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Lessons Of The Auction-Rate Securities Crisis

For most of this year, thousands of people have been unable to gain access to large sums of money they placed in investments they had been assured were "just like money-market funds." But auction-rate securities are not just like money-market funds, a fact that became clear to most investors only after the market for these securities crashed in the throes of the credit crisis of 2008.

Federal and state authorities accused major Wall Street investment banks of continuing to sell auction-rate securities after it became clear the market was collapsing. After regulators threatened to take action against these firms—including Citigroup, UBS, and Merrill Lynch—and Congress scheduled hearings, the companies agreed to buy back the securities at full value and pay multibillion-dollar fines. The institutions deny allegations of wrongdoing.

As the wreckage was cleared away, investors can step back and consider lessons to be learned from this latest example of financial excess.

Since the introduction of auction-rate preferred shares in 1984, the market for the securities has grown into a $330 billion business. Investors have been attracted by normally quick access to their cash and interest rates that are generally higher than those of money-market funds and certificates of deposit.

Auction-rate securities typically consist of bundled corporate and municipal bonds with long-term maturities. The interest rates the securities pay are reset at weekly or monthly auctions, and because rates aren't locked in for long periods, investors are never stuck with below-market yields. Moreover, because the issuers of these securities—ranging from mutual fund and student loan companies to nonprofit entities such as schools, museums, and municipalities—tend to be respectable groups looking to raise cash, auction-rate securities have been touted as solid and safe.

Trouble with the securities began when buyers, spooked by the widening credit crunch, fled complex investment instruments. With no one buying at the securities auctions, there was no cash to pay investors who wanted to withdraw their funds. Yet, according to allegations in numerous lawsuits, Wall Street firms not only kept selling auction-rate securities but also failed to warn clients about the danger.

The attorneys general of Massachusetts and New York began investigating the firms marketing auction-rate securities, and some of the larger firms have agreed to buy out their clients. That may sound like a happy ending, but the many investors who for months had no access to their money won't be compensated for having their funds frozen.

State investigators allege that the

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And Now, Behind The Headlines...

Amidst all the "sturm und drang" of the financial markets and the economy, we find it heartening that life goes on: babies being born, people being kind and charitable. Indeed, if we look past the constant scab-picking of the media, there are wonderful stories of hunger being fed, grief being consoled, science healing disease, votes being cast peacefully.

By the same token, while the decline in housing prices has brought down our personal net worth, it has made it possible for others to buy their first homes with reasonable down payments and honest mortgages. And this isn't the first time that real estate values have gone down; those of us with memories that go back to the '80s also remember that eventually they went back up.

The fears in the credit market have created amazing bargains for prudent investors—"prudent" now defined as having some cash. Municipal bonds yield more than Treasury bonds and remain tax-free, to boot. And stocks? How about blue chips paying dividends that amount to something now?

We hope you get something of value from this edition, whether it's about your pets (look for the opening of the beautiful and amazing new facility of the Humane Society, Silicon Valley in Milpitas) walking for health, or your IRA.

Regards from your team at LWWAG,

Curt

A Walk Every Day Can Keep Aging At Bay

It's much easier to talk the talk about staying young than it is to walk the walk. Starting in our 20s and 30s, we commence a long, seemingly inevitable physical deterioration. Our maximum heart rate declines, and with it the amount of oxygen-bearing blood the heart can pump. Muscle is gradually replaced with fat and weight edges upward. And decade by decade, as oxygen intake drops, it becomes a little harder just to get around. Eventually, in our 70s, 80s, or 90s, most of us lose our "functional independence," the ability to live on our own. We move to assisted-living or nursing homes because, literally, our living needs to be assisted.

But what if there were a simple way to turn back the clock? In a recent article in the British Journal of Sports Medicine, Roy Shephard, a physician at the University of Toronto, reports that for people 64 and older, a vigorous, hour-long walk five days a week cuts a dozen years from their biological age. In a review of other published work on the subject, Shephard found that such an exercise program could also extend a person's functional independence, which tends to be lost when maximal oxygen intake falls below 18 milliliters per kilogram per minute in men and 15 ml/kg/min in women.

Without this kind of exercise program, about 10 years of physical aging normally corresponds with a loss of about five ml/kg/min. But Shephard found that beginning a program of vigorous aerobic exercise could restore about 25% of maximal oxygen intake within three months, raising that essential level by an average of six ml/kg/min and decreasing biological age by 12 years.

Shephard also found that regular exercise provides other benefits, helping prevent conditions that may hasten aging including obesity, high blood pressure, diabetes, heart disease, osteoporosis, and even some kinds of cancer. And the improved muscle tone that comes with brisk walking, swimming, or other aerobic activities may help older people avoid falls.

Another study, from Texas, further highlights what exercise can do. In 1966, five healthy 20-year-olds were kept in bed around the clock for three weeks—and suffered many of the ills normally associated with aging. They gained weight, their heart rates and blood pressure rose, and their hearts lost pumping capacity. Then, an eight-week exercise program more than reversed the effects of inactivity. In a follow-up with the men 30 years later, actual aging had imitated the effects of the forced bed rest. But here, too, an endurance exercise regimen undid most of the damage, restoring all of their lost aerobic capacity.

The moral? Exercise always helps, and it's never too late to start pushing back the hands of time. ●

When You Can No Longer Care For A Pet

If you own a pet, you know that somewhere ahead lies the heartbreaking day your companion will die. But what if you die first? Or become incapacitated? Under U.S. law, pets are counted as personal property, in the same category as clothes, a home, vehicles, and other possessions. If you die without making provisions for a pet, the beneficiaries of your estate will become the animal's legal owners. Similarly, if your health deteriorates or you have to go into the hospital or a nursing home, you'll have to hope family members or friends will take in your pet.

That may be fine; your children, for example, may be more than happy to take care of your cat or dog either temporarily or permanently. But if you know they couldn't or wouldn't want to take on that responsibility, a "pet trust" could establish who will take your pet, how it will be cared for, and how the care will be funded. This may be a necessity if you live alone and have no heirs; if you are elderly or ill; if your pet has special needs; or if your pet has a long life expectancy, such as certain birds and snakes that may survive for decades. Of course, even dogs and cats may live for more than 20 years.

Setting up a trust is one option in a five-step process to protect your pet, according to estateplanningforpets.org.

• Select a caretaker. The person or organization that will care for your pet must be willing and able to do it. Make sure the designated caretaker understands your pet's needs, and arrange a time for them to get to know each other. Also discuss funding for care and any compensation for the caretaker.

• Get paperwork in order. You'll need documentation identifying your pet, veterinary information, care instructions, and any trust or other legal documents.

• Ensure access. Give the caretaker

A Time To Recall Financial Planning Basics

Just a few years ago, almost everyone knew at least one person who had made a fortune in the stock market. Today, many of us have lost a fortune. For those who are wondering what went wrong, here's a refresher course in financial planning basics.

Diversification. In the late 1990's, many investors thought diversification meant buying three computer stocks and two Internet stocks. Others assumed they were being prudent because they owned a dozen mutual funds. But true diversification means buying a range of investments in markets that do not move in lockstep with each other. Through most of the 1990s, growth stocks were the spectacular performers; in recent years value stocks have been successful. A balanced portfolio will have both. It will also include bonds. But just starting out with the right mix isn't enough; you also need to rebalance your portfolio regularly, trimming positions that have done well and adding to others that may be poised to rebound.

Planning. Establishing clear life goals and a long-term strategy is the essence of sound financial planning. A solid plan lays out the amount you must save annually, assuming an expected average rate of return, to reach your financial targets. It prepares you for future expenses, such as a child's college education, and unexpected setbacks, such as premature death or disability.

Saving. Money doesn't grow on trees, but it does grow provided you invest it. The more you put aside and the longer you allow it to compound, the better off you'll be. The rule of 72 is the easiest way to see how this works*. Simply divide 72 by your rate of return to get the number of years it will take for your money to double. For example, with an 8% return, your investment will double in nine years and quadruple in 18. A steady, automatic withdrawal from your paycheck is probably the most effective way to save. That way, you don't miss the money, because you never see it, and you're able to load up on assets when they're doing poorly and reap the benefits when they go up.

Retirement contributions. The government rewards savers by offering tax benefits to retirement accounts such as 401(k)s, 403(b)s, and IRAs. In most cases, you contribute pre-tax dollars and the money grows tax-deferred, meaning you don't owe taxes on gains until you withdraw the money. With Roth IRAs, you contribute money that has already been taxed but your withdrawals are tax-free. Either way, the boost from Uncle Sam is so generous that it's worth stuffing as much as possible into retirement accounts before allocating to regular savings and taxable accounts.

Tax planning. Hidden within hundreds of pages of tax laws are a broad range of special breaks for taxpayers. Shifting income from one year to another, selling assets that have lost money to balance out gains from top performers, and making contributions to educational savings accounts are just three possibilities. Review your tax situation with a financial professional at the beginning of the year and again in December.

Insurance. Planning for the unexpected is the key when determining insurance needs. You should have enough life insurance to meet heirs' long-term needs. Your health insurance should include coverage of catastrophic accidents or illnesses. Disability insurance is relatively inexpensive, but could make a big difference if you need it. And you should seriously consider long-term care insurance if you don't think your retirement income will be sufficient to pay for nursing home care.

Estate planning. Having the right estate plan will ensure that your wishes are respected. If you have substantial assets, developing a well-thought-out estate plan can minimize taxes even while you are alive and maximize the amount you are able to leave to loved ones and your favorite charities. Even if you don't have enough in your estate to be liable for federal or state estate taxes, having a valid will can save your heirs a lot of trouble and money.

In the dying days of the 20th century, there was talk about how the old financial rules no longer applied. "It's different this time," everyone said. But it wasn't all that different, and millions of investors lost ground and time on the road to their financial goals. It's never fun to start over, but it does give you one more chance to do everything right. Taking care of these basics should prepare you well, and we are happy to help. ●

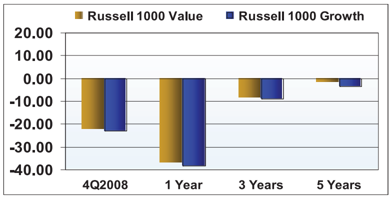
***The Rule of 72 is hypothetical and there can be no assurance that any investment will double within the specified timeframe.**

keys to your home and the location of pet-related documents.

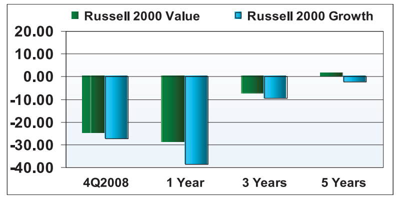
- Calculate funding needs. Estimate what it will cost to take care of your pet. Take into account everything from food and vet bills to grooming, boarding, and other costs.
- Make legal arrangements. You can simply draw up a written plan, have the caretaker sign it, and make a gift of any caretaking funds. Or you could have your attorney create a pet trust, which will also mean appointing a trustee to oversee the caretaker actions under a trust agreement.

A pet trust is a legal document mandating care and maintenance of pets in the event of the owner's death or disability. You place the pet and caretaking funds in the trust, designate a caretaker, and appoint a trustee. This may have several advantages over providing for your pet in a will, which may not take effect until days or weeks after your death. A trust clicks in immediately, and it can cover both death and disability and exclude your pet from a lengthy probate process. ●

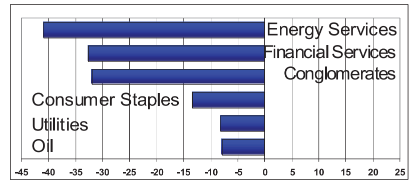
Market Data Bank: 4th Quarter 2008



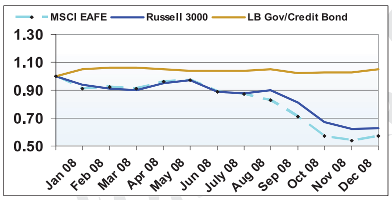
LARGE VALUE VS. LARGE GROWTH
Substantial declines for leading U.S. banks and oilfield services shares pushed large value- and growth-oriented stocks down roughly 22% in 4Q08; over the year, both lost 36% to 38% of their total worth.



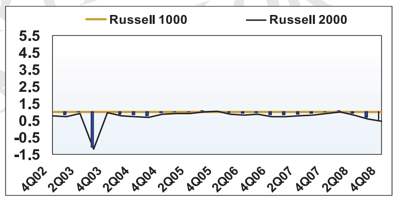
SMALL VALUE VS. SMALL GROWTH
Smaller banks and consumer-focused companies continued to outperform their growth-driven peers, but still ended down 24%. Over the last five years, only small value has held onto any gains at all.



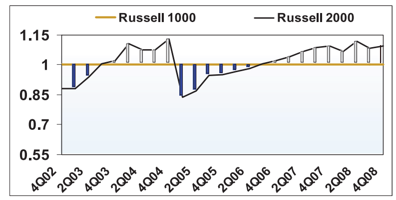
THREE BEST AND WORST SECTORS
All major industry groups suffered in the broad-based rout. Oil companies, utilities, and relatively defensive consumer staples manufacturers held up the best, but delivered substantial losses nonetheless.



FOREIGN, US STOCKS & US BONDS
Extreme aversion to all forms of market risk pushed government bond prices higher while punishing equities. In 2008, U.S. shares lost 37% of their value; foreign shares plunged a harrowing 43%.



LARGE VS. SMALL STOCK EARNINGS
The biggest companies managed to fatten their profits by 13.5% in 4Q08, but their smaller rivals found growth harder to find. Small-cap earnings growth slowed to just 5.9%, its lowest level in several years.



PRICE-TO-EARNINGS RATIO
As stock prices retreated, shares became somewhat cheaper to investors on a fundamental basis. Smaller companies fetched a higher price per dollar of earnings in 4Q08, continuing a two-year trend.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do not represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Securities Crisis

(Continued from page 1)

firms encouraged analysts and brokers to gloss over potential dangers and push investments that were profitable to the firms, even at the expense of their clients. New York Attorney General Andrew Cuomo alleged that Citigroup repeatedly committed securities fraud by misleading investors into believing auction-rate debt was equivalent to cash and failing to reveal that the shares carried market-related risks.

The primary cause of risk in the market was the lack of a daily source of trading data on auction-rate securities, such as there is for Treasury bonds and stocks. Issuers had to rely on Wall Street dealers to function as buyers of last resort when bidders couldn't be found, and the risk was that an economic crisis would leave the dealers without the financial ability to support the market. That's exactly what happened. Big investment banks, already battered by failed investments in mortgage-backed debt, wouldn't or couldn't buy these securities.

We Take It Back

Several firms that marketed auction-rate securities have agreed to buy them from investors. Here's the estimated value of those buy-backs.

Investment Bank	Value of Repurchased Securities
UBS	$19.4 billion
Merrill Lynch	$12 billion
Citigroup	$7.3 billion

Investors can learn several lessons from the auction-rate securities mess. The most important, of course, is *caveat emptor*. When Wall Street markets investment opportunities that seem to have an edge over similar products, it's likely because there are hidden risks. Higher potential returns almost always come with higher risks, though that's a warning that may be hidden in a fine-print disclosure if it's made at all.

Our firm educates clients about all products, and if you don't understand the risks of any of your investments, then please let us know. ●

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