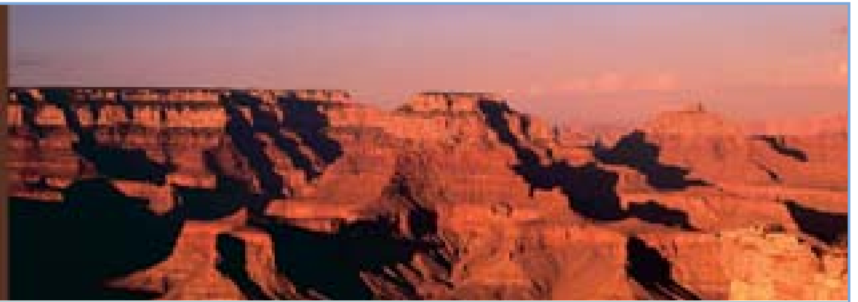


602-212-1040 Third Quarter 2010

Now Is A Good Time To Reassess Your Risk Profile

The recent past has given investors an invaluable lesson in risk, which makes now an ideal time to reconsider your "risk profile," the amount of volatility you're willing to accept. From the happy heights of late 2007, the Standard & Poor's 500 stock index lost 55% of its value by March 2009, and much of the damage came sickeningly fast, with a 40% freefall between September and November of 2008. Then came a dizzying recovery, as the S&P rallied 60% between March and December 2009. Yet even after the comeback, the large-company index remained some 30% below its record high.

How your portfolio has fared during this remarkable period depends on how much risk was built into your investments, and on how you responded when conceptual risks became all too real. Many investors, lured into volatile areas of the market when most investments were rising, were shocked when numerous sectors suddenly dropped by more than half. Some of these investors watched helplessly, unable to sell as holdings kept plummeting, while others got rid of everything, determined to stick with cash for the foreseeable future.

Neither predicted outcome was good or anticipated. The purpose of determining your risk profile is to use it to build a portfolio that minimizes disruptive surprises. If you think you can handle a 15% annual loss but would be apoplectic if your investments dropped twice that much, then you need a portfolio that, in most economic and market scenarios, wouldn't dip by much more than that "comfortable" 15%.

But markets don't always behave as predicted. The recent financial crisis highlighted the reality that assets under duress can move together. All manner of stocks—from shares of enormous, normally rock-solid companies to those of small, fast-growing firms and stocks in once-hot emerging markets—headed down together. And while some bonds fared a little better, Treasuries fared the best as safety-obsessed investors bid up prices and caused yields to decline considerably. And alternative investments, including real estate, commodities, and hedge funds, had major issues of their own.

As a result, most investment portfolios did worse than expected, and that exacerbated the problems of investors who had taken on too much risk. Panicking, many sold when investment values were at their lowest point, and with losses locked in, they've missed out on stocks' historic rally.

Reassessing your risk profile now, and making appropriate portfolio adjustments, could help you prepare for the next financial upheaval. This process may involve several steps. The first is to understand how you really feel about risk. How did you react in September and October of 2008, when

(Continued on page 4)

In The Wake Of Financial Upheaval, Three Steps To Take

With nerves still frayed over the global economic crisis that began in late 2008 and more recent struggles in Europe, it's difficult to be optimistic. But it may be helpful to put the bad news about the American economy in perspective.

According to the International Monetary Fund, U.S. gross domestic product in 2009 totaled more than $14 trillion. That represented nearly a fifth of the world's total output of goods and services, even though we have less than one-twentieth of the world's population. America remains the world's dominant economic power.

And though much of the financial and economic news has been bleak, stock prices rose more than 70% from their March 2009 lows and the economy has slowly improved.

Where does all of this leave you? Here are three steps to take:

1. Be open to diversifying across asset classes that behave differently from each other, and to reevaluating your financial goals to ensure they are realistic.

2. Give more attention to your long-term financial plan—this is a time for proactive planning.

3. The recovery in stocks offers a chance to reassess your risk profile or to rebalance and sell some of your stock gains. If you learned during the market fallout that you can't tolerate as much investment risk as you thought you could, please call to make an appointment so we can consider changes to your portfolio.

Whole Life Or Term? It's A Tough Choice

If you're shopping for life insurance, you'll find myriad policies with innumerable options and riders. But individuals often face a choice between two common types of life insurance: whole life or term. While whole life provides permanent coverage and some cash value, it's normally much more expensive than a term policy that merely promises a death benefit if you die within a specified length of time. After years of steadily declining, the premiums for some term insurance policies have recently started to creep up. That could lead you to rethink your options.

Consider these differences between the two types of policies.

Whole life insurance. This is the traditional form of permanent life insurance. (Variations include "universal" life insurance and other cash-value policies.) The annual premiums are generally fixed when you buy the policy, which remains in effect for as long as you live if you continue to pay the premiums. In addition to providing a death benefit, the policy builds up a cash value on a tax-free basis. Typically, you're able to borrow against that value, or take the cash with you if you surrender the policy. If you decide to surrender the policy, you will receive the accumulated cash value less any surrender charges or fees. But the premiums for whole life insurance are sharply higher than those of a term policy, particularly when you're younger and term insurance is relatively cheap.

Term life insurance. As the name implies, you can buy term insurance covering a specified term, usually 10 years or longer. You could tailor the length of a policy to the amount of time you project that you will need coverage, perhaps choosing to have it expire at your expected retirement date, when replacing your income becomes less of an issue. Most term policies let you continue coverage at a higher rate. One main reason why term premiums are lower than those for whole life policies with the same death benefit is that term insurance doesn't have to divert part of what you pay to fund a cash build-up.

The bottom line. The standard financial advice on life insurance has been to buy a term policy and invest the difference between that cost and what you would pay for a whole life policy. Of course, every situation is different. For instance, with the cost of term insurance rising, you may prefer the peace of mind of having permanent insurance. But your choice doesn't have to be either/or; you could combine both kinds of insurance as part of an overall financial plan.

Major life events such as the birth of a child or grandchild, the start of a new business venture, or a change in your personal health are important times to review your life insurance coverage. We are happy to help you evaluate the right mix of insurance for your unique situation. Please feel free to give us a call. ●

Do You Know Estate Planning Basics?

With the future of the estate tax up in the air, you may be tempted to neglect estate planning. The federal tax on inherited wealth is currently scheduled to be repealed in 2010, only to return in 2011 under less favorable terms. Congress will most assuredly resolve this issue before year-end, perhaps exempting all but the wealthiest families from estate tax liability. Yet whatever the fate of the law, having a thoughtful, effective estate plan will continue to be crucial.

At a minimum, you need a legally enforceable will that lays out how you want your assets to be distributed. An accompanying, non-binding letter of instruction could further spell out your wishes. You may also want to establish one or more trusts designed to minimize taxes, manage assets for minors, provide asset protection for heirs, implement philanthropic plans, or protect assets from creditors. And a living will (or health care proxy) could provide valuable direction on end-of-life health care.

Are you familiar with estate planning basics? Use this quiz to test your knowledge.

1. Which of the following is true?

a) A will is legally valid only if drafted by an attorney.
b) You can transfer jointly owned property through a will.
c) A will may appoint a guardian for minor children.
d) Your property must go through probate if you don't have a will.

2. When can a will be changed and remain legally enforceable?

a) Only if the changes are recorded by an attorney
b) Only when the heirs named in the will provide their consent
c) Any time before your death or mental incompetence
d) Never

3. In 2009, the federal estate tax exemption was:

a) $1 million
b) $2 million
c) $3.5 million
d) Zero

Wealth Transfer Ideas For Tough Times

If you happen to die in 2010, your estate planning problems are over—at least they might be. For a year, at most, the federal estate tax is gone. But the tax is scheduled to return in 2011 in a much more punishing form than it took in 2009, and that prospect could motivate a congressional compromise, with new rules that may be applied retroactively to wealth transfers during 2010. That means there's really no holiday for wealthy families looking for tax-efficient ways to move assets to the next generation. And though there is no federal estate tax in 2010, there is a limited step-up in basis which could trigger capital gains for beneficiaries of large estates assuming they sell the assets immediately. Still, with stocks, real estate, and almost every other kind of asset worth less now than before the recession, you may be able to transfer more to your heirs at lower cost, and today's rock-bottom interest rates could also help. Consider these five strategies that attempt to take advantage of the current economic environment.

1. Get the most from the annual gift tax exclusion. This tried-and-true vehicle may be worth more now than ever before. In 2010, you can give up to $13,000 of assets to as many recipients as your choose—or a maximum of $26,000 for each gift if your spouse joins in—without gift-tax liability. But keep in mind you'll have to file a gift tax return for joint gifts, even if the total gifts are $26,000 or less. The trick here is to give away something whose value has dropped but is likely to recover.

2. Take advantage of low interest rates to make a loan or asset sale to family members. Here, too, current economic circumstances can maximize the value of funds you transfer to the next generation. You could lend money to buy a home or start a business, charging interest based on today's low applicable federal rate (AFR)—in June 2010 just 4.30% on loans with a term longer than nine years. Or you might sell assets—whose value may be at a low point—to family members directly, or to an irrevocable trust set up for their benefit, with installment payments also based on the AFR rate.

3. Create a grantor trust with undervalued assets. This can be yet another way to capitalize on the temporarily depressed value of many assets. You can use your annual gift tax exemption—perhaps supplemented by some or all of the $1 million lifetime exclusion that individuals may employ to shield gifts from taxes—to transfer assets into the trust. Then, you'll be responsible for income and capital gains taxes on trust assets. Though those payments further reduce your taxable estate, they aren't considered gifts to the trust's beneficiaries, and they enable trust assets to continue to grow unencumbered by taxes, adding to the potential recovery of beaten-down assets.

4. Boost the benefits of a grantor retained annuity trust. A GRAT can preserve assets from the sale of a business interest or other holdings. Essentially, you transfer assets to an irrevocable trust, but retain the right to receive distributions over the trust term. The annuity is based on the amount transferred and the prevailing interest rate set by the government under Section 7520 of the tax code. (The 7520 rate as of June 2010 is 3.2%.) The lower the rate, the lower the payout, resulting in more asset preservation for your heirs—particularly if the assets rebound in value. It's also possible to "zero out" a GRAT, effectively eliminating any gift tax on the transfer to the GRAT. (Keep in mind that Congress may modify the rules affecting these techniques.)

5**. Use a charitable lead trust (CLT) to help charities and your heirs.** With a CLT, income on trust assets during the term of the trust goes first to the designated charity and then to your heirs, who also ultimately inherit trust assets. Most nonprofits have suffered during the recession, and they'll welcome this annual infusion of cash. And if the CLT earns more than the specified yearly payment—based on a fixed amount or percentage of assets—the excess is added to principal. If an economic recovery increases the value of trust assets, your beneficiaries could benefit.

One or more of these strategies could help you and your heirs benefit from an otherwise dismal economic environment. Yet uncertainty abounds. No one knows what will happen to the estate tax or to tax rates on gifts and income, and there's no guarantee that the economy will improve, or that stock prices or real estate values will soon recover what they lost during the long downturn. We can work with you and your attorney to consider your wealth-transfer goals and to create a plan that makes sense for you in these troubled times.●

4. In 2010, the annual gift tax exclusion shelters gifts to individuals of up to:

a) $10,000 c) $1 million
b) $13,000 d) Zero

5. For estate tax purposes, the value of assets is based on:

a) Their fair market value on the date of the owner's death (or six months from that date)
b) The amount received from the sale of those assets
c) The assets' original cost
d) The value stated in the owner's will

6. A "power of attorney" is best described as:

a) A bequest in a legally validated will
b) A document authorizing an agent to act on your behalf
c) A document allowing life support systems to be shut down
d) The use of a lawyer in estate planning matters

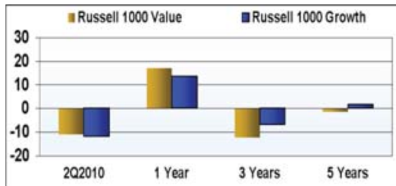
7. Which of the following is not true?

a) The value of your principal residence is excluded from your estate.
b) The value of property transferred to your spouse is exempt from estate tax at your death.
c) A testamentary trust takes effect when you die.
d) A will normally determines who will care for minor children.

If you have questions about estate planning or need to refine your plan, please give us a call. We can work with you and your attorney to make sure all of your needs are met.●

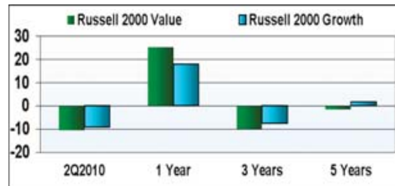
Answers: 1-c; 2-c; 3-c; 4-b; 5-a; 6-b; 7-a

Market Data Bank: 2nd Quarter 2010



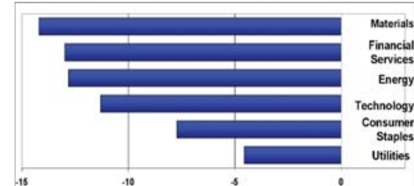
LARGE VALUE VS. LARGE GROWTH

Equity prices corrected in the second quarter as the yearlong rally gave way to renewed fears about the sustainability of the economic recovery. Both large growth and large value shares fell by about 11%.



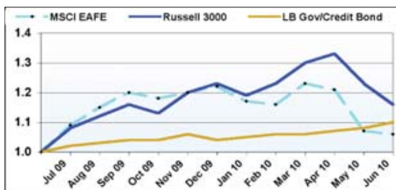
SMALL VALUE VS. SMALL GROWTH

The retreat applied to small-cap shares as well. Still, while small value lost 10.60% and small growth shed 9.22%, both strategies have still delivered substantial returns on a year-over-year basis.



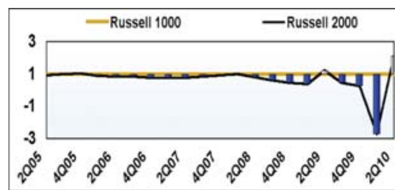
THREE BEST AND WORST SECTORS

All major industrial groups ended the quarter with losses. Relatively defensive utilities and consumer staples companies held up best, while economically sensitive commodity producers fared worst.



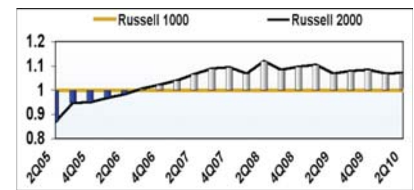
FOREIGN, US STOCKS & US BONDS

While Wall Street suffered, the carnage in foreign markets was sometimes truly harrowing. Global risk aversion pushed fresh money into the Treasury market, giving bond investors added upside.



LARGE VS. SMALL STOCK EARNINGS

Small, relatively nimble companies expanded their profits 8.7% in 2Q10, outstripping their larger counterparts' real (but relatively tepid) fundamental growth for the first time since late 2005.



PRICE-TO-EARNINGS RATIO

Investors remained willing to pay a slight premium for small-cap shares. By quarter's end, small stocks traded at $16.80 per dollar of earnings, versus a valuation of $15.70 for their larger peers.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital/ International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do nott represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Reassess Your Risk

(Continued from page 1)

account balances slid lower almost every day? Were you able to take a long view, assuming that even this bear market would pass, or did you treasure safety above all else? Would you rather stick with less volatile investments even if that means accepting lower long-term returns?

Your answer to that last question depends in part on what you need your portfolio to achieve, and re-examining your financial needs is step two of this process. Perhaps the prospect of postponing retirement or spending a little less during your later years seems like a reasonable trade-off for the comfort of holding less volatile investments.

Once you've figured out how much risk you're willing to accept, and how much you need to reach your goals, the third step of the process is to incorporate your readjusted risk profile into a formal "investment policy statement." This document puts your strategy in writing and commits you to the discipline of a plan built around your financial objectives, risk profile, and investing timetable.

You'll also need to rebalance your portfolio, selling some holdings and buying others, first to get in line with your new risk profile and then to keep allocations steady as markets fluctuate. Finally, it's important to monitor your investments, periodically re-evaluating what you own in light of your evolving personal circumstances.

We have the tools, experience, and expertise to help investors successfully complete this crucial post-crash process, helping position investments for a potentially smoother ride through the next crisis and steady progress toward financial goals. If you would like to speak with us about your portfolio, please give us a call. ●

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