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LMK Wealth Management

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The Prudent **I** NVESTOR

SEPTEMBER 2010

Coming to Terms with Stocks

With all of the volatility in the stock market over the past few years, it can be difficult to determine how to devise an investment strategy to help reach your financial goals. To help you determine a reasonable rate of return to expect on your stock investments, it might be instructive to review some "facts" about the stock market:

✓ **The stock market's historical return can change dramatically depending on the period considered.** For instance, from 1926 to 2009, the Standard & Poor's 500 (S&P 500) had an average annual return of 9.6%. From 1984 to 2009 (25 years), the average return was 10.4% and 0.9% from 1999 to 2009 (10 years).*

✓ **The market tends to revert to the mean.** There is a tendency for the stock market, when it has an extended period of above- or below-average returns, to revert back to the average return. Thus, following an extended period of above-average returns in the 1990s,

the stock market experienced a significant downturn, bringing the averages back in line.

✓ **History may not be a good predictor of future returns.** The expected rate of return for your investment program is typically based on an analysis of past returns, since no one can predict future returns. However, realize that those returns may not be replicated in the future. During much of the stock market's history, the United States was in a substantial growth phase as it grew from a struggling nation to a superpower. Growth in the future may not approach those levels, which could dampen stock returns.

✓ **The pattern of actual returns affects your investment balance.** Even if you get the average rate of return exactly right, your portfolio's balance will depend on the pattern of actual returns during that period. Some years will experience higher-than-average returns, while other years will have lower or even negative returns. If you experience high returns in the early years, your portfolio's value will be lower than if those returns occurred in the later years. If you encounter negative returns in the early years, you will have a higher balance than if those negative returns came in the

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Summertime, Theme Parks and Roller Coasters!

Ok, so it is a corny title, but it sums things up concerning the current investment environment (theme). A roller coaster ride of ups and downs in the market provided lots of thrills and fear! The talking heads seem to change the "Theme" as to where the economy is heading based on the current hill or dip in the markets. We have gone from the "depression" scenario of spring 2008, to the extremely bullish economic projections of early 2010, and back to the latest forecast of the Double Dip recession!

LMK Wealth Management style is driven "Top Down" with an economic assessment as to where we are in the economic cycle and an assumption as to where the economy will evolve over the next six to 12 months. The themes expressed in our newsletter, *The Prudent Investor*, at the start of the year and in the March edition remain intact today — sluggish to moderate growth. In fact, our suggestion that the rate of growth in the second quarter 2010 would slow down is intact

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Coming to Terms

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later years.

✓ **Historical returns do not include several items that investors must deal with.** Two of the most significant items not accounted for in historical returns are inflation and taxes. Over the long term, from 1926 to 2009, inflation averaged 3.0%.* Short-term capital gains are taxed at ordinary income tax rates of up to 35%, while long-term capital gains and dividend income are taxed at 15% (0% for taxpayers in the 10% and 15% tax brackets).

✓ **Investors have a difficult time earning historical returns.** Several studies have found that investors' returns tend to lag the overall market, since investors have a tendency to buy high and sell low. One study found that the average investor's return is at least 2% lower than the market return (Source: *Money*, January/February 2010).

What does all this mean to an investor? When designing an investment program, use a conservative estimated rate of return, since it may be difficult to earn the historical returns of the past. It's easier to start out with a lower expected rate of return and find out later that your actual return is higher, which means you just need to save less. However, if you use a higher estimated rate of return than you actually earn, it may be difficult to increase your savings to make up for that difference.

Consider these strategies when designing your investment program:

✓ **Take a fresh look at your financial goals.** Reevaluate your goals, how much you need to reach them, and how much you should be saving annually based on lower expected returns.

✓ **Save more of your income.** If you can't count on returns to provide growth in your portfolio,

Take a Look at TIPS

Perhaps you appreciate the idea of including fixed-income investments in your portfolio, but you do not like the thought of inflation chipping away at your principal. If so, Treasury Inflation Protected Securities (TIPS) may be a good option for you.

These Treasury bonds were created in 1997 to provide bond investors with inflation protection by periodically adjusting the bond's face value based on the increase in the Consumer Price Index for All Urban Consumers (CPI-U). The bond's interest rate is determined at auction and does not change during the bond's life, but the principal is adjusted every six months. Thus, subsequent interest payments are based on the increased principal amount.

If the CPI-U decreases, your principal will decrease, so that

you should compensate by saving more of your income. That may mean you'll need to work overtime or take on a second job to provide additional income. Another strategy is to reduce your living expenses and save the reductions.

✓ **Invest in a tax-efficient manner.** Taxes are often a significant investment expense, so using strategies to defer the payment of taxes can make a substantial difference in your portfolio's ultimate size. Utilize tax-deferred investment vehicles, such as 401(k) plans and individual retirement accounts. Or emphasize investments generating capital gains or dividend income rather than ordinary income. Minimize turnover in your portfolio, so unrealized gains can grow for many years.

✓ **Adequately diversify your investment portfolio.** Typically, you do not know which asset class will perform best on a year-to-year basis. Diversification is a defensive strategy — it helps protect

your interest payments will also decrease over time. However, when the bond matures, you will receive the greater of the adjusted principal or the full face value.

From a tax standpoint, interest income is subject to federal income taxes but not state or local income taxes. Also, any increases in the bond's principal value is subject to federal income taxes in the year the adjustment is made, even though the funds aren't received until the bond matures. However, if the TIPS is held in a tax-advantaged account, such as a 401(k) plan or individual retirement account, income taxes are not paid until the funds are withdrawn. There is no guarantee that investors will receive par if TIPS are sold prior to maturity.

Please call if you'd like to discuss TIPS in more detail. ○○○

your portfolio during market downturns and helps reduce your portfolio's volatility. Diversify your investment portfolio among a variety of investment categories, such as stocks, bonds, cash, and other alternatives. Also diversify within investment categories. Diversification does not assure a profit or protect against loss.

✓ **Evaluate your portfolio's performance annually.** That way, if returns are lower than you targeted, you can make adjustments to your strategy to compensate for these variations in return.

Please call if you'd like to review your investment program. ○○○

* Source: *Stocks, Bonds, Bills, and Inflation 2010 Yearbook*. The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future returns.

Dealing with Bond Price Fluctuations

There are two primary factors that affect bond prices — interest rate changes and credit rating changes. Interest rate changes typically will cause a bond's value to fluctuate more than credit rating changes.

As interest rates rise, a bond's price adjusts downward, while the bond's price will increase when rates decrease. Simply put, bond prices and interest rates move in opposite directions. Also, bonds with longer maturity dates are more vulnerable to interest rate changes, since the difference will impact the bond for a longer time period. One of the reasons longer-term bonds typically pay higher interest rates is because there is more risk that interest rates will change during the bond's life.

Credit ratings also influence a bond's price. When a bond is issued, rating agencies assign a rating to give investors an indication of the bond's investment quality and relative risk of default. Typically, higher-rated bonds pay a lower interest rate than lower-rated bonds. After the bond is issued, the rating agencies continue to monitor it, making changes if warranted. A bond's price tends to decline when a rating is downgraded and increase when a rating is upgraded. The price change brings the bond's yield in line with other bonds with a similar rating. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, such as a downgrade that moves a bond from an investment grade to a speculative rating, a downgrade of more than one notch, and a series of downgrades over a short period of time. In those situations, you should review your holdings to determine whether you want to continue to hold the bond.

If you want to minimize the

risk of price fluctuations, consider these tips:

✓ If you hold a bond to maturity, you receive the full principal value, so you won't be affected by price fluctuations. Thus, consider purchasing bonds with maturity dates that match your investment time horizon.

✓ Consider investing in bonds with shorter-term maturities, which are less susceptible to interest rate changes.

✓ Design your bond portfolio using a ladder, so you'll have bonds coming due every year or so. This strategy typically lessens the effects of interest rate changes. Since the bonds are held to maturity, changing interest rates won't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates.

✓ Choose bonds that match your risk tolerance. Safer bonds, such as U.S. Treasury bonds or investment-grade corporate bonds, are less susceptible to credit rating risks.

Please call if you'd like to discuss this topic in more detail.

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Evaluating P/E Ratios

Price/earnings (P/E) ratios are a common measure of stock value, both for individual stocks and the overall market. Calculating a P/E ratio is straightforward — it is simply the price of a single share of stock divided by the company's per share earnings. However, P/E ratios can be calculated using different earnings numbers. Trailing P/E ratios, which are typically reported in newspapers, use earnings per share for the most recent four quarters, while forward P/E ratios use forecasts of future earnings per share.

The difficulty is deciding what a reasonable P/E ratio is for a particular company or for the overall stock market. For individual companies, investors' expectations about future earnings affect the P/E ratio. P/E ratios for the overall market change based on broad market conditions and investors' views about how desirable stocks are compared to other investments.

There is no absolute measure of what P/E ratio should be paid for a given company with a given growth rate. P/E ratios can fluctuate significantly over time and among companies and industries. It generally helps to follow the P/E ratios of stocks that interest you, along with companies in similar industries, to develop a feel for how the P/E ratios fluctuate. Reviewing a company's P/E ratio for prior years can also be helpful.

You can also divide a company's current P/E ratio by the market's overall P/E ratio. If that figure is much higher than one (and thus higher than the overall market), you should evaluate whether the company's prospects justify that valuation.

If you'd like help using P/E ratios to make investment decisions, please call. ○○○

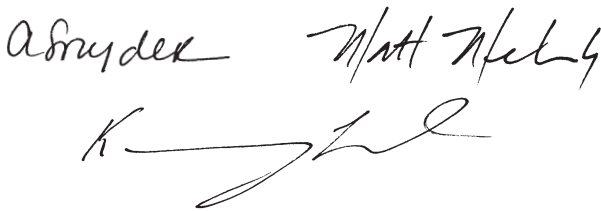
Summertime

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and is looking reasonable for the remainder of the year. Many earlier forecasts for more robust economic growth in 2010 have been reduced. Those forecasting economic Armageddon for 2010 have been rather quiet lately. In March, we expressed the opinion that "High Unemployment Rates, Tight Business Credit, Expectation of Higher Taxes and Deleveraging" would "temper demand" in the recovery. In fact, adjusted for inflation, final sales growth has been much slower than in recent recoveries at this point in the cycle.

Although we don't forecast forward earnings, we recognize that so far, profits seem to be doing quite well. Top-line revenue growth is far less impressive. Companies have done an excellent job of increasing productivity, cutting expenses and liquefying balance sheets with cash and cash equivalents. When the "Unusual Uncertainty" outline in Dr. Bernanke's testimony to congress on July 21, 2010, is resolved, good things may happen to corporate revenue and profits! **IN THE END, WE BELIEVE IT IS EARNINGS THAT DETERMINE STOCK PRICES!**

Inflation seems to be contained for now. The globe still seems to be balancing between inflation and deflation. Interest rates remain at historic low levels. The near miss in Europe over the last quarter has fostered the "Flight to Safety Trade," bringing the 10-year U.S. Government bond rates lower in June 2010. Steady as she goes for now; however fragile, the recovery continues at a slowing pace.



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Financial Aspects of a Death

If you have to handle the financial aspects of a loved one's death, it can seem overwhelming to deal with all the details. Following is a checklist of items to consider:

- ✓ Your most immediate concern will be to notify family and friends of the death and to make funeral arrangements. If you aren't sure of the deceased's burial wishes, look for a letter of instruction or a will that details preferences.
 - ✓ If a surviving spouse and/or minor children are involved, evaluate their means of support and determine whether care for the dependents needs to be obtained.
 - ✓ Locate any safe deposit boxes and follow necessary procedures to have them opened.
 - ✓ If the deceased was employed, contact his/her employer to start the process of collecting any outstanding pay, life insurance proceeds, or other benefits.
 - ✓ Locate important documents, including wills, trusts, deeds, investment records, insurance policies, business and partnership arrangements, and other evidence of assets and liabilities.
 - ✓ Meet with an attorney to discuss the deceased's estate matters.
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Financial Thoughts

Only 16% of workers are very confident that they will have enough money for a financially secure retirement, with 19% of retirees feeling the same way. Approximately 27% of the work force has saved less than \$1,000, with 54% saving less than \$25,000, not including the value of their homes and defined-benefit assets. Most workers lack confidence in their ability to finance medical expenses (51%) and long-term-care costs (61%) during retirement.

Fewer than half (46%) have tried to calculate a retirement savings goal (Source: Employee Benefit Research Institute, 2010).

Among those with less than \$1 million in assets, 44% said the economy has had a negative impact on their philanthropic activity, compared with 33% of those who have \$1 million to \$5 million, and 29% of those who have over \$5 million (Source: PNC, 2010).

A recent survey of certified

public accountants indicated that 74% of their clients had become more risk averse in the past year and 62% of retirement-age clients delayed retirement by at least one to five years (Source: American Institute of Certified Public Accountants, 2010).

Less than 20% of employers are very confident that their employees will be able to retire with enough assets to fund their nonworking years (Source: Hewitt Associates, 2010). ○○○