JOHNSTON INVESTMENT COUNSEL

TRUSTED FIDUCIARIES & FEE-ONLY ADVISORS

April, 2009

Johnston Investment Counsel
Gregory A. Johnston, CFA, CFP, QPFC, AIF
President & Chief Investment Officer
331 Fulton
Suite 429
Peoria, IL 61602
309-674-3330
309-685-6957
gjohnston@jicinvest.com
www.jicinvest.com

In this issue:

Writing Off Worthless Securities on Your Taxes

Investing in a Low Interest Rate Environment

What You Don't Know Can Hurt You

How much of your company's stock should you hold?

Writing Off Worthless Securities on Your Taxes

It's a classic good news/bad news situation. If you're holding a stock that has become worthless, the bad news is obvious: you've lost your investment. The good (or at least better) news? You may qualify to deduct the investment as a loss on your tax return.

Worthless stock or bonds are those that are completely--the key word here being *completely*--without value. A company's filing for bankruptcy does not necessarily mean that the stock is worthless; the stock may still trade and retain at least some of its value.

The mechanics

If you own stock in a company that liquidates, you may receive at the end of the year a Form 1099-DIV, which lists the liquidating distribution made during that year. For tax purposes, you should treat this distribution as if you had sold the stock, using the distribution date on the form as the date of sale. You would subtract your cost basis from the amount of the distribution.

If you don't receive a 1099--and it's highly likely you won't--you may still be able to take a deduction for worthless stock, but the process becomes more challenging. You'll need to be able to present proof that the stock became worthless during the year in which you're deducting the loss. Examples of documents that might be considered proof include a letter from the company stating that it has shut down and there are no assets to pay shareholders, or a letter from a broker stating that the stock no longer has value. For tax purposes, worthless stock is treated as though you sold the shares on the last day of the year in which they become worthless.

Abandoning a stock

You may also be able to claim a stock as worthless if you abandoned it after March 12, 2008. To do so, you must relinquish all rights to it and receive nothing in return; however, you should consult a tax professional to ensure that the transaction is not considered a sale, exchange, contribution to capital, dividend, or gift, which could change the tax implications.

Don't ignore timing

In general, you must claim a loss on a worthless stock in the year in which it becomes worthless. (However, if you do neglect to claim the loss in the appropriate year, you can do so later by filing an amended tax return within 7 years.) IRS Publication 550 includes more information about recognizing capital gains and losses.

What if a stock is worth almost nothing?

If a stock is no longer traded but is not formally defunct, there's another (though more complicated) possibility for milking tax value from an investing mistake. You could sell the shares in an arm's length transaction (to a willing, unrelated buyer for fair value). Be sure that ownership of the shares transfers to the new owner.

You also could check with your brokerage firm to see whether it purchases virtually worthless shares from customers for a nominal amount to supply them with a trade confirmation for tax purposes.

Writing off worthless securities is far more complex than this brief discussion might suggest. Consult a tax professional to ensure you don't make any missteps.

Investing in a Low Interest Rate Environment

Low interest rates create a dilemma. Do you accept a low return because you feel you must protect your principal? Or do you take on greater investment risk in order to try for a higher return? In balancing those two concerns, here are some factors to think about.

Consider laddering your CDs

When yields on Treasury bonds began dropping last year, many investors were attracted to certificates of deposit (CDs) offered by banks that needed to attract capital. However, interest rates won't stay low forever, and at some point you may want access to your money before a CD matures. One way to achieve higher rates while retaining flexibility to adjust your strategy over time is to ladder CDs. Laddering involves investing in CDs with varying maturity dates. As the shorter-term CDs mature, you can reinvest in one with a longer term and higher rate. Over time, laddering can give you both the higher rates typically offered by longer-term CDs and the ability to adjust as interest rates change.

Example: *Susan wants to invest $60,000 in CDs. She puts $20,000 in a six-month CD that pays 2.6%, another $20,000 in a three-year CD that pays 3%, and the final $20,000 in a five-year CD that pays 3.5%. When the six-month CD matures, she reinvests that money in another five-year CD. When her two-year CD matures, she reinvests it in still another five-year CD. At that point, funds from a maturing CD will be available roughly every other year, but will earn the higher five-year rate. If rates are lower when a CD matures, she has the option of investing elsewhere. (This is a hypothetical example and doesn't represent the results of any specific investment.)*

Pay attention to expenses

Low returns magnify the impact of high investing expenses. Let's say a mutual fund has an expense ratio of 1.00, meaning that 1% of its net asset value each year is used to pay operating expenses such as management and marketing fees. That 1% represents a bigger relative bite out of your return when the fund is earning 3% than it does if it's earning 10%. At the higher number, you're losing only about 10% of your return; at 3%, almost a third of your return goes to expenses. Before investing in a mutual fund, carefully consider its fees and expenses as well as its investment objective and risks, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing. If you prefer individual stocks, keep an eye on trading costs.

Think about your real return

Low interest rates may not be quite as problematic as they seem. Even if you're earning a low interest rate, your real return might not suffer too much if inflation is also low. Real return represents what your money earns once the impact of inflation is taken into account. With an annual inflation rate of 0.1%--the December 2008 Consumer Price Index (CPI) figure--a bond that pays 3% would produce the same real return as a bond that pays 5% when annual inflation is running at 2.1%.

Compare interest rate and yield spreads

When market instability drove many investors to the safety of Treasury bonds, their prices rose and yields fell. As a result, the spreads between Treasury yields and those of corporates and municipals have been relatively high over the last year because non-Treasury bonds have to offer higher yields to compensate for investors' anxiety about the safety of their principal and possibility of default.

Consider small changes

You may not need to remake your portfolio completely to seek a higher return. For example, if you're in Treasuries, you could move part of that money to municipal bonds, which may involve greater risk of default but whose net returns are boosted by their exemption from federal income tax. Or you could shift a portion of your stock allocation to dividend-oriented stocks and ETFs, or preferred stock.

Look for buying or selling opportunities

Interest rates also can be used to help evaluate equities. Some analysts like to determine the relative value of the stock market using the so-called Fed market valuation model. (Though not officially endorsed by the Federal Reserve Board, the method evolved based on a 1997 Fed report.) The model compares the earnings yield on the S&P 500 to the 10-year Treasury bond's yield. If the S&P's yield is higher than the T-bond's, the model considers the market undervalued relative to bonds. If the Treasury yield is higher, the market is overvalued. However, this is only one of many valuation models and shouldn't be the sole factor in your decision.

Don't stop at yield

If you're tempted to seek a higher return, don't forget that yield alone shouldn't be your only criterion. In reaching for additional yield, you may be taking on additional risk. Also, if and when interest rates rise, the change may affect a bond's market value unless held to maturity. Don't hesitate to get expert help to assess whether you can increase your return without taking on more risk than you can afford.

What You Don't Know Can Hurt You

You've probably heard the saying, "what you don't know can't hurt you," but when it comes to your finances, ignorance is not necessarily bliss. It's easy to make bad financial decisions when you lack sufficient information or you are misinformed. By the time you realize your mistake, it's usually too late to correct it. Here are several common mistakes that can be avoided with just a little bit of forethought.

Naming the wrong insurance beneficiary

Life insurance has many benefits. Among them is the fact that death benefits are generally paid directly to the beneficiary you name in the policy without passing through probate. But what happens if the beneficiary you name is unable to accept the death benefit, because he or she is a minor, deceased, or incompetent? In these circumstances, unless you've named an alternate beneficiary, the life insurance proceeds will be subject to all of the expenses and delays associated with settling an estate through probate.

You could make financial decisions that turn out to be wrong because you lack sufficient information or you were misinformed altogether.

What can you do before it's too late? Review your life insurance beneficiary designations at least annually to be sure the proceeds will pass to the proper beneficiary without the involvement of probate. Also, consider adding at least one contingent or alternate beneficiary in case the primary beneficiary is unable to receive the proceeds.

Selecting the wrong pension option

If you're lucky enough to have an employer-sponsored pension for your retirement, the distribution choices you make usually can't be changed, regardless of whether your circumstances change. Before making your choice, get all of your plan's options from the plan administrator and review them with a financial professional who can help you crunch the numbers. Estimate your retirement income needs, then determine what the best strategy is for you and your family.

What can you do before it's too late? If you're married you're required to take a joint and survivor option, unless your spouse waives his or her rights to your pension. If you elect the single life option, your payments will be larger, but at the expense of a future spousal benefit. If you choose the single life option, make sure you have plenty of other income or life insurance to replace the pension for your surviving spouse.

Owning assets jointly

Owning assets jointly often can be a good strategy to avoid probate or minimize estate taxes. However, this form of asset ownership also has disadvantages. The joint owner has equal rights to the jointly owned asset, meaning he or she can withdraw from a joint bank or brokerage account or sell his or her interest in the asset without your consent. In addition, adding someone's name to an asset may be considered a gift, subject to possible gift taxes. And, owning assets jointly exposes those assets to the creditors of your joint owner. Finally, with respect to long-term care planning and Medicaid qualification, adding a joint owner can negatively affect your Medicaid eligibility.

What can you do before it's too late? Consider the ramifications of joint ownership carefully before implementing this strategy. If your intent is to leave the asset to the joint owner, alternatives such as payable on death accounts, trust designations, or life estates may accomplish your goal and protect your interest in the asset at the same time.

Underinsured homes

Imagine this scenario: you just suffered through a terrible fire that destroyed your home and most of its contents. You get an estimate on the cost to rebuild your home and file a claim with your homeowners insurance carrier. To your shock, you find that they are not going to cover the entire cost to rebuild. You thought your policy covered the full replacement cost of your home. However, the policy actually provides extended replacement cost, which offers up to 120% of the policy's face amount--not enough to cover all of the costs to rebuild your home.

What can you do before it's too late? Review your policy at least annually and make sure the face amount is enough to cover the cost to rebuild your home should the unthinkable occur. That means you need to know the approximate cost to rebuild, including any additions and improvements you made to the home. Also, take into consideration increasing costs of materials and labor.

Other common mistakes

- *Failing to provide for financial loss due to a non-work related disability*
- *Miscalculating how much life insurance you need*
- *Owning too much company stock in your employer-sponsored retirement plan*
- *Underestimating how long your retirement may last*
- *Overestimating the annual rate of return you'll earn on your investments*
- *Trying to save for your children's college education at the expense of saving for your retirement*

Johnston Investment Counsel
Gregory A. Johnston, CFA, CFP, QPFC, AIF
President & Chief Investment Officer
331 Fulton
Suite 429
Peoria, IL 61602
309-674-3330
309-685-6957
gjohnston@jicinvest.com
www.jicinvest.com

Forefield Inc. does not provide legal, tax, or investment advice. All content provided by Forefield is protected by copyright. Forefield is not responsible for any modifications made to its materials, or for the accuracy of information provided by other sources.

Prepared by Forefield Inc, Copyright 2009

Ask the Experts

How much of your company's stock should you hold?

No matter how good a company you work for, you should think carefully about how much you should have invested in it. Yes, there are companies whose employees have become wealthy from company stock that was part of their compensation. But there also are stories about employees of companies such as Enron, Bear Stearns, and Lehman Bros.--people who believed in their employers but learned the hard way that allowing one company--especially a current employer--to dominate their investment or retirement portfolio can have devastating consequences.

According to the most recent Employee Benefit Research Institute statistics (Issue Brief No. 308, August 2007), company stock represents an average of 11% of 401(k) plan participants' assets (though that percentage is less than in previous years). However, few mutual fund managers would allow a single stock--any stock--to represent that much of a fund's portfolio. And a corporate pension plan is actually prohibited from investing more than 10% of its holdings in the company's own stock.

Ironically, the better your company's stock has performed, the greater the chance that it may have grown to dominate your portfolio. However, even if your company is a good one, working at a company means you've invested your "human capital"--your earning ability--in that firm. If you also have a large portion of your investment capital there, your financial well-being is even more dependent on a single company. If a company's stock is suffering, it might react by cutting jobs companywide. If yours were one of them, both your human and investment capital would be hit.

And don't forget to consider whether an equity mutual fund you hold also may have invested in your company's stock. You can find out a fund's holdings by checking its annual and semiannual reports. You can use the information to estimate your total exposure to your employer's stock.

What issues might company stock options raise at tax time?

If stock options are part of your compensation package, a significant market downturn can mean special financial pain.

In many cases, people who receive options to buy their company's stock find that during a downturn, the stock's market price is lower than the option's exercise price. Since few would choose to exercise an option that requires paying more than the market price, the option is said to be "underwater"--a situation that was widespread last year. If your options are underwater, it's worth checking to see if your company has considered asking its shareholders to approve repricing the options, or exchanging them for a smaller number of options with a lower exercise price. Some companies are taking such steps to try to retain valued employees.

If you exercised options to purchase your company's stock in 2008, you may face a more complex problem. The type of option and when you exercised it can raise a number of issues at tax time. If you own nonqualified stock options, you'll generally owe ordinary income tax on the difference between the exercise price and the stock's market value as of the date you exercised it. That amount is considered compensation and, if you're an employee, should be listed on your W-2 form.

If you exercised incentive stock options (ISOs), tax is ordinarily deferred until you sell the stock that you acquired. However, unless you sold the stock in the same year that you acquired it, you have to factor in the alternative minimum tax (AMT). For AMT purposes, when you exercise an ISO, income is generally recognized to the extent that the fair market value of the shares when acquired exceeds the option's exercise price. This means that a significant ISO exercise in one year can trigger AMT liability, even though no income is actually received. This application of AMT could be a real problem if you exercised the options in early 2008 and later saw the value of the stock you received dramatically decline in value. If you are subject to AMT as the result of an ISO exercise, you'll be entitled to a resulting AMT credit that can be used in future years.

The Emergency Economic Stabilization Act of 2008 included some relief for taxpayers who exercised ISOs prior to 2008, and makes it easier to claim unused AMT credit. However, it will be of little help if you exercised ISOs in 2008. For more information, talk to a tax professional.