



Capital Advice

Capital Financial Advisors of New York, LLC

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What's New at CFANY

We are delighted to recognize Kerry Mayo as a partner effective January 1, 2011. Kerry began working for CFANY while in graduate school and later returned to CFANY after a few years working as a research economist. Within one year of his arrival, Kerry completed the coursework and examination for his qualification as a Certified Financial Planner® practitioner, and he is well on his way to completing the requirements for the Chartered Financial Analyst designation.

Kerry and his wife Megan recently welcomed their first child, Owen. Needless to say, Kerry is quite busy juggling his working, studying and family life, particularly in the midst of a great ski season in the Northeast!

Walt Williams also welcomed his first grandchild, Eli. It's, of course, a wonderful event for Walt without the same time commitment.

Paul and Walt attended the NAPFA conference in Boston in November. Paul attended the AICPA Advanced Personal Financial Planning conference in Las Vegas in January. All of us at CFANY attend numerous educational programs throughout the year.

Our clients have learned that opportunities accompany crises. During the recent recession, we were able to take advantage of falling investment values to harvest tax losses and immediately get back into similar or better investments that had exceptional gains over the last two years. We are particularly pleased that our clients have more investment values now and are better positioned today than before the recent, very severe recession.

For the last few months, there has been a lot of hoopla over possible increasing defaults in the \$2.9 trillion municipal debt market. In fact, even the most dire default predictions amount to only a minuscule piece of this mammoth market. Municipal debt is historically very safe. In the past century only one state, Arkansas, defaulted on its debt in the depths the great depression.

General obligation (GO) debt is backed by the full faith, credit and taxing power of the issuer. This means that issuers use money from their general fund to pay interest, and bondholders can force additional tax collection or legislative appropriation if the issuer defaults.

Revenue bonds are backed by a dedicated stream of revenues from almost any municipal service one can imagine. Revenue bonds for essential services such as power, water and sewer are often considered more secure because the issuers can raise rates to pay their debt.

Nevertheless, state and municipal budget deficits and benefit funding issues dominate the headlines. Defaults by Harrisburg, PA, Jefferson County, AL and Vallejo, CA certainly merit the attention they have gotten. Yet, headlines about state and local budget problems have not translated into a rash of municipal bond defaults.

The credit environment could remain challenging for some time because of the weak economy. Certainly unfunded pension liabilities pose a long-term challenge for states. However, states must balance their budgets annually by increasing taxes, cutting expenses or reforming pensions and other benefit plans.

Fear in the municipal debt markets brings opportunities. We have been buying very good quality taxable and tax-exempt municipal debt at significant discounts. As the fear subsides, we can sell this debt at higher prices, and along the way our clients safely collect the interest on the debt. Despite the risk of more defaults, we focus on selecting the best quality debt, and we find great value today in the municipal bond markets.

We have also found great value in collateralized mortgage obligations (CMOs). We have the experience to evaluate these securities and get relatively safe, very good short-term returns in a difficult environment for fixed income.

Paul J. Corr, CPA/PFS, CFP®
Walton A. Williams, CPA/PFS
Kerry G. Mayo, CFP®

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What's New at CFANY

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Are We in a Bond Bubble?

Investors have been pouring money into bonds. Investment Company Institute statistics show that since January 2007, average net new money going into bond mutual funds each month has been roughly four times greater than net *outflows* from equity funds.* So does that mean we're in the bond market's equivalent of the late-1990s tech bubble?

What's been driving interest in bonds?

There are several reasons why bond funds have been attracting investor interest. First, in the wake of both the tech crash of 2000-2002 and the 2008 financial crisis, the Federal Reserve felt it needed to make credit more available by lowering interest rates. Over the last 10 years, the yield on the 10-year Treasury bond has fallen from 5% to well under 3% at the end of 2010.** And for the first time ever, 5-year Treasury Inflation-Protected Securities (TIPS) actually paid a negative yield when they were auctioned last October.*** Because bond prices rise as interest rates fall, that has increased bond prices generally.

As a result, bonds have outperformed stocks in recent years. For the last 20-year period, total returns from stocks and bonds have been equal: 8.2%.**** And during the decade between January 2000 and the end of 2009, bonds actually outperformed stocks; the S&P 500 saw a total return of -0.9%, while long-term government bonds returned 7.7%.**** That outperformance has lured investors who may have forgotten that past performance doesn't guarantee future results, and invest in an asset class based on its recent history rather than its prospects for the future.

Demographics also have played a role. Many aging baby boomers who became accustomed to investing much of their IRAs and 401(k)s in stocks are beginning to realize that their time horizon for retirement isn't as long as it used to be, and that they should consider allocating an increasing percentage of their retirement portfolios to income-producing assets. The financial crisis also sent many frightened investors scurrying to put their money anywhere besides stocks.

Finally, diminished dividends from stocks have encouraged many investors to look elsewhere for income. During the tech boom, companies preferred to reinvest in growth or buy back stock rather than increase dividends, and according to Standard and Poor's, 2009 was the worst year on record for dividend payments. Though there has been some reversal of that trend in recent months, stingy dividends helped make bonds and their income more attractive.

What to watch out for

No investing trend lasts forever without interruption. Here are some factors that could affect bond prices:

- Signs that inflation is picking up: Higher inflation means fixed income payments will have less purchasing power in the future, diminishing bonds' appeal as income vehicles.
- Fed reversal on interest rates: As the economy recovers, the Federal Reserve will need to withdraw the support it has given the bond markets. As it gradually ratchets up interest rates, bonds will begin to reverse their pattern of the last decade. Depending on the pace of the Fed action, that reversal could be swift. Rising interest rates typically mean falling bond prices, and longer-term bonds often feel the most impact because bond buyers are reluctant to tie up their money long-term if a better rate lies ahead.
- Lack of overseas interest in U.S. debt: Foreign buyers have been large purchasers of U.S. government debt. If foreign buyers show signs of turning away from U.S. debt, it could send shivers through the bond markets.
- Muni bond troubles: Some experts worry that defaults by cash-strapped state and local governments could become a problem.

However, balance those factors against the possibility of further sovereign debt problems abroad. Several European nations are still struggling to deal with their debt problems; another bout of global jitters like the one in spring 2009 could remind investors that the United States has never defaulted on its debt. Also, if the potential for deflation that the Fed is so concerned about turns into an actual decline in wages and prices, that could be a positive for bonds, since the income they pay would be more valuable as prices fall. Either way, now is an especially good time to keep an eye on your bond investments.

*Average of monthly net new cash flows from January 2007 through September 2010 as reported in Investment Company Institute's "Long-Term Mutual Fund Flows Historical Data" as of Nov. 20, 2010.

**Source: U.S. Treasury historical data on daily Treasury yield curve rates.

***Source: "Record Setting Auction Data," www.treasurydirect.gov.

****10- and 20-year returns based on data on the Standard and Poor's 500 and long-term government bonds from *Ibbotson SBBI 2010*.



Bond outperformance has lured investors who may have forgotten that past performance doesn't guarantee future results.

Are There Gaps in Your Insurance Coverage?

Buying insurance is about sharing risk. For example, health insurance will cover some of the cost of getting and staying healthy. Homeowners insurance will assume the risk of loss in case your home is damaged or destroyed. But oftentimes, we think we're covered for losses by insurance when, in fact, we're not. Here are some common coverage gaps to remember when reviewing your own insurance coverage.

Life insurance

In general, when coupled with savings and income, you want to have enough insurance that will allow your family to continue to live the lifestyle to which they're accustomed. But changing circumstances may leave a gap in your life insurance coverage.

For example, if you have life insurance through your employer, changing jobs could affect your insurance coverage. You may not have the same amount of insurance, or the policy provisions may differ. Your coverage may have decreased, or the type of insurance may have changed. Where your prior employer may have provided permanent life insurance, now you may have term insurance that will expire on a predetermined date. Review your income, savings, and expenses annually and compare them to your insurance coverage. Changing circumstances may require more insurance. Your financial professional can help you determine if you have enough coverage to meet your family's future income needs.

Homeowners insurance

Homeowners insurance can be tricky as to what perils are covered and how much damage will be paid for. Clearly, it's important to know what your homeowners policy covers and, more importantly, what it doesn't cover.

You might think your insurer would pay the full cost to replace your home if it were destroyed by a covered occurrence. But many policies place a cap on replacement cost up to the face amount stated on the policy. You may want to check with a building contractor to get an idea of the replacement cost for your home, then compare it to your policy to be sure you have enough coverage.

Even if your policy states that "all perils" are covered, most policies carve out many exceptions or exclusions to this general provision. For example, damage caused by floods, earthquakes, and hurricanes may be covered only by special addendums to your

policy, or in some cases, separate insurance altogether. Also, your insurer may not cover the extra cost of rebuilding attributable to more stringent building codes, or your policy may limit how much and for how long it will pay for temporary housing while repairs are made.

To avoid these gaps in coverage, review your policy annually with your agent. A face-to-face meeting is always best with the policy right there in front of both of you. Also, take heed of notices you may receive. While it looks like boilerplate language, it could actually be changing your coverage significantly. Don't rely on your interpretations--seek an explanation from your insurer or agent.

Auto insurance

Which drivers and what vehicles are covered by your auto insurance? Most policies provide coverage for you and family members residing with you. So your child who is living in a college dorm is probably covered, but living in an off-campus apartment might exclude your child from coverage. If you and your spouse divorce, which policy insures your children who are living with each parent at different times during the year? Notify your insurer about any change in living arrangements to avoid a gap in coverage.

Other gaps include no coverage for damaged batteries, tires, and shocks. And you might not be covered for stolen or damaged cell phones or other electronic devices (e.g., MP3 players). Your policy may also limit the amount paid for a rental while your vehicle is being repaired.

In fact, insurance coverage for rental cars also poses many gaps in coverage. For instance, your own collision coverage may apply to the rental car you're driving, but it may not cover all of the damages alleged by the rental company, such as loss of use charges. If you're leasing a car long-term, your policy may only cover the replacement cost if the car is a total loss or is stolen. But that amount may not cover the outstanding balance of your lease. Gap insurance can cover any difference between what your insurer pays and the balance of your lease.

Policy terms and conditions aren't always well defined, and you may not understand what's covered until it's time to file a claim. So review your insurance coverages with your financial professional to be sure you've filled all the gaps in your coverage.



If you own a condo, your association's property insurance may leave gaps in coverage. For example, most association insurance doesn't cover your furniture, wall coverings, electronics (e.g., televisions, radios), interior walls, and structural improvements made to the interior of your unit. Review your condo documents, particularly the master deed, which may describe those parts of your unit the association insurance covers, and which parts you may need to insure.



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Ask the Experts



Understanding the math of recovering from losses

Everyone knows the stock market has its ups and downs, but just what's involved in recovering from a serious down? If you lose 10% one year but your portfolio returns 10% the next year, are you even again?

The short answer: no. The math of recovering from a loss isn't quite that symmetrical. You have to gain more than you lost to recoup all your losses. To understand why, let's look at a hypothetical example. Say you have a \$50,000 portfolio. In Year 1, you suffer a 10% loss and are down \$5,000. That leaves your portfolio worth only \$45,000.

In Year 2, the market rebounds and your portfolio rises by 10%. However, that 10% increase is based on a \$45,000 portfolio, not \$50,000. That means the 10% return adds only \$4,500 to your portfolio, not \$5,000, leaving you still \$500 down from where you started. You would actually have to earn a return of a little over 11% to get back to your original \$50,000.

The bigger the loss, the bigger that rebound needs to be to get you even. For example, if that \$50,000 portfolio had taken a 40% hit, as many did in 2008, you'd need almost a 67% increase to offset that \$20,000 loss and get back to the original \$50,000. That could take several years even if stocks perform well.

The challenge is compounded by investor psychology. Adjusting your asset allocation to aim for a higher return is one way to try to recoup losses faster. However, many investors find it difficult to take on additional risk after having watched their investments take a hit. And there's no guarantee that more risk will necessarily produce the desired result--at least not within the desired time frame.

The lopsided nature of recovery from market losses underscores why risk management is such a key component of successful portfolio management. Being realistic about the level of risk your portfolio involves and how much time you have to come back from potential downturns may help increase both your emotional and financial resilience.