PASI since 1977 NEWS

Volume 34 - Number 1 **Spring 2010**

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Market Update: *A Paradoxically Placid Quarter*

By: David A. Jaffe, M.D.

If not for a little excitement on the Aegean Sea, it would have been a thoroughly dull quarter. Oh, and yes … Congress passed a controversial bit of legislation late in the quarter. The markets yawned over that news as well. In fact the health care bill didn't even make the *Wall Street Journal's* quarterly "Dow Rewind" chart, which graphs the performance of the Dow Jones Industrial Average as a timeline with major news events superimposed. Just guessing, but that bill may yet leave its mark on the "Dow Rewind" chart of a future quarter.

Thanks to yet another Greek debt crisis, the U.S. dollar lost the ugliest currency contest. Investors continue to view U.S. treasuries as a safe haven, supporting demand and keeping our interest rates low. For the conservative investor considering a 5-year CD returning 2.76%, owning McDonald's stock yielding a 3.1% cash dividend, with capital gains potential and maybe a Happy Meal discount coupon for shareholders, should look pretty attractive.

In fact, the stock market posted its best quarterly showing since 1998. The S&P 500 (with reinvested dividends) added 5.39% to the outsized gains of 2009. The Dow Jones Industrial Average (DJIA) advanced 4.1%, while the NASDAQ composite gained 5.7%. If you like big numbers, the 12-month returns will give you thrills. From March 31, 2009 to March 31, 2010 the S&P 500 surged 46.6%. Of course, that period began close to the bear market low set on March 9, 2009. If only our foresight was as acute as our hindsight, we could have all made a boatload of money betting *against* the March 2009 doomsayers! As it is, we were well rewarded for staying the course.

The PASI composite portfolio performed well in the first quarter, besting the S&P 500 with a gain of 6.20%, including reinvested dividends. Bond returns were modest at 1.45% for our corporate portfolio, leaving the average 60:40 balanced account with gains approximating 4.30%.

The real puzzle is why the stock market continues to advance in the face of widespread economic uncertainty, including weak consumer demand, high unemployment, escalating national debt, troubled European economies, and sticking gas pedals. In fact, corporate earnings reports have surprised on the upside and there is a growing consensus that U.S. economic growth has staying power. The real test will come as the government props that have supported the economy, low interest rates, easy credit, and government spending programs, are slowly withdrawn. We continue to hedge our bets on the strength of this recovery, with a cautious mix of steady growers and economically sensitive businesses. We won't complain if the next three quarters of 2010 are as dull as the first, but in the likely event that things get more interesting, our diversified portfolio and balanced account structure (stocks and bonds) should help keep the excitement at a manageable level.

"City Upon a Hill"

By: Nathan Polackwich, CFA

U.S. households remain up to their necks in debt, and the Federal Government is literally drowning. Economic output is still below where it was in the second quarter of 2007. Our government is so polarized and our problems seemingly so intractable that it feels like the American dream is on the verge of sinking. But it has always been so.

Sailing across the Atlantic on board the *Arbella* in 1630 the Puritan leader John Winthrop admonished the future Massachusetts Bay colonists that "The eyes of all people are upon us. So that if we shall deal falsely with our God in this work we have undertaken...We shall shame the faces of many of God's worthy servants, and cause their prayers to be turned into curses upon us 'til we be consumed out of the good land whither we are a-going." Winthrop's speech was one of the earliest examples of America's long and unique tradition of "jeremiads", or righteous prophecies of doom.

The word jeremiad comes from the prophet Jeremiah who foretold that his fellow Judeans' idolatry and other violations of the Jewish covenant would bring disaster. Jeremiah's warnings went unheeded and in 586 B.C. the Babylonians crushed the Kingdom of Judah taking most of the population captive. In his sermon on board the *Arbella*, John Winthrop deliberately and ominously compared the colonists to the Israelites. As the foundation of the Torah is the belief that the Jews are the chosen people – those chosen to be in a covenant with God – the Puritans also believed they were chosen by God. As Winthrop made plain, theirs was to be a "city upon a hill," a model to the world of reformed Christianity.

So from the very beginning America's religious and political leaders were acutely sensitive to perceived signs of societal decay. As Harvard professor Sacvan Bercovitch notes in his classic, *American Jeremiad*, "Within the first decade of settlement, the clergy were already thundering denunciations of a back-sliding people." And jeremiads have remained a core and distinctly American custom. The citizenry of other countries, though they may periodically lament the degradation of their government or state of their economy, far less frequently exhibit the kind of "losing-our-country" fears which have endured as a staple of American political consciousness. Thus, while not minimizing the extent of our country's current travails, some comfort can be derived from the fact that the end of America – from Valley Forge to Fort Sumter, from Black Tuesday to the Soviet launch of Sputnik – has almost always seemed imminent.

Of course, the U.S. (and global) economy currently finds itself in a real pickle. Although we've passed through the worst part of the financial crisis – the panic – we now must deal with the aftermath, which will linger for years. For instance, U.S. household debt grew twice as fast as the overall economy over the past three *decades*. Logic suggests that more than a year or two will be required for households to get their balance sheets back in order. And while rising debt levels provided an artificial, steroid-like boost to economic growth, a sustained period of falling or stagnant household debt growth will act as a stiff headwind – particularly as consumer spending accounts for two-thirds of the U.S. economy.

Our biggest problem, however, is the prospect of trillion dollar Federal budget deficits as far as the eye can see. Under normal circumstances, we could grow our way out of debt, as happened in the decades following WWII. That is, as the economy grows, tax revenues rise and budget deficits become more manageable. But this time we must contend with the hangover from a burst credit bubble of historic proportions. As noted above, the largest part of our economy – consumer spending – is likely to grow at a below-average rate for some time. Simultaneously, government spending will rise at an accelerating pace as the Baby Boomers tap Social Security and Medicare benefits in ever greater numbers. Thus, the prospect for significantly higher tax revenue looks minimal, while the prospect for higher government spending looks assured. Is there no way out?

Some market commentators suggest that inflation is ultimately the weapon the government will choose to battle its debt problem. They posit that when faced with huge funding shortfalls, money will simply be "printed" to plug the gap, and more money in circulation means inflation. Ah, if only it were that simple.

Remember that the government's largest long-term liabilities – Social Security and healthcare costs from Medicare/Medicaid– are both indexed to inflation (the former officially and the latter unofficially). In addition, the average maturity of publicly held government debt is just 3.9 years and 40% is short-term (matures in less than one year) . This implies that should the government try to "inflate" away its debt, bond investors would immediately demand much higher yields and the interest the government would have to pay would increase quickly and dramatically. Thus, as inflation rises, so does spending on entitlement programs and interest on the national debt. A policy of inflation, therefore, is tantamount to bailing water out of a leaky boat's cabin and dumping it right back on the deck.

So will trillion dollar budget deficits just continue until the interest we owe on our debt becomes so onerous that national bankruptcy becomes inevitable? Should we start stocking up on canned goods and ammunition? In short, no. We have two ways out of our current morass, one definite, one possible. Starting with the "definite", there's an old saying that if something can't go on forever, it won't. The reality is that investors in U.S. Treasuries simply won't allow our government's debt to reach the point of no return. Well before that happens they'll balk at buying T-bonds and T-bills at measly low single-digit yields. Instead they'll demand much higher interest rates in return for the risk of lending to such a profligate borrower. This will precipitate a fiscal crisis because the Federal Government obviously can't afford a big increase in its interest payments. Thus, bond investors will literally *force* Congress to cut entitlement spending (whether directly, or, more likely, by raising the ages at which beneficiaries qualify) and rein in bloated discretionary costs like defense spending. Our budget deficit will be put on a more sustainable path, and interest rates will normalize.

This process has already begun in some of the peripheral European countries like Greece and Ireland. And in the coming years we'll see this scenario repeated throughout much of the developed world from Europe to Japan and even, ultimately, China (where excessive government spending is mainly directed toward infrastructure). These spending cuts, of course, won't be pleasant. They will almost certainly cause a recession, and probably a sharp one. But Americans will adjust, and the global economy will eventually regain its footing. It won't be the end of the world or of America as we knew it.

Now for the "possible" way out of this mess – It's conceivable that technological innovation will help to cushion the blow of draconian government spending cuts, which are all but assured. Specifically, rapid progress in new industries like alternative energy, biotechnology, nanotechnology, or something completely out of the blue could spur an economic revival that allows us to grow our way out of debt.

Although admittedly optimistic this possibility isn't without precedent. Throughout human history progress has been driven by advances in communications – beginning, most importantly, with the printing press in 1440 – which enabled a much faster and wider dissemination of ideas. Today we're in the midst of a second watershed event in communications – the Internet. New ideas now circle the globe instantaneously and collaboration among researchers happens in real time. We've only just begun to reap the benefits of this breakthrough, and I expect technology to progress at a rate that surprises even the optimists.

As always, rumors of America's demise remain greatly exaggerated. The elements that have made America the strongest economy and most vibrant society in history remain firmly in place. We continue to have unrivaled universities that draw the best and brightest from around the world. We continue to have an exceptionally open society that not only tolerates but welcomes smart entrepreneurial immigrants. America continues to be a place where parents see their children having the greatest opportunities to succeed and be happy, a place where people want to put down roots. So long as these attributes don't change, America will remain the world's city upon a hill.

Increasing taxes and liability

By: Chris Steele, CFP

The tax cuts that were enacted by President Bush in 2003 are set to expire at the end of this year bringing the top marginal rate to 39.6% from 35%. High income earners will also be hit by new taxes relating to the recent passage of the healthcare reform bill. Specifically, an additional 0.9% Medicare surtax on wages that exceed $200,000 for single taxpayers and $250,000 for couples is slated to begin in 2013. The healthcare bill further imposes a 3.8% Medicare tax on the unearned income (dividends, capital gains, interest, rent, royalties and annuities) of those taxpayers.

The healthcare bill provides coverage to an additional 32 million people, but failed to address the issue of tort reform. In addition to higher taxes, increased patient volume may increase physicians' risk of medical malpractice litigation.

There are several strategies one can employ to help shield assets in the event of a liability judgment. Most, unfortunately, are complex and expensive. A simple and relative cheap method, however, is to take maximum advantage of an ERISA qualified retirement plan (defined-benefit, 401(k), profit-sharing). A plan can fall under ERISA (the Employee Retirement Income Security Act of 1974) if it includes one or more non-owner employees.

For 2010, the contribution levels for various plans are:

Plan	Age 49 & below	Age 50 & above	
401k (employee) 401(k) / Profit-sharing	16,500 49,000	22,000 54,500	 Employee + employer max
Profit-sharing	49,000	49,000	Maximum is 25% of salary capped at $245k or $49K
SEP-IRA	49,000	49,000	Maximum is 25% of salary capped at $245k or $49K
IRA	5,000	6,000	Deductibility subject to income levels

Qualified ERISA assets have been protected from private creditors since a United States Supreme Court decision in 1992, though still subject to claims resulting from a divorce, IRS judgment, or criminal fines and penalties. Further, Congress extended protection of non-ERISA tax qualified plan assets and payments as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, including traditional and Roth IRAs, 403(b) and 457 plans.

Tax savings *and* asset protection: if these attributes are of value to you and you’re not currently taking advantage of a retirement plan, we can help you sort out the available options and decide whether adopting a plan is right for you.

Custody Issues

From the time that PASI was founded our client assets have always been held by an independent custodian (trust bank or brokerage firm). This structure provides additional checks and balances and another layer of security and comfort for our clients.

Spurred by recent events in the financial industry such as Bernie Madoff's multi-billion dollar Ponzi scheme, the Securities and Exchange Commission has broadened the circumstances under which an investment advisor is viewed to have "custody" of client assets to include the ability to direct transfer of client funds. As we addressed in a recent mailing, because we are *not* a custodian these regulations now require a client signature for distribution requests.

Existing scheduled account distributions are not affected. Any requests for a change or new distribution must be accompanied by a signed form. Please call our office with such requests and we will prepare the form, which we can mail, fax, or e-mail to you for your signature. We can then accept an electronic copy in order to act on your request, though we must also ask you to return the form with your original signature for our records.

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