



# Quarterly Memo

January 2009

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## Dealing With a Longer, Deeper Recession



Most economists believe the current recession that began in December 2007 will be one for the record books. With GDP probably contracting at a 5% annual rate in the last quarter and possibly also

in the first quarter of 2009, this slowdown has the potential to be the most severe global recession since the 1930's and the worst post-war slowdown in the US. Under- and unemployment is estimated at 14%, with job losses totaling 2.6 million so far. (As frightening as that sounds, we are nowhere near Great Depression levels – see last quarter's article.) How much longer and deeper will the recession go?

Of course, no one knows. Remember, the economy is a "wicked system" that defies any person's or computer program's ability to predict or model it precisely. But studying history may give some clues.

First, this is not an "ordinary" recession – in the sense that it was caused by rising interest rates instigated by the

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## Meet National Advisors Trust Company

Matrix is pleased to announce it has become a shareholder member of National Advisors Trust Company (NATC) a federally-chartered trust company with assets of more than \$4 billion. NATC was formed by over 135 of the nation's top financial advisory firms to provide clients with a new standard of excellence in trust and custodial services. This relationship allows Matrix to remain the Financial Advisor in a family relationship and service a trust locally while working with NATC

as the corporate trustee and custodian to fulfill all legal and administrative responsibilities.

For years, the need has existed for independent trust services in many client situations. Large institutions have been a poor solution, characterized by proprietary investments, impersonal service, and high fees. The passing of two beloved clients in 2008 highlighted this need. You now have a cost effective corporate trustee alternative for your

trust needs. Most estate plans will or potentially will involve the use of trusts, some of which could last for many years. Naming NATC as the corporate trustee in your documents will bring your family an experienced trust administration team while maintaining the advisory relationship with Matrix Wealth Advisors.



## Dealing With a Longer, Deeper Recession (continued from page 1)

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***“Vibrant economic growth could be years, not months away.”***

Central Bank to cool down an economy growing too fast and/or to dampen inflationary forces. This recession had its roots in interest rates that were too low for too long. This led to far too much liquidity seeking a home and it found it in the mortgage market. With mortgage money too easily available (blame securitization, Fannie, Freddie, mortgage brokers, etc.) housing prices soared into bubble territory. The mortgages had been sliced and diced into securities that became either worthless or illiquid, as no one could value them in the wake of falling home prices and foreclosure rates higher than ever dreamed. Institutions whose net worth was tied to these instruments failed or were nationalized. The lack of confidence in financial institutions turned a credit crunch into a worldwide credit crisis. With credit effectively cut off from the corporate sector, business expansion ground to a halt

and began contracting. Consumer confidence plummeted to all time lows and spending fell sharply. This is far oversimplified, but the point is we did not get where we are today in any “normal” fashion. It is possible the recovery from this will be anything but normal.

Secondly, the government’s fiscal and monetary policy has and will probably continue to be unprecedented. The Fed’s discount rate is near zero. While the fiscal stimulus package is estimated to be \$800 billion, will it be enough? The amount of lost wealth in the recession is estimated at \$5.26 trillion (\$2.52 trillion in real estate declines and \$2.74 trillion in stock market losses). One economist estimates it will take **17.6 years** to recover this lost wealth! Other countries that experienced post-war asset bubbles saw similar losses percentage wise.

The consensus of opinion

among economists is that GDP will drop sharply in the first quarter, less so in the second quarter, with slow growth returning in the third quarter. Even if it does work out that way, unemployment can be expected to continue to rise even as the economy turns the corner. Another “jobless recovery” might be in the works as cautious businesses hire back at a slow pace. Vibrant economic growth could be years, not months away.

While there are both possibilities of prosperity returning quickly and the economy falling further to depression levels, “muddling through” may be the most likely outcome. Given that we may be in this for a while, what should you be doing?

**1. Liquidity first.** An adequate reserve fund has and always will be a fundamental financial

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## Meet Daniel Kreutzer

Matrix welcomes Daniel Kreutzer to our staff as an Investment Associate. He graduated from UNC–Chapel Hill with a BS degree in Business Administration with a Finance concentration. After graduation, Daniel joined Wachovia Bank, working in exchange

traded derivatives and later worked on a team managing large databases of stock and economic data. He is currently a Level 2 candidate for the prestigious Chartered Financial Analyst (CFA) designation.

Daniel’s roles at Matrix

include assisting with investment research, monitoring and reporting, preparing client presentations, and updating investment data.

Daniel enjoys watching the Tar Heels, spending time with family, and many recreational activities.

## The Lessons of Bernard Madoff

Awful market returns, a credit crisis, and a deepening recession - it seemed it couldn't get any worse. It did. The largest Ponzi scheme in history came to light last month.

By now, you've probably heard of the incredible scope of this crime, how friends, family, and charities were all victims, and at least one investor suicide. While books will be written analyzing this event in great detail, there are some immediate lessons that can be learned.

### 1. If it sounds too good to be true... You've

heard this all your life and 99.9% of the time it's true. Madoff's hedge fund returns were more than 11% each year for 15 years – too good and too consistent through some periods of wrenching market volatility.

**2. Trust but verify.** One of the most glaring aspects of the fraud was that investors allowed Madoff to custody their funds at his in-house brokerage firm. Anyone who has taken an accounting course or runs a business knows of the importance of separation of duties in internal control. Investors should expect a third party

custodian for most investments. For example, Matrix clients use Charles Schwab or National Advisors Trust Company as independent custodians. Clients receive periodic statements directly from the custodian and all account additions are payable to the custodian.

**3. Know your auditors.** Madoff used Friebling & Horowitz, which consisted of a partner in his 70's living in Florida, a secretary, and CPA David Friebling working from a 13' by 18' office. Like his

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***“Madoff’s hedge fund returns were more than 11% each year for 15 years – too good and too consistent...”***

## What You Can Expect from Obamanomics

Quickly, the national good feeling following the inauguration about a “new beginning” will fade and popularity ratings will fall as our new President tackles a financial crisis while hoping to placate the constituencies that put him in office. Based on what we have seen so far, the President will not be the liberal crusader hoped for by the left and so feared by conservatives. While he likely believes in and may eventually push a very liberal agenda, he is also intelligent enough to realize that right now, he must govern from near the center. Obama's cabinet and other

appointments represent more pragmatism than ideology.

The latest \$825 billion stimulus package is another example. It includes \$275 billion in business and personal tax cuts designed to garner Republican support. Of course, there are goodies for everyone in there, including \$58 billion for energy projects, \$16 billion for science and technology, \$92 billion in infrastructure, \$141 billion for education, and \$153 billion for health care related items. With minor changes, the package will likely be passed shortly.

Looking further, what other tax and economic policy initiatives can we expect? Candidate Obama proposed an ambitious and expensive healthcare program, which would provide low-income Americans with subsidies to purchase health insurance. While it would not be surprising to see changes in the way health insurance functions, the realities of the budget deficit effectively forces the new administration to shelve its plan for now.

Tax policy is another area where campaign promises

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***“The last thing you want to do is to invade the long term portion of the portfolio during a difficult market period, such as now.”***

## Dealing With a Longer, Deeper Recession (continued from page 2)

planning recommendation. The rule of thumb is six months of living expenses should be kept in a safe, liquid investment in case of unexpected expenses or income disruption. People with unstable incomes or job situations should aim for 12-24 months. When possible, this should be backed up with a home equity line of credit that could be drawn upon in an emergency. For those in the “decumulation” phase of life, a sufficient amount to cover cash flow needs for several years should be kept relatively safe. The last thing you want to do is to invade the long term portion of the portfolio during a difficult market period, such as now.

**2. Spend less than you earn.** Or as one author said it, “Act your wage!” To build up a liquidity fund will require some savings and a lifestyle that doesn’t require everything you make to sustain it. While “living within your means” was accepted as common sense a generation ago, far too many people base their lifestyle on their neighbors, friends, or relatives rather than their paycheck. Lifestyle adjustments are no fun and delayed gratification may be difficult for some. But the alternative is far more painful – debt, stress, foreclosure, and Chapter 7 or 13 bankruptcy. The ugly fact is we might have avoided

a deep recession if the millions of homeowners now facing foreclosure had just said “We’ll buy something more affordable – that payment could eventually be more than we could handle.”

What if you are depending upon your portfolio for cash flow and the portfolio had posted a loss? The “safe” part of your portfolio that is there to handle cash flow needs probably posted a gain last year. You should have enough in that portion of your portfolio to last a number of years before it needs to be replenished, hopefully giving the depressed equity markets time to recover. However, given a choice, deferring some discretionary expenditures would be prudent to reduce the pressure on your portfolio.

**3. Avoid the use of debt.** If we face deflationary times, debt will be your worst enemy. That’s because debt doesn’t deflate while your assets may. The most conservative option is to eliminate all debt. That said, debt comes in flavors, from the most distasteful to the palatable.

Consumer, nondeductible debt is the worst. No one should carry over a monthly credit card balance – ever. If you have to do so, it’s a sign your finances need

serious attention. If you have an auto loan, it means you didn’t plan ahead to purchase it with cash. A cash purchase is almost always the best way to purchase a depreciating asset, absent bargain rate financing.

Consumer, deductible debts involve the use of home equity lines for consumer purchases. While this is tax efficient, you now have a lien on your residence and financed a consumer item for possibly many years longer than it will last.

Student loans could be justified as a way to finance a human capital investment. Some student loan interest may be tax deductible and is sometimes subsidized. However, interest rates are usually no bargain and repayment can be a significant burden for many years after graduation. Saving ahead, scholarships, and part-time work should be ahead of loans on the list.

Tax deductible debt to purchase a home or other asset very likely to appreciate over time is acceptable, in our opinion - if in prudent amounts and interest rate risk is managed. Why? Take the example of a \$500,000 home purchase and a \$400,000 interest-only (for simplicity) mortgage with

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an after-tax interest rate of 3.5%. After five years, you will have paid interest of \$70,000. However, if the home appreciates 3% annually, the value of the home has appreciated by almost \$80,000. Your equity in the home grew by 80% over five years to \$180,000.

What if the home didn't appreciate? You're out the \$70,000 in interest, but you did get to live in the house.

The scenario that must be avoided is buying a home at an inflated price plus a mortgage with a potentially unaffordable payment. Combine a drop in home prices in many areas of 20% or more with a mortgage payment resetting to an unaffordable amount and refinancing is not an option. Many simply give up and await foreclosure.

With today's low conventional mortgage rates, creditworthy homeowners have an opportunity to refinance up to \$417,000 and optimize their mortgage structure. A 30 year fixed mortgage may not be the right answer for everyone, but locking in a rate that is fixed for the expected ownership period of your home could be a good move.

**4. Don't neglect giving.** You've probably read about the budget

problems of many charities during this recession. Reducing or eliminating giving is a widespread response to bad economic news and low consumer confidence. Paradoxically, this is when many organizations' services are most needed. Scripture is replete with admonitions on giving and generosity – entire books have been written on that worthy subject alone. There does seem to be a transcendental principle that those who are generous to others are ultimately rewarded – what goes around comes around. Think about it – have you ever met a truly generous yet unhappy person? So before cutting back on giving – think about why you are giving in the first place, the effect on the recipient, and the effect on you.

**5. Have a long-term plan in place.** The greatest benefit from having a financial plan is the peace of mind from knowing where you stand with respect to your major financial objectives. If you are well on your way to meeting those objectives, an adverse investment environment may require adjustments, but it's not likely that your goals will suddenly be unattainable. A plan allows you to make intelligent decisions given new circumstances. You can rationally assess the impact of financial choices on your future situation,

rather than guessing or proceeding blindly. While no one knows the future, people with financial plans in place have some vision of what theirs may look like. They have concrete, articulated goals and know what it will likely take to reach them. They can react calmly and less emotionally to adverse events, knowing that their plan will take it all into consideration.

If you were expecting a "put everything in gold and bury it in the backyard" recommendation, sorry to disappoint you. To repeat, no one knows the future. A depression scenario is possible but still considered unlikely. The "muddle through for a few years" scenario seems most likely, as the government's efforts, imperfect as they may be, and other built-in stabilizers, such as unemployment insurance, kick in to prevent the economy from falling off a cliff. The Great Depression produced a generation of savers. This crisis has the similar potential to positively change the economic psyche and behavior of this generation – if it lasts long enough and causes widespread pain. If we can break the widespread attitude of "buy it now on credit and worry about how to pay for it later", then this crisis will have served a worthwhile purpose.




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***"...locking in a rate that is fixed for the expected ownership period of your home could be a good move."***

## What You Can Expect from Obamanomics (continued from page 3)

are (thankfully) on hold. Yet, it seems clear that the massive deficits being created must result in tax increases at some point. It's equally clear that 2009 will not be the year.

Obama's original proposal was essentially wealth redistribution - to increase marginal tax rates for higher income brackets while reducing or eliminating them for lower brackets. He may discover that there simply aren't enough high income taxpayers to finance the distribution to the low income taxpayers while making a difference in the deficit. Marginal rates for higher income taxpayers will likely be increased but lower brackets may have to be left alone. The income tax is already "inefficient" in that it taxes only 60% of the population according to The Tax Foundation. The other 40% live in households that pay no income tax or get subsidies in the form of the refundable earned income credit.

What about capital gains taxes? During the campaign, he was all over the map, with 28%, 25%, and "about a 20% rate" applicable to people making over \$250,000 being mentioned at different times. All of the rates are higher than the current 15% rate that

expires at the end of 2010. We were concerned that 2008 might be the last year of the historically low rate and some clients took capital gains in anticipation of that. It now appears we have at least one more year.

Eventually, Obama will likely propose to eliminate the maximum 15% rate applicable to dividend income, except for lower income taxpayers. With higher marginal rates on both dividend and interest income, municipal bonds could see prices increase and yields fall due to increased demand.

An area of concern has been Obama's stance on free trade and protectionism. Both the Clinton and Bush administrations were noted for expanded trade agreements. However, Obama voted against CAFTA (the Central American Free Trade Agreement) and has expressed misgivings about NAFTA (the North American Free Trade Agreement). His expressed views support labor rights, protection of US industries, and environmental concerns. If trade policies take a protectionist turn during this administration, you can expect equities to react negatively. New trade barriers might temporarily benefit some

traditional American manufacturers, but can be expected to slow overall economic growth and add to wage inflation pressures.

You can expect the Obama administration to reform financial market regulation. This could get ugly, given past history of government over-addressing problems e.g., ERISA in 1974. Obama's pick for head of the SEC, Mary Schapiro, is troubling. She was previously the head of FINRA, the Financial Industry Regulatory Authority, formerly known as the NASD. While the SEC has appropriately taken heat on missing Mr. Madoff's shenanigans, where was FINRA? Madoff's broker dealer was subject to its supervision. There is strong suspicion that Schapiro will be true to her past allegiances and advocate that all financial advisors should come under FINRA's purview in the name of comprehensive regulation. This would apply to RIA firms such as Matrix, currently regulated by the SEC and adhering to a high fiduciary standard when dealing with clients, far more pro-client than FINRA's rules. The big brokerage firms would like nothing better than to reduce all advisors to their lower standards to level the playing field.

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***"If trade policies take a protectionist turn during this administration, you can expect equities to react negatively."***

## 2008 – The Year of the Market Earthquake

Did you know earthquakes are a real possibility in the Carolinas? A visit to Charleston is a vivid reminder, where you can see many older buildings with “earthquake bolts” strung through them to hold them together after the 1886 magnitude 7 quake. Between 60 and 110 lives were lost. Severe damage occurred within a 100 mile radius. Buildings in Charlotte suffered damage, including fallen chimneys, fallen plaster, and cracked walls.

Lately, we have seen the word “seismic” used frequently in connection with the financial system and stock market’s gyrations. That seems an appropriate analogy to a Charleston earthquake – market behavior last year was equally unexpected, improbable, widespread, and disastrous. In 2008, depending upon traditional diversification to protect against significant losses failed miserably. Stocks of every description – large, small, growth, value, US, and foreign – were all down 35-45% or more. REIT’s dropped 38% and long-only commodities fell 36%. Precious metals mutual funds fell 30%. What about bonds? Unless you were invested in government or mortgage bonds, it was an ugly year. Corporate bonds were down 3%, municipal bonds off 2.5%, and high yield bonds down 26%. It resembled a

mass rush for the market exits – investors dumped any asset with perceived risk and sought safety at all costs. How else can you explain seeing three month Treasury bill yields at **zero** on several occasions?

So why don’t we structure our portfolios so that we can avoid painful losses no matter what happens (e.g. by only investing in CD’s or Treasury bills)? Over the large majority of time periods, you can earn significantly higher returns elsewhere. After taxes and after inflation, those investments provide little chance for growth. Building a portfolio to withstand a 2008 market would be the equivalent of building a house capable of withstanding an F5 tornado – it could be done, but you wouldn’t like the cost or living in a bunker.

While we have addressed this many times, we still get comments wondering why we did not reposition portfolios ahead of time to avoid the market downturn. We do not attempt to time the market and don’t know of anyone with a *consistent* record of doing so. The fact is making market timing calls can increase portfolio risk, as every decision carries the risk of being seriously wrong.

What are the lessons learned from 2008? First, non-traditional

diversification did provide benefits. Direct energy investments, while illiquid, continued to provide good cash flow and consistent returns. While many hedge fund strategies struggled last year, the managed futures fund used in most accredited investor clients’ portfolios produced a 12% return. If we have a regret, it’s that allocations to these sectors weren’t larger.

The second lesson is the importance of liquidity. Having adequate reserves to fund cash flow needs is critical during market downturns. Otherwise, you can face the unsavory prospect of liquidating positions that have declined in value at the worst possible time.

While many businesses have cut back, we feel now is the time to increase research efforts and work even harder to identify opportunities, as evidenced by adding an Investment Associate. With new custody capabilities for alternative investments through National Advisors Trust Company, expect later this year to discuss some new and innovative options to deal with the challenging investment environment. 2008 was brutal and 2009 may be challenging, but history teaches better portfolio returns can be expected to eventually return.

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***“2008 was brutal and 2009 may be challenging, but history teaches better portfolio returns can be expected to eventually return.”***

## The Lessons of Bernard Madoff (continued from page 3)

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client, 49 year old David seems to have been living a double, fictitious life. For the past 15 years, he told the American Institute of CPA's that his firm did no audits, which would have mandated his firm go through a peer review. Also like Madoff, he was well connected and well liked. Friehling is the immediate past president of the Rockland County chapter of the New York State Society of CPA's and sits on the chapter's executive board. He is also on the board of the local Jewish Community Center and "nothing but the nicest guy in the world" according to its director. Some hedge fund-of-fund managers

noted that Madoff's billion dollar funds were being audited by a one person shop and passed on investing for that reason. Good decision.

#### 4. Diversification is your first line of defense.

Madoff's saddest victims are those that invested all of their assets with him. Many may lose their homes and have seen their net worth nearly wiped out. Matrix imposes portfolio diversification requirements in every case – no manager, no matter how highly esteemed, would ever receive a 100% allocation.

#### 5. Due diligence requires more than

**character references.** Madoff moved in the best circles, was known for his charitable giving, and was highly regarded in the brokerage industry, having even chaired the NASDAQ at one point. Since he turned away investors occasionally, it was thought to be a privilege to invest with him. Some of the best known financial institutions and fund managers were charmed as well, apparently bending or ignoring normal due diligence practices.

Unfortunately, Madoff will not be the last of his kind. There's always a market for a "perfect investment."

### 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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