



MARKET OUTLOOK

A publication of Strategis Financial Group and MarketOwl.com

2007 proves to be a poor year for financial markets

As late as Halloween, it appeared that 2007 had the potential to be a pretty good year for the stock market. The Nasdaq was up about 17%, the Dow was up 12% and the S&P 500 was still holding a 9% gain.

The week before Christmas, the picture was markedly different with the S&P 500 barely clinging to a 2% gain. The Nasdaq was leading with a 7% gain and the Dow was up just 6% for the year.

Barring some unforeseen rally the last week of the year, 2007 is

going to go into the books as a very ho-hum year for investors.

There are plenty of reasons for the recent weakness in stocks. The sub-prime mortgage fiasco gets most of the press. But high energy costs and rising inflation are also to blame.

Heading into 2008 there seems to be little reason for optimism. Undoubtedly there will be opportunities for profits as there were in 2007. But overall market risk seems to be increasing.

Chances are stock market move-

ment in 2008 will be heavily influenced by the presidential elections. Democratic candidates have already talked about increasing capital gains taxes.

Watch for a sharp sell-off in late summer, particularly if Democrats are leading in the polls or if the race appears to be very close.

Wall Street does not like uncertainty and the prospect of a new president--especially one of a different political party--increases the chance for a wide range of economic doubt.

Understanding defined contribution retirement plans

Earn more from your 401K, Simple IRA, or other plan

Prior to the Employee Retirement Income Security Act of 1974 (ERISA), companies that offered pensions to their employees were usually in charge of how those pension assets were invested. That didn't always turn out well.

Corruption and defaults prompted Congress to make some changes. The result included several types of defined contribution plans where the employer, employee or both contribute to an employee's individual retirement account. These plans

include 401Ks, Simple IRAs, SEP IRAs, profit sharing plans, and more.

At first, most companies that offered these plans still made the decisions about how they would be invested. The assumption was that employees weren't smart enough to make sound investment decisions.

As things turned out, many of the people overseeing the plans did not make great decisions, either. As a result, today most companies have adopted defined contribution plans that allow the employees to choose how their plan assets will be invested.

If you work full time, chances are you are participating in some type of defined contribution plan or at least have the choice to participate. From plan to plan there is a wide variation in the types of investment options available to plan participants. Obviously, this will have a direct impact in how the plan assets perform over time.

For example, my wife is an educator. In addition to her state sponsored retirement, the school district she works for offers her the opportunity to contribute to a 401K plan. The district contributes an amount equal to .25% of her salary each



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Winter 2008
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year. That doesn't amount to much, but anything is better than nothing.

My wife also makes a tax-deferred contribution to this account each month. That means the money comes out of her check before taxes are withheld.

Her 401K plan is totally self directed. In other words, she decides where the money will be invested and how it will be allocated. She is restricted, however, to the investment selection offered by the plan. In this case, she has about 20 investment options. She is allowed to change her allocation once per month.

You might be wondering where the plan comes from and who decides what investment choices will be included. In this case, the plan itself is actually a variable annuity created and offered by an insurance company.

Most 401K plans offered at small companies fall into this category. The employing company chooses an insurance carrier's 401K plan to offer employees much as it selects a plan for health insurance.

The investment offerings within the plan are determined by the

insurance company and are variable annuity sub-accounts. The best way to describe a sub-account is that it is essentially a clone of a mutual fund offered through the insurance company.

To obtain these sub-accounts, the insurance company contracts with a mutual fund company to create clones of some of its existing funds. The sub-account might even have the same name as the fund it is replicating. But because it is a duplicate and not the original, there will be differences in performance.

Even though it is the same manager, execution times might be slightly different, the amount of money the manager has to work with will be different, and there could be differences in trading restrictions.

So when someone owns Fund A in his 401K account and he checks the year-to-date performance on Yahoo!, it is likely to be different than what is reflected on his account statement.

In contrast, the defined contribution plan offered by my employer is a Simple IRA. In this case, instead of coming from an insurance company, my plan is set up

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through Fidelity, a brokerage firm. I can choose virtually any investment option available through Fidelity for my plan.

I can purchase stocks, Exchange-Traded Funds (ETFs), regular mutual funds, and more. In this case, the mutual funds I buy are the real funds, not clones. I can change allocations any time I want, but I am subject to fees and penalties imposed by the investment vehicles and by Fidelity.

Most defined contribution plans are going to fall between these extremes when it comes to the number of investment choices that are offered.

Choosing a strategy

If you have any sort of a self-directed retirement account, it is important that you have a strategy for managing those financial assets. Without some kind of a plan, there is a high likelihood that you will take too much risk or have a low return.

Many plans try to help participants with this problem with offerings called lifestyle or lifecycle portfolios.

Lifecycle portfolios consist of an asset mix determined by a professional manager. This mix is

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adjusted depending on how many years remain before participants are going to retire.

Sometimes these portfolios are given a name that corresponds to a future year. One might be called XYZ Insurance Lifecycle 2020. The next might be XYZ Insurance Lifecycle 2025, and so on. Participants merely choose the fund that corresponds most closely to the year they intend to retire.

Other times the portfolios are less specific. For example, in my wife's 401K the lifecycle selections are called Short Horizon, Medium Horizon and Long Horizon.

Usually the asset mix is an assortment of stock funds and bond funds. The lifecycle choices that are closer to maturity contain a higher percentage of bond funds as an attempt to reduce volatility and risk.

In contrast, lifestyle portfolios usually correspond to a risk category. These are usually defined as something like XYZ Insurance Lifecycle Aggressive, XYZ Insurance Lifecycle Moderate, XYZ Insurance Lifecycle Balanced, etc.

While both lifecycle and lifestyle portfolios are professionally supervised, there can be huge disparities in performance within offerings in the same plan or among the offerings of different plans. So it is important to thoroughly investigate the management style and performance history of the plan offerings.

Buy and hold or asset allocation

Another option for managing your defined contribution pension plan is to follow a diversified buy and hold approach. This is also commonly referred to as asset allocation.

With this type of strategy the account owner attempts to minimize risk by dividing the account assets among several of the plan's investment alternatives.

For example, the plan participant might put 20% in a bond fund, 20% in a large cap fund, 20% in a small cap fund, 20% in an international fund, and 20% in an S&P 500 index fund.

In reality, this type of strategy doesn't do much to reduce overall market risk. There are many studies that show there is a fairly high correlation between international funds and an A&P 500 index fund, for example. So while a person taking an asset allocation approach believes he has diversified his risk, that might not be true.

Active management approach

Some plan participants want to take a more active role in the management of their retirement assets. While that can be a good thing, it can also increase the risk level.

Often the increased risk occurs because plan participants are unsure of how they should invest the assets of their account. So they seek out the advice of a co-worker who is perceived to have some knowledge about the investment markets.

I know of one office where most of the participants in the company 401K plan invested all of their assets in an energy sector fund on the recommendation of a company supervisor.

It was a period of rising oil prices and the recommendation turned out well for most participants. Unfortunately for some, they neglected to sell when the price of oil dropped and their accounts suffered accordingly. The point is, even for those who got out in time, putting all of their assets in a single market sector was risky and inappropriate.

When properly practiced, an active management approach can actually decrease portfolio risk. Instead of a static allocation like

the buy and hold investment style, active management involves moving assets to cash or to lower risk alternatives when market risk is high then reallocating to stronger sectors when market risk declines.

Obviously the difficulty is being able to identify those high risk periods and knowing when to move assets from one market sector to another.

To successfully follow an active management approach, an investor needs to have a fairly high level of market knowledge and sophistication. Like any other field, this usually comes through study and experience. Fortunately there are plenty of places an investor can go to acquire information.

The phrase "active management" can be a little misleading. Sometime investors get the incorrect impression that active management means constantly changing one's portfolio allocation. In practice, changes are only made when absolutely needed. In a 401K or other retirement plan, those times might only occur once or twice a year.

At Strategis Financial Group our active management utilizes a combination of technical, cyclical and fundamental tools to help us make

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As your investment advisor, we are required by the Investment Company Act, Rule 3a-4, to make recommendations in accordance with your individual needs and financial circumstances. We must also periodically check to ensure that these needs and circumstances have not changed. So if there have been changes in your financial circumstances, please contact your advisor at **1-800-279-3377**. We will be happy to make any necessary adjustments in your portfolio selection.

decisions about when to make changes in portfolio allocations. You can get a feel for our tools and some of our decision-making process by signing up for our FREE weekly investment blog at:

www.marketowl.com

Throughout the course of a year, we include information about many of the tools and the decision-making process in this weekly advisory service. These include things like moving averages, various oscillators, breadth indicators, and momentum indicators.

Professional management

Some investors like the active management style, but lack the time or expertise to do it themselves. Some defined contribution plans allow for the possibility of professional management by an outside party. Usually the cost for this type of management is in the range of 1% to 2% a year.

If you are unhappy with the performance or cost of your company's 401K or other defined contribution plan, please feel free to contact Strategis Financial Group for a review of the plan and a comparison proposal.

In many cases we can actually offer a less expensive alternative that includes much better features and investment options.

—Flint Stephens

Mr. Stephens is marketing director for Strategis Financial Group. He has been a writer and editor for numerous investment publications. He has a masters degree from Brigham Young University.

The problem of fund distributions

The end of the year brings one of the more confusing aspects of



mutual funds for investors. Fund owners are given a distribution, usually sometime in December. The distribution comes from the dividends and yields paid to the fund from the stocks it holds.

The term “distribution” is a little misleading, because instead of passing these dividends on to the mutual fund client, the fund keeps the cash and reduces the value of the fund shares. Then it issues additional share to fund investors to make up for the difference.

For example, on Dec. 15 Fund ABC has an Net Asset Value (NAV) of \$10 per share. Investor Bob owns 10 shares for a total account value of \$100.

On Dec. 16, Fund ABC issues a 10% distribution. Investor Bob still has \$100 in his account, but he now owns 11 shares valued at \$9.10.

Investors who are not aware of how these distributions are handled can be shocked when they check the share price of a fund they own and find that it dropped dramatically for no apparent reason. Often they fail to see that the price decrease is offset by owning a greater number of shares.

The accompanying chart illustrates this problem. The red arrows mark two separate December distributions. In each instance, the price of the fund appears to plunge. In reality, anyone owning the fund

would have the price decline offset by an increased number of lower-price shares. So the net effect on account balances would be zero.

Of course, there can also be tax implications with these phantom distributions. In qualified accounts like IRAs or 401Ks, the distribution is essentially a non-event. But in a taxable account, the distribution is counted as income.

That means in the example above, as far as the IRS is concerned, Investor Bob received an extra \$10 in income on which he must now pay taxes. It doesn't matter than his account value did not change.

In this example, the amount is not significant. In real life, phantom distribution income can be major. In funds with high returns and high portfolio turnover, distributions can be 20% or even more. That can result in an unexpected hefty tax burden for someone caught unaware.

Some investors avoid the distribution problem by finding out when a fund historically makes its distributions and then selling ahead of that date. Of course the investor who takes this approach must then wait the required period before buying back into the fund or he faces the tax implications of a wash sale.