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THE FSAG ADVISOR

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Market Update

Not too hot, not too cold. Interest rates aren't too high, the economy isn't growing too fast. Unemployment is low, manufacturers are producing more goods than ever. Some have described the U.S. as being a Goldilocks economy, "It is just right!" But with the volatility of oil prices, big deficits and a housing bubble, could it be a Redhead economy wearing a Goldilocks wig?

The past year has been surprisingly strong. Corporate profits and government revenue are both at record levels. Productivity continued to increase in the manufacturing and service industries. We have added almost 3 million jobs in the year 2006 alone. When housing is excluded, in the second and third quarters of 2006, real Gross Domestic Product grew a healthy 3.3%. When most prognosticators did not see how the stock market could increase more than a few percent for the year, the Dow Jones Industrial Average actually rose 19.05%. Workers are faring just fine as wages and salaries are up an annualized 6.7%. If there is more money in consumers' pockets, they are going to spend it. While Holiday sales are not all in yet, it should prove to be another solid season for retailers.

The markets have misbehaved a bit as well. With the Fed raising rates this year, one would have thought that inflation would be tamed. But it refuses to lie down as the core Consumer Price Index has risen 2.6% after having increased 2.2% in 2005. Commensurately, short term yields have not been this high since 2001. Oil prices have ended the year where they started, but the markets were badly shaken as a barrel of crude approached $80 in July. The housing market has also reeked havoc in many areas of the country. Other negative signs are reflected in our ever increasing budget deficit.

There are huge amounts of cash sloshing around in our economy and around the world. Last year, corporations had record levels of cash on their balance sheets, even after paying out dividends and buying back stock. Companies say they like to have the extra money around just in case of a rainy day! Hedge funds and private equity funds have used their inflows by taking out 2% of the market capitalization on the New York Stock Exchange in leveraged buyouts during 2006. Even local governments are awash in new money as tax revenues climb during this long period of economic growth.

2006 Returns

DOW	*19.05%*
S&P 500	*15.79%*
NASDAQ	*9.50%*
Russell 2000	*18.37%*
Mid Cap 400	*10.32%*
MSCI EAFE	*26.34%*
Lehman US Agg.	*4.32%*
Lehman Muni.	*4.84%*
10 Year Treasury Yield	*4.71%*

Watching how all these institutions use their funds will be something to continue to watch in 2007.

The New Year is proceeding with plenty of positive momentum. The Dow and S&P 500 are near record highs. Corporate profits are on a long win streak. The consumer is feeling wealthy again. Government coffers are flush with cash. Better check the punch bowl, is it empty or is there some cheer left? And who was that at the table? A Redhead or Goldilocks?

I'm Retired. How Can I Minimize Fluctuations in My Income?

Look at your asset allocation. Though it doesn't guarantee a profit or insure against a loss, a diversified portfolio improves your chances of having some investments that perform well when others don't.

Maintain a financial cushion. That may help you avoid having to sell income-producing assets unexpectedly, which could reduce your future income.

Investigate noncallable bonds. Bonds, especially those with fixed rates that pay interest every six months, have traditionally been an important income provider in a retirement portfolio. However, the higher the interest rate and the longer a bond's maturity, the greater the chance the issuer will call the bond and pay off its debt early, ending that income. You'll have to reinvest your principal elsewhere, possibly at a lower interest rate. With a noncallable bond, that can't happen.

Buy bonds with various maturity dates. "Laddering" bonds can help even out your income stream. As each one matures, you can reinvest the principal. "Laddering" can give your

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Rate Changes and Your Portfolio: Awaiting with Interest

The bond seesaw

Why do bond prices tend to go up when interest rates go down, and vice versa? Because whenever interest rates are falling, bonds that are issued today will typically pay a lower interest rate than a similar bond that was issued when rates were higher. That means that older bonds with higher coupons are more valuable to investors, who are willing to pay a higher price to get that greater income stream. The opposite is true when interest rates are rising.

Over the last two years, we've grown used to rising interest rates. Ever since mid-2004, the Federal Reserve Board has regularly increased the federal funds target rate. However, that pace has begun to moderate. It's not necessarily safe to assume that interest rates will be flat or drop, but it's no longer a given that they'll automatically go up, either. What does this mean when it comes to your portfolio?

Balance bond yields and values

As interest rates rose, you may have noticed that the prices of any bonds you own probably dropped. That's because bond prices tend to move in the opposite direction of interest rates; when rates go up, prices go down, and vice versa. More stable interest rates should also translate into more stable bond prices. If you own short-term bonds, U.S. Treasury bills, or a short-term bond mutual fund, you might talk with your FSAG professional about whether the current interest-rate outlook represents an opportunity to diversify into intermediate or longer-term maturities that offer a higher yield. However, be aware that if interest rates continue to rise, longer-term bonds will feel the impact on prices more than short-term bonds will. A drop in value could eliminate the advantage of any increased yield. Also, you'll need to think about the yield curve: the difference between the yield on short-term securities and the yield on long-term securities. Is the difference great enough to compensate you for the additional risk of a longer-term security?

Take stock of your situation

Whenever interest rates begin to flatten out, it's usually because the Fed believes the economy has begun to slow. That has implications for the stock portion of your portfolio. Consider how you've balanced your stock portfolio. Think about whether you own stocks that might be especially sensitive to a slowing economy and possible cutbacks in spending by consumers. Will people be traveling as much? Will they be buying new homes, cars, or appliances? Conversely, are there companies or industries that you think will do well given the current economic and interest rate environment? Are there companies whose products or services are relatively insensitive to interest rates, whose prospects depend more on their own execution, or that might actually benefit if the economy were to slow? Another area to consider is dividend yields. If income is your primary investment focus, is the dividend rate from your stocks competitive with bond yields? Has your tax situation changed? If so, does your new status have any implications for your preference for capital gains, dividends, or interest payments?

Remember the rest of the world

Interest rates also can affect the strength of the dollar compared to other currencies. If the dollar weakens, that could favor U.S. companies that do much of their business overseas. It also might mean it's time to reexamine the balance between your U.S. and international holdings. However, be careful; in some cases, stock mutual funds devote part of their holdings to foreign companies. That could mean that the portion of your portfolio that's in foreign investments might be larger than you realize.

Consider your asset allocation

This might also be a good time to reexamine how your assets are divided among various types of investments. If you're concerned about stability, you could increase the amount you've invested in bonds or cash. If you feel confident that you can ride out any volatility and are more focused on long-term growth, you might keep an eye on stocks you'd like to buy, especially if they're available at bargain prices. It's a good idea to periodically revisit your asset allocation.

If you decide changes are needed, you can make gradual alterations by:

- Adjusting only a portion of your bond or stock holdings
- Shifting allocations over a period of time, using dollar-cost averaging
- Directing only new money into assets that may benefit from current interest rates

Qualified Personal Residence Trust (QPRT)

If you own a home and expect to have a large taxable estate, you may want to consider this popular estate planning tool that can minimize federal gift tax and eliminate federal estate tax.

What is a qualified personal residence trust (QPRT)?

A qualified personal residence trust (QPRT, pronounced "Q-Pert," and sometimes referred to as a grantor retained interest trust, or GRIT) is an irrevocable trust into which you transfer a primary residence or vacation home while retaining the right to live there rent free for a specified number (term) of years. At the end of the term of years, the property passes outright to whomever you've named as the trust beneficiaries.

Tax advantages of a QPRT

When you transfer a home into a QPRT, you're considered to have made a taxable gift to the trust beneficiaries. However, the value of the gift isn't the full fair market value of the home, as it would be with an outright transfer. Rather, the gift can be discounted to reflect your retained interest (i.e., your right to live in the home). Note: You can leverage your $1 million lifetime gift tax exemption, to the extent it has not already been used, to offset any gift tax that is due. Another tax benefit of a QPRT is that, as long as you outlive the term of years, the value of the home (plus any appreciation) will avoid estate tax because, when you die, it won't be includable in your gross estate. Finally, you get to keep all the income tax benefits of homeownership during the term of years.

Deciding on the term of years

One disadvantage of a QPRT is that if you die before the term of years ends, the full fair market value of the home at the time of your death will be includable in your gross estate. So, deciding on the term of years becomes a tradeoff. The longer the term of years, the smaller the gift to the beneficiaries (and the smaller the gift tax), but the greater the likelihood you won't outlive the term, defeating the purpose of the QPRT. One further consideration: If you decide to continue living in the home after the term of years ends, you may do so, but you'll be required to execute a written lease and pay fair market rent to the beneficiaries.

Capital gains tax savings tradeoff

If your beneficiaries were to receive the home at your death, they would receive an income tax basis that is "stepped up" to fair market value. With a QPRT, however, because your beneficiaries receive the home at the end of the term of years, they'll receive a carryover basis (i.e., your basis). If the home has appreciated substantially

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I'm Retired. How Can I Minimize Fluctuations in My Income?

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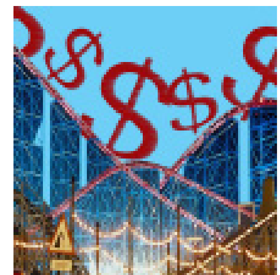
portfolio smoother transitions and greater flexibility, even though interest rates (and thus your income) will still change over time as you reinvest in newer bonds. Another option is a series of zero-coupon bonds with maturity dates that match a set schedule. "Zeros" pay interest only when they mature, but you'll know in advance exactly how much you'll receive from each one and when. If you invest in municipal zeros, you generally won't owe federal taxes on the interest.

Set up a baseline income. A fixed annuity can distribute specified payments over a given time period, your lifetime, or the lifetime of both you and your spouse. That could provide a stable foundation that allows you to invest other assets differently. Your financial professional also may suggest a systematic schedule for liquidating assets or taking distributions from an IRA or retirement plan.

Study dividend histories. If you invest in stocks, consider companies with a long-term track record of stable or increasing dividends.

These are only a few ideas for managing the income roller coaster. Your FSAG professional has more, and can suggest which ones might make sense for you.



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Stocks in the News: Qualcom (QCOM)

When someone says they are, "in a transition year" doubts come to mind. For Qualcom, this is a good thing as they move the world from second generation (2G) to third generation (3G) cell phone technology. Qualcom sells the electronic guts for cell phones using one of the most popular technologies they pioneered. The stock did not perform too well in 2006 as investors have questioned how receptive clients will be to the upgrade. Uncertainty just may lead to opportunity.

Code Division Multiple Access (CDMA) cell phone technology was perfected by Qualcom. They patented its work and sells the use of its intellectual property to other cell phone chip makers for about 4.3% of the price of a new phone. This business unit makes up 35% of the company's sales, grows about 15% per year and has gross profit margins that run over 90%! Rather than build the electronics themselves, a phone maker may choose to buy a completed "chipset" from Qualcom. This little motherboard carries not only their CDMA technology, but also a complete package of electronics that may include other features such as GPS, WiFi and Bluetooth. With this, a customer such as Nokia can take the chipset, put it in their cool handset, add their software and produce a finished product. The chipset business generates nearly 60% of Qualcom's revenue and grows about 8% a year.

What is new this generation? 3G technology allows for added applications to run on cell phones. As phones turn into Swiss Army knife like devices, customers crave the flexibility to put more tools on their phones, such as music, tracking, and mapping capability. Continued advances in semiconductor manufacturing makes the new chips smaller and more efficient. This efficiency reduces the need for power, which in turn increases battery life. This is important in emerging countries where dependable power is hard to get and find. Smaller and fewer chips help reduce size and weight as well. If trends persist, cell phone owners will be quick to upgrade to the latest new phones once they are made available.

Recent positive news for the stock includes Motorola's decision to start using Qualcom's' chips. Historically, Motorola has purchased cell phone chips from Freescale, Motorola's own chip business which they spun off in 2004. Motorola likes Qualcom's chips for their high end phones, and will continue to use Freescale chips for the lower end models.

In other news, China may implement CDMA technology in preparation for the 2008 Olympics. China's efforts to build their own cell phone infrastructure using a competing technology is not going too well. With the world watching China closely during that time, their need to have a properly working network is imperative.

Key Statistics: QCOM	
Price	*$37.80*
EPS	*$1.44*
Estimated EPS	*$1.78*
P/E Ratio	*26.25x*
PEG Ratio	*1.75x*
Dividend	*$0.48*
Market Cap	*$62B*
52 Week High	*$53.01*
52 Week Low	*$32.76*
Beta	*1.45*
Expected Annual Growth Rate	*15.0%*
ROE	*20.4%*

This family run, large cap company was founded by Irwin Jacobs. After being involved in the company for over 15 years, his son Paul is now CEO. He leads a company that is in an enviable financial position. The company has nearly $10 billion in cash, $3.25 billion in annual cash flow, no debt, over 30% margins and operating margins that run around 35%. That strength allows for the company to stay on top of its industry, as well as find new niches that may compliment its technology. Qualcom is in no slump, it's just the top of the third inning.

Qualified Personal Residence Trust (QPRT)

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in value, the increased capital gains tax your beneficiaries will owe upon the sale of the home may offset any gift tax savings you will enjoy.

QPRT rules

To qualify for beneficial QPRT tax treatment, the trust must conform to many rules and regulations, including: 1. You can't transfer more than one home to a single QPRT. However, you're allowed to set up two QPRTs, transferring one home (a primary residence or vacation home) to each trust. 2. You, your spouse, or your dependents must occupy the home for the entire term of years. The home must be used as a residence at all times, and generally can't be sold or used for any other purpose. 3. Generally, a QPRT can't hold any property other than the home (and related buildings and land reasonably appropriate for residential use). However, a QPRT can hold cash, subject to certain conditions, for limited purposes, such as the initial purchase of a home, the replacement of an existing home, or the payment of certain related expenses.

Plus, asset protection

A QPRT can help minimize gift and estate taxes, and because the trust is irrevocable, it can also be used as an asset protection tool, even if taxes are not a concern. If you're interested in learning more about QPRTs, talk to your FSAG advisor.

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