CYPRESS FINANCIAL REVIEW

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Cypress Financial Planning, LLC

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Editor's Note

While investors worldwide were cheering the rebounding stock market in the fourth quarter, Cypress Financial Planning was cheering the addition of its newest economist, Jeremy Russell Jones born on November 4th! This little man wasted no time in issuing his first forecast. Summoning the powers of his inner Warren Buffet, pictured on the right is his stock market forecast for the year 2034 when he joins the firm full-time. A special thank you to our clients and friends for your support during these past few exciting months.

Financial Tips for Fortysomethings

In our previous two editions of the Cypress Financial Review, we explored specific actions individuals and families in their twenties and thirties can implement to build a solid financial foundation. Now that you are in your forties, however, the stakes are much higher. Retirement no longer feels so distant, and every back-to-school shopping trip with your children is a reminder that college tuition is one year closer. This decade is very crucial for long-term financial planning, although many families exit their forties no better off financially than they entered it due to the fact that this decade is busy and expensive! Regardless of how financially savvy you were in your younger years, adhering to the advice in the following paragraphs will prepare you for success.

Tie up Loose Ends from Previous Decades

Life does not follow a pre-defined script, and your unique situation may have left you in a position where you are now in your forties but find yourself slightly behind the curve of what professional financial advisers would consider appropriate. If so, here is a brief summary from previous articles of action items worth immediate attention. First, you must pay off non-mortgage debt. Budgets are tight and your forties is no time to be devoting precious cash flow to high credit card balances or even student loans. Risk management is absolutely crucial and needs to be squared away at this point. Reach out to a financial planner or someone else you trust to help determine an appropriate amount of life insurance and long-term disability insurance. Determine what is offered by your employer and ensure that any gap is mitigated with a private policy. Regardless of your wealth, there are also three basic documents necessary for an estate plan: a will, power of attorney and living will/medical directive. If you have children, the will is the document where you name the guardian of your minor children in the event of your death. This is not a decision you want to be in the hands of the court system.

In this Issue

Financial Tips for Fortysomethings	1
2011 Financial Year In Revie	3

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Make Savings Automatic

You are likely finding that time is at a premium these days. If you have children, their activities become your commitment. Even if you are not a parent, you have likely reached a point in your career where your level of responsibility has never been greater and requires considerable sacrifice of your personal time as well. As a result, your forties can be a time when personal finances are placed on the back burner. The saving grace for folks in this situation is a modern marvel called automatic electronic transfer. Your biggest goals in the future are retirement and possibly college tuition, and you should have accounts set up specifically for these. Equally important, however, is a systemized, regular contribution plan into these accounts. To make this strategy last, create a budget detailing your total income, expenses and excess cash flow. Automatically capture surplus savings into these accounts; you will live on what is left over.

Organize and Consolidate

You may have worked for multiple employers during your 15-20 year career thus far. If you have multiple retirement accounts or brokerage accounts cluttering up your life and your mailbox, it can be difficult to keep track of everything effectively. More importantly, it is almost certain that these accounts are not being invested in an appropriate manner as a whole. Handfuls of mutual funds do not equate to adequate diversification. Roll all of your old company retirement accounts into an IRA and consolidate all of your brokerage accounts into one, ideally at a single custodian.

Refine Retirement and College Savings Goals

Now that you have a system in place to make ongoing contributions for these monumentous goals, how do you know if those contributions are enough? Or too much? These are complicated but vital questions to ask. There won't be much time in later years to make up for shortfalls at this stage. More important, the power of compounding that amplifies any savings from early in your working career will not be nearly as effective on contributions in the future. Through compounding, a $100 earning 8% annually can grow to $2,172 over a 40-year working career. With only twenty years left, $100 can only grow to $466. Whether college or retirement, you need to begin by estimating the cost of the goal. From there, determine if your current account balances plus estimated future contributions will grow enough to meet that expense. Many families who want to be confident that they are making the most appropriate decisions enlist the help of a qualified financial planner to help with this complex task.

Pass Your Knowledge to the Next Generation

It has been proven that the most important source of financial guidance for a young adult is her parents. How you behave, what you say, and what you do not say, will all shape the financial future of not just you, but also your children. Following the recommendations in this article will show your children that you "walk the walk" – that a focus on financial security is an important value in your family. To supplement your actions, there are significant life lessons that you can teach a child of any age. One of the most important is the value of earning a dollar. Whether they do chores for an allowance or have a part-time job, the process of what to do with that money is crucial. The best technique I have seen involves teaching children to separate money into three buckets: Saving for future, Enjoying now, and Donating to charity. If a child can appreciate these three important uses for earnings, she will be very well prepared for financial success as an adult. While you may think that your child would rather watch grass grow than learn about personal finance, there are tools available that make finance fun. An interactive website called the "It's Your Life Game" is offered through the Schwab brokerage website. Although it only takes a few minutes, it helps show how life decisions starting in middle school through your late working years all have a significant impact on your financial well being. The link to the tool is:

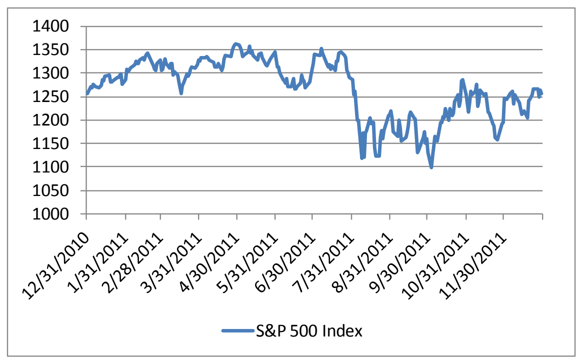
http://www.schwabmoneywise.com/kids/activities/game/index.php

Right Back Where We Started: A Look Back at 2011

2011 marked a stressful year for investors, as flashbacks to the carnage of 2008 swirled through our minds. Stock markets worldwide displayed an exorbitant level of volatility in the second half of the year, often swinging more than 3% in a day. Emotions ran high as a negative headline would spark fear, leading to massive selloffs. The next day, a positive piece of economic data or even a lack of a new negative headline would call into question the severity of the previous day's rout, and a strong rebound would ensue. When the dust settled, almost $6.3 trillion in stock capitalization was erased globally in 2011. We are entering 2012 with a very cautious tone as Europe tries to restore confidence in its ability to pay its debt and the US enters an election year.

US Stock Market Performance

On the heels of 27.8% and 11.6% returns in 2009 and 2010 for US stocks as measured by the S&P 500 index, investors were hopeful that the global economic recovery would continue and help extend the winning streak. At the beginning of 2011, the consensus of leading economists was for stocks to gain 9% in the year. It looked like we would be coasting right through that target as we sprinted out the gate to an 8.4% return by the end of April. However, there are certain events that can create a result that exceeds or falls short of a forecast. The tsunami in Japan was an event that could not have been foreseen but ultimately slowed the global economy. The debt crisis in Europe was well known in advance, but few economists anticipated the rapid deterioration in the health of the Eurozone that occurred in the fall. Fears of a double-dip recession, combined with a possible default on US debt and subsequent credit rating downgrade caused the market to quickly reverse course, falling 19.4% over the next five months. Political headlines could only do so much, and ultimately the strength of corporate profits enticed bargain hunters to reenter the market. Stocks surged in the final quarter of the year, leaving the S&P 500 exactly 0.04 points or 0.003% lower than the end of 2010, effectively back where it started. Small cap stocks fared slightly worse, finishing the year down 4.2% as investors reduced their exposure to the more risky asset classes.



International Stock Market Performance

With the most severe economic catastrophes hitting Europe and Japan, it is no wonder that international stocks lagged significantly behind the US. The MSCI EAFE index of international developed countries lost 14.8% in 2011 including a 25.2% loss for Italy and 51.9% rout on Greece. Although not in the middle of the sovereign debt crisis, emerging markets actually fared worse, falling 20.4% on the year as a group. With most of the growth in EM countries dependent upon exports to Europe and the US, these countries will be especially sensitive to global slowdowns. Additionally, countries such as India, China and Brazil are struggling to tame inflation and maintain healthy growth rates.

Bond Market Performance

In the bond world, 2011 will be remembered as a year the experts got it wrong. Former NJ Governor Jon Corzine took a gamble on the sovereign debt of European nations with his firm's capital and drove MF Global into one of the largest bankruptcies in US history. Prominent market analyst Meredith Whitney, who had correctly forecast the fall of Citigroup during the 2008 financial crisis, began the year by predicting a massive wave of defaults in municipal bonds. Not only did these defaults never come to pass, but muni bonds proved to be one of the stronger assets classes of the year with a total return of 10.7%! Along a same vein, Bill Gross, manager of the world's largest mutual fund, the PIMCO Total Return bond fund, determined US treasury bonds to be significantly overvalued and eliminated his exposure to them. Shortly thereafter, the European sovereign debt crisis caused a rush to the world's safest asset, the US treasury bond. This inflow drove up treasury prices and drove down yields to record levels. As a result, treasuries returned 9.8% on the year. US corporate bonds performed strongly as well, returning 8.2% in 2011.

Alternative Investment Performance

The so-called smartest investors also struggled in the alternatives arena in 2011. Hedge funds are an asset class where investment managers have significant flexibility to place bets for or against any type of security. However, their inability to accurately predict market movements led to an average 5% decline on the year. Gold showed its first sign of weakness after years of being considered a "risk-free" investment by many. After soaring to a record $1,889 an ounce during the climax of the August turmoil, prices plunged 17% through the end of the year. Whipsawed by Middle East uprisings, hostility towards Iran and a global slowdown, oil swung as high as $113 a barrel in May to a low of $76 in October to finish the year up 8.2% at $98.83. Easing some pressure on home heating bills, natural gas fell to its lowest level in more than two years thanks to mild temperatures and a surge of newly discovered domestic reservoirs. Once as high as $6 in early 2010, natural gas now trades at $2.99 per million BTUs.

Disaster in Japan

On March 11th the strongest earthquake (9.0) to hit Japan in at least 300 years claimed the lives of over 10,000 people, left 13,000 missing and nearly a half million individuals and families homeless. The country's Fukushima-Daiichi power plant suffered the worst radiation leak since 1986's Chernobyl. The Japanese stock market plunged 16% in the two days following the disaster as factory production at companies from Toyota Motor Corp. to Sony Corp. was severely disrupted.

European Sovereign Debt Crisis

It is commonplace for the governments of developed nations to spend more than they take in as tax revenue, issuing bonds to make up for the difference. When a bond matures, these governments do not have the monetary reserves to pay off the debt in full, so they issue new bonds instead. This process has existed for centuries and relies on the assumption that investors will always be willing to lend new capital as the government rolls over its debt. Europe has learned the hard way that it cannot rely on this assumption while grossly living beyond its means.

Greece was the first casualty. With fatter pensions, longer vacations and earlier retirements than their European neighbors, Greece quickly spent its way into a crisis. It was not long until the country was completely shut out of the bond market with the only alternatives being a bailout or a default. A similar fate befell Ireland and Portugal. The saving grace at this point was that these three countries together only accounted for 6% of total Eurozone economic output.

In October, what was once unthinkable began to occur: investors began selling the government bonds of Italy, one of the world's biggest economies. Until then, the financially strong of Europe had been able and willing to save the financially weak. But Italy, with nearly $2.6 trillion in national debt was too big to save. That month, Eurozone leaders agreed on a package of measures to restore investor confidence. Beginning with a negotiated settlement with banks to accept a 50% write-off of Greek debt, the European Union would also increase a previously created European Financial Stability Facility to 1 trillion euros. EU leaders also agreed to a common fiscal union with strict and enforceable budget rules embedded in their EU treaties.

There still remain two powerful tools available to the Eurozone that would likely result significant easing of the current crisis, but carry potential long term negative consequences. Some economists and politicians are calling for the creation of Eurobonds – debt instruments that would be collectively guaranteed by every government within the EU. The second strategy would be for the European Central Bank (Europe's counterpart to our Federal Reserve) to effectively print euros to make large scale purchases of government bonds. While both would remove the knife that is currently on the throats of the troubled countries, the side-effects might ultimately prove more harmful. Bailed out countries would have significantly less incentive to implement much needed austerity measures and budget controls to prevent this crisis from happening again. Both strategies also shift more risk onto the stronger countries such as Germany, which might result in credit rating downgrades and runaway inflation.

US Legislators Inability to Legislate

While Europe's debt woes were brought upon by nervous lenders, the US government almost created its own debt catastrophe in early August. In the US, we have established a debt ceiling – a national credit limit that must be congressionally approved to raise. In the past, this is usually a non-issue because there is no other alternative; the only way we can pay off our old debts is to issue new. Only at the last possible minute did Congress agree to raise the debt ceiling in time to pay off our maturing obligations. Unfortunately, the damage had been done. Stocks were pummeled with the uncertainty and our national credit rating was downgraded from AAA for the first time since we were awarded that rating over 100 years ago. On four straight days in August, the Dow Jones Industrial Average swung more than 400 points.

A stipulation to raising our debt ceiling was that a bipartisan supercommittee would be given until Thanksgiving to identify $1.5 trillion in deficit reduction steps to be undertaken over a ten-year period. Possible areas included: tax increases, military spending cuts and measures to slow the growth of entitlement programs. On November 21st, the committee issued its only finding: "After months of hard work and intense deliberations, we have come to the conclusion today that it will not be possible to make any bipartisan agreement available to the public before the committee's deadline." Investors were so frustrated and had such low expectations of congress by this point that stock markets did not have a significant reaction.

For all of 2011, American workers have enjoyed a government-subsidized raise in the form of a 2% payroll tax "holiday". This was agreed to by Congress in the final months of 2010 as a way to boost a flagging economy. Experts are split over the degree of its impact although most are not complaining about the additional cash in their pockets. With President Obama quick to label the expiration of this holiday on December 31st a "tax increase", no politician wanted to be viewed as willing to let this occur. Bipartisan politics ensued, with Democrats wanting to pay for an extended payroll tax holiday with a surcharge on millionaires, Republicans wanted to link its passage with an approval for a controversial oil pipeline. Effective negotiation proved impossible once again, as frustrated congressmen agreed at the last minute to extend the payroll tax holiday into the first two months of 2012 with the hope that further negotiations would allow for a full year break.

Outlook for 2012

If there is one thing that economists can agree on for 2012, it is that the markets will continue much of the volatility seen in the latter part of 2011, leaving the average investor hanging on for the ride. Foremost on our minds is the situation in Europe. If Eurozone leaders can craft a coordinated policy response that succeeds in driving down borrowing costs for globally significant countries such as Spain and Italy, stock markets worldwide will recover sharply. However, if the crisis escalates and drags down France or even Germany, expect significant market declines and a flight to safety. The past three years have marked an unprecedented time in which governments went to great lengths to stimulate their economies through interest rate easing and fiscal intervention. 2012 is going to be a year where it is unlikely that governments will be able or willing to prop up their local economies, leaving the private sector and households to fend for themselves. Recent data in the US has been surprisingly optimistic. The unemployment rate has fallen to 8.6% in November, but most economists don't expect it to drop much further in 2012. Expectations are for the US to avoid a double dip recession and continue to grow at a modest pace despite the uncertainty in Europe. Corporations have proven very resilient in their ability to earn and grow profits and are priced at moderate valuations with room to grow. S&P analysts are calling for a second half rally to push the S&P 500 to 1400, an 11% return for the year. We all hope this is true.

On the bond front, investors should be a little more cautious. Owners of bonds and bond mutual funds earn a return in two ways, through interest received and through changes in the prices of the bonds. The interest received is always a positive return, but the price can rise or fall. Over the past few decades, declining interest rates have led to surging bond prices, creating a strong positive environment for bond investors. Going forward, if an investor desires to lend her money to the US government for 10 years, she will be rewarded with a 1.89% return before taxes. 30 years will offer a 2.89% return. Meanwhile, if interest rates begin to rise from these historically low levels, the prices of bonds and bond mutual funds will decline, possibly negating the positive yield.