The
FINANCIAL UPDATE
DAY & ENNIS, LLC
FEE-ONLY FINANCIAL PLANNING

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Is It Different This Time Or Will The Gloom Subside?

If the financial news has you hanging your head, thinking about hiding your money under the mattress, turn off the TV, and take a deep breath. We've been here before.

Breathless talk of bank bailouts, the collapsing dollar, record oil prices, and mounting foreclosures has many investors nervously eyeing the safe haven of CDs, gold, and low-yielding Treasury bonds. Yet while a well-diversified portfolio might include some of those assets, overemphasizing them could carry a high cost in terms of lost opportunities and long-term losses.

It's hardly a secret that our current economic woes are linked to what had been a phenomenal rise in home prices that started during the late 1990s and gained momentum after the Sept. 11, 2001, terrorist attacks. Spurred by historically low interest rates and other factors, inflation-adjusted home prices rose 85% between 1997 and 2006, according to Yale University economist Robert Shiller, who developed the S&P/Case-Shiller Home Price Indices in the 1980s. It was the biggest national housing boom in U.S. history, and historic booms tend to be followed by historic busts. According to the S&P/Case-Shiller Home Price Indices, median home prices fell 8.9% nationwide in 2007, and that has sparked an explosion in foreclosures, a pervasive credit crunch, a slump in earnings for financial institutions, and plunging consumer confidence.

Financial stocks, now volatile and significantly off their highs, had been roaring ahead for years, helped along by the popularity of mortgage-backed securities. As home prices rose, mortgage activity soared, and banks repackaged bundles of home loans to sell to other investors.

By December 2006, the stock of financial companies had bubbled up to account for a record 22.3% share of the Standard & Poor's 500 stock index—almost 10 percentage points higher than in December 1999. But many of the bundled mortgages were of the notorious subprime variety. When the housing market cooled, defaults on those loans began, and soon financial institutions were swallowing huge losses. Their share prices plunged, and by April 2008, financial stocks were back down to a 17.2% share of the S&P.

As often happens when a bubble bursts, many investors found themselves over-concentrated in the hardest-hit sectors. Their financial holdings, which had been growing rapidly for years—and thus came to represent a disproportionate share of their portfolios—suddenly fell off the table. But the broader market has also suffered. The Dow Jones Industrial Average, after reaching an all-time high of 14,279.96 on Oct. 11, 2007, fell as low as 10,731.96 on July 15, 2008.

A similar chain of events occurred during the early 1980s. Energy stocks, which had comprised only 15.7% of the S&P in 1970, surged to a 28.2% weighting by 1980—and then fell to 11.6% in 1985.

That rise and fall was mirrored by

(Continued on page 4)

Are Your Bank Deposits Safe?

Investors generally understand their portfolios' gains and losses as it relates to investing in stocks and bonds. However, we rarely consider the "exposure" of our cash funds held in bank and savings institutions. That is, until those institutions begin to fail – then it raises our awareness to the possibility that we could lose cash deposits if we exceed FDIC insurance limits. The well-reported deterioration in the real estate market, subprime mortgage and credit markets have caused some banks to fail and have put others in serious jeopardy.

Losing money on bank deposits because of the failure of a bank is a very preventable loss if you pay attention to the FDIC insurance limits and manage your accounts accordingly. Steps to avoid such a loss include:

- Ensure your bank is a member of the FDIC (most are).
- If you maintain more than $100,000 in the aggregate in cash and CD's in one bank, make sure you understand the FDIC's rules as it relates to separate accounts.
- Don't forget about your business accounts. They generally are limited to $100,000 of coverage also.
- Go to the FDIC web page (www.fdic.gov) to get specific information on FDIC coverage.
- The FDIC web page has a link to "Bank Rating Services" where you can gain additional information about the safety and soundness of your bank.

We are glad to help if you have further questions on this matter.

John R Day Bill Ennis

Don’t Wait Till The Last Minute On Taxes

Most people wait until the last couple of weeks in December to do year-end tax planning. By then, however, it’s often too late to shuffle things around. It’s like waiting till the day before Christmas to do your holiday shopping -- all the bargains are gone. Waiting until the 11th hour with your tax planning could mean missed opportunities, particularly when you need to get tax information from one professional to another. Consider acting on these four ideas before the end of the year.

Manage AMT exposure. The alternative minimum tax continues to affect millions of taxpayers in the middle and upper income tax brackets.. When your tax bill under the AMT formula exceeds your regular tax, you pay your regular tax plus the excess AMT amount above your regular tax. Are you going to exercise incentive stock options, realize hefty capital gains, or take large deductions for state and local taxes, miscellaneous itemized expenses, or accelerated depreciation? If so, you stand a chance of being ensnared by the AMT.

When AMT applies, the tax rate is 26% for incomes less than $175,000; 28% if above, which may actually be lower than your regular income tax bracket. Once you know you’re going to be caught in the AMT boat, you might actually save by pushing additional income into that year.

To manage your AMT exposure, you’ll need to project your income and deductions over multiple years. You may want to shift income to years in which the AMT gives you a lower tax rate, while pushing deductions that would be lost under the AMT into non-AMT years. Deductions allowed under both tax regimes, such as charitable gifts, save you more the higher your tax bracket. Finally, if you know the AMT is coming, avoid private-activity municipal bonds, whose income is taxable if you owe AMT. The sooner you figure out if you’ll be caught by the AMT, the better chance you have for planning around it to lower your taxes.

Don’t miss a chance to deduct college costs. This year, more liberal rules apply to deducting payments for college tuition and fees. If you’re single and make between $65,001 and $80,000 this year, or married and earning from $130,001 to $160,000, you may deduct the first $2,000 in costs. If your income is below those ranges, the first $4,000 in college costs are deductible; above the ranges, zilch. Don’t let an extra dollar of income cost you. If you are close to the upper end of the income ranges, plan now for ways to defer income to maximize this deduction.

Plan business opportunities. Businesses may deduct the first $125,000 of assets purchased in 2007 ($128,000 for 2008). But buy too much and you’ll save less, because the maximum deduction is reduced by each dollar of equipment purchased in excess of $410,000. And this deduction can’t create, or add to, a business loss. However, you can deduct as bonus depreciation half of the cost of new property you don’t write off.

Corporations, meanwhile, can stretch their cash flow this year. Only 80% of estimated tax for the third quarter is due by the usual September 15 deadline. The remainder may be paid October 1.

Review state tax changes. Not all moves reducing your IRS bill slice local taxes. Some states have declined to adopt recent federal tax breaks, while others have rewritten laws in response to fiscal crises. Examine your state’s latest rules at the following website: www.taxsites.com/state.html. ●

Marriage Doesn't Mean Owning All Your Assets Jointly

Marriage is all about togetherness. Yet when it comes to owning assets, too much togetherness may not be financially healthy.

Owning assets jointly is more convenient than individual ownership, and it’s the simplest way to avoid probate after a spouse’s death. But couples often should consider separating their assets. Here’s why:

Estate tax implications. Estate rules let spouses leave unlimited property to each other tax free. That’s okay when the first spouse to die leaves everything to the second, but the second death could result in a whopping tax bill. Couples likely to have estate tax issues could acquire property individually to help maximize the value of each other’s estate tax exclusion. While owning a house jointly is important for giving both spouses equal claim if they divorce, other assets can and should be held separately in roughly equal shares.

Dividing jointly owned property. How you take title also affects who can inherit your property. If you own it individually or jointly as “tenants in common,” each of you may specify in your will that you want a particular asset or share of an asset to go to a designated heir. However, if you take title as “joint tenants” (with rights of survivorship) or “tenants by the entirety”—the most common form of ownership for married couples—you won’t be able to say how assets are split. That may work if you and your spouse share the same beneficiaries. But it could be a problem if, for example, you’re in a second marriage and want to divide assets among children from different marriages.

Consider John and Mary. Because they own their property as tenants in common, each holds 50%, and John

How Far Have Housing Prices Dropped?

You don't have to be in the market for a house—or, worse, trying to sell one—to know home prices have been dropping across the nation, and residential real estate values may fall still further. During the past year, homes in the seven hardest-hit areas—Las Vegas, Miami, Phoenix, Los Angeles, San Diego, San Francisco, and Tampa—lost more than a fifth of their value on average. All 20 metropolitan areas included in the Standard & Poor's/Case-Shiller Home Price Indices have lost value in the past year. The composite index for the 20 areas fell 15.3% from April 2007 to April 2008, a record low. 13 of the 20 sectors posted record low annual declines, with 10 in double digits.

It's no coincidence the markets with the largest declines are those that enjoyed the most spectacular growth in prices during the past few years. During 2004 and 2005, for instance, homes in Las Vegas appreciated at an annual rate of more than 50%, while Miami residences gained 30% a year.

That all changed when the subprime mortgage market collapsed. Easy credit for unqualified homebuyers ultimately spawned record numbers of foreclosures. And while the mortgage failures make up only a very small percentage of the overall market, they contributed to the glut of homes for sale, causing prices to fall in most major U.S. markets.

Las Vegas and Miami home prices fell most among the 20 real estate markets measured, losing 26.8% and 26.7%, respectively, during the April-to-April period. Detroit, Minneapolis, and Washington, D.C. rounded out the 10 markets suffering double-digit losses.

Seeing *Red*:
Home values fell in all 20 metropolitan areas
Year-over-year changes in housing prices from April 2007 to April 2008.

Biggest Losers		Best Performers	
Las Vegas	-26.8%	Charlotte	-0.1%
Miami	-26.7%	Dallas	-3.4%
Phoenix	-25.0%	Denver	-4.7%
Los Angeles	-23.1%	Portland	-4.7%
San Diego	-22.4%	Seattle	-4.9%
San Francisco	-22.1%	Boston	-6.4%

Source: S&P/Case-Shiller Home Price Indices

While many analysts view this downward trend as a normal market adjustment after home prices had more than doubled during the past decade, few anticipate a quick upturn. "There might be some regional pockets of improvement, but on an annual basis the overall numbers continue to decline," said David M. Blitzer, who chairs the index committee at Standard & Poor's,

The regional pockets of improvement that he is referring to are the eight markets that were positive in April, up from two markets without losses during March. Leading the indices in April were Cleveland and Dallas, at 2.9% and 1.1% respectively. In March, Charlotte and Dallas' monthly increases were the first in any of the 20 index markets since August 2007.

While seven markets reported losses of more than 2% in April, only two markets lost more in April than they did in March, which may be evidence of a slow recovery.

The 20-city composite index peaked in July 2006 at 206.52, after rising steadily from the yardstick's initial value of 100 in January 2000. In April 2008, the 20-city composite stood at 169.85, down 17.8% from its peak—though still showing a 70% gain in prices nationally since the beginning of the decade.

Home prices are likely to continue to fall at least through the third quarter of 2008. With the U.S. economy slumping, fewer potential buyers will enter the market, and foreclosed properties will add to the large inventory of unsold homes. In many areas, there are now triple the normal number of houses on the market.

Charlotte and other cities in which homes have kept much of their value have benefited from growth in high-paying jobs. More people in those areas can afford to buy houses, and fewer were caught in the subprime mess. These regions also saw less activity from real estate speculators, who sent prices into overdrive in Las Vegas and other "hot" markets.

The Case-Shiller indices—developed in the 1980s by Yale University economist Robert Shiller, author of Irrational Exuberance, and Wellesley College economist Karl Case—have become the gold standard for economists and investors seeking to monitor the real estate market. Case and Shiller developed the "repeat sales pricing technique," which tracks the prices of specific single-family homes through local records. On resale, the new price is matched to the first price of each home—the two data points comprise a "sale pair"—and all sale pairs in a region are aggregated into one index, with adjustments for foreclosures, sales between family members, suspected data errors, and even changes in quality due to remodeling, additions, or neglect.

Some investors use financial instruments based on the Case-Shiller indices to hedge their investments in real estate. But with such steep recent declines, buying opportunities are beginning to present themselves. If you bought your house near the market's peak and are concerned about the continuing drop in prices, or if you're thinking of buying now to catch a housing market rebound, we can help you evaluate your options. ●

can bequeath his share to children from a prior marriage. Mary won't automatically inherit John's interest.

But if they hold their assets as joint tenants the surviving spouse becomes the sole owner of everything the couple owned together. It won't matter that John's will names his children as beneficiaries; if he dies first, the title documents will govern, and Mary will decide how assets are divided when she dies.

Other considerations. Owning assets separately is especially important if your combined net worth is at or above the IRS estate tax exemption—$2 million in 2008 and $3.5 million in 2009. Once you approach those levels, it pays to consider ways to separate assets. Also, since joint-tenancy assets can be taken by creditors or lost in lawsuits once an individual's assets are exhausted, doctors or others who can be sued easily will want at least half of their assets in their spouse's name.

Deciding how to hold title to your assets is not a simple decision, as state laws differ and each situation is unique. We can work with your attorney to help decide what's best for you and your spouse. ●

Don’t Bet Farm On Financial Calculators

Financial calculators, found everywhere on the Web, can be helpful planning tools. But different calculators may produce markedly different results, depending on the assumptions and defaults built into them. While these online calculators are okay to use as a guide, it’s a little scary to think that some people actually rely on these tools to plan anything as important as their retirement finances.

For example, suppose a 45-year-old husband and wife want to determine how much they’ll save by retirement at age 65. They have a combined annual income of $130,000 and savings of $350,000 in their employee retirement plans, with half the assets in stocks, 35% in bonds, and 15% in cash equivalents. Both plan to continue making 10% annual 401(k) contributions.

Enter these assumptions into one popular online calculator and you get a projection of $1.45 million in retirement assets. But type the same numbers into another calculator, and the couple’s nest egg grows dramatically, to $1.925 million. Because they assume different rates of return, inflation, taxes, and other variables, the two calculators project drastically different outcomes. For instance, the calculator with the higher result anticipates 3% annual pay raises, whereas the other doesn’t factor in salary increases. The calculator providing the lower estimate assumes a 31% combined federal and state tax rate, whereas the other calculator takes into account only a 25% federal rate.

And the differences matter. Assuming a withdrawal rate of 4% during retirement, that $1.925 million would provide $77,000 annually, whereas the $1.45 million would mean yearly income of only $58,000.

Which brings us to the problem of making realistic assumptions. Economists are hard-pressed to predict inflation and interest rates a year in advance, so how can you know what will happen in 10, 20, or 30 years? To calculate investment returns, you can use historical averages, but those are only educated guesses—and a miss by a few percentage points either way could compound into a mammoth error.

Still, the ballpark estimates you get from most online calculators could be useful as a first step when planning how to pay off debt, save for your children’s education, or invest for other long-range goals. You may be able to change some of a calculator’s assumptions, substituting other, perhaps more realistic numbers for return projections, inflation, and other variables. And to get a better idea of likely outcomes, you could rerun calculations several times with different variables. For example, if a calculator lets you assume different inflation rates, you might test the impact of rates varying from 2% to 6%, keeping in mind that the very low inflation of the past few years is well below historical averages.

Monte Carlo analysis software takes exactly that approach, instantly considering a multitude of assumptions and scenarios and providing a percentage probability of success rather than a specific outcome. But there are few online Monte Carlo calculators, and in any case, planning your retirement and the rest of your financial future is much too important to entrust to simple Web tools. ●

Will The Gloom Subside?

(Continued from page 1)

the boom and bust of technology shares in the late 1990s. By August 2000, information technology stocks had risen to account for one-third of the S&P 500. When that bubble burst, that sector's weighting fell to 14.3% within a year.

Bubbles That Went Bust

Sector	Boom	Bust
Energy stocks	28.2% of S&P 500 in 1980	11.6% of S&P 500 in 1985
Internet-related stocks	33.6% of S&P 500 in 2000	14.3% of S&P 500 in 2001
Financial stocks	22.3% of S&P 500 in 2006	17.2% of S&P 500 in 2008

Source: Standard & Poor’s

While many investors suffered losses when these bubbles popped, the economy soon recovered, and it will happen this time, too. There’s no way to know exactly when that will occur, but the point is to remain invested and diversified. That lets you take advantage of lower prices and puts you in position to benefit when the market inevitably turns upward.

Think about which investors had the best results during past bubbles. Was it those who panicked and fled the markets after the bubble burst—or those who made short-term adjustments but stayed invested and bought more while prices were low?

We’re now in a transition from a market where growth and revenue reigned supreme to an era when a strong balance sheet will be most important to investors. When the economy is shaky and the market is well off its highs, it often makes sense to turn toward solid companies in steady industry sectors, such as consumer durables, and put less emphasis on high-flying prospects.

Sure, the stock market probably will remain choppy for a while, as the economy continues to recover from the nation’s house-happy hangover. But savvy investors will see the situation as just another great, post-bubble buying opportunity. ●

John R. Day CPA/PFS Bill Ennis CPA/PFS 125 Plantation Centre Dr., Bldg. 400 Macon, GA 31210
(478) 474-7480 www.dayandennis.com