



# HWM ViewPoint

March 2008

**Henry Wealth Management, LLC**  
1370 Washington Pike  
Suite 403  
Bridgeville, PA 15017  
412-838-0200  
Phil@HenryWealth.com  
www.HenryWealth.com

Dear Friends and Clients,

The volatility that the financial markets have experienced over the past six months is not so surprising, following the prolonged period of stability and low volatility enjoyed over the past four years. Please keep in mind that 10% corrections are normal, natural and should be expected. This doesn't mean they are any less gut-wrenching.

Resist however, the urge to analyze recent volatility through a "**microscope**", opting for the long-term view afforded through a "**telescope**". If you are tempted to change strategies, you run the risk of turning paper losses into real losses. We'd be happy to meet to review your goals and performance in greater detail.

On a very happy note, please join me in congratulating our associate, T.J. Drost and his wife Chrissy, now the proud parents of Rose!

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## Do You See What I See?

My mother told me at age 10, that I needed more science to go along with my passion for sports. That Christmas I received a microscope and a telescope. I vividly remember trapping various species of insects between two small panes of glass for further microscopic inspection, while alternatively, gaining a neat telescopic perspective on the the far away moon.

The question for investors is, with which apparatus do you view your stock portfolio? Those preferring the microscope will concern themselves with every short term event such as the recent sub-prime mortgage crises, the price of oil, and every Enron-type scandal. Moreover, two over riding emotions may tend to drive their behavior into a state of (over) reaction!

### Two Motivating Investor Emotions

**Fear** may have investors reducing or eliminating their stock holdings after the market tumbles. "*Cut my losses,*" is the mantra of those caught in the "fear-factor". Listen carefully and you may hear a mumble following the tumble - "*I'll get back in when things are more stable*". Usually that means re-entry into stocks after the market bottoms out and is halfway back to a new high! Of course, the fear reflex is based on a microscopic assessment, causing one to sell near the bottom of a decline and quite possibly, missing half of the upward swing.

Greed is the other motivating emotion. Its mantra is, "I want more." Though opposite in its rationale, it tends to produce similar results. During a run up in stock prices, the greedy investor may be tempted to move funds allocated for bonds over to stocks, or reposition one segment of stocks into another (such as shifting small caps to large caps). Greed can throw the notion of a well-diversified and balanced investment strategy out the window, causing one to concentrate on those asset classes that are presently outperforming others, despite the fact that this may result in excessive risk and the abandonment of historically sound investments. Thus, this micro-managed move tends to buy near the top of an advance.

### Opt for the Telescope

Consider the wisdom of the investor who sets aside the *microscope* in favor of the *telescope*. This person has a long-range view. His/her good judgment creates confidence in the capital markets and promotes a buy and hold strategy, diversified among many sub-asset classes. It reminds one that there has always been, and will always be, an investment "malaise du jour" (*French: problem of the day*).

The book of Ecclesiastes 1:9 states, "***That which has been is that which will be, and that which has been done is that which will be done. So there is nothing new under the sun***". This verse has certain application in the world of investment management. My advice, discard the investment microscope and clean the lens of your investment telescope! As an aside, my childhood microscope was broken; Dan, my little brother, best friend and now business partner, was the culprit!



**HENRY**  
WEALTH MANAGEMENT, LLC



*In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal.*

## How Well Are You Navigating the Efficient Frontier?

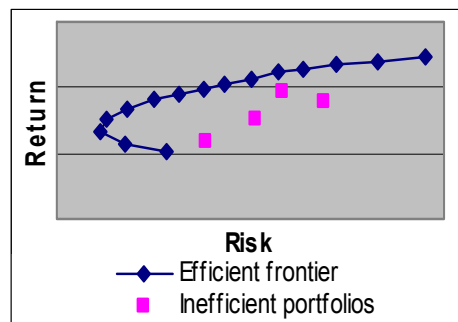
Investing isn't just about achieving the highest return possible; it's also about the tradeoff between return and risk. Modern portfolio theory (MPT) is based on a key assumption: No rational investor wants to take more risk than is necessary to achieve the desired return. The concept was outlined by Harry Markowitz in a pioneering 1952 *Journal of Finance* study titled "Portfolio Selection," which argued that you can manage the type and level of risk you take by combining investments that tend to behave very differently from one another.

### Different strokes for different folks

Modern portfolio theory tries to create portfolios that maximize return for a given level of risk—or alternatively, that minimize risk for a given level of return. MPT compares a portfolio's standard deviation—how much its return may vary from its statistical mean return over time—to its returns. An efficient portfolio navigates the risk/reward tradeoff by combining investments based on their level of risk, their expected return, and their correlation with other investments in the portfolio. MPT argues that a portfolio that doesn't do so isn't optimized—in other words, it takes too much risk for the return it provides.

### Efficiency is in the eye of the beholder

Even with a limited number of securities, the ways to combine them into a portfolio are practically limitless. For any group of assets, there may be multiple efficient portfolios, each of which combines those assets differently. Collectively, they represent what economists and financial professionals call "the efficient frontier." On a chart, the efficient frontier is a line that represents all optimized portfolios for a given group of assets. That line is actually a series of points; each represents a portfolio that provides the best return for whatever risk you are comfortable taking.



The efficient frontier represents all of the combinations of a given group of assets *that combine risk and return most efficiently*, expressing that tradeoff in graphic form. In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal. Each GPS user may choose a different destination, but in each case, the GPS suggests the most effective way to get there.

### So what is risk anyway?

Risk has traditionally been measured by volatility; an asset whose price varies dramatically is considered riskier than one that is more stable. However, some experts have begun to question whether a portfolio can be better optimized by focusing on downside risk, arguing that such an approach more closely matches the way investors tend to think.

Unlike MPT, this so-called "post-modern portfolio theory" concentrates not on how an investment's return deviates from its statistical mean—its ups and downs—but on how often its returns fall below an individual investor's minimum acceptable return, how far below that figure they fall, and the potential worst-case scenario possible for that investment. Outlined in *Managing Downside Risk in Financial Markets* by Frank Sortino and Stephen Satchell of the Pension Research Institute, this approach attempts to combine portfolio theory with behavioral finance, hoping to more closely reflect the human decision-making process.

Depending on how risk is measured—by volatility or by downside risk alone—the efficient frontier may look very different, even for the same group of assets.

### The balance is up to you

Whichever approach is taken, the efficient frontier still doesn't tell you which assets are right for you, or in what combination. Only you can decide where you want your portfolio to be along the efficient frontier, and what type and level of risk you're willing to take.

Though past performance is no guarantee of future results, it can help serve as a guide when developing an appropriate asset allocation. Using data about past and anticipated returns of various assets as well as estimates of their volatility or downside risk, your financial professional can position your portfolio at the point along the efficient frontier that makes sense for you.

## Will You Pay Taxes on Your Social Security Benefits?

Did you know that you might have to pay federal income tax on your Social Security benefits? If Social Security was the only income you had during the year, then your benefits generally won't be taxable. However, if you or your spouse worked and had any earned income during the year, or if you had other substantial income (such as investment income), then a portion of your Social Security benefits may be taxable.

### Gather information

Your benefits are taxable if one-half of your Social Security benefit plus your other income (called your "combined income") exceeds a certain amount (called the "base amount"). To determine if your benefit is taxable, you need to know three things: (1) how much you received from Social Security during the year, (2) your combined income, and (3) the base amount for your filing status.

### Find out how much you received from Social Security

Each January, the Social Security Administration (SSA) will send you a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits you received during the previous year. You'll need to use this information to figure out whether any of your benefit will be taxable.

### Calculate your total income

Once you know how much you've received from Social Security, it's time to calculate your combined income. This figure includes the following:

- One-half of Social Security benefits received
- Other income including wage income, and taxable interest and dividends
- Tax-exempt interest income
- Income that's normally excludable-- interest from qualified savings bonds, employer-provided adoption assistance, foreign earned income or foreign housing, and income earned by bona fide residents of American Samoa and Puerto Rico

The IRS has a worksheet you can use to calculate your combined income and determine whether or not your Social Security benefits are taxable. You can find this worksheet and more information about the taxation of Social

Security benefits in IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

### Compare your combined income against the base amount for your filing status

Once you've calculated your combined income, you must compare that against the base amount for your federal income tax filing status. If your total income is less than the base amount, then your Social Security benefits won't be taxable. If your combined income is more than the base amount, then part of your benefits will be taxable. Base amounts aren't indexed for inflation, so they're the same year after year.

Your base amount is:

- \$25,000 if you file as single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for the entire tax year
- \$32,000 if you file as married filing jointly
- \$0 if you file as married filing separately and you lived with your spouse at any time during the tax year

For example, let's say your combined income for the year was \$30,000 and you file your taxes jointly with your spouse. Because your combined income is less than the base amount for your filing status, \$32,000, your benefits won't be taxable.

### How much of your benefit is taxable?

Even if your combined income exceeds the base amount for your filing status, you won't have to pay taxes on the entire amount of benefits you've received. Generally, up to 50% of your benefits will be taxable, but if your combined income is more than \$34,000 (\$44,000 if you are married filing jointly), or if your tax filing status is married filing separately and you lived with your spouse at any time during the tax year, up to 85% of your benefit will be taxable. Again, see IRS Publication 915 for worksheets you can use to figure your taxable benefits.

Keep in mind that taxation of Social Security benefits can be complicated. Different rules apply to certain U.S. citizens and nonresident aliens living abroad and in other situations. If you have any questions, consult your tax professional.

### Did you know?

*Social Security benefits were not subject to federal income taxation until 1984. They became taxable as a result of the 1983 Amendments to the Social Security Act.*



### Tax withholding

*You can have federal income taxes (but not state income taxes) withheld from your benefits if you so choose. Complete IRS Form W-4V and select the percentage that you want withheld (7%, 10%, 15%, or 25%), then return it to your local Social Security office.*



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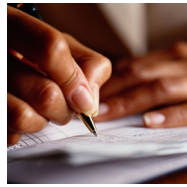
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**HENRY**  
WEALTH MANAGEMENT, LLC

## Ask the Experts



### Is my pension safe if my employer goes bust?

If your employer goes out of business and terminates a defined benefit pension plan that's adequately funded (that is, the plan has enough assets to pay benefits), then your pension will be secure. The plan will purchase an annuity for you that will pay your benefits when due (some plans may also let you elect a lump-sum payment). But you'll only receive the benefit you've earned as of the plan's termination date, which could be far less than the full pension benefit you had counted on.

If, however, the plan is underfunded (that is, there aren't enough assets to pay all benefits earned to date), then the fate of your pension depends in part on whether or not your plan is insured by the Pension Benefit Guaranty Corporation (PBGC). Luckily, most defined benefit plans are covered (check with your plan administrator). When an underfunded plan terminates, the PBGC takes over responsibility for making pension payments. The PBGC guarantee applies only to "basic benefits"--

normal and early retirement benefits, survivor annuities, and disability benefits--earned (and vested) before the plan terminates. If the plan terminates while your employer is in bankruptcy, the guarantee may be limited to benefits earned before the bankruptcy filing.

For plans that terminate in 2008, the maximum amount guaranteed by the PBGC is \$51,750 per year for single life annuity benefits beginning at age 65. The limit is reduced if your payments start before age 65, if your benefit includes a survivor annuity, or if your plan was adopted (or amended to increase benefits) within 5 years of plan termination. In some cases you can receive more than the PBGC guaranteed amount (for example, when your plan has sufficient assets to pay nonguaranteed benefits).

According to the PBGC, 84% of retirees in recent years received the same benefit from the agency that they would have received from their pension plan. For more information, visit [www.pbgc.gov](http://www.pbgc.gov).

### Should I take my pension benefit in a lump sum or an annuity?

Although the traditional form of payment from defined benefit plans at retirement has been an annuity, in recent years there's been a sharp upward trend in plans offering a lump-sum payment option. If your plan offers a lump-sum payment, should you take it?

An annuity offers the security of knowing you'll receive a fixed payment for your lifetime. If you're married, payments can also continue for your surviving spouse's lifetime. However, like all fixed payments, your benefit could lose buying power because of inflation. For example, assuming a 3% inflation rate, a \$1,000 expense today will cost \$1,343 in 10 years. Check to see if your plan provides a cost-of-living adjustment if you take the annuity.

Some plans also offer subsidized benefits that are built into your annuity payments. Subsidies are benefits that are greater than what a straight actuarial calculation provides. For example, some plans provide early retirement and/or survivor annuity subsidies. If you choose a lump sum, the value of these subsidies is generally lost.

Because annuity payments end at your death (or your spouse's death if you receive a joint and survivor annuity) your (and your spouse's) health should also be considered. Annuities are calculated based on standard life expectancy tables. If you expect to live longer than the tables project, the annuity may be a good deal. On the other hand, if you are in poor health, the lump sum might be the better option.

If you elect a lump sum, you'll probably roll the payment over into an IRA to avoid current taxation. How comfortable are you taking control of investing your retirement dollars? The challenge for you, together with your investment professional, will be to generate an income stream from the IRA equal to--or greater than--the annuity option would have provided.

The decision you make is irrevocable. It's important that you fully understand the value of each payment option available to you before making this important decision.