



SECOND QUARTER PERSPECTIVE

April 7, 2009

Market Perspective

After an extremely difficult year in the stock market in 2008, investors hoped that a new administration might help stabilize our fragile financial institutions and economy, and turn the tide of the declining stock market. However, after a very short rally at the start of the year, the stock market continued its slide during the first quarter, with the Dow Jones Industrial Average closing the quarter at 7,608, down 13%.

While the quarter ended with a negative return, monthly returns were a different story. After stepping backward in both January and February, March took a solid step forward, closing up 7.7% for the month. While it is impossible to know with certainty if the market has bottomed, we can at least see some light in these results. Market bottoms are achieved through a process of establishing new lows, and testing and retesting those lows, before eventually heading up. So while it's next to impossible to call a market bottom until after the fact, it's constructive to understand the process and know that eventually we will turn the corner.

Another point that is important to keep in mind is that according to Jeremy Siegel, Wharton School of Business, empirical studies have shown that when stocks are down 50% from their peak, future returns are likely to outperform. The stock market posted a negative 10-year rolling return this past decade; given our fundamental belief in a regression to the mean, we are actually quite optimistic about the decade ahead.

One of the major challenges that continues to be at the core of our current economic difficulties is the decline in housing prices, and the impact this has on our feelings of wealth and security. According to the Case-Shiller index, which tracks prices across twenty major cities, through January of 2009 home prices have fallen 30% from their 2006 peak. Combined with current 30-year mortgage rates being available between 4.5 - 5%, a real opportunity for bargain hunters may be emerging. According to the National Association of Realtors, as of February 2009, existing home sales were up 5.1% and new home sales were up 4.7%. While we may be seeing a glimmer of hope with real estate sales, it's unlikely that we will see home prices stabilize while supply remains elevated. In February, the US showed a nine months' supply for existing homes and a 12 months' supply for new homes (nearly double what is considered normal inventories).

It certainly would be nice if there was a one-to-one correlation between economic events and stock prices in the short term; however, the capital markets are far more complex and assigning cause and effect, while desirable, is often an exercise in futility. The best course of action we can take is to keep our eyes on achieving our long term goals, understand the headwinds and tailwinds that are pushing the market, and to stick with our plans knowing the economy and the markets are cyclical.

We are all human beings and it is human nature to believe that whatever phase of the economic cycle we are currently in will never end. In good times, we believe the party will never stop, and in bad times

we begin to believe our troubles will not pass. The reality is that one constant we can always guarantee is change. There is light at the end of the tunnel and whether we emerge from this tunnel a month, a year, or two years from now, we will emerge and a brighter future is out there. -- Joe

Retirement Planning : Where Do We Go From Here?

The financial crisis has been hard for all of us, but it has been particularly hard for people who are in or nearing retirement. The \$64,000 question is: how will the decrease in my net worth affect my retirement plans, my lifestyle going forward, and my ability fund my goals?

We use long term projection software to get a handle on this question. We input a client's spending, goals, and net worth, and then run the program out to age 95 or so to understand how a client's nest egg might hold up against their planned spending through a long life. When we are re-running these projections now, with account values down 20%, 30%, 40% or more, we're getting markedly different results than last year, before the fall, which is not surprising, but is disconcerting. Both we and clients are feeling a bit whipsawed by this; one year, they're fine, and the following year, the picture has dramatically changed for the worse. And, of course, the ill effects of 2008 could reverse in the next few years, leaving plans back on track. We just don't know.

We were prepared for this kind of result, as we modeled the uncertainty of a plan's outcome by using the Monte Carlo simulation; nonetheless, being confronted with negative outcomes, despite being intellectually prepared, is difficult. The Monte Carlo probabilities gave us a sense of how likely it would be that a client would have to change their spending and goals at some point to avoid running out of money, given normal variations on annual investment returns. Each Monte Carlo iteration lays out a path, and the path our clients have taken in the last year is one with exceptionally bad returns in the first year of the plan. So, where do we go from here?

The financial planning field is very focused on this question right now. I've been reading and listening to numerous opinions on retirement planning in these challenging times, and have heard some new ideas that are likely to alter the way we do our long term projection updates going forward.

The most interesting idea comes from Bob Curtis, president of the company that produces Money Guide Pro, a competing product to the NaviPlan projection software that we use. Curtis' idea is that we need to ask clients for more than one set of assumptions. There's an ideal value for each goal, and an acceptable value. For example, for Client A, the ideal retirement age may be 62, but anywhere up to age 65 is acceptable. \$6,000/month may be the ideal spending figure, but \$5,000/month is acceptable. A new car every five years may be ideal, but a new car every seven years, downsizing to one car in the last few decades of life, is acceptable.

Armed with not just the ideal inputs, but a range of acceptable inputs as defined by the client, we can run projections that give us a more nuanced look at the future. Monte Carlo probabilities may be low for executing on the ideal plan, but are likely to be much higher for executing somewhere on the acceptable range. The point is to get the client thinking about an acceptable range before the next bear market -- before clients feel emotionally scarred by economic events. Curtis' conclusion is that if you run projections with these acceptable ranges, clients will find that things are worse than they like but generally better than they fear.

We have to use this economic crisis as a way to improve the value we bring to our clients; we can't go through this kind of extreme environment without some hard-earned lessons learned going forward. All of our clients have the same bottom line question -- will I have enough? -- and changing the way we run projections could result in a better answer to that question. -- Therese

Shorts

- **Tax Loss Harvesting, Round Two.** The continuing stock market losses in Q1 meant that we harvested tax losses, again, in our Q1 portfolio reviews (in taxable accounts where the losses met our minimum size and percentage loss thresholds). Remember, tax loss harvesting benefits you in two ways:
 - Unused losses can be carried forward on your tax return indefinitely, to be used to offset realized gains (which will occur in the future, hard as it may be to imagine right now), and
 - \$3,000 of realized losses can be used as a deduction each year against your other, ordinary income. For those of you in the 28% marginal tax bracket, for example, that's an \$840 reduction in your tax bill.
- **Stimulus package and home improvements.** The stimulus package includes a beefed up tax break for energy-efficient home improvements: a tax credit equal to 30% of the cost of the improvements, up to a maximum credit of \$1,500. That means that if your improvements cost you \$4,500 out of pocket, and your improvements qualify according to the IRS definition of energy-efficient, you would receive a tax refund of \$1,500 when you file your tax return. Eligible improvements include:
 - Energy efficient exterior doors and windows
 - Insulation
 - Heat pumps
 - Furnaces
 - Central air conditioner
 - Water heaters

There are income phaseouts, and other details; let us know if you want more information.

- **Stimulus package and car purchases.** The stimulus package also legislates a tax deduction for car buyers who don't itemize their deductions. If you buy a new vehicle between 02/17/09 - 12/31/09, you can deduct the sales/excise taxes paid on the purchase on your 2009 tax return, above-the-line, which means that the deduction is available even if you take the standard deduction. Eligible: newly purchased foreign and domestic cars, light trucks, motorcycles, and certain motor homes. Note that if you itemize your deductions, you take this deduction below-the-line, with your other itemized deductions. Again, income phaseouts apply.
- **Continuing Education.** All three of us attended a day-long educational symposium sponsored by the Financial Planning Association of Puget Sound in February. It was a strong lineup of speakers, including Kaye Thomas, who is one of the leading national experts on Roth IRAs.
- **In a nutshell.** Best one-paragraph explanation of the source of this financial crisis, from Jeremy Siegel, and published in the newsletter Knowledge at Wharton:

"Financial firms bought, held, and insured large quantities of risky, mortgage-related assets on borrowed money. The irony is that these financial giants had little need to hold these securities; they were already making enormous profits simply from creating, building, and selling them.

During the dot-com IPOs of the 1990s, the firms that underwrote the stock offerings did not hold on to those stocks. They flipped them. But in the case of mortgage-backed securities, the financial firms decided these were good assets to hold. That was their fatal flaw."

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