

K & S Spring 2008 Financial Fitness Newsletter- “Tune Out The Noise!!!”

During the twentieth century, there were numerous reasons not to invest; the Great Depression, World Wars I and II, the Cuban Missile crisis, the OPEC oil embargo in the 1970's, the S&L crisis during the late 1980's and 9/11 to name a few. We believe most investors who remained disciplined and invested for the long term ended up much farther ahead financially than those who panicked in the face of short term adversity in the financial markets. Unfortunately, economic recessions, global military conflicts and political unrest throughout the world are probably going to continue to occur in the future. Currently, higher energy prices, a Presidential election year and worries about the economy top the list. Normally a healthy economy grows at a rate of at least three to four percent annually. Financial analysts are forecasting that the U.S. economy may slow to one to two percent growth during the first half of this year and two to three percent during the second half or fall into a mild recession.

It remains to be seen to what extent the sub prime loan losses in the financial sector will have on the U.S. economy. On February 7, the federal government agreed to provide a \$152 Billion economic stimulus package which is intended to stimulate consumer spending and accelerate needed business investment. As a result of the fallout from the deterioration of lending standards and to keep up with the pace of financial innovations such as derivatives and exotic mortgage securities, law makers are considering numerous solutions to increase regulation of major financial firms and the home lending business. On March 17, the FED continued to utilize monetary policy to increase much needed liquidity in the financial system by lowering bank interest rates and offering short term loans to investment banks. The Bush administration is also considering a plan to assist homeowners who are at risk of foreclosure by helping them refinance into more affordable mortgages backed by public funds. In the past month in the D.C. area, the conventional loan limits have been increased from \$412,000 to \$729,000 to encourage borrowers to refinance to a lower rate. The plan would encourage lenders to forgive a portion of those loans and issue new, smaller mortgages in exchange for the financial backing of the federal government.

Sub-prime Mortgage Accountability

Unfortunately, the majority of the sub-prime mortgage mess has been created by low income borrowers. There is a cast of characters who contributed to and are responsible for the current mortgage crisis. The list includes overzealous real estate developers, banks and the big Wall Street investment firms who we believe acted out of greed and poor judgment and have had to sell large chunks of equity in their firms to Sovereign Wealth funds owned by governments in the Middle East and Asia in order to be bailed out from billions of dollars of loan losses. The root of the problem, in our opinion, can be traced to well intentioned politicians and special interest groups (particularly the Boston FED which issued an inaccurate report about mortgage lending discrimination in 1992 and activist groups such as ACORN). These entities pressured the federal government to ease lending standards so individuals who could not normally qualify for a mortgage loan would be able

to purchase homes. The federal government has organizations such as HUD and FHA set up to provide mortgage assistance to low income borrowers. Apparently those organizations did not provide enough services to satisfy the cast of characters, either the process was too stringent or there was too much red tape. Similar to the tech boom in the late 1990's, investors were chomping at the bit to capture a piece of the rise in real estate prices which accelerated as a result of declining interest rates during the period from 2001 to 2003. The lobbying groups were eventually successful in pressuring the federal government to relax mortgage lending standards. Essentially almost anyone could receive a mortgage loan because no documentation was required. As a result, the flood gates were opened and the rest is history. The CEO's of many of the big Wall St. firms have been fired as a result of the devastating losses that these companies have reported during their watch. And the losses keep piling up. Who knows what the final tally will be?

Community leaders are sounding off and claiming that the low income borrowers were victimized and forced into mortgages by the banks. These groups want to have it both ways. They want to have access to loans for borrowers who are not financially qualified when the real estate market is rising. While they also want to be able to walk away from their financial commitments if the real estate market declines in value. The perpetrators who facilitated this financial mess need to be recognized and held accountable for their actions. This will act as a deterrent to future attempts by these groups to manipulate the federal government into implementing socialistic policies which frequently end up costing the U.S. taxpayer dearly.

Stock Market Outlook- In late January we published a "Stock Market Historical Perspective" message which outlined our case as to why investors should remain calm and stay focused on the long term. The message can be viewed by visiting our website at: **KrosnowskiandScott.com**. One concept that was not included in that message is one which relates to stock price to earnings ratios (P/E). *P/E Ratio and Multiple: The price of a stock divided by its earnings per shares. Also known as the multiple, it gives investors an idea of how much they are paying for a company's earnings.* Historically, stocks with lower P/E ratios have had better performance and less risk or volatility than higher P/E ratio stocks. At the stock market peak in March 2000, the average P/E ratio of the S&P 500 stock index was 26. Currently, the average P/E ratio of the S&P 500 is in the 15 range. Even though a slowing economy can cause a decline in corporate earnings, it is our opinion that the current P/E ratios indicate that stock prices may represent a good value when looking out over the next three to five years. By the end of the second quarter we are hopeful that most of the bad news in the financial sector will be reported. Until then, we feel the stock market is going to continue to be choppy and trading sideways. During the second half of this year and into next year we are cautiously optimistic that both the economy and the stock market will slowly begin to recover as we work our way through the Presidential election process.

In light of the current financial conditions it makes sense to focus on providing for your

base income needs and to cut back or delay purchases of luxury items or upgrades to your lifestyle that are not necessary. Generating additional income by continuing to work during retirement will not only increase your financial well being, but it may also make you happier and more mentally alert by keeping you active and socially stimulated.

Some of our clients have expressed concern over the severe decline in the value of the U.S. dollar. This has been caused by the balance of trade deficit which can be partially attributed to our country being a net importer of crude oil from countries outside the United States. Analysts feel that the weak U.S. dollar may provide a positive tail wind to the U.S. economy by stimulating demand for U.S. produced goods and services from consumers abroad. Financial trends indicate that economic cycles last around five to six years. At some point in the next few years there is a high probability that the U.S. dollar will rally against foreign currencies. We encourage investors to be globally diversified in their portfolios. This method of managing assets may mitigate currency exchange rate risk by investing in securities throughout the world.

“Tying It All Together”- Hedge funds, closed end fund IPO’s, insurance annuities, managed futures, index securities, covered call writing, private equity, and separately managed accounts (SMA’s). Over the years the big Wall Street firms have created quite a variety of investment alternatives for investors to choose from. When first introduced to the investing public by these investment firms, these programs are frequently marketed as something new, exciting and different. More often than not these investment products are packaged in fancy marketing brochures which contain sophisticated descriptions. We advise investors who are considering whether to participate in these programs to look beneath the surface before they make their final decision whether to invest or not. An excellent question to pose to a financial adviser who is recommending one of these packaged products is: **“How much of your own assets have you personally invested in this program?”** Judging a book by its cover may be a very unwise investment decision. Here is our opinion about the pros and cons of participating in some of these different investment programs.

Index Traded Securities (ITS)- This form of investing is known as “passive” investing. Investors purchase securities that represent a basket of stocks such as the S&P 500 stock index. *The S&P 500 Index is an unmanaged index that is generally considered representative of the U.S. Stock market. The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in any index. Past performance is never a guarantee of future results. Investments offering the potential for higher rates of return also involve a higher degree of risk. Actual results will vary.* **Pros:** Two of the main advantages of ITS investing are diversification and very low fees. **A. Expenses-** Fees typically fall in the .25 to .50% range. However, in some instances the investment fees can be much higher when the index securities are managed by a financial adviser or money management firm. Under this arrangement, investors are charged a management fee in addition to the annual fee of the ITS. The annual costs of

managed ITS programs can be two to three times that of managed pooled portfolios. B. **Diversification-** Index securities represent many asset classes (stock: U.S. & International, Developed & Emerging Markets, Value & Growth, Large, Medium & Small Capitalization etc., bond: government, corporate, preferred etc. with varying maturities and credit risk) as well as sectors (energy, consumer, real estate, financial etc.). Spreading assets across five or six broadly diversified index securities can provide investors with a high degree of portfolio diversification. **Cons:** Index securities are unmanaged. They represent “the good, the bad and the ugly” of a given investment category. For example: in the late 1990’s the S&P 500 stock index’s largest stock holding was Enron. The diversification within stock indexes can periodically become dramatically skewed. As a result of the run up in the Japanese stock market in the 1980’s, by 1989 the EAFE International stock index had a weighting of 59.8% in Japanese stocks (average P/E ratio: 51.9). *The MSCI EAFE is an unmanaged, market capitalization-weighted index that is designed to represent the performance of developed stock markets outside the United States and Canada. It is commonly used as a benchmark for measuring international equity returns, the Morgan Stanley Capital International® Europe, Australasia, Far East (MSCI® EAFE®) Index consists of more than 1,000 stocks in 21 developed market countries, representing approximately 85% of the total market capitalization in those countries.* The remaining 40.2% which was invested throughout the rest of the world (excluding the U.S.) had an average P/E of 13.0. On March 31, 2000, near the peak of the technology stock bubble, tech stocks which had an average P/E of 59.2, represented 33.3% of the S&P 500 stock index. The remaining 66.7% had an average P/E of 19.3. On December 31, 2006, Energy/ Financial stocks comprised 50.5% of the Russell 1000 Value index. *The Russell 1000 Value Index is an unmanaged, market-value-weighted index that contains stocks from the Russell 1000 Index with a less-than-average growth orientation.* Actively managed portfolios may help to guard against some of these historic stock market anomalies. Professional money managers are trained to avoid concentrating assets in too few sectors as well as to pay attention to P/E ratios and to reduce exposure to high P/E stocks to manage risk. Historically, lower P/E stocks have had better performance and less risk or volatility than higher P/E stocks.

Separately Managed Accounts - SMA’s are professionally managed investment portfolios that hold individual stock and bond positions. **Pros:** A. **Investment Efficiency** (“Old Money/New Money”)- One of the advantages of SMA’s over pooled funds is that the investor’s results are not impacted by cash in flows and cash out flows. A SMA is individually managed for each client. The portfolio manager is not forced to purchase or liquidate securities when other clients contribute or deduct assets from their accounts (which is the case for pooled funds). For this reason, the SMA style of asset management can in some cases be more efficient than investing in pooled investment portfolios. B. **Tax Efficiency-** SMA’s allow investors the flexibility to request year end transactions within their portfolios to generate capital gains or losses for their tax planning needs (this benefit is not applicable to tax deferred accounts such as IRA’s). Pooled investment portfolios do not provide for this customized service. **Cons:** A. **Fees-**The annual fees are significantly higher

than pooled funds (two to three times higher in some cases).

Insurance Company Annuity Products- Earnings within an annuity accumulate tax deferred, as a result these products may be attractive to investors who are in a higher income tax bracket (28 to 38% for example) and who have after-tax (non-qualified) assets to invest.

Many of our clients have a significant portion of their assets in pre-tax qualified retirement plans such as IRA's. Since IRA's accumulate tax deferred, we feel that investing qualified assets in an annuity contract may be unnecessary. We normally encourage IRA investors to shy away from insurance company annuity products for the following reasons:

- A) **Fees** – depending on the type of annuity contract, the cost structure may be very high.
- B) **Simplicity** – these policies can be very complicated and difficult to understand.
- C) **Liquidity** – if you may need access to a significant portion of your account balance, you may be out of luck. Many annuity programs carry very stiff withdrawal penalties over the first five to ten years of the contract.

The Bottom Line- Periodically when reviewing the investment solutions that we recommend to prospective clients we are questioned as to why we sometimes encourage investors to invest with primarily one particular firm. **Pros**- A. When assets are invested with one investment firm versus multiple firms, investors receive volume fee discounts (investor's costs decrease as their assets under management increase). Our philosophy is that if our client's annual fees are as low as possible (less than 1.0% ideally), their chances of investment success may be improved versus higher cost alternatives. B. **Efficiency**- We provide investors with access to in our opinion some of the foremost money management firms. We believe these firms have earned a reputation for providing above average annual returns over the long term with less risk or volatility than applicable financial market indices and industry competitors. **Cons**- Over time, some money management firms have had their day in the sun. Having the lion share of an investor's assets managed by one investment firm makes it necessary to closely monitor the money management firm to ensure satisfactory results.

We insulate our clients from this concern through our **risk management process** which:
A. requires us to work with clients in selecting a **target asset allocation** and **triggering mechanism**, **B.** selects a group of managed portfolios that stand alone versus the competition in each of the different asset classes that we are using to construct the portfolio, **C. monitors** both the **performance** of the money managers and the **asset allocation** to monitor returns. **D. re-balances** the portfolio when stock or bond allocations exceed the preset triggers. This activity serves to restore the target asset allocation. If a particular portfolio begins to lag in performance versus other alternatives, adjustments are made by shifting assets from one portfolio or money manager to another. We execute this process by

providing our clients with both money manager performance and asset allocation summary reports at least annually. **E.** Assets are **re-allocated** when the client's feelings, current situation or family dynamics change and their portfolio needs to be adjusted.

Nutritional Update- "Reduce Arthritis Pain" Here are five little known remedies that may help you reduce the symptoms of arthritis: **1. Drink Tea-** this may suppress arthritis inflammation. **2. Consume vitamins C & D-** slow the progression of osteoarthritis. **3. Try Willow Bark/Boswellia-** these herbs reduce inflammation. **4. Eat Grapes-** resveratrol reduces inflammation. **5. Therapeutic Taping-** takes pressure off of joints. It is suggested to consult a physician or physical therapist to learn the proper techniques. Source: "Bottom Line Personal- winter 2008."

The Latest on Us- Melissa is preparing to have her second son in May. We wish her positive thoughts and best wishes in hopes that she will have a safe and healthy delivery. Since August I have been studying during evenings and weekends toward receiving a **Certified Wealth Strategist (CWS) designation**. The focus of the program is to enhance the services and advice that we provide our clients in comprehensively addressing their wealth management needs. This entails not only providing guidance on investment and retirement planning but also covers such areas as tax, insurance, estate, mortgage and college planning needs.

We know that the volatile stock market environment is testing your patience. We appreciate your support and continue to advise you to stay the course. As each month passes, the likelihood that the stock market will begin to stabilize and recover continues to increase.

We hope that you and your family are looking enjoying the Spring weather.

Sincerely,

Andrew J. Krosnowski Melissa Scott Paine
Senior Financial Consultant Financial Consultant