

notes from the assabet

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Pick Your Plastic

“Cash or check?” When was the last time you were asked that? Today it’s “Credit or debit?” as we hand over the plastic at checkout. The evolving technology of consumer purchases has given us more payment options. Most of us use all four types, in different proportions and for different reasons. Think about which payment media you use for which payments. Why do you do it that way?

To some degree, the difference in habits is generational. My (Lisa’s) 23-year old uses a debit card for a \$2 coffee while I pay cash. In her head, the debit card is a cash substitute. In mine, simply because it’s plastic, it’s a credit substitute and I don’t use credit for tiny purchases. Preferences also vary by the size of the purchase, by the type of item purchased, and because of people’s personal financial situations. The same factor can drive individuals to different results. For example, some people use a credit card because their ample wealth enables them to do so without incurring debt. It’s a convenience. The credit card industry refers to these folks as “transactors,” or “deadbeats” because their accounts aren’t especially profitable. Other people use the credit card because it offers an instant loan, permitting them to buy what they can’t currently afford. These “revolvers,” who carry monthly debt, bolster credit card company profits.

Some of our inclinations are hard to explain. I pay all of my bills electronically through my checking account, so why do I still use a check to pay tithes and offerings at church? Why not just direct it remotely through my charitable gift fund or contribute online? Could it be that I

feel the pull of a centuries-old practice of bringing “first fruits” to the altar? My daughter’s church has a kiosk where you can swipe a card. I would not do that either. Would you?

Individual quirks aside, in the choice between payment media, there are some real tradeoffs. Carrying a debit or a credit card means that you don’t have to carry much cash. And, have you ever tried to scrape ice off of your windshield with a wad of twenties? The debit card gives you those advantages without incurring debt, and allows you to get “cash back.” But with “security holds” (where the merchant ties up more of your money than the purchase amount for an interval) you run the risk of overdrafts if you tend to maintain a low account balance.

Your credit card bill makes it easy for you to keep track of your spending. Use of credit can improve your credit score, making it easier to get a loan or a better interest rate. It enables you to dispute the purchase with the merchant. Yet credit cards are no panacea. Some people worry about privacy and how their purchasing data might be used. Each purchase is associated with a merchant category code (MCC). Those with too many 7273s (escort services) or 5933s (pawnshops) might be particularly sensitive.

The primary risk of credit cards is very basic: overspending and debt. Very conservative financial advisors like Dave Ramsey (“The Dave Ramsey Show” on Fox TV) hate the cards on principle. Dave writes, “When you pay cash, you can “feel” the money leaving you. This is not true with credit cards. Flipping a credit card up

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Pick Your Plastic (continued)

on a counter registers nothing emotionally. If you use credit cards instead of cash you will spend 12-18% more. This is money you could have saved.” Don’t get Ramsey going on revolving debt which, when late fees or raised interest rates go into effect, can drown the debtor. Dave won’t use credit cards himself or permit them for payments for items from his website. His advice? “Plasectomy!”

New rules governing credit card industry practices will take effect in July of 2010. These are the latest chapter in the history of credit cards which were initiated early in the 20th century. In the 1920’s gas stations and individual stores began offering charge cards. Cards that could be used at multiple locations came in the 1950’s-60’s. By the ‘80’s they were commonly used but were a loss leader for the banks whose profits were limited by state “usury laws.” When, in 1981, the rate of inflation actually exceeded the interest rate, Citibank moved its card business from New York to South Dakota where usury laws were being eliminated. Other states followed suit and credit cards began to be hugely profitable. Since then, the banks have altered the product based upon marketing needs, changing regulations, and profit margins. Changes have included: annual fees that enable card companies to cover the costs of the “deadbeats,” the use of individual data to charge personalized

interest rates, reducing minimum payments (thus elongating the life and profitability of the debt), penalty fees, abbreviated payment windows, altering interest rates with only a brief notice period, even making the due date a holiday or Sunday, thus increasing the number of late payments. The credit card industry has proven very skillful at adapting to regulations by finding new revenue sources.

This year, the big credit card issuers raised their payment minimums from 2% to 4%, a voluntary reform. In July, 2010 all issuers will have to implement these new rules (among others): give 45 days warning on rate changes, allow accountholders 21 days to pay monthly bills, more clearly disclose the terms, limit interest rate hikes on existing balances, discontinue the practice of “universal default” (in which the card issuer raises the interest rate on an account because of a default with another lender) and restrict over-the-limit and subprime credit card fees.

Expect the card companies to find ways to replace the lost revenue.

“Consumer Behavior and Payment Choice,” 2006 Conference, Federal Reserve Bank of Boston, “Regulators finalize sweeping credit card rule reforms” www.creditcards.com, “Frontline: The secret history of the credit card,” www.pbs.org, “The truth about credit card debt,” www.daveramsey.com,

Quarterly Economic and Financial Review

After a very strong third quarter performance (+15% for the S&P 500 Stock Index) the domestic stock market sold off on the first day of the final quarter. The U.S. economy appears to be in recovery. Fed Chairman Bernanke declared the recession “most likely over” but also predicted that the recovery would be slow and spotty. In fact, recent economic data has been mixed. Employment, which typically improves later than the general economy, remains very weak. Recent consumer confidence readings were worse than expected, possibly forecasting a poor retail holiday season. And the latest manufacturing reports also were disappointing. At the same time, new and pending home sales have risen and corporate profits have been healthy, mostly from cost containment. Most analysts expect advances in employment to be quite sluggish, perhaps not beginning until 2010.

From a 12-year low in March, the stock market gained +56% in a 7-month rally bringing the year-to-date gain to 17% (S&P 500). Mid-cap and small-cap stocks outperformed. International markets rose more than U.S. markets as global economies began to recover. Emerging markets led both international and domestic.

The domestic bond market had positive performance across all sectors. Low interest rates and hopes for economic recovery drove investors to take on more credit risk. Purchases by foreign investors and the Federal Reserve bolstered the Treasury and mortgage-backed markets, keeping yields and mortgage rates low. Companies increased debt sales to lock in low interest rates. The Fed maintained the low Federal Funds rate of between 0-0.25%, indicating its greater concern about the economy than the possibility of an imminent spike in the rate of inflation.



Help Wanted

I wouldn't want to be looking for work this year. Unemployment is at a 26 year high. The jobs are few and the lines are long. In this environment, employers have witnessed many "out of the box" techniques employed by creative and/or desperate job-seekers trying to differentiate themselves from the enormous pack. For instance:

Food related: milk and cookies sent to the hiring manager, a resume mailed in a pizza box, Krispy Kreme donuts used to bribe the receptionist into ensuring that one's resume stays on the top of the pile.

Dogged persistence: Standing outside of the office from 9 to 5 every business day for a full month, in suit and tie, distributing resumes to motorists at the foot of the Ben Franklin Bridge.

Cute and quirky: At Eastertime, entering the office dressed as the proverbial Bunny, sending a shoe along with the resume to "get the foot in the door."

A marketing flair: sending a press release announcing that you have been hired for the job as a cover letter for the resume, creating an informed and positive blog about the company, writing the company about a job opening that doesn't exist and recommending yourself for it.

For your interest, the last three, which achieved the proper balance of creativity and professionalism, were successful. Some of the others failed. In the movies, an aspiring person does outrageous things to impress someone else, who turns around and admires their "Moxie!" In real life, however, there seem to be right and wrong reasons to be memorable.

I read in one blog: "Few companies want cookie cutter marketers, but nobody hires oddballs." Not true. I've seen plenty of oddballs (and incompetents, and outright sloths) over my many working years. Today, I know many highly skilled, talented and industrious people sending out resumes, if not shoes. There but for fortune.....

BusinessWorcester.com 8/3/09, the Panelist site 6/20/09, Dana Drifilippo "Unusual Tactics" Philadelphia Daily News

Please Pass the Spam

21st century Americans have been people who don't delay gratification easily. We buy houses before we are ready because we want a house. If we can't afford something at the moment, why wait? That's what credit is for! Five years ago, our savings rate was negative. In the summer of 2008, we saved one quarter of one percent of our disposable income. That's why the announcement of a dramatic climb in savings, in May, to 6.2% the highest rate in 15 years, was so notable. If you find yourself doubting the possibility of such a rapid behavioral turn, you're not alone. Several analysts agree that the government's Bureau of Economic Analysis is too high by at least 6%!* (The BEA reported 4.2% in July.)

Perhaps we have not become savers overnight. But there is dependable evidence that we have adjusted spending habits. Spending declines have even hit health care, once thought impermeable to hard times.** Depending upon which polls you read, either 32% (Gallup—July) or 63% (CNN) say that the change to spending less and saving more is permanent—a "new normal."*** There is not much difference across income levels.

The most obvious source of the plunge in spending was the drop in durable goods purchases. As home values and nest eggs deteriorated, and layoffs mounted, Americans have bought fewer cars, computers and appliances. Clothing and furniture sales also fell. What Americans spend on food has dropped dramatically.**** We've been eating out less often. Coffee made at home has replaced expensive designer lattes. We are buying less meat, sweets and alcoholic beverages. Hormel Foods is prospering as shoppers turn to Spam and Dinty Moore products. Nestle is selling more bouillon cubes and instant coffee. Store brands are outpacing name brands. Not only has behavior modified, but cultural values have shifted as well. Today, people boast more about their frugality than their lavish acquisitions. A question for our readers: is this the "new normal?" When times improve, will this hold?

*Jon Markman MSN.com 7/7/, Andrew Kaplan, "The Savings Rate has Recovered...if you Ignore the Bottom 99%," 9-31-09, **WSJ 9/22/08 "Consumers Cut health Spending" ***Gallup.com 7/20/09 "Spending less - the New Normal." ****WSJ 2/13/09 "Consumers Cut Food Spending Sharply"

Be Wary of Capital Gains Distributions

Taxation of mutual fund capital gains distributions in taxable accounts has aggravated investors for some time, but in 2008 the practice was particularly galling. Some fund investors, perhaps even you, paid significant tax on capital gains in funds which experienced large losses. For example, an investor who bought shares of Vanguard's Precious Metals & Mining Fund at the beginning of 2008, not only saw the value of the investment decline by -58% during the year, but was hit with a capital gains tax liability of \$ 1.723 per share. Insult to injury! How did this happen?

As a stock owner, you pay capital gains taxes when you sell a stock at a price that exceeds your cost. Mutual fund gains work differently. You pay capital gains tax on the realized gains of single securities throughout the life of your fund ownership, not when you sell your fund shares. (At that point, a gain or loss on the value of fund shares becomes recognizable.)

As a mutual fund shareholder, you don't own the securities held in a mutual fund portfolio. Yet when the fund manager sells a security at a price higher than its purchase price, you are assessed on the gain during the year in which the fund manager makes the sale. In order to avoid federal tax at the fund level, fund companies are required to distribute substantially all of the gains on such sales to their shareholders. The distribution itself does nothing to increase the value of your holding (which is equal to the number of shares you own times the Net Asset Value per share (NAV).) The NAV is reduced by the amount of the distribution and fund shareholders receive additional shares or cash equal to the amount of the distribution. The two actions offset each other.

It may seem unfair to be taxed on a transaction that doesn't increase your value, but if you have been in the fund for a while, likely you have benefited from the security's increased value over time as it contributed to an increase in the NAV. On the other hand, you may have purchased shares of the fund just days before the distribution occurred. As the fund's distribution is doled out equally (on a pro rata basis) to all shareholders on the record date, you would incur a tax burden from a gain you never enjoyed.

Fund companies are more or less sensitive to tax impacts, and may try to moderate them by balancing capital gains and losses, even holding onto stocks until there are losses they can use to offset gains. Yet in the case of the Vanguard Precious Metals & Mining Fund, as with so many others, managers had run out of losses by mid 2008. During the market slide, many managers had to sell securities with large gains in order to meet the massive redemptions by anxious investors. So, some fund shareholders endured a major tax hit during a year when their investment suffered a major decline. Insult to injury.

Some people argue that mutual fund shareholders should not take on the tax burden of cap gains on underlying securities until they sell their fund shares. The delay would increase the tax burden at that point, but in the meantime, the assets can enjoy tax-free compounding. Also, the value of payments made in tomorrow's dollars are lower because of inflation.

Failing that reform, how do you avoid the tax burden of distributions? If your account is tax-qualified, like an IRA, there's no problem. In the taxable arena, some funds, such as index funds and exchange-traded funds, tend to have lower capital distributions. If you're planning to buy a fund, wait until after the distribution date which will tend to occur late in the year. Sometimes both the date and the amount are announced on the fund family's website. Or, if you discover that a large distribution is planned on a fund in which you have a significant holding, you can sell the fund just before the distribution and buy it back after the legally mandated waiting period to avoid wash sale penalties. If you want to stay in that market without observing the waiting period, you can purchase a somewhat similar fund.

Your investment advisor should be watching this for you.

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