



*FERGUSON ASSET MANAGEMENT, INC.*

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*Investment Counseling & Asset Management for Individuals & Institutions*

## **Mid Quarter Commentary**

**February 2007**

In this report we look at:

- The market reality check
- An asset allocation model update
- The Alternate Minimum Tax blues
- Travel planning, turn to a pro
- Potpourri

### **The Market Reality Check**

The past six months have seen the markets, both domestic and international, move higher and higher. Our balanced portfolios, those with about 75% equities and 25% fixed income, have only gone in one direction during the past six months, up. I just calculated several moderately conservative accounts and, based on the past six month's performance, they are on course for nearly a 24% annualized 12 month return. We have several new accounts that have experienced these returns and never had a monthly statement that showed a value decline

This is a wakeup call. Markets, while trending higher for over 75 years, do not go straight up. We expect a correction sometime and we haven't the slightest idea when or how much. Furthermore, given the underlying worldwide positive economic scenario, we are little concerned about the where and when of such a pullback.

Last year the Dow 30 Industrials had a double digit yearly gain, but the popular average declined over 8% from its high in May to its low in July. Historically, the period from May to October is the time when the markets may catch their breath. They digest their gains from the previous six months, and scare the investment pants off the novice.

As we all know, or should know, the markets are unpredictable in the short term. In 2003 the Dow did not oblige those looking for a mid-year pullback, as the Dow advanced nearly 18% from May through mid-October.

We structure our portfolios for you within our mutually agreed upon time horizon and your degree of risk tolerance or risk assessment. Since Reality television shows seem to be the current rage, we thought we would do our own. The markets don't go straight up. Expect your account(s) to experience some declines this year and every year. They may go down 1-6% in any given month, more than that is not out of the question, but the normal monthly "correction" averages about 3%. The long-term trend is our focus.

During January the markets had several days of one half-percent moves both up and down. *The Wall Street Journal* attributed the advances to declining oil prices. Then, a few days later when the markets declined, the *WSJ* also attributed them to declining oil prices. Go figure! We gave up long ago trying to justify these mini-market moves, but we do chuckle.

### **An Asset Allocation Model Update**

Recently a client asked us, "What asset mix would provide a 9% (annualized) return with the greatest safety?" The following is my written response.

Your question as to what asset mix would provide a 9% return with the greatest safety is being distilled to a brief, but I hope meaningful answer. There are probably 100,000 pages of data on the subject in current circulation!

For 75 years from 1931-2005 the S & P 500 had an average return of 10.5%, and for the twenty years from 1986-2005 the return averaged 11.9%. For the five years from 2001-2005 the return was slightly less than one half of one percent annualized.

During the same 75 year period small cap value index had a return of 16.1% and 14.6% for the twenty year period. Large cap value was 16.1% and 14.6% for the same periods. Over the past 75 years one month T bills returned 3.4%, long term Treasuries averaged 5.5% and inflation was 3.4%. International value has averaged 15.7% for the twenty year period and international growth 7.9%

When we construct asset allocation models our default is 70% US stocks, 25% International developed country stocks, and 5% emerging market stocks. This is the basis for equity allocation strategies. For the fixed income allocation our default is half in two year global fixed income, and half in five year global fixed income.

Therefore, using the above allocation, a 60/40 portfolio would have 42% US stocks, 15% International, 3% Emerging markets, 20% two year fixed and 20% five year fixed.

During the past 20 years a 60/40 portfolio, as allocated above would have had an average return of 10.01%. A 40/60 portfolio would have had an 8.27% average return.

The answer to your specific question, "What asset mix would provide a 9% return with the greatest safety?" is 47% equities and 53% fixed income...based on the historical returns for the past twenty years. (Biggest loss year would have been less than 4.5%)

That concluded my response, but here I will be even more specific. Using \$100,000 as the model account, \$32,900 would be in a mix of large to small cap domestic funds, \$11,750 would be in a mix of developed country non-US stock funds, and \$2,350 would be in emerging market country funds. Examples of emerging markets include India and China, much of Southeast Asia, countries in Eastern Europe, and parts of Africa and Latin America.

The balance of the assets, \$53,000 would be divided half generally in two year or less US Treasuries and the other half in five year or less highest rated global bond index funds.

Harry Markowitz, who shared a Nobel Prize with Merton Miller and William Sharpe for what is generally known as “Modern Portfolio Theory” (MPT), indicated that a 60/40 mix gave an investor the greatest return for the least degree of risk.

### **The Alternate Minimum Tax blues**

I recently attended a National Association of Personal Financial Advisors (NAPFA) seminar on income taxes. Most of us who were in attendance do not do tax preparation. We do want the overview to integrate this knowledge into our advisory practice. The alternate minimum tax (AMT) is the tax that can bite when we least expect it.

The AMT is a parallel tax system that disallows many deductions and exemptions allowable in computing our normal tax liability. It went into effect in 1970 and was intended to target less than 200 high-income households that were paying little or no income tax. It was not indexed to inflation, and now many middle-income taxpayers finding themselves subject to this higher tax. What made us sit up and pay attention was the comment “prepaying your state income tax may trigger the AMT.” We were told that we should calculate our estimated taxes in October or November and see if we are doing things that could cause us to pay more in taxes (AMT) than necessary. This is a very basic primer and may help you in working with your accountant to minimize or avoid the dreaded AMT.

Interest that is exempt from your normal income tax may or may not be exempt from the AMT. If you have substantial income from bonds that are not fully tax exempt you may well face the AMT requirement.

The standard deduction is not allowed under AMT. If you are a high income earner it may pay to itemize if you are not already doing so.

State and local income tax prepayment may trigger the AMT. Plan ahead.

Interest deductions on second mortgages are not deductible if used for investment purposes other than buying, building, or improving your home.

Some or all of your medical expenses may not be allowed under the AMT.

If you claim big deductions for unreimbursed expenses from your employer you might end up triggering the AMT.

Exercising a hefty incentive stock option will probably see you pay the AMT.

The AMT does not treat all Tax Shelters equally. Some will come back to haunt you, as several partners in major law firms have recently found out.

Even your standard exemptions may contribute to an AMT liability. We suggest you speak with your accountant this tax season about what you should do in 2007 to avoid the tax that was designed over 36 years ago to tax the very rich. It now affects about 1 in 6 taxpayers. Welcome to the world of the very rich!

## **Travel planning, turn to a pro.**

Has travel planning got you down too? When we travel it is no longer a call to United Airlines for their schedule. Now, if it is an international trip, we wonder if we should fly to a major overseas hub and then use a low cost carrier like Ryanair to get around, or use the even lower cost Asian upstarts to move around that part of the world. My sister recently spent hours searching for fares and schedules for an overseas pleasure excursion, and then concluded she didn't know what kind of deal she had received.

We have had success with Mark Twain Travel and recommend them to you for any of your travel plans. There are several reasons to recommend a pro. One, they can get bookings on flight consolidators that are not available to us. These savings may be quite significant. Two, they save us the time and effort trying to put together an itinerary that just doesn't seem to work. Three, this agency is headed by our friend Joan Appel and I believe she may have been to every place which you have ever thought about going. She brings personal insight to the planning process. They are members of the International Association of Travel Agencies and are members of ASTA. You can reach Joan at: [www.marktwaintravel.com](http://www.marktwaintravel.com) or 800 689-3774.

## **Potpourri**

We still like the world of 529 plans and most frequently use Utah as the plan of choice. The cost, performance, and transportability are our reasons for selecting Utah. Another state 529 plan we like is West Virginia. You may check them out on their websites. 529 plans are only for "higher education." They may not be used for day care through high school even though we wish they could!

Dimensional Funds expect to announce a new fund called Dimensional International Real Estate Fund. We anticipate this fund to open before the end of April. We knew it was coming and have been doing analysis of international real estate markets. We expect to add this fund to some, but not all accounts. It may have a higher degree of risk than some accounts need.

The domestic real estate bubble bursting is, in our opinion, burst. Sure, some areas of the country are in for "soft" pricing, but this was no tulip mania. We have heard of some Florida condo projects that were purchased almost entirely by speculators expecting to "flip" for a large profit. Greed got in the way of prudent investing. Our surveys indicate that home ownership is still the number one investment choice.

Derek Johnson just celebrated his seventh year with Ferguson Asset Management. We and our clients are better off for this relationship with Derek who is delightful, dedicated, and constantly striving to improve all facets of wealth management.

Zachary Ferguson starts a 12 week Dale Carnegie course in Effective Communications and Human Relations this month. The course material claims that Zach will be "better equipped to perform as a persuasive communicator and problem-solver."

Have a pleasant winter. I'll have another commentary for you in early April. John Ferguson

