



NORTHSTAR

FINANCIAL  
PLANNING INC

APRIL 2008

603.216.9226

## 2008 Q1 Investment Letter

It was only a year ago that the April 1<sup>st</sup> version of our quarterly letter to you and our clients included these words:

*“Now let’s talk about some recent headlines and market news that may be on your mind as you’re listening to the evening news about oil prices climbing towards \$100/barrel or real estate crashing. We are always plagued by a gnawing fear of the future- it’s hard-wired into our subconscious by thousands of years of cultural memory.”*

Sound familiar? Back then, the US stock market as measured by the S & P 500 Index was at 1,422. Today - a year later – the news is about the same and the S & P 500 sits at 1,315. The 107 point drop (after dividends and capital gain returns of 2.0% were reinvested), represents a 12 month total return loss of -5.5%. Not pleasant but should that amount of loss in a year be normally expected in the exceedingly complex & dynamic system that is the stock market?

Actually yes, since a statistical analysis shows that in any given year, total market returns of the S & P 500 should be expected to vary by plus or minus 9 percentage points from the previous period about two thirds of the time. We are well within the bounds of the expected.

We have all lived through volatile markets before and survived and even prospered. Paradoxical as it may seem, as long-term investors we desire volatility. It is easy to forget that reward and risk are joined at the hip. Risk drives reward and you can’t have one without the other. A truly risk-free investment - one that has absolutely no chance of ever dropping in value - also has absolutely no chance of dramatically increasing in value.

We sometimes hear the talking heads say “This time is different-the system is broken and the US market economy is heading downhill fast!” But is that really true? We’ve seen rough patches in the US markets before.

- August 1998 had a one-month drop in the 14% to 20% range (*in one month!*), depending on the asset class.
- 2002 was the fifth worst year in US equity market history.
- All asset classes in the first quarter of 2003 saw negative returns - there was no place to hide!



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But remember what happened after the first dismal quarter of 2003? We saw huge annual returns in all major US market sectors in 2003:

- o S & P 500 +28%
- o Large Cap Value +34%
- o Micro Cap +60%
- o Small Cap Value +46%

Speaking of a “*buy at the sound of the cannons, sell at the peal of the bells!*” approach to investing, amid all the gnashing of teeth and rending of hair in the media about the real estate market, guess which market sector had the best performance in so far this year? Why - wait for it - real estate funds! Diversified mortgage REITs were up 3.6% last month and (1.2%) for the first quarter, 2008; this compared with comparable numbers in the S & P 500 of (0.4%) for March and (9.4%) for the first quarter.

#### Caution –Active Manager Ahead!



Mason Hawkins has been Chairman and Chief Executive Officer Southeastern Asset Management since 1975, and he and his partners manage the Longleaf Partners Funds. Hawkins is a legendary deep value investor, and a long-time follower of the investment strategies best embodied in our times by Warren Buffett.

Their flagship fund is the Longleaf Partners Fund, a \$12 billion large cap value no-load fund that has beaten the S & P 500 index by over 2 & ½ percentage points (+273 basis points) since its inception in 1975 and is ranked in the top 10% of all funds in its category during that time. Here at Northstar, “LLPFX” is on our Preferred List on those occasions when we include an actively managed fund in our investment allocation execution.

Hawkins is taking advantage of the current market environment to buy attractive companies. He says: “*Over the last six months, most of the improvement in the Price to Value metric (P/V) has come from the P as the result of prices coming down. Values are not nearly as volatile as prices, which obviously gives us opportunity at times when fear is driving prices. Most of our appraisals have grown or remained steady throughout the last six months. At a number of our companies we expect values to grow substantially because management is using the financial strength of the business to aggressively buy in shares at steeply discounted levels. Buying in shares at half of value grows the value per share of the company materially.*”



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Why do we think Hawkins' actions are important? Because, as we often remind ourselves, in the short run, the stock market is an auction, subject to the ebb and flow of emotions and harkening to baying of the speculative hounds in full cry.

In the long run, the market is a very efficient weighing machine, fairly appraising reward & risk and assigning value. A manager such as Mason Hawkins wears earplugs at the action and buys & sells with eyes only his weighing machine. Right now, he is buying while the crowd is selling. That is exactly how Hawkins beat the market by 25% over the long haul. That's the sort of investment philosophy we espouse as well.

#### **A Limited Tax Break**

Here's an interesting thought on a rare tax break for you if you are now (or expect shortly to be in) a low tax bracket. Over the next two years, you can take advantage of a capital gains tax break. From 2008 to 2010, taxpayers in the 15 percent tax brackets –those whose MFJ taxable income is less than \$65,100 - will pay zero percent in capital gains taxes. Individuals in the lowest two brackets will be able to sell stocks, bonds, real estate and other assets without paying any capital gains taxes. With some proper tax planning, this can be useful for many retirees.

Who can benefit? This capital gains tax break can primarily benefit the following people:

- *Adult children who support low-income parents or seniors helping out adult children who fall into the 10 or 15 percent tax brackets.*
  - Instead of giving cash, you can give stocks and bonds instead. You can give away \$12,000 a year tax free, and if the parents or adult children sell the stocks and bonds between 2008 and 2010, they will not pay a capital gains tax on the proceeds.
- *Retirees with investments in taxable accounts.*
  - Tax-deferred retirement savings plans are not affected by capital gains. But if you are a retiree with stocks or mutual funds in a taxable account, you can sell without incurring a capital gains tax. If you are planning on retiring this year, you may want to sell taxable investments and delay Social Security payments or distributions from a tax-deferred plan.

There are some potential downsides to sell investments, so you need to be sure it is the right step for you. Before you take any action, consult your tax professional.



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The proceeds from the sale of the investments will be added to your income, which can have some unintended consequences. For example, it could push you into a higher tax bracket, thereby losing some of the benefit of the zero-percent tax rate. It could also affect eligibility for Medicaid or cause previously non-taxed Social Security benefits to be taxed.

Please call if you have and questions or comments.

Sincerely,

Robin A. Young, CFP<sup>®</sup>, RLP<sup>®</sup>  
Alexa Darbe, CFP  
Sam Hull, CFP<sup>®</sup>, RLP<sup>®</sup>