Quarter Notes

FIRESTONE CAPITAL MANAGEMENT, INC.

JACK M. FIRESTONE, CFP
CAROL G. KAUFMAN, CFP
www.firestonecapital.com

April 2007 | Second Quarter 2007 | Volume 15 No 1

In this Issue

- *Market Summary*
- *Retirement Cash Flow*
- *Sub-Prime Loans*
- *Growth Prospects Ahead*

Fed Keeps Status Quo
March was the 6th consecutive meeting at which the Federal Reserve left interest rates unchanged.

Tax Trivia
Based on the the 2004 tax year, individual returns with at least $100,000 of adjusted gross income make up only 12% of returns, but paid 65% of all taxes. Source IRS

China is Back
The Chinese Shanghai stock index opened at 3041 on February 27, the day of the 9% drop which triggered a 400 plus point drop in the Dow. By March 21 the Chinese index had recovered all the loss and closed at 3057.
Source BTN Research

1500 San Remo Ave.
Coral Gables, FL 33146
Tel: 305-669-2119
Fax: 305-669-1976
jack@firestonecapital.com
carolk@firestonecapital.com

Have Reasonable Expectations for the Year Ahead

Index	Close on 3/30/2007	YTD % Change
DJ Industrial Average	12354.35	-0.90%
S&P 500 Index	1420.86	0.20%
Nasdaq Composite	2455.63	0.30%
Russell 2000 Index	811.05	1.70%
MSCI EAFE	2147.51	3.50%
US Bonds*	4.65%	1.50%
*10 year Treasury		

Market returns for the first quarter of 2007 gave investors more of a rocky ride than they have been accustomed to lately. After the outsized returns of 2006, we were bound to have a leveling off of the markets. Despite weaker quarterly returns, the markets have still not seen a 10% correction in more than four years.

The Dow Jones industrial average fell by .9%, while the broader S&P 500 index was up .2% for the year. The NASDAQ index rose .3%. The Russell 2000 index, which tracks smaller companies, beat the large-company indexes with a return of 1.7%. International stocks fared even better, gaining 3.5%. Diversified positions such as international real estate, commodities, and other tactical investment helped boost returns. The AIG commodity index rose 3.3%.

Fixed income investments provided some capital gains for portfolios, as money moving into bonds forced the yields on the 10 year Treasury to fall from 4.9% to 4.6% during the quarter.

Retirement Cash Flow Planning

Our financial lives have two stages: wealth accumulation and wealth distribution. The wealth accumulation phase tends to generate the most thought. As our Baby Boomer clients approach retirement, discussions are beginning to focus on the wealth distribution or liquidation phase. So how does our financial advice and method of management change in moving from accumulation to distribution planning?

Clients approaching retirement face both financial and emotional issues. We can model budgets and determine how much is a reasonable draw from invested assets. That is the easy part. But the fears of doing without a paycheck and lacking productive work, the worries about health, and the potential for marital stress from too much togetherness are harder for some clients. Many retirees think that they have to remove all risky assets from their portfolios, but higher-risk assets add the potential for growth, which is required for maintaining purchasing power. Most retirees will have decades of life left to fund, so growth is important.

When we prepare a portfolio for someone in the distribution phase, it is not substantially different from one in the accumulation phase. We will create a diversified portfolio, considering the overall portfolio risk parameters with which the client is comfortable. A portion of that portfolio will be in short-term bonds and enhanced money market funds. The next 12 to 15 monthly distribution checks will be issued from this pool of cash and bonds. When we rebalance the portfolio, the cash will be replenished, the investments will be monitored, and the positions will be rebalanced. This strategy precludes having to sell equity positions during short-term market pullbacks to meet monthly cash flow needs.

Determining the right distribution rate can be tricky. The first step is to see what cash flow needs will be in retirement. The next step is to identify regular income that comes in from other sources: social security, pensions, and other income. Retiring before Medicare eligibility adds substantial additional costs for health insurance which might have been paid by an employer previously.

A 4-5% distribution rate is considered a sustainable withdrawal rate for a diversified

(Continued Page 2 Column 2)

Side Bits

Money is like Soap: The more your touch it the smaller it gets. *-Dirk Kodge*

We can tell our Values: by looking at our checkbook stubs. *-Gloria Stienman*

Net vs Gross: My problem lies in reconciling my gross habits with my net income. *-Errol Flynn*

Umbrellas: A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain. *-Robert Frost*

Growth Prospects in the Year Ahead

The powerful 2006 year-end returns continued through the beginning of 2007. What followed may have been a return to normal market volatility, but it was more jarring than investors with short memories had experienced in quite some time. How do we evaluate what lies ahead and how markets may be affected?

Although the growth in the US economy has slowed from the last quarter of 2006, GDP (Gross Domestic Product) is still expected to reach 2.5 to 3% this year. As a point of reference, last year's GDP grew by 3.3%. This means that, although growth is slowing, we are still in an expanding economy. In addition, the rest of the world is experiencing even stronger growth. China is only slightly off its torrid pace, and Japan, South Korea, and Mexico are forecast to see a pickup in economic activity.

At the last Federal Reserve meeting in March, the Fed alluded to ending its tightening bias. It concluded that the US economy was expected to continue at a moderate pace. This is confirmed by a recent report on industrial production showing an increase in manufacturing since November. In addition, the falling dollar has increased the competitiveness of US goods on the world markets and makes it more attractive for US consumers to "buy American". Consumer spending is holding steady, mostly because of the low unemployment rate of 4.5%. Business spending, which has been slow, is expected to pick up in the second half of 2007, as firms have depleted their previously built up inventories.

The bottom line is that despite the recent gains for equity investors, fundamentals (like price/earnings ratios and profit growth) are still within reasonable levels. Even with subdued growth prospects, it is conceivable that we will see high single-digit returns for the equity markets this year. With a forecast of earnings growth in the 7% range and a 2% dividend rate, a 9% return is possible even if price-to-earnings remains the same. Of course, the crystal ball doesn't really tell us the future, so we will continue to hedge our bets with diversification.

Impact of Sub-Prime Loans

Problems with sub-prime loans have captured the headlines in the last few weeks. What effect will these problem loans have on the overall US economy?

Sub-prime mortgages are home loans extended to borrowers with less than stellar credit ratings. Lenders usually charge higher (and often variable) rates to compensate for taking higher-risk clients. Compounding the problem is the fact that some of these loans were issued with teaser rates as low as 1%. "Negative amortization", where the interest paid does not cover the true interest cost and the unpaid interest is added to the loan balance, has also affected borrowers. As interest rates increase and are reset to market rates, defaults on these loans have increased markedly.

Companies extending sub-prime loans are experiencing increased defaults and foreclosures. Even institutions that do not directly participate in sub-prime loans experience repercussions when sub-prime lenders pool groups of mortgages, slice and dice them into pooled investments, and resell them as asset-backed bonds. Therefore, the total exposure of a crisis in this segment of the market is not easily quantifiable.

To put this risk in perspective, the sub-prime mortgage market makes up less than 14% of the total mortgage market. Larger lenders anticipated problems and began to raise credit standards during the past six months. Most of these lenders have increased their reserves for bad debts. Thus, although the increasing defaults and foreclosures have put pressure on residential real estate prices, the broad US economy should not be significantly impaired. Other factors, like the low unemployment rate, stable and reasonable interest rates, and continued worldwide economic growth, should help temper any fallout from the sub-prime mortgage difficulties.

Retirement Planning

(Continued from Page 1 Column 2)

portfolio of 50% stocks and 50% bonds. This assumes that 3% of returns is allowed to remain in the portfolio for growth and inflation protection. However, many clients have outside assets (like real estate investments) which will eventually be liquidated and used to replenish funds in their portfolio. Thus, they could comfortably handle higher withdrawal rates.

Flexibility is critical. Re-evaluate the plan regularly. If you experience ugly investment returns at the beginning of retirement, you may have to adjust. Having a portion of your portfolio in cash or short-term bonds, along with a diversified portfolio designed for growth, gives our clients the best shot at meeting their distribution goals.