



Quarterly Memo

October 2007

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Another year, another crisis

2007 will go down as the year of the worst housing crash in memory. Crashes don't just happen – they are the result of something going too high, too fast, for too long. The culprit was easy mortgage money, which fueled an unsustainable housing boom. Far too many people were able to get loans that never should have been made. We went from “low doc” to “no doc” to “liar’s loans”. The percentage of so-called

subprime loans skyrocketed, creating an artificial and temporary demand for housing. Many of these loans were interest only, had variable interest rates, had initially low teaser rates, or all three. Rising interest rates produced the deadly combination of rising mortgage payments and falling home prices. With an unaffordable payment and the inability to refinance a mortgage that exceeded the now-

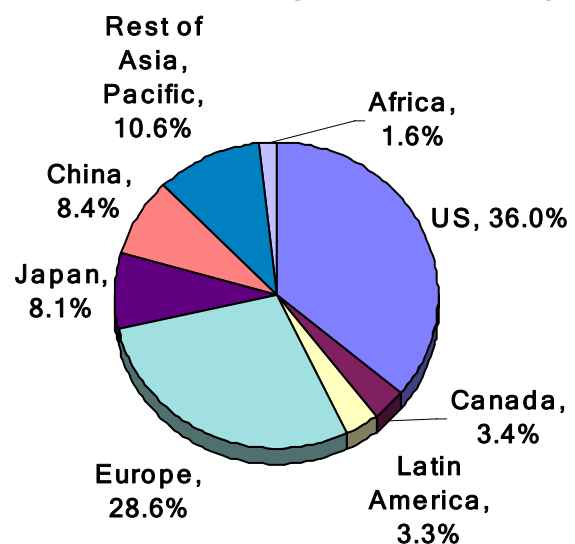
reduced home value squeezing these marginal borrowers, should a rise in delinquencies and foreclosures surprise anyone?

While all these developments had been foreseen, the worldwide near-meltdown of liquidity that followed was a surprise. Modern financial engineering practices of packaging, repackaging, slicing, and dicing home

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A true “global portfolio” may surprise you

Globalization and the rise of investment markets outside the United States is old news. But have you considered how investment opportunities are now distributed around the world? Using the market capitalization of the world’s stock markets as an indicator, a truly globally weighted portfolio would have 64% of its value invested outside the US. The weightings are shown in the adjacent chart to the right.



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Another Year, Another Crisis (continued from page 1)

“If one could figure out how to take junk grade securities and transform them into very sellable investment grade securities, you have the equivalent of spinning straw into gold!”

mortgages in an attempt to mitigate risk morphed into a contagion that we managed to export worldwide. The guy down the street who is behind on his ARM nearly brought worldwide investment markets to their knees.

How could this happen? Most people know that mortgage loans are rarely held by the originating institution – they are typically sold so that the mortgage company can make new loans. Over half a trillion of loans found their way into “mortgage backed securities” last year. Those are packages of loans that are assembled by investment bankers and then resold to investors. Nothing wrong with that – owning a slice of a large pool of loans is less risky than owning a single loan. But the investment bankers figured there was more money to be made if the pool could be sliced into pieces with different

investment attributes and resold. One that has been around for awhile is to slice the pool into the interest and principal components and sell them separately. Now you have two securities that individually behave very differently than the pool. For example, if you own the interest payment component, falling interest rates are a killer. That’s because homeowners will refinance and all the future interest payments vanish, leaving the investor with nothing. If you own the principal payment component, you’re a happy camper, collecting your principal sooner rather than spread over many years.

It’s easier to sell investment grade securities than junk grade securities. If one could figure out how to take junk grade securities and transform them into very sellable investment grade securities, you have the equivalent of spinning straw into gold! Leave it to

Wall Street to figure it out. You slice and dice the mortgage pool differently.

To borrow an example discussed in *Fortune* (“House of Junk”, October 29, 2007), let’s assume you have assembled 8,274 *second* mortgage loans with an average interest rate of 10.5% where the borrowers’ average loan to value ratio is 99.29% - that’s right – practically 100%. Over half of the loans are the no-doc or low-doc variety. Because the mortgages are second mortgages, there’s no practical way to foreclose on the underlying property. This sounds like a cesspool of financial toxic waste, right? Not so fast. What if you created a slice (or tranche, to use the financial term) that was entitled to receive its principal first? Arguably, there’s less risk involved with that tranche, so it paid a rate of just over 6%. Repeat the process of

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“Kiddie Tax” Break Expiring at End of 2007

Congress learned that taxing citizens that can’t vote worked well when it enacted the “Kiddie Tax” on taxpayers younger than age 14. The tax effectively taxes the child’s unearned income above \$1,700 at the parents’ marginal rate. It

worked so well that it has expanded the complex tax to children younger than age 18 for 2006. Now on a roll, Congress further expanded the tax to include all children through age 18 and full-time students up to age 23 if the child’s earned

income does not exceed one-half of the amount of the child’s support. For calendar year taxpayers, this expansion will be effective in 2008. For parents with children who are currently age 18 -22,

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IRA Charitable Contributions – Act Now

Unless Congress acts, a useful tax provision for older Americans with IRA's is set to expire at the end of 2007. For 2006 and 2007, charitable contributions of up to \$100,000 can be made directly from IRA's for taxpayers who are age 70½ or more. Making contributions from an IRA account can be advantageous for several reasons: (1) while the contribution doesn't produce a tax deduction, neither is the IRA withdrawal included in income. As a higher income can result in deductions being phased out and Social Security

taxed more heavily, the direct IRA contribution generally produces a better result than withdrawing from the IRA and donating the amount to charity; (2) IRA assets don't receive a step-up in basis at death, making them attractive assets to donate versus others that do receive a basis step-up; and (3) a contribution can satisfy the required minimum distribution applicable to IRA holders at age 70½.

Because the donee organization's signature is required before the contribution can be effected, it's essential to

begin work on these contributions well before year end.

Even if you're not age 70½, think about using part of your IRA for testamentary charitable contributions. Because an IRA is taxed for both income and estate tax purposes, your heirs' inheritance may not be diminished as much as you might think. It's a simple process to change your IRA beneficiaries to add (or later change) a charity, ministry, or church.

For more information, contact Cindy Carroll at Matrix.

“...it's essential to begin work on these contributions well before year end.”

Tax Law Change Makes NC's 529 Plan Worth a Look

On July 31, Governor Mike Easley signed the North Carolina budget bill for 2007-2008 passed by the General Assembly. Included in the budget was a useful provision for anyone concerned about funding a college education.

North Carolina has offered a Section 529 plan for many years. Despite statewide advertising, it attracted little interest from informed investors due to (a) mediocre investment options and (b) no state tax incentives for

contributing to the NC plan versus other states' plans. Given these factors, Matrix clients in North Carolina have been steered primarily to the CollegeAmerica 529 plan offered by Virginia, which featured low expenses and the flexibility to design custom portfolios using a no-load share class of the highly regarded American Funds group. Our South Carolina clients were advised to use the SC plan due to the very generous state income tax deduction, even though the investment options are

only average.

North Carolina responded by adding additional investment options, including some decent funds from Vanguard. In 2005, the General Assembly passed a state income tax deduction of up to \$1,500 for NC 529 plan contributions, but only for moderate and low income taxpayers. There was still no compelling reason for our clients to use the NC plan at that point – few qualified for the minor tax

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“...all NC taxpayers making contributions to a 529 plan are eligible for a tax benefit worth up to \$413 each year.”

NC's 529 Plan [continued from page 3]

deduction worth only about \$75.

The 2007 amendment makes the NC 529 Plan a more attractive. The maximum tax deduction has been raised to \$5,000 for a married couple and the income limitations have been removed through 2011. This means that all NC taxpayers making contributions to a 529 plan are eligible for a tax benefit worth up to \$413 each year - more than pocket change and worth completing a few forms.

Even if you have fully funded your 529 plans, you can still take advantage of the new tax deduction. The NC Department of Revenue has told us verbally that a transfer from another state's 529 plan will qualify as a contribution.

This means that anyone with an existing out-of-state 529 plan can transfer \$5,000 into the NC plan each year and take advantage of the tax deduction.

Interestingly enough, the NC Department of Revenue also stated that a transfer from the NC 529 plan to another state's 529 plan does not result in the recapture of the tax deduction. So a contribution made or transferred to the NC plan could be moved to another state's 529 plan with no tax penalty.

Have you been thinking it's too late for a 529 plan? Are you currently paying college expenses out of pocket? A contribution to the NC 529 plan can make \$5,000 of current college expenses tax deductible on your NC tax

return. There's no specific time requirement for the funds to remain in the 529 plan. So a deductible contribution this year could fund the upcoming semester's expenses.

We believe other states' 529 plans (such as Virginia's) offer superior investment alternatives and flexibility. So we intend to keep our clients' 529 plans outside NC while taking advantage of the NC tax deduction. Compounding the potential tax savings for 18 years results in a fund of over \$15,000. Maybe that will only cover a semester of public college in 18 years, but that's one semester less to fund out of your pocket.

529 plans have been the best college savings strategy – now they are even better for us in NC.

Kiddie Tax Break [continued from page 2]

you have a brief window for the remainder of 2007 to determine what, if any, action you should take.

What sort of action? The 2007 capital gain rates available to your 18-22 year old may be the best tax deal we will have for a while. So a 2007 sale of appreciated assets that would otherwise be sold in a later year before the child reaches age 23 could make sense. For

example, your 18 year old son earns \$2,000 in wages, \$200 in interest, and will be selling assets with a \$35,000 gain in the next four years to cover college expenses. If the sale occurs in 2007, his Federal tax bill will be \$1,593. If the sale occurs in 2008, the tax bill jumps to a whopping \$5,050 – more than a 300% increase.

What if your 18 year old

won't need the assets until past age 22? You still might consider a sale. A 5% Federal capital gains rate may be a thing of the past in a few years.

All situations are different. An analysis of your individual circumstances is the best way to determine how to take advantage of this tax planning window. Contact the planning team at Matrix for more details.



You may not be smiling in 2008...

Fourth Quarter Investment Synopsis

The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. But it was, with the S&P 500 gaining 2%. Moreover, through September the index is up 9.1% on the year. While the numbers for the overall stock market were quite satisfactory over both periods, there was a wide degree of variation across asset classes. Value benchmarks were in the red for the quarter, with smaller-caps doing worse. Growth benchmarks did quite a bit better, with larger-cap growth stocks generally delivering strong returns during the quarter. For the year growth is ahead of value by a wide margin after seven consecutive years of under-performance. International stocks gained over 4% in the quarter, extending their run of impressive returns. With the exception of high-yield bonds most other fixed-income asset classes had a solid quarter, with investment-grade bonds climbing almost 3%. Commodity futures gained over 6%. REITs managed to post a positive quarter with a return of 2.4% though they are still in the red on the year.

When excesses end, things don't just return to "normal." Often they go to

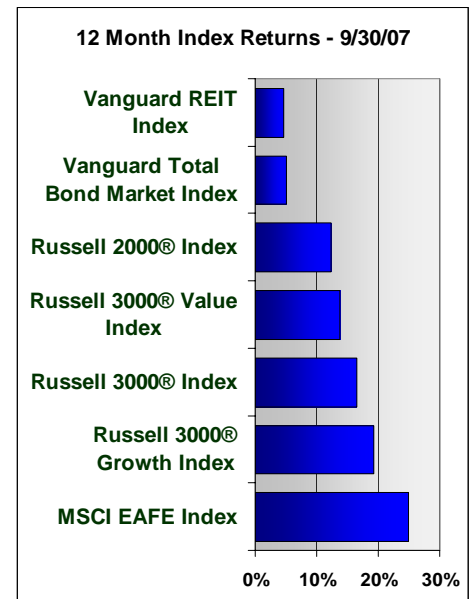
excess in the other direction. This type of snapback triggered much of the volatility during the third quarter as there was an extreme lack of interest in holding consumer-backed debt, and an inclination on the part of most institutions not to lend to each other. This cascaded into broader risk avoidance on the part of investors, hedge funds, and other financial market players who had played an important role in expanding the amount of available credit. This was greatly exacerbated by large amounts of leverage (debt) held by many of the non-bank credit providers (e.g., hedge funds). The result was that credit, which as noted is crucial to the economy, was sharply restricted for a few weeks. With the Fed's decisive action in September to cut the federal funds rate by 50 basis points things have settled down but they have not returned to normal. Capital will no longer be available to certain groups of borrowers and it will be costlier to other groups. This we can count on and it's not a bad thing, because excess liquidity was leading many investors to make imprudent investment decisions. What is bad is a seizing up of the credit markets in a credit-dependent economy. It seems highly probable that the economy will, at

the very least, experience slower growth.

The question now is how long it will take to fully return to a normal credit environment, which is necessary to mitigate recession risk. If there are other events that shock the markets and cause another retrenching, recession risk will rise further. Because there is a lot of credit extended through hedge funds (which lend their capital) and structured products (e.g., collateralized debt obligations which slice and dice loan portfolios to create different risk tranches that are then repackaged and sold to investors) it is difficult to know the magnitude of some of the more questionable debts, who holds them, and whether they are in strong or weak hands. This in turn makes it hard to know if there may be blow-ups yet to come.

While the credit markets are better than they were but still not back to normal, the other problem—also making daily headlines—is the housing market. The housing market is loaded down by months of excess inventory, while at the same time the downfall of the subprime lending market and the tightening up of the rest of the mortgage market has led to a sort of negative feedback loop. The

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Another Year, Another Crisis (continued from page 2)

“Aftershocks will be evident in the next few months. More losses are yet to be uncovered.”

slicing tranches 12 more times with decreasing security and increasing rates for each. Because the large majority of the tranches pay rates of less than 8%, there's a nice profit left for the promoting firm and a small margin to cover defaults (less than 3%).

The rating agencies loved it. Both Moodys and S&P gave the first three tranches (68% of the issue) the highest rating – AAA. Another 25% received lower but still investment grade ratings. Only the bottom three tranches (7%) were rated as junk or unrated. Voila! You have created sugar out of compost.

Given yield hungry investors and the blessing of the rating agencies who discounted the risks, this issue sold out easily in the spring of 2006. But less than one year later, defaults began to take their toll. In February 2007, the issue's tranches were downgraded across the board, substantially reducing their market value. In March 2007, the lowest tranches became worthless as defaults eliminated the possibility of any future repayment. By now, 18% of the loans have defaulted, rendering the bottom seven tranches worthless. Three more are questionable,

currently rated as junk, with only the top three tranches still (barely) rated investment grade.

Repeat this scenario hundreds of times (granted this is one of the worst) to the tune of \$1.5 trillion of subprime debt. When the world investment markets saw “investment grade” debt becoming worthless, they had a seizure.

The first victims (to use the term loosely) were the subprime mortgage originators. First, no one would buy the loans they originated. Secondly, most loans contain a “put” provision requiring the originator to buy the loan back if a default occurs within a specified period under the theory that the underwriting was flawed for a default to occur so quickly. With limited resources to make good on the loans being put back to them, many went bankrupt very quickly.

Anything that could even be partially labeled as “subprime” very quickly had no liquidity as buyers could not be found. No one quite knew what these securities might be worth, so values dropped precipitously. When the securities are collateral for loans (as is often the case in hedge funds), your equity can be quickly wiped out. Let's say you run a \$10

million portfolio funded with \$2 million of equity capital and \$8 million of borrowed capital. If the value of the portfolio falls by 25%, all the equity is wiped out and the lenders are calling their loans. Several hedge funds bit the dust with this scenario and more will likely follow.

Hedge fund problems also create some nasty collateral effects. To raise capital to meet margin calls, they are forced to sell securities, creating downward pressure on prices. Many hedge funds also short securities, so they are forced to buy lower quality securities to unwind short positions. Those that engage in currency hedging or commodities futures also had to unwind many of those positions, creating more market turmoil.

One interesting aspect of the subprime debacle is its global reach. For better or for worse, we managed to export a portion of the problem to all parts of the world. Foreign investors as diverse as Chinese banks, French hedge funds, and Australian municipalities have all experienced painful losses.

Aftershocks will be evident in the next few months. More losses are yet to be uncovered.

A true “global portfolio” may surprise you (continued from page 2)

This means one could rationally argue that a portfolio of equities that strays significantly from this allocation is “unbalanced”.

Traditionally, portfolios have emphasized US equities with relatively minor allocations to foreign issues. Some investors’ attitude about foreign stocks is like broccoli – I don’t particularly like it, but I know it’s good for me, so I should have some. Why is that?

First is the perceived risk of foreign currency fluctuations. True enough, one does face currency risk if the dollar rises in value (consequently lowering the value of investments denominated in foreign currencies.) A rising dollar has not been a problem lately!

Secondly is the “home market myopia” phenomenon. Investors tend to far overweight the stocks of their familiar home country, be it the U.S., the U.K. or Austria. One would agree that it would be difficult to justify keeping 70% of your assets in Austria just because you happen to live there.

If you read a prospectus for a foreign stock fund, you’ll see a section on political risk. What if there’s a revolution in a country? There have been cases of expropriation of privately

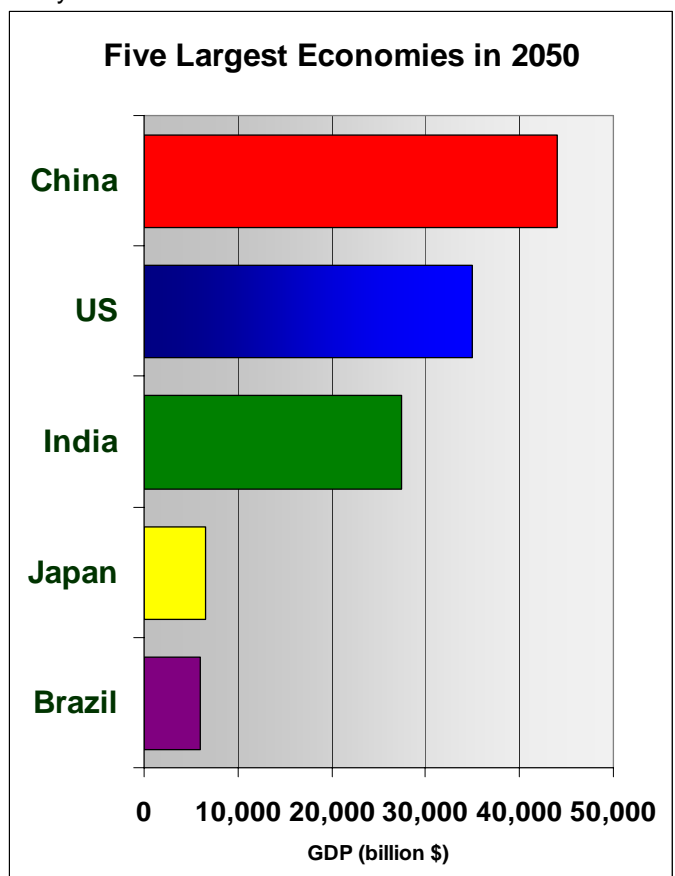
owned assets, with and without just compensation. We saw this first hand in Cuba and recently in Venezuela. Mark Yusko with Morgan Creek Capital Management argues convincingly that a country with huge budget deficits, astronomical unfunded Social Security and Medicare liabilities, enormous current account deficits, and huge tax increases likely in the future is the one with political risk! (He’s talking about us, not a banana republic.)

One can argue that the US is still the world’s largest economy and therefore deserves the lion’s share of an equity portfolio. The counter-argument is that the times are changing and we should pay attention to the global macro trend of China and India. Depending upon which futurist you find most believable, the Chinese economy surpasses the size of the US economy at some point in the first part of this century. According to British economic journalist Hamish McRae in his book *The World in 2020*, the US will be in second place in a new Sino-centric world order, with India not far behind. (See his projection in the accompanying chart.) The implications for trade, investments, energy prices, and just

about everything are almost mind boggling. There are issues that make direct investing in China and India difficult and, yes, risky. But we ignore such a pervasive trend at our peril.

We don’t believe the US is going to fall like the Roman Empire in our lifetime (though some parallels are unnerving!) As you know, Matrix’ core investment philosophy focuses on risk control. To us, the evidence is mounting that, contrary to the conventional wisdom, a *higher* allocation to foreign equities will be more prudent – and less risky - in the future.

“According to British economic journalist Hamish McRae in his book *The World in 2020*, the US will be in second place in a new Sino-centric world order, with India not far behind.”



Fourth Quarter Investment Synopsis (continued from page 5)

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problems result in fewer and more-cautious buyers, which makes for softening prices, which keeps lenders cautious, which makes for fewer buyers, which softens prices, and so on. With housing equity extraction largely shut down and home sales severely slumping, the economy is faced with the possibility of a material cutback in consumer spending—the primary driver of economic growth. Consumers have less cash available, there are fewer homebuyers buying things for their new home, and the homebuilding and mortgage industries are retrenching. All this has a negative multiplier effect on the economy.

About Matrix Wealth Advisors, Inc.

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

But the news is not all bad. The global economy has been quite strong and is less dependent on the U.S. than it used to be. In general, due to much-improved economic fundamentals, the emerging markets are playing a much more important role in the global economy. On the other hand, the credit crunch is being felt around the world, not just in the U.S. Europe, in particular, is sharing the U.S.'s experience and in several countries there are similar problems in the housing market.

The weakness in the dollar, as long as it doesn't turn into a rout, is like an interest rate cut.

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

It will help U.S. export growth, which has already been very healthy, and contribute to the bottom line of U.S. firms that do business globally. Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy. For this reason central banks around the world would take extreme measures to avoid it.

The Fed does have influence and room to maneuver. If the economy continues to weaken, the Fed can be expected to continue to lower short-term interest rates.

As usual, the crystal ball is murky. Stay tuned.

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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