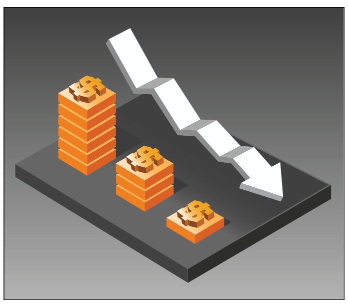
GLOBAL
WEALTH ADVISORS LLC
Registered Investment Advisor

INSIGHTS

Michael J. Krencicki, MSF, CFP® January 2009 James M. Knaus, MSM, CFP®

How Will We Know When The Credit Crisis Is Over?

When searching for the bottom of a bear market in stocks, experts often seek signs of "capitulation." That's the moment when almost everyone throws in the towel, selling in a panic. The notion is that all the bad news—about the economy, earnings, everything—is out there, and things could only improve. Now, as global markets suffer a seemingly endless credit crunch, it makes sense to look for the same kind of crucial juncture.



To find the end, consider the beginning. In 2003, the world economy had cash to burn. The U.S. federal funds rate, for lending among banks, had bottomed out at 1%, and interest rates around the globe had also dropped to near-record lows. As the economy began to pick up, all that cheap money was put to work in the form of business financing, consumer loans, and home mortgages—lots and lots of mortgages. Growing demand for real estate pushed up prices, and holding loans on fast-appreciating assets seemed safe and profitable. So investment banks began packaging mortgages into opaque securities that promised a steady stream of investment income.

It was those mortgage-backed investments, largely built around adjustable-rate loans to "subprime" borrowers, that ultimately spelled disaster. When rates on those loans jumped higher, homeowners began to default, and foreclosures flooded real estate markets with unsold homes. House prices declined, and the sinking value of mortgage-backed debt led to billions of dollars of losses at investment banks. To meet capital requirements, those institutions sold assets and invited investments by deep-pocketed outsiders. But each quarter brought more dismal news.

Last March, the U.S. Federal Reserve provided a $30 billion credit line for JPMorgan Chase to help it take over Bear Stearns, one of the nation's largest investment banks, which had been crippled by bad mortgage debt. The sale was accompanied by an announcement that the Fed would make funds available to other cash-strapped investment banks to help prevent additional failures.

Still, the drumbeat of multibillion-dollar losses continued. Investment banks, required to "mark to market" the worth of their portfolios, kept reducing the estimated value of their mortgage-backed debt. In July, Merrill Lynch sold collateralized debt obligations with a face value of $30.6 billion for just $6.7 billion, a move that guaranteed other banks, too, would take more huge write-downs.

As fall approached, the credit crisis intensified. One week into September, the government announced it was putting the two U.S.-sponsored mortgage behemoths, Fannie Mae and Freddie Mac, into federal receivership, while Lehman Brothers, another pillar

(Continued on page 4)

A Personal Note From Global Wealth Advisors

The most recent economic expansion began in late 2001 and lasted until December 2007. The non-profit National Bureau of Economic Research finally declared (with the benefit of one year of hindsight) that the U.S. economy slipped into recession in December 2007.

Three years from now, we'll look back at 2008 and recall an astonishingly wild ride. Virtually all asset classes produced negative returns of significant magnitude. The collective events of 2008 were unique, but then all economic downdrafts are one of a kind. Each recession, for example, has its own causes, severity, duration and ensuing impact.

The coordinated global response, both fiscal and monetary, was unprecedented, and continues to unfold. For each prior recession, the assertion was made that it was unique and required a different response. And each time, we recovered. The equity markets usually begin ascending about a half year before the recession ends. Moreover, in the one-year period following the low point from each of the bear markets since 1957, the S & P 500 has experienced a sizable double-digit return. To participate in the recovery, you must stay invested.

Call on us at any time to review your individual circumstances, and thanks for your continuing confidence.

Jim Knaus Mike Krencicki

Downsizing A Home Could Bring Savings

When your family shrinks, should the square footage of your castle follow suit? As the population ages, that's a question more and more couples face. Replacing a suddenly oversized home with a smaller house or condo could mean much lower outlays for everything from monthly mortgage and tax payments to maintenance, insurance, and utilities. And considering how much your home may have appreciated in value since you bought it, you might walk away with a nice chunk of change. But this good fortune could also push your home-sale profit above the amount you can exempt from capital gains tax liability.

Much depends on home prices in your area, and your gain will also be affected by how long you've been in the home. But the basic rule is this: You may claim a capital gains exclusion of up to $250,000 of your profit on a home you've occupied for at least two years; for a couple, the maximum exclusion is $500,000.

If your gain is less, downsizing could pay off nicely. Suppose you put your 5,000-square-foot home on the market. Currently, you pay a total of $4,750 a month for your mortgage and property taxes. If the house brings $1 million and you clear

$500,000—after retiring your mortgage and paying a real estate commission and closing costs—you would owe nothing in taxes. You could spend the proceeds on a much smaller place nearby. If your taxes dropped by half—say, to $750 a month—and you didn't need a new mortgage, you'd save almost $50,000 a year. You'd also spend much less on homeowner's insurance, utility bills, and upkeep.

But what if you live in an area where that home fetches much more—say, $3 million? Your mortgage would probably also be larger. But suppose you made $2 million on the sale. After excluding $500,000, you'd owe $225,000 in federal capital gains tax. Downsizing still might make sense, but if you hate handing over so much to the IRS, it may be better to stay put. If the house is sold after the death of one or both spouses, the tax bill should be much lower.

When the first spouse dies, the tax basis on his or her share of the property will be "stepped up" to the home's current fair market value. The profit on a sale then drops to half what it was when both spouses were alive. Under the new mortgage law passed in 2007, and if the house is sold within two years of the death, the surviving spouse can still take the full $500,000 exclusion. After that, the exclusion drops to $250,000. After both spouses have died, the full tax basis will be stepped up, leaving heirs with little or no capital gains exposure if they sell the house. They might, however, owe estate taxes. ●

After Wall Street Failures, A New Order

Last September, as stock prices plunged and one after another Wall Street institution had its day of reckoning, wealthy investors finally got mad. In a survey by Prince and Associates of Redding, Connecticut, 70% of clients at major Wall Street brokerages who had investable assets of more than $1 million said they wanted to fire their financial advisors, and nine of 10 were determined to pull at least some money from the brokerage accounts. Those percentages compared with 38% and 68%, respectively, just two months earlier. Although these firms have always dominated the money management business and handle more than five times the assets managed by independent advisors, this sentiment suggests real change could finally be at hand.

One reason, no doubt, was the failure of Lehman Brothers and the takeover of Merrill Lynch, as both investment banking giants found themselves crippled by their bets on mortgage-backed securities. Yet any shift toward independent advisors probably isn't the sole result of the latest turmoil. Time and again, large brokerages have failed to put clients' interests first, and this latest instance may have been the last straw for many investors.

The first problem was Wall Street brokerages' traditional business model. Their brokers earned commissions every time they bought or sold an investment for a client, and the firms structured compensation so brokers earned more selling whatever was most profitable for the firm. Often, as with limited partnerships and variable life insurance, the products they pushed turned out to be

Lessons Of The Auction-Rate Securities Crisis

For most of last year, thousands of people have been unable to gain access to large sums of money they placed in investments they had been assured were "just like money-market funds." But auction-rate securities are not just like money-market funds, a fact that became clear to most investors only after the market for these securities crashed in the throes of the credit crisis of 2008.

Federal and state authorities accused major Wall Street investment banks of continuing to sell auction-rate securities after it became clear the market was collapsing. After regulators threatened to take action against these firms—including Citigroup, UBS, and Merrill Lynch—and Congress scheduled hearings, the companies agreed to buy back the securities at full value and pay multibillion-dollar fines. The institutions deny allegations of wrongdoing.

As the wreckage was cleared away, investors can step back and consider lessons to be learned from this latest example of financial excess.

Since the introduction of auction-rate preferred shares in 1984, the market for the securities has grown into a $330 billion business. Investors have been attracted by normally quick access to their cash and interest rates that are generally higher than those of money-market funds and certificates of deposit.

Auction-rate securities typically consist of bundled corporate and municipal bonds with long-term maturities. The interest rates the securities pay are reset at weekly or monthly auctions, and because rates aren't locked in for long periods, investors are never stuck with below-market yields. Moreover, because the issuers of these securities—ranging from mutual fund and student loan companies to nonprofit entities such as schools, museums, and municipalities—tend to be respectable groups looking to raise cash, auction-rate securities have been touted as solid and safe.

Trouble with the securities began when buyers, spooked by the widening credit crunch, fled complex investment instruments. With no one buying at the securities auctions, there was no cash to pay investors who wanted to withdraw their funds. Yet, according to allegations in numerous lawsuits, Wall Street firms not only kept selling auction-rate securities but also failed to warn clients about the danger.

The attorneys general of Massachusetts and New York began investigating the firms marketing auction-rate securities, and some of the larger firms have agreed to buy out their clients. That may sound like a happy ending, but the many investors who for months had no access to their money won't be compensated for having their funds frozen.

State investigators allege that the firms encouraged analysts and brokers to gloss over potential dangers and push investments that were profitable to the firms, even at the expense of their clients. New York Attorney General Andrew Cuomo alleged that Citigroup repeatedly committed securities fraud by misleading investors into believing auction-rate debt was equivalent to cash and failing to reveal that the shares carried market-related risks.

The primary cause of risk in the market was the lack of a daily source of trading data on auction-rate securities, such as there is for Treasury bonds and stocks. Issuers had to rely on Wall Street dealers to function as buyers of last resort when bidders couldn't be found, and the risk was that an economic crisis would leave the dealers without the financial ability to support the market. That's exactly what happened. Big investment banks, already battered by failed investments in mortgage-backed debt, wouldn't or couldn't buy these securities.

Investors can learn several lessons from the auction-rate securities mess. The most important, of course, is *caveat emptor*. When Wall Street markets investment opportunities that seem to have an edge over similar products, it's likely that there are hidden risks. Higher potential returns almost always come with higher risks, though that's a warning that may be hidden in a fine-print disclosure if it's made at all.

Our firm educates clients about all products, and if you don't understand the risks of any of your investments, then please let us know. ●

terrible investments. It was a system rife with conflicts of interest that ignored what might be appropriate for a particular client.

Eventually, faced with competition from independent financial advisors who charged fees rather than commissions, gave impartial advice, and provided access to investments from a variety of sources, stockbrokers began to call themselves advisors and to offer slightly wider product choices. But then, earlier this decade, came another scandal, when mutual funds at several firms were caught favoring their own traders, hedge funds, and other major clients. Late trading, market timing, and front-running let investors on the inside increase profits at the expense of individuals.

Through all of this, the big firms' marketing managed to portray them as investors' allies. But this time, it really may be different. Wall Street companies took on so much inappropriate risk that they've been brought to their knees. And though they'll continue in some form, providing investment products and services, they may no longer dominate.

We are independent advisors not tied to Wall Street, and our goal is what it always has been—to help investors formulate and achieve their financial objectives. ●

Millionaires Optimistic On 2009 Economy

Not even a cockeyed optimist could be pleased with the current state of financial affairs. Home prices continue to lose altitude, the stock market has never really recovered from its January swoon, and the economy's either in recession or so close that the difference doesn't matter. Yet if you look ahead to next year, the view brightens considerably—or at least it did for participants in the 2008 Fidelity Millionaire Outlook, a survey of more than 1,000 decision-makers from families with at least a seven-figure net worth (excluding real estate and retirement assets). Asked last January for their opinion of the economic climate, they could hardly have been gloomier. But when questioned about 2009, most predicted a rebound, especially in real estate and the stock market. Many also said they intended to add to their investments in the meantime.

The survey, conducted for Fidelity Institutional Wealth Services, asked respondents to rate perceptions of five key areas—consumer spending, business spending, value of real estate, the stock market, and the economy—on a scale of one to five, from "very weak" to "very strong." Those answers contributed to an overall "confidence score" that could range from -100 (most pessimistic) to +100 (most optimistic). The composite confidence level in January 2008 was decidedly downbeat, at -50, whereas the outlook for 2009 was a much more sanguine +18.

It also turns out you're only as wealthy as you feel—and that the wealthier these millionaires perceived themselves to be, the sunnier their outlook. Those who said they felt wealthy had confidence scores of -47 and +21, respectively, for their current and future outlooks. That compares with scores of -58 and +8, respectively, for those who didn't consider themselves so wealthy.

Three out of four of the surveyed millionaires, who had average "investable assets" of $4.3 million, reported their portfolios had suffered in the wake of the subprime mortgage meltdown. But more than 40% expected the subprime situation to improve within a year, and almost as many looked upon high energy prices, though perhaps a personal bane, as a good investment opportunity.

There could be bumps on the road to better days, according to the survey. Most surveyed millionaires, for example, considered it likely or very likely that the next five years will bring significant hikes in tax rates on income, dividends, and capital gains, and they expected they would need to adjust their investment strategies as a result.

And if they needed help with those strategies? More than 26% of respondents to the 2008 survey were working with an independent financial advisor, compared with 22% in 2007. These millionaires also trust their primary advisors to manage a larger share of their investable assets—71% in 2008 compared to 56% in 2007. ●

How Will We Know

(Continued from page 1)

of Wall Street, desperately sought to sell itself. But now no one wanted to throw good money after bad. Lehman had to file for bankruptcy, and Bank of America rescued Merrill Lynch, which had also been on the brink of failure. Just one day later, the federal government put together an $85 billion loan package to prop up American International Group, a giant insurance company that had insured mortgage-backed investments for virtually all of the banks now on the ropes. If AIG, too, had gone down, it would likely have triggered a chain reaction of additional failures. The same week, the last two major American investment banks, Goldman Sachs and Morgan Stanley, announced that they were reorganizing as bank holding companies, a move that invites much closer regulation but could help them survive.

Yet even after all of this, credit markets still floundered, and the Bush administration announced it was working with Congress on a $700 billion plan to buy bad debt from financial institutions. As legislators wrangled and presidential candidates hovered, banks around the globe stopped lending. Capitulation, it appeared, was finally at hand.

Even if the giant rescue plans by the U.S. and other governments around the world manage to restore some confidence in the financial system, and banks resume providing the credit so essential to businesses and consumers, a lasting return to the days of easy money is unlikely. The U.S. will let more banks fail and be acquired, merely doing what it can to preside over an orderly rout. Major financial institutions will be larger, fewer, and much more tightly regulated. While that's not ideal for the long-term health of the economy after the crisis settles, if responsible borrowing and lending can resume, it will be a major improvement.

In the meantime, you should consider investing while prices are depressed to take advantage of the many buy-low opportunities that we're identifying. Throughout history, the most successful investors are those who remain invested, and those who cash out during a panic often miss out on the eventual rebound.●