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Building Wealth, Wisdom & Well-Being

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All of this Recession Talk Makes Me Sick

by

Dr. Robert J. Froehlich, Vice Chairman of DWS Investments

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Well the economic debate is finally over. It's official: The National Bureau of Economic Research (NBER) confirmed that the US economy officially slid into a recession about 12 months ago in December of 2007. While many on Wall Street use the overly simplistic measurement of a recession as two back-to-back quarters (six months) of negative economic growth, it is not that simple.

What Is A Recession Anyway?
The actual economic definition of a recession is not limited to two quarters of negative growth. It is more sophisticated and complex than that. There are several indicators of economic activity that the NBER takes into consideration when analyzing the economy and the business cycle, including employment, income, real manufacturing and wholesale-retail trade sales, and industrial production.

So now, according to the NBER, after 73 months of expansion that began in November 2001 (for your frame of reference the previous expansion of the 1990s lasted 120 months) the decline in economic activity in 2008 has met their standard for a recession. The 1.2 million jobs lost in 2008 was the biggest factor in determining the start of the economic contraction. Payroll employment peaked in December 2007. This is when they say the recession began.

Tells Us What We Missed
To me, one of the most fascinating things about recessions is that all they really do is tell us what Wall Street economists missed. Declaring now that we were in a recession 12 months ago doesn't do investors much good. Conversely, waiting to get the "all-clear" signal from Wall Street economists before you invest again probably means you will have missed the rally and recovery as well. Recessions tell us what has already happened, not what is going to happen.

How Long Will This One Last?
As I travel around the country one of the questions I get everywhere is "how long is this going to last?" History provides us with a good guide to try and answer that question.

According to the NBER the average length of post-World War II recessions – from economic peaks to recessionary valleys - has been 10 months. So we're already into this current recession longer than the historic average since World War II. The major recessions of 1973 and 1981 both had peak-to-valley cycles of 16 months. So that is the long-side timeframe, judging by our most recent economic recession history.

Of course, past experience can't guarantee future economic or market performance. But this suggests that we may well be most of the way through the long peak-to-valley cycle, as we are already near post World War II historic levels already.

Is it Different This Time?
I also ask myself "Is it different this time?" According to the NBER the most salient indicator of this current recession is the peak of employment in December of 2007. Jobs, or the lack of them, signaled this recession. Employment has been down ever since. The recession of 1973 was caused by inflation and energy which tripled. And in 1981 the recession was caused by interest rate hikes which ended inflation. So, in my view, our circumstances in 2008 are completely different. This time we have our very own baby boomer-created recession. I believe the cause of this recession is excess capital chasing increasingly lower returns. The source of the excess capital

was debt, both personal and corporate.

Where Are We Now?

So where are we now? I believe we are witnessing a generational and landmark event in our financial history. This is not a "textbook" recession where inflation, higher energy prices or rising interest rates were the culprit. This is a different recession.

That is why it has been so difficult for policy-makers. They have little ability to change the actual behavior of leading players in the economy. You see, these leading players - consumers and businesses - are attempting to save rather than spend; they are focused on paying off or paying down debt rather than taking on more credit. Now to make matters even worse, as economic conditions worsen, that means asset values (especially stocks and real estate) continue to decline and lose more of their value. That is why it is so difficult for policy makers to reverse these trends, which without a reversal sets the stage for a vicious cycle. From my perspective, this is why the government's public policy responses to stimulate our economy have taken on historic and landmark endeavors.

What Does All This Mean?

You may be asking yourself what all of this means. Well, in my opinion, in terms of where we are in this economic recession I believe we are closer to the end than the beginning. I see this lasting maybe 18 months which puts us to mid-2009. The reason I pick 18 months is that this was a real estate implosion, followed by a Wall Street collapse, followed by a credit crunch. This was the "Axis of Evil" for investors, which is why it may last a few months longer than the previous post-World War II worst recession time frames of 16 months that we saw in 1973 and 1981.

As an investor, remember that historically, the markets recover before the economy gives us the "all- clear" signal. Just like it was too late to get out once economists finally declared an official recession, you will potentially have missed the rally once the economists declare we have turned the corner.

Low Rates Help

One thing we know for certain is that interest rates are at historic lows and will probably stay that way for some time. I believe this low interest rate environment will be the trigger that will encourage risk-taking again, which could then prompt our economic recovery, the beginning of the next economic expansion and the creation of the next bull market.

Little If Any Experience

Think about this for a minute. The last major recession we faced was almost 28 years ago in 1981. What makes this current recession feel so bad is that half the people in the world today weren't alive then. In other words they are likely to be a little more frightened and uncertain about how to handle this one. According to the United Nations the median age of the world's population is only 28. (Talk about feeling old; that means I am double the world's population median age.) While I have not experienced everything, I can tell you that experience and history are the greatest teachers.

Dr. Bob's Diagnosis

In closing, here is my diagnosis for your "wealth" and your "health" using a medical analogy. I want you to think of this recession like the flu. In comparison, we can look at the 1930's Great Depression more like the plague. A recession is just like the flu - you can treat its symptoms with new funding mechanisms like TARP, but you can't actually cure it until it runs its course. Just like the flu, it has to run its course. I know this recession feels awful; so does the flu. But it is not fatal, and I believe it too will pass by the middle of 2009, if not sooner.

Have a great day, keep a positive attitude, get your flu shot and please join me in resolving to remain a long term investor in a short term world.

Protecting Your Company's Value in a Recession

By

Gregory R. Banner

This article is devoted to explaining a few of the ways you can do exactly that by concentrating on specific items taken from a fiscal year agenda that we use with many business owners. (Meeting annually with your advisors before your fiscal year-end is a great way for all of you to keep your planning on track.)

Minimizing Tax Exposure

You and your advisors should begin any discussion about minimizing your tax exposure with a review of your current business income tax status. From there, your CPA or CFO should be able to prepare an initial estimate of the company's and your income tax liability.

You should then review what you are currently doing to reduce income tax liability. One of the purposes of ongoing tax planning is to avoid extreme peaks or valleys in corporate taxable income. By anticipating increased taxable income, through proper tax planning there is much you can do to minimize the actual tax costs. These methods include:

- Shifting income taxation from one year to the next.
- Implementing tax reduction devices, such as qualified retirement plans, medical expense reimbursement plans and the payment of large bonuses.
- Increasing deductible payments to shareholders, such as renters for equipment or buildings that may be owned individually by the business owner and leased to the business.

After reviewing what you are doing to minimize taxes, turn your attention to your advisors' suggestions of new ways to reduce tax liability. For example, you might consider (with the input and counsel of your advisors) the new tax credits and incentives for "small businesses" promised by the new Obama administration.

Business Contraction

During a period of contraction, most business owners dig themselves into a deeper hole, not by cutting expenses too rapidly, but by hanging on too long to the existing operation, primarily because of pride or a deep aversion to laying off loyal employees. Business owners also don't like to admit they are cutting back; the American Way is to grow, grow, grow. Yet we've all seen businesses that spend themselves into bankruptcy.

One of your most important goals must be to preserve value for the business in difficult times. Your advisory team demonstrates its greatest value when it helps you face hard facts and then helps you translate your decisions into action.

As you weigh the choices you face, use your advisors' expertise to make decisions and to execute them in a manner that is legally correct and minimizes the affect on the remaining employees' morale. For example, it may be better to reduce staff and overhead as you would remove a bandage: quickly. Moving slowly through all-but-inevitable cutbacks just prolongs the "Am I next?" period for employees.

Other Corporate Considerations

If you haven't made an annual pre-fiscal year-end review part of your standard operating procedure, there are a few more items on that agenda that you might want to review.

- Business Continuity. Does your existing buy-sell agreement take into account a decrease in current value?
- Employee Considerations. Are your key employees contractually bound to restrict competition and protect trade secrets? Are their compensation structures defined in writing?
- Business Contracts. Are your existing contracts and forms up to the challenges of a tougher economic environment? When did you last review your property, casualty and liability policies to determine not only if there are ways to save money, but also if you and your company are adequately protected?

Individual Planning Considerations

You should also be talking with your advisors about your own income tax status. Is this the time to leave income in the company or take it out? If you take it out, there are a number of techniques you can use to reduce taxation at the individual level.

Finally, meet with your advisors to see how increased taxation, business contraction or a reduction in business value will affect your financial planning and estate planning goals.

While there are few silver linings in a recession, one is that a recession tests the mettle of your advisors. While they aren't magicians who can make a recession disappear in a poof of smoke, they should bring you ideas and strategies to help you protect, if not build, value during difficult times.

New Year's Tips from Top Advisors

John Jenkins was quoted in an article that received wide media distribution in December. Here is an excerpt:

To ring in the New Year, a group of experienced financial advisors offer a range of philosophical and tactical advice to help ensure your joys outweigh your anxieties in the year ahead. More than any other new year in recent memory, change is on the horizon. From an historic election to the unprecedented efforts underway in Washington to bring our nation's economy back from the brink, 2009 promises to be a year of firsts. While hope always springs eternal as the calendar turns, it is unlikely market volatility will subside any time soon. So what's an investor to do?

John Jenkins in San Diego, CA, says "Belt-tightening makes sense even if you figure your job is secure." He suggests that his clients reduce their consumption and spending. "Remember, sacrifices you make today could mean more lifestyle choices when you retire." Jenkins also notes that today's volatile economy underscores the importance of keeping six months of your current income in a liquid, interest-bearing account. This will help to manage unforeseen circumstances such as unemployment or an unexpected expense, without tapping into investments or retirement savings. "If you dipped into your emergency stash last year, replenish the fund, and make sure it reflects your current household income," he adds.

Is Commercial Property the Next Real Estate Bubble ?

By Ronald Ceniceroz

So far, the current credit crisis has focused on mortgages for the less affluent. Any loan to any borrower can begin to seem subprime if there's too little down and too much debt. And that, unfortunately, brings us to the commercial real estate market.

For the past several years, the market for commercial property - offices, malls, apartment buildings, industrial spaces and warehouses have enjoyed the very best of times. Prices soared, and lenders lent readily. Owners had no problem meeting their payments. By early 2007, delinquencies had fallen to record lows.

In some cases, commercial real estate loans were no less risky than those made to home buyers with less than desirable credit. And as with the subprime mess, the repercussions will come. Just like what happened in other sectors already hit by the credit crunch, these loans will cause problems that will probably find their way beyond the obvious players in the commercial-real-estate market. Judging by the aspects of the credit crisis we've already seen, commercial real estate trouble will probably emerge sooner than people expect and will be worse than they anticipate.

The problems are going to be simple and familiar. The commercial real estate story has none of the ongoing complications found in the residential market. There aren't issues of "misleading homeowners" into risky or expensive loans. There are no huge failures by government regulators. The aftermath won't see people thrown out of their homes. Nobody was "tricked" into taking on loans they couldn't afford.
I feel that while a blow up in the commercial real estate market will be ugly, it won't be as bad as the current housing crisis. It's a smaller market, and any single property often has a diversified group of tenants with different sources of income. The supply of buildings didn't increase dramatically over the past several years, as in residential real estate. And the losses won't be as severe, because many commercial spaces can be refashioned for new occupants at lower rents.

With residential mortgages, one of the most persistent myths to take hold in recent years was that home prices on a national level had never decreased in a given year. That wasn't true, but perhaps we can forgive people for being hopeful.

The commercial real estate market has no such excuses. Everyone knows that the business is highly cyclical. Indeed, a huge downturn had occurred as recently as the early 1990s, within the memory of most of the professionals now in the market.

Amid the tall office buildings of America's cities, big-money pros have simply been playing a game

"Those who agree with us may not be right, but we admire their astuteness." – ***Cullen Hightower***

of trying to bring in huge returns with borrowed money and sell out before the arrival of the crash they knew was coming. And in this case, they won't just be famous developers. Some of the same banks and Wall Street firms now entangled in the subprime residential crisis will also be caught in the mess. The commercial-real-estate meltdown will be a market failure, pure and simple. We will be able to look at the wreckage in the next several years with wonder and awe, untroubled this time by sympathy for those left holding the bag.

Here's what we know about what happened in commercial real estate. Lending standards were reduce sharply. What's more, it used to be that banks made loans for no more than 80 percent of the value of a property to ensure a healthy cushion of protection, but by the early part of 2007, loans were sometimes made for 120 percent of a property's value. Who would be so crazy as to lend more than a property is worth? Anyone who believes in perpetual-motion machines—that is, that rents and underlying property values must always go up.

A prime example is Tishman Speyer Properties, which paid a record price for two giant New York apartment complexes. To make the purchase work, the company must now figure out a way to kick out current tenants—many of whom have their rents stabilized by law—at a faster rate than has been managed in years past, in order to replace them with ones who will pay more. Historically, that turnover has been about 6 percent, says Todd, but Tishman Speyer is assuming a rate of more than double that for the first couple of years, and 10 percent for the next few after that.

Lending standards had been loosening across the industry for years. Standard & Poor's and Moody's both voiced early concerns in late 2004 and the beginning of 2005. Sure, "supply and demand is in balance, but that's not a license to loan more money against a given cash flow," says Tad Philipp, Moody's managing director of commercial-mortgage finance. "What we were seeing was riskier and riskier loans, and the loans got riskier still. And we are just past the top of the cycle."

Workshops

7 Steps to a Successful Business Exit

With Gregory Banner, CFP® CLU®, Asset Preservation Strategies, Inc., and Alejandro Matuk, Esq., Strazzeri Mancini LLP, will take place on February 5, 2009 from 2:30—4:00 PM at the Southern CA Institute.

Every business owner needs to plan with the end in mind as to how they are going to transition out of their business. Exit planning is a customized process of setting goals and deciding how to best achieve them. Proper exit planning will help maximize a business owner's return and minimize the tax liability when the business is transferred or sold. Please RSVP at 858 455-1825.

Town Hall Meeting
An Open Forum

We are hosting two Town Hall Meetings on Tuesday, February 3rd, 2008 from 10:30 - Noon and again from 6:00 - 7:30 PM.

The meetings will be facilitated by John Jenkins, Greg Banner, Ron Ceniceroz and Joe Strazzeri, Esquire.

You should consider attending if:
- You are concerned about a possible prolonged recession
- If you would like to understand how economy got into this mess
- You would like to know what to do now
- If you are afraid of outliving your assets

In addition, we will facilitate an open, question and answer session on any additional topics, concerns or questions you may have.

Please RSVP and bring a friend along with your questions.

The date for the Town Hall Meeting is subject to change, so please verify when you RSVP.

Staff Changes at APS

Ashley Powell left the firm on January 7, 2009. I know you join with us in wishing her the very best in her future endeavors.

Mark your Calendar

6th Annual Circle of Friends

Please mark your calendar and plan to join us on Thursday evening, February 26, 2009 at 6:00 PM at the Hyatt Regency La Jolla Hotel for our 6th annual Circle of Friends Gala Event.

This year funds raised will benefit the Autism Intervention Center at Rady Children's Hospital.

Each year, friends of the Southern California Institute and the firms that support it, including Asset Preservation Strategies, Inc., convene for a two-day educational event called The Gathering. The professional education event takes place on Thursday and Friday, February 26th and 27th. On Thursday evening, members and Fellows of the Southern California Institute gather with friends, family and clients to enjoy a fun and festive evening and to give something back to the greater community.

Past beneficiaries of Circle of Friends include the Muscular Dystrophy Association and Sharp Hospital's Brain Trauma Center where funds raised were specifically targeted to returning Iraqi War Veterans. Our cause is equally deserving this year, as any family impacted by Autism can explain.

We hope you will carve out the time and plan to join us at this fun and memorable event. For more information please contact Paula at 858 455-1825.

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Jenkins Article Picked up Nationally

An article published by John L. Jenkins, AEP, EA, CFP® entitled "Financial Resilience Requires a Professional: Now More Than Ever Investors are Seeking..." has been picked up by numerous media outlets including:

- MSN Money
- Global Investing Today
- Forbes.com
- Market Watch
- Reuters
- Yahoo! Finance
- The L.A. Times; and
- The Los Angeles Business Journal

Please contact us if you would like to receive a copy of the article or to obtain the links to these online sites.