# Nicholson Financial Services

## Did You Know...?

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The Markets started 2008 off with a sell off in January that surely rattled many investors. However, the Federal Reserve took action by cutting key interest rates by 1.25% for the month. In addition, the government has pushed through the well publicized stimulus package. Through all this, my message to clients has remained the same. Take a long-term view of the markets, make sure you are properly diversified, and check that the style and class of the investments you own are in line with your goals and risk tolerance. Volatile markets can be nerve-wracking. However, you'll be best served by reviewing your goals and plans and, if found to be sound, sticking to them.

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***In this issue:***



## The U.S. Dollar and Your Portfolio

The U.S. dollar has struggled over the last few years. The Canadian dollar recently reached parity with the greenback for the first time in three decades. In October 2000, the euro was worth 82 cents. Last year it hit a record $1.45 and kept going, while the British pound sterling was at a 25-year high. (All statistics are from the Federal Reserve system.) According to the Federal Reserve Board of Governors, as of last August the dollar had dropped 26% (adjusted for inflation) against the major industrialized nations' currencies, and 7% against key emerging-market currencies, since early 2002.

| Change in Value of U.S. Dollar Jan. 1 to Nov. 30, 2007 | |
|---|---|
| Euro | -10.8% |
| Yen | -7.7% |
| Canadian dollar | -15.1% |
| Pound | -5.4% |

*Data source: OANDA Corporation*

If you have no plans to travel abroad, don't eat imported out-of-season fruit, and buy only domestic cars, a weaker dollar may not worry you. However, a falling dollar can lead to rising inflation. Not only can it affect the price of commodities such as oil, but with the higher cost of overseas products, domestic manufacturers may feel more comfortable raising prices. And inflation can lead to higher interest rates, which could affect everything from credit cards to mortgage rates.

A diluted dollar also can affect your portfolio. If you've held international investments in the last few years, you may have caught a tailwind. Past performance is no guarantee of future results, of course, and there are special risks to global investments, including not only currency risks but also political risks and different accounting standards. Risk factors vary considerably by country and region, and as with any investment, you can lose some or all of the funds you invest.

However, returns produced in part by the dollar's decline are one reason investing globally has become popular. According to the Investment Company Institute, more than 90% of the $160 billion of net new money added to stock mutual funds in 2006 went into funds investing in foreign companies.

**Looking over the hedge**

A mutual fund that invests overseas may or may not try to hedge against currency fluctuations. Some are managed to try to minimize the impact of exchange rates; others deliberately do not hedge their currency exposure. Your preferred approach will depend on your view of the dollar's future and how much currency exposure you want in your portfolio. A weaker dollar may boost an unhedged fund's performance because the fund holds securities denominated in other currencies. However, an unhedged fund would suffer more from any dollar recovery. Obtain and read a fund's prospectus carefully before investing.

**Domestic can also be global**

A weak dollar makes U.S. companies' products cheaper abroad, which has benefited many large multinational corporations that are headquartered here but have substantial overseas sales. According to Standard & Poor's, roughly 44% of the 2006 revenues of companies in the S&P 500 Stock Index came from international sources; in 2001, that figure was 32%. Even companies without overseas operations may benefit. For example, with higher prices for overseas goods, some distributors and retailers have begun to find less expensive U.S. suppliers. Also, a weak dollar in the past has made some U.S. companies targets for foreign acquisition.

**What goes down can come up**

The dollar goes through cycles, of course. A stronger economy, higher U.S. interest rates or lower rates abroad, foreign currency crises, market turbulence, or lower federal deficits could help boost the dollar's value. When determining your overall asset allocation, consider both your currency exposure and your level of international investments.

## How Well Are You Navigating the Efficient Frontier?

Investing isn't just about achieving the highest return possible; it's also about the tradeoff between return and risk. Modern portfolio theory (MPT) is based on a key assumption: No rational investor wants to take more risk than is necessary to achieve the desired return. The concept was outlined by Harry Markowitz in a pioneering 1952 *Journal of Finance* study titled "Portfolio Selection," which argued that you can manage the type and level of risk you take by combining investments that tend to behave very differently from one another.

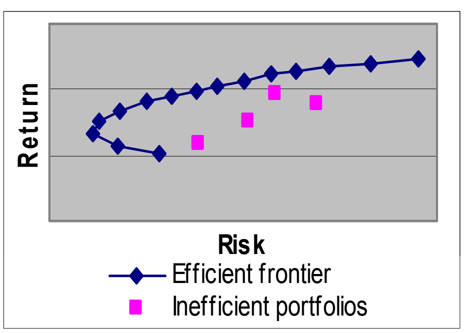
**Different strokes for different folks**

Modern portfolio theory tries to create portfolios that maximize return for a given level of risk--or alternatively, that minimize risk for a given level of return. MPT compares a portfolio's standard deviation--how much its return may vary from its statistical mean return over time--to its returns. An efficient portfolio navigates the risk/reward tradeoff by combining investments based on their level of risk, their expected return, and their correlation with other investments in the portfolio. MPT argues that a portfolio that doesn't do so isn't optimized--in other words, it takes too much risk for the return it provides.

***In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal.***

**Efficiency is in the eye of the beholder**

Even with a limited number of securities, the ways to combine them into a portfolio are practically limitless. For any group of assets, there may be multiple efficient portfolios, each of which combines those assets differently. Collectively, they represent what economists and financial professionals call "the efficient frontier." On a chart, the efficient frontier is a line that represents all optimized portfolios for a given group of assets. That line is actually a series of points; each represents a portfolio that provides the best return for whatever risk you are comfortable taking.




The efficient frontier represents all of the combinations of a given group of assets *that combine risk and return most efficiently*, expressing that tradeoff in graphic form. In a sense, the efficient frontier functions like a global positioning system (GPS) for investing, showing the most efficient way to get to your goal. Each GPS user may choose a different destination, but in each case, the GPS suggests the most effective way to get there.

**So what is risk anyway?**

Risk has traditionally been measured by volatility; an asset whose price varies dramatically is considered riskier than one that is more stable. However, some experts have begun to question whether a portfolio can be better optimized by focusing on downside risk, arguing that such an approach more closely matches the way investors tend to think.

Unlike MPT, this so-called "post-modern portfolio theory" concentrates not on how an investment's return deviates from its statistical mean--its ups and downs--but on how often its returns fall below an individual investor's minimum acceptable return, how far below that figure they fall, and the potential worst-case scenario possible for that investment. Outlined in *Managing Downside Risk in Financial Markets* by Frank Sortino and Stephen Satchell of the Pension Research Institute, this approach attempts to combine portfolio theory with behavioral finance, hoping to more closely reflect the human decision-making process.

Depending on how risk is measured--by volatility or by downside risk alone--the efficient frontier may look very different, even for the same group of assets.

**The balance is up to you**

Whichever approach is taken, the efficient frontier still doesn't tell you which assets are right for you, or in what combination. Only you can decide where you want your portfolio to be along the efficient frontier, and what type and level of risk you're willing to take.

Though past performance is no guarantee of future results, it can help serve as a guide when developing an appropriate asset allocation. Using data about past and anticipated returns of various assets as well as estimates of their volatility or downside risk, your financial professional can position your portfolio at the point along the efficient frontier that makes sense for you.

## Will You Pay Taxes on Your Social Security Benefits?

Did you know that you might have to pay federal income tax on your Social Security benefits? If Social Security was the only income you had during the year, then your benefits generally won't be taxable. However, if you or your spouse worked and had any earned income during the year, or if you had other substantial income (such as investment income), then a portion of your Social Security benefits may be taxable.

**Gather information**

Your benefits are taxable if one-half of your Social Security benefit plus your other income (called your "combined income") exceeds a certain amount (called the "base amount"). To determine if your benefit is taxable, you need to know three things: (1) how much you received from Social Security during the year, (2) your combined income, and (3) the base amount for your filing status.

**Find out how much you received from Social Security**

Each January, the Social Security Administration (SSA) will send you a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits you received during the previous year. You'll need to use this information to figure out whether any of your benefit will be taxable.

**Calculate your total income**

Once you know how much you've received from Social Security, it's time to calculate your combined income. This figure includes the following:

- One-half of Social Security benefits received
- Other income including wage income, and taxable interest and dividends
- Tax-exempt interest income
- Income that's normally excludable--interest from qualified savings bonds, employer-provided adoption assistance, foreign earned income or foreign housing, and income earned by bona fide residents of American Samoa and Puerto Rico

The IRS has a worksheet you can use to calculate your combined income and determine whether or not your Social Security benefits are taxable. You can find this worksheet and more information about the taxation of Social Security benefits in IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

**Compare your combined income against the base amount for your filing status**

Once you've calculated your combined income, you must compare that against the base amount for your federal income tax filing status. If your total income is less than the base amount, then your Social Security benefits won't be taxable. If your combined income is more than the base amount, then part of your benefits will be taxable. Base amounts aren't indexed for inflation, so they're the same year after year.

Your base amount is:

- $25,000 if you file as single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for the entire tax year
- $32,000 if you file as married filing jointly
- $0 if you file as married filing separately and you lived with your spouse at any time during the tax year

For example, let's say your combined income for the year was $30,000 and you file your taxes jointly with your spouse. Because your combined income is less than the base amount for your filing status, $32,000, your benefits won't be taxable.

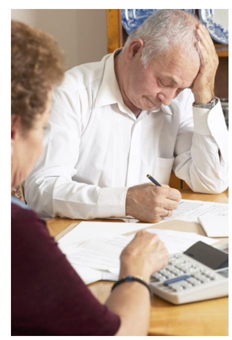
**How much of your benefit is taxable?**

Even if your combined income exceeds the base amount for your filing status, you won't have to pay taxes on the entire amount of benefits you've received. Generally, up to 50% of your benefits will be taxable, but if your combined income is more than $34,000 ($44,000 if you are married filing jointly), or if your tax filing status is married filing separately and you lived with your spouse at any time during the tax year, up to 85% of your benefit will be taxable. Again, see IRS Publication 915 for worksheets you can use to figure your taxable benefits.

Keep in mind that taxation of Social Security benefits can be complicated. Different rules apply to certain U.S. citizens and nonresident aliens living abroad and in other situations. If you have any questions, consult your tax professional.

***Did you know?***

*Social Security benefits were not subject to federal income taxation until 1984. They became taxable as a result of the 1983 Amendments to the Social Security Act.*



***Tax withholding***

*You can have federal income taxes (but not state income taxes) withheld from your benefits if you so choose. Complete IRS Form W-4V and select the percentage that you want withheld (7%, 10%, 15%, or 25%), then return it to your local Social Security office.*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## Ask the Experts

### I'm planning a cruise to the Caribbean this winter. Do I need a passport?

Not yet. New passport rules requiring passports for all land and sea travel between the United States and Mexico, Canada, the Caribbean, and Bermuda were originally scheduled to take effect in January of 2008. But a massive backlog of passport applications (caused by another requirement that all travelers flying to these destinations have a passport by the fall of 2007) prompted the federal government to delay implementation of the new rules until sometime between the summer of 2008 and June of 2009. The precise implementation date will be announced later, with at least 60 days notice given.

In the meantime, beginning January 31, 2008, Americans traveling by land or sea to Mexico, Canada, the Caribbean, or Bermuda will need to show a government-issued photo ID, such as a license, and a birth certificate or other proof of citizenship.

And if you're planning to travel by land or sea to any of these destinations later this year or in 2009, consider applying for a passport as soon as possible. The State Department reports that the current wait time is 4 to 6 weeks, but recommends allowing 10 weeks during busier times like the summer travel season (during peak application periods in 2007, waiting times reached 16 weeks). The State Department estimates that 23 million passport applications will be filed in 2008, and 30 million in 2009. So don't delay.

For more details, visit the State Department's website at http://travel.state.gov and click on the link "Passports for U.S. Citizens," or call the National Passport Information Center toll free at 1-877-487-2778.

### How do I apply for a passport?

In most cases, you'll need to apply for a passport in person, which you can do at one of the more than 9,000 public places nationwide that accept passport applications, typically U.S. post offices and government offices. For a list of facilities near you, check the State Department's website at http://travel.state.gov.

You must apply in person if: (1) you are applying for a passport for the first time, (2) your previous passport was lost, stolen, or damaged, (3) your previous passport was issued more than 15 years ago or when you were under age 16, (4) your name has changed since your passport was issued and you don't have a legal document formally changing your name, or (5) you are under age 18.

When you apply, you'll need to provide: (1) a completed one-page application, which can be obtained at the passport acceptance facility, most travel agent offices, or from the State Department's website, (2) proof of U.S. citizenship (a certified birth certificate is acceptable), (3) proof of identity, such as a valid driver's license, (4) two recent, identical passport photos (many passport acceptance facilities offer photos on site), and (5) a fee of $97 for adults or $82 for children age 15 or younger. Passports are valid for 10 years for adults or 5 years for children age 15 or younger.

In some cases, you may be eligible to apply for a renewal passport by mail. The fee is $67. If you need a passport quickly (2 to 3 weeks), you'll need to file an expedited application, which costs an additional $60. And if you have a "life and death" emergency involving serious illness, injury, or death in your immediate family that requires you to travel within 24 to 48 hours to a country that requires a passport, you must appear in person at one of a handful of Passport Agencies for emergency service. Call the National Passport Information Center at 1-877-487-2778 to schedule an appointment at the Passport Agency nearest you.