for shorter-term goals, the safety of the money is more important than its growth and we therefore recommend the safety of bonds.

> *"The safety of bonds, especially in volatile economic times, is the reason we recommend that funding for short-term goals be in bonds and not stocks."*

Q. Why would I invest money when the economy is so terrible?"

A. When most people use the word "invest", they're thinking of the stock market. When they think of the word "save", they think of their bank savings account (cash). We recommend that people considering saving and investing to be the same thing and utilize an appropriate mix of stocks, bonds, and cash to earn the returns they need to achieve their goals with the least risk possible. If you keep a cash emergency fund to cover your expenses in case of something extreme like a job loss, and you invest (save) the rest of your money in a vehicle that is appropriate for the goal you want to achieve, it really doesn't matter what the economy does over the short-term.

Q. "Ok, so for my long-term goals, why would I invest in stocks when the economy is so terrible? Shouldn't I wait until the economy turns around?"

A. The stock market is forward-looking. Just as stocks started to fall at the end of 2007 well before the economy fell apart, it will begin to recover well in advance of the economy showing signs of improvement. In 2002, the market was almost 50% off it's highs after the bursting of the dot-com bubble, September 11th, and corporate scandals like Enron and Worldcom. The newsflow was terrible. Unemployment was increasing. And yet the stock market found its bottom right at that same time. It was a full 9 months later that unemployment peaked and employers started really hiring again.

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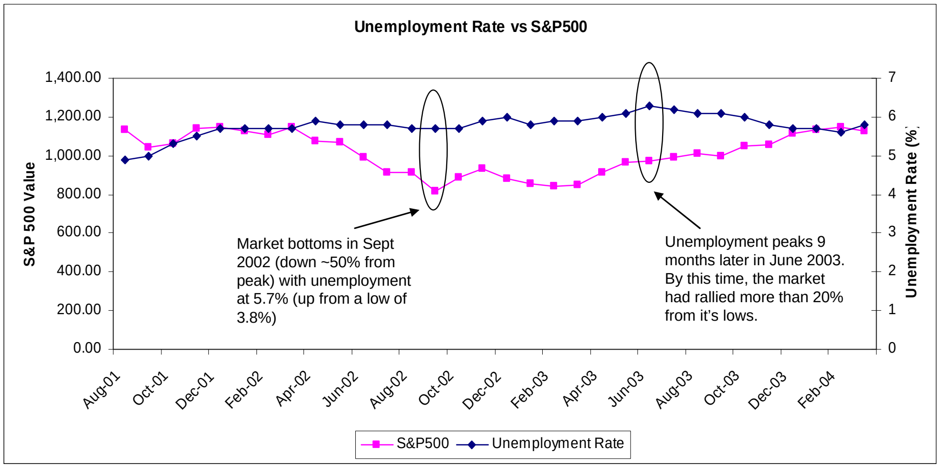
[1] As measured by the Vanguard Aggregate Bond Fund ETF and the iShares 20-30 Year U.S. Treasury EFT.



What this shows is that trying to predict the tops and bottoms of the market based on the performance of the economy is extremely difficult. It makes much more sense, for long-term goals, to develop and stick to a consistent investment plan over time. When the market hits a down cycle, you'll be investing at a lower price. When the market hits an up cycle, you'll be closer to having the amount of money you need to achieve your goal. This means you need less of a return in the future which means you can move more of your portfolio to the safety of bonds. It allows you to always continue buying stocks when the market is lower and take a little off the top as the market moves higher. A consistent plan that enables buying low and selling high without the emotional struggle of being naturally fearful when the market is falling and greedy when the market is doing well.

Q. "When will house values stop falling?"

A. We believe there are five key factors that play a role in this answer. They are:

- Inventory of Current Homes For Sale – as of the end of January, there were an estimated 3.6M homes for sale. The current annual rate of sale of homes is 4.45M homes per year. This means that it would take 10 months of selling to exhaust the current inventory of homes assuming no new homes are put on the market. During 1994 – 2004, there were approximately 4-5 months of supply. Until that supply is reduced or demand picks up significantly, house values will continue to decline.

- Foreclosure Rate – every foreclosure puts pressure on home prices because when the lender takes over the home, it is anxious to re-sell it quickly. It accomplishes this be selling the home below it's probable market value. That sale becomes a comparison point for other values in the neighborhood and so lowers the values of homes around it. The current U.S. foreclosure rate is 1 in every 466 homes, but for the worst cities, primarily in FL, NV, and CA, it is as high as 1 in every 60. The national average rate is 17.7% higher than it was in Jan of 2008. Until that rate stops increasing, house values will continue to decline.

- Initial Affordability / Credit Availability – mortgage rates may be at historical lows, but the qualification standards for obtaining a mortgage are very high. In most cases, to qualify for a mortgage, buyers need at least a 10% and more often a 20% down payment on the house. This means that to buy the median U.S. home valued at $170K as of Jan., a buyer would have to have $34K to qualify for most mortgages. After a long period of not needing any down payment for a mortgage, we'll assume that when the recession started in 2008 most people had very little saved/invested that they planned on using to purchase on a house. With the median U.S. family household income at $60k/yr, if we assume a savings rate of 20% of income (a definite stretch), it would take at least until the end of 2010 before the average family has the money required to pay for the average mortgage. Without the ability to qualify for the mortgage, low rates aren't a huge help for the housing market, which means it will be some time until demand returns in aggregate.

- Ongoing Affordability – this is the one factor that is improving rapidly. Median family income has only fallen ~2% in the past year while median home prices, mortgage rates, and the portion of the home that is financed as a mortgage (now 80%) have all fallen dramatically. Once the family is in the house and has the mortgage, the median family only has to spend 15% of their monthly income paying the mortgage on the median house. If we assume a 10% downpayment which may have been typical at the start of 2008, the mortgage cost 21% of income. And if we assume a 5% downpayment in Jan 2006 (typical of those times), the family would have spent a whopping 29% of their income on mortgage payments. This shows that once a home-buyer can qualify for a mortgage, making the payments will be substantially easier than a few years ago. So once people have a chance to save/invest some money for their future down payment, they will find the housing market much more affordable.
- Sentiment – probably the largest factor of all, consumer sentiment is awful. No matter how much money people have and how affordable homes are, if they fear losing their job or fear instantly losing money on a new home purchase, they will not buy. Sentiment will be restored when the economy stops worsening. With sentiment worsening and depending on the economy and the economy worsening and depending on sentiment, we have an endless downward spiral. For that reason, (those of you who know me well should be able to hear the pain in my voice as I say this), we are dependent on our government to properly stimulate the economy so that sentiment will improve and turn the economy around without further government intervention. Since the government's plans have been slow to evolve, it is impossible to predict when they'll get the proper plan in place. With that said, let me be clear… I have full confidence that they will, at some point, get the right plan in place.

So, it is impossible to precisely answer the question unless we can predict all the preceding factors with certainty. All we can do is monitor these areas for signs of a turn around. For the time being it seems fair to say that the trend is down, but that there are new government programs that point toward a possible break of that trend. When it does break, the affordability of homes should lead to a complete stabilization of the economy and set it up for steady growth for several years to come.

Q. "Is now a good time to refinance?"

A. The decision to refinance comes down to three things:

- How much will it cost to refinance (closing costs, origination fees, points)?
- How much will you save per month on your mortgage payment if you refinance?
- How long do you plan to keep the house/mortgage?

Rates are at historical lows, with the national average rate near 5% and rates in some areas in the mid-4%'s. Given the current level of government intervention, it is possible that rates could move rapidly in either direction from here. If you can currently obtain a mortgage from a lender that will reduce your payments enough to make up for the up-front fees within the time you plan to own the home, then it makes sense to refinance. If you need help with this sort of calculation or want to compare multiple options from a lender, contact your advisor.

There is a catch though, if the value of your home has fallen in such a way that you owe more than 80% of your home's value on your mortgage, you will have difficulty finding a lender that is willing to let you refinance. Depending on your situation, there could be government programs that can help in this scenario. Please see http://treas.gov/press/releases/tg48.htm for more information on these programs and contact your lender to see if you qualify to use them.

Q. “How can AIG lose $60B in a quarter and why do we keep giving them money?”

A. Most people know AIG as an ordinary insurer that writes life insurance policies, home and auto insurance, etc. Those units are slow and steady performers that continue to perform well today. Several years ago, during the housing boom, leadership (if you can call it that) decided that they could dramatically increase earnings by providing insurance to financial products as well. They started insuring complex packages of mortgages, municipal bonds, and the livelihood of corporations. That is, if the people stopped paying their mortgages, or municipalities stopped paying their debts, or corporations went bankrupt, AIG would make the debt holders whole on their loss. (This type of insurance on a corporation’s survival is called a “credit default swap”, which is a term you may have heard in the press in the last few months). Similar to the way every other kind of insurance works, in return for the insurance, AIG would collect a small premium from those who lent money to the homeowners, municipalities and corporations.

As long as the premiums are coming in and few insurance claims are filed, the small premiums add up to big profits. In the case of ordinary insurance, states regulate the number of policies that one insurer can write so that in the case of a large number of claims the organization can pay all of its policyholders. But these financial insurance contracts were unregulated and so AIG was able to write so many policies that it could never pay them all off if needed. During the good times, they collected massive amounts of premiums that led to the growth of the company. But as the economy started to turn, they had to start making payments to the policy holders, usually banks that were trying to insure their debts. So many policies filed claims that AIG quickly depleted its assets and was on the verge of bankruptcy. Had AIG bankruptcy occurred, all of the banks that held policies would suddenly have no insurance and be at risk of suffering large losses if the homeowners, municipalities, and corporations defaulted. This came right at the time that homeowners, municipalities, and corporations actually started to default due to the economy. Those uninsured defaults would mean big losses for lending banks. This would send more banks into bankruptcy, cause more losses, and a death spiral of the financial system could ensue. This “contagion” or “systemic risk” caused AIG to be deemed “to big to fail” by the government who in a sense was forced to keep it afloat in order to avoid widespread financial catastrophe. So, now AIG continues to pay its insurance claims, continues to lose money, and continues to receive funding provided by the government (ultimately you, the taxpayer).

Q. “How can a bank like Citigroup plead poverty to get money from the government and then announce a profit the very next quarter?”

A. Capital (cash) is the fuel of a bank. Their profits are highly dependent on the cost of obtaining the capital that they can loan out via mortgages, business loans, etc. for profit. While bad loans (above and beyond those that may have been insured by AIG – see above), which were leveraged multiple times, have defaulted and depleted Citigroup’s capital almost to the point of bank failure, it hasn’t changed their ability to turn profits on new loans going forward if they can access capital at a lower cost than the interest rate at which they can lend it. Since the government has given Citi billions of dollars of capital at a 0% interest rate, they’re now making boatloads of profit on new loans. To illustrate a very simplified case, let’s say Citi gets $50B from the government and lends it all out to worthy borrowers at 5% interest per year. 5% of $50B is $2.5B in proceeds every year, with no cost of capital. So why is Citi’s stock at $2 if they’re making so much money? Well, there’s a catch to the “free” capital from the government. The government now owns a very large portion of the $2.5B of profit, not the private shareholders. When you divide the $2.5B amongst all the shareholders including the government, each share doesn’t get very much (but it’s still better than losing money). So, the injection of capital has succeeded in keeping Citi afloat, making it profitable again, and assuming Citi isn’t taking excessive risk to make their profits now (i.e. they learned their lesson), the government will be able to sell it’s stake in the future and return Citi to its shareholders.

Q. "How can I protect my family from a Bernie Madoff-like scenario?"

A. By now virtually everyone has heard of Bernie Madoff. His asset management firm was a Ponzi scheme, under which, instead of using client's money to buy investments, he deposited the money in his own business account and then used that account to make payments to those who requested withdrawals. As long as the withdrawals never exceeded the sums he collected and his investor base grew, he would be able to claim paper gains on falsified statements and never be caught. In the 15+ years of operation, Madoff never purchased a single security for any of his 4800+ clients.

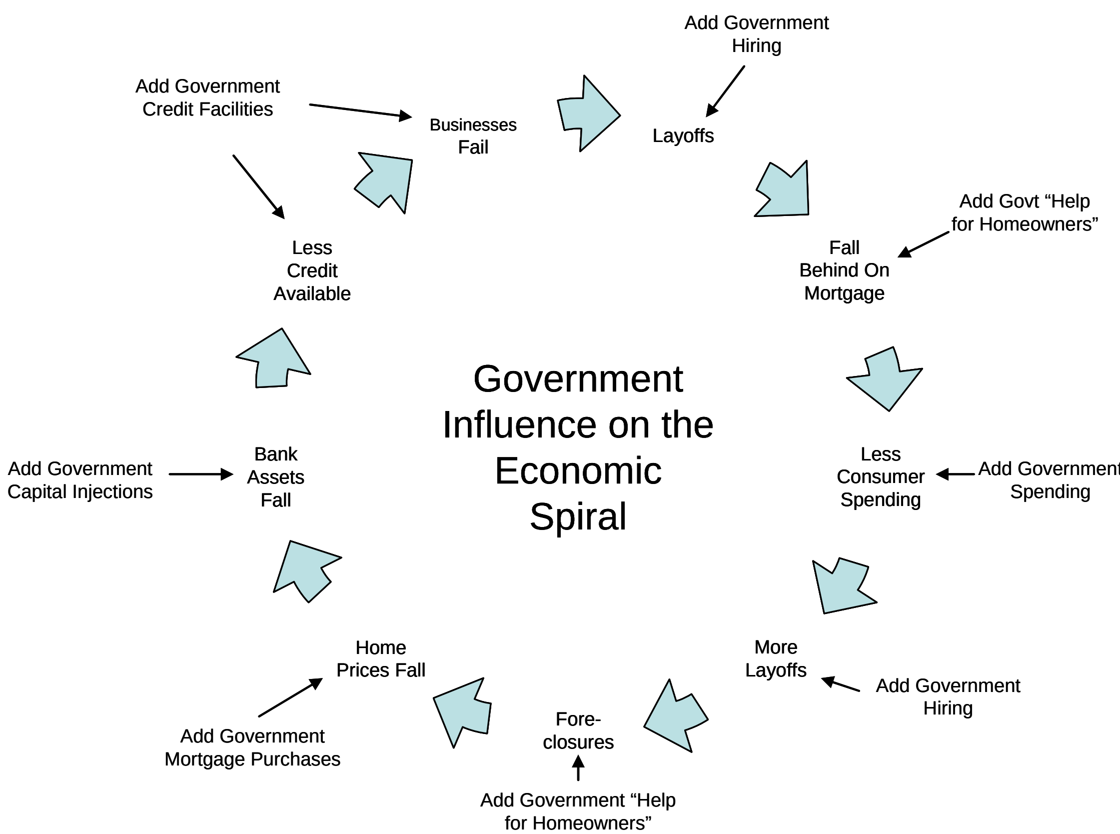
There are a few simple ways to make sure you and your loved ones avoid falling victim to scheme's such as this (of course as a PWA client, all of the following pertain to your accounts, but I believe this could be helpful for your friends/family that are not PWA clients):

1) Never give your advisor custody of your funds. Do not write checks for anything other than fees to your advisor.
2) Make sure your accounts are opened in your name. Your advisor may have the ability to trade on your behalf, but the account should be yours.
3) Do not provide your advisor with the ability to withdraw money from your account for anything other than fees.
4) Never accept a check from your advisor's account as a withdrawal from your account. This is a huge red flag that would imply that you don't have funds in your own account to withdraw.
5) Never trust an advisor that guarantees you consistent high returns. There is no way to earn more than a risk-free return (like savings account interest or U.S. treasury bills) without taking risk.
6) Avoid advisors who charge fees that are based as a percentage of your gains (instead of your assets). Unless you are a high-net-worth individual, this is illegal, and even if you are, it provides a terrible incentive for the advisor to take massive amounts of risk.
7) Review your statements. If you are invested in vehicles that are not publicly traded or that don't have a "ticker" that you can put into Yahoo Finance and find out what the investment is, ask your advisor for details. If you don't understand the investment and it's not publicly traded on an exchange, you're asking for trouble.
8) Choose an advisor who is a CERTIFIED FINANCIAL PLANNING™ professional.
9) Read your advisor's Form ADV before beginning your engagement. This form discloses the workings of the advisor's business as well as any ethical violations or reprimands from regulatory bodies that he/she has received.
10) Choose an advisor that answers your questions to your satisfaction. If answers are convoluted and use jargon you don't understand as a way of confusing you so you don't ask another question, odds are something is not right.

Q. "Will the government's efforts to turn the economy around work?

A. Let me divide it into two parts. Will the economy turn around? Yes, definitely. Will it be because of the government's efforts? Maybe. It's easy to criticize the government and in a two party system like ours, criticizing the party in power is the norm. In my opinion, the actions of the government since the crisis started have been positive overall, at least over the medium-term. The stimulus package, despite being loaded with non-stimulative spending, will help. If nothing else, its placebo effect will help confidence and eliminate some of the corrosive sinicism that has become commonplace. The actions of the Treasury, the Federal Reserve, and the FDIC have been nothing short of monumental. In short, they have been providing necessary liquidity to the markets through short-term loans, guaranteeing short-term loans that are provided by the private markets, and recapitalizing the banking system by providing equity capital and by keeping rates low. In the latest week they have also announced two potentially game changing programs. The Treasury will be facilitating a public-private partnership that will buy some of the illiquid mortgage-backed assets that started the credit crisis and have been clogging up the banking system since. The Fed will be buying actual mortgages as well as buying new treasuries to provide financing for the Treasury and the Federal government to continue with their programs, thereby keeping both long-term treasury rates and mortgage rates near historical lows. Taken together, I'm confident that these actions will stop the economic death spiral we've been working toward for the past six months.

However, over the long-term, these actions could create even bigger problems. The expansion of the Federal government, its increased spending, its involvement in previously private matters, and its movement towards a redistribution of wealth form a dangerous combination of disincenting private investment (which could hurt growth in the future), while necessitating an increase in taxes to pay for the new spending (which almost certainly will hurt growth in the future). At the same time, the extreme liquidity that the Fed is providing and the fact that they are now literally printing money to help the Treasury and government pay for its debts can bring about severe inflation in the future. It is possible to manage though these issues, but we're definitely using up our margin of error.



The government attacks the self-reinforcing cycle at each stage. Through programs, fiscal stimulus, and monetary expansion, the loop will breakdown and the recession will end. The government's ability to reign in spending and undo the monetary expansion once the recession ends and before long-term consequences take hold remains to be seen.

Q. "Is there any bright side to this recession?

A. Yes, a big one. The pace our economy was on was not sustainable for the future. Housing prices cannot grow indefinitely at a rate faster than the income of the people buying houses. Outstanding credit cannot grow endlessly and provide the main source of fuel for the economy. Even if it could, we simply cannot afford the cost of natural resources that would be needed in that scenario.

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So, we really faced two options. Very slow growth for the long-term, or a recession and then a return to normal growth following it. Which is better? For those who are young enough to work through the recession and into the next growth cycle, the recession is clearly better. For example, take a 40 year old (we'll call him Al), planning to retire at age 60 in two scenarios. In scenario 1, the economy slows in growth and the market reflects this by growing 3.4% per year for the next 20 years, with no recession at the start. In scenario 2, the economy goes into a severe recession and then returns to normal growth. The market falls 55% in response and then grows 8% per year until Al's retirement. In both scenarios, the market reaches the same value at Al's retirement. If Al had $100k to start with and contributes $15k per year toward his retirement each year in both scenarios, he'll wind up with ~$965k at age 60 in scenario 2 (with recession) and only $650k at age 60 in scenario 1 (with no recession). The reason should be clear. Recessions provide opportunities to invest at lower prices and those with a consistent investment plan that doesn't give in to fear and greed will do better with that opportunity.

What about those already near or in retirement? Their plan should have called for a more conservative allocation and much of their money should not have been in the stock market. They should be on much more of a safe, fixed income from bonds. The recession for them presents an opportunity in reducing the cost of living (oil is no longer $140 per barrel, gasoline is no longer $4 per gallon). On a fixed income, reducing your costs is akin to increasing your income.

We never like it when it happens, but those who plan properly plan for the cyclical nature of the economy. They can not only accept it, but can benefit from it. PWA is focused on helping our clients with exactly that type of planning and execution.

The Pretirement Press is a PWA's quarterly newsletter to clients. If you have comments or suggestions for future newsletters please contact us at newsletter@perpetualwealthadvisors.com. If you're not a PWA client, but received this newsletter and would like to be on our mailing list, please send an email to subscribe@perpetualwealthadvisors.com with Subject Line: Add Me. As always, if you or someone you know are interested in PWA's comprehensive planning, asset management, decision support, or tax prep services, please contact us to set up a free consultation. It's a small amount of effort to start down the journey to perpetual wealth.
