Shannon & Associates, LLP | 1851 Central Place S, Suite 225 | Kent, WA 98030 | 253.852.8500
SA-KG Advisors, LP | 701 Brazos Street, Suite 500 | Austin, TX 78701 | 800.542.4916 | info@kgadvisors.com

First Quarter 2009

SA-KG Advisors Quarterly

When Times Are So Scary, Opportunties Emerge

As the nation struggles through a severe financial crisis, you're undoubtedly worried about your financial security and the safety of your nest egg. But this is no time to sell stocks or make wholesale changes to a well-balanced portfolio that is aligned with your goals and investment time horizon.

Remember that short-term volatility isn't a big worry when you are invested for the long term. And though stocks have underperformed bonds during recent years, over many decades equity investments have almost always come out on top.

Even if the nation is in a recession, there is a lot in the economy that is doing pretty well. Unemployment, though rising, hasn't exploded, interest rates are still low, and inflation remains under control despite higher energy and food prices. The economy is resilient and the federal government is taking steps to get past the credit crunch.

As for stock prices, much of today's and tomorrow's bad news already has been factored into the market. Selling stocks or mutual funds after a decline simply means getting out at a low point. Nervously entering and exiting the market heightens your risks and lowers your returns.

So what should you do? Stay the course and remain diversified, but ask your advisor about adjusting your portfolio to take advantage of investments more likely to produce solid returns during a bear market. Here are several potential opportunities:

- Before their recent declines, global growth trends had sent commodity prices soaring for energy, agricultural products, and precious metals. Now, lower prices can give volatility-tolerating investors a good entry point for gains once the economy stabilizes. Commodities can also serve as a hedge against inflation.
- Yields on Treasuries dropped as shell-shocked investors fled to the safety of government bonds. But the market fallout should reiterate the importance of broad portfolio diversification—and that includes low-yielding treasuries. Allocation back into stocks and corporate bonds, while prices are low is also important.
- Though not quite as safe as Treasuries, municipal bond funds can deliver income that's not subject to federal and, sometimes, state income taxes. Muni prices have fallen and yields have risen, in some cases nearing the yields of corporate bonds even before figuring in munis' tax advantage. But tread with caution: there are concerns about the worsening financial health of local and state governments along with municipal bonds' lack of liquidity.
- Yields on corporate bonds, too, may be attractive today, when companies must offer higher rates in order to get the financing they need. Though default risks are also high, taking well-considered risks can improve potential returns.

(Continued on page 4)

A Reminder: Always Expect Unexpected Events

What's going to happen next on the investment scene? No one knows for certain. In fact, if there's one sure thing, it's that you can expect the unexpected.

For instance, events unfolding in the far corners of the world could affect your portfolio. Political unrest. Natural disasters. Deepening recession. Runaway inflation. Corporate scandals. They've all occurred before and will happen again.

So how do you protect your assets against a potential calamity? If you don't have an investment policy statement (IPS) in place, it's a good time to develop a game plan to address your needs. If we have already helped you create an IPS, rely on it to ride out the hailstorms.

The IPS outlines general investment goals and objectives, and, typically, it describes an asset allocation designed to meet those goals. It may also emphasize strategies tied to your risk tolerance, liquidity requirements, and retirement needs. Finally, the IPS may delve into other financial areas, including your estate plan.

The principal reason for developing a long-term investment policy, in writing, is to protect your portfolio from ad-hoc revisions during times of market turmoil and assure that your investments stay true to your long-term goals. Of course, an IPS isn't a panacea for all possible ills. But it will help you be better prepared when the unexpected happens...and it will.

Go Directly From A 401(k) To A Roth IRA

Shall we dance? In the past, if you rolled over funds from a 401(k) plan to a Roth IRA, you had to do a Texas two-step: 1) Transfer the cash from your 401(k) to a traditional IRA 2) Convert the traditional IRA into a Roth IRA, paying income tax on the amount you convert.

Now, thanks to a recent tax law change, the choreography is simpler, with just one step required. Furthermore, new IRS guidance gives 401(k) plan participants a slight edge on Roth conversions.

With a 401(k) plan, you accumulate funds on a pre-tax basis. You make annual salary deferrals (of up to $15,500 in 2008, plus $5,000 if you're age 50 or older) that may be partially matched by contributions from your employer. Some plans also permit after-tax contributions. Plan investments compound tax free, but distributions from the 401(k) during retirement are taxed at ordinary income rates, currently as high as 35% plus the state tax obligation.

A Roth IRA works the other way around. Money goes in after taxes have already been paid, but qualified distributions, assuming the Roth has been around for at least five years, aren't taxed. To qualify for a tax-free, penalty-free distribution, you have to be at least age 59½, though exceptions are made in the event of death or disability, or to pay expenses for a first-time homebuyer (up to a lifetime limit of $10,000).

You can convert a traditional IRA, built with pre-tax funds, into a Roth only in a year in which your adjusted gross income is $100,000 or less. Beginning in 2010, however, there will be no income ceiling. That change is a provision of the Pension Protection Act of 2006, which also eliminated the need for a two-step move from a 401(k) to a Roth. Now, you can avoid the interim step of moving your money to a traditional IRA, though you'll still have to deal with the $100,000 income ceiling until 2010. (Some employers now offer an after-tax Roth 401(k) option, and these plans also can be rolled over directly to a Roth IRA.)

In a recent notice, the IRS sweetened this deal with the news that no tax is owed if you convert only non-deductible 401(k) contributions. In contrast, in any conversion from a traditional IRA to a Roth, all distributions must be based on the ratio of non-deductible contributions (ie., contributions that you can't deduct from taxes) to the total value in all of your IRAs.

Suppose you have $200,000 in an IRA and $200,000 in a 401(k) to which you made $40,000 in non-deductible contributions to each. That five-to-one ratio means that if you convert $10,000 from the IRA to a Roth IRA, only $2,000 will be exempt from tax. But if you convert $10,000 in after-tax contributions from your 401(k) to a Roth, no tax will be owed.

Determining whether a Roth IRA conversion is right for you depends on a number of factors including your age and tax bracket. Though the Roth conversion dance is simpler now, you may still need a partner. We can help you determine whether a one-step rollover is right for your unique situation. ●

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 is a mess, and a recession seems certain. 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

Knowing When The Credit Crunch Has Ended

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 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. ●

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. ●

Opportunities Emerge

(Continued from page 1)

- With the Federal Reserve likely to keep interest rates low, inflation could continue to be a concern, and Treasury Inflation-Protected Securities, or TIPS, can help insulate you against that risk. TIPS' principal increases in step with rises in the Consumer Price Index, and at maturity the buyer receives either the adjusted principal or the original principal, whichever is greater.
- Domestic stocks began their fall before international stocks and could be first to recover. Also, as overseas economies weaken, the dollar may resume its recent climb, reducing the value of foreign holdings for U.S. investors.
- European bonds may be a good bet as European countries drop interest rates in order to boost ailing economies. Declining interest rates favor bond holders.

- U.S. small-cap stocks may be preferable to large-caps because larger, multinational companies tend to have more exposure to international financial woes. Also, small caps tend to rebound first after a recession.
- Investing in surviving financial services firms might be worth considering, though only for those who can tolerate risk in a sector undergoing profound, unpredictable changes, and who have an advisor that has studied this sector significantly. ●

These views represent an appraisal of possible events. Outcomes and performances are not guaranteed. The investments discussed may go up or down in value and are not suitable for all investors. The information provided is not specific financial advice or a recommendation to buy or sell. We must review your profile, needs, and accounts specifically to determine what is right for you.

You should consider any investments objectives, risks, charges, and expenses carefully before you invest. Information regarding potential investments, including a fund's prospectus, contains this and other information and should be read carefully before investing. Prospectuses and information may be obtained from our office.

Reproduction of this material in whole, or in part, is prohibited without the express permission of Advisor Products Inc.

Shannon & Associates, LLP
1851 Central Place S
Suite 225
Kent, WA 98030
253.852.8500

SA-KG Advisors, LP
701 Brazos Street, Suite 500
Austin, TX 78701
800.542.4916

info@kgadvisors.com

©2009 API