John M. Smartt, Jr., CPA
FINANCIAL COUNSELING & ADMINISTRATION
Registered Investment Advisor

Client Newsletter Volume XVI Number 3 November 1, 2008

I. Bear Markets and Our Investments:

No doubt about it, bear markets are painful. When stocks go down more than 20% from some "peak" we are, by definition (as we are now), in a bear market. At this writing, stocks are down close to 35% for the ten months of 2008. What do we know, and what should we do in a bear market?

Since the end of World War II, there have been 13 bear markets. With one exception, the bottom of each bear market is **higher** than the bottom of the bear market which preceded it. This means that, almost overwhelmingly, even though stock prices have gone down, and gone down enough to cause us pain, they have gone down to a **higher value** than the last time there was a bear market. Note this is not a guarantee, but it is a strong trend based on more than six decades of recent history.

Stocks peaked in May, 1946, after the end of WWII. At that peak, the S&P500 index stood at a value of 19.3. As this is written, on the morning of October 31, 2008, the S&P500 index was just above 950. Stocks have had a great run in the last 6 decades; stocks have done twice as well as bonds and, subtracting inflation out of the equation, stocks have done three times as well as bonds. [The Dow, muchly touted, represents less than 20% of the market; the S&P500 represents approximately 75%.]

So about every five years, on average, but not foreseeable, we have a bear market and we get our emotions run through the ringer.

The cost of investing in stock is these periodic (and unpredictable) declines in value. If stocks did not cause us concern periodically, if they went up each quarter, just like the balance of your savings account (plus what little interest that it earns), then the value of stocks would be expected to yield about what savings accounts, CDs and savings bonds yield, very little after inflation and practically nothing after income taxes are paid. We obtain the projected (but not guaranteed) fruits of increases in the value of stocks **through** accepting the pain of these periodic declines.

We invest in stocks because we need the long-term, not guaranteed but strongly anticipated, higher rates of investment return than are available on bonds, CDs, etc.

We protect ourselves from bear markets by trying, as best we can, to anticipate our future need for funds from our investments and we should not be investing in stock any funds that we might need in five years. Even this is not a guarantee against loss in value, but it is a reasonable way to deal with the uncertainty of the investment world. Given the lessons of the past, we ought to have at least five years of anticipated spending invested in bonds and money market accounts.

Since we have that "cushion" of investment in bonds/money market accounts, we need **do nothing** else during a bear market.

I have heard from about half of you during the past year. You call me, write me, or sidle up to me after church services and ask, in one way or another, "Am I okay? Should I be doing anything different with my investments?" Unless there is something in your financial life which has changed and which we have not discussed, I do not believe there is anything which should change. Selling out of stocks during a bear market is making a potential (paper) loss into an actual loss, I urge you to continue to "stay the course." If you have concerns or, especially if something in your life changes, then please let me hear from you.

I am proud of your ability to bear the consequences of financial uncertainty. Assisting you with this is part of why you have hired me to assist you.

There are only three good things about a bear market: (1) having gotten through it, the next bear market is less frightening, we gain experience and have a bit more confidence the next time. (2) For investors with currently taxed accounts (e.g. not IRAs, 401(k) accounts, or annuities), now is a great time to create tax losses. See Section IV for further discussion of this opportunity. (3) For those with cash who believe in the US economy, it is a buying opportunity.

Stocks spike up in value as quickly as they spike down. Although "this time looks different", try to recall that each month, each recession, each year, each set of economic conditions and stress in financial markets looks and is different from the last time. But the world will go on, people will continue to buy what they need to live. Companies will still sell products and services. Eventually, the level of financial stress will decline, we will feel better.

Much of the momentum of our economy is independent of the mistakes of the financial system and is independent of the mistakes of government oversight and regulation. Most of the "Old Man River" of the economy just keeps rolling along.

Quoting Nick Murray, a 45-year veteran of financial advising: "Bear markets are an always temporary interruption of a positive long-term trend."

II. <u>What Are OUR and THEIR Asset Allocations?</u>

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of September 30, 2008	Clients	The Smartts
Money Market Funds	3.9%	0.9%
Bond Funds	28.4%	5.7%
Stock Funds	<u>67.7%</u>	<u>93.4%</u>
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family.

III. Vanguard Rates of Return (through September 30, 2008):

Performance percentages are per ***Morningstar.*** Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended September 30, 2008	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index	**-18.5**	(25)	**5.9%**	(26)	**3.9%**	(34)
Tax-Managed Capital Appreciation	**-19.8**	(48)	**5.6%**	(30)	**4.2%**	(31)
Tax-Managed Small Capitalization	**-8.0%**	(8)	**9.9%**	(18)		
REIT Index	**1.8%**	(17)	**12.9%**	(45)	**12.2**	(50)
Tax-Managed International	**-27.5**	(23)	**10.2%**	(27)		
Balanced Index	**-11.1**	(12)	**5.2%**	(31)	**4.7%**	(33)
Total Bond Market Index	**0.7%**	(12)	**3.7%**	(10)	**5.0%**	(15)
High–Yield Corporate Bond	**-8.5%**	(38)	**3.4%**	(70)	**3.7%**	(49)

For comparison, here are several stock and bond benchmarks:

Periods ended September 30, 2008	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**-19.3%**	**5.2%**	**3.1%**
Russell 2000 (small stocks)	**-10.4%**	**8.2%**	**7.8%**
Lehman Brothers Aggregate Bond Index	**0.6%**	**3.8%**	**5.2%**
CS First Boston High-Yield Index (bonds)	**-9.1%**	**4.8%**	**5.3%**

For the first nine months of 2008, all Vanguard funds performed as expected: capturing the returns of each portion of financial markets, trailing the market by the expense level of the fund.

The above-listed mutual fund rates of return are for the investor class of the regular, "open-ended" Vanguard mutual fund. Vanguard ETFs have lower costs and, long term, including brokerage and other charges, are expected to yield higher rates of return (e.g. the Vanguard Total Stock market ETF has costs of approximately 0.1% per year less than the regular mutual fund. The dividend yield of the ETF is thus approx. 0.1% HIGHER than the regular mutual fund). Vanguard also has an Admiral or a Signal class of funds with lower costs for investments of more than $100,000. These funds are also expected to yield higher rates of return.

IV. Bear Markets Provide Opportunities to Realize Tax Losses:

While I do not recommend changing your asset allocation among stock, bonds and money market accounts because of the bear market, for you who have investments in currently taxed accounts, I recommend considering taking losses for tax purposes. The rules are a bit complicated and, although I am a CPA, I am not your primary tax advisor. In summary, if you have capital gains and capital losses in a year, and there are more capital losses realized in that year, then your income for tax purposes can be as much as $3,000 lower. Further, if you have net tax losses in an amount which exceeds $3,000, you may carry the losses forward to another tax year to either net against future year capital gains or you may take up to $3,000 of carryforward losses as a decrease in taxable income in a future tax year.

This opportunity to decrease taxable income, and personal income tax bills along with it, is the reason for realizing tax losses. Please get in touch with your tax advisor and me about this soon.

There are some costs involved. When we sell (or buy) an ETF or a mutual fund, our primary custodian, TDAmeritrade, charges a commission, relatively small in relation to the projected income tax savings.

This is the process: (1) within a currently taxed account, sell an investment, or the part of an investment that is lower in market value than when purchased (many stock purchases in the last few years qualify). (2) Quickly buy an investment that is similar but not identical. (3) Generally, wait 31 days and then reverse the process. The 31day wait is necessary to comply with some technical IRS rules (the "wash sales" rules). If the replacement investment is more broadly diversified and/or lower cost than the original investment, step (3) is skipped.

The result is a lowering of income tax bills. If lower tax bills are of interest to you, we need to talk!

Here are sample swaps (all are Vanguard mutual funds or ETFs):

Sell: Total Stock Market Index (fund or ETF)	Buy: Large Capitalization Index ETF
Sell: Tax-Managed Capital Appreciation Fund	Buy: same as above
Sell: Tax-Managed Small Cap Fund	Buy: Extended Market ETF
Sell: Tax-Managed International Fund	Buy: FTSE All World ex-US ETF
Sell: Total Bond Market Index (fund or ETF)	Buy: Short-term Bond ETF
Sell: High Yield Corporate Bond Fund	Buy: same as above
Sell: REIT Index (fund or ETF)	Buy: Total Stock Market Index ETF

Some risks exist. A mutual fund can only be sold at the market prices at the end of the day. ETFs m ust be purchased while the market is open; thus there is a time lag. If market prices change, some small part of the earning power of our investment capital might be lost, or we might obtain a gain in the earning power of that capital.

I do not recommend going through this process if the losses which might be "fixed" for tax purposes are small. If the losses are large, you might consider taking advantage of this.

V. <u>"Tax Freebie" for Lower Income Investors:</u>

An AARP publication, submitted by a client, notes that if you are relatively low income this year, or 2009 or 2010, then you pay zero income taxes on capital gains. In 2008, couples filing jointly with $65,100 or less in taxable income, and individuals with $32,550 or less, will pay no income tax on certain capital gains. Consult your tax advisor on this. If you qualify, and by this time in the year you probably have a good handle on your income, deductions, etc., then this is an opportunity to make changes in your investments that IRS regulations discouraged you from doing in other years.

If, for example, you own a large number of shares of an individual stock that has, over the decades, risen in price so much that you have hesitated to sell it, then this is your chance to do so without paying income taxes on the gain.

Congress may not extend this benefit beyond 2010, so, to those who qualify, this is a good time to consider "cleaning out your financial attic."

John M. Smartt, Jr., CPA	Phone: 865 588-4159
2001 Partridge Run Lane	E-mail: johnsmarttcpa@yahoo.com
Knoxville, TN 37919-8967	Website: www.johnsmarttcpa.com