LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Over the last three months, the stock market was generally up -- then down some. Bond prices were generally down -- then up some. Interest rates were generally up -- then down some. Most recent data shows Northeastern home prices up some -- Southern home prices down some. Up and down, down and up. The financial markets are forever changing and adjusting, creating volatility that has the potential to foster harmful emotional reactions on the part of investors, particularly when the swings are severe. Later in this issue, we discuss the emotional element of investing, as well as several new legal developments. To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective. Hopefully you have an advisor helping you with your strategy and financial plan.

Economy

The bad news is that the economy grew at a meager 7/10% annual rate in the first quarter of 2007, which is pretty slow, but at least it is growing. The good news is that the Federal Reserve believes that economic activity has expanded since then. Interest rates were relatively low early in the year, paralleling the lower economic activity level. They have risen again as activity has picked up. Higher interest rates have increased mortgage costs, putting renewed pressure on real estate. There is some concern that adjustable rate mortgages that were taken out several years ago, and are now coming due, will have to be refinanced at the higher interest rates prevailing today, straining some borrowers. The fallout from this process may continue to depress home sales and prices. The mortgage issue has also caused a problem for a hedge fund that invested heavily in “sub-prime” mortgages. No one seems to be certain whether this pressure will spill over into other parts of the economy. It is a development worth watching for.

Meanwhile, all the other indicators show continuing, if moderate, economic growth, which is typically a good environment for investment. Unemployment is low, leading indicators are up. Production and sales are up modestly. Corporate profits, which were measured at about a 30% growth rate six months ago, have dropped off to about 6%.

Financial Markets

The stock market likes rising profits and falling interest rates. It had both from the middle of last year to the beginning of this year. The recent lower earnings growth and rising interest rates took some of the steam out of the market during June. This is also now a time of year when stock prices tend to be weaker. We have been mentioning since 2002 that stocks have been undervalued relative to bonds. While this is still true, the valuation difference is not as distinct as it used to be. While still more risk averse than usual, investors now seem to be ready to assume some more risk. Over the last year they bid prices up faster than earnings growth and interest rates would otherwise indicate. Accordingly, a measure of stock price value, the ratio of prices to expected earnings (the forward PE ratio), has increased recently from 14 last June to almost 16 now, which is a level that is about average.

Emotions and Investing

Some readers may remember that we believe asset allocation is the most important factor that determines your investment results. In second place is the effect of emotion. If not controlled, normal emotions lead to less than optimum asset allocation or just plain bad investment decisions. If a person is afraid of losing money, they will favor very conservative investments, receiving returns that are lower than otherwise achievable, and possibly lose purchasing value by not keeping up with inflation. Conversely, if a person's goal is to profit handsomely, they are likely to take on too much risk and perhaps lose money. This effect was demonstrated quite clearly after the Internet ".com" bubble of 2000. Making investment decisions based upon emotions, through the ups and downs of the business and market cycles, will often lead to taking the wrong actions at the wrong time. When prices are rising, it is natural to become optimistic and dream of the extra riches you can acquire by increasing your investment exposure. This usually occurs just as prices are about to turn down. When prices fall, it is natural to become afraid of losing substantial amounts, causing many sellers to bail out of their stock holdings near the bottom. These emotions are the primary forces that create market volatility, and the reason that prices go to extreme highs and lows that are not justified by fundamental information.

In addition to the adverse effects of acting on strong feelings, emotions can often masquerade as forecasts, incorrectly coloring one's expectations of the future. Unless investors are vigilant, their subjective feelings about taxes, deficits, the government, the environment etc., can unconsciously cloud decisions. Since the future is unknowable, both your forecasts and those of media "experts" may be influenced by an emotional bias. It is not an accident that measurements of consumer confidence tend to roughly follow stock prices (or vice versa). Reducing emotion is one advantage of using the services of an investment advisor. A primary reason that many advisors advocate the buy-and-hold philosophy is, because, if practiced stoically, it eliminates emotional mistakes. Unfortunately this approach also exposes the investor to all the risk involved in market volatility. *LFM&P's* solution is to practice risk management. We use a methodology that unemotionally measures market risk to adjust asset allocation, reducing the effects of emotion as well as the volatility risk inherent in other common approaches.

Legal Updates – "Kiddie Tax" and Broker/Dealer Exemption

It has been common practice for parents to save for children's education in UTMA (or UGMA) accounts. By placing the savings in the child's name, the income was taxed at the child's tax rate, which was usually lower than the parents'. Congress made this tactic less appealing by enacting the "Kiddie Tax" and subsequently amending it to say that the unearned income, over $1700, of children under age 18 will be taxed at the parents' rate. The law has recently changed again to be even more restrictive. It now applies to children who are age 18 or are full-time students under the age of 24. If your child has more than a little unearned income of his or her own in a UTMA or UGMA account, you may want to reconsider your savings approach.

Readers of this newsletter may remember a prior discussion about the differences in the responsibilities of registered investment advisors and stock broker/dealers. The SEC sought to exempt brokers from complying with the Investment Advisors Act, which allowed the brokers to avoid an obligation put their client's interest before their own, as registered investment advisors must. A recent federal court decision overturned this exemption. Now, if a broker charges you a commission or fund load, they are acting as a broker and need only make sure that the investment is suitable for you. If they charge some other type of fee, they must also be registered as an investment advisor and act as a fiduciary. This requires them to place your interests before theirs. If you have one of the estimated one million "fee-in lieu of commission" accounts, your broker is likely to amend your account documents over the next several months to comply with this ruling. If this happens to you, make sure you understand any changes in your costs and your broker or advisor's responsibility to you.

To learn more about *LFM&P* financial planning and investment management services, our client goal-centered and risk-managed financial philosophy, and to better understand the value we can bring to your financial life, we encourage you to contact us or look at our website, www.linnardfinancial.com.

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