

Planning & Investment News

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SUB-PRIMES AND STERN BEARS

A well known investing maxim is “*the stock market is never down in an election year.*” This election year could very well be the first time that saying will not hold true. With the S&P 500 down approximately 9% through March 20, 2008¹, the market is going to have to rally to end in positive territory for the year. As usual, though, it is not hard to find a pundit who says we will have such a rally. It is also just as easy to find pundits who cry the end is near. And, as usual, we do not know which way the market is going. One of the best articles we have found explaining the current mess was written by David Leonhardt of *The New York Times*.

(http://www.nytimes.com/2008/03/19/business/19leonhardt.html?_r=1&oref=slogin). Leonhardt discusses the sub-prime mortgage crisis from its beginning up through the latest installment of the failure of famed brokerage firm Bear Stearns.

Leonhardt’s explanation reminds us of comments by John Kenneth Galbraith in his book *A Short History of Financial Euphoria*. Galbraith, a renowned Harvard economist, claimed there really is nothing new under the sun with respect to investments. It all comes down to debt. He traced how the investment community habitually repackages debt under different names from the Holland tulip crisis of the 1630’s to the junk bond debacle of the 1980’s. Possibly as interesting is his observation of the recent approximate 10 year intervals between these debt induced events. Note how the 80’s gave us the aforementioned junk bond crisis, the 90’s gave us the tech implosion, and now we have the sub-prime crisis.

“Far more money has been lost by investors in preparing for corrections, or anticipating corrections, than has been lost in the corrections themselves.” Peter Lynch, Worth (September 1995)²

The current stock market downturn does not cause us alarm for the near term as much as it does for the years to come. The lack of margin in the economy stands out to us a concern. Bear Stearns’ failure is an example of how too much leverage (read “debt”) prevented it from weathering the current storm.

We have never claimed, nor wanted, to be market timers. We simply do not think one can adequately predict near term market movements. Nevertheless, we have been taking a more conservative stance over the last few years. Client recommendations over the past three years include:

- 1) increasing emergency reserves;
- 2) paying down debt;
- 3) increased use of bonds;
- 4) increased use of non-correlated assets such as real estate investment trusts and commodities;
- 5) increased use of annuities with living benefits.

We are continuing the conservative direction of our recommendations. Please contact our office if you would like to discuss the risk characteristics of your portfolio given the current market conditions and your overall financial situation.

G. Richard Truitt, CFP™

March 2008

1: <http://news.morningstar.com/index/indexReturn.html?msection=IdxReturns>
2: <http://seekingalpha.com/article/61171-market-timing-dont-let-emotions-take-control>

THE U.S. DOLLAR AND YOUR PORTFOLIO

The U.S. dollar has struggled over the last few years. The Canadian dollar recently reached parity with the greenback for the first time in three decades. In October 2000, the euro was worth 82 cents. Last year it hit a record \$1.45 and kept going, while the British pound sterling was at a 25-year high. (All statistics are from the Federal Reserve system.) According to the Federal Reserve Board of Governors, as of last August the dollar had dropped 26% (adjusted for inflation) against the major industrialized nations' currencies, and 7% against key emerging-market currencies, since early 2002.

Change in Value of U.S. Dollar January 1 to November 1, 2007

Euro	-10.8%
Yen	-7.7%
Canadian dollar	-15.1%
Pound	-5.4%

Data source: OANDA Corporation

If you have no plans to travel abroad, don't eat imported out-of-season fruit, and buy only domestic cars, a weaker dollar may not worry you. However, a falling dollar can lead to rising inflation. Not only can it affect the price of commodities such as oil, but with the higher cost of overseas products, domestic manufacturers may feel more comfortable raising prices. And inflation can lead to higher interest rates, which could affect everything from credit cards to mortgage rates.

A diluted dollar also can affect your portfolio. If you've held international investments in the last few years, you may have caught a tailwind. Past performance is no guarantee of future results, of course, and there are special risks to global investments, including not only currency risks but also political risks and different accounting standards. Risk factors vary considerably by country and region, and as with any investment, you can lose some or all of the funds you invest.

However, returns produced in part by the dollar's decline are one reason investing globally has become popular. According to the Investment Company Institute, more than 90% of the \$160 billion of net new money added to stock mutual funds in 2006 went into funds investing in foreign companies.

Looking over the hedge

A mutual fund that invests overseas may or may not try to hedge against currency fluctuations. Some are managed to try to minimize the impact of exchange rates; others deliberately do not hedge their currency exposure. Your preferred approach will depend on your view of the dollar's future and how much currency exposure you want in your portfolio. A weaker dollar may boost an unhedged fund's performance because the fund holds securities denominated in other currencies. However, an unhedged fund would suffer more from any dollar recovery. Obtain and read a fund's prospectus carefully before investing.

Domestic can also be global

A weak dollar makes U.S. companies' products cheaper abroad, which has benefited many large multinational corporations that are headquartered here but have substantial overseas sales. According to Standard & Poor's roughly 44% of the 2006 revenues of companies in the S&P 500 Stock Index came from international sources; in 2001, that figure was 32%. Even companies without overseas operations may benefit. For example, with higher prices for overseas goods, some distributors and retailers have begun to find less expensive U.S. suppliers. Also, a weak dollar in the past has made some U.S. companies targets for foreign acquisition.

What goes down can come up

The dollar goes through cycles, of course. A stronger economy, higher U.S. interest rates or lower rates abroad, foreign currency crises, market turbulence, or lower federal deficits could help boost the dollar's value. When determining your overall asset allocation, consider both your currency exposure and your level of international investments.

COPING WITH A SLOWER ECONOMY

Economics isn't called the "dismal science" for nothing. There's an old joke that accuses economists of having predicted 9 of the last 5 recessions (and yes, those figures are in the correct order). However, forecasting the direction of the economy can seem easy compared with trying to figure out how to weatherproof your finances. It can help to understand some of the questions that many investors ask themselves if they're concerned about the potential impact of slower growth.

IS IT TIME TO CHECK MY PORTFOLIO?

Changing consumption patterns can have implications for a variety of companies and industries, and create investing opportunities. Some investing sectors might be especially economically sensitive and might therefore suffer from any economic downturn. On the other hand, some industries or companies may actually benefit from a slower economy. For example, companies that produce highend goods might be relatively immune from economic pressures--or maybe not. Shifts in spending patterns could also mean that consumers continue to spend money but choose less expensive alternatives, or focus more on getting the greatest value from each dollar.

If you rely on your investments for income, you may want to review how sensitive your portfolio might be to changes in interest rates. If the Federal Reserve Board sees greater danger from a slowing economy than from the possibility of higher inflation, lower interest rates could cut into your income. Conversely, if the Fed becomes increasingly concerned about inflation, rates could go up. It might be a good time to see whether the yields you're receiving are competitive, and what kind of impact on your monthly income you might expect from any changes in rates.

SHOULD I REVIEW MY ASSET ALLOCATION?

Now might also be a good time to reexamine how your assets are divided among various types of investments. If you decide you need to shift a portion of your portfolio, those changes don't necessarily have to be made all at once. Consider:

- Adjusting only a portion of your bond or stock holdings
- Using systematic investing to shift allocations over time
- Investing any new money differently to increase your exposure to asset classes you may have neglected

HOW CLOSE AM I TO THE EDGE FINANCIALLY?

The benefits of reducing debt should be pretty obvious, given the recent credit crisis. Troubles in the mortgage industry have driven home the importance of managing debt wisely. The last thing you need if you're worried about uncertain economic times is to lock yourself into spending patterns that push you beyond your means.

Whether the economy is in robust health or seems to be catching the flu, it's never a bad idea to have a cushion against unexpected financial stress. An unanticipated medical emergency--and is there any other kind?—a sudden job loss, or anything else that affects your income stream can bring the effects of a slower economy home in a dramatic way. If you're employed in a highly cyclical industry or one that's undergoing substantial changes, having a financial reserve becomes even more important. And if a lot of your retirement plan savings are invested in your employer's stock, think about whether your long-term finances might potentially face a double whammy. Serious financial trouble at your company could mean the possibility of layoffs, a drop in the value of your holdings--or both.

HAVE I PLANNED FOR THE UNEXPECTED?

If you're planning to retire in the next few years, consider the potential impact if you were to be "retired" prematurely. It's easy to assume you'll work until a certain date or earn income after retirement, but health concerns and the job market don't always permit that. Doing some "what if?" calculations with an earlier retirement date than you might otherwise choose could prepare you for what might happen if you were laid off and had difficulty finding new employment, or were unable to work for health reasons.

A transition to a post-retirement career is likely to be easier if you plan thoroughly. For example, launching a small business can be challenging under the best of circumstances; try to have as much of the groundwork laid as possible before relying on it for your entire income. Sales estimates that are more conservative than they might otherwise be may help minimize cash flow problems.

Asking questions such as these lets you hope for the best while preparing for the worst.

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WILL YOU PAY TAXES ON YOUR SOCIAL SECURITY BENEFITS?

Did you know that you might have to pay federal income tax on your Social Security benefits?

If Social Security was the only income you had during the year, then your benefits generally won't be taxable. However, if you or your spouse worked and had any earned income during the year, or if you had other substantial income (such as investment income), then a portion of your Social Security benefits may be taxable.

GATHER INFORMATION

Your benefits are taxable if one-half of your Social Security benefit plus your other income (called your "combined income") exceeds a certain amount (called the "base amount"). To determine if your benefit is taxable, you need to know three things: (1) how much you received from Social Security during the year, (2) your combined income, and (3) the base amount for your filing status.

FIND OUT HOW MUCH YOU RECEIVED FROM SOCIAL SECURITY

Each January, the Social Security Administration (SSA) will send you a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits you received during the previous year. You'll need to use this information

to figure out whether any of your benefit will be taxable.

CALCULATE YOUR TOTAL INCOME

Once you know how much you've received from Social Security, it's time to calculate your combined income. This figure includes the following:

- One-half of Social Security benefits received
- Other income including wage income, and taxable interest and dividends
- Tax-exempt interest income
- Income that's normally excludable-- interest from qualified savings bonds, employer-provided adoption assistance, foreign earned income or foreign housing, and income earned by bona fide residents of American Samoa and Puerto Rico

The IRS has a worksheet you can use to calculate your combined income and determine

whether or not your Social Security benefits are taxable. You can find this worksheet and more information about the taxation of Social Security benefits in IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

COMPARE YOUR COMBINED INCOME AGAINST THE BASE AMOUNT FOR YOUR FILING STATUS

Once you've calculated your combined income, you must compare that against the base amount for your federal income tax filing status. If your total income is less than the base amount, then your Social Security benefits won't be taxable. If your combined income is more than the base amount, then part of your benefits will be taxable. Base amounts aren't indexed for inflation, so they're the same year after year.

Your base amount is:

- \$25,000 if you file as single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for the entire tax year
- \$32,000 if you file as married filing jointly
- \$0 if you file as married filing separately and you lived with your spouse at any time during the tax year

For example, let's say your combined income for the year was \$30,000 and you file your taxes jointly with your spouse. Because your combined income is less than the base amount for your filing status, \$32,000, your benefits won't be taxable.

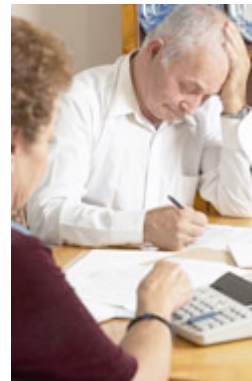
HOW MUCH OF YOUR BENEFIT IS TAXABLE?

Even if your combined income exceeds the base amount for your filing status, you won't have to pay taxes on the entire amount of benefits you've received. Generally, up to 50% of your benefits will be taxable, but if your combined income is more than \$34,000 (\$44,000 if you are married filing jointly), or if your tax filing status is married filing separately and you lived with your spouse at any time during the tax year, up to 85% of your benefit will be taxable. Again, see IRS Publication 915 for worksheets you can use to figure your taxable benefits.

Keep in mind that taxation of Social Security benefits can be complicated. Different rules apply to certain U.S. citizens and nonresident aliens living abroad and in other situations. If you have any questions, consult your tax professional.

Did you know?

Social Security benefits were not subject to federal income taxation until 1984. They became taxable as a result of the 1983 Amendments to the Social Security Act.



Tax withholding

You can have federal income taxes (but not state income taxes) withheld from your benefits if you so choose. Complete IRS Form W-4V and select the percentage that you want withheld (7%, 10%, 15%, or 25%), then return it to your local Social Security office.

HOW WELL ARE YOU NAVIGATING THE EFFICIENT FRONTIER?

Investing isn't just about achieving the highest return possible; it's also about the tradeoff between return and risk. Modern portfolio theory (MPT) is based on a key assumption: No rational investor wants to take more risk than is necessary to achieve the desired return. The concept was outlined by Harry Markowitz in a pioneering 1952 *Journal of Finance* study titled "Portfolio Selection," which argued that you can manage the type and level of risk you take by combining investments that tend to behave very differently from one another.

DIFFERENT STROKES FOR DIFFERENT FOLKS

Modern portfolio theory tries to create portfolios that maximize return for a given level of risk--or alternatively, that minimize risk for a given level of return. MPT compares a portfolio's standard deviation--how much its return may vary from its statistical mean return over time--to its returns. An efficient portfolio navigates the risk/reward tradeoff by combining investments based on their level of risk, their expected return, and their correlation with other investments in the portfolio. MPT argues that a portfolio that doesn't do so isn't optimized-- in other words, it takes too much risk for the return it provides.

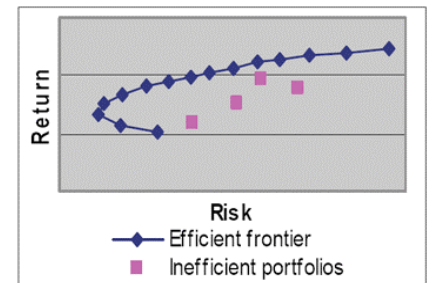
EFFICIENCY IS IN THE EYE OF THE BEHOLDER

Even with a limited number of securities, the ways to combine them into a portfolio are practically limitless. For any group of assets, there may be multiple efficient portfolios, each of which combines those assets differently. Collectively, they represent what economists and financial professionals call "the efficient frontier." On a chart, the efficient frontier is a line that represents all optimized portfolios for a given group of assets. That line is actually a series of points; each represents a portfolio that provides the best return for whatever risk you are comfortable taking. The efficient frontier represents all of the combinations of a given group of assets *that combine risk and return most efficiently*, expressing that tradeoff in graphic form. In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal. Each GPS user may choose a different destination, but in each case, the GPS suggests the most effective way to get there

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SO WHAT IS RISK ANYWAY?

Risk has traditionally been measured by volatility; an asset whose price varies dramatically is considered riskier than one that is more stable. However, some experts have begun to question whether a portfolio can be better optimized by focusing on downside risk, arguing that such an approach more closely matches the way investors tend to think.



Unlike MPT, this so-called "post-modern portfolio theory" concentrates not on how an investment's return deviates from its statistical mean--its ups and downs--but on how often its returns fall below an individual investor's minimum acceptable return, how far below that figure they fall, and the potential worst-case scenario possible for that investment. Outlined in *Managing Downside Risk in Financial Markets* by Frank Sortino and Stephen Satchell of the Pension Research Institute, this approach attempts to combine portfolio theory with behavioral finance, hoping to more closely reflect the human decision-making process.

Depending on how risk is measured--by volatility or by downside risk alone--the efficient frontier may look very different, even for the same group of assets.

THE BALANCE IS UP TO YOU

Whichever approach is taken, the efficient frontier still doesn't tell you which assets are right for you, or in what combination. Only you can decide where you want your portfolio to be along the efficient frontier, and what type and level of risk you're willing to take.

Though past performance is no guarantee of future results, it can help serve as a guide when developing an appropriate asset allocation. Using data about past and anticipated returns of various assets as well as estimates of their volatility or downside risk, your financial professional can position your portfolio at the point along the efficient frontier that makes sense for you.

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WHAT ARE THE BENEFITS OF DONOR-ADVISED FUNDS?

If you plan to make significant charitable gifts over a long period of time, a donor- advised fund (DAF) can be an attractive alternative to a private foundation.

While private foundations are separate charitable entities operated by their donors, a DAF is merely an account set up with a host organization, such as a community foundation or educational institution. You make contributions to the account, and the organization makes grants to qualifying charities in your name. Although the organization legally owns your contributions and has ultimate control over grants, you can advise the organization on how to invest your contributions and how grants should be made.

Donor-advised funds have become popular recently because they require less money, time, legal assistance, and administration than private foundations. DAFs also enjoy greater tax advantages.

Generally, you can open a DAF with a smaller initial contribution than would be required with a private foundation (as little as \$10,000). And because DAFs are qualified public charities, you generally get an immediate income tax deduction for your contributions (subject to the usual limitations).

Additionally, while private foundations are required to distribute a minimum of 5% of their assets each year, DAFs currently have no such minimum distribution requirement. You can let your account build up tax free for many years, deferring distributions until a later date. Further, DAFs are not subject to excise tax as private foundations are.

Finally, DAFs don't need to fulfill many of the reporting and filing requirements that are imposed on private foundations. And because the host organization handles any legal, administrative, and filing requirements (including tax returns), you're completely freed from these responsibilities.

HOW DO I ESTABLISH A DONOR-ADVISED FUND?

The first thing you should do is select an organization that offers donor-advised funds (DAFs). DAFs are offered by community foundations, financial service firms, educational institutions, cultural organizations, and public charities. Where you choose to establish your account depends on whether the charitable goals of the offering organization are compatible with your own.

Once you have selected a fund, be sure to obtain and carefully review the program's policies and guidelines before you open an account.

To open an account, you will need to complete and sign an application, also known as a letter of understanding. Many DAF accounts can be opened online. Typically, there is no charge to open the account, although you may be charged an administration fee each year thereafter.

You will then need to name your account. You can name it after yourself or your family, in memory of someone, or for a charitable purpose. If you prefer, you can name your account in a way that protects your anonymity.

You will also need to make the required minimum initial contribution. Typically, the minimum amount for subsequent contributions is lower than for the initial contribution. You can contribute cash, stocks, bonds, real estate, life insurance, business interests, and other types of assets, but once made, contributions are irrevocable. If you wish, you can also name someone who will continue donating to your fund after your death.

Finally, you can designate someone to advise the fund for you if you don't plan to advise the fund yourself. Once your account is open and funded, you can recommend grants at anytime.