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TAX STRATEGIES FOR LOWER STOCK PRICES

There are very few advantages that investors might find during market declines, but one area of offsetting benefit may be tax breaks from stock price declines. Consider these strategies:

CONVERT A TRADITIONAL INDIVIDUAL RETIREMENT ACCOUNT (IRA) TO A ROTH IRA. When converting from a traditional to Roth IRA, transferred amounts must be included in income if taxable when withdrawn (e.g., contributions and

earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal tax penalty. However, with portfolio values down substantially, converting now will result in a lower tax bill. For example, assume that several months ago you had a traditional IRA with a \$200,000 balance in stocks (all taxable). If you are in the 28% marginal tax bracket, converting would have meant a tax bill of \$56,000 (\$200,000 times 28%). Now, however, your balance has declined 30% to \$140,000. Converting now would result in a federal tax bill of \$39,200, a reduction of \$16,800. (This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)

DOES HISTORY FAVOR VALUE OR GROWTH STOCKS?

Is there a clear winner in the debate between value and growth investing? And is there any reason to favor either one now that we're in the midst of a bear market?

GROWTH INVESTING

For those who believe the main reason to invest in individual stocks is to outperform the indexes by a wide margin, growth investing holds a special allure. By definition, growth stocks are comprised of companies experiencing well above-average growth rates in revenues and earnings. Typically, revenues and earnings are growing by a minimum of 20% per year, while growth rates of 50% or higher per year are not unusual.

Generally speaking, growth companies are relatively early in their life cycle and feature new products, new technology, or dramatically new marketing or distribution strategies. The most common fundamen-

tal benchmark of growth companies is a high price/earnings (P/E) ratio compared to the prevailing average for the company's industry or the overall stock market, typically 20 or higher.

VALUE INVESTING

Instead of spectacular annual returns, value investors seek more modest but steady rates of return, often coming at least in part from dividends. In contrast to growth companies, value firms typically demonstrate solid but unspectacular rates of growth in revenue and earnings, often below 15%.

Value companies tend to be well-established firms, often with stock prices that have suffered in connection with some adverse developments. The key to being identified as a "value stock" is the belief that the adversity is temporary, and that the company's management can lead the company to better performance. In

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Once the IRA is converted to a Roth IRA, qualified distributions can be taken on a tax-free basis. To convert, your adjusted gross income (AGI) cannot exceed \$100,000, excluding any conversion amounts. This income requirement will be permanently removed in 2010, so that all taxpayers will be able to convert. There are many factors to consider, but the ability to pay the tax bill with funds outside the IRA is a major advantage.

Did you already convert some-time in 2008, but now the value of your Roth IRA is even lower? You

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TAX STRATEGIES

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have until October 15, 2009, to recharacterize your conversion, meaning you can convert back to your original traditional IRA. You can then reconvert your traditional IRA to a Roth IRA at a later date, provided your AGI does not exceed \$100,000 in the conversion year. Reconversion can be completed at the later of 30 days after the recharacterization or the beginning of the tax year following the first conversion.

USE STOCK LOSSES TO OFFSET OTHER CAPITAL GAINS. You can use stock losses to offset other types of capital gains. You don't have to match stock losses with stock gains. If you have capital gains from the sale of another type of asset, such as a business or real estate, consider selling stocks with losses to offset those gains.

RECOGNIZE LOSSES TO AT LEAST OFFSET \$3,000 OF ORDINARY INCOME. Keep in mind the tax rules regarding capital gains and losses — capital losses offset capital gains, and an excess of \$3,000 of capital losses can be offset against ordinary income. If you are holding stocks with losses in your portfolio, you should probably take advantage of this tax rule.

Don't want to part with any of your stocks right now? You can sell the stock, recognize the loss, and then repurchase the stock. You just have to make sure to avoid the wash



sale rules. These rules state that you must repurchase the shares at least 31 days before or after you sell your original shares to recognize the loss for tax purposes. That timing can be troublesome. If the stock's price rises substantially before you repurchase it, your tax savings from the loss deduction may not be worth as much as the investment gains during that time period. You can avoid that concern by purchasing the additional shares first and then selling your original shares 31 days later. Another strategy is to purchase a similar stock, perhaps a competitor, to replace the stock you sold. Since it isn't the same stock, you don't have to wait 31 days to purchase it.

CONSIDER RECOGNIZING ALL, OR A SUBSTANTIAL PORTION, OF YOUR LOSSES. First, realize that no one likes to sell investments at a loss. And since you can only offset an excess of \$3,000 of capital losses against ordinary income, you might wonder why you should incur large losses that can't be used currently, even though you can carry the losses forward to future years. There are a couple of advantages to this strategy.

First, it gives you an opportunity to totally reevaluate your portfolio. If you are convinced your investments are good ones, you can sell them, recognize the tax loss, and then repurchase the stocks, being sure to avoid the wash sale rules. But it's probably more likely that you own some investments you wish you didn't or you don't think will recover as quickly as other investments. This is your opportunity to reinvest in stocks you believe have better potential going forward.

Second, it gives you more flexibility when recognizing gains in the future. After this bear market, you may be a little more skittish about letting capital gains ride with the market. Until you use all of your capital losses, you can recognize capital gains without worrying about paying taxes. Even if your losses are long term, you can use them to offset



short-term capital gains that would be subject to ordinary income tax rates.

GIFT STOCKS. Every year, you can gift a specific amount (\$12,000 in 2008, \$24,000 if the gift is split with your spouse) to any number of individuals free of gift taxes. Additionally, you have a lifetime gift-tax exclusion of \$1,000,000. Thus, those with estates large enough to be subject to estate taxes should consider using this exclusion to remove assets from their taxable estate. This also removes any future appreciation or income generated on those gifts from your estate.

Since gifts of securities are valued at their current market price at the time of your gift, you can now gift more shares of stocks whose values have gone down without causing any tax ramifications.

DON'T GIFT STOCKS WITH LOSSES TO CHARITIES. If you are planning a large charitable contribution, it makes sense to donate appreciated stock held for over a year. You deduct the fair market value as a charitable contribution subject to limitations based on a percentage of your AGI, and avoid paying capital gains taxes on the gain. If the stock has a loss, however, you should sell it first and then send the cash to the charity. That way, you get the charitable contribution and recognize a tax loss on the sale.

No one is happy when their portfolio values decline. At this point, however, the only thing you can do is use those losses to your best advantage. Please call if you'd like to discuss these strategies in more detail. ○○○

DOES HISTORY FAVOR?

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essence, value companies' stock prices are at bargain prices, and over time, it is believed that the prices will rise. Their P/E ratios tend to be below their industry average or the broad market average.

According to a study by Ibbotson Associates, from 1969 through 2006, value stocks outperformed growth stocks by an average of 2.5% per year, while being 15% less volatile (Source: *The New York Times*, July 8, 2007).^{*} Studies have also shown that value stocks perform well in bear markets. One study found that in the 2000–2002 bear market, the average value stock increased over 80%, while the stock market as a whole fell 48.6% (Source: MarketWatch, March 3, 2008).

After reviewing the results of these studies, you might think the best portfolio strategy would be to concentrate exclusively on value stocks. However, value stocks tend to underperform growth stocks during bull markets. For example, during the bull market years of 1998 and 1999, large growth stocks experienced total returns of 38.1% and 33.2% respectively, compared to total returns of 15.7% and 7.4% for large value stocks' returns (Source: Allianz Global Investors, 2008).

As a result, there's been a growing consensus that investors should be invested in both value and growth stocks at all times. It's impossible to select the exact moment that a bear market begins or ends. Without being invested in both styles, investors are not only certain to miss at least a portion of the benefit of each, but run the risk of switching at the wrong time. Please call to discuss this in more detail. ○○○

^{*} These returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment. Past performance is not indicative of future performance.

HOW LONG UNTIL THE NEXT BULL MARKET?

If you're feeling investment pain right now, it's no wonder. The question on everyone's mind is: When will this bear market end and the next bull market begin? The answer is that no one really knows, but a quick look at history can provide some clues as to what to expect.

Prior to this, the Standard & Poor's 500 has experienced 10 bear markets since 1956, or one approximately every five years. These bear markets lasted from three months to almost two years, with an average length of 14 months. The range of declines was 19.9% to 49.2%, with an average decline of 30.4%. After those bear markets, it took from 4.3 months to 69.4 months to return to previous highs, with an average recovery period of 18.8 months. Details of those 10 bear markets follow:

Period	Percent Decline	Duration (Months)	Recovery (Months)
March 2000 to October 2002	49.2%	30.5	51.0
July 1990 to October 1990	19.9	2.9	4.3
August 1987 to December 1987	33.5	3.3	19.7
January 1981 to August 1982	25.8	19.2	5.1
September 1976 to March 1978	19.4	17.5	17.3
January 1973 to October 1974	48.2	20.7	69.4
November 1968 to May 1970	36.1	17.9	21.3
February 1966 to October 1966	22.2	7.9	6.9
December 1961 to June 1962	28.0	6.4	14.3
August 1956 to October 1957	21.6	14.7	11.1

Source: Standard & Poor's Corporation. The Standard & Poor's 500 is an unmanaged index generally considered representative of the U.S. stock market. Past performance is not a guarantee of future results. Investors cannot invest directly in an index.

While it's instructive to review how long it took to recover losses, what's really important is how long it takes until the markets find a bottom and start to recover — marking a new bull market with new opportunities. During bear markets, the stock market doesn't typically just head straight for a bottom and then start rising again. Bottoms tend to be choppy, with the markets advancing and declining over a period of time. That's because they occur during a period when fear and optimism about future economic conditions shift back and forth. During bear markets, growing fear outweighs brief moments of optimism, dragging stock prices down.

The stock market is a leading economic indicator, meaning it reflects investor opinions about where the economy is headed, not where it is at the current moment. Typically, it anticipates economic conditions by six months or so. Since we never know when the economy will emerge from a period of contraction, you can only know in hindsight whether an upturn in a bear market is temporary or will be followed by further lows.

In the end, it's important to remain calm during bear markets, since portfolio decisions made in moments of panic tend to be the worst possible moves. In light of the current market and economic conditions, it pays to review your own portfolio and strategies. Your portfolio should reflect your risk tolerance and investment time horizon. It should also be properly diversified, both to minimize your risk and to help maximize your returns once the stock market turns around. Please call if you'd like to review your portfolio. ○○○

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INFLATION-PROOFING YOUR PORTFOLIO IN A BEAR MARKET

After averaging just 2.7% a year between 1998 and 2007, U.S. prices rose 4.2% during the first nine months of 2008, even though we are mired in a bear market that normally portends lower economic growth ahead (Source: Bureau of Labor Statistics, 2008). Thus, you can't ignore the menace to your portfolio that inflation poses.

Inflation is a significant risk to your portfolio's value that often goes unacknowledged by investors. Not only does it reduce the purchasing power of your investments, but when it flares up, it can be responsible for significant economic problems. Stocks are the asset class typically touted to protect against inflation, but they are suffering large declines in this bear market. Where can you turn now?

First, let's review the causes of inflation and our economy's experience with it.

OUR LONG-TERM INFLATION RATE IS BENIGN

Except for a few brief periods, the U.S. economy has experienced a relatively low inflation rate, as measured by the Consumer Price Index (CPI). Compiled by the Bureau of Labor Statistics, the CPI has risen an average of 3.1% annually from 1926 to 2007.

A low and stable inflation rate both contributes to and is a sign of a healthy economy. A low inflation rate holds down interest rates and the cost of borrowed capital. A stable rate

makes it easier for consumers and businesses to plan reliably for the future. When combined with rising wages, low inflation also stimulates saving and investment by making payments on fixed-rate loans and mortgages a smaller share of household income.

But when the inflation rate spikes, economic growth suffers. The cost of borrowing increases, putting a damper on the loans that fuel business and consumer spending. In turn, that leads to lower profit margins, higher operating costs, lower sales, and ultimately, rising unemployment — conditions that can lead to a recession.

Things get out of hand, however, when buyers spend beyond their means by taking on too much debt. When the government joins in by borrowing or printing too much money, you get the right conditions for inflation to get out of control. That was the case in the 1970s. Between 1973 and 1982, the stock market moved virtually sideways, while inflation hit double-digit rates in four years and averaged 9% a year during this period — triple its current long-term average.

Are we in for a repeat of the 1970s? The conditions are reminiscent. America is fighting two wars, the stock market is experiencing a bear market, and it looks like we are entering or already in what could be a severe recession. At the same time, a series of huge bailout measures to rescue major financial institutions

has ballooned government spending, and the fundamentals of global supply and demand suggest the recent decline in oil prices may only be a temporary respite.

In the near term, stocks don't seem likely to serve as the trusted inflation hedge that they have for most of the last 80 years, so it's natural to be concerned about the effects of inflation. Thus, you may want to consider Treasury Inflation Protected Securities (TIPS).

THE BASICS OF TIPS

In 1997, the U.S. Treasury created a new investment: a bond protected against inflation and backed by the full faith and credit of the U.S. government. To provide this inflation protection, the bond's face value is periodically adjusted based on the increase in the Consumer Price Index for All Urban Consumers (CPI-U). The bond's interest rate is determined at auction and does not change during the bond's life, but the principal is adjusted every six months. Thus, subsequent interest payments are based on the increased principal amount.

If the CPI-U decreases, your principal will decrease, so that your interest payments will also decrease over time. However, when the bond matures, you'll still receive the full principal value.

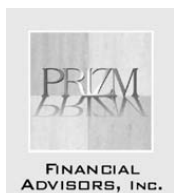
From a tax standpoint, interest income is subject to federal income taxes but not state or local income taxes. Also, any increase in the bond's principal value is subject to federal income taxes in the year the adjustment is made, even though the funds aren't received until the bond matures. However, if the TIPS is held in a tax-advantaged account, such as a 401(k) plan or individual retirement account, income taxes are not paid until the funds are withdrawn.

If you think an investment in TIPS is worth considering, please call to discuss them in more detail. ○○○

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PLEASE CALL

As year-end rapidly approaches, now is a good time for a complete review of your portfolio to see if there are any changes or tax strategies that should be implemented. It is also a good time to review your investment strategy, reinforcing the long-term nature of that strategy. Please call if you'd like to review your portfolio. ○○○

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