Lassus Wherley ...a view from the top

Building Better Futures

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Looking Forward to the New Year!

Current Happenings

There was tons of news this week and some of it was really ugly and some of it was not so bad. The unemployment numbers have continued to rise as expected. We know that the fastest way for companies to cut expenses is through reducing the number of employees. We expect that the unemployment rate will continue to increase over the next few months before it stabilizes. As painful as rising unemployment is for all of us, we know that it is a result of what has already occurred in the economic slowdown. By the time companies recognize the slowdown, things have already changed and they are once again playing catch-up. And……….. as soon as companies cut employees to the point that service starts to suffer, revenues start back up and it is time to start hiring for the next growth cycle. As we go through the pain of the process, we have to continually remind ourselves that it is a **cycle of supply and demand** and all things in our economy are driven by these two basic factors.

If we start on the growth side, firms are never quite able to hire enough experienced people to keep pace with growth. This forces salaries to rise **and** we end up paying more and more for qualified people. When we finally have enough people, it is typically time for the next phase of the cycle which is the downside. At this stage firms begin to let go many of the newest hires from the recent growth stage until they reduce the workforce to the point that profitability begins to improve. And we are off to the next part of an endless cycle.

This period will go down in history as the period of time where Wall Street was "almost" successful in bringing down Main Street. Note that I said almost. We are seeing an amazing deleveraging of the US including Wall Street, businesses and individual consumers. The cost in the short term has been very high in terms of the economy and all the related problems. The deleveraging will lead to a much more stable economy going forward where people won't be living on borrowed funds but will save today to be able to spend tomorrow. That is a much healthier paradigm than the one we have been living with over the last 10 years.

Our challenges will not end tomorrow but we do see light at the end of the tunnel and the future will continue to become brighter as we work our way through the issues. We are certainly going to see markets continue to trade up and down and sideways but we are getting closer and closer to a real turning point.

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Here is our latest collection of questions and answers.

Question: *I have received quite a few confirmations recently and don't understand why you are doing so much trading.* **Answer:** As I have mentioned in past newsletters, there are quite a few of our mutual funds that are distributing capital gains that are very high. We want to avoid accepting those gains in taxable accounts where we know the client is in a very high tax bracket. So……..we are still reviewing based on the record date of the fund. We have tried to group some of these funds together so we don't make you crazy getting individual trades but it isn't always possible. Some of these funds wait until very late to let us know what they are doing. In these cases, such as Hussman we had to react very quickly to sell the fund before the record date. If we still own the fund on the record date, you receive the distribution. We aren't quite done. We still have a few funds where we are reviewing to make decisions on where it makes sense to sell the shares and in which accounts.

Question: *Are you really sure that adding dollars to the US Large Cap and International Large Cap makes sense now?* **Answer:** We are beginning to rebalance more accounts and actually buy mutual funds where we know they aren't distributing capital gains. We held off for a while because the extreme volatility was very unsettling for everyone. We are actually (and I know I have said this before) starting to see some rational moves in this market. Last week we opened negative for several days but still managed to climb out of it and have some positive returns. This is a good sign. So…….yes I do believe it is time to be adding dollars to the two large cap markets. We are obviously adding more to the US market since we believe it will recover more quickly than the International markets. We have continued to hold off adding much to holdings in International Small Cap or to Emerging markets because we haven't seen a return to rational movement or enough stability yet.

Question: *If you now like bond funds so much more, why are you selling some of my bond funds?* **Answer:** Great question. The reason is that bond funds as a percentage of your overall portfolio allocation have increased significantly as the equity has decreased in value. Since we are adding dollars to equity to slowly bring them back into balance, we need to take some of the "profits" out of the bond funds and move these dollars to the stock funds. This is part of our "buy low" and "sell high" philosophy for rebalancing.

Question: *I noticed you bought a small amount of a real estate fund in my IRA? Does that mean you are now ok with adding to real estate positions?* **Answer:** Real estate funds are currently paying a very high yield at approx. 6.5% plus due to the decline in market value. We are beginning to add small amounts to these funds but are not yet ready to bring them up to our longer term target allocation.

Question: *I know your company revenue comes from a percentage of assets under management and assets have to be down a lot. How are you and Clare coping with such a significant reduction in company revenue?* **Answer:** We do have some other sources of revenue with tax preparation and financial planning but the largest part of our revenue is based on the value of assets we manage. So it does impact our revenue directly. Like most other companies we have expenses that we can't reduce and others we can control. We are doing all the things that most companies are doing right now with the exception of reducing employees. We are cutting expenses by delaying purchases of new computers and other things that we can push into the future and will do everything we can to maintain our employees and our high standard of service. Everyone is pulling together to find ways of doing things more cost effectively.

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I keep rerunning this question because it is so critical to understand what we are doing as we review portfolios in the negative market at this time of year.

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 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. We are currently reviewing funds that have record dates towards the end of December.

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Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share it with others.

For those who have asked if you can forward our newsletters to others who are worried, please feel free. We put these together as a service to our clients but are very willing to share with others. We also keep them on our website if you would like to refer someone to it at **www.lassuswherley.com**.

I keep hoping for boring and not getting it, but once again I hope things are boring for the next few weeks so that we all have a chance to enjoy our families and think about everything we have to be thankful for during the upcoming holiday season!

Have a wonderful holiday season and please let us know if you have any questions or concerns.

Diahann

More Food for Thought

One of my favorite *WSJ* authors Jason Zweig wrote an article in the November 29th paper that made an interesting point. He valued Social Security payments over your life expectancy and reflected it in your net worth statement as an inflation-adjusted annuity. In many ways, that is exactly what it is. The example he used was a 65 year old man with a life expectancy of 17 more years. He came up with an estimated value of $327,000 that you would add to your bond portfolio. His point was that you have a lot more in fixed income investment than you would normally think.

This same logic would apply if you are receiving any type of pension payment. This would also have a present value that could be added to your overall fixed income portfolio. The point of this analysis is that if you have a portfolio where your bonds are currently 40% of your overall portfolio, then you add the value of your other sources of income such as SS or a pension payment, the percentage of dollars in your bond portfolio probably goes up to 45% or 50%.