CAPSTONE investment financial group, inc

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Consider the Impact of Inflation on Your Financial Plan

Would you purchase $10 billion of five-year U.S. Treasury inflation protected securities (TIPS) at auction with a yield of negative 0.55%, in effect, paying the U.S. government to take your money?

When that happened October 25, 2010, the message was clear. Investors expect that the Federal Reserve's announced intention to create inflation will be effective. Effective to the point of substantially recovering the loss incurred at the initial purchase of the securities through the TIPS' increase in yield over time to match inflation.

After two years of government intervention to get the economy back in gear and lower unemployment, the Federal Reserve stepped in at its November meeting to initiate Quantitative Easing II with a very specific goal – to spur inflation at a sustainable rate of 2%. In comparison, for the first three quarters of 2010, U.S. inflation, as measured by the Consumer Price Index, averaged just above 1%.

Inflation at its most basic is a broad rise in the prices of goods and services that reduces purchasing power.

Inflation encourages people to buy more today, moving purchases forward in time. When it works as intended, inflation-produced demand drives a ramp up in production, creating new employment opportunities from the manufacturing floor to the sales room.

Extending this same reasoning to the housing market, inflation could stabilize sales prices and create

continued on page 2

Bubbles and the Investor

The greatest destroyer of wealth over the centuries is a tight race between wars and investment bubbles. Both situations are a result of human nature and government actions and tend to produce collateral damage well beyond the primary event. In an effort to understand investment bubbles and the signs that may help identify the next bubble, we present the following, with the caution that bubbles are easiest to recognize with hindsight. Some of the best minds in the financial industry have found anticipating a bubble impossible, including former Federal Reserve Board chairman Alan Greenspan.

The most famous bubbles have included:

- 1634-1637 – Tulipomania
- 1711-1720 – South Sea Bubble
- 1717-1721 – Mississippi Scheme

continued on page 3

Resolve to Plan

"Good plans shape good decisions. That's why good planning helps to make elusive dreams come true."
Lester R. Bittel

For many people, retirement may seem an elusive dream. But part of what can make that dream elusive is if it stays a dream, not a plan. To retire, you have to achieve financial security. That starts with understanding what financial security is to you. How much money will you need in retirement to live the way you would like to?

The next step is to put together a plan to create that financial security. Begin by visiting www.choosetosave.org/ballpark. Ballpark is an easy-to-use online worksheet designed to help you quickly identify approximately how much you need to save to fund a comfortable retirement. There are other retirement calculators out there that will do much the same, but we like Ballpark for its non-profit, educational structure.

Completing a retirement calculator substantially increases the odds that you will retire financially secure. People who put together a plan for retirement save more than those who fail to plan.

Keep in mind that Ballpark is a very simplistic starting point. To put a good financial plan for retirement in place, contact our office and let's sit down and take an in depth look at your situation. Without good information, you can't be sure that the decisions you make today are the right ones. Start 2011 off with the information you need to achieve a secure retirement.

Consider the Impact of Inflation on Your Financial Plan — *continued from page 1*

increases in housing prices, spurring a recovery in an area viewed with the most concern by many economists. If foreclosed homes can be sold for higher prices, losses will be less for banks, mortgage investors – including Freddie Mac and Fannie Mae – and ultimately the U.S. taxpayer. With sufficient improvement in home values, home building will make sense again, generating construction jobs.

Inflation will be good news for borrowers because they can repay their debts with currency that is worth less. Higher inflation also tends to push up wages, making it easier to pay off fixed-rate loans. For local, state and federal governments, higher wages mean increased tax revenues, providing more funds to pay off accumulated debt and to fund increasing costs.

> ***"Inflation is not such good news if you are retired, however, even if 2% may seem like a manageable annual increase."***

Inflation erodes the value of savings

Deliberately creating inflation could open Pandora's box. Will the Fed be able to control inflation at its 2% target? In targeting a sustainable 2% rate of inflation, the Federal Reserve uses the median Consumer Price Index. The median CPI disregards price changes in food and energy, two factors that have considerable influence on household budgets.

Another issue, is the tool the Fed will use to create inflation – quantitative easing. Quantitative easing (QE) essentially floods the market with excess cash by printing money to purchase federally insured debt. The first round of Quantitative Easing took place throughout 2009, as the Fed bought up distressed mortgage-backed securities from banks in exchange for cash, taking the Fed balance sheet of securities from $800 billion to $2.2 trillion.

Interest rates and value of U.S. dollar will be affected

In addition to spurring inflation, QE II is expected to drive long-term interest rates lower and continue the decline in the value of the U.S. dollar. While lower interest rates benefit borrowers, they penalize creditors. Many investors are creditors through their investments in income producing bonds and debt securities.

A lower U.S. dollar will make U.S. exports more attractive in international markets but has the potential to increase imported energy and food costs as well as the costs for a vast array of products imported from other nations.

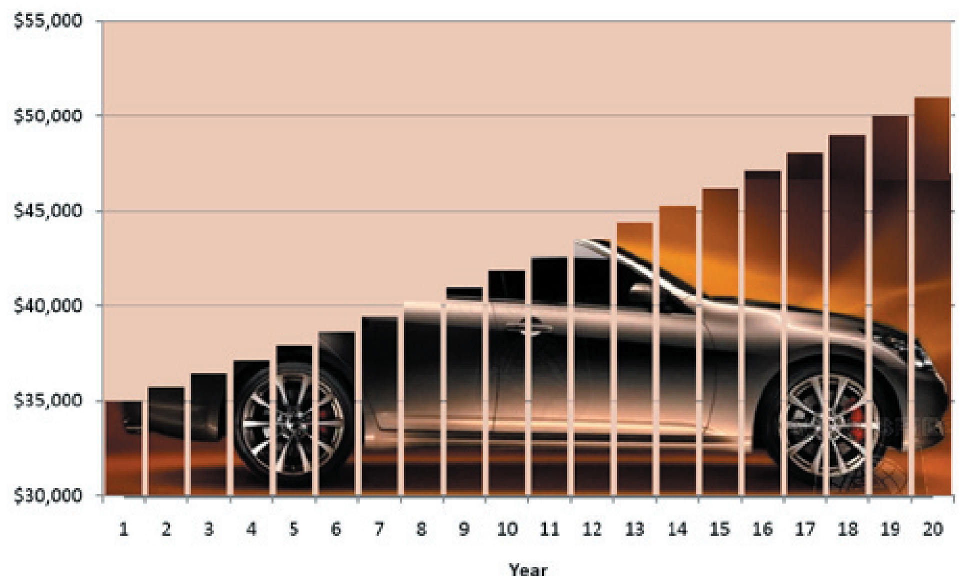
By lowering the yield of Treasuries and other safe debt instruments, the Fed encourages investors to put their money into different, potentially higher-yielding investments. Investment in equities and high-yield debt will increase funds available to businesses to expand. The risk to investors in moving from relatively low risk/low return securities to higher return/higher risk investments is that they fail to understand the risk they are assuming for that higher return.

Factoring inflation in a portfolio

In uncertain times, capital preservation has to be a primary consideration. The current market uncertainties will pass and there will be opportunities to profit with lower risk, but only if your capital is kept intact. Preserving and optimizing capital through risk managed investing is essential.

Investments cannot be selected based on what has worked in the past, but what is working now. Any investment in equities must be made with an exit plan in place. Short-term debt, which gives the investor the flexibility to reinvest when interest rates rise, Treasury Inflation Protected Securities (TIPS) that adjust to keep pace with changes in the consumer price index, and floating-rate debt are tools to consider.

These are tricky markets to negotiate. Before you invest in these or other investments suitable to inflationary times, talk with your financial adviser, understand your risk exposure and remember, times change. Don't lock yourself into positions from which you cannot recover.



2% inflation adds up over time. A car that cost $35,000 in year 1, will cost $37,000 in year 5, $41,000 in year 10 and $45,000 in year 15.

Bubbles and the Investor — *continued from page 1*

- 1840s – Railway Mania
- 1920s – U.S. Roaring Twenties Market
- 1970s – Nifty Fifties
- 1980s – Biotech stocks
- Late 1980s – Japanese stocks
- 1987 – Taiwanese stocks
- Late 1990s – Internet stocks
- 1990-2000s – Real Estate
- 2008 – Commodities
- 2010s – Gold??

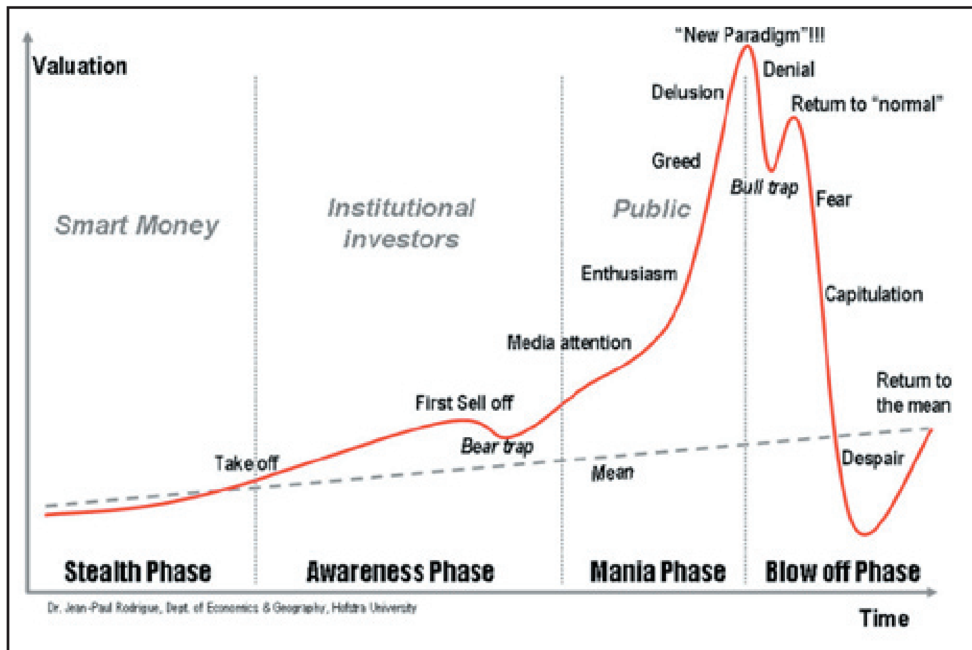
In **Investment philosophies: successful strategies and the investors who made them work,** by Aswath Damodaran, the author identifies four stages to a speculative bubble.

Phase 1: In the Birth of the Bubble, comes a kernel of truth. The market provides positive reinforcement of the argument and more investors pile in.

Phase 2: The Sustenance of the Bubble is provided by institutional investors – from investment banks, brokers and analysts, portfolio managers and the media. Bubbles make for an exciting investment story, one that is easy to sell. Ultimately academia joins the rush, providing intellectual support for why old rules no longer apply and why the bubble has staying power. New paradigms are presented.

Phase 3: The Bursting of the Bubble is typically the result of a confluence of factors. At some point, the supply of vulnerable new investors runs short. Each new investment opportunity into the bubble is often more outrageous than the previous one. The first hint of doubt among the true believers turns quickly to panic as reality sets in. Well-devised exit strategies break down as everyone heads for the exit doors at the same time. The same forces that created the bubble cause its demise. The speed and magnitude of the crash tend to mirror the formation of the bubble.

Phase 4: The Aftermath often starts as complete denial. As time passes and investment losses from the bursting of the bubble become too large to ignore, the search for scapegoats begins.



Dr. Jean-Paul Rodrigue, Dept. of Economics and Geography, Hofstra University, presents the phases of a bubble in a slightly different format in the graphic above.

The problem with bubbles is that when they collapse, so does the broader market, in part because the bubbles are typically the stocks or leverage propelling the market upward. Even when investors enter a bubble market with the intent to sell at the first sign of weakness, computerized models and trading accelerate the speed with which the initial bubble collapses, making it more difficult for the general public to avoid catastrophic losses.

The persistence of bubbles over time is one of the main reasons active management is so important to investors. If we accept that human nature tends to produce cycles and periods of extreme values, then it only makes sense to put in place investment strategies that seek to take advantage of bubbles by riding the up move and minimize participating in falling markets or seeking investments that avoid the highs and lows of bubble driven markets.

Minimum Distribution Requirements are Back

In 2008, Congress suspended minimum distribution requirements from qualified retirement plans for 2009 for retirees age 70½ and over. That suspension is now over. If you turned 70½ during 2010, your first distribution must be made by April 1st, 2011.This ability to delay distribution until April of the next year is only available for the first year distributions are required. All other distributions should be made by December 31st.

To calculate the minimum amount, the Internal Revenue Service requires your account balance as of the previous Dec. 31 be divided by your remaining life expectancy. Actuarial tables can be found online in IRS Publication 590 and should be used based on your current age. You can always withdraw more, but you must withdraw the minimum or be subject to a 50% excise tax on the amount you should have taken. For more information, or to make certain you are making adequate distributions from your retirement account, please contact our office.

Use First Time Jobs to Fund a Roth IRA for Your Teen

Was the teenager in your family employed in 2010? If so, it may be a good time to fund a Roth IRA for that individual. To fund an IRA, your teen must have earned money in a manner that can be substantiated, whether from a summer job or part-time work after school. The lesser of the total amount earned or $5,000 can be contributed to the Roth IRA.

While the same amount could be contributed to a regular IRA, a Roth has some advantages that work better for young savers. With a Roth IRA, contributions are after-tax. The contribution to a regular IRA can be deducted from current income. The lack of a tax deduction for a Roth contribution typically doesn't matter for young earners, however, whose income is likely to be taxed at very low rates, if at all. (An unmarried dependent child's standard deduction will automatically shelter up to $5,700 of earned income – for 2010 and 2011 – from federal income tax.)

In addition, Roth IRAs have some special provisions that can be very beneficial for young savers. The first benefit is simply the ability to potentially accumulate a substantial nest egg by retirement through compounding over 50 years. A $5,000 annual contribution made for five consecutive years, compounded at 6% annually would be worth $411,240 in 50 years. Under the Roth IRA structure, the original $25,000 in contributions and the accumulated earnings will be free of federal income taxes.

Second, after five years, a Roth IRA account holder can withdraw all or part of regular Roth contributions – without any federal income tax or penalty – to pay for college or for any other reason. Roth earnings can be withdrawn tax-free if they meet the five-year test and one of four types of qualified distributions:

- Distributions made on or after the date the accountholder reaches age 59½.
- Distributions made to a beneficiary after death.
- If the account holder becomes disabled, distributions attributable to the disability.
- "Qualified first-time homebuyer distributions."

In addition to helping a young person accumulate funds for retirement, a first home, or a serious need, establishing a Roth IRA is a great way to start a teenager on the path of saving. While a parent or someone else can provide the money used to fund a Roth IRA (provided the individual in whose name the account is set up has verifiable earned income), it's important to make certain the individual contributes funds as well. You want them to take a sense of ownership in the account and the actions that cause it to grow in value.

CAPSTONE
investment financial group, inc

615 North Nevada Ave.
Colorado Springs, CO 80903
Phone: 719-477-9883
Toll Free: 888-571-3713
4643 S. Ulster St.
Suite 800
Denver, CO 80237
Phone: 720-363-2434
info@capstoneinvest.com
www.capstoneinvest.com

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