



October 2008 Newsletter

3rd Quarter 2008 Investment Management Report Capital Advantage, Inc.

Throughout the several decades we have been working within the financial services sector, we have been able to successfully navigate through many market 'corrections' (-10%), many 'bear' markets (-20%), hyperinflation that led to bond market crashes, the 9/11 terrorist attacks, the dot-com bubble and resulting market fall, and numerous foreign currency collapses. In prior economic upheavals, we always had a series of investment alternatives to which we could reallocate clients' assets...but not this time.

This current crisis is truly global in nature. The value of every stock and bond market (excluding government securities) throughout the world has dramatically sold-off and not one sector stands in positive territory. While you may feel yourself full of disappointment, despair, or even fear, remember that while each economic crisis is interpreted differently by each of us, our economies have never failed to recover. Remember, it is not a matter of **if** they will recover; it is a matter of **when**. With our disciplined approach, Capital Advantage, Inc. will aim to successfully navigate your investment portfolio through this economic storm.

What Happened?

What we are experiencing is the unwinding of 2-3 decades of easy money, financial deregulation, lack of transparency, lobbyists, over-inflated real estate prices, speculation, and excess leverage and risk. During the run-up toward this crisis, low nominal interest rates, ample liquidity, and robust global growth encouraged many banks to take on more risk in hopes of achieving high corporate profits. Loans based upon inflated assets were granted to those who could not afford them. This strategy generally proves profitable, but is based upon the underlying assumption that real estate only increases in value...

Unfortunately, nothing goes up forever, and the trillions of dollars of loans based upon inflated real estate assets seemed to become worthless overnight. If we consider banks as the 'heart' and credit as the 'blood' guiding our financial system, these bad loans act as a blood clot, causing the current global financial heart attack. Our economy depends on credit to function properly. Financial markets respond to falling credit availability by slowing to a stall and moving toward recession.

What Have We Done?

In the summer of 2007, we became concerned about a slowing economy, initially because of the real estate peak that began in 2006, but even more apparent was the dramatic rise in commodity prices. Oil doubled in value from \$70/barrel to \$140/barrel in twelve short months, and corn, wheat, steel, and copper similarly followed. The common belief that this was due to increased demand from overseas emerging economies may have been somewhat true, but we believed that there was also much speculation in the markets. Declining real estate values, a potential bubble in commodity prices, and exploding international stock markets created a formula that raised a red flag. We began raising our money market targets to triple their normal levels by reducing our allocation to international equities. We also began building our small cap and mid cap equity positions, as these types of securities tend to perform better in slowing economies.

These moves were designed to create portfolio stability in a market down turn, but this strategy was no match for the global sell-off that followed. On October 2, 2008 Congress passed the \$700 billion dollar bank bailout bill, which we hoped would finally put a 'floor' to the credit crisis. Our initial expectation was that the stock market would react euphorically. However, the very next day, news of a 16-year high unemployment rate led to our decision to sell more securities and continue raising our money market positions. Not only did the bailout bill fail to put a floor in the markets, it unleashed a global wave of panic selling.

3rd Quarter 2008 Investment Management Report, Cont'd.

What Are We Doing?

Today, each portfolio has enormous liquidity, and the securities that remain are positioned to weather a looming global recession. We believe, over time, that our government actions will prove successful. We also believe that corporate and municipal bonds will be the first sector to see positive performance, and are currently raising our fixed income targets to reflect this outlook.

Equities may have reached a floor of around 8000 (as measured by the Dow Jones Industrial Average on October 10, 2008) but it will take time – probably years - to return to the 14,000 level we experienced in 2007. We predict that prices will rise in time; we are already witnessing liquidity returning blood flow to financial systems.

We believe that the United States is entering a recession, and our real estate values have yet to find their bottom. The rest of the industrialized world is 6-12 months behind us; therefore, we will remain under-allocated in international and emerging markets.

We have just experienced a tremendous global sell-off in equities, fixed income and real estate values, stemming from a near collapse in our banking and credit facilities. The experience and disciplined approach of Capital Advantage, Inc. will allow us to successfully navigate your investment portfolio through this economic storm. Take comfort in knowing that we have, and will continue, to take preemptive and ongoing measures to protect your portfolio to the best of our abilities.

Please call our office at (925) 299-1500 or toll free (888) 299-1500 if you are interested in scheduling a review of your investment strategy and/or financial plan. If you are not a client of Capital Advantage, Inc., we offer free no obligation consultations.

Be Careful About Picking Beneficiaries for Your IRAs and 401(k)s

By the Financial Planning Association

Inheriting IRA or 401(k) proceeds from a friend or relative can be a potentially huge windfall, but it can also be a sizable tax headache. For both the giver and the recipient, it's worth seeking some advice.

Bank accounts, stocks/bonds, real estate, and life insurance proceeds generally pass to heirs free of income tax. However, inherited retirement benefits, such as, IRAs, annuities, 401ks, and pensions can be a different story. Beneficiaries have to pay ordinary income tax on distributions from retirement benefit plans and IRAs after they are inherited. For Roth IRAs – the benefits can be free of income tax to your heirs if all tax requirements are met.

Here are some general guidelines:

Spouses are the first stop: Federal law dictates that your surviving spouse must be the primary beneficiary of your 401(k) plan benefit unless your spouse signs a waiver to redirect those funds. Even with a traditional IRA, naming the spouse as the primary beneficiary may be an appropriate option. Should the surviving spouse have his or her own IRA, this approach would allow them to simply roll over the assets from the decedent's IRA into their own. Furthermore, if the surviving spouse is significantly younger than the deceased, the surviving spouse would receive the added benefit of stretching out distributions from the IRA until he or she turns 70 1/2. The stretch-out allows the assets to continue to grow on a tax- deferred basis, thereby maximizing asset value and delaying any income tax due.

When might you want to rethink a spousal beneficiary? If your surviving spouse's estate is expected to exceed the applicable exclusion amount for federal and state estate taxes. The applicable exclusion amount after allowable expenses is \$2 million in 2008 and above \$3.5 million in 2009. It should also be noted that in addition to federal estate tax, many states impose a state tax on estates with considerably lower asset levels (often anything over \$1 million). Proper estate planning may alleviate this issue.

What about non-spousal beneficiaries? Today, non-spouse beneficiaries may be able to roll over all or part of inherited 401(k) benefits to an inherited IRA. A recent change in IRS regulations still requires non-spousal heirs to withdraw a minimum amount from inherited IRA assets every year, but it's based on the age of the recipient rather than the age of the decedent.

Establishing a Stretch IRA: Due to recent changes in the minimum distribution law, taxpayers may now establish IRAs designed to stretch out the time period over which a non-spouse beneficiary (i.e. child) is required to take minimum distributions from an inherited IRA. Proper use of this vehicle may potentially allow for continued growth of tax-deferred earnings over multiple generations and can have a substantial impact on the future value of the family portfolio.

Naming trusts or charities as beneficiaries: Placing IRA assets in trust can have substantial advantages but can be complex. It should only be considered after receiving tax advice from a CPA or tax advisor. Trusts can be complex instruments with which to bequeath assets, and even though naming a charity as one's primary beneficiary will not affect distributions in your lifetime, it could affect the tax consequences for non-charitable beneficiaries who are sharing the same asset upon your death.

Make Estate and Financial Planning a First Step after Divorce

By the Financial Planning Association

After a marriage breaks up, about the last thing most people want to do is sit down with one more attorney. Regardless of your age or whether you have kids, it's important to consult both financial and legal experts to make sure you have an updated estate and financial plan for your new life once the divorce decree is final.

It's also best to blend estate planning with financial planning post-divorce. If you weren't working with a financial or estate planner during the divorce process, it's time to do so now. The immediate months after a divorce can be disorienting – even if you don't move, you are literally starting a new household that you will have to direct yourself, and that means new money issues to face.

This is why that the weeks immediately after a divorce are a good time to revisit short- and long-term spending and planning goals. Here's a general road map to that process:

Start with a Financial Plan: Whether you plan to stay single, remarry or move in with a new partner, it's good to get a baseline look at your finances as early as possible after the divorce is final. Expenses for the newly single can pile up quickly and unexpectedly, and your Financial Advisor at Capital Advantage, Inc. can help you review your new current spending and savings needs, compare strategies to achieve long-term goals like college and retirement and give you critical tools to protect your assets and loved ones if you die suddenly. Even if you have a good relationship with an ex-spouse and you addressed key issues for your children as part of the divorce proceedings, you need to revisit all these issues as a single individual before you move on to the next stage.

Talk with a licensed estate planning attorney about wills and other critical documents: True, there are software programs and other kit solutions available to write basic wills, powers of attorney and certain simple trust agreements. But it makes sense to coordinate these activities with your Capital Advantage, Inc. Financial Advisor and with a qualified estate planning attorney who can tailor an overall estate plan specific to your needs (if you need a referral to an estate attorney please contact John, Gary or Donna). Even if you are very young with few assets, it makes sense to get some solid advice in this area so you'll be able to manage such planning as you age and your finances get more complex. Particularly if you have kids, such planning is important if you plan to remarry and if you want to guarantee that specific assets are guaranteed for them upon your demise. In some cases where a spouse dies unmarried with minor children, an ex-spouse might automatically gain control of assets that were supposed to be earmarked for the kids. If you don't want that to happen, you need to plan for that legally.

Make a guardianship game plan for your kids: It's not enough to plan how money and assets will go to your children if you or your ex-spouse die suddenly or are incapacitated. If your children are minors, it's particularly important to make sure you and your ex-spouse have a guardianship plan for their upbringing as well as any assets they may inherit. You might completely trust your ex-spouse's new husband, wife or partner to raise your kids if your ex-spouse dies before you, but there may be others better-equipped to do so – spell that out now. Also, if there are any trust or wealth issues that will become effective for your children once they reach adulthood, it's also important to establish an efficient legal structure for distributing those assets as well as appointing a trustee in a will to train and guide your kids through that financial transition.

Plan for special needs kids: If one of your children is disabled and is expected to need lifetime assistance of some type, then you should consult a qualified attorney to help you create a special needs trust. It will help protect your child from having to give up any public or social financial assistance as well as access to special doctors, medical help, special prescriptions or treatments that could be taken away if they were to personally inherit assets that would disqualify them for these programs. When such assets are held in trust, they are not counted as the child's assets. The advantage is that those inherited assets may still be used to support their housing or other personal living needs.

Get solid protection in place: Most people focus on what may happen to their health insurance if they get divorced, but insurance issues like life, property/casualty and disability insurance are sometimes put on the back burner. If you're newly single, you definitely need the best health coverage you can afford for yourself and your kids, but life, property, liability and disability insurance becomes doubly important, particularly if you failed to address those needs during the divorce. Even if your ex-spouse is cooperative with financial support, it's wise to insure yourself as if they weren't.

Review all your investments for primary ownership and beneficiary information: Even if you were advised correctly to change the names on assets you and your spouse were dividing between yourselves, it still makes sense, post-divorce, to review the names are indeed correct on those assets, and most important, to make sure all beneficiary information is updated and correct.