



Quarterly Memo

October 2009

Of Special Interest:

- "If you get too cold, I'll tax the heat, if you take a walk, I'll tax your feet..."

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- All that glitters

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- Matrix makes *Medical Economics* top adviser list

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No velocity, no inflation

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Higher Taxes – Only a Matter of Time?



Last quarter, we highlighted the massive Federal budget deficits projected for the next decade. One observer has stated we should not

worry about the projected deficits – because the markets simply will not allow them to happen. Even the Federal government will find out that the world will not continue to make unlimited loans to a borrower with an unbearable debt load. Before the deficits become a runaway problem, the government will be forced to cut spending and raise taxes. Most economists believe a

tax increase currently would be a bad idea, given the nascent recovery. An ill-timed tax increase could indeed engender the feared "W" or double-dip recession – we see that from history.

The Great Depression is popularly viewed as a severe economic decline that began in 1929 and persisted until the outbreak of WWII. The numbers tell a different

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Gold Prices Break \$1,000 – Should You Buy?

As gold passed \$1,000 per ounce, many investors suddenly found a new interest in the yellow metal and TV ads seemed to multiply. (If nickel hit a new high, would there be as much interest?) What is behind the recent price rise? Does it make sense to own a gold position?

As a commodity, gold has its own supply and demand factors like any other. It also has a near-cultish following based on its popular reputation as a store of wealth, inflation hedge, and the ultimate

safe investment. It now has the ability to be easily and instantly traded in an exchange traded fund (ETF) that has become the world's seventh largest owner of gold worth \$37.5 billion. All together, these factors make predicting future price trends tricky.

Gold production is up 7% and higher prices have brought 900 tons of new supply from scrap in the first six months of 2009 alone. Simultaneously, gold demand for jewelry and industrial uses is

down 20% due to the recession. Clearly, normal supply and demand factors are not the explanation.

The traditional explanation is that rampant inflation fears are driving prices higher. However, other inflation hedges are not responding similarly. The

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Higher Taxes – Only a Matter of Time? (continued from page 1)

“...inept government policy, including tax policy, can short-circuit an economic recovery.”

story. The Great Depression was actually two downturns (August 1929 – March 1933 and May 1937 – June 1938) bracketing a period of vigorous recovery and growth. The period between the downturns was marked by economic growth of over 9% annually (even factoring out government spending) and unemployment falling from 25% to 11%. The first phase of the Great Depression ended even before the advent of the New Deal and despite 9,100 bank failures and policy blunders, such as the Smoot-Hawley tariff (effectively a consumption tax), dramatic Fed discount rate increases in 1931, and boosting the top marginal income tax rate from 25% to a stratospheric 63%. In 1936, the top rate was boosted again to 77%, the Fed doubled the reserve requirements for banks, Social Security taxes were enacted, and corporate taxes were raised, arguably contributing to

the second decline phase the following year. The lesson here is that inept government policy, including tax policy, can short-circuit an economic recovery.

If we assume that cuts in government outlays are not a political possibility and that continued massive Federal borrowing will not continue (by choice or otherwise), the only logical conclusion is that government receipts must increase. What forms could tax increases take on?

Income taxes. It is highly likely that the 2001 and 2003 tax reductions for higher income individuals will be allowed to expire as scheduled under current law at the end of 2010. This will mean higher marginal tax rates on ordinary income (e.g., the current 35% bracket will revert to 39.6%), dividends (from 15% to as high as 39.6%), and capital gains (from 15% to 20%). It is probable that

Congress will extend other provisions, such as the 10 percent bracket at the low end, marriage penalty relief, and child tax credits.

In May, the Obama administration released the so-called “green book” outlining its wish list for further income tax changes estimated to raise \$900 billion in additional revenue in the next decade. These include:

- Ending the last-in, first out (LIFO) inventory accounting method.
- Ending the expensing of intangible drilling costs (IDC) under the theory that “expensing encourages over-production of oil and gas” and “is detrimental to long-term energy security”. Was it that long ago that domestic energy production was seen as a *good* thing?
- Make oil and gas working interests subject to the passive loss rules.

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Matrix Team Named to Best Adviser List Again

For the sixth time, *Medical Economics* has named Giles Almond to its list of the 150 best financial advisers for doctors. Giles is one of five selected in North Carolina and the only adviser named in the Charlotte area.

The Matrix team works

with physicians with the CHS and Novant systems as well as independent practices of all sizes and across most specialties. Physicians are the firm’s single largest client sector.

Given the prospect of major health care reform, physicians face

unprecedented financial uncertainty and their need for planning has never been greater. Matrix helps physicians achieve clarity about financial goals and make sound decisions for their families and their practices.



Matrix Named as Trust Representative Office

Matrix Wealth Advisors became a shareholder firm of National Advisors Trust Company (NATC) in 2008. NATC recently announced that Matrix Wealth Advisors has also been named as a Trust Representative Office (TRO). Giles Almond and Janice McGunnigle completed a comprehensive trust training program, qualifying Matrix to formally represent the largest federally chartered trust company in the country created by Registered Investment Advisors (RIA's). Matrix is one of thirteen shareholder firms nationally to receive

the TRO designation by NATC so far.

The mission of the TRO program is to build lasting relationships among local estate planning attorneys, CPAs, Matrix, and NATC for the benefit of mutual clients. In many cases, the client's financial, family, or business needs are clearly served best through the use of trust services by a professional fiduciary. Using NATC in such cases allows families to continue to benefit from its advisory team's experience and knowledge with an independent trust solution having a very competitive fee structure.

Chartered in 2001, NATC is a \$4 billion institution headquartered in Overland Park, KS (not in a costly metropolitan area). Unlike many other large institutions offering trust services, NATC accepts no deposit accounts, offers no investment products, and makes no loans. Its unique business model is to provide excellent trust administration and custody services exclusively for the clients of its shareholder RIA firms. This gives NATC flexibility in working with co-trustees, holding assets in multiple states, and handling irrevocable life insurance trusts.



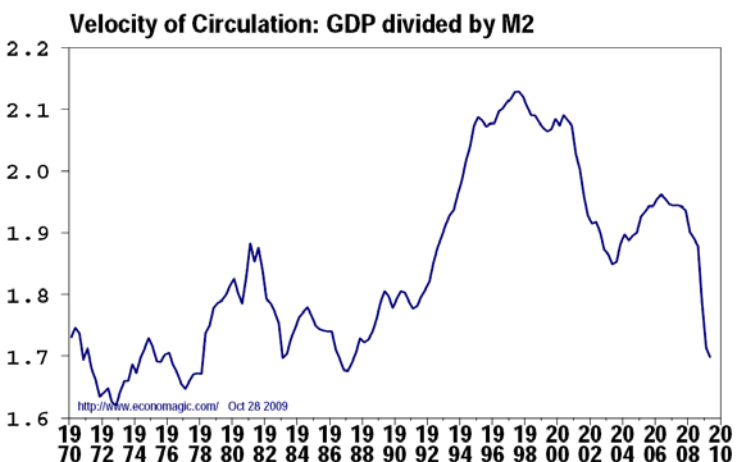
Inflation? Deflation?

The answer may be "yes." Last quarter, we wrote of the next train wreck of runaway federal budget deficits and the prospect of higher inflation three to five years out. Why is the current massive increase in the money supply not likely to spark inflation in the near term? The answer is a concept called *velocity*.

The economy can be expressed in a formula. The quantity of goods and services produced multiplied by the price level (yielding GDP) must logically equal the amount of money in the economy times the turnover of the

money (velocity). The relationship between velocity, the money supply, the price level, and output is represented by the equation $M * V = P * Y$ where M is the money supply, V is the velocity, P is the price level, and Y is the quantity of output. P * Y, the price level multiplied by the quantity of output, gives the level of GDP.

Over the past year, M has dramatically increased, Y decreased, while P was a bit lower. According to the equation, V must fall – and, like a rock, it did. If V begins to rise, absent a decline in M and/or Y,



then P must rise, i.e., inflation. Until then, the possibility of deflation will remain with us. This is an oversimplified analysis – just remember that with continued falling velocity, inflation will be hard to find.

Higher Taxes – Only a Matter of Time? (continued from page 2)

- Repeal the percentage depletion deduction for oil and gas income.

At present, there are no proposals that would hike income tax rates at the scale seen in the 1930's. However, the income tax is not your only concern.

Estate and gift taxes. As you are probably aware, the estate tax is scheduled to be shelved for 2010 before returning with a vengeance in 2011 with a much lower \$1 million applicable exclusion amount and a higher maximum rate of 55%. Once the \$1 million level is reached, the tax begins at 41% - not including state taxes.

For years, efforts to fix or repeal the "death tax" have failed for various reasons as 2010 loomed closer and closer. We are told the most likely action now will be a one year extension of current law through 2010. Now the scary part – if Congress takes no further action, the exemption will drop as scheduled in 2011. We are also told that many members of Congress believe a \$1 million exemption would raise revenue and promote social mobility and economic equality.

Securities transaction tax. H.R. 1068, the *Let Wall Street Pay for Wall Street's Bailout Act of 2009* was introduced in

February 2009 by Rep. Peter DeFazio (D-OR) and 13 Democratic co-sponsors. The bill would impose a tax of .25% on securities transactions on national exchanges, which would include stocks, stock options, and stock and commodities futures. As written, the bill would not cover bonds or open end mutual funds, but would apply to exchange traded funds (ETF's) and closed end funds. The text of the bill points out that this is not a new idea – such a tax existed from 1914 to 1966. While the bill targets "Wall Street investors" (whoever that might be), it would impact small investors most. Large institutions would have an incentive to move trades to non-US exchanges. You and I don't have that ability.

Value added tax (VAT). According to the *Wall Street Journal*, "Nearly every European country that has passed national health care has also eventually imposed a VAT, and it's foolish to think the U.S. will be different." House Speaker Pelosi said as much in an October 5 interview: "Somewhere along the way, a value-added tax plays into this." A VAT also has support from Sen. Kent Conrad (D-ND), who chairs the Senate Budget Committee, and White House advisers Paul Volker, Ezekiel Emanuel, and John Podesta.

One allure of a VAT is its opacity. Unlike a sales tax for all to see, the VAT is added on at each level of production. All the consumer knows is that things just cost more. Another fact is that a VAT can be a substantial revenue raiser. Over 130 countries have a VAT, with rates ranging from 5% in Japan to 25% in some European countries.

From a social policy perspective, the VAT is an intriguing idea as a substitute for the income tax. Because it is a consumption tax, proponents say it would spur investment and savings. We may get a VAT simply because there is no other way to raise the needed revenue.

Implications. Short of becoming an expatriate, what can be done? No easy answers exist. In general, be wary of paying a tax now based on a presumption of future tax laws. For example, accelerating income or a Roth IRA conversion may look attractive based on assumed future tax rates. But what if the income tax is largely replaced with a VAT? Congress could choose to tax large Roth IRA's again (under an "excess accumulations tax" scheme). A lower estate tax exemption would mandate new estate plans. As usual, we will track developments and advise you as actions are needed.

"Nearly every European country that has passed national health care has also eventually imposed a VAT, and it's foolish to think the U.S. will be different."

Wall Street Journal,
October 8, 2009

Gold Prices Break \$1,000 – Should You Buy? (continued from page 1)

spread on the 10-year Treasury bond and the 10 year inflation indexed bond (TIPS) is less than 2%. If inflation fears were pervasive, the spread would logically be larger.

One possible explanation is the declining value of the US dollar since March. A depreciating currency can cause nervous investors to seek a purchasing power hedge.

Should investors own more than a token gold position as a long-term, *strategic* position? We do not feel there is a compelling case for this. First, there is the fundamental logic of owning an asset that produces nothing and *solely* has value based on the expected price a future buyer is willing to pay. Unlike a stock, bond, or rental real estate, it has no cash flows to value. (It actually has a negative cash flow, as you have to pay to store it.) As Warren Buffett put it, "Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Secondly, there are more efficient ways of hedging the risks typically feared by a gold investor. In other words, gold now has much more competition than in its history. If you

want to hedge inflation risk, there are TIPS and various commodity funds. For dollar devaluation, you can hedge using any number of currency ETF's. Gold is not the only game in town any more.

Lastly, the effectiveness of gold as an inflation hedge is at least questionable. While gold has produced excellent returns since 2001, the period from 1980 to 2001 was a painful time to own gold. Based on the chart below, gold has provided a zero real (inflation adjusted) return since 1983. Clearly, gold can and does produce good returns over some shorter time periods, but its long-term track record and volatility make it a difficult asset to own strategically. Some investment managers use gold tactically in a portfolio, including one used

by Matrix. We are comfortable with this, as the manager has a proven track record and experience with tactical gold allocations.

"Gold bugs" point out that gold has been a store of value and medium of exchange for thousands of years. However, a grocery store accepting gold would be hard to find now. As one blogger stated "Using gold as money is about as rational in these complex financial and economic times as using the telegraph or the pony express to communicate."

Who knows – gold may fulfill some forecasts and run up to \$3,500 or even \$5,000 per ounce. However, buying an asset when it is at a high price historically and widely touted in the media rarely works out well.

"...gold has provided a zero real (inflation adjusted) return since 1983."



GDP and Equity Market Returns

“Don’t expect the current economy to give you clues on the market’s direction.”

We all know that the economy and the stock market are joined at the hip, right? Good economic performance increases company earnings, which leads to higher stock prices. This appears to be one of those ideas where the applicable quote is "It's not what we don't know that's the problem, it's what we know that ain't so!" as an examination of the historical data indicates otherwise.

In a recent study by the Brandes Institute, annual stock market returns and annual gross domestic product (GDP) were analyzed for the period 1929-2008. Viewed graphically, one can easily see a wide dispersion of combinations of market returns and GDP growth –

see Exhibit 1. From the statistician’s perspective, there is a low correlation coefficient between the two sets of data, with an r^2 of only .16, where 1.0 is perfect correlation (the behavior of the independent variable perfectly explains the behavior of the dependent variable) and 0 indicates random, uncorrelated sets of data that apparently have no relationship with each other.

Some might believe that while the stock market may not react in the current year to economic events, surely in the following year the market reflects what happened in the economy. The data do not support this hypothesis at all – see Exhibit 2. In fact, the correlation coefficient for

this scenario is only .02 – no correlation, for all practical purposes.

We have not found a reliable short-term predictive statistic for stock market performance, but we can tell you one that is not – GDP. Basing a decision about owning stocks in your portfolio based on what the economy did last year or this year has no foundation based on history. That is counter-intuitive, but both analyses reveal numerous data points showing poor economic performance and positive stock returns. Likewise, there are many occasions where the economy grew yet stocks performed poorly. Don’t expect the current economy to give you clues on the market’s direction.

Exhibit 1: Relationship between Real Changes in U.S. Year-on-Year GDP and Concurrent U.S. Equity Returns, Annually, 1929-2008

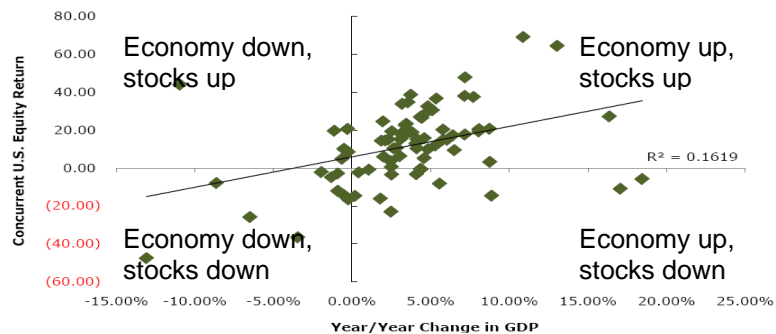
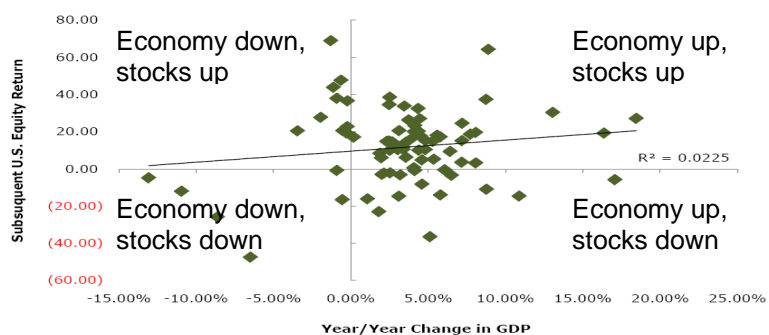


Exhibit 2: Relationship between Real Changes in U.S. Annual GDP and Subsequent U.S. Equity Returns, 1929-2008



Source: The Brandes Institute, FactSet, as of 12/31/08

Some Million Dollar Advice - Insights from Millionaires

Fidelity Investments conducts an annual survey of millionaires on their investment attitudes and economic outlook. To be included in the sample, you must be a "real" millionaire – with an investment portfolio of at least \$1 million, not counting homes, company retirement accounts, or personal use assets.

Richard Day Research, an independent firm, conducts the survey on behalf of Fidelity from a representative sample of 1,012 US millionaire households. Results are considered statistically accurate with a margin of error of +/-3%.

With an average age of 59, millionaires as a group have the benefit of experience, having weathered previous economic storms since the oil crisis induced recession of 1973-1974. That said, 77% responded that this downturn is the worst in their memory. 46% reported they do not feel wealthy, a sharp rise from 19% reported the previous year. That is not surprising considering this group reported a decrease in both assets and income of 21% last year. With the decline in real estate values of 28% and an increase in reported debt levels, overall net worth declined by almost a third (32%).

Nevertheless, millionaires proved to be a resilient

and savvy group. In previous downturns, 64% of those surveyed said they stayed committed to investing for the long term. 18% moved their assets to more conservative investments while the remaining 18% actually saw a buying opportunity. While other variables may be at work, it is interesting that those who saw a buying opportunity report an average portfolio of \$3.4 million, those who stayed the course had \$3.3 million, and those who became more conservative show a portfolio size of \$2.4 million. During this downturn, 68% said they stayed committed to a long-term investment strategy.

Millionaires generally feel positive about the economy for 2010. On a scale of -100 (very weak outlook) to +100 (very strong outlook), the consensus was a +28. The optimism was based on a positive outlook for the stock market (+43), business spending (+28), and consumer spending (+25).

Stocks received the highest number of mentions (44%) as the asset class most promising over the next five years. Bonds only received 6% and precious metals garnered a scant 1% of votes.

What economic sectors are favored by this group?

Green technologies came in first with 28%, followed by health care (16%), biomedical technologies (15%), and financial services (11%).

The US is believed to be the best region for investments over the next five years by 60% of those surveyed. Nevertheless, 81% are invested internationally with an average portfolio allocation of 13% to foreign investments of some sort.

So what advice was offered by this group? The top three recommendations were "stay the course" (42%), "remain calm and optimistic" (24%), and "cut back on spending/save more" (23%).

A large majority of millionaires see the tax handwriting on the wall and expect increases in rates for capital gains, dividends, and ordinary income. In the next twelve months, 50% say they will harvest tax losses on investments and 29% are planning to increase allocations to tax-advantaged investments. Only 13% say they are planning on a Roth IRA conversion.

If most of the above findings sound familiar and ring true, then you are not alone – you are in line with your fellow, sophisticated high net worth investors.

"During this downturn, 68% said they stayed committed to a long-term investment strategy."

Matrix 2009 Client Survey Results

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Every two years, Matrix conducts a client survey to gain candid feedback, guiding the firm's efforts to improve services. Firm management studies the responses in detail and uses the information in making decisions about services to be offered and looks for specific opportunities to improve quality, service and responsiveness.

The overall mood of many clients is decidedly less positive given the market trauma that began two years ago and this is reflected in the survey results. The survey response rate fell from 58% to 49%, still a very good response rate.

Overall client satisfaction fell from 4.7 to 4.6 on a five point scale. Even with difficult market conditions, clients' comfort with their portfolio risk level remained unchanged at 4.6.

Our current methods of communication received the following scores on a four point scale:

Periodic meetings – 3.8
Quarterly reports – 3.7
Quarterly memo – 3.5
Special emails – 3.1
Seminar events – 2.5

Some possible additional communication methods being considered scored:

Webcasts – 2.8
Monthly blog – 2.7
Conference calls – 2.7

Video conferencing – 2.5
Twitter – 1.8

A copy of the survey results will be provided to clients upon request. We sincerely thank all respondents, especially those who wrote in comments, both compliments and criticisms are genuinely appreciated and thoughtfully considered. As promised, Matrix has made a donation for each response to the American Red Cross.

As for the suggestions that we "grow money on a tree" and "improve market conditions" – all we can say is we'll work on it!

About Matrix Wealth Advisors, Inc.

Planning is the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered process to offer comprehensive financial planning and investment management services that help clients

close the gap between where they are now and where they want to be. Matrix is a fee-only, fiduciary firm and is compensated solely by our clients.



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