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### Sam Webber

Second Vice President-Wealth Management  
Financial Planning Specialist

950 Winter Street  
Waltham, MA 02451

phone: 781-672-5404  
fax: 781-672-5199  
tollfree: 800-344-4495

sam.webber@smithbarney.com  
www.samwebber.com

## Market Commentary

### A Timely Update for Investors

The investment community came back from its late year holiday season in time for a fairly severe beating, with the S&P 500 dropping 4.5% in what was essentially the first trading week of the New Year. A combination of rising oil prices and disappointing employment numbers, not to mention some investment ratings downgrades around the Street (centering on technology stocks), contributed to the general malaise that has been in place for much of the past two months.

Going forward, Chief U.S. Strategist Tobias Levkovich has year-end 2008 market targets remaining at 1,675 for the S&P 500 and 15,100 for the DJIA, with a strong likelihood for some better gains in the first half offset by a modest pullback in the second half. His overall outlook for 2008 include greater economic risk than has been the case for the past few years, given the credit crunch and its implications for jobs and capital investment, as well as the psychological impact of weaker home prices and elevated oil prices. In addition, the probabilities of corporate margin weakness are increasing. However, these issues are very widely known and disseminated due to published investment research and often dire media reports. As a result, Tobias thinks that much of the bad news is already priced into stocks. Concern about recession potential are more sector oriented, with the Industrials, Materials and Energy sectors more exposed than Tobias thinks is understood by most investors, especially given the international sales to a rapidly slowing European economy, which accounts for the vast majority of U.S. companies' overseas sales.

Should recession be averted, as Tobias currently expects, he contends that some of the most beaten-up groups like Diversified Financials and Retailers would most likely act as coiled springs and lead markets higher (thus outperforming), with defensive sectors lagging. Hence, he continues to emphasize select areas within the Information Technology sector alongside overweight stances in Financials and Consumer Discretionary, while underweighting Materials and Industrials.

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# Funds for School

## 529 Plans Benefit Students and Donors Alike

With college costs rising faster than both wages and inflation year after year, it's not surprising that thousands of parents have seized the tax advantages of 529 savings plans to ease the strain of educating their children. But parents aren't the only ones. Thousands of grandparents are finding that 529s provide both an efficient estate-planning tool and a way to help their loved ones surmount one of life's greatest economic challenges.

The idea behind 529 plans is simple. Similar to a 401(k) retirement plan, a 529 is an investment account in which savings can grow on a tax-deferred basis until they are needed. The difference between 529s and IRAs, though, is that 529s enable you to designate a beneficiary who will ultimately use the money for educational expenses. When the money is withdrawn, there are no federal income taxes, as long as the money is used for qualified expenses, such as tuition, room and board, or textbooks.

Many states offer tax breaks as well. Legislation allowing for the plans was enacted in 1996 by the federal government but the plans are sponsored by state governments and available through brokers or direct.

### Generation to Generation

Many grandparents are finding that 529s allow a convenient and tax-effective way to pass money along to their descendants—money that might otherwise have remained in their estates and been subject to hefty estate taxes before their descendants could inherit it. One of the primary advantages of 529s is that the person setting up the plan (the donor), not the person who will receive the money (the beneficiary), maintains control of the assets. With a trust, a child assumes complete control of the assets at a predetermined point in time.

If the beneficiary decides not to go to college, the 529 plan assets can be transferred to a new beneficiary. In fact, there are no restrictions on the number of times the plan can be transferred to a new beneficiary. If a donor ultimately decides not to use the money for education, capital gains must be paid, plus a 10 percent penalty, but only on the gain, not the principal.

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### Flexibility Matters

"One widespread misperception about 529s is that they must be used at specific universities, such as a state college," says Sheryl Colyer, Smith Barney Private Client Group. In fact, many 529 savings plans are administered through individual states and can be used at any approved educational institution. While all plans offer relief from federal capital gains taxes, some states further sweeten the pot by offering reductions in state taxes. Also, each state has a different cap on the total that can be invested in a single plan. Donors can purchase plans offered by any state, whether they live there or not, and can buy plans for as many beneficiaries as they like.

So why stop at the grandkids? After all, there's no limit on when the plans can be used. A beneficiary may use the money at any time, as long as it goes toward qualified expenses, Colyer says. With retirees living longer and more vibrantly than ever before, donors might even want to establish a 529 to go back to school themselves.

# Recessions and the Stock Market

## A Look at the Road Ahead

**Weakness in many regional housing markets, as well as volatility in the global credit markets, have led some analysts to worry that the U.S. economy may be at risk of falling into a recession—a period of rising unemployment and economic contraction.**

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Many investors assume such a contraction would lead to a significant stock market downturn, such as the deep bear market that accompanied the 2001 recession.

There are valid reasons to be concerned about the strength of the U.S. economy, although most forecasters—including former Federal Reserve Chairman Alan Greenspan—are predicting a slowdown in the rate of growth, not an outright economic contraction. These concerns recently led the Fed to lower short-term interest rates for the first time since June, 2003.

### The S&P 500 During Periods of Recession

Recession	Duration (in months)	Annualized Return
1945	11	+30.7%
1948-49	11	+15.7%
1953-54	10	+29.7%
1957-58	8	-2.3%
1960-61	10	+24.9%
1960-70	11	-1.9%
1973-75	16	-6.0%
1980	6	+19.8%
1981-82	16	+10.8%
1990-91	8	+12.7%
2001	8	-1.3%

**Average Return: +12.1%**

Past Performance is not guarantee of future results.

Sources: National Bureau of Economic Research, Consulting Group

Investors also have good reason to fear that a recession would be a negative for the stock market. Economic contractions are often associated with sharp declines in corporate profits, which can push stock prices lower.

However, past experience suggests recessions and bear markets are not as tightly linked as many investors seem to think. According to the National Bureau of Economic Research—a private group that tracks the ups and downs of the U.S. business cycle—there have been 11 recessions since 1944. Yet, returns on the S&P 500 Index were positive in seven of those downturns. Indeed, returns on the S&P 500 averaged an annualized 12.1% during those recessionary periods, which is actually higher than the long-term return trend.

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At first glance, such a result may seem surprising, given that recessions typically have had the expected negative impact on corporate earnings. The Commerce Department reports profits have declined in 8 out of the past 10 recessions. Other things being equal, this could be expected to produce severe corrections in stock prices, if not outright bear markets. However, other critical factors can also play a role:

- **A rapid acceleration in inflation** may lead investors to doubt the future value of corporate earnings. Conversely, if a recession slows inflation, investors may become more confident about future earnings. As a result, stock prices might rise, or not fall as much as a decline in nominal earnings would suggest.

**For most individual investors, the prudent approach is to focus on long-term trends, while treating market corrections and economic downturns as opportunities either to acquire attractive stocks at temporarily distressed prices, or to sell stocks that no longer appear desirable.**

- **The Fed typically responds to a slowing economy** as it did recently—by lowering short-term interest rates. This may increase the attractiveness of stocks relative to fixed-income assets, supporting both valuations and prices.
- **Markets often rise and fall** for reasons that appear unrelated to trends in the real economy. The 1987 stock market crash, for example, took place even as economic growth was starting to accelerate.

Most importantly, investors need to remember that financial markets tend to focus on the future, not the present or past. This is why markets often turn volatile when the economic outlook grows uncertain, even if current conditions appear healthy. It is also why the stock market often recovers from a downturn before the economy does, as investors anticipate an improvement in earnings.

On the other hand, the market isn't always right. Many economic slumps widely predicted by analysts and investors have failed to appear. Thus the old joke: Wall Street has correctly predicted ten of the last five recessions. Even when recessions do lead to bear markets, there isn't necessarily a connection between the severity of the economic downturn and the depth of the stock market's decline.

Take the 1981-82 recession, for example. It was both deep and long, as the Fed raised interest rates to record highs to break an inflationary spiral. The stock market also fell, but recovered relatively quickly—perhaps because market valuations were depressed going into the downturn, but also

perhaps because many investors were encouraged to see the Fed tackle inflation. The 2001 recession, on the other hand, was comparatively mild, but the stock market suffered its deepest bear market since the 1930s.

### Conclusion

There is no way to know if the economy is heading into recession, or what might happen in the stock market if it does. However, history shows that investors who have tried to “time” the economy—selling stocks when they think a recession is imminent and buying them back when they believe the economy has bottomed—have often been disappointed.

For most individual investors, the prudent approach is to focus on long-term trends, while treating market corrections and economic downturns as opportunities either to acquire attractive stocks at temporarily distressed prices, or to sell stocks that no longer appear desirable for fundamental reasons—potentially harvesting tax losses that can be used to shelter future capital gains.

The key to implementing a smart, long-term strategy is to have a carefully constructed plan. We are always available to discuss your individual strategy and to address any concerns you may have about your current plan and investment goals.

INDEX DEFINITION: The S&P 500 Index covers 400 industrial, 40 utility, 20 transportation, and 40 financial companies of the US markets (mostly NYSE issues). The index represents about 75% of NYSE market cap and 30% of NYSE issues. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

# Potential Left Turn Ahead

By Edward M. Kerschner, CFA, Chief Investment Strategist, Citi Global Wealth Management

As campaigning heats up for the 2008 U.S. presidential election, Democrats seem to have the advantage, with polls showing that negative opinion of Republicans is at a 15-year high.

While there is plenty of political jockeying yet to be had, the party that in the end wins this hotly contested race will face a complex slate of issues—not the least of which is fiscal stewardship of the world's largest economy. This is an especially important issue this election cycle, as a number of key tax provisions are scheduled to expire at the end of 2010.

**History shows that the average and median stock-market performance is similar during Democratic and Republican administrations, suggesting that the party in power generally doesn't dictate the stock market's direction.**

History shows that the average and median stock-market performance is similar during Democratic and Republican administrations, suggesting that the party in power generally doesn't dictate the stock market's direction. However, there have been more periods of stock-market decline under Democrats (eight) than Republicans (four), although the single-biggest market decline (the four-year period beginning in 1929) occurred with a Republican in the White House.

Below, we review possible implications of a Democrat winning the presidency.

**Foreign exchange: the dollar.** There is a risk that foreign investors, who have been significant buyers of US financial assets in recent years, may choose to play it safe amid uncertainties about the impact of a new administration and curtail purchases of US assets (or trim existing holdings).

It's hard to see how this would be positive for the greenback, which has weakened against major global currencies in recent years.

**Equities vis-à-vis fixed income.** Any new initiatives that adversely impact private equity firms, such as a change in tax treatment, could negatively affect stocks, considering private equity has been a significant source of stock-market demand in recent years.

It is important also to note that stocks are long-duration assets. That means they are highly sensitive to changes in inflation and interest rates (just as the price of a 30-year bond is more sensitive to these factors than the price of a 10-year bond), making stocks poor hedges against inflation.

**High-quality bonds**—most notably US Treasury securities—could benefit from any flight to quality that might result from heightened volatility. Thus, it seems that selected fixed income securities would be more attractive than equities in the event that a Democratic election win spurs a flight to quality.

**Traditionals versus alternatives.** Traditional investments—such as equity mutual funds—do not seem as well positioned as some alternative investment options if certain policy changes are enacted. Specifically, US equity mutual funds would be hurt by any increase in the capital gains tax or by an economic slowdown that leads to diminished equity-performance expectations. That said, in an environment of heightened volatility, active equity managers might perform better than passive investments—such as index funds or exchange-traded funds—given their ability to trade on opportunities and to manage risk more effectively.

**Heightened volatility** also could allow hedge funds to profit from perceived asset-pricing inefficiencies. Hedge fund managers who see an opportunity in a particular sector have the flexibility to make a concentrated bet, unlike a mutual fund that is constrained by sector weights. Likewise, if a hedge fund manager perceives an unusual amount of risk, he or she can move to cash. Equity mutual funds, on the other hand, are often required by a prospectus to maintain some equity exposure.

**Relatively speaking**, private equity could face greater risk than hedge funds, given that private equity is “long only.” The ability to go short enables hedge fund managers to offset some risk. Of course, any re-pricing of risk—as reflected in a widening of credit-market spreads—could make it difficult for private equity firms to obtain financing and potentially cost hedge funds more to use leverage.

As for real estate, a couple of points are worth bearing in mind. First, real estate has performed well in prior periods of high inflation (such as 1979), but—as was the case in the early 1990s—such investments have not always done well in periods of moderate inflation (the likely risk of any Democratic win election scenario). Second, real estate investment is a lagging economic indicator since leases are typically signed for multiyear periods. The state of the economy when leases roll over is the critical factor in determining investors’ return on real estate. For these reasons, real estate may not be affected—positively or negatively—in the immediate term.

**For the record.** Even though the poor standing of Republicans seems to bode well for Democrats in their pursuit of the presidency, no northern Democrat has won the White House since John F. Kennedy’s victory in 1960. What’s more, no sitting senator has won the White House since JFK.

With that in mind, two of the leading Democratic contenders today are sitting senators from northern states: Hillary Clinton (the junior senator from New York, who hails from Illinois) and Barack Obama (the junior senator from Illinois, who spent most of his childhood in Hawaii). Their lack of a natural base in the southern US and their policy positions gleaned from Senate voting records might work against these Democrats in a contest against a Republican who doesn’t have a voting record to account for with the public.

Even if a Democrat is elected president in 2008, some of the more bearish investment-risk scenarios outlined above may not come to pass. After all, Bill Clinton learned that it was tough to push a liberal agenda in Washington, even with Democrats controlling Congress. His political fortunes improved early in 1996 when he proclaimed that, “the era of big government is over.” Clinton ultimately created a favorable environment for investors.

**Neither Democrats nor Republicans have been bad historically for markets. Nevertheless, should a Democratic victory have a deleterious impact, some investments would seem to have an edge.**

In sum, neither Democrats nor Republicans have been bad historically for markets. Nevertheless, should a Democratic victory have a deleterious impact, some investments would seem to have an edge. First, Europe and most of the BRICs (Brazil, Russia and India, and less so China, which has relatively high US trade exposure) appear favored over the US and its neighbors, Canada and Mexico, which also have substantial exposure to US trade. Second, select US fixed income investments could have an advantage over US equities. Third, certain alternatives (such as hedge funds) could outperform traditional investments.

Call or schedule an appointment at any time to learn more about the impact the upcoming election may have on the investments you hold or to schedule a portfolio review.

# Keys to A Smart Financial Check-Up

Too many people wait until they file their income-tax returns to evaluate the preceding year's finances and plan for the next. You should really begin much sooner, though, perhaps before year-end. This will give you plenty of time to analyze what you have accomplished and to plan for what you hope to accomplish.

A checklist of questions might help.

- 1. What are your financial goals?** Before you do anything with your money, you should decide how you want to spend it. You should itemize what you have presently, what you need for the year ahead and what you hope to have ten, 20, or 30 years in the future.
- 2. Over the past year, have you made progress toward achieving your goals?** You should probably compare the performance of your investments to the goals you've established with regard to those investments for the year. The results of this analysis will help you decide whether or not you should alter your investments.
- 3. Are any changes about to occur that will affect either your immediate needs or your long-term goals?** A job change, for example, may drastically alter your income and your lifestyle. Other circumstances that may affect your finances might include buying a new house, financing an education or paying for a wedding. Planning at least a year in advance will help you to adjust to these changes financially.
- 4. What can you do to reduce your taxes?** A general rule for tax purposes is to defer income to the next year while accelerating deductions for the present year. To defer income, you might postpone selling assets or you might also purchase Treasury bills or other investments that will mature the following year. To accelerate deductions, you might double up on your charitable contributions, pay your state taxes before year-end (if you are not subject to alternative minimum tax) or invest in a tax shelter.



**Before you do anything with your money, you should decide how you want to spend it.**

Quite often people (who qualify) will also make contributions to their Individual Retirement Accounts (IRAs) at the last minute for an additional deduction. However, in the long run it's much better to make your IRA deposits early in the contribution year rather than wait until you file your income tax return for that year to take advantage of tax-deferred compounding.

- 5. Do you need any additional help to implement your plans for the future?** Financial Advisors often partners with attorneys, accountants, trust officers and other professionals in making certain your portfolio is structured to accommodate all of your life goals. Working with the right Financial Advisor who can identify additional planning resources can be one investment that makes all the difference in attaining your goals.

# Did You Know?

## A Little Lesson On A Big Topic—Asset Allocation

Asset allocation is the process of distributing funds among various investment instruments or asset classes for the purpose of managing risk. Done properly, asset allocation enhances the likelihood of achieving desired investment returns with the least amount of risk. It accomplishes this by reducing the exposure to losses caused by a decline in the value of one or more of a portfolio's components.

Distributing funds among several asset classes that have dissimilar expected return and risk characteristics increases the probability that a portfolio's components will complement one another, thereby improving overall risk-adjusted returns. Diversification does not ensure

against loss. There may be additional risks associated with international investing involving foreign economic, political, monetary and/or legal factors. International investing may not be for everyone. These risks may be magnified in emerging markets.

As the world of investing has grown larger and more complex, so too have the number of asset classes and investment styles. But complexity has its price as the expansion of investment choices has given rise to a host of labels to describe various asset and style options. Here are some common categories as defined by Smith Barney's Portfolio Management Group.

<b>Growth Style</b> Growth stocks tend to have prices that are high relative to earnings, dividends or book value. Earnings growth projections tend to be higher than the market average.	<b>Value Style</b> Value stocks tend to have prices that are low relative to earnings, dividends or assets. Earnings growth tends to be relatively modest and often is influenced by short-term economic fluctuations.		
<b>International Markets</b> International markets tend to be those of more mature, industrialized countries of Europe, as well as Japan, Australia and New Zealand.	<b>Emerging Markets</b> Emerging markets comprise the developing economies of South-east Asia, Latin America, Africa and Eastern Europe.	<b>Fixed Income</b> Fixed Income includes the universe of securities that pay a regular stream of interest income such as corporate bonds, Treasuries, mortgage securities and foreign bonds; as well as hybrid securities such as convertible bonds.	
<b>Large Cap</b> Market capitalization is calculated by multiplying the number of outstanding company shares by the stock price. Large-cap stocks have a market capitalization of \$5 billion or more.	<b>Mid Cap</b> Mid-cap stocks are those with a market capitalization of more than \$1 billion but less than \$5 billion.	<b>Small Capitalization</b> The Small-cap market securities consist of stocks with a market capitalization of less than \$1 billion.	<b>Micro Capitalization</b> Micro-cap stocks are those Small-Cap stocks that have an approximate market capitalization between \$50 million and \$300 million. Market-cap below this threshold is often called Nano-Cap.

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