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Enclosed is our quarterly newsletter we send to clients.

Pension Reform Law and Tax Planning

Now is a great time to do some tax planning to reduce your tax bill for this year. The new Pension Protection Act of 2006 signed into law in August is probably the most sweeping legislation in decades. Just like the Tax Increase Prevention Act we talked about in last quarter's newsletter, this act is a bit of a misnomer. For those of us that are still working the message can be distilled into these words; you're on your own. The government is making it easier for companies to terminate defined benefit pension plans and substitute defined contribution plans, where your retirement will be funded by you instead of the company. One important benefit is you can inherit a qualified plan such as a 401(k) plan from your parents and roll it into your own IRA. Know the rules for doing this as there are several traps that can result in immediate taxation. I have posted a summary of the new provisions on my web site at www.CompFinancial.com on the Documents page.

Sending Your Kids to College?

The landscape of options for helping you reduce the cost of college has changed significantly this year. Coverdell Savings Accounts, UTMA or Custodial accounts and 529 Plans are the vehicles most used. New financial aid rules give 529s the edge over UTMA accounts. UTMA accounts are considered the child's assets and 35% of these are expected to be used for college in the aid calculation. 529s are parental assets and only 5.6% of these are used in the financial aid calculations.

Most people miss many other options. Did you know you can pay your kids to help in your business or even just around the house as long as the child is 8 years old? The kids can then invest in their own IRA to prevent any "kiddy tax" problems. Once in college they can withdraw funds from the IRA without paying the usual 10% penalty on withdrawals before 59 1/2 as long as the funds are used for college. This will generate taxable income to the child, but you can then use several education tax credits such as the Hope and Lifetime Learning credits to eliminate any tax due.

Shifting income to the kids can save reduce you taxes by thousands of dollars every year. If you would like to put a college savings plan together, give me a call.

Against the Gods

Peter Bernstein's book "Against the Gods" tells a fascinating story of how the concept of risk management has evolved over the centuries. Most of my clients understand returns but don't really understand what risks they are taking and how risks can be managed. The best quote I've heard is "you can't manage the market but you can manage how much risk you take in the market".

One of the more interesting aspects of the book is the remarkable spectrum of backgrounds of the people involved. For centuries the government of England sold annuities on the lives of it's citizens to fund various activities, mostly ventures in overseas conflicts. Before 1789 a 21 year old could purchase a lifetime annuity at the same cost as a 51 year old. To bad annuities aren't that simple now. It took the famous astronomer Edmund Halley to determine a more equitable pricing model. Yes, this is the same Halley for which the famous comet was named.

Daniel Bernouli, a Swiss mathematician in the 18th century, was one of eight in his family to distinguish himself in the sciences and other endeavors. In my previous life as an engineer I knew his name from "Bernoulli's Law". Daniel's simple formula is the basis for understanding many modern miracles of science, such as how one can build a plane to fly. More remarkably, Bernouli more than any other, developed an understanding of human behavior and their aversion to risk. He was able to take game theory and probability beyond just the numbers and develop an understanding of the human element that no psychologist had ever even contemplated. For those who would like to gain some understanding of why we do some of the silliest things when faced with risk, it's a good read.

Market Overview

This is the first time our portfolios have trailed our benchmarks in eight quarters. Many reasons combined to produce this result including our allocation to commodities, our overweight to small-caps and growth stocks. The larger-cap S&P 500 index gained 5.6% for the quarter. Smaller-caps were nearly flat, gaining 0.4%. Other asset classes were also positive for the quarter: domestic investment-grade bonds and international stocks were each up about 4%, while short-term local currency emerging-markets bonds gained almost 3%. In contrast, commodity futures lost 6.5%.

From its most recent bottom in mid-July, the S&P 500 is up almost 9% and has made new highs for the year. However, the small-cap, NASDAQ and foreign stock indexes have not followed suit with the large-cap index in reaching their highs set in early May. This change in leadership is significant in that the large-

caps have been trailing small-caps for over five years, matched them over the last year and have taken leadership over the last five months.

By most measures large-cap stocks look cheap. At the beginning of September we reduced the small-cap exposure in our portfolios and moved the proceeds into large-caps. In reaching this decision, we looked at data from several sources, and in every case these metrics showed small-cap valuations at or near the high end of their historical range relative to large-caps. We also believe that cyclical considerations favor a lower small-cap weighting. We're well into the economic cycle, and small-caps' best periods of relative performance typically come early in the cycle.

While we did increase the average market capitalization of our portfolios by around 20% to \$14 billion, our portfolios are still below the benchmark market capitalization of \$25 billion. Our preference for small-caps over the long run is still in place, just not as much so. While we may lag our benchmark for some time, we are confident over the long run our allocation to small-caps will add value.

Growth stocks continue to look slightly cheap relative to value stocks on a statistical basis, an opinion which has also been voiced by many of the managers we respect. Although our allocation to growth and value mutual funds are evenly weighted, some of our value and core managers are seeing more value in traditional growth companies, resulting in real portfolio allocations that have been leaning to the growth side of the Morningstar style matrix, and doing so increasingly over the last year. Although this overweight to growth has hurt our performance this year, we are confident going forward.

Our commodity index allocation hurt our performance this quarter and over the last year. We will continue to use this effective diversifier and hedge against inflation and rebalance our portfolios when appropriate.

On the fixed-income side, high-quality bonds, generally the best-performing asset class during recessions, have an important role to play in our balanced portfolios. With the Federal Reserve finally putting on hold the string of interest rate hikes that began more than two years ago-prompted by decelerating earnings growth, a slowdown in the housing market, and a drop in oil prices, among many other factors-we believe that the risk of recession is greater today than in recent years. Therefore, we need to manage our portfolios with an eye towards this and other risks. Similarly, our position in emerging-market short-term local-currency bonds provides valuable diversification and the potential for better long-term returns than domestic bonds. This will be especially important if we are right that the US dollar will continue to decline against the currencies of some of our important trading partners, such as China, Mexico, and those in Latin American and Asia.

Let me know if you would like to meet to discuss your financial needs.

Sincerely,

Stan Johnson
Registered Investment Advisor
Comprehensive Financial Planning, Inc.