

Financial *notes*

INSIGHTS TO ORCHESTRATE FINANCIAL INDEPENDENCE

FROM THE OFFICE OF DR. SCOTT STRATTON, CERTIFIED FINANCIAL PLANNER (TM)

Issue 4, Volume 3

September 2008



Dear Scott,

August was a back-and-forth month in the stock market, as traders tried to make sense of contradictory news, earnings reports, and economic data. In spite of all the noise, the S&P 500 index rose 1% for the month, from 1269 to 1282.

In this month's newsletter, we look at the trend towards increased correlation of US and international markets, as well as alert you to a change to capital gains rules for homes. If you have a second home or vacation property, pay attention, because this could have a big impact on your taxes!

International Stock Market Correlations

Does the creation of a global economy hurt diversification?

One of the fundamental concepts of Modern Portfolio Theory is that diversifying into non-correlated assets can reduce risk in an investment portfolio. We often talk about international stocks as being diversified from US stocks, but we're finding that in recent years that international stock markets are becoming more closely correlated to the US Stock Market.



For example, if we compare the Wilshire 5000 (the broadest measure of US Stocks) against the MSCI EAFE index (Europe, Australasia, Far East), we see that the correlation coefficient has increased substantially over the past four 5-year periods:

Wilshire 5000 / EAFE correlation coefficient			
1986-1990	1991-1991	1996-2000	2001-2005
0.44	0.48	0.76	0.87

A high correlation coefficient means that the two indexes are more likely to move in the same direction together, however, it does not

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[Your Last 5 Years Online](#)

[Housing Act Changes Capital Gains Rules](#)



The best compliment you can give me is the referral of a friend or family member!

Scott Stratton, CFP(R)
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This September, Scott and Erin are celebrating their 10th Anniversary! Our first date was 18 years ago this month and I have to say that getting married was one of the best

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tell us anything about the magnitude of the relative performance. The behavior of international stocks in recent years, to me, seems to be like US stocks on steroids (or "high beta" in geek speak). Last year, the S&P 500 was up 5.5% and the EAFE was up 11.1%. This year, the S&P 500 is down 10.1% and the EAFE is off by 18.2%. They've been moving the same direction (high correlation), but with the international stocks moving in a greater magnitude (high beta).

With the EAFE outperforming the S&P 500 for the previous 6 years (2002 through 2007), some investors started to assume that international stocks would outperform domestic stocks indefinitely. They mistakenly thought that because international was outperforming domestic that they were uncorrelated. I think there are a couple of good lessons from these events:

- 1) The development of a global economy suggests that the US and foreign stock markets could continue to be closely correlated.
- 2) As markets become more correlated, international stocks won't protect you from a loss. Adding more stocks to your portfolio doesn't necessarily make you more diversified!
- 3) Nothing outperforms forever; the stocks which have risen the fastest may also fall the fastest.

Past performance is no guarantee of future results. Diversification can not protect you from a loss.

Your Last 5 Years goes online!

In August, I launched a new website as a companion to my book, **Your Last 5 Years: Making the Transition from Work to Retirement**. This will enable readers of my book to ask questions, contact me, or learn more about my services. Additionally, I've posted back issues of my newsletter on the website for your reference. Please take a look and let me know what you think: www.yourlast5years.com

Housing Act Changes Capital Gains Rules

The new "Housing and Economic Recovery Act of 2008" passed last month has many programs designed to help distressed borrowers, troubled GSEs, and weak housing markets. The cost of these initiatives is being offset by a change in the capital gains taxes for primary



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In this month's [D magazine](#), Erin is quoted several times in an article about the Dallas Symphony's new music director ("Danger: Notes Being Played").



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residences. Under the current rules, you may exclude up to \$250,000 (single) or \$500,000 (married) of capital gains from the sale of a house, as long as it was your primary residence during two of the past five years.

Effective January 1, 2009, homeowners cannot receive the tax break for years when the home was not their primary residence. For example, if they owned the house for 5 years, but only used it as a primary residence for 2 years, then they can exclude only 2/5 (40%) of their capital gains. Under the old rules, the homeowner could have excluded 100% of their capital gains up to the \$250/\$500k limit.

Who will this impact? Anyone who owns a second home or vacation property may have significant imbedded capital gains if they've owned the property for some years. Previously, you could move into the house for two years and get up to \$500,000 in capital gains exclusions. Now, you will have to make the house your primary residence before January 1 if you want the full exclusion. Homeowners who have moved to a new primary residence and are either renting their previous house, or are unable to sell it, may now be taxed on the capital gain when they sell the house in 2009.

The new rule only counts years from 2009 going forward towards the exclusion, however, the amount of the capital gain remains based on the entire duration of ownership. The Senate Finance Committee estimates this change will raise \$1.4 billion in new taxes over the next 10 years.

Consult with your tax attorney or CPA concerning your personal situation. This information is for educational purposes only and is not to be construed as specific tax advice.

If your outgo exceeds your income,

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BILL EARLE

As always, please feel free to call me anytime with any questions or concerns. I'm here to help! Thank you for your business.

Sincerely,

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Dallas, TX 75248

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