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The Good News & The Challenges

February 2010

First the Good News

Two of the strategies that most of you participated in did extremely well during these recent, troubled times. However, the year ahead is likely to be quite challenging.

1. Because I foresaw danger ahead in 2007¹, I moved all of our managed accounts to my defensive manager, Ocean Park Asset Management. Our move into Ocean Park in 2008 helped to protect our assets and we remained in their high yield bond strategy during 2009 because I believed these bonds were at an historic over-sold condition and appeared to have a strong possibility of significant total returns. In 2009 these accounts had an excellent return.

2. Early in 2009 I created a new active risk management system to better protect assets inside of all accounts that I allocate and offered it to all of you at no additional cost. Because I could now quickly change asset allocations, I could take advantage of the same over-sold condition of high yield bonds inside most of our portfolios. These contracts allowed us to participate in the positive market returns in high yield bonds.

Where are we now?

Between September 2008 and March 2009 the U.S. led the world in experiencing the worst global financial crisis and the worst stock market collapse since the Great Depression. Quick and decisive actions by the Treasury, the Federal Reserve and a consortium of world banks appear to have saved us from imploding into a depression. Since March, we have seen a spectacular recovery in the stock and bond markets around the world (albeit from a very low base) and an "official" end to the recession. The key issue in my mind is whether we have in fact seen the bottom and are now on sustainable recovery (called a "V" recovery), or whether we have significant setbacks ahead of us yet (called a "W" recovery).

PIMCO has coined the term "The New Normal" to underscore the likelihood that whatever form the recovery takes; it probably will not take us back to "Normal" as we knew it for the past 20 years. With the wisdom of hindsight we can now see that our heady growth was supported by massive trade imbalances and unsustainable massive borrowing. It is quite possible that a major, long-term global economic restructuring is now underway.

Here's the situation. The collective net worth of America has been shrinking. U.S. household wealth fell by \$11 trillion in 2008.² Our collective stock market wealth is \$2.5 trillion less than a decade ago.³ Even after the comeback of 2009, our stock market is still down -24.1% from a decade ago.⁴ In 2009 mortgage delinquencies reached an all-time high of 7.5%⁵ and may even set a new record in 2010. Twenty-three percent of all residential mortgages had negative equity in 2009.⁶ The number of working age Americans who are unemployed, underemployed or have given up even looking for work is more than 26 million, over 17% of our workforce!⁷

What continues to grow in America is our debt. Total household debt now is greater than \$16.3 trillion. Our national debt is \$12.3 trillion and continues to grow at a rapid pace. Each citizen now owes more than \$39,800.⁸ (By the way, \$2,500 is owed by every man, woman and child in the U.S. to China!⁹) Over the next two years, 48 of our 50 states are projected to run deficits totaling more than \$350 billion.¹⁰ The U.S. government has been stimulating the economy through the "cash for clunkers" program, through tax credits for home buyers, and by the Federal Reserve's program of buying \$1.25 trillion worth of mortgages to keep mortgage interest rates unsustainably low. Although using additional debt to solve problems created by debt may work as a temporary expedient, obviously it cannot be a long-term solution.

Will Real Estate Continue to be a Problem?

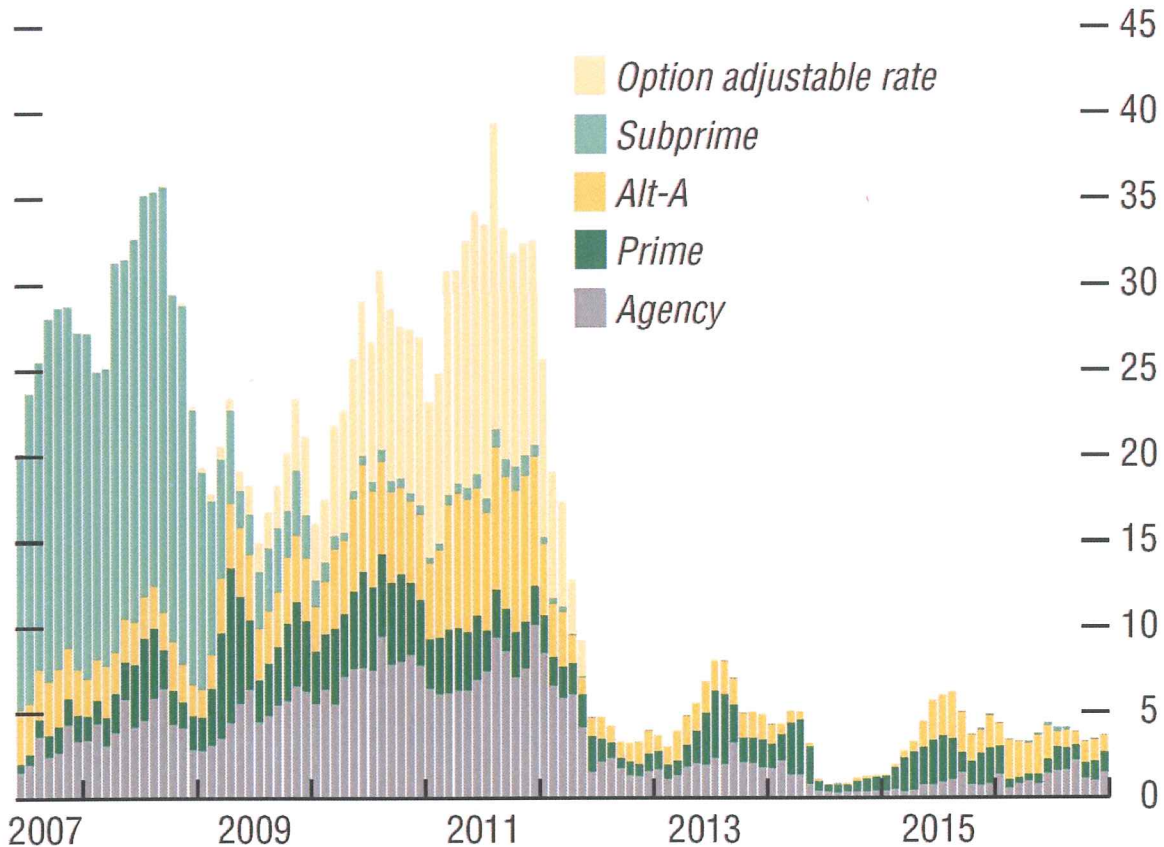
I can see several issues that could derail the current recovery, particularly in the real estate markets. The Federal Reserve has announced that they intend to end their \$1.25 trillion program by the end of March that has been buying mortgages to keep mortgage rates low. Congress is expected to allow the newly expanded homebuyer credit to expire, which would close the door on buyers not under contract by April 30. Could these events lead to significantly higher mortgage rates as well as reduced demand for housing sales?

Of even greater concern to me are the millions of mortgages that will be reset in 2010 and 2011. What a "reset" means is a mortgage that was taken out with a lower interest rate that resets to a higher rate, or a mortgage that allowed for lower payments (typically during the first 5 years) but now must be reset to a higher, fully amortized payment. Since these mortgages are already on the books, it can be estimated when they will have to be reset to higher payments. Given the current prices of houses, it is safe to assume that most of these houses will have no equity or negative equity in them. On the next page is a chart created by Credit Suisse showing these potential resets.

In 2008 we experienced what happened when millions of subprime loans were scheduled to reset. Homeowners could not pay the higher payments, could not refinance because their homes had lost too much equity, and consequently we had a record number of foreclosures. Notice, after a breather in 2009, once again in 2010 and 2011 there are huge numbers of resets due. The majority of the loans needing resets are "Option Adjustable Rate" and "Alt-A" loans. Many of these loans offered the option of making payments so low that they could have negative-amortization, in other words, borrowers aren't paying enough to even meet the interest costs, and the loan balance has continued to grow. I think it is quite possible that we will have another record wave of foreclosures when these homeowners are unable to pay the higher reset rates, cannot refinance, and owe more than their houses are worth.

Figure 1.7. Monthly Mortgage Rate Resets

(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Investment Strategies for Troubled Times

I am always aware that I am investing my clients retirement assets, which is the money that none of us can afford to lose. This means that I will always err to the side of capital preservation. If there are short-term opportunities that may be profitable, I will only participate in them if I am confident that we can do so with low to moderate risk. As you all know, we have built in protection strategies from the beginning, using guaranteed fixed annuities,* using annuities with income guarantees,* and using active risk management through our own program or with outside managers like Ocean Park.

At the time of writing this letter, we are still over-allocated into high yield bond products even though they have already participated in a strong recovery and are no longer significantly over-

sold. However, I feel the differential in the average dividend rate for high yield bonds versus what can be earned on most bank accounts remains very attractive. Goldman Sachs believes that the Federal Reserve will keep interest rates close to zero for all of next year. If this occurs, we could still see double digit total returns in high yield bonds. On the other hand, if problems show up from foreclosures in real estate, or from any other source, and high yield bonds begin to drop in value, our risk management systems will trigger a sell in short order. Whenever I make a change in your allocations, I will always be looking for the investment option(s) that I can protect the best.

I am grateful to have you as my clients and I appreciate having the opportunity to help you achieve your financial goals. Please call me if there is any change in your financial situation, or if you have financial questions on any topic.

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The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America.

*Guarantees are based on the claims paying ability of the insurer.

Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

¹ *Coleman Report October 2007*. "Now Is The Time For Defense."

² PIMCO, "What is the New Normal?"

³ Tim Paradix, AP, December 29, 2009

⁴ Yahoo Finance. Tim Pardis, December 31, 2009

⁵ PIMCO, **Op.Cit.**

⁶ First American Core Logic: "Media Alert: November 24, 2009

⁷ www.BLS.org

⁸ www.USDebtClock.org

⁹ PIMCO, **Op.Cit.**

¹⁰ PBS Newshour, January 12, 2010