



September 30, 2009

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3rd Quarter 2009

These are Interesting Times

The best aspects of a financial crisis are the new perspectives that arise as people look at where we have been and where we might be going. The information below is a collection of interesting insights. We're not sure where they will go, but we are looking forward to finding out the results.

The three decades after World War II saw the rise of the middle class, whose income gains outpaced the gains of the wealthy. One reason may have been the top marginal income tax rates, which ranged from 70 to 91%. Did the wealthy have less incentive to make money, or did the high tax rates reduce the amount of capital they had to invest in wealth building?

The recent period has been one in which considerable wealth was created not by the economy of producing and selling goods and services, but by selling assets back and forth. In the savings and loan crisis of the 1980s, institutions were selling commercial property back and forth to each other, marking a profit on each transaction, even though no actual value was added to the property. Much the same took place in a more esoteric manner with collateralized mortgage securities. If this was an abnormal period, where do we go from here?

Bull or bear? According to historical data and a still struggling economy, we may be in a cyclical bull market in a secular bear market, says Tom Lauricella in a June 15, 2009 *Wall Street Journal* article, "Is This Bull Cyclical or Secular?" If he is right, the market's run up in the second and third quarters is a temporary respite in a longer-term bear market.

If you are feeling poorer, you are not alone. Net worth of American households (difference between assets and liability) at the end of 2008 was down nearly 18% from 2007, according to the Federal Reserve. Net worth fell another 2.6% in the first quarter of 2009, according to Fed data. Household liabilities are also on the decline, falling 2% in the fourth quarter and 1.2% in the first quarter of 2009.

There's a lot of money sitting on the sidelines. According to ICI statistics, there was in excess of \$ \$3.6 trillion in money market mutual funds in mid-August 2009. That is nearly 24% of the value of U.S. equities, estimated at around \$15.2 trillion.

What this will mean to your investments remains to be seen, but with active management, we have the flexibility to respond to changes. And that can make all the difference.

According to a 2005 study from Harvard University, medical bills trigger more than 50% of all bankruptcies, even when individuals have health insurance.



Your Most Important Investment

If there is one single investment with the potentially highest payout, we would argue that it is maintaining a healthy body. All too often in the pursuit of financial health, we forget that we also need to invest in caring for our physical health.

Universal health care insurance, increased Medicare and all the benefits sought by health care legislation are only of value once health is broken. And, even with the best health care program, there can be no guarantees that medical intervention will restore your health or that poor health won't destroy your financial security. According to a 2005 study from Harvard University, medical bills trigger more than 50% of all bankruptcies, even when individuals have health insurance.

Exercise and a good diet are the first steps. If you are over weight, the most important change you can make to add longevity and comfort to your life is to lose weight. Being overweight can cause joint and back problems, acid reflux, sleep apnea, foot pain, and more, and contributes to carpal tunnel syndrome, diabetes, heart disease and some cancers.

While it would be nice to have perfect health habits, even minor changes in your behavior to get more exercise, eat better, etc., are better than none.

There's lots of help out there for finding what constitutes the right diet and exercise for your life. You just have to set aside time to do the research and then follow through.

The next step is to take care of small problems before they become big problems. Medical issues are a lot like market declines. They rarely happen without signaling their onset. Getting regular health screens are a start, but you also have to pay attention to yourself.

Successful people often have difficulty admitting that they have problems, particularly when the problems seem minor. But when small problems are persistent and don't go away, find out why. Once you have a medical diagnosis, ask questions. Don't accept the doctor's opinion as the final word without confirmation. It's hard to forget the following doctor's quote. "Until we do the autopsy, we're just guessing." Your goal is to avoid the autopsy by making certain the "guesses" are as accurate as possible.

In all the posturing and position statements on providing health care for all, you can't afford to overlook the fact that you are the only one who can give yourself a healthy body. The medical professional can fix some problems, but all too often the root cause of the problem is the patient. The best health care coverage you can have is coverage you don't need.

Can You Trust the Caller?

Just when almost everyone has caught on to the fact that it's not a good idea to blindly respond to emails seeking personal information, phishers have turned our phones against us as well, with a twist. Now it's possible to get a call that Caller ID identifies as your bank that is actually fraudulent.

Through the use of Caller ID Spoofing technology, phishers are using a financial institution's number to fool Caller ID. A typical scam informs the phone user that the person's bank account has been compromised or credit card/ATM card has been deactivated. The potential victim is directed to call a number or go to a spoofed Web site to reactivate the card. There, the potential victim is asked for account and PIN numbers or other information that can be used to drain the account or post fraudulent charges.

Avoiding fraud is a simple matter of contacting your bank, credit union or credit card issuer directly, using numbers and web sites found on the back of your card, statements and other documents. "Trust no one, assume nothing" may seem like a harsh way to face the world, but when it comes to protecting your financial security it's good advice.

President Harry S. Truman is claimed to have said he wanted a “one-armed economist” due to the fact that his economic advisors typically gave him advice stating, “on the one hand...and on the other hand...” They knew every forecast carries with it a sizeable possibility of error in a variety of directions. Like Truman, many of us wish we could predict the future. More than ever, in these volatile times, and with word that the recession may be ending, investors are asking, “What’s next?”

We continue to be encouraged by progress on the economic front and are addressing asset allocations as needed. The “training wheels” of the economy are slowly being removed. However, can the Fed engineer a successful exit strategy and still maintain economic momentum? With continued signs emerging that the capital markets have become more settled, attention in the investment community has turned to post-crisis policy. Especially where the Federal Reserve is concerned, many investors worry about the inflationary effects of the flood of liquidity it has poured into markets since September 2008 in an effort to relieve financial strains. Investors are interested in the Fed’s plans to absorb the excess liquidity and stem the inflationary threat it carries.

Fed chairman Ben Bernanke, sensitive to these inflation concerns, wrote a recent Wall Street Journal article to affirm the Fed’s commitment to an exit strategy and lay out its options in pursuing such a policy change. Though he acknowledged the “need to tighten monetary policy to prevent the emergence of an inflation problem down the road,” he concluded that the economy remains weak enough so that “accommodative policies will likely be warranted for an extended period.” The circumstances as described by Bernanke and as characterized by an array of statistics suggest that policy will wait a while to change. Even so, it offers a measure of comfort that the Fed has outlined its exit strategy for avoiding the inflationary implications of its past acts once the crisis abates. We’ll be watching the Treasury yields and credit spreads as the Fed’s programs come to an end, as any sizeable increase in yields or spreads could bring a quick end to the stabilization we’ve seen in the housing market and the tenuous recovery we’ve seen in the economy.

Remarkably, more than a dozen countries posted growth in their GDP during the second half of 2009, benefiting from unprecedented global stimulus. While the United States was not among those nations that posted growth, US companies are benefiting from the dual forces of resumption in global demand, as well as weakness in the US dollar, with 40% of revenues for companies in the S&P 500 index being internationally driven. The S&P is now trading more than 20% above its 200-day moving average – a feat only seen three times historically. A correction would not alarm us as the market might need to catch its breath after the stellar run that saw most major averages move up over 50% from the March lows.

Economists will most likely continue to have “two hands” as the economic data we are presented with remains a mixed bag and investors try to make heads or tails of the slow global rebound. We expect this theme to play out over and over again in the months ahead.

Pay No More Taxes than Necessary

One of the most important rules of achieving and maintaining financial security is to pay no more taxes than required. Any time you can minimize or defer taxes you have more money to invest for retirement, education, a new business and so on. If you aren't already doing so, you need to talk to your financial adviser about the following:

- Maximize tax-deferred and tax-free investments by contributing the maximum to qualified retirement plans and education savings plans. This reduces taxable income.
- If you are in the 10 and 15% tax brackets you have a unique opportunity to fund a Roth IRA in terms of a 0% capital gains tax rate through 2010. Qualified investors can take a highly appreciated long-term investment, sell it at 0% capital gains and invest up to \$5,000 per person (\$6,000 if you are over age 50) in a Roth IRA.* That could be up to \$12,000 for a couple.
- Starting in 2010, the existing \$100,000 income test for converting a traditional IRA to a Roth IRA will no longer apply. You can convert an ordinary IRA to a Roth IRA, paying income taxes on half the conversion amount in 2011 and the other half in 2012.
- Homeowners in areas hit by tumbling property values should appeal their tax assessments. Many homes were last appraised by counties prior to the housing crash.

Track expenses that can be deducted! Investment expenses, medical expenses, some educational expenses and more qualify as income tax deductions, although there are some minimums to be met.

Paying for a College Education

One of the big reasons for saving is to enable your children, or your grandchildren, to attend college. The caution is that **you should never** finance your children's higher education at the expense of funding your retirement. There are a lot of ways to finance a college education from loans to scholarships, work study programs and more. Your resources for retirement are very limited. There are no loans, grants or scholarships to retire. In the end it comes down to what you have accumulated.

With that said...what are some of your options when it comes to paying for a college education?

One year of tuition, room and board at a public university averages \$14,333 for in-state students; \$25,200 for out-of-state students according to 2008-2009 data from the College Board. Private universities average \$34,132 per year. Textbooks can add another \$800 to \$1,000 a year. For more information on specific universities in your area, visit the schools' web site.

To pay that cost, you have five primary resources:

- (1) Savings.
- (2) Student loans.
- (3) Grants/Financial aid.
- (4) Scholarships.
- (5) Work study programs.



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Which of these resources you will have access to is going to depend to a degree on your family's financial status. The more money you have, the fewer the resources for which you will be eligible. The exception is the 529 plan, where everyone is eligible and the contributions are substantial (more than \$300,000 per beneficiary in many state plans).

In this article, we look at vehicles for college savings, but the following are some very informative web sites on the other four resources. <http://www.college.gov/> and <http://studentaid.ed.gov> are great starting points for student loan information. At <https://studentaid2.ed.gov/getmoney/scholarship/> you can search for scholarships by area of study. <http://www.ed.gov/programs/fws/> offers a look at federal work study programs that offer part-time employment to offset post-secondary education costs.

529 plans are state-run with assets professionally managed either by the state treasurer's office or by an outside investment company hired as the program manager. Although contributions are not tax deductible, investments grow tax-deferred, and distributions to pay for the beneficiary's college costs are federally tax-free. Unfortunately, very few of these plans fared well in the recent market downturn.

Types of 529 plans

529 plans are usually categorized as either prepaid or savings plans.

Savings Plans work much like a 401K or IRA by investing your contributions in mutual funds or similar investments. The plan will offer several investment options from which to choose and will go up or down in value based on the performance of the particular options selected.

Prepaid Plans let you pre-pay all or part of the costs of an in-state public college education. These plans may also be converted for use at private and out-of-state colleges. The Independent 529 Plan is a separate prepaid plan for private colleges.

Many states offer incentives to their residents to use the state's plan, but you can invest across state lines in plans offered through other states. Just make certain you understand how those plans will be treated with respect to your state income taxes.

Contributions to **Coverdell Education Savings accounts** are limited to \$2,000 a year and are not deductible. But earnings are tax free if used to pay college costs or expenses for elementary and secondary school education including private and parochial schools. To contribute to a Coverdell your adjusted gross income must be under \$110,000 if you are single or \$220,000 if you are married and file a joint return.

Roth IRA. Because Roth IRA contributions can be withdrawn any time tax- and penalty-free, this retirement savings account can be a powerful college-savings tool. Over ten years, for example, parents could contribute a total of up to \$100,000 to Roth IRAs, and it could all be withdrawn tax- and penalty-free to pay college bills. Earnings can be withdrawn penalty-free to pay education bills, too, although taxes would be due on that amount ... unless the parents were over 59½ at the time

IRA withdrawals for education. A taxpayer under age 59½ can avoid the 10% penalty on early IRA distributions used to pay higher education expenses for his or herself, a spouse or a dependent. However, the payout from a traditional IRA is taxable at your personal income rate.

Savings bond interest. Interest on Series EE savings bonds bought after you turned 24 can be excluded from income if the proceeds are used to pay college costs for yourself, your spouse or a dependent, if you meet adjusted gross income qualifications.

Don't overlook the value of simply building your own financial net worth. After all, very few wealthy people can't afford to send their children to college.

3rd Quarter Newsletter

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