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Third Quarter Overview
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The Quarterly Report

Reflections on the Past Year It's now widely understood that we've been living through a period for the financial history books. The stunning failure of major financial institutions (Fannie and Freddie, Lehman, AIG, Washington Mutual, and others) in August and September of 2008 triggered a series of events that almost resulted in the collapse of the global financial system. In the months that followed, market volatility was the highest since the 1930s, resulting in stunningly rapid shifts in investment risks and opportunities. *As a result, over the last year we made more tactical portfolio shifts than we had ever made over any other 12-month period in our history as financial advisors.*

Just over a year ago, we wrote to our clients as the crisis intensified to explain how the stock market was behind the curve in pricing in the damage to the financial system and the economy, and that further stock-price declines could be material and develop quickly. Rather than rebalancing our portfolios to take advantage of lower equity prices, we remained underweight, which proved prudent. (Stocks eventually bottomed in March 2009.)

In communications throughout the year, we walked through our thinking and also discussed why our portfolios had at times performed poorly in 2008. We also believe it is fair to take credit for good decisions we've made and over the last year we believe we've had a very strong run of winning tactical decisions. The most important tactical move we made over the last year was to take a sizable position in high-yield bonds. Since March, the funds we bought have returned over 36%. High-yield bonds are not the type of position one might think of holding during the busting of a debt bubble. However, the asset class had been crushed and our analysis suggested strong returns.

Returns of Major Indexes	3rd Qtr. 2009	12 Months
Vanguard Total Bond Market Index	3.67%	10.49%
Vanguard 500 Index	15.60%	-6.86%
iShares Russell 2000 Index	19.25%	-9.38%
Vanguard Total International Stock Index	19.67%	4.65%

Challenges in the Present and Future Evidence now strongly suggests that the recession ended sometime this summer. However, that does not mean that we are assured a lengthy period of robust growth that will quickly return the economy back to its long-term growth trend line and support a sustained bull market for stocks.

> ***"Patience and fortitude conquer all things."***
> **~ Ralph Waldo Emerson ~**

As we look ahead there are a few thoughts we'd like to leave you with. First, we believe the last year underscores the appeal of tactical asset allocation. As we've stated over the years, great fat-pitch tactical opportunities come along only occasionally, but when they do, they can provide an opportunity for a significant performance advantage over the long run. Second, our approach to tactical allocation requires a multi-year time horizon. We will not always be rewarded quickly so patience is required—a critically important investment trait that is lacking among many investors. We were fortunate with our high-yield move. We did not have to wait long in the asset class before underperformance turned into outperformance. Other times we have had to wait for many months or over a year. But over the years our track record has been strong in terms of ultimate success.

Finally, when making tactical moves, we are by definition investing our portfolios differently than their benchmarks because we believe it makes investment sense to do so. This therefore requires a willingness among investors to accept results that are different from the benchmark. Over time, if we can continue our long-term success, this different performance will mean periods of outperformance will more than offset periods of underperformance, resulting in overall long-term outperformance. But shorter-term, we will enjoy and suffer through both types of periods.

Be assured, we remain focused on making the best decisions possible in a still-challenging and complex market and economic environment. Thank you for your continued trust and confidence. ~ **RWT** ~

Tax Tips for Year-End 2009

As we move into year-end planning, consider the following tax tips:

Account for refinancing. Some of you may have refinanced your mortgage taking advantage of lower rates which results in a lower-interest deduction. Also, if you used any of the proceeds for something other than physical improvements to your home, that amount may be subject to the alternative minimum tax (AMT). On the brighter side, remember that points paid in prior refinancings that you didn't already deduct can be deducted in the year you refinanced again.

2009 Federal Limits for Retirement Accounts		
Account	***Contribution limit***	***Catch-up contribution***
401(k), 403(b) & 457	$16,500	$5,500
SIMPLE IRA	$11,500	$2,500
Qualified Retirement Plans/Keogh & SEP-IRA	20% of net self-employment income (or 25% of compensation), up to $49,000	None
Individual 401(k)	20% of net self-employment income (or 25% of compensation) plus $16,500, up to $49,000	$5,000
Traditional IRA & Roth IRA	$5,000	$1,000

Prepay quarterly estimated state tax payments. If you're not vulnerable to the AMT, consider paying your fourth-quarter 2009 estimated state income taxes (plus any estimated balance due) by December 31 so you can take the deduction on your 2009 taxes. If you pay your February installment of property tax by December 31, you can take it as a deduction on your 2009 return. Again, watch out for the AMT, which disallows these deductions.

Alternative Minimum Tax – Ouch! We are finding more and more clients facing AMT. If you're one of these taxpayers, you might want to flip the typical strategy of deferring income and accelerating certain deductions. Instead, try to defer payment of state and local taxes and accelerate income to the point where you're no longer subject to the AMT. Multiyear planning is a must—talk to us or your tax professional.

Harvest losses. No one likes a losing investment. But at tax time, they can be blessings in disguise, as you can use capital losses to offset taxable capital gains. Look in your taxable accounts for investments with relatively large losses where you don't expect a comeback. Remember, any losses you can't use to offset gains this year can be carried over into future tax years. One word of caution: Watch out for the so-called wash sale rule, which prohibits taxpayers from recognizing losses on sales of securities that are repurchased within 30 days.

Make the most of tax-advantaged accounts. It is time to ignore your emotions and bring your asset allocation back in line with your overall retirement goals. You can do this without incurring taxes by rebalancing in tax-deferred retirement accounts like IRAs or 401(k)s.

Take full advantage of your employee retirement plan, at least to the point of any employer match. And if you're 50 or older, make a catch-up contribution. Make your annual IRA contribution too. Even though you have until next April 15 to make your 2009 contribution, the sooner the better—your money will have more time to benefit from potential long-term compound growth. Then, make your 2010 contribution early next year. Consider a Roth IRA if you're eligible, especially if you're not eligible for a deductible traditional IRA contribution.

Act before year-end. For 2009, you can give up to $13,000 each to as many individuals as you wish this year and pay no gift tax. Spouses can "split" gifts for a total of $26,000 per beneficiary, per year. This may allow you to put more in your child's College 529 Plan.

Give appreciated securities or cash. Consider your blessings and share with your church, synagogue or favorite charity. Yes, you receive a tax deduction but you may also touch a life that changes someone's future.

Whether some or all of these suggestions fit your situation, we're only scratching the surface here. Call or schedule a meeting to discuss in more detail if needed. After you decide what to do this year, resolve to make financial planning a year-round exercise going forward (you've probably got better things to do around the holidays). That way, it'll be easier to check your progress, update your plan and, if necessary, take action long before the ball falls in Times Square on New Year's Eve. *[Schwab.com]*