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The Prudent **I** NVESTOR

SUMMER 2009

What's Going on with Muni Bonds?

Traditionally, municipal bonds have been relatively safe investments. Over the past couple of years, however, that market has been extremely volatile, due to several factors:

Credit ratings of bond insurers have been downgraded. Historically, the municipal bond market has experienced very few defaults, making their credit quality relatively high. However, a significant portion of municipal bond investors are individuals who wanted added assurance that these investments were safe. Thus, in the late 1980s, insurance companies started issuing municipal bond insurance, which grew significantly in popularity. Recently, over 50% of all new municipal bonds obtained this insurance. The bond issuer purchases the insurance when the bonds are brought to market, with

the insurance company committing to make timely payment of principal and interest in the event of the bond issuer's default. When the bonds are insured, the bond receives the same rating as the insurance company's rating.

Initially, insurance companies only provided insurance for municipal bonds, but then they started insuring taxable bonds as well. Some of that debt was tied to subprime mortgages, which caused problems for the insurance companies. Due to sizable losses from the subprime mortgage products, the ratings of several insurance companies were downgraded, causing the

downgrading of ratings of underlying municipal bonds. While the insurance companies received downgrades to their ratings due to losses on taxable insured bonds, that had a direct impact on municipal bonds. Typically, most of the insured bonds are investment-grade quality, even without the benefit of the insurance. However, many municipal bonds are trading based on the underlying rating of the bond or even lower, with no consideration given for the insurance.

Auctions for auction-rate bonds started to fail. Auction-rate

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Using a Bond Ladder to Manage Risk

A bond ladder is a portfolio of bonds of similar amounts that mature in several different years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date. By spreading out maturity dates, the effects of interest rate changes are lessened. Since the bonds are held until maturity, changing interest rates don'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.

When designing a bond ladder, decide on an average maturity date, which could be five, 10, or even 20 years, depending on your financial needs. There should be enough "rungs" on the ladder for principal to mature every year or two. If the rungs mature in longer than two-year increments, you might miss interest rate changes. Consistently follow your plan by automatically reinvesting principal at the longest maturity date.

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



Encourage Your Child to Fund an IRA

Once your child starts working, help him/her develop good savings habits by encouraging him/her to fund an individual retirement account (IRA). Even if your child only contributes for a few years, an IRA can provide significant funds for retirement.

Your child must have earned income to contribute to an IRA and may only contribute the lesser of earned income or the maximum IRA contribution. The maximum

limit is \$5,000 in 2009 and 2010.

Assume your 16-year-old daughter starts working part-time. If she contributes \$2,000 to an IRA from the ages of 16 to 22, she will contribute \$14,000 over seven years. With no further contributions, the IRA could potentially grow to \$527,437 on a tax-deferred or tax-free basis by age 65. That assumes earnings of 8% compounded annually, but does not include any income taxes that might be due.

If your child continues \$2,000 IRA contributions until age 65, she would make total contributions of \$98,000 and could accumulate investments of \$1,145,540. *(These examples are provided for illustrative purposes only and are not intended to project the performance of a specific investment vehicle.)*


Although most children will be eligible to contribute to both a traditional deductible IRA and a Roth IRA, you should probably encourage your child to fund a Roth IRA, which has several advantages:

 **Roth IRAs are more flexible.**

Your child can withdraw all or part of his/her contributions at any time, without paying federal income taxes or penalties. Thus, if your child later decides to use contributions for college, a car, a down payment on a home, or for some other purpose, contributions can be withdrawn with no tax consequences.

 **Earnings accumulate tax free, plus qualified distributions can be withdrawn tax free.**


A qualified distribution is one made at least five years after the first contribution and after age 59 1/2. There are also certain circumstances where earnings can be withdrawn without paying income taxes and/or the 10% federal income tax penalty. If your child allows the funds to grow until at least age 59 1/2, all contributions and earnings can be withdrawn without paying any federal income taxes.

 **A traditional deductible IRA offers little tax benefit to a child.**


When your child first starts working, he/she will typically pay a low marginal tax rate on his/her income. So, even though the Roth IRA contribution is not tax deductible, your child typically receives little or no tax benefit from deducting the traditional IRA contribution anyway. ○○○

Get Your Finances in Order


You'll probably need significant investments to reach your financial goals. But before worrying about investing, you should get your finances in order. Consider these tips:

 **Have insurance in place for all major risks.**


At a minimum, make sure you're adequately insured for life, health, disability, long-term care, homeowners, automobile, and personal liability.

 **Pay off your credit card debts.**


If you're struggling to pay credit card debts, it's unlikely you'll have much additional cash for investing purposes. Also, you are unlikely to find better guaranteed returns than you get from paying off these debts. Since you don't get a tax deduction for interest payments on consumer debts, paying off a credit card balance with an 18% interest rate equates to a 24% pretax return for those in the 25% tax bracket.

 **Establish an emergency cash reserve.** This will

give you funds to deal with short-term emergencies, such as a temporary job loss, a short-term disability, a major home repair, or a large medical bill. How much you need in that reserve will depend on your age, health, job outlook, and ability to borrow.

 **Take advantage of matching contributions in your 401(k) plan.**

Make sure to contribute enough to your 401(k) plan to take advantage of all employer-matching contributions. When you don't contribute, you simply lose that money. Additionally, your contributions are made from pre-tax dollars, with earnings accumulating on a tax-deferred basis.

 **Establish financial goals based on your time horizon for investing.**

Thoroughly evaluate your financial goals and how long it will take to reach them. The answers will significantly impact your investment decisions and will ensure that your investments are compatible with your financial goals. ○○○

Muni Bonds

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municipal bonds are long-term bonds with maturities of 10 to 30 years that have a floating interest rate. Every seven to 28 days, the bond underwriter holds an auction to reset the interest rate. The auction is a Dutch auction, which means that the interest rate is reset at the lowest rate that results in a sale of all the bonds. For issuers, they are basically issuing long-term bonds at short-term rates. Investors receive a highly liquid bond that can be sold in an upcoming auction, while earning interest rates slightly higher than money market rates. If there are not enough bids to complete the auction, the sellers are not able to sell their bonds, but they receive a predetermined penalty interest rate. Traditionally, if there were not enough buyers, the underwriter would step in and purchase the bonds. In January 2008, an auction failed because the underwriter would not step in. After that, auction failures became widespread, putting further pressure on municipal bonds.

Many institutional investors sold their muni bonds. Some institutional investors had to sell muni bonds because their ratings had dropped below allowable limits.



Of more consequence, however, was the fact that billions of dollars of municipal bonds were sold by hedge funds to meet margin calls. Troubled banks, brokers, and insurance companies have also sold massive amounts of muni bonds to raise cash. The end result has been that there are more sellers than buyers, further depressing muni bond prices.

What Is the Current Situation?

Historically, municipal bonds have yielded less than Treasury securities, because their income is exempt from federal income taxes and possibly state and local income taxes. The ratio of yields between the two securities has varied over time, depending on prevailing interest rates and tax rates. For individual investors, the attractiveness of municipal bonds is highly dependent on their individual tax bracket. Municipal bonds with maturities of 10 years or more have typically yielded between 80% and 90% of Treasury bond yields.

Over the past several months, it has not been uncommon to see ratios of 150% to 300%, meaning that the interest rates on municipal bonds are substantially higher than Treasury securities, despite the income tax advantages. Currently, interest rates as of April 24, 2009, are:

Maturity	Treasury	Municipal Bond Yields			
	Yields	AAA	AA	A	BAA
1 year	0.50	0.97	1.25	1.88	2.47
5 years	1.96	2.12	2.40	3.06	3.71
10 years	3.03	3.23	3.60	4.33	5.00
20 years	3.99	4.66	5.05	5.76	6.46
30 years	3.89	5.04	5.42	6.16	6.87
% of Treasury yields					
1 year		194%	250%	376%	494%
5 years		108%	122%	156%	189%
10 years		107%	119%	143%	165%
20 years		117%	127%	144%	162%
30 years		130%	139%	158%	177%

Sources: *Federal Reserve Statistical Release*, April 27, 2009 and *The Bond Buyer*, April 27, 2009.



Should You Invest in Municipal Bonds?

By historical measures, municipal bonds are very cheap compared to Treasury securities. On a tax-equivalent basis, assuming you are in the 25% tax bracket, a AAA-rated 10-year municipal bond is yielding 4.31% compared to 3.03% for a 10-year Treasury security. But does that mean that you should purchase them?

The municipal bond market has become very volatile over the past couple of years, and no one knows when or even if it will return to normal levels. However, if the current situation corrects itself and the ratio between Treasuries and munis goes back to more traditional levels, purchasing now makes sense. Also, if income tax rates increase, current yields will be even more attractive on an after-tax basis.

If you purchase individual municipal bonds and hold them to maturity, then you do not have to worry about changes in principal value. You will receive all of your principal when the bond matures. And at this point in time, the yields of even the highest quality municipal bonds are attractive. If you want to reduce your risk, you can purchase intermediate-term muni bonds with investment-grade credit ratings. If you'd like to discuss whether you should purchase municipal bonds, please call.

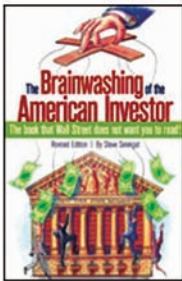
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News and Announcements

Steve Selengut has been a private investment manager since 1979. His life experiences as an investor started in 1970 at age 25, when he was given the responsibility to manage a \$60,000 portfolio. He developed an Asset Allocation Model then (decades before the concept became popular) that he still uses today and a trading approach to investing that allowed him to start his own business at age 34.



The Brainwashing of the American Investor – Revised Edition is the



updated, hands on, practical investing manual that challenges the prevailing wisdom to put your trust blindly in Wall Street. Author Steve Selengut tells you why you need to think outside the Wall Street box and proceeds to outline a practical, realistic and safe strategy for long-term, profitable investing.

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Keep Saving after Retirement

Just because you're retired doesn't mean you should stop saving. Consider these tips:

- ✓ **Consider part-time employment.** Especially if you retire at a relatively young age, you might want to work on at least a part-time basis. Even earning a modest amount can help significantly with retirement expenses.
- ✓ **Contribute to your 401(k) plan or individual retirement account (IRA).** If you work after retirement, put some of that money into a 401(k) plan or IRA.
- ✓ **Try before you buy.** Want to relocate to another city or purchase a recreational vehicle to travel around the country? Try renting first.
- ✓ **Keep debt to a minimum.** Most consumer loans and credit cards charge high interest rates that aren't tax deductible. If you can't pay cash, avoid the purchase.
- ✓ **Look for deals.** Take the time to shop wisely, not just at stores, but for all purchases. When was the last time you compared prices for auto or home insurance? Can you find a credit card with lower fees and interest rates?
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Financial Thoughts

Approximately 44% of 401(k) plan participants who were entitled to a lump-sum distribution in 2006 rolled the entire amount over to a qualified savings plan, compared to 19% in 1993. Almost 25% of those between the ages of 21 and 30 rolled the entire amount over, while 64% of those between the ages of 61 and 64 did so (Source: Employee Benefit Research Institute, 2009).

Employers can expect to pay \$9,552 per employee for health benefits, an increase of 6% over last year's costs and 29% more than five years ago (Source: Towers Perrin, 2009).

U.S. households with assets of \$1 million or more experienced losses of 30% in the current financial crisis. Nearly one in five sustained losses exceeding 40% (Source: *Trusts & Estates*, 2009).

More than 1,200 companies voluntarily terminated their pension plans in 2007, even though they still had enough assets to pay out all benefits earned. The most common reasons cited were benefits restructuring (31%), the cost of benefits (19%), and adverse business conditions (14%) (Source: *U.S. News & World Report*, 2009). ○○○