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THE WEALTH MANAGEMENT FIRM

THE KELEMEN, WAY & SHEPPARD
financial PERSPECTIVE

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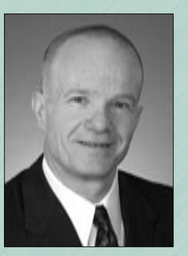
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Sub-prime Loans and The Market—What's Going On?

Being able to say "We told you so," is a mixed bag. It's nice to be proven right, but it is no fun seeing the results in the financial markets or the effects on real people losing their homes. In our August 2005 issue, we warned of the overheated real estate market. Our concerns were the speculative fever of people flipping properties and questionable mortgage lending practices.

It's taken a couple of years, but now the proverbial chickens have come home to roost. In 2006 some $600 billion of sub-prime loans were extended by banks trying to cash in on the housing boom. Home prices are declining in many parts of the country, causing tens of thousands of home loans to go bad. And home construction has dramatically slowed down. These alone aren't enough at this time to put pressure on the financial markets. That's because, while home construction is down, overall construction is up due to large public projects and commercial construction. And homes are still being built and sold, but at a slower rate.

But what really hurt certain sectors of the financial markets were two things. First, some hedge funds bet heavily on sub-prime loans, borrowing to do so. They lost big time, especially since they were so leveraged. The share value of the brokerage firms that sponsored them also took a hit. Second, a number of mortgage companies and sub-prime lending companies are either bankrupt or close to it because of the defaults. As a result, other borrowers are starting to see their credit tightened, whether they deserved it or not. This can have a big ripple effect on Wall Street. *(In our portfolios, we have moved out of our floating rate fund positions into high quality government bonds in anticipation of this weakening credit situation and subsequent flight to quality.)*

More borrowers will most likely default, but that doesn't mean all sub-prime loans are in jeopardy. In fact, Federal Reserve Chairman Bernanke said recently that he expects losses in the range of $50 billion to $100 billion as a worst-case scenario.

That's a lot of money, but we need to put things into perspective. Total mortgage debt is $9.7 trillion (with a T), and that is only 43% of the value of US real estate, according to the Fed. Of that total, according to the Mortgage Bankers Association, delinquent (not defaulted) loans account for only 3% of the overall mortgage market. And if every sub prime loan defaulted, they would be less than 1% of the overall mortgage market, by dollar amount.

Given the size of our economy and the fact that corporate earnings continue to rise and other key economic indicators are positive, it would take much more than a sub-prime meltdown to trigger a 10-20% market sell-off, let alone a recession.

In short, we are seeing a typical pattern of a Wall Street over-reaction fueled by the media. Yes, many investors are temporarily affected by this ripple effect, but the vast majority didn't play the sub-prime game in their portfolios. Most of the major indexes are still positive year-to-date. And 86% of sub-prime loans are not delinquent. These loans have given first-time buyers a shot at home ownership, which has been good for the economy. If nothing else, this should serve as a lesson about "can't lose" speculation and too much leverage.

Getting An Honest Grip On Retirement

In recent months we have noticed two disturbing trends among people seeking our retirement planning advice. And we think that other financial advisors would agree. What we see are 1) people are getting overly optimistic about their net worth, and 2) they don't really have a handle on expenses.

1. The Net Worth Factor

Rising real estate values and a good stock market the past few years are giving people a false sense of security. They lump all of their assets together and think, "Gee, my net worth is $____. I could retire on that." Well not quite. **What really matters is which assets you own that can actually produce a sustainable, inflation-adjusted income.** Your RV, vacation home, or art collection can't do that unless you are willing to sell them off. Few people actually do, especially with art and collectables. The same holds with your residence. Some people really are downsizing, but many of them (like yours truly) are downsizing in size only, not fair market value.

The solution? Clearly divide your net worth statement into two categories:

1) Financial Independence Assets

2) Lifestyle Assets.

Match the liability against the asset to which it belongs.

Financial Independence assets are everything that you are willing to sell and convert to an income stream today. Yes, maybe some day you might sell the vacation home, large residence, Picasso, or boat, but it's not classified as a financial independence asset until you actually do. Again, we have observed many clients over the years that had good intentions, but became too attached to their lifestyle or to the asset to actually convert it.

And by the way, the process works in reverse. The next time you purchase an asset, ask yourself whether or not it is a true Financial Independence Asset or a Lifestyle Asset in disguise with no honest intention of selling. This may help curb certain lifestyle purchases cutting into your ability to build solid Financial Independence assets.

Even if you include only Financial Independence assets at today's nice values, you may not have enough. You need to factor in longevity and inflation. You could easily be retired for 30 or 45 years, perhaps longer than you worked. And at only a 3% inflation rate, prices double every 24 years. Thus, $1 million dollars net worth today will only be the equivalent of $500,000 in the year 2031. What costs $1 today will cost $2. Imagine—how old will you be then?

THE FINANCIAL PLANNING WAY OF LOOKING AT NET WORTH STATEMENTS

TYPE	ASSETS	LIABILITIES	TOTAL
Financial Independence (Things that can actually generate cash flow)			
Life Style (Possessions held for living and enjoyment)			
TOTAL			

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Our So-Called Negative Saving Rate

"There are lies, damned lies, and statistics," wrote Mark Twain in an era before prolific government statistics. We wonder how he would describe our personal savings rate (PSR), as defined by the Federal Government. It has to be one of the most misleading government statistics ever created.

We've all seen the doom and gloom articles that say that our "personal savings rate" is at its lowest point since the Great Depression. Federal Reserve data show that the PSR was over 8% in 1985, declining to -1.5% in 2006. Yet during this same period, household net worth (excluding home values) increased four-fold. How can this be if we aren't saving?

The answer lies in how the PSR is calculated. It was designed in the 1930's when families placed their savings in the banking system because that was just about the only savings option available to them. This was long before money market funds, IRAs and 401ks existed. So, if you start a business, purchase a stock or mutual fund, they don't count. Mortgage payments on your home or rental property don't count. Nor does the equity build up in them. Your contributions to a 401-k or IRA don't count as savings. In fact, when you retire and withdraw funds from a retirement plan, it counts against the PSR!

But wait—it gets worse! The PSR calculates "owner's imputed rent." This is what government accountants think homeowners should pay themselves to rent the homes they own and occupy. This number is over $1 trillion each year, enough to increase the PSR to 7% of GDP.

What does this mean? As a blanket statistic, it's meaningless. Maybe as a whole we aren't saving enough, but we're certainly saving. What really counts are your net worth and what you are saving in the most tax efficient way—not whether it's in a taxable bank account. There are other meaningless government statistics, which we might write about in the future. The employment statistics, for example, don't reflect the fastest growing sector of our economy— self-employed individuals.

Income Planning

2. The Expense Factor

It's hard to plan your cash flow for next month or for 30 years out if you don't know your expenditures. For some people, it's easy. Subtract the amount that goes into savings each month from your net take-home pay. But this doesn't tell the whole story. Big vacations, major home repairs, tuition bills, or periodic new vehicle purchases take a bite out of your savings and distort your true living costs over a longer time period. "Well, that was just a one-time expense," you might say. But as the saying goes, "It's always something." Retirement is for the rest of your life, not the rest of the year.

To get a grip on your expenses and possibly find "new" money that can make your retirement a solid reality, you need to know not only the total amount, but the line item. Track your expenses for a year. **But more importantly organize your expenses into three major categories:**

1) Committed Expenditures
2) Somewhat Discretionary Expenditures
3) Very Discretionary Expenditures

The purpose of this exercise is to learn your core cost of living, thus making it easier to design realistic retirement projections. This can give you an edge on reaching retirement earlier or sustaining it longer because you can truly weigh your retirement priorities (such as when and how much to save for it) against lifestyle choices. Some of those lifestyle choices may be worth another year or two of work, or maybe not.

Important: If you have lifestyle assets, you should assign their maintenance or carrying costs in either the "Somewhat" or "Very" discretionary categories. For example, a timeshare is clearly a lifestyle asset. Therefore, its monthly maintenance fees should reflect this because if you sold the timeshare, you would have an increase in cash flow. The same could be said for the maintenance and insurance costs for that third or fourth vehicle in the driveway.

We all love our lifestyles and toys. Lifestyle assets or expenditures in and of themselves aren't bad—in fact many of them are beneficial in terms of our well-being and satisfaction with life. **A major purpose of retirement planning should be to find a good balance between the lifestyle assets you enjoy owning and the financial independence assets that can provide you with retirement income. It takes both kinds to create a satisfying retirement. Looking at things in this different way gives you a powerful tool to take control and set priorities.**

BUDGETING WORKSHEET TO GET A GRIP

TYPE	MONTHLY	ANNUAL
1. Committed Living obligations food, clothing, utilities, insurance, medical, etc.		
Fixed Obligations (debt service, taxes, college tuition, etc.)		
COMMITTED SUBTOTAL		
2. Somewhat Discretionary Basic entertainment, contributions, hobbies, gifts, organizations, etc.		
3. Very Discretionary Home improvements, high-end entertainment, autos, art, boats, personal property, "toys," financial gifts to adult children, extended trips, etc.		
TOTAL		

The Team Advantage

Ron ®Kelemen and Mary Way are independent Certified Financial Planner™ certificants. Together with Alex Sheppard they jointly serve their clients as a team with over 37 years of combined experience. Their fee-only practice focuses on wealth planning and management for professionals, business owners, and retirees. Together, they have developed ***The Planning Vision Process***® and several other unique processes. They are advisory associates of The H Group, Inc., one of the largest independent fee-only registered investment advisory firms in the Northwest with 18 professionals and over $1 billion under active management.

About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP**® is a contributing author of three financial planning reference books. *Medical Economics* listed him as one of the 150 best financial advisors for doctors. He is active in Salem Rotary, mentoring and in several local charities, and is frequently quoted in the national press and professional journals.

About Mary Way, CPA, CFP®

Mary Way, CPA, CFP®, has been a member of the practice for over 13 years. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She sits on the Investment Policy Committee of The H Group, Inc. and is on the board of the Willamette Valley Estate Planning Council. She is active in Salem Rotary and the Financial Planning Section of the Oregon Society of CPAs.

About Alex Sheppard, MBA

Alex Sheppard, MBA joined the practice in March 2005, and has passed his CFP® comprehensive exam. He has a variety of experience in financial services, including four years as an analyst with a major mutual fund company. He is a active in Rotary, the Salem Area Chamber of Commerce, and serves on the boards of The Red Cross and South Salem Rotary.

TEAM UPDATE

We thought last summer was busy as we finalized our conversion to a fee-only firm. This summer is busier with lots of update meetings, new planning cases, and existing clients seeking advice on a variety of topics. Changing account custodians from Fiserv to Fidelity is also very time consuming.

Lani and husband Jim's empty nest didn't stay empty for long as son Caleb returned from Hawaii. They are busy battling deer and moles who have found their garden. But on the bright side, they are delighted that daughter Holly, her husband, and children are moving to Yreka, CA, which is just a four hour drive, instead of a seven hour flight.

Debbie is very busy with the gradual change over to Fidelity. She and husband Bob flew to Arizona to visit their son, then drove his old pickup back to Oregon for him. They also took their annual trip with friends to Neskowin Beach for a few days in July.

Alex survived his annual golf tournament in central Oregon with his dad, uncles, and cousins. He and wife Virginia went to a wedding in Austin and celebrated their one-year anniversary with a weekend trip to Neskowin Beach. Alex was recently voted on to the board of the Willamette Chapter of The Red Cross.

Mary and husband Steve finally sold their south Salem home and moved into their new Silverton home, which they had purchased in January. They're still up to their elbows in boxes, but are working on plans for an open house and a party for Steve's employees. Mary changed gyms and now goes to a new dance class called "Group Groove" which she says is difficult but fun.

Ron was installed as President-Elect of Salem Rotary. He backpacked part of the rugged coastline of Olympic National Park in June with his brother and nephew, then spent some of July recuperating from it. He and Kathy spent their 30th anniversary weekend at Carson Hot Springs in the Columbia Gorge. They later went to Philadelphia and Boston to visit their daughters, drove up the Maine coast, then finished the trip off with a conference in Chicago. He's training for Cycle Oregon in September, and trying to swim laps at noon outdoors.

If You Had A Bank

We thought the following would be appropriate as the summer begins drawing to a close. Ron found this among his personal files from 1975. *(Sometimes it pays to be a packrat!)*

Suppose you had a bank that credited your account each morning with $86,400. It carried over no balance from day-to-day, and allowed you to keep no cash in your account. Every evening it cancelled whatever part of the amount you had failed to use during the day. What would you do? Draw out every cent, of course!

Well we all have such a bank and it is called "Time." Every morning it credits us with 86,400 seconds. Every night it rules off as lost whatever of this we have failed to invest to good purpose. It carries over no balances. It allows no overdrafts. Each night it burns the records of the day, if we fail to use the day as deposits against the "tomorrow." We don't know when it will close. So, we must live in the present on today's deposits, and invest our time so as to get the utmost in health, happiness, and success.

We hope you're having a great summer. Make the most of what's left of it!

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Protecting The Identity Of The Deceased

When a loved one dies, probably the last thing on your mind is protecting his or her identity. But identity theft of dead people is a real and growing problem. Thieves take pieces of information, such as birthdates, addresses, and Social Security numbers and use them to obtain drivers licenses, fake IDs, credit cards and more. Here are a few things that should be done immediately after one's death:

- ❑ Try to avoid listing the decedent's month and date of birth in the obituary. That gives ID thieves valuable information. Avoid publishing the address, too.
- ❑ Hire an off-duty security guard or have a neighbor watch the house during the funeral, especially if the address was published.
- ❑ All credit cards and charge accounts should be cancelled as soon as possible after a death.
- ❑ Call Equifax, (888-766-0008), Experian or TransUnion; (the three credit-reporting bureaus) and set up a fraud alert. However, this may delay you if you intend to open a new credit account in the near future. Once death certificates have been obtained, send copies to them.
- ❑ Ask DMV to cancel the person's driver's license and not honor any requests for duplicates.

It's easier to clear up ID theft issues while you are still alive. Periodically check your record and keep it clear. The tips above might seem like a lot to do at a bad time, but it's quicker and easier to do them than to deal with ID theft later.