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## The Year in Review

It's a Friday afternoon in January, 35 degrees and raining. It will be dark at 4:30 and the Dow is down over 200 points. I'll tell you that because while I have every excuse to feel discouraged about the markets, I still find myself rather more excited about the future than I am fearful about the present (and I've only been drinking coffee, honest!). If we've ever had the chance to chat about it, I'm sure I've mentioned to you that it's my job to be most vigilant when everything seems to be going right in the markets, and most fearless when everything seems to go wrong—like now. If I can keep that kind of focus, I can hopefully avoid some of the market traps at the tops and invest some cash at the bottoms. I think that we are now simply working out some excesses in the financial system that were long overlooked and that this process will not only put us on a firmer footing for the long haul, but also create some great opportunities for us short-term. While I reserve the right to let new facts change my mind, I really am more excited than discouraged about our prospects for a durable up leg in the markets.

As I said, we are working off some excesses in both our domestic economy and the financial markets. I think a brief review of the major issues might help us understand where we are in the process and why. While some of what I am about to say could be misconstrued as politically motivated, trust me, I'm

going to lay out the facts as I see them and leave the politics to others. I think there are three major, interrelated issues that the financial markets are grappling with:

•**Real Estate:** The deflation of the real estate bubble is the necessary result of a decade long process in which nearly everyone involved can be blamed. The number one question I've been asked lately is "where was the government and/or the regulators?" Well, it was actually the well intentioned yet ultimately disastrous rules changes of the 1990's administration and Congress that enabled the beginnings of the mortgage mess that spilled into the real estate mess. Yes indeed, lower lending standards increased the number of home owners (and also speculators) but they also simultaneously increased the number of home owners that ultimately couldn't pay the mortgage bill. The watchdog not only didn't guard the house, it opened the front door. Call it the law of unintended consequences at work. I believe the



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**Special points of interest:**

- Markets closed—Martin Luther King Day, Presidents Day and Good Friday.
- It's not too late to contribute to your IRA for 2007. Deadline: April 15th!
- IRA contribution limits are increased in 2008 to \$5000 with \$1000 catch-up if age 50+.

## Fourth Quarter 2007 Market Wrap

<u>Market Indexes</u>	<u>% Change in Q4</u>
S&P 500	-3.83%
DJIA	-4.54%
NASDAQ Comp	-1.82%
MSCI EAFE	-2.04%
KLD Domini 400	-3.7%

<u>Mutual Fund Yardsticks</u>	<u>% Change in Q4</u>
Equity Income	-3.94%
Large Cap Growth	-0.02%
Balanced	-1.28%
Gen US Taxable	+0.03%
Intermediate Bond	+1.80%



## The Year in Review (cont.)

Federal Reserve had a role to play as well through low interest rate and high liquidity policies that, while helpful post 9/11, were simply left in place too long creating a liquidity bubble. When the public viewed the equity markets as a “bad” place to invest in 2002-2003, that liquidity bubble found its way to real estate. Any real estate buyer that bought more home than they needed through a teaser or sub prime mortgage, over-extended on commercial real estate, or just plain speculated in real estate is also complicit in the disaster. While the real estate mess is primarily a non-Wall Street phenomenon (it is a tangible asset after all, not an intangible one), Wall Street shares the blame in its securitization and sale of sub prime loans and the subsequent further derivitization and hedging by the supposedly “smartest guys in the room” (who weren’t). Had Wall Street been either smarter or less greedy, and I know that’s a lot to hope for, the real estate bubble would have deflated in the hinterlands and the financial markets would be in much better shape than they are.

•**Politics:** Like it or not, 2008 is an election year and like it or not I believe the financial markets are starting to believe that the next President and Congress will be Democratic. Each and every Democrat running for President has proposed tax increases and some form of roll-back on the Bush tax cuts. Many on Wall Street believe that the blueprint will be House

Ways and Means Chairman Charlie Rangel (Dem, NY) tax proposal of last fall. As Michael Boskin (Professor of Economics at Stanford University, Senior Fellow— Hoover Institution and former Chairman of the Council of Economic Advisors) put it so succinctly last December 13 in the *Wall Street Journal*, “Revoking the 2001 and 2003 top marginal tax rate reductions and uncapping Social Security taxes, and adding the proposal by House Ways and Means Chairman Charlie Rangel for an additional 4.6% tax rate on adjusted gross income as part of his AMT fix, results in **tripling of the federal taxes on dividends, an almost doubling of the tax on capital gains**— and sharply reduced work and investment incentives. The combined (including California state) **top marginal tax rate reaches almost 70%**, which is back to the ruinous levels of the 1970s.”

From both the Republican and Democratic camps we have also heard the drumbeats of disaster—protectionism and populism. If we had learned or could remember anything about the Great Depression we should know better than to heed that siren call. Again, Professor Boskin points out, “Even worse policies could be just around the corner. Protectionism and calls for more regulation and higher taxes on upper-income earners and capital are emanating from Capitol Hill and the campaign trail; some are even demonizing globalization and corporate America. This doesn’t build

confidence in the future of the economy. “

If I believe as a manager that sometime in 2009 the favorable and rational tax rates for capital gains and dividends will likely disappear due to politics, I will take profits at a more favorable rate in 2008 and view dividends in a less favorable light going forward. This would be a beneficial, clear, rational action to take and I am certainly not the only one to figure that out. Indeed, I have wondered if the selling on the first days of this new year is not due to Wall Street’s concern about the inevitability of much less favorable taxation in 2009.

•**Recession:** The real estate mess and political rhetoric have led logically and inexorably to fears of an economic recession. I’ll say two things right up front. I think we may have entered a recessionary period last quarter and I’m not particularly scared by that. Here’s why—recessions are rear view mirror events. By the time we officially recognize that we are in a recession (2 quarters of negative GDP) we’re already 6 months down the road and most likely already on the upswing. Secondly, Wall Street doesn’t wait for the announcement to react to a slowdown. Again, by the time main street is told we’re in a recession, Wall Street has already reduced stock prices to reflect the new reality and is looking forward to the next expansion. The fact that now, in January 2008, we are hearing about a recession probably means that we’re already in

one and the fact that the market is down since last fall means a good deal of the dirty work is done.

Recessions are not the end of the world anyway. Economies rise and fall like the tides on a regular basis. They expand and recede over time. Recessions can be the pause that refreshes in the capital markets and gives us a firmer plateau from which to build the next up leg. In the half century since 1955 there have been 8 official recessions and yet I think if I could give any of you a chance to invest at 1955 stock levels today, you’d jump at the fantastic opportunity you’d have.

Stocks are 10% off the highs of 2007 and we recently hit a new retail money market high of one trillion dollars (the previous high was 975 billion in April 2001 during the last recession). I think someone’s already figured this recession thing out. There’s also two trillion dollars in corporate cash around and the combined three trillion in cash can certainly move the market when the time is right.

Remember that fear sells papers and that the media will use the “r” word against the uninitiated to get them to buy papers and keep their eyes glued to the commercials that make them money. I think we’re more at the end of the beginning than the beginning of the end.

MARKET TALK

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Preparing Financially Savvy Children

Roy and I are fortunate to be the parents of two teenage children. The fallout from us both being in the financial business is that some of our dinner table conversation centers around the economy and personal finance. In these discussions I am often struck by how ill-prepared children are to enter the financial world. The school system does not teach them how to manage or save money, where to invest it and how to gauge their progress. What advice should you give your children? Here are a few basics:

- ◆ Start by investing small amounts in good, diversified, no-load mutual funds. Although individual stock picking is sexier, they will be better served at this level to get a basket of high quality stocks in a growth oriented mutual fund.
- ◆ Track their progress. Once a year they should review their holdings to see how they are performing.
- ◆ Call us for help! We are now servicing the next generation of investors for many of our clients and are happy to help.
- ◆ Begin saving for retirement now! If they have a summer job or work after school have them set aside a portion of their pay in a Roth IRA. If they are out of college and eligible for a retirement plan through their employer (401k, etc) sign up for it! Remember that they have time on their side.
- ◆ Save 10% of everything that you make. The uncertainty of Social Security and the demise of Pension Plans make this good advice for anyone but critical for the younger generation.



Pat Sokolowski, CFP®

*"A lack of planning can be hazardous to your wealth."* ▶ ▶ ▶

New Beginnings



Happy New Year! January is a time for introspection and making resolutions. If you are like me you think about scheduling your annual physical, getting your cars serviced and making spring vacation plans. In the world of personal finance it is an excellent chance to review your insurance coverage (life, home, disability, long-term care), your estate plans (Wills, Durable Power of Attorney, Trusts), and your investments. Unfortunately, most of these things take time and they get postponed—sometimes indefinitely.

A professional financial planner can facilitate this process and make it almost painless. With a plan your life becomes simpler and your decisions easier. Having a financial plan can help you sleep at night. Make January your time to schedule your financial assessment with us and you will reap the benefits all year long.