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THE FSAG ADVISOR

Inside this issue:

Market & Economic Update

Some economic data (retail sales, consumer confidence and certain housing statistics) are pointing to a moderation in the rate of decline. The improvement in economic data has been occurring at the same time that the Federal Reserve has been ramping up its quantitative easing policies and coincident with additional clarity regarding the government's plan to remove toxic assets from bank balance sheets. All of this is not to say that the economy has necessarily bottomed, but we do believe we have moved past the period of maximum weakness.

An eventual economic recovery would depend on the manifestation of a number of trends, including monetary easing, fiscal stimulus, bank restructuring and recapitalization, and a boost in confidence. Among developed markets, the United States appears closest to fulfilling these conditions, while Europe appears to be lagging. It is important to note, however, that the data is not pointing to a robust or steep US recovery and that there is still plenty that can go wrong, both in terms of policy failures and a renewal of more severe economic data.

Taking a look back over the last year, we can see how global equity markets have been following a script of sorts. In the first half of 2008, the global market downtrend broadened geographically and across sectors as markets anticipated expanding global economic problems. In the fourth quarter, we witnessed a widespread global flight to quality, surging volatility and some outright panic conditions based on fears of deflation contagion. This was followed by aggressive policy responses, interest rate cuts, bailouts, stimulus packages and quantitative easing. We now appear to be in a period of improving market performance based on some less ominous economic news and indications that negative investor sentiment has peaked and is starting to reverse.

On balance, we do believe that the recession has peaked and that the economy will stabilize in the second half of this year. Achieving such stability will remain a challenge for policymakers, and the environment remains fraught with risks. In any case, our confidence is growing that global equity markets are ending the bottoming process that started with the waterfall decline last October and that the lows from early March do represent the lows for this cycle. Should that be the case, we would expect the United States to continue to outperform other developed markets and believe that emerging markets and commodity-related investments should also continue to outperform.

Source: BlackRock (Bob Doll, Vice President and Director)

2009 Returns

DOW	*-12.49%*
S&P 500	*-10.93%*
NASDAQ	*-2.79%*
Russell 2000	*-14.95%*
Mid Cap	*-8.98%*
MSCI EAFE	*-13.94%*
Lehman US Agg	*0.12%*
Lehman Muni.	*4.89%*
10 Year Treasury Yield	*2.71%*

2009 Retirement Plan and IRA Limits

An increasing number of retirement plan and IRA limits are indexed for inflation each year. Some of the key numbers for 2009 are shown in the graph to the right.

The amount you can contribute to a traditional or Roth IRA remains at $5,000 for 2009, and the maximum catch-up contribution for those age 50 or older remains at $1,000. You can contribute to an IRA in addition to an employer-sponsored retirement plan. But if you (or your spouse) participate in an employer-sponsored plan, your ability to deduct traditional IRA contributions may be limited, depending on your income. Roth contributions are also subject to income limits.

Contribution limits: 2009 tax year
(2008 limits in parentheses)

Plan type	Annual dollar limit	Catch-up limit
401(k), 403(b), and 457(b) plans	$16,500 ($15,500)	$5,500 ($5,000)
SIMPLE plans	$11,500 ($10,500)	$2,500 ($2,500)
Traditional and Roth IRAs	$5,000 ($5,000)	$1,000 ($1,000)

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The Market Valuation Q-uestion

At the close of 2008, with US markets approximately 10% higher than their current levels, PIMCO CIO Bill Gross proclaimed that "today's Q ratio has almost never been lower, and certainly not since WWII, implying extreme undervaluation…"

At the same time, Russell Napier, a strategist at CLSA, a leading international brokerage and investment firm, said Q ratio values supported his expectation of a "horrific" market bottom and further 55% drop in the S&P 500 Index by 2014.

So who is right?

As with most broad-based valuation tools, the Q ratio does not provide uniform and unambiguous guidance to investors. Understanding its derivation and methodology, however, leads to important insights about economic and market trends.

The Q ratio was developed in 1969 by the late economist and Nobel laureate James Tobin, and the metric is often referred to as Tobin's Q. It measures the market value of a company (i.e., its stock price) relative to the replacement cost of its assets. A value greater than one indicates that a company's assets could be purchased more cheaply than the company itself and, hence, the market is overvaluing the company, while Q ratios less than one indicate market undervaluation.

John Mihaljevic, a former research assistant of Tobin's and a leading expert on the Q ratio, writes the Equities and Tobin's Q, a quarterly publication with his own estimate of the Q ratio and its implications for investors. Mihaljevic is "modestly bullish" based on the current Q ratio of 0.43.

Calculating the numerator for the market's prevailing Q ratio is relatively straightforward, since it equals the market value of the equity and debt of the companies that comprise the S&P 500, less net liquid assets and land value. Calculating the denominator, however, is much more problematic. The replacement value of assets is inherently subjective and can, at best, be estimated. Mihaljevic uses Federal Reserve data to calculate the replacement value of structures, equipment, software, and inventory.

Currently, the Q ratio is very close to historical bottoms that have corresponded to beginnings of bull markets. At the beginning of March, it reached a low of 0.33, at which point Mihaljevic was strongly bullish – a sentiment that was justified by the ensuing 20% rally.

Since 1900, the average Q ratio has been 0.78, and at the beginning of 2008 it was 0.89, declining to 0.55 at the end of last year.

In a 2003 paper, Duke researchers Matthew Harney and Edward Tower showed that the Q ratio offered superior value, as compared to all variants of the P/E ratio, in predicting rates of return over alternative time horizons. They tested the Q ratio against P/E ratios using 30-, 20-, 10-, 1-year moving-averaged earnings. Predictive ability was measured by comparing Q ratio values to subsequent rates of return on the S&P 500 index and ranking the results by R-squared. Incidentally, 30-year P/E ratios offered the second-best predictive value, followed in order by 20-, 10- and 1-year values.

Mihaljevic explored this question further, evaluating predictive value using three different methods for computing the Q ratio. He found that the best strategy was to buy when the Q ratio was below 0.40 and sell when it was above 1.00, as shown in the graph below.

Over the past several decades, this strategy would have produced a compounded annual rate of return of several percentage points higher than the S&P 500 Index.

Mihaljevic is confident that Q will reach extreme levels. The ratio hit a low of 0.29 twice over the course of the past century — in 1948 and again in 1974. The ratio was 0.33 or lower in 1918-1921, 1932, and 1949. Those who argue that today's Q sends an extremely bullish signal appear to focus solely on the level of Q, ignoring the direction of change. A ratio of 0.43 is very bullish if Q is on the upswing, but when Q is in decline, a value of 0.43 is only modestly bullish. Those who say the current Q Ratio is an extremely bearish sign, meanwhile, are missing three key points, Mihaljevic says:

♦"Attempting to buy equities at or close to Q's lows would have caused investors to miss out on decades of strong equity returns."

♦"The relationship between Q and stock prices is not quite linear. We estimate that a 50% drop in Q from current levels would be accompanied by a one-third drop in stock market indices."

♦"Replacement cost, the denominator of the Q ratio, has increased each year since 1946."

Mihaljevic notes two reasons why critics contend the Q ratio may be losing predictive value. The US economy has become increasingly service-oriented and driven by intellec-

Continued on page 4

Tobin's Q Ratio — Historical Buy and Sell Signals, 2000–2009 [2]

Source: The Federal Reserve; Blanchard, Rhee, and Summers; *The Manual of Ideas.*

Will the Estate Tax Stay Repealed for 2010?

In 2001, a law was passed that gradually phased out the federal estate tax through 2009, and repealed it altogether in 2010. That law, however, "sunsets" or expires in 2011 and reinstates pre-2001 tax law levels (with an exemption of $1 million and a top tax rate of 55%). Since 2001, the economic and political climate in the United States has changed significantly. The federal budget deficit has ballooned, the financial markets have been in turmoil, and most importantly, power has shifted to the Democrats. So, the question is: just how likely is it that 2010 will be an estate tax-free year?

Chance of repeal?...virtually zero

Of course, anything can happen, but President Obama has made it clear that he believes the estate tax should continue in some form or other. And in the Senate, Finance Committee Chairman Max Baucus has firmly stated "...repeal isn't going to happen." With increased Democratic majorities in both chambers of Congress, it seems highly likely that some action will be taken soon to head off the one-year sabbatical scheduled for 2010.

Future of the estate tax

Several bills have been introduced in Congress in the intervening years since 2001, some calling for full repeal, others for reform. Reforms that have been proposed include:

- Raising the exemption and/or lowering the tax rates
- Making the exemption "portable" between spouses (allowing surviving spouses to use any unused portion of the deceased spouse's exemption)
- Replacing the estate tax with an inheritance tax (transferring the transfer tax burden to heirs)
- Replacing the step-up in basis rule with a carryover basis rule (also transferring the tax burden to heirs in the form of capital gains tax)

President Obama has endorsed the following reforms:

- Freezing the estate tax at 2009 levels ($3.5 million exemption and 45% top rate)
- Indexing the exemption for inflation
- Disallowing or limiting valuation discounts

Planning for continued uncertainty

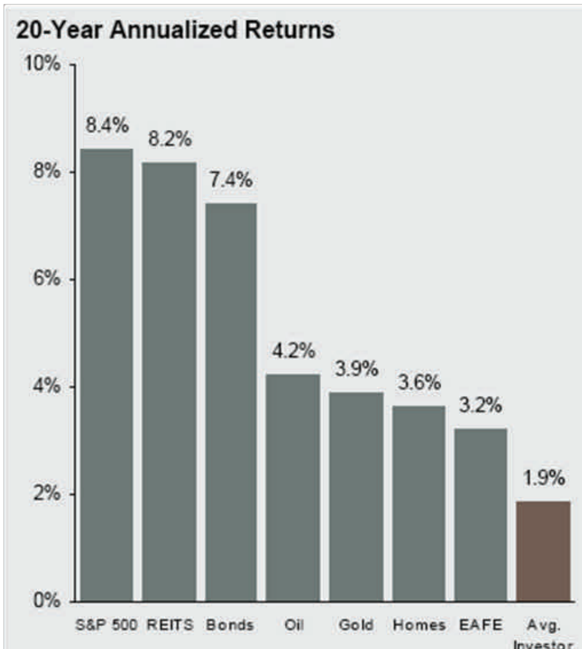
All indications point to the estate tax remaining for the foreseeable future. While the uncertainty that continues to surround the exact components of the estate tax may tempt some individuals to do nothing or wait and see, it may be wiser to review your plans now to ensure that they can withstand the winds of change.

Creating a flexible estate plan is the key to avoiding the pitfalls of future tax law changes, as well as changes that may occur in your personal life. A flexible estate plan uses language and provisions in wills and trusts that maximize the ability to pass estate assets free of estate taxes. And other tools, such as disclaimers and powers of appointment, can allow heirs or trustees to respond to circumstances existing at the time of your death.

Beyond tax

Remember that dealing with estate taxes, no matter what the future may hold, is just a piece of your estate plan. An experienced financial professional can help you identify strategies that may help you achieve your overall estate planning goals.

Chart of Interest: Long-term Returns and Bear Market Cycles



Bear Market Cycles vs. Subsequent Bull Runs

Market Peak	Market Low	Bear Return	Length of Decline	Bull Run	Bull Run Length	Yrs to Reach Prev. Peak
5/29/46	5/19/47	-28.6%	12	257.6%	122	3.1 yrs
7/15/57	10/22/57	-20.7%	3	86.4%	50	0.9 yrs
12/12/61	6/26/62	-28.0%	6	79.8%	44	1.2 yrs
2/9/66	10/7/66	-22.2%	8	48.0%	26	0.6 yrs
11/29/68	5/26/70	-36.1%	18	74.2%	31	1.8 yrs
1/5/73	10/3/74	-48.4%	21	125.6%	74	5.8 yrs
11/28/80	8/12/82	-27.1%	20	228.8%	60	0.2 yrs
8/25/87	12/4/87	-33.5%	3	582.1%	148	1.6 yrs
3/24/00	10/9/02	-49.1%	31	101.5%	60*	4.6 yrs
Average:		**-32.6%**	**14 mo's**	**176.0%**	**68 mo's**	**2.2 yrs**

Investment Strategy Highlight: Principle Protection

In the 2nd Quarter 2006 FSAG Advisor, FSAG wrote: "The stock market is up more than 60% from the bottom three years ago and many advisors suspect that equity returns will be in the low-to-high single digits for the next few years, and bond returns may even be lower. As a result, we are seeing investors and advisors reaching for more return by taking more risk. At FSAG, we believe that today it is more prudent to take less risk."

While we did not anticipate just how bad the crises would get, we did take several measures to protect client portfolios and we continue to believe that utilizing principle protection strategies are appropriate given the recent rally from market lows (as of this writing S&P 500 is +25%).

One of our strategies is to lock in a portion of the profits from the recent rally and reinvest them into structured notes that provide clients with upside (if the market continues to rally) and downside protection (if the market does not continue to rally). Listed below are two examples of recent investments that were added to client portfolios.

Maturity	Investment	Downside Protection	Maximum Return	Issuer
18 months	S&P500	20%	25.25%	UBS
18 months	S&P500	15%	31.65%	Goldman Sachs

At FSAG, there is no commission and we receive no additional compensation when purchasing a structured note or any other investment vehicle.

High-Yield Municipal Bonds: Relatively Low Default Rates

Historically, the default rates on high-yield munis have been much lower than those on similarly rated corporates. According to a Moody's Investors Service study of fixed-income default rates between 1970 and 2005, the average cumulative rolling ten-year default rate for high-yield munis was 4.3% over that period, versus 32.7% for high-yield corporate debt. The graph to the right shows default rates across all rating categories. There is no evidence to suggest that default rates changed on an absolute or relative basis through 2008.

Fixed-Default Rates

Rating Category	Municipal	Corporates
AAA	0.00%	0.56%
AAA	0.06%	0.58%
AAA	0.03%	1.42%
BBB	0.13%	4.89%
Investment Grade	0.07%	2.23%
High Yield	4.29%	32.71%
All Grades	0.10%	10.14%

Source: Moody's Investors Service

The Market Valuation Q-uestion

Continued from page 2

tual property, and the Q ratio does not consider the replacement cost of intangible assets. Those critics should recall, however, that the Q ratio reached excessively high levels at the peak of the Dot Com bubble.

Others contend that the economic rationale behind the Q ratio is sound, but the underlying adjustment mechanism may take longer than most equity market investors can tolerate. Mihaljevic agrees, and he does not advocate using the Q ratio as a short-term market timing tool. When the Q ratio reaches extreme levels (below 0.40 or above 1.50), however, he says it offers meaningful predictive insights for long-term investors.

Although he has never (to our knowledge) explicitly cited the Q ratio, Warren Buffett implicitly embraces the concept. Buffett advocates investing in businesses with "wide moats" – companies that have created defensible barriers to entry, making it difficult for existing or potential competitors to replicate their business model. The cost of replacing such a business would be relatively high, and therefore it would have a low, attractively valued Q ratio.

Source: Advisor Perspectives, Robert Huebscher

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