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CLIENT NEWSLETTER

SPECIAL EDITION

What going on!? Banks are failing, the stock market is raging and plunging. Is 1929 here again!? Or the 1970s?

In this Special Edition of our Newsletter we'll try to give you brief, non-technical answers to those questions. And just to put things in perspective: One trillion dollars ($1,000,000,000,000), if stacked in one-dollar bills, would be about 80,000 miles tall, or about 1/3 the way to the moon!

Let's start with the US Economy. Statistics now show that we have been in a recession since February-March 2008. We have lost jobs every month in 2008, with 159,000 lost in September alone. One of the things driving the stock market today is the recognition of these facts. Gross Domestic Product *went down* in the third quarter by 0.3%.

What about the banks? Several factors were at work in the banking, investment banking, and stock brokerage industries. In 1999 the Gramm-Leach-Bliley Act repealed major portions of the Glass-Steagall Act of 1933 which prohibited banks, investment banks, securities firms, and insurance companies from offering each others services, or coming under common ownership. The Glass-Steagall Act was intended to prevent the excesses of the financial community in the 1920s that ultimately led to the Crash of 1929. The Gramm-Leach-Bliley act removed many of the protections of the Glass-Steagall Act.

As a result of this, and other relaxation of regulation, the financial services industry (as it then came to be called) was permitted to engage in highly speculative activities, previously restricted. The activity that has received the most attention in the current crisis is the marketing of mortgages, especially "sub-prime" mortgages. (For simplicity, for the rest of this article, the term "Bank" means a traditional bank, investment bank, brokerage house, Fannie Mae, Freddie Mac, or any other financial institution that engages in banking activities.)

How did this work? When Harry took out a mortgage from Bank ABC, the bank immediately sold his mortgage to another financial institution, Bank X, who combined Harry's mortgage with many other mortgages, creating a package of mortgages. Bank ABC got all of its money back immediately, plus the value of the future payments of interest. Bank ABC might continue to collect the monthly payments (for which it is paid a fee), or it might sell the job of collecting payments to someone else.

The biggest Bank X's are Fannie Mae and Freddie Mac, corporations organized by the US Government for the express purpose of making it easier for people to get mortgages. The debts of these companies are guaranteed by the federal government.

Fannie, Freddie, or Bank X then sold "shares" of the package to other investors. These shares were called "Collateralized Debt Obligations" or "CDOs". Many buyers of CDOs were themselves banks, other financial institutions, and Fannie & Freddie. Bank Y bought a CDO for a portion of the package containing Harry's mortgage. It also bought CDOs in other packages of mortgages. Then it took a bunch of CDOs it had bought (each representing shares of different packages of mortgages), and combined the CDOs into Super-CDOs (which became known as "CDOs-Squared"). Are you following this!?

The problem was that once these elaborate pieces of paper (the CDOs) were widely circulated, everyone lost track of what the underlying mortgages were. Many of them were loans granted to weak borrowers. This meant that no one really knew what a particular CDO was worth. Just because Fannie, Freddie, or Bank Y paid $100,000,000 for a CDO did not make it worth that much. When people began to default on mortgages, everyone began to doubt the value of CDOs.

Why did banks lend to people whom they knew were likely to default? Why did they advertise that anyone could get a mortgage, even with poor credit ratings and unverified income, assets, and debts? Because (1) banks and mortgage brokers earned large fees by granting mortgages, and (2) the banks did not care about repayment because they knew they would immediately sell the mortgages.

So what happened to those CDOs? First, the two largest companies that rate the quality of debt, Moody's and Standard & Poor's, gave these CDOs their highest (that is, safest) rating, AAA. Triple-A debt is considered by most to be nearly as safe as US Government bonds. As the crisis unfolded, Moody's and S&P admitted that they had erred. Second, new accounting rules went into effect on November 15, 2007 (known as FASB 157) which forced corporations to value financial assets at the price for which they could be *sold*. That meant that CDOs (and other exotic investments) had to be looked at from the point of view of a *skeptical buyer*, rather than an *optimistic owner*. This forced banks to "write down" the value of CDOs to realistic values, which they could only estimate. (That's why they continue to take more write-downs.) When a company lowers the value of something it owns, it is reported as a "loss" on the company's financial statements.

"Writing down" billions of dollars worth of losses meant that many banks that had before appeared financially solid, were, in fact, financially weak. Their assets were an illusion: Bear Stearns, Lehman Brothers, Washington Mutual, Countrywide, to name but a few.

Weak banks are not trusted, even by other banks. Until mid-October banks were so untrusting of *each other* that they would not lend even *to each other*, much less to businesses or individuals. So business loans, car loans, mortgages, etc.

became basically unavailable. That is what is known as a “credit crunch”, and that’s where we are today.

But there’s more. Loans, bonds, and CDOs, are debt obligations. They are pieces of paper that essentially say, *I promise to pay* a specific sum of money at a specific time(s), and pay a specific rate(s) of interest. Suppose you had loaned money to Company C, and later became nervous about C’s ability to pay its debt to you. You could by *insurance* that guaranteed you would get your money back. All you had to do was go to a company that sold “Credit Default Swaps” (“CDS”), and they would sell you a CDS on the debt you were nervous about. The giant insurance company AIG was the largest seller of CDS’s.

You would then have two choices: You could keep your insurance policy (your CDS), or you could *sell it* to someone else. If Company C’s credit worthiness got worse, the value of your CDS would go up, as other creditors of Company C got more nervous.

So banks, brokerage houses, and insurance companies were buying and selling CDS’s to one another. The problem was that just as no one knew what CDO’s were worth, neither did they know what CDS’s were worth! *Fortune Magazine* (9/30/08), in an article entitled “The $55 Trillion Question” estimated there are $54.6 trillion of CDS’s on the market. Ultimately the CDS’s that guaranteed the CDO’s were in danger of being called upon to make good on their guarantees. (Read that again.) And AIG (and others) would not have enough money to honor their obligations under the debt insurance (CDS’s) they had written. This meant that (1) AIG required a federal rescue of more than $125 billion, and (2) banks had more worthless assets (the CDS’s) requiring more write-downs (losses).

Finally, and this gets worse, unlike stocks, bonds, and bank accounts, CDO’s and CDS’s came under *absolutely no government regulation* of any kind. Banks were even free to *borrow money* to enable them to buy this paper of unknown value (“junk”). And most of them did. They took real cash, much of it borrowed, and spent it on junk. What would happen to your personal finances if you did that? Therefore, when this house of cards began to come down, the banks not only had worthless (or nearly worthless) assets, they had piled up huge amounts of debt that, without those assets, they could not possibly repay. When Lehman Brothers went under, *it owed 30 times as much* as it was worth. And they aren’t the only with a debt ratio like that.

What can you, as an individual do?

The first thing is not to panic, because panic leads to irrational decisions. Everyone who has investments (and remember, an IRA, 401(k), pension plan, or bank certificate of deposit is an investment), should have a talk with their investment advisor. Based upon individual circumstances, particularly age, this may or may not be a good time to change your investment strategy. There are also tax consequences when investments are sold. Retired people in particular should probably look at much more conservative investments, including annuities (see attached article) and US Government bonds.

If you are working, and your employer is laying people off, or you suspect they will do so in the near future, start looking for a new job *now*. When job hunting, you are always in a better position if you are employed, rather than unemployed.

If you own your own business, you need to look carefully *now* at how the recession is going to affect both your income and expenses. Perhaps the recession has already impacted your business. You need to have a plan for any eventuality.

If you have a variable rate mortgage, you should be watching the mortgage market carefully. At some point in time, re-financing to a fixed rate will not only be advisable, but immediately cost effective. There are still good mortgage brokers who will do this for you.

If your house has declined in value, you have no cause for concern *unless* you are (1) being forced to sell (to relocate to a new job, for example), or (2) looking to re-finance out of a variable rate mortgage, or (3) need to re-finance for some other reason (such as to pay college costs). *Under no circumstance* should you stop making your mortgage payments just because the house is worth less than the mortgage. Unless you are being *forced* to sell or re-finance, defaulting on your mortgage will always hurt you.

If you have suffered a severe decline in income due to a lost job or pension, lower income from investments, or other reasons, and you cannot pay your mortgage or other debts, it is often possible to negotiate with creditors for more favorable repayment terms. There are several proposals being considered by the federal government to *force* renegotiation of mortgages, rather than foreclosing.

If your house is in foreclosure, negotiation might still be possible. So might a "short sale" which involves you selling the house for as much as you can get, and the bank agreeing (in advance) to accept whatever you get as payment in full of the mortgage.

Most experts believe that the markets will go back up, but no one knows when or by how much. Most believe that the current recession will end, but no one knows when, or how deep the recession will be.

Hopefully we will come out of this with as little long-term harm as possible. But there is no doubt that we are all in for financial pain, at least in the short term.

Please feel free to call or write if you have any questions.

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Dan and Eric

Non-qualified Deferred Annuities and How They Work

There are many different kinds of annuities. Non-qualified deferred annuities are purchased with after-tax dollars and are commonly used as a way to supplement qualified retirement plans, such as a 401(k) plan. Like qualified plans, any earnings on non-qualified annuities are tax-deferred and can provide retirement income. But annuities have certain features which distinguish them from qualified plans.

Annuities are long-term financial products that are designed for retirement purposes and may be fixed or variable. Fixed annuities are guaranteed* by the contract to pay a fixed rate of return over a fixed period of time. Variable annuities fluctuate with the underlying securities. Investment options for many variable annuities include portfolios that contain stocks, bonds, money market instruments or a combination. Annuities may be purchased by making a lump sum contribution. In addition, some annuities allow you to make additional contributions (by check, or in some cases, through electronic fund transfers).

Choice of Payout

One feature of an annuity is that you can decide how you want to receive your annuity payments during your retirement: in a lump sum payment, over a specified period (such as 20 years), over your lifetime, or over your lifetime plus the lifetime of someone else.

Growth Potential

Like qualified retirement plans, any earnings from annuities are tax-deferred until the money is withdrawn. This feature can make annuities a useful supplement once you have made the maximum contributions to your qualified retirement plan.

Because non-qualified annuities are purchased with after-tax dollars, they are not subject to many of the limitations of qualified retirement plans. For example, the government does not limit to the size of contributions you may make to an annuity and you don't have to make withdrawals from your annuity until you are age 85 or, in some cases, even older. This means that your money can potentially grow over a longer period of time.

Benefits to the Beneficiary

Another feature available with some variable annuities is the guaranteed minimum death benefit.* If you die before your variable annuity begins payout, your beneficiary is generally guaranteed to receive a death benefit equal to all the premiums you invested (adjusted for withdrawals)—even if the current value of your investments has declined. Also, annuities pass to your estate free of the potential difficulties, delays, and costs associated with probate, however, the value of the annuity is included in the estate for income tax purposes.

While non-qualified deferred annuities have many benefits, they are not for everyone. They are not suitable for short-term goals because company imposed surrender charges are imposed in the contracts early years. Variable investment options within variable annuities are subject to fluctuation in value and market risk, including the possibility of loss of principal. There are contract limitations, fees and charges associated with annuities which include, but are not limited to, mortality and expense risk charges, sales and surrender charges, administrative fees, and charges for optional benefits. A financial professional can provide cost information and complete details.

Withdrawals from annuities are subject to normal income tax treatment and if taken prior to age 59 1/2 may be subject to an additional 10% federal income tax penalty. Withdrawals may also be subject to a contractual withdrawal charge.

Please consider the charges, risks, expenses, and investment objectives carefully before purchasing a variable annuity. For a prospectus containing this and other information, please contact a financial professional. Read it carefully before you invest or send money.

Talk to your financial professional to determine if a non-qualified deferred annuity is a suitable choice as a supplement to your retirement planning needs.

*Guarantees are based on the claims paying ability of issuing Insurance Company

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