



Quarterly Memo

April 2008

Of Special Interest:

- It's not that bad – really!
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- Medicare – the growing 800 lb. budgetary gorilla
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- Tax rebates - a return must be filed to get one
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A pretty normal correction – so far

Looking at your portfolio reports for the first quarter of 2008 will not be a pleasurable experience. That's because US stocks (as measured by the Russell 3000 index) fell by 9.5% for the period.

That's the second worst start to a year in the past thirty years, exceeded only by the -12% return for the first quarter of 2001.

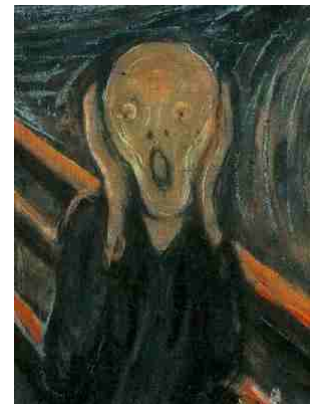
Before you scream in terror, consider the perspective of history. If

one looks at the last 240 rolling three month periods (rather than calendar quarters), this quarter doesn't even make the top ten list. See the table on page 2.

On a twelve month basis, the index is down 6%. While that's not what we like to see happen, in the context of history, negative returns of that magnitude happen frequently. The past twelve months rank as the

39th worst out of the past 240 trailing twelve month

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The 34 trillion dollar issue no one talks about

What's the greatest threat to our economic future? If you said the trade deficit, the housing crash, or high energy prices, you'd be wrong – at least according to Alan Greenspan. He has consistently – and unsuccessfully – tried to create political urgency concerning the impending financial Armageddon called Medicare.

In the next President's first term, we will achieve a milestone of the worst sort. Medicare A funding will go negative, meaning the receipts from the 2.9%

Medicare payroll tax will be less than the program's payments. The difference will have to be made up through payment cuts or from general tax receipts. If you project out future benefits and tax receipts, you'll need \$34 trillion (that's with a t) to balance. That number could be even worse, as it's based on some questionable assumptions, such as slashing payments to doctors by 41% over the next nine years. So the real number could be \$53 trillion, or around

\$455,000 for every American household.

If you think that the issue is just too large to comprehend, you're not alone. The presidential candidates don't seem to have a clue about what to do, either. Check their web sites. You'll see statements about universal health coverage, the uninsured, more medical research, more efficiency in health care, and evil, greedy drug companies, but no real

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A pretty normal correction – so far (continued from page 1)

periods – pretty unremarkable to us. In fact, if you have a negative year, the average loss is -12.8%. So while the causes may be unusual, what we have seen so far is just “normal” volatility.

We have received about three anxious emails and calls from clients. Please forgive us if we don’t get anxious along with you. Having seen worse volatility in 1987, 1990, 1994, 1998, and 2001-2002, this seems like another day at the office. We’ve seen this movie before. If anything, the more fear, pessimism, doom and gloom we hear, the more optimistic we become!

Warren Buffett has said that his success comes from trying to be “fearful when others are greedy and greedy when others are fearful.” While this advice is clearly right, it is hard to follow! Baron Phillippe Rothschild is reported to have been the

source of the famous quote that the best time to buy is when there is “blood in the streets”. The often omitted second part of the quote is “even if the blood is your own!”

Every great buying opportunity of the past has occurred at a point of great pessimism. While we’re not prophets or market predictors, we can’t help but see the headlines from just one recent news magazine:

“Meltdown... The Worst is Yet to Come.”
“Growth is slowing in wireless and broadband,”
“Bonds...are losing value fast”
“Experts are now questioning...free trade”
“The wounded deal economy”
“Brace yourself: Home prices could fall an additional 25%”
 and even *“Raising fears about bone fractures among women”.*

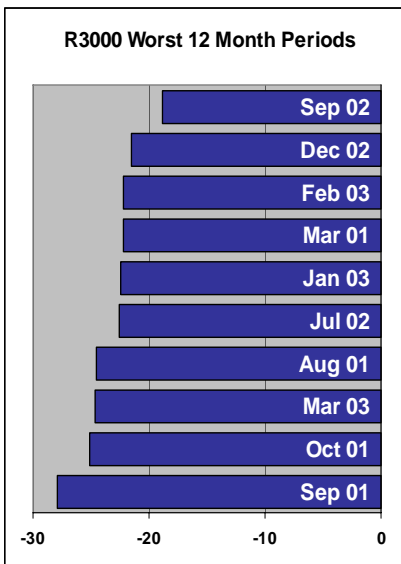
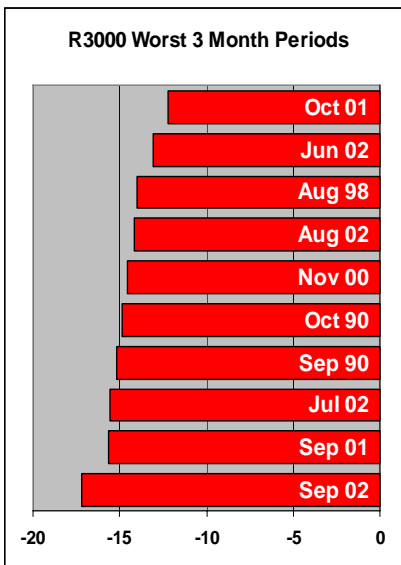
No wonder consumer confidence is at a 26 year

low! There is plenty for people to worry about:

- **Housing:** The housing market is in the worst downturn since the 1930s and evidence suggests there is still a ways to go. With a huge backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take years to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.

- **Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. There is an adverse feedback loop in play with losses from leveraged entities forcing them to sell assets (deleverage), which triggers more losses, and so on. The ability to

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Meet Ebony Greene, Student Intern

Ebony Greene is our current Student Intern. A native of Charleston, SC, she is currently a senior at Winthrop University majoring in business with an emphasis on personal financial planning. Ebony is gaining experience in a variety of areas, assisting in the data gathering and

data entry process for financial plans, while on the investment side, she performs quantitative analysis on investment managers. According to Ebony, “I work with a company that practices integrity, honesty, hard work, and protecting its clients’ best interests...”

The knowledge I have acquired from the expert professionals within the firm creates a great foundation for my success in the financial planning field. Matrix provides an environment that fosters learning and investing in its employees.”

Why Granny Should File a Tax Return

By now, you have probably seen the IRS postcards reminding you of the tax rebates to be issued beginning in May. Those who are eligible and file a joint return will receive a total of between \$600 and \$1,200. Those with children will get an additional \$300 for each qualifying child. If a person is claimed as a dependent on another's return, no rebate applies.

Unfortunately for most of our clients, the stimulus payment (both the basic component and the additional funds for qualifying children) begins to phase out for singles

with adjusted gross incomes (AGI) over \$75,000 and married couples who file a joint return with AGI over \$150,000. The combined payment is reduced by 5 percent of the income above the AGI thresholds. So a married couple with two children and \$186,000 in AGI will see no rebate at all.

However, many of us may have elderly parents or disabled relatives with incomes consisting primarily of Social Security and/or VA benefits that haven't been required to file tax returns in years. They will be entitled to a

rebate if their 2007 Social Security and VA benefits are at least \$3,000 and they file a return.

These individuals can file a tax return by completing a Form 1040A on paper, going to a tax preparer, purchasing tax software (such as TurboTax), or by going online. Under the *Free File Alliance* program, six software providers will give free software and e-filing to those who qualify (income typically less than \$54,000). For more information, see the IRS web site at www.irs.gov.



The Tooth Fairy, Fountain of Youth, and Market Timing

We do our best to explain our investment philosophy - strategic asset allocation - and emphasize how this differs from other approaches. We even document this in the *Investment Strategy Summary* signed by every client. It says, in part: "Matrix follows a broad strategy known as 'strategic asset allocation', meaning that investments are chosen with a long-term outlook (three years or more) and assumes that short-term investment market performance is inherently chaotic and unpredictable. This is contrasted with 'tactical asset allocation' which

attempts to capitalize on short-term market trends by shifting between various asset classes, or 'market timing', which attempts to be fully invested during periods of rising prices and invested in cash during periods of falling prices."

In other words, we don't practice tactical asset allocation or market timing. Yet there it was: the email that said "It seems to me that as soon as you see things declining you should pull out instead off [sic] waiting...Yes I know we're in it for the long haul but short-term adjustments

seem prudent."

So for the benefit of any who may still harbor the belief that an advisor's job is to predict and take advantage of short-term market movements, here are the fundamental reasons why we don't subscribe to the popular myth of market timing.

Every decision you make is a chance to get it wrong. Market timing requires you to be correct on two major decisions: when to enter the market and when to exit the market. If you get either

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"...we don't practice tactical asset allocation or market timing."

The Tooth Fairy, Fountain of Youth, and Market Timing [continued from page 3]

“Essentially all of the stock market’s return in the past 28 years happened in just 66 days...”

substantially wrong (or dreadfully both), you can do serious damage to your long-term returns.

Market timing increases the divergence of possible investment outcomes.

This corollary to the first point means that your returns become less predictable over time as the cumulative consequences of many decisions give rise to spectacularly good or bad terminal values. As financial planners, we know the most important rate of return – the one that drives your financial plan. It is imprudent to take risks that endanger the achievement of the minimum acceptable return in a quest for a higher return.

You don’t know, we don’t know, and they don’t know. Anyone who

claims he or she can predict the short-term future of the markets which is controlled by unforeseeable events is a liar, deranged, or a crook. If such were possible, why are huge losses occurring in firms run by the most brilliant investment minds on the planet? (That could be an entire book.) Only with hindsight can one see the now obvious trend!

Upward movements in equity markets happen abruptly and unpredictably.

If you are an equity investor, you must be present when the market decides for some unpredictable reason to go up 3% in a single day. Stock market returns are amazingly concentrated! Earlier this year, we analyzed the daily returns of the S&P 500 index going back to 1980, constituting 6,588 trading

days. Over that 28 year period, the compound annual return for the index was a respectable 9.7%. In order to see the effect of missing the market’s best days (as could happen to a market timer), we took the return of the best one-half of one percent (0.5%) of the daily returns (33 days) and set them to zero. The return dropped by more than half, to 4%. If the best 66 daily returns were reset to zero, the return shriveled to just .7%. Essentially all of the stock market’s return in the past 28 years happened in just 66 days – 1% of all the trading days. You are guaranteed to experience the market’s best days if you stay there. If you try to avoid the bad days and only catch the good days, you may do just the opposite and profound failure becomes a possibility!

What do tax returns say about your candidate?

“...34% of the Clintons’ income was derived from non-US sources.”

If the checkbook is a window into the soul, then a tax return is a peek into the checkbook. Tax voyeur that I am, I couldn’t resist scrolling through the 1040’s of Bill and Hillary Clinton, Barack and Michelle Obama, and John McCain. Here are some of the things that caught my attention.

The Clintons – their 68 page document looks like that of an erudite,

secretive family. They have, by far, the highest income, reporting over \$16 million in 2006 (their 2007 return is on extension), with around \$12 million coming from Bill’s speaking and writing and \$2.5 million in “guaranteed payments” from one of three offshore hedge funds listed on the return. As a tax professor commented, “the action is in the K-1’s” – we can’t see what is going on in

their investment entities. Their foreign tax credit form indicates 34% of the Clintons’ income was derived from non-US sources.

The Clintons donated \$1.6 million to their family foundation, the only charitable contribution on the return. Since 2001, the Clintons donated more than \$5 million to their

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A pretty normal correction – so far (continued from page 2)

borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps even more important to a stable economy is the ability to refinance maturing debt. The longer the problem lasts, the more damage there will be to the economy.

• **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see a clear weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

• **Global Growth Is Slowing:** It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape, however, we don't expect them to be fully immune from economic weakness in the developed world.

• **Energy Prices:** With crude oil and gasoline prices continuing to move upward, consumers have less to spend and the trade deficit worsens.

What are the positives?

• **The Fed to the Rescue:** The biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented actions of the Federal Reserve. Though the Fed's moves have not been as effective as they would like, they have made it clear that they will do what it takes to stop a major economic downturn and they will use all the weapons in their arsenal, such as directly buying mortgage securities in the public market.

The Fed's activism in structuring the J.P. Morgan buy-out of Bear Stearns was an example of a newfound willingness to intervene in the financial markets. Only time will tell if this activism proves to be a courageous and successful effort to stabilize the capital markets perilously close to falling off a cliff, or, as some have argued, the Fed should have let the markets take their course and eliminate the weaker players, even if significant collateral damage results. The Fed has also taken criticism for opening up the discount window to

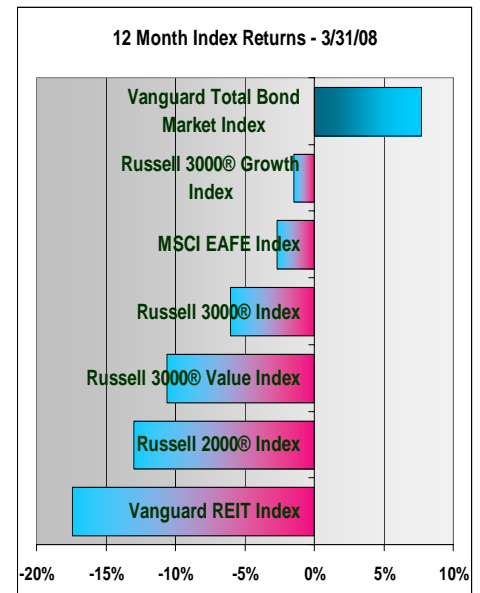
non-banks, although there doesn't seem to be significant borrowing going on after Bear Stearns is factored out.

• **The Weak Dollar:** The dollar's weakness has significantly improved the competitiveness of U.S. businesses versus foreign competitors. Export strength is already happening with exports contributing a significant one percentage point to economic growth over the last six quarters (annual rate). This almost offsets the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

• **Low Unemployment:** While employment growth has indeed turned negative, the unemployment rate has just barely edged up to 5.1%, a rate that typically signified periods of growth rather than recession. While we can expect the rate to edge up further, we are a long way from the 7-11% rates seen in past recessions.

• **Corporate Balance Sheets Are Strong:** Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly

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A pretty normal correction – so far (continued from page 5)

“...so many shoes have dropped, it looks like Imelda Marcos’s closet.”

healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years. Weighing the evidence, the odds seem to favor a recession but the length and depth are far from certain. Economic forecasts vary widely from just a pause in growth to a serious, prolonged downturn. Anyone who purports to know - doesn't.

In this environment of ongoing asset write-downs by financial companies, no one can be certain if or when the next one will occur. One commenter wrote so many shoes have dropped, it looks like Imelda Marcos's closet. The write-offs have totaled up to \$232 billion. The International Monetary Fund (IMF) predicted in its *Global Financial Stability Report* on April 8 that total losses for banks, hedge funds, pension funds, insurance companies, and sovereign wealth funds could reach \$565 billion on mortgage securities. That's a big number considering the total amount of subprime debt outstanding is around \$900 billion. The IMF actually expects the problems to spread to prime mortgages, commercial loans,

consumer loans, and corporate debt, creating total potential losses of \$945 billion worldwide. (By comparison, the S&L crisis of the late 1980's is said to have cost \$160 billion and Hurricane Katrina's total economic toll is estimated at \$200 billion.)

So you can expect these issues to roil the markets for some time. You will hear more stories about rising foreclosure rates, housing price drops, and possibly more credit market seizures. The gloom and doom is with us for a while. There will be those who say, like the Fred Sanford character from the 1970's that this is “the big one”, claiming markets don't work any more. This time the clever financial engineering will take us under, they say.

While not ruling out any possible outcome, we don't think so. (Remember, we, you, and they don't know.) There is still a lot of fuzzy math going on. Who knows how much subprime debt will ultimately default? What will be recovered through foreclosure? Will prime mortgage default rates rise as homeowners walk away from homes that are “under water”? What role will the government

play in a rescue plan for borrowers? Are the write-downs for real or the result of worst-case accounting by companies at the behest of their auditors? Will the fiscal and monetary stimulus in the works begin to take effect and help stem the tide of defaults and foreclosures?

The US economy has taken a number of hits in its history and has proven resilient. For sure, there are plenty of long-term challenges that have been written about in these pages. The current situation seems to us to be another noteworthy economic event in our history, but probably not “the big one”. Based on history and the positive factors mentioned previously, things will likely look different in a year. In the past, patience and discipline served investors well. We have no reason to believe “it's different this time!”



What do tax returns say about your candidate? (continued from page 4)

favorite charity while it only expended \$1.25 million. A Clinton spokesperson said the 2007 tax returns will show that more has been passed on to other charities.

Their home mortgage balance is listed as \$3.3 million.

An unusual item is “imputed interest from loan to family member” indicating that around \$400,000 has been loaned to someone, Chelsea, perhaps? Political bloggers have suggested that if someone wanted to make a questionable investment, the funds could be channeled through a family member. Perhaps it was for a home purchase? Who knows?

The Clintons paid over \$400,000 in self-employment taxes. Someone should mention to them the idea of using an S corporation, which can reduce self-employment taxes through the use of dividend distributions that are not subject to employment or self-employment taxes.

The Obamas – their returns look more like those of ~~typical~~ (oops, we can’t use that word) a more ordinary high income household. The Obamas reported 2006 income of \$991,000, with about half coming

from Barack’s book royalties and the rest from their salaries and directors fees. Their investment income was minor and they are still using up a capital loss carryover from prior years. Unlike the Clintons, the Obamas investment income of less than \$6,000 indicates a small personal investment portfolio. They seem to exemplify American values by spending everything they make!

The Obamas paid \$60,449 in home mortgage interest and their charitable contributions included \$22,500 to the now infamous Trinity United Church of Christ, \$15,000 to Care, \$13,107 to the Congressional Black Caucus Foundation, and \$5,000 to the Muntu Dance Theatre. There are no miscellaneous itemized deductions, not even a tax preparation fee. Was it buried somewhere else in the return or was their return prepared for free?

Like the Clintons, Barack Obama could benefit from the use of an S corporation to reduce his \$13,568 of self employment taxes.

They did not check the box for the Presidential Election Campaign Fund – not setting a good example there!

John McCain – that’s right – just John, not Cindy. He filed a separate return in 2006 and 2007, no doubt resulting in thousands of dollars in extra taxes, but avoiding scrutiny of his wife’s separate finances. She is said to own a beer distributorship worth \$100 million.

Arizona is a community property state, so Cindy and John each reported half of their community income, including her salary of \$433,000 and his book income of \$177,000. With only \$122 of investment income on John’s return, it’s easy to see where the wealth is in this family. (Someone had to pay the household help wages of \$273,000!)

The couple made charitable contributions of \$211,000, with \$177,000 going to their family foundation and the rest unspecified. There was no interest expense on the return. John McCain was the sole candidate with an alternative minimum tax of \$5,413.

Final observations – two of the candidates use family foundations. None of the candidates set up retirement plans to help shelter their book income. No IRA’s were noted anywhere. Maybe the next President needs a good financial planner!

“None of the candidates set up retirement plans to help shelter their book income.”

The 34 trillion dollar issue no one talks about (continued from page 1)

Matrix Wealth Advisors, Inc.

831 East Morehead Street
Suite 760
Charlotte, NC 28202

PHONE:
(704) 358-3322
(800) 493-3323

FAX:
(704) 358-3522

E-MAIL:

Giles Almond, CPA/PFS, CFP®, CIMA®
galmond@matrixwealth.com

Donna Barrow
dbarrow@matrixwealth.com

Cindy Carroll, CMFC, CRPS
ccarroll@matrixwealth.com

Ebony Greene
egreene@matrixwealth.com

Jonie Parks, CFP®
jparks@matrixwealth.com

Kim Wilhelm, CIMA®
kwilhelm@matrixwealth.com

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substance on the Medicare deficit. By 2070, given the aging population, projections show Social Security, Medicare, and Medicaid will consume 18% of GDP – that's as much as the entire Federal budget! According to Treasury Secretary Paulson, "Without change, rising costs will drive government spending to unprecedented levels, consume nearly all projected federal revenues, and threaten America's future prosperity."

CNN host Glenn Beck has compared this issue to an asteroid closing in to catastrophically strike the

Earth. Unfortunately, we don't have Bruce Willis to save us this time. There are no easy or politically palatable ways out.

Raise taxes – Hiking the current 2.9% Medicare tax to 6.44% would solve the problem. Try and get re-elected after voting for that!

Means Testing – This is already occurring now with Medicare Part D, where seniors with incomes above \$80,000 pay progressively higher premiums until income reaches \$200,000. John McCain has suggested this must be part of the overall solution.

Reduce benefits – Can

you say "third rail"? The AARP, AMA, and the National Committee to Preserve Social Security and Medicare will mobilize their members and our representatives will feel the heat.

Yet the facts are clear – a solution must be worked out and soon. Because we invented a Ponzi-like program that promised more in benefits than we were willing to pay for, the bill for the free lunch will arrive soon. Let's hope the solutions will be fair to beneficiaries and those who will work to pay for it, lest we risk class or intergenerational warfare. The asteroid is drawing closer and we ignore it at great economic peril!

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.



MATRIX WEALTH ADVISORS, INC.
831 East Morehead Street, Suite 760
Charlotte, NC 28202