



## Quarterly Commentary | *January 2008*

This is the first “Quarterly Commentary” published by our new firm. We are proud to use this opportunity to share with you our firm’s insight and broad array of services. We hope you find these quarterly comments of interest and benefit.

During 2007, volatility returned to the stock markets causing many investors to reconsider their investment strategies. So what’s an investor to do? **STAY FOCUSED!** We develop investment strategies within a long-term strategic framework based on expected after-tax returns and volatilities to be realized over long horizons. We do not pursue momentum investing, tactical allocation shifts, or, especially, product strategies having poor disclosures and illiquid assets (in other words, Hedge Funds). We spend a lot of time trying to ensure that the volatility of our clients’ portfolios coincide with their ability to tolerate such events. The recent market behavior reinforces our confidence in our core investment philosophies:

### **Equities**

We believe that equities over a long period of time will give us a higher return than bonds and cash. We also believe they are riskier than bonds and cash. For example:

- From 1926–2006 the S&P 500 had the following results: 23 out of the 81 years produced negative returns. In 10 of those years, the losses were greater than 10 percent. In five of the years, the losses exceeded 20 percent. In two of the years, the losses exceeded 30 percent. In one year, the loss exceeded 40 percent.
- Over the same period of time US Five Year Treasury Notes had the following results: 8 out of the 81 years produced negative returns. In only one year did the loss exceed 5 percent.

Why take this risk? We believe equities higher return is due to the additional risk investors are taking. There is no “Free Lunch”. Historically, the premium investors have received for taking this risk, called the equity premium, has been approximately 5 percent. For most, this additional return is worth the risk. Remember, the only way to achieve this additional return is to maintain your position in equities.

### **Global Diversification - Not Market Timing**

Even with all of the academic research espousing market efficiency, it has not stopped speculators and other traders from attempting to read the future. Market timing offers a seductive prospect, especially in tough times. By predicting market direction ahead of time, a trader might capture only the best-performing periods and avoid the worst.

However, large gains historically come in quick, unpredictable surges. For example, using the time period of January 1, 1970 to December 31, 2006, the S&P 500's worst one-day loss occurred on October 19, 1987 but the best one-day gain occurred on October 21, 1987. Just two days apart.

A buy-and-hold investor who purchased the S&P 500 on January 1, 1970 and held it till December 31, 2006 would have earned an 11.23% annualized return. If an investor had the skills to determine when the worst periods were going to occur and they avoided October 19, 1987, they would have earned an 11.92% annualized return—less than a point higher than the entire period. But missing October 21, 1987 would have reduced their return to 10.97%.

If they were skillful enough to miss the worst one year period ending September, 1974, they would have earned a 12.72% return. However, if the investor had missed the best one year period ending in June of 1983, their return would have been reduced to 9.81%. As you can see, market timing can have a significant impact on an investor's return.

We have not seen any reliable method to implement a market timing strategy that would give us or any other investor the ability to time the market on a consistent basis. Therefore, it is our opinion that it is not prudent for investors to play that game.

A December 3, 2007 Wall Street Journal article asked 12 financial experts to comment on lessons learned from the events of 2007. Included on that list was John Bogle, Vanguard founder and advocate of individual investors.

Bogle said, *"The volatility is enormous. I think a very important lesson is: Don't let your emotions drive your investment program, because you will be thinking of getting in and out. For investors the best rule by and large is to ignore the daily moves of the stock market. The stock market is a giant distraction for the business of investing."*

Another commentator from the article was Jeremy Siegel, Professor of Finance at the Wharton School of Business. He stated, *"A lot of people are scared away when they hear the headlines of big declines in the market. It's very important not to be caught up in the prevailing sentiment, because usually those are not good times to sell when the market is going down..."*

Global diversification to us seems to be the most prudent method for investors to achieve their investment goals. Investors should realize that even with a diversified portfolio they will have times of negative returns. However, by diversifying, we hope to limit the downside exposure.

## Capital Gain Planning for 2008

The current ordinary income tax rates for individuals are 10%, 15%, 25%, 28%, 33%, and 35%. Certain capital gains and qualified dividends (i.e., adjusted net capital gains) are taxed at 15%, or 5% for taxpayers in the 15% or 10% tax brackets. Pursuant to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and extended by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the 5% rate drops to 0% from 2008 to 2010. In 2011, these rates will sunset and revert to the pre-2001 rates of 15%, 28%, 31%, 36%, and 39.6%. Qualified dividend income will lose its favorable status, and capital gains rates will revert to pre-2003 rates, generally 20% (10% for gains in the 15% bracket). Some commentators speculate that, under certain circumstances, the favorable rates may be rescinded after 2008, which is a presidential

election year, and from the rumbling we have heard during the primaries, no one should be surprised if federal tax rates on capital gains increase in 2009. With an increasing deficit and an on-going war, political commentators all seem to agree that no matter which party wins the White House later this year, so long as Democrats remain in control of both houses of Congress, some tax bill will be one of the first orders of business. In any event, exactly when this would go into effect, and how rates for individual tax payers will be affected, are details still unknown. However, it's not too early to begin to consider circumstances that might justify accelerating the sale or gift of highly-appreciated assets, this year, before they may be subject to higher capital gains tax rates in 2009.

There are at least a couple of cases where the answer to the acceleration question is probably "no". First, where the assets aren't needed for the current generation and will receive a basis step-up when passed to the next generations. And second, where the assets are earmarked for future gifts to charity. In both of these cases, voluntary realization of capital gains this year is simply unnecessary.

For many other cases, the conclusions aren't so clear. For example, portfolio rebalancing, moving to new investment opportunities and/or preferred managers, replenishment or expansion of cash reserves, and reducing concentration risk of a single security could argue for taking action sooner rather than later.

Determining whether accelerating capital gains makes sense requires exploration of the impact of several variables: the level of potential tax rate increases, size of the asset's embedded gain, expected future investment return and the anticipated future investment timeframe. The longer you would expect to hold the asset, the less it makes sense to sell it now.

In the coming year, we will be evaluating our clients' portfolios and having conversations with clients that would be impacted by the changing tax rates. We look forward to assisting you on these and other important matters in 2008.

## Dimensional Fund Closure:

Dimensional has begun implementing a soft close of the US Micro Cap Portfolio (DFSCX) and US Small Cap Value Portfolio (DFSVX) as of December 31, 2007. A soft close limits purchases to existing fund investors—defined as anyone holding shares as of a specified date. Of course, investors may redeem shares at any time. The purpose of a soft close is to manage net fund inflows to avoid penalizing existing shareholders by the effects of fund transaction volumes.

While we appreciate Dimensional's commitment to shareholders, we have been preparing due diligence reports on appropriate changes to our clients' portfolios and/or replacement funds. We are in the process of evaluating our current asset allocations to ensure we are capturing the risk attributes we want in a tax and cost efficient manner. As always, any changes to our asset allocations or fund managers would be discussed with our clients before implementation.

Our goal for this firm is to provide our clients with the best service possible. Therefore, we need to know what we are doing well and what we are not doing so well. If you have any comments you believe would help us to better serve you, please do not hesitate to communicate them to us. We would greatly appreciate your thoughts.

Referrals from clients and professionals in the community are our greatest source of new client relationships, and for that we wanted to say thank you. It is the greatest compliment when existing clients and professionals recommend our services to their friends and family members. The firm is still growing and accepting new clients. Please continue providing us with your referrals.

We continue to work daily to earn your trust and confidence.

Best regards,

Fischer & Hutchinson Wealth Advisors, LLC