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What Historically Follows Severe Economic Crises

What if U.S. home prices dropped by more than a third, and didn't recover for six years? Or if stocks slid by 56% in a three-year bear market? Consider what would happen if the unemployment rate rose by seven percentage points, or per capita economic output fell more than 9%, and didn't recover for two years.

While parts of that scenario may seem extreme, in fact it's just average for almost a score of banking-led financial crises around the world since World War II. In a recent paper, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University put the current U.S. downturn in global and historical perspective. They considered 18 postwar financial crises around the world, including what they dub the big five: Spain in 1977, Norway in 1987, Finland and Sweden, both in 1991, and Japan in 1992. Add to that group the U.S. upheaval that began in 2007—which is "now beyond contention...severe by any metric," they write. They also factored in famous emerging market crises, including Asia in 1997-1998, Colombia in 1998, and Argentina in 2001, and incorporated data from the Great Depression. In all of these cases, banking system meltdowns triggered major recessions. The Reinhart-Rogoff paper maps the fallout in several areas and charts how long it took before conditions improved.

By late 2008, when the paper was written, U.S. real housing prices had fallen by almost 28% from their peak—more than twice the decline during the Great Depression. And though many countries have suffered much worse setbacks, including drops of more than 50% in Finland, Columbia, the Philippines, and Hong Kong, the U.S. retreat has approached the 35.5% average noted by Reinhart and Rogoff, who found that the average recovery time for home prices is almost six years.

The U.S. stock market retreated further since Reinhart and Rogoff compiled their data, and prices dipped close to the 55.9% average loss noted in their paper. Here, too, some equity markets have fared much worse, with stock prices in Iceland collapsing by more than 90% during the current crisis and Thai equities sliding about 85% after 1997. Though the average recovery time has been 3.4 years, several markets have taken more than half a decade to bounce back.

Job losses always come with recessions, but when banking crises lead to downturns, the rise in unemployment rates tend to be particularly jarring. The worst was a more than 20 percentage point increase during the Great Depression, a catastrophic result that no postwar recession has approached. Still, the seven percentage point average spike in unemployment that Reinhart and Rogoff observed amounts to an enormous drag on any economy, and the 9.5% U.S. rate in June 2009 was

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New Opportunity For Roth IRA Conversions

In our last newsletter we included an article on Roth IRA conversions. I want to address this topic again because of a great opportunity that you will have beginning in 2010. Now and in the past, if your adjusted gross income was more than $100,000 you were not eligible to convert your traditional IRAs to a Roth IRA. And if you earned $110,000 or more ($160,000 for married joint filers) then you weren't eligible to contribute to a Roth IRA. This kept upper income taxpayers from enjoying the benefits of a Roth IRA.

Starting in 2010, all taxpayers will be allowed to convert a traditional IRA to a Roth IRA. Although this change applies to years after 2010, if you convert in 2010 the income taxes due on the conversion can be spread over two years. So the 2010 conversion amount may be included as taxable income in 2011 and 2012. In subsequent years the conversion amounts will be included in income during the tax year in which the conversion is completed.

Even if you don't qualify to make Roth IRA contributions or deductible traditional IRA contributions, you can still make after-tax contributions to a traditional IRA. You can then convert your traditional IRAs (both deductible and non-deductible) to a Roth IRA. Note that we advise that you only consider converting if you have other cash to pay for the taxes due on the conversion. And it is always best to consult with a financial professional regarding your particular situation prior to converting. Let us know if we can help.

All the Best,

Jean Sinclair

Are You Wealthier Than Most Americans?

Wealth is a comparative term, and in assessing how your own net worth stacks up, it helps to have official benchmarks such as those in the federal government's Fall 2008 Statistics of Income (SOI) Bulletin. This report provides data compiled from tax returns, other official documents, and analytical studies. The latest SOI bulletin (with data from 2004) includes a wealth of information on the nation's wealthiest individuals.

By the bulletin's definition, an individual who had a gross estate worth more than $1.5 million (the exemption for federal estate tax in 2004) was wealthy. About 2.7 million Americans holding $11.1 trillion in assets qualified, and after accounting for total debts of more than $850 billion, this group had a combined net worth of $10.2 trillion.

Though these officially wealthy individuals comprised only 1.2% of the adult U.S. population, they held 20.3% of the country's total net worth. Consider these details:

Demographics. About 1.6 million of the richest adults, or 57%, were men. Their ages divided evenly into three groups: under age 50; between age 50 and 65; and age 65 and over. The female group skewed slightly older. Only 25.8% were under age 50 while 39.2% were age 65 or older.

Marital status of the wealthy also varied by gender. Although seven in 10 of the wealthiest males were married, only half of the women in that group were married. But 24% of wealthy women were widowed compared with 6.8% of the men.

Asset allocation. As a group, the wealthy in 2004 kept 40.6% of assets in real estate (including personal residences), but this figure declined to 12.6% for those who had a net worth of $10 million or more. Similarly, while men overall had 15% of their money in retirement plans, that dropped to 4% for the richest of the rich (likely because of statutory limits on contributions). Finally, the amount allocated to stocks increased with net worth, from 14.9% for all males to 40.9% of those with $10 million or more.

The statistics for women were similar with a few notable exceptions. Compared with men in each wealth category, women held proportionately more of their assets in personal residences and stock and less in business interests.

The wealthiest states. California, Florida, and New York had the greatest proportion of people with at least $1.5 million in assets. California, in particular, had more than its expected share of the national total. One in five wealthy individuals in 2004 lived in California, though the state accounts for only 11.9% of the national population. Florida, with 6.1% of the population, had about 9% of the country's officially wealthy individuals.

Clearly, the nation's financial landscape has changed significantly since 2004, but the report can still give you a glimpse of where you fit into the national picture on wealth. You can download the entire SOI Bulletin at www.irs.gov/pub/irs-soi/08fallbul.pdf. ●

Where The Money Is

States with the largest numbers of residents with a net worth of $1.5 million or more, 2004 (numbers in thousands)

State	Number of residents with net worth of $1.5 million or more	Total adult population	Percentage of adult population
California	428	26,297	1.6%
Florida	199	13,394	1.5%
New York	168	14,655	1.1%
Texas	108	16,223	0.7%
Illinois	101	9,475	1.1%
Pennsylvania	86	9,569	0.9%
Massachusetts	83	4,952	1.7%
New Jersey	79	6,543	1.2%
Ohio	61	8,680	0.7%
North Carolina	59	6,423	0.9%

Source: IRS SOI Bulletin, Volume 28 No. 2, Figure J

Not Having A Plan Is A Costly Mistake

Your deadlines at work are impossibly tight. Your to-do list gets longer every time you turn around. And with constantly shuttling the kids to Little League and piano lessons, it's no wonder your financial life gets short shrift. Yet, however good your excuse, failing to plan your financial future is a costly mistake.

Most Americans lack a formal financial plan, according to a recent survey by the Certified Financial Planner Board of Standards. Yet the same survey finds those with a written financial plan are more satisfied with how their finances are managed, more confident about their financial decisions, and less worried about being financially secure at retirement.

Financial planning doesn't start with deciding where to invest your money, and those who arrive at the door of a financial planner asking "Where should I invest?" are likely to be greeted with two words: "Slow down." You need to step back, assess your current financial situation, identify short- and long-term goals and your risk tolerance, and figure out your timetable—what will you need, and when will you need it?

You also need to consider asset protection—though again, don't rush to buy insurance until your financial plan is in place. It can help you decide what coverage you really need, and which options and riders make sense. Beyond pointing to the obvious homeowners and automobile coverage, your plan will guide you to the right life, health, umbrella liability, and disability policies and look at any unique liabilities associated with your work or your participation in community activities or corporate boards.

College Savings Plans For A Grandchild

Let's say you've managed to reach retirement in great financial shape. Your home is paid for, you have plenty of money available to travel and enjoy your hobbies, and you've accumulated enough funds to provide security for the rest of your years. What's more, your children are out on their own and doing reasonably well. It may seem as if you've addressed all of your major financial obligations. Chances are, however, that your children could still use your assistance, especially when it comes time to pay for their offspring's college education.

According to the College Board, the average cost of tuition and fees at a private college for the 2008-2009 school year was $25,143, up 5.9% from the previous year. And the cost of attending many top private schools can be much higher. Moreover, with inflation in college expenses outpacing overall price increases each and every year, it's tough even to guess how much college will cost by the time your grandchildren matriculate.

But if you'd like to help with that major future expense, you don't have to wait until the tuition bills come due. You can set up a Section 529 college savings plan now that will pay some, most, or all of a grandchild's education costs. Every state offers these plans, and most are open to non-residents as well.

There are actually two types of 529 plans—prepaid tuition plans and investment plans. With a prepaid tuition plan, you pay for future tuition in today's dollars. Most of these cover costs at state schools; if current tuition is $10,000, for example, a contribution of that amount now will be guaranteed to pay 100% of a year's tuition whenever your grandchild enters school. But most grandparents opt for investment plans that offer greater flexibility, though without a tuition guarantee. If the plan investments perform well, the returns could potentially match or beat annual tuition increases, but they could also lose value if the underlying investments depreciate as they did in 2008 and early 2009.

Most plans offer multiple investment options that may include a target-date portfolio (based on the year a child will enter school) that gradually adjusts allocations from a stock-heavy mix during the early years to a more conservative strategy as freshman year approaches. Other state plans manage 529 money alongside state pension assets, while still others let you set your own asset allocations.

Each state establishes the contribution limits for its own college savings plans, but the caps tend to be generous, reflecting the high future cost of college. Also, though many people believe otherwise, plan beneficiaries aren't required to attend school in their home state. The full value of the account may be used at any accredited college and university in the country—and even at selected foreign institutions.

If you set up a plan for a grandchild who doesn't go to college, you can roll over the funds tax-free into an account for a different beneficiary, such as another grandchild. But distributions from the account must begin when the eventual beneficiary reaches age 30.

In all 529 plans, earnings accumulate tax free for both federal and state purposes, and distributions are exempt from federal and state income tax as long as the funds are used for qualified educational expenses. Many states also offer state tax deductions or credits to residents who choose their plans.

If plan funds are withdrawn for other uses, earnings on plan distributions will be taxed at ordinary income rates, and there will also be a 10% federal penalty unless the beneficiary has died, become disabled, or doesn't need the money because he or she received a scholarship. States may assess additional penalties.

Finally, though your contributions to a Section 529 plan are considered gifts, you may give up to $13,000 a year without gift tax consequences to one or several beneficiaries. And if you're married, your spouse can kick in another gift-tax-exempt $13,000 per grandchild. Moreover, special rules for 529 plans let you make five years of contributions in a single year. That's a total of $65,000 per spouse for each beneficiary. Want to establish 529s this year for three grandchildren? Together with your spouse you could give $130,000 per child, or a total of $390,000, without owing gift tax.

The bottom line is that helping with your grandchildren's college costs not only reduces the burden on your children; it also reduces the size of your taxable estate. That makes this option worth considering as part of your overall estate plan. We urge you to discuss your goals with us and also with your children so that funding college is a coordinated effort of all parties. ●

By presenting a broad view, your financial plan helps you understand how each financial decision affects other areas of your finances. For example, suppose you receive an inheritance and use it to pay off your mortgage. That frees up more of your earnings to put into your retirement plan. But your taxes rise because you've lost your mortgage interest deduction, and your expanding net worth means estate taxes could become a problem. Like a compass, your financial plan keeps you pointed in the right direction even as your life inevitably changes. What's more, the comprehensive nature of financial planning should help you avoid major mistakes—from choosing a high-flying mutual fund with no regard for its risk to overestimating how much you can safely withdraw from your nest egg.

Developing a plan takes time, but often, simply articulating your values, hopes, and dreams can increase your motivation to save. Your plan also enables you to chart your progress. Review and regularly revise it as needed, and it will be a road map that can last a lifetime.

The sooner you get on the planning road, the better. As Yogi Berra once said, "If you don't know where you are going, chances are you will end up somewhere else." ●

A Walk Every Day Can Keep Aging At Bay

It's much easier to talk the talk about staying young than it is to walk the walk. Starting in our 20s and 30s, we commence a long, seemingly inevitable physical deterioration. Our maximum heart rate declines, and with it the amount of oxygen-bearing blood the heart can pump. Muscle is gradually replaced with fat and weight edges upward. And decade by decade, as oxygen intake drops, it becomes a little harder just to get around. Eventually, in our 70s, 80s, or 90s, most of us lose our "functional independence," the ability to live on our own. We move to assisted-living or nursing homes because, literally, our living needs to be assisted.

But what if there were a simple way to turn back the clock? In a recent article in the British Journal of Sports Medicine, Roy Shephard, a physician at the University of Toronto, reports that for people 64 and older, a vigorous, hour-long walk five days a week cuts a dozen years from their biological age. In a review of other published work on the subject, Shephard found that such an exercise program could also extend a person's functional independence, which tends to be lost when maximal oxygen intake falls below 18 milliliters per kilogram per minute in men and 15 ml/kg/min in women.

Without this kind of exercise program, about 10 years of physical aging normally corresponds with a loss of about five ml/kg/min. But Shephard found that beginning a program of vigorous aerobic exercise could restore about 25% of maximal oxygen intake within three months, raising that essential level by an average of six ml/kg/min and decreasing biological age by 12 years.

Shephard also found that regular exercise provides other benefits, helping prevent conditions that may hasten aging including obesity, high blood pressure, diabetes, heart disease, osteoporosis, and even some kinds of cancer. And the improved muscle tone that comes with brisk walking, swimming, or other aerobic activities may help older people avoid falls.

Another study, from Texas, further highlights what exercise can do. In 1966, five healthy 20-year-olds were kept in bed around the clock| for three weeks—and suffered many of the ills normally associated with aging. They gained weight, their heart rates and blood pressure rose, and their hearts lost pumping capacity. Then, an eight-week exercise program more than reversed the effects of inactivity. In a follow-up with the men 30 years later, actual aging had imitated the effects of the forced bed rest. But here, too, an endurance exercise regimen undid most of the damage, restoring all of their lost aerobic capacity.

The moral? Exercise always helps, and it's never too late to start pushing back the hands of time. ●

Severe Economic Crisis

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already more than five points above the low recorded in March 2007. On average, it has taken nearly five years for employment to rebound to pre-crisis levels.

The bottom-line impact of a recession is the decline in a nation's economic output, and by that measure, banking-led crises have also been unusually severe, according to Reinhart and Rogoff. Emerging economies have suffered most, probably because they depend on external credit sources that may dry up when times get tough. Per capita gross domestic product (GDP) dropped by more than 20% in Argentina after 2001 and by almost 15% in Indonesia after the 1997 financial crisis. Much worse, of course, was the nearly 30% plunge during the U.S. Great Depression. But developed countries have also seen economic output drop sharply in more recent times, and on average, recovery takes almost two years.

And the cost to governments of trying to coax their economies back to life? The average rise in public debt during the three years following banking crises has been 86%, according to Reinhart and Rogoff. "Even recessions sparked by financial crises do eventually end, albeit almost invariably accompanied by massive increases in government debt," they write.

It's not certain, of course, that the current crisis will follow the pattern of past upheavals, and the authors note that some central banks have been particularly aggressive this time in promoting economic recovery. Still, they write, "one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion." They hardly needed to add that the limits of that hypothesis have become painfully clear. ●

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