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Second Quarter 2009

Markets Often Rebound Before The Economy

Given the extreme recent volatility of the stock market and the worsening economy, it's no wonder investors are on edge. Most have suffered significant setbacks during a recession that is already at record length and could continue for another year or more. It hardly seems like the right time to buy stocks. Yet while no one can know for sure when markets will turn around, that typically happens well before the economy gets going again.

The numbers don't lie. One recent study examined nine recessionary periods defined by the official arbiter, the National Bureau of Economic Research (NBER). According to NBER data charting recessions from 1953 through 2001, the stock market typically declines until sometime during the middle of the downturn and then begins to strengthen.

Starting at the low point of each recession and continuing until six months after its official end, the Standard & Poor's 500 stock index averaged a gain of 36%. That compares with an average decline of 21% for the S&P during a period starting six months before the official onset of each recession and ending at its low point. The average return for an entire recessionary period, including the six months before and after the actual recession, was 8%, and the average recession lasted 11 months.

The positive return is due to the role of the markets as a leading indicator, meaning that by the time the recession grips the economy, the markets are already looking forward to the eventual recovery. Similarly, much of the drop in the markets occurs in anticipation of the recession, many months before it is made official.

Throwing in the towel. Despite the hard data showing its benefits, buying stocks during the depths of a recession is bound to feel counterintuitive, particularly if you've spent months watching current holdings steadily lose value. Psychologically, it feels better to jump into the market after prices are already surging and getting out when they're falling. But it's exactly when most investors have finally given up on stocks—a situation market pros call capitulation—that the market is likely to bottom out and start climbing. Capitulation tends to happen when economic news is most dire.

Indications of things to come. In the end, of course, market movements are driven by supply and demand, and stocks won't improve this time just because they've risen under similar circumstances in the past. Still, history can provide important clues about where the economy and markets are likely to go, and economists consider the stock market a leading indicator—a preview of what may be to come for the economy.

Other lagging economic indicators

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Employees Want Financial Planning Ideas And A 401(k)

Business owners looking for ways to enhance benefits for their employees might want to consider adding financial planning to the mix.

The 6th annual MetLife Study of Employee Benefits Trends shows a marked increase in the number of employees who want professional financial advice connected with their 401(k) plan and other benefits. According to the third-quarter 2007 study, which surveyed 1,380 full-time employees and 1,652 benefits managers, 44% of employees desire financial planning at work, up from 30% in 2006. About half also want workplace advice on retirement.

Just 37% of U.S. employers offer financial planning services to employees, even though the Pension Protection Act of 2006 gives companies some protection from employee lawsuits if they bring in advisors to help workers with investment decisions.

Employees are feeling increasing pressure to manage their finances, and the study shows that 47% want professional advice about benefits (compared with 33% a year earlier), 49% desire guidance about retirement savings (compared with 38% in 2006), and 44% want advice about their overall financial situation (up from 30%).

Business owners who improve their benefits packages with services such as financial planning not only help employees but also experience better employee retention and loyalty, the MetLife study asserts.

Gifting A Business Can Cut Estate Taxes

If you have a family business, transferring shares of it to your heirs now rather than at your death could help minimize disruptions to the company and save millions in potential gift and estate taxes. You don't have to give up your controlling interest. By retaining a majority of the stock, you can ensure that you always have a voice even when you retire. But if you think your business is about to take off, the time to get part of it out of your estate may be now, not later.

Gifts of Stock. Each year, a parent may give $13,000 to a child or other recipient without gift-tax consequences. In addition, everyone gets a $1 million lifetime gift-tax exemption. The annual exemption doesn't count against the lifetime cap.

Suppose you and your spouse own a business that you plan to take public next year and you'd like to transfer partial ownership to your two children before the initial public offering—after which, you hope, your stake in the business will skyrocket. Together, you and your spouse could give the kids a tax-free gift of stock worth up to $2,052,000—using up your full lifetime exemptions, plus the $13,000 each of you may give each child.

And the benefit? Suppose that rather than receiving the stock now as a gift, your children inherited it after you and your spouse have died. Estate tax laws are in flux, and it's impossible to say what their liability would be years or decades down the road. But under today's rules, if $2.052 million in stock had appreciated to, say, $20 million, the children might owe estate taxes of almost $8 million. (This assumes you and your spouse used a bypass trust to preserve your full estate-tax exemptions—currently $3.5 million for each of you for 2009.) By giving the stock now, you avoid any tax on the transfer.

Giving away partial ownership could provide an even greater advantage if you are transferring a minority stake in the form of illiquid stock. For tax purposes, your gift can be discounted. For example, if you gave your daughter a 40% stake in your $400,000 company, the discount could reduce its value by another 25% to 35%. That share of the company might be valued at just $104,000—40% of $400,000, discounted by 35%.

Gifts of Real Estate. You don't have to limit your gift to cash or stock; if your business owns real estate that either has a low tax basis or generates a lot of income, you can reduce your current income tax bill by shifting the ownership of these assets to family members in lower tax brackets and leasing the property from them. But you may want to give income-generating property only to adult children. For younger children (under age 19 or full-time students under age 24), the income is generally taxed at the parents' tax rate under the "kiddie" tax. ●

The Tax Rules Of Buying Or Selling A Home

Though the mortgage-interest deduction may be the most obvious example of the government's largesse to home-owners, other significant breaks apply when you buy or sell a home. People buy or sell a home for lifestyle reasons and not for tax reasons. But knowing the tax rules can save you a bundle on a house sale by keeping your tax bills to a minimum. Consider these strategies.

Don't sell too soon. With the way that home prices have appreciated over time (despite the recent decline), selling your house could net you a major profit with no tax bill—unless you make your move too soon. If you've lived in a home for at least two of the past five years, you can exclude up to $250,000 of your gain from capital gains taxes; if you are married, you and your spouse can avoid taxes on a profit of up to $500,000. If you sell after just a year, however, you'll be taxed on your profit at the 15% rate for capital gains—and if you sell a place you've lived in less than 12 months, your gain is considered short-term, and taxed at your ordinary income rate of up to 35%.

Plead hardship. So-called hardship sales—necessitated by medical problems, divorce, job loss, or multiple births—could win you a tax break even if you sell before living in your home for two years. If you qualify, you'll get a reduced home-sale exclusion based on your amount of time in the house, expressed as a fraction of the ordinary two-year minimum. If you sold after 18 months, for example—three-quarters of the minimum—you could exclude a profit of up to three-quarters of the usual $250,000 or $500,000 exclusion.

Minimize your gains. If you have to pay tax on your profit, look for ways to increase your home's tax

A Little Bond Logic Yields Insights

In recent months the Federal Reserve has been cutting down interest rates to near zero in an attempt to help jump-start the economy. But what goes down must come up, so you can expect this trend will eventually be reversed and interest rates will begin to climb again.

If you're wondering how these developments affect bonds you already own, it's a good question. Even experienced investors can find it a challenge to grasp how bond markets really work. However, there is logic behind the ups and downs.

Bond Basics. Put simply, a bond is an IOU. Governments and businesses issue bonds to raise cash for various purposes. The markets use several descriptors to identify a bond: the issuer's name, the bond's face (or par) value, the rate of interest paid to the bondholder, and the maturity date (on which the issuer repays the principal). Because bonds trade on the open market, their prices fluctuate—and that is where things can get complicated.

How Interest Rates Affect Bond Prices. While many factors may push the price of a bond above or below its face value, perhaps the most direct impact comes from changes in interest rates. As interest rates rise—or threaten to rise—bond prices tend to fall, and vice versa.

Imagine you own a bond that pays 5% interest. After a Federal Reserve rate hike, newly-issued bonds offer a 6% rate. To someone in the market for bonds, the new rate seems much better. Lower demand for the 5% bond translates into lower prices. Conversely, if the prevailing rate falls to 4%, your bond suddenly becomes more attractive, and should command a higher price. (Note, these figures are hypothetical.)

Price vs. Yield. However, markets generally refer to bond values not by price, but by yield—the annual interest divided by the current price. If your 5% bond has a face value of $10,000, you receive $500 a year in interest. If the bond sells "at par"—the face value—the yield would be 5% ($500 divided by $10,000). But if the bond's price dips to $8,000, the yield would be 6.25% ($500 divided by $8,000).

Therefore, as price falls, yield rises, and vice versa. Think of it this way: if you buy a $10,000 bond at $8,000, your investment will "yield" more, in the form of interest payments that, in percentage terms, reflect a better return on your investment. (That's known as current yield. Another measure, yield to maturity, gauges the total return you would receive by holding the bond to maturity.)

So, once again:

- As interest rates rise—or threaten to rise—bond prices tend to fall, and vice versa.
- As prices fall, yields rise, and vice versa.

That means:

- As interest rates rise—or threaten to rise—bond yields tend to rise, and vice versa.

These movements bring the yields of existing bonds into line with those of new issues.

Exploring the Yield Curve. To understand this concept, start with the fact that long-term bonds tend to have higher yields than short- or intermediate-term bonds. That's because long-term bonds carry more risk—more can happen to affect the price during the longer term of the bond—and investors expect a higher yield for that extra risk.

The yield curve plots the current yields of bonds of various maturities on a graph. A normal curve shows a rise in yields as terms get longer. With a steep curve, long-term yields are substantially higher than short-term yields, while a flat curve shows short- and long-term yields that are more or less equal. An inverted curve happens when short-term yields are higher than long-term yields.

The yield curve is important because it may reflect investor sentiment or expectations. For instance, a steep curve indicates investors are bidding up the price (and therefore driving down the yield) of short-term rates. That could mean they expect interest rates to rise. They want to hold short-term bonds that will mature quickly, so they can reinvest at a higher rate.

What About Inflation? Why does the bond market often fall on good economic news? The fear is that strong economic growth could trigger inflation—which means bond investors would be repaid (both principal and interest) in cheaper dollars. Positive economic news can also lead investors toward stocks and away from bonds, which are often considered "safer" investments to turn to when times are tough.

In reality, of course, all markets are far more complex than this, and unusual market movements can confound even the most sophisticated analysts. Still, a little logic can make *"Inflation fears send bond yields higher"* a little easier to understand. ●

basis—for example, by including the closing costs you paid when you bought the house. A higher basis means a smaller gain. However, if you depreciated a portion of the house because you used it for business purposes—such as for a home office—you'll generally owe capital gains tax on some or all of the depreciated amount.

Latch onto a new tax credit. If you're a first-time homebuyer—someone who has not owned a principal residence for the prior three years—you can claim a credit of up to $8,000 for a home purchased after 2008 and before December 1, 2009. But the credit is phased out for high-income taxpayers.

Get the points. When you take a mortgage for a new home, you may pay "points" in exchange for a lower interest rate. Because the IRS considers points to be prepaid mortgage interest, you may be able to deduct them from your income for the year of the purchase. For instance, two points paid on a $500,000 mortgage—that is, 2% of the half-million—would give you a $10,000 deduction. However, if you finance the points along with the mortgage balance, you must deduct them over the life of the loan. Spread over the term of a 15-year mortgage, for example, that same $10,000 would mean a deduction of only $667 a year. ●

Financial Plans Are Meant To Be Revised

One great benefit of a financial plan is that it gives you a feeling of certainty. Designed to take into account wide-ranging scenarios, it seemingly should be able to shrug off an uptick in inflation, a bear-market stretch for stocks, or a spike in interest rates. Yet there are some circumstances —such as the recent once-in-several-decades plunge of the economy and financial markets—that even the most carefully constructed plan can't fully anticipate. Such events, as well as possible changes in your own situation, mean that every financial plan, sooner or later, will have to be revised. Preparing a financial plan is a process, not a one-time event, and making smart, timely alterations is crucial.

Consider how that process works. A financial advisor takes stock of an investor's overall financial situation and asks questions about goals, comfort level with investment risks, and the timetable for using investment proceeds. Then, the advisor establishes a comprehensive plan designed to help achieve those objectives.

That requires several assumptions about how markets and the economy will behave.

For example, an advisor might base a plan on a projected inflation rate of 3%, an 8% average annual return for stocks, and 4% yearly gains for bonds. Though some or all of those assumptions might miss the mark, the idea is that, taken together, they should be close enough to be useful. Yet even small inaccuracies, left uncorrected for 20 or 30 years, will leave a plan seriously out of whack.

Think of a ship setting out from New York for, say, Lisbon. The captain charts a course that should take the ship across the Atlantic to Portugal. But what if he makes a small miscalculation? Even if he's off only 1%, that could be a problem, and unexpected changes in winds and currents along the way are likely to make things worse. If he sticks to his original bearings, he could end up in Africa—or Ireland.

But that won't happen, because every good sailor understands the need for minor but constant course corrections. And a financial plan requires similar adjustments. Look at the predictions of economists, market forecasters, or the government, and you'll see that no estimate extending more than a year or two into the future will be even close. So a financial plan written to predict the feasibility of a retirement 30 years away won't—and can't—be accurate. But it can establish a starting point. Reaching your goals requires frequent adjustments to compensate for the winds and currents you meet along the way.

Once you understand that basic certainty, you can prepare by discussing how, and under what circumstances, your plan will need to be altered. We would be happy to review your plan with you to make sure it continues to move you toward your long-term goals. ●

Markets Often Rebound

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reflect what has already occurred. For example, a higher unemployment rate typically develops because the economy is struggling; when demand for goods and services slackens, companies often respond by reducing their payrolls. Similarly, inflation may keep rising for months after upward pressure on prices, reflecting an economy at its peak, has already largely dissipated.

Stock prices, in contrast, are based on what investors consider to be a company's prospects. When the economy is at its worst, the road ahead may begin to seem comparatively bright, and company earnings could start to rebound even while current statistics continue to paint a gloomy picture. And when investors finally stop selling and start buying, rising demand for stocks will push up prices.

Chances are that this time, as in the past, the stock market will strengthen well before the economy and point the way forward for investors. But keep in mind that the sample size of this study is very small; only nine recessions occurred between 1953 and 2001. Also, the current economic crisis is largely viewed as the worst since the Great Depression, so the rebound may take longer than past recessions.

As always, it's crucial to stick with a long-term investment plan that reflects your goals, timetable, and risk tolerance. We are closely following developments in the economy and investment markets and would be happy to discuss whether any adjustments to your portfolio might be in order. ●

Average return from six months before recession starts until recession low point	Average return from recession low point until six months after recession ends	Average total return from six months before recession until six months after recession
-21%	+36%	+8%

Source: "A Historical Look at Recessions and Stock Market Returns," JennisonDryden, Prudential Insurance Company of America

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