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Credit Crunch Places Focus On Rating Agencies

The names are familiar to every investor: Standard & Poor's, Moody's Investors Service, Fitch Ratings. They're the nation's premier credit rating companies, and they're supposed to provide investors with credible, independent information to help evaluate investment risk. All three are now under fire, accused of conflicts of interest that may have contributed to the agencies' failure to warn of the credit crisis sparked by the subprime mortgage fiasco.

A group of federal regulators led by Treasury Secretary Henry Paulson has demanded the credit agencies change the way they do business, warning that if they don't act quickly they will face stringent new rules. The Treasury Department and other financial regulatory agencies want the credit rating agencies to rate complex structured products differently than they do conventional bonds. The agencies routinely assigned top ratings to securities that bundled mortgages issued to borrowers with questionable creditworthiness. When those homeowners began to miss payments, the defaults had a domino effect on the whole credit system. Regulators now also want the credit agencies to toughen standards for companies that originate complex loans wrapped in securities, to disclose conflicts of interest, and to release more details of their work.

Those were among the recommendations of the President's Working Group on Financial Markets, which includes the heads of the Federal Reserve Board, the Federal Reserve Bank of New York, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission. The reforms are intended to ensure that credit ratings are more accurate, timely, and understandable, and that rating agencies are objective and not beholden to the companies they rate.

The current scrutiny of these agencies was triggered by their late reaction to the nation's burgeoning credit crisis. Moody's, S&P, and Fitch all failed to downgrade the investment ratings of securities backed by subprime mortgage loans until July 2007, despite warnings raised months earlier by major banks. The rating agencies had also been widely criticized in 2001 and 2002, when they failed to downgrade bonds issued by Enron and WorldCom until after those companies imploded.

At the heart of the problem are potential conflicts of interest. The credit agencies rate securities while providing advice, for a fee, to Wall Street firms on how to package those securities to obtain the highest possible credit rating. In addition, the top three firms have a virtual monopoly on providing investment banks and brokerages with the risk evaluations the SEC requires. "Lack of competition has lowered the quality of ratings, inflated prices, stifled innovation, and allowed abusive

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Time To Refocus Under Our Market Umbrella

Over the last near-decade(and especially in the last year), the buy-and-hold approach to investing has taken one on the chin. For many, it will be years before they recoup the losses—but at FSA, we have taken measures to minimize the market impact by staying true to our strategy of getting under our money market fund umbrella while the rain falls.

This is a great time to see what else needs to be put under the umbrella. Over the years, we have continued to encourage you to tell us about the "big picture" of your financial life. As markets move (up or down) and as life happens (up or down), we always want to make sure that your investments are allocated properly. For example, let us help you with your 401(k) so that it complements your FSA portfolio.

This goes beyond your investments. How much are you saving? How much life insurance do you have? How long until you plan to retire? How long until the kids are off your "payroll?" These are just a few variables that factor into our recommendations regarding your portfolio.

In this issue, enjoy articles relating to other facets of our lives, including whether to share assets with a spouse and a look at how trusts work. Also, read about a major factor that led our economy from under the umbrella over the last several years: the credit crisis.

Jim Joseph, CFP®
Vice President

They Don't Call 'Em Trusts For Nothing

Maybe you heard the story about the 60-year-old oil heiress who died and left everything to her husband. He was 71 and died just two months after remarrying a much younger woman, who inherited his first wife's fortune. The heiress' children got none of it. Or perhaps you heard about the man who left his son $500,000, which he used to buy a house with his wife. Two years later, they divorced, and she got the house in the settlement.

Then there's the one about a couple that inherited $250,000 from an uncle but received none of it because the IRS exercised its right to take the inheritance to satisfy back taxes.

Obviously, these aren't the kinds of stories that you want people to tell about your family. To avoid the possibility of such trouble, you may need to establish a trust.

A trust is an agreement in which you transfer ownership of property to a trustee of your choosing, who then manages it for the benefit of your loved ones. The trust can be funded during your lifetime or at your death if your will provides for it. Typically, it costs between $1,000 and $2,000 to set up a trust, although you might spend more depending on where you live, the legal advisor you use, and the complexity of the trust.

Life is full of surprises, but experts say that you can trust a trust

Trusts have long been used by the wealthy to reduce estate and income taxes, but more and more middle-class people are finding trusts can benefit them, too. Appreciation in real estate values over the long term, stock market gains for astute investors, and the slow march of inflation have thrown many middle-class individuals into higher income tax brackets and left them facing the prospect of estate taxes that could decimate the value of bequests to their loved ones.

A bypass trust can ensure that a married couple maximizes its combined estate tax exemption of $4 million (for 2008); a charitable remainder trust can reduce estate taxes while allowing you to do good for your community; and a life insurance trust can help guarantee the amount your heirs will receive. You can also use a trust to direct how the assets you leave behind will be managed, and to ensure that your bequests end up with the intended heirs.

The oil heiress, who had thought she was too young for estate planning and had feared that her 25-year-old son and 27-year-old daughter would squander the money, could have used a trust. She might have set aside some assets in the trust for her children until they were older, or she could have appointed a trusted friend or advisor as trustee to disburse the assets.

A trust also would have left the divorcing son in a better bargaining position to keep his house. Had his father left the money in a trust, allowing a trustee to buy the house for the son, the wife wouldn't have been able to get it. And the IRS could not have seized the assets in a trust established for the beneficiary with tax problems.

Life is full of surprises, but you can trust a trust. ●

Want To Cut College Costs? Hire Your Kids

Spending even more on your children can actually save you money. Sounds paradoxical? Thanks to a strategy called income shifting that lets you transfer assets to a family member in a lower tax bracket than yourself, it's true. Hiring your kids broadens this option by lessening your taxable income and slicing business taxes.

Here's the math in a nutshell: The salary expense reduces your business profit, so you save on taxes at your marginal rate. Your child may even be able to earn an annual salary reaching five figures without paying income taxes. That means potential savings of several thousand dollars for your family.

The job must be real. For your business to deduct the salary, the expense must be necessary for its operation. You can't pay your child for doing chores around the house and expect a tax deduction. Recently, a physician's payment of $11,000 to his son to empty trash, sort mail, and answer telephones was found "unreasonable" by the IRS and the salary was recharacterized as a taxable gift. Researching local job-market conditions can help document a fair wage for the job.

Administratively, treat your child as you would any employee. Prepare a job description, keep time sheets, and put your child on payroll—in other words, don't pay him as an independent contractor.

Besides tax rules, you may need to comply with federal and state labor laws, depending on your child's age, the type of work performed, and other factors.

Determine the savings. There are several tax benefits. Not only do you pay taxes on less income, your child gets breaks that may not be available to you. For instance, he can take a personal exemption for himself, saving you from being hit with higher taxes if you earn $239,950 or more for 2008. Married taxpayers whose earnings exceed this amount forfeit all or a portion of their deduction for dependents. Moreover, your child may

How Far Have Housing Prices Dropped?

You don't have to be in the market for a house—or, worse, trying to sell one—to know home prices have been dropping across the nation, and residential real estate values may fall still further. During the past year, homes in the seven hardest-hit areas—Las Vegas, Miami, Phoenix, Los Angeles, San Diego, San Francisco, and Tampa—lost more than a fifth of their value on average. All 20 metropolitan areas included in the Standard & Poor's/Case-Shiller Home Price Indices have lost value in the past year. The composite index for the 20 areas fell 15.3% from April 2007 to April 2008, a record low. 13 of the 20 sectors posted record low annual declines, with 10 in double digits.

It's no coincidence the markets with the largest declines are those that enjoyed the most spectacular growth in prices during the past few years. During 2004 and 2005, for instance, homes in Las Vegas appreciated at an annual rate of more than 50%, while Miami residences gained 30% a year.

That all changed when the subprime mortgage market collapsed. Easy credit for unqualified homebuyers ultimately spawned record numbers of foreclosures. And while the mortgage failures make up only a very small percentage of the overall market, they contributed to the glut of homes for sale, causing prices to fall in most major U.S. markets.

Las Vegas and Miami home prices fell most among the 20 real estate markets measured, losing 26.8% and 26.7%, respectively, during the April-to-April period. Detroit, Minneapolis, and Washington, D.C. rounded out the 10 markets suffering double-digit losses.

Seeing *Red*:
Home values fell in all 20 metropolitan areas
Year-over-year changes in housing prices from April 2007 to April 2008.

Biggest Losers		Best Performers	
Las Vegas	-26.8%	Charlotte	-0.1%
Miami	-26.7%	Dallas	-3.4%
Phoenix	-25.0%	Denver	-4.7%
Los Angeles	-23.1%	Portland	-4.7%
San Diego	-22.4%	Seattle	-4.9%
San Francisco	-22.1%	Boston	-6.4%

Source: S&P/Case-Shiller Home Price Indices

While many analysts view this downward trend as a normal market adjustment after home prices had more than doubled during the past decade, few anticipate a quick upturn. "There might be some regional pockets of improvement, but on an annual basis the overall numbers continue to decline," said David M. Blitzer, who chairs the index committee at Standard & Poor's,

The regional pockets of improvement that he is referring to are the eight markets that were positive in April, up from two markets without losses during March. Leading the indices in April were Cleveland and Dallas, at 2.9% and 1.1% respectively. In March, Charlotte and Dallas' monthly increases were the first in any of the 20 index markets since August 2007.

While seven markets reported losses of more than 2% in April, only two markets lost more in April than they did in March, which may be evidence of a slow recovery.

The 20-city composite index peaked in July 2006 at 206.52, after rising steadily from the yardstick's initial value of 100 in January 2000. In April 2008, the 20-city composite stood at 169.85, down 17.8% from its peak—though still showing a 70% gain in prices nationally since the beginning of the decade.

Home prices are likely to continue to fall at least through the third quarter of 2008. With the U.S. economy slumping, fewer potential buyers will enter the market, and foreclosed properties will add to the large inventory of unsold homes. In many areas, there are now triple the normal number of houses on the market.

Charlotte and other cities in which homes have kept much of their value have benefited from growth in high-paying jobs. More people in those areas can afford to buy houses, and fewer were caught in the subprime mess. These regions also saw less activity from real estate speculators, who sent prices into overdrive in Las Vegas and other "hot" markets.

The Case-Shiller indices—developed in the 1980s by Yale University economist Robert Shiller, author of Irrational Exuberance, and Wellesley College economist Karl Case—have become the gold standard for economists and investors seeking to monitor the real estate market. Case and Shiller developed the "repeat sales pricing technique," which tracks the prices of specific single-family homes through local records. On resale, the new price is matched to the first price of each home—the two data points comprise a "sale pair"—and all sale pairs in a region are aggregated into one index, with adjustments for foreclosures, sales between family members, suspected data errors, and even changes in quality due to remodeling, additions, or neglect.

Some investors use financial instruments based on the Case-Shiller indices to hedge their investments in real estate. But with such steep recent declines, buying opportunities are beginning to present themselves. If you bought your house near the market's peak and are concerned about the continuing drop in prices, or if you're thinking of buying now to catch a housing market rebound, we can help you evaluate your options. ●

qualify for either the Hope or Lifetime Learning education credits, both of which begin to phase out in 2008 for couples who earn more than $96,000.

However, that's not quite the whole story. Total family payroll taxes may actually increase by about 12% of the salary paid, offsetting some of the income-tax savings described above. But even so, this strategy can slash the family's taxes. If a business owner with an annual profit of $250,000 hires and pays his 20-year-old son $20,000, the family's total tax bill will be almost $5,000 lower, assuming a 5% state income tax. At $350,000 of profit, the savings would be $6,000.

Consider financial independence. If your child provides more than half of his own support—which presumably he will if the salary helps fund college or other expenses—you generally can't claim him as a dependent. While the family's total IRS bill may be reduced, consider whether employing your child can have a negative affect on financial aid. ●

If you were to pay your child just $2,000 per month, here's what would happen:

$24,000 salary (adjusted gross income)
- $3,200 personal exemption
- $5,000 Standard Deduction
= $15,800* TOTAL FEDERAL TAXABLE INCOME

$2,005 Federal income tax on $15,800
- $2,000 Education credit (maximum*)
= $5 INCOME TAX

* If your child is over age 18, you would need to withold FICA.
** Assumes Lifetime Learning Education credit based on $10,000 of qualified education expenses.

Marriage Doesn't Mean Owning All Your Assets Jointly

Marriage is all about togetherness. Yet when it comes to owning assets, too much togetherness may not be financially healthy.

Owning assets jointly is more convenient than individual ownership, and it's the simplest way to avoid probate after a spouse's death. But couples often should consider separating their assets. Here's why:

Estate tax implications. Estate rules let spouses leave unlimited property to each other tax free. That's okay when the first spouse to die leaves everything to the second, but the second death could result in a whopping tax bill. Couples likely to have estate tax issues could acquire property individually to help maximize the value of each other's estate tax exclusion. While owning a house jointly is important for giving both spouses equal claim if they divorce, other assets can and should be held separately in roughly equal shares.

Dividing jointly owned property. How you take title also affects who can inherit your property. If you own it individually or jointly as "tenants in common," each of you may specify in your will that you want a particular asset or share of an asset to go to a designated heir. However, if you take title as "joint tenants" (with rights of survivorship) or "tenants by the entirety"—the most common form of ownership for married couples—you won't be able to say how assets are split. That may work if you and your spouse share the same beneficiaries. But it could be a problem if, for example, you're in a second marriage and want to divide assets among children from different marriages.

Consider John and Mary. Because they own their property as tenants in common, each holds 50%, and John can bequeath his share to children from a prior marriage. Mary won't automatically inherit John's interest.

But if they hold their assets as joint tenants or tenants by the entirety, the surviving spouse becomes the sole owner of everything the couple owned together. It won't matter that John's will names his children as beneficiaries; if he dies first, the title documents will govern, and Mary will decide how assets are divided when she dies.

Other considerations. Owning assets separately is especially important if your combined net worth is at or above the IRS estate tax exemption—$2 million in 2008 and $3.5 million in 2009. Once you approach those levels, it pays to consider ways to separate assets. Also, since joint-tenancy assets can be taken by creditors or lost in lawsuits once an individual's assets are exhausted, doctors or others who can be sued easily will want at least half of their assets in their spouse's name.

Deciding how to hold title to your assets is not a simple decision, as state laws differ and each situation is unique. We can work with your attorney to help decide what's best for you and your spouse. ●

Focus On Rating Agencies

(Continued from page 1)

industry practices and conflicts of interest to go unchecked," says Rep. Michael Fitzpatrick, Republican of Pennsylvania.

In 2006, Congress passed the Credit Rating Reform Act, which Fitzpatrick co-sponsored. It requires rating agencies to disclose their procedures and largest clients, and it was supposed to make it easier for competitors to get into the ratings business. But critics say the law doesn't go far enough, and now the President's Working Group on Financial Markets is pushing the agencies to clean up their methods, with the threat of tighter regulation looming. "Regulation needs to catch up with innovation and help restore investor confidence but not go so far as to create new problems, make our markets less efficient, or cut off credit to those who need it," Paulson said in a recent speech at the National Press Club.

The Working Group issued recommendations for other members of the financial community as well. For instance, the panel called on issuers of mortgage-backed securities to disclose whether they "shopped" for ratings, meaning they approached more than one credit rating agency before being rated. The group stopped short of calling for Wall Street firms to be held liable for creating mortgage-backed securities that they should have known carried excessive risks, but Paulson did fire a warning shot in that direction, suggesting that simply receiving a high rating for a particular product didn't absolve investment banks and brokerages. "The idea that [the packagers of risky investments] can abdicate their responsibility and be overly reliant on ratings is something that really didn't wash in the past and won't wash in the future," Paulson said. "They need to do independent analysis, and they need a better understanding of risk. There is not a free lunch."

Questions about the integrity of leading credit rating agencies reinforces the importance of investors to do their own research before making investment decisions or to enlist a trusted financial advisor to act in their best interest. Managing investment risk on your own isn't easy. Feel free to call us if you have any questions. ●

Financial Services Advisory   One Church Street, Suite 901, Rockville, Maryland 20850   (301) 949-7300   Fax: (301) 949-7034

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