Lassus Wherley ...a view from the top

Building Better Futures

Issue 11: October 27 2008

Now What?????

Where Are We Now?

As we are sending you quarterly reports for the quarter ending 9/30/2008, in October we are living through one of the most painful bear markets since the early 1980s. I was speaking to a friend of mine this morning who has been in the advisory business for 37 years . He drew a parallel to the 1980s as being comparable to the action we have seen in this market. Others keep trying to draw a parallel to the crash of 1929. The real point is that the markets have been here before (even if we haven't) several times. But, the reality is whatever historical period you compare it to, it doesn't make it less scary or less painful.

Actions taken in the last 30 days are having an effect. We are seeing some positives in terms of LIBOR. It is continuing to come down. Commercial paper is starting to flow more smoothly, but the concern is that the freeze isn't thawing quickly enough to head off a recession or shorten it. We are also seeing more structure being put in place to stabilize the commercial paper market. A process is emerging for pricing and establishing a market for the mortgage securities that have been hiding in the basement. Unfortunately, it will be a slow process just as the process around building the Resolution Trust Company of the 1980s was a slow process. That thrift crisis took ten years to work through but the economy and the financial markets rebounded in a much shorter time-frame.

And the bottom line right now as we approach the end of October, is that the S&P 500 is at 877 or down close to 40% year to date. The international markets have come down even more. We know the markets will recover but the uncertainty of figuring out when that might happen still causes some queasiness as we continue to see volatility in markets worldwide.

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I included an article from *WSJ's* Jason Zweig which discusses the fact that so many folks are waiting for capitulation. I won't dwell on it here but have included the article at the end.

What Do We Do Next?

We are continuing to raise cash where it is needed and are rebalancing and moving dollars into the market where it makes sense. However, we have been more cautious in what we are doing because of the volatility in the financial markets.

We are continuing to review what our options are and what we may need to do differently based on the expected global recession. We are currently evaluating the risk in the emerging markets and have put a hold on adding dollars to this sector. We have reached the conclusion that emerging markets are becoming unstable after a strong period of growth. This means that on a strategic level a reduction of our exposure in emerging markets and an increase in the US markets will provide a better opportunity to recover losses over the next 6 to 12 months. The increase in investment in the US market will be focused on US large cap and will be primarily in funds that invest in dividend paying stocks. If the market continues to trade up and down and sideways, the dividends will keep us well paid as we wait for the recovery.

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Another move we are currently considering is an increase in allocation to hedge strategies funds. We have identified a fund that utilizes a hybrid strategy that is more proactive and defensive. It is a new fund but has been used in individually managed accounts for a long time. We are reviewing how we might carve out some of the current positions in bond funds to allocate to this strategy. It utilizes many different hedge strategies in a diversified portfolio which can assist in increasing diversification in a challenging environment.

We are reviewing all asset classes to determine if there is a need to revise strategic asset allocations.

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Here is our latest collection of questions and answers.

Question: *I noticed that when you sold a fund the dollars you reinvested in the new fund were less than the dollars you received in the actual sale. I thought we were going to stay fully invested so we don't miss the move up.* **Answer:** There are several instances where we have made the decision to raise some extra cash. In those instances, we have reduced the purchase of new funds and allowed the excess dollars to go to the money market. Typically, we have done this where we know there will be cash requirements within the next few months or we know there will be a need for a larger amount of cash within the next 6 to 12 months. We prefer raising this cash over time rather than all at once in this type of market.

Question: *I thought you would continue to hold bond funds because they are doing better than other types of funds but I noticed you sold one of my funds.* **Answer:** We are consolidating our investment in bond funds to a few high quality funds that we can track more closely. We removed several bond funds from our recommended list due to slightly lower performance than our top funds. We have begun to replace those funds as we review portfolios where they are held. It will not have a significant impact in the short-term but over time could add several percentage points to our bond returns. We will continue to review funds based on expectations in the bond markets.

Question: *You sold some investments earlier in the year and I still have quite a bit in capital gains. Will I have to pay taxes on those dollars even though we have losses in my account based on the downturn in the market?* **Answer:** We are beginning to review accounts for several things related to managing tax liability. The first is tracking any distributions that mutual funds may make towards the end of the year. The second is capturing losses by moving from one fund to another while still staying fully invested. Both of these actions would be taken in taxable accounts only and will be based on managing taxes and after-tax returns.

Question: *This is the time of year when funds are making their capital gains distributions. Some years I really get clobbered with these distributions. Is there anything we can do to minimize the tax impact of these distributions considering the market losses so far?* **Answer:** First, capital gains distributed out to holders of the fund are the result of trading activity within the fund during the year. The fund is required by law to distribute all capital gains both short- and long-term that they incur during the year. If you hold the fund on the record date, you are subject to these distributions. We are reviewing portfolios to see what makes the most sense in terms of either holding the fund and paying taxes on the distributions or selling the funds and avoiding the taxable distributions. Here are examples of different situations to help you understand why we are doing what we are doing.

Assume we have Fund A with a current NAV per share of $10.00. This fund incurred and is going to distribute a short-term capital gain of $.50 and a long-term capital gain of $2.00 per share. The action we will take will depend on the distributions or selling the funds and avoiding the taxable distributions. Here are examples of different situations to help you understand why we are doing what we are doing.

Assume we have Fund A with a current NAV per share of $10.00. This fund incurred and is going to distribute a short-term capital gain of $.50 and a long-term capital gain of $2.00 per share. The action we will take will depend on when we purchased the fund in your account and how much you actually paid per share or your cost basis per share. One more thing you need to understand is that whether you sell now or hold until the distributions are made you receive the same dollar value for the shares. The only difference is how and when they are taxed.

If you sell Fund A before the distribution you receive the current NAV or market value per share of $10.00. If we hold the fund and wait for the distribution, when the distribution of $2.50 is paid out the current NAV or market value becomes $10.00 minus the $2.50 distribution or $7.50.

Example 1: Your cost basis is $7.50 per share and has been held for 12 months so that it is all long-term capital gain which will be taxed at 15%. If we sell the fund the gain is a long-term gain of $2.50 which would be taxed at 15% plus the state tax. If we hold the fund there will be a short-term gain of $.50 which is taxed at ordinary income tax rates somewhere between 20% and 30% and $2.00 which is taxed at long-term capital gains rate of 15%.

In this case, we will sell because it provides the most tax-effective return.

Example 2: Your cost basis is $5.00 per share and has been held for 12 months so that it is all long-term capital gain which will be taxed at 15%. If we sell the fund the gain is a long-term gain of $5.00. If we hold the fund the distribution would be as noted in *Example 1*. In this case, we will hold the fund because it provides the most tax-effective return.

Example 3: Your cost basis is 10.00 per share and has been held for only 6 months. If we sell the fund the taxable gain would be $0 which would generate no capital gains tax. If we hold the fund the distribution would be as noted in *Example 1*. In this case, we will sell the fund and avoid the taxes on the $2.50 distribution.

Example 4: Your cost basis is $12.00 per share and has only been held for 2 months. There is a penalty for selling the fund if held less than 90 days. If we sell the fund the tax loss would be -$2.00 plus whatever the penalty is (typically 1%). If we hold the fund the result would be the same as *Example 1*. In this case, we will sell the fund. We capture the loss to use against other capital gains to further reduce taxable income and we avoid taxable income of $2.50 per share.

With the proceeds from the sale of the funds, we will do one of three things: purchase a comparable fund that has already paid out their yearly distribution, purchase an Exchange Traded Fund (this type of fund does not typically make capital gain or loss distributions), or hold the proceeds in cash until the fund selected for reinvestment of proceeds pays out their year-end distribution. You may see sales of funds in your account occurring in stages since different funds have different distribution dates.

As you can see, it becomes a very complex analysis as we work our way through these decisions. We literally track the estimated capital gains distributions for all of our mutual funds beginning in October. We review right down to the wire to make decisions on whether or not to sell. Please let us know if you have any questions concerning these transactions.

Question: *What should I be doing during this time of turmoil in the markets?* **Answer:** There are several things that are really important in difficult times like these. The first is to take control of those things you can control. First and foremost is spending. Review your expenses and reduce spending as much as you can. Make sure you understand where your dollars are going especially in areas where you have a choice such as eating out or buying gifts for others. If you use credit cards, keep all receipts and review them to better understand where your money is going. If you haven't been tracking your expenses now is a really good time to start.

If you are still in the getting ready for retirement phase focus on continuing and increasing savings programs. Anyone that is employed and able to add to a 401k plan or IRA should be taking full advantage of these opportunities to add to accounts during a time when we can truly "buy low" in investments.

October 25, 2008

Capitulation: When the Market Throws in the Towel: Surprisingly, Bear Markets Don't Always End With a Bang - Sometimes It's Just a Whimper

By Jason Zweig

Wall Street often resembles a blindfolded person looking in a darkened closet for a pair of black shoes that isn't there. With the Dow taking another battering in the past week, another round of futility is under way: the search for "capitulation."

There's a belief that the market can hit bottom only when vast numbers of investors finally capitulate, throwing in the towel and selling off the last of their stock portfolios. In theory, if you could spot this moment, you could make a killing buying at the bottom.

There are two problems here. First, capitulation is almost impossible to define. Second, even if you could get a positive ID on capitulation, that might not do you any good. Market lows aren't necessarily marked by tidal waves of frantic selling; just as frequently, stocks bottom out in a dull and lonely atmosphere as trading dries up and most investors no longer even care. Bear markets often end not in capitulation but stupefaction.

"The idea is, 'We'll know we've hit bottom when the fat lady capitulates,'" says finance professor Robert A. Schwartz of Baruch College at the City University of New York. "But she could just sputter instead, or capitulate more than once, or slowly slide around along the bottom." Warns Prof. Schwartz: "On the way down, you get a lot of faux capitulation. And how do you know, until after the fact, whether it is friend or faux?"

Oddly, even market pundits who believe in capitulation admit they can't define it. "Capitulation is a state of mind, without any specific definition," says Al Goldman, chief market strategist for Wachovia Securities. "You can't measure it; it's best identified in hindsight."Hugh A. Johnson, chief investment officer at Johnson Illington Advisors, says almost wistfully: "I wish I could quantify it for you so I could say, 'Here, this is capitulation.' But a lot of this is anecdotal. Talk to enough investors and you get an idea of whether we have capitulation."

Talk to them later, however, and you may get a different idea altogether. What seems like capitulation today will no longer qualify if the market goes even lower tomorrow. Mr. Goldman puts it best: "I think I'm right that we had capitulation on Oct. 10 [the day the Dow lost nearly 700 points]. But if we keep going down from here, then I would have to say that I was wrong and that it wasn't capitulation."

This is somewhat like insisting that your pet is a dog until you notice that it is meowing. In truth, bear markets often end not in a crescendo of selling but a cloud of indifference. For example, take Dec. 6, 1974, a day that will long live in market infamy. The Dow closed at 577.60, down 45% from its levels in January 1973. Total trading volume was a tepid 15.5 million shares; a few days earlier, it had totaled only 7.4 million, tying the lowest level in more than three years. Lucien Hooper, one of the nation's leading security analysts, told The Wall Street Journal that day that the market was "just waiting the bad times out." Far from throwing in the towel, most investors weren't even at ringside.

"The most interesting thing about [the 1974 market bottom] was its dullness," veteran fund manager Ralph Wanger recalled to me. "It wasn't a crash, it was a mudslide. You came in, watched the market go down a few points and went home. The next day you went through the same thing all over again." And then, without a moment's warning, the bull woke up and took off. By Jan. 6, 1975, the market had shot up 10%, and a year after that the Dow had risen 54% from its 1974 low.

In short, bear markets sometimes end with a bang, sometimes with a whimper. You're more likely to see a unicorn in your backyard or a chimera in your kitchen than you are to spot an indisputable sign of market capitulation. The obsessive attention so many investors are paying to the huge swings in the Dow suggests that we may not have hit bottom yet; stupefaction seems not to have set in yet. What we can be quite certain of, however, is that stock markets around the world are already on sale. If you have cash to spare, put some to work. If you don't, save up until you do. But don't kid yourself into thinking that you will ever get a clear signal out of such an unclear indicator.

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I included this article because we are hearing so much about the need for capitulation and panic selling and retesting the bottom and many other technical terms. The reality is that investing is not a science and many of the “experts” that we see on TV and in the press have no more information than anyone else has in this environment. What they seem to have is more time to come up with theories and enough nerve to try to sell it to others.

We know we will come out of this and the markets will begin to go up over time. As difficult as it is in this environment, we have to remain patient.

Please let us know if you have any questions and keep doing that deep breathing to relieve the stress.

Diahann