



# theadvisor

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Fall 2007 Newsletter

## UNWINDING

The residential real estate crunch throughout the U.S. is in the process of “unwinding”. In some locales this will take a few months, yet in other places the effects could remain much longer. For the past year or so many pundits have discussed the emerging problems with so called “sub-prime” mortgages (those with lower credit capabilities). What has not received much attention however is that the concerns over delinquencies are spread throughout the mortgage market sector far beyond “sub-prime”. One of the largest mortgage lenders in the country said exactly this in an earnings statement in late July: “Delinquencies are not the real issue; but delinquencies lead to defaults and the ability of the mortgage holder to buy back the properties in many cases is insufficient.” There are at least a dozen major markets where delinquencies exceed 5% and a couple places north of 8%. It will take awhile for these high rates of delinquency / default to work through the system.

The credit boom that we have enjoyed the past dozen or so years will take even longer to pull back towards an equilibrium point. Owners of mortgage backed securities are global. In early August, a French bank froze withdrawals from a hedge fund because the mortgages could not be valued. Liquidity events of this kind are not solved overnight.

The holders of all this mortgage debt (in many cases hedge funds) could well see total wipe out losses. That’s right, **100% losses** in some cases. Some of these high priced hedge funds aimed at the super wealthy type investors (who should be a bit smarter than this on measure) were marketed as “super duper” income generators (a.k.a. fixed income) and the investments could end up as total losses.

The good news – if there is some – is that a survey of 28 metropolitan markets published in the July 26, 2007 *The Wall Street Journal* indicated that inventories of unsold homes actually declined in a couple of the markets from earlier this year. That may mark the bottom in those markets but in many others the “unwinding” will take longer. Many buyers are “marooned” – they can’t buy a new house because they can’t sell their existing house. None of this will end tomorrow and the impact upon the financial markets could be substantial. The day-to-day volatility that the markets witnessed at the end of July and early August is to a large extent traced to these difficulties.

## INSURANCE VS. INVESTMENTS

A nice tidbit from one of my favorite publications, *The Week*, in the July 20, 2007 issue about the idea of combining insurance with investments. There are of course a plethora of insurance products that have variable accounts similar to mutual funds within the “tax favored” insurance policy. We have always cautioned clients that the structure of these annuities and other insurance oriented policies is simply unsound. The article agrees saying, “For one thing, the insurance portion of these products is overpriced. Worse, a slew of marketing, sales and investment fees significantly drag down investment returns”. We agree.

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## CAPITAL GAINS OF BOTH KINDS (REALIZED AND UNREALIZED)

The overall positive market conditions over the past 4+ years have gone a long way towards creating a “problem” for many. The “problem” is the imbedded (or unrealized) capital gains within taxable portfolios. The quotation marks are around the word “problem” because of the current state of capital gain taxation. In the over 25 year long history of our firm, capital gain taxes have never been lower. The top rate on long-term capital gains is 15% while the highest marginal tax bracket is 35%. Many of you have heard us say that it is hard to believe that any type of income will ever be taxed at a

*Continued on Page 2*

*Cont'd from page 1*

lower rate. Yet, over and over again we have discussions with clients about imbedded capital gains and their inability to sell or realize these gains because of the 15% tax.

Regardless of your particular political persuasion, it seems much more likely than not that the current tax rate of 15% will at the very best be allowed to die a natural death at the end of 2010. There are any number of possibilities for what to do after that point including making no distinction between capital gain and ordinary income. There have also been many noises made about moving the 2010 expiration date in a bit. No one knows for sure at this point but the future capital gain tax rates appear well positioned to increase by significant margins in the not too distant future. It might be time to approach the current 15% rate as a positive and realize gains at this rate. Holding out for a possibly better rate appears more and more foolish.

**FUN FACTS**

- Despite the overhang of negative news from the housing sector and the ongoing international tensions, the financial markets have shown a good deal of resilience. In the long run market prices are in one way or another keyed off of corporate earnings. Overall earnings have been quite good and this has led to the continued positive performance of most segments of the investment markets. In fact, based on the most recent quarterly earnings from those firms that comprise the Standard and Poors 500 index, the market is more fairly priced than at any time since 1991.
- To add yet an additional positive element to the equation is the growth of the worldwide economy. Economic growth throughout the world has been setting a pace not seen previously and with the help of China, India, the former Soviet Union, Africa and Eastern Europe. The flow of capital and the increasing mobility of these financial resources have spurred much of this growth.

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**SIMPLE and EFFICIENT**

As many of you know, we have been working this year with a consulting firm (Quantuvis) to audit and review all of our client processes. This has led to several changes in our quarterly reporting format and financial independence analysis along with other minor tweaks in less visible areas of our operation. All of these changes have been introduced in order to properly align our work with our overarching philosophy to have a simple and efficient firm.

We live in an increasingly complex and rapidly changing world. Against this backdrop we believe that there can be substantial value in injecting an element of simplicity and efficiency within this framework. More often than not, clients come here with complicated structures that usually detract from the longer-term objectives. Creating a sound and simple framework for making financial decisions allows for much greater clarity and improves the quality of the decision-making.

We will continue to look for areas where we can provide greater simplicity and efficiency in our interactions with you. If you have any ideas or suggestions please let us know.

**TIM GAHAN**

Many of you remember our former Business Administrator Tim Gahan. A retired Marine Corps Colonel and widower, Tim left us 4 years ago to enter Roman Catholic seminary to pursue a vocation to the priesthood. We are extremely pleased and proud that Tim (now Father Tim Gahan) was ordained to the priesthood along with 5 other men on July 27 here in Columbia (the largest ordination class for this diocese in 51 years). He will function as a priest for the Diocese of Charleston, which comprises the whole of South Carolina. His initial assignment will be here in Columbia at St. Joseph's Catholic Church just a few blocks down the street from our office. We know that you join us in congratulating Father Gahan.

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