2009 and Beyond

Now that 2008 has come to a close, we turn our attention to 2009 and the myriad of economic and geopolitical issues facing us. Determining how these issues affect us is the key to successful navigation of the markets with a reasonable outcome for our investors and their businesses. Rather than jump into predictions, I think it important to orient ourselves in the current economic environment. To do this we must review from whence we came. Harbor client portfolio positions were well thought out and communicated in most cases by a written financial plan. The recommended portfolio was comprised of private equity, real estate and partnerships such as natural gas income offerings, cash, bonds, equity and strategic investments which included hedge strategies and an energy/commodity overweight.

Our mix proved advantageous in 2007 as our returns were above benchmark by a wide margin. 2008 continued this outperformance as well. Due to additional loss prevention, as well as loss harvests, our portfolios ended the year holding their value much better than the markets and indeed most managed portfolios.

This history puts us in a relatively advantageous position as we enter 2009. We believe the cash we hold is very valuable and that most portfolios should not take excessive risk in this market. We do like conservative yield while we wait out the downturn. Some buying at advantageous prices is appropriate as well.

We are taking a proactive stance, learning as much as we can and applying what we know to the current market situation. It bears mentioning at this point that what we know needs to be constantly verified. For example, physical assets, traditionally strong in poor market conditions, cannot be relied upon as before. I have likened the situation to a physician entering an operatory where none of the instruments are where they belong, drugs have the opposite effect as intended and diagnostic equipment does not work at all.

We have bought ourselves some time to consider various strategies and can afford to be thoughtful. This is not the time for aggressive moves or big plays, rather a true conservative approach which we believe will allow us to react to the unknown market forces to come.

While it has been a very difficult few months, we are satisfied with our results and look forward to 2009 and beyond. We have confidence that we will maneuver the financial markets with a good measure of success as we have the past 30 years.

Best wishes for a new year filled with wonder and fulfillment.

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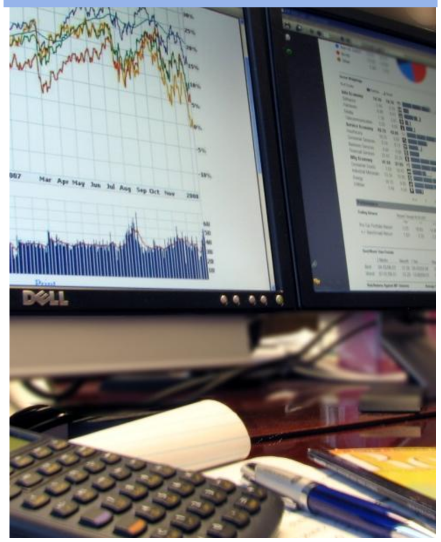
Rule of 72: Want to know how long it will take to double your money at a given interest rate? Divide 72 by the interest rate to get the approximate number of years. For example, with 6% interest, you will double your money in 72 ÷ 6 = 12 years.



2008 Market Recap

One of the staples at amusement parks is the log ride. After a steady climb upwards, the riders hurtle down into the water and emerge soaked. Unfortunately, the vast majority of investors can draw comparisons to investing during 2008.

Reliance on seemingly immutable truths of investing exposed investors to unseen risks, a financial iceberg. Easy credit fueled a massive leverage bubble. Complex models designed to evaluate the risk of major financial institutions failed to include the possibility of a collapse in the US housing market or an end to easy money, ultimately leading to their demise.

Market performance was among the worst in history: the S&P 500 finished down 38.5% on the year, the NASDAQ down 40.5%, the Russell 2000 down 34.8%, the EAFE down 45.1% and the Wilshire 5000 down 38.7%[1].

In spite of the massive amount of bailout funds allocated by governments around the world, 2009 looks to be highly unsettled with the economic climate likely worsening further before any signs of recovery appear. Whether this starts in mid-2009 or at a later date, one thing is certain: this ride is not over yet.

[1] Wall Street Journal, January 2, 2009, US, R1

"For myself, I am an optimist – it does not seem to be much use being anything else." Sir Winston Churchill

Fund Focus: Vanguard GNMA (VFIIX)

In this uncertain market, we focus our attention on funds with stable returns. This quarter's featured fund is Vanguard GNMA (VFIIX), a mutual fund invested almost entirely in Government National Mortgage Association (GNMA or Ginnie Mae) certificates. These certificates are fixed income securities with an ownership share in a pool of mortgages backed by the U.S. government. Established in 1980, the goal of the fund is to provide investors with moderate and sustainable interest income. In 2008, it returned 5.43%. While this return seems conservative compared to equity returns in bull market years, we are pleased with the fund's performance in comparison with funds in the same category, as well as the global markets as a whole.

Unlike mortgages securitized by Freddie Mac and Fannie Mae, Ginnie Mae mortgages are explicitly guaranteed by the government and are subject to much higher levels of scrutiny and vetting. This accounts for the dramatic differences in performance over the past year as the housing market collapsed.

Dividend Yields

As 2009 begins, investors retain the sobering thought that they just experienced one of the worst years in history for returns in equity and fixed income markets. Conservative investors perhaps fared the worst during the financial turmoil in 2008 as some investment vehicles clearly were not as safe as advertised. The question now is where do we go from here? We think the answer may rest in dividends.

In this market environment, investor sentiment may lead in a few different directions. One is the view that this as a golden opportunity to buy low. With the S&P 500 off 38.5% and MSCI EAFE off 45.1% in 2008, clearly there are opportunities for bargain stock picking. However, there is always the possibility that the DJIA will fall another 3,000 points. In reality, macroeconomic news is grim; corporate earnings have diminished, home equity prices have cratered, debt is rising, unemployment is high and real wages are slipping. With this in mind, it may be a while before those bargain stocks bounce back and provide decent growth in portfolios.

Refining this strategy, another option is to find select dividend paying companies that have solid fundamentals, but have been indiscriminately sold off along with the rest of the equity market. One causal effect of this market decline is the corresponding increases in yields, or essentially the dividend rate paid by a corporation in relation to its stock price. Suppose a stock is trading at $50 a share and paying a dividend of $0.50 a share quarterly with a 4% annualized yield. If that stock drops 50% to $25 a share, as many did in 2008, and the company has the financial strength to continue paying dividends, then the same $0.50 quarterly dividend turns into an 8% yield. With recessionary data hitting the newswire almost daily, it appears in the short term that markets will struggle with the exception of the occasional bear market rally. Why not capitalize on the increased yield plus potential capital gains? If the market moves horizontally for the next few months or years, then the best method to increase total returns in equities is through dividends.

In the long-term, the merits of this strategy will shine through as your portfolio will have built cash, giving your portfolio more flexibility with more purchasing power. We are actively employing this methodology; please let us know if you have any questions about our specific strategies in your portfolio.

The Value of Planning

Creating a financial plan has been a cornerstone of this practice since 1980. Gathering resources, listing obligations and projecting future values is a valuable exercise. The process protects against loss by reviewing casualty insurances and protects loved ones from adverse consequences through life, disability and long term care insurance. In addition, it is an educational tool for both planner and client as every individual has different needs and tolerances for risk and different definitions of success and failure.

Recently the value of planning was emphasized with the peace of mind that comes from having a plan in place. Those with a plan found perspective and took comfort in the knowledge that while different forces were at work, the plan has stayed the same. This is primarily due to two factors. First, the individual nature of the plan. For example, if you are retired, the plan ensured that you have adequate cash to ride out the downturn. Second, the plan is forward thinking by virtue of its strategic nature. The process naturally looks over bumps in the road, in this case big ones and focuses on longer term trends.

The past year renews our dedication to the planning process. While time consuming and expensive, it works. And we need to focus on what works in this environment.
We suggest that you:

- Review your plan - Are you on track?
- Review your goals - Have they changed?
- Review your budget - Cut back where you can.
- Review your risk tolerance - This may have changed over recent months.

The entire Harbor staff is trained and prepared to help you with this process.

Equity-Indexed Annuities

Investors have been searching for safe havens to protect their assets from market turbulence, even to the point of shifting toward 0% yielding securities. Adding a fixed or equity-indexed annuity to your portfolio may be a more effective way to dilute the impact of volatile markets while still earning some yield. In the past several years, we have recommended equity-indexed annuities for many of our clients to protect their principal investment against market losses while providing the opportunity to take advantage of market gains.

Annuities fall under two general categories: variable and fixed. Variable annuities are invested in mutual funds and unless the policy has a minimum guarantee, the annuity will gain or lose value depending on the underlying mutual fund. Fixed annuities pay a stated rate of interest each year. Equity-indexed annuities are included under the fixed annuity umbrella. With most equity-indexed annuities, the policyholder has the option to choose the allocation between the fixed and indexed-annuity portion each year. The equity-indexed annuities we recommend have a minimum interest guarantee over the life of the annuity but also include a performance kicker when the markets are performing well. The performance cap is tied to a specific index, such as the S&P 500. Assuming a 100% equity allocation, if you have a market cap of 7% for any given year and the S&P 500 performs at 10%, you will receive the 7% return. However, if the market drops 10% in a given year, your return will be zero. At the end of the annuity term, if your overall return is zero, the annuity will be credited with the minimum guarantee annual interest rate, which is currently 2%.

If you would like to learn more about adding an equity-indexed annuity to your portfolio, please contact our office.

Living Well

Ski season is upon us and although that trip to the Alps might be on hold, there are plenty of bargains to be had closer to home. Many resorts are offering larger discounts to attract visitors in this difficult economic environment. Extended stay packages and free lift tickets with lodging are a common theme. Wanted to go heli-skiing in Alaska, but you couldn't pull the trigger? How about a few days of snow cat skiing near a local resort instead?

Perhaps the cheapest alternative is "earning your turns": backcountry skiing. With improvements in gear and a greater awareness of the risks, more skiers are exploring this option. The lack of an easy ride to the top is balanced with the freedom to pick any line, while saving on a lift ticket and picking up a little extra exercise.

Living Smart

With mortgage rates at their lowest rates in several years and conceivably going even lower it may be time to think about refinancing. If you are considering refinancing keep in mind the following:

Your home's value compared to the amount of the mortgage you are requesting: Equity of at least 25% is standard right now for your loan request to be considered. Remember that rates on jumbo loans are higher than standard mortgage loans.

Your credit rating: Lending standards are strict. You can expect a grilling, including documentation, about your income and assets as well as the expectation of a stellar FICO score.

Analyze your actual savings: The new guidance is to recoup the closing costs in the first year and save ¾ of a percent every year thereafter.

Though credit is tight, refinancing requests have soared in the past weeks. For those homeowners with a solid credit rating and plenty of equity, it is well worth looking into.

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Cover image: Jesse Varner

Roth IRA Conversions

A Roth IRA conversion is the process of transferring a traditional, SEP or SIMPLE IRA to a Roth IRA. If your contributions to the original IRA were pre-tax, a conversion will cause the taxes to be due at your normal tax rate when the IRA is converted to a Roth IRA. Subsequent Roth withdrawals will then be tax free. A Roth conversion might be considered in a year of low income or a significant business loss when your taxable income is lower than usual. In effect, you are trading tax dollars now for the tax-free status of the Roth withdrawals in the future. Other benefits of the Roth conversion include the avoidance of required minimum distributions at age 70 1/2, greater flexibility to withdraw Roth funds early without incurring a penalty and estate planning considerations for large estates. The decision to convert to a Roth needs to be based on your personal financial, estate and tax situation and should be discussed with us and your accountant.

Harbor Happenings

Educational Seminar

This quarter Harbor will be hosting a seminar on investment real estate with a guest speaker from CNL. Stay tuned for details.

Market Updates - What is your preference?

Over the past several months we have added email market updates as a means to keep you (our clients) updated on the market. We have received very positive feedback and are considering setting up streaming video emails or teleconferencing. We would like to hear from you – do you have a preference? Give us a call or email Denise at denise@harborfin.com

2008 Closures

Our office will be closed on the following New York Stock Exchange holidays in 2009: President's Day-Feb 16, Memorial Day-May 25, Independence Day-July 3, Labor Day-September 7, Thanksgiving Day-November 26, and Christmas-December 25.

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