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In this issue:

A Mid-Year Financial Review: More Time to Plan

Evaluating Risk in Your Portfolio

How Much Life Insurance is Enough?

I started a business that lost money this year. Do I have NOL?



A Mid-Year Financial Review: More Time to Plan

Mid-year is an ideal time to take a look at your finances, because the demands on your time may be fewer, and the planning opportunities greater, than if you wait until the end of the year. Here are a few tips to get you started.



Identifying your needs

Financial plans often need to be modified when personal circumstances change. Answering these questions can help you identify the financial issues you want to address within the next few months.

- Are any life-changing events coming up soon, such as marriage, the birth of a child, retirement, or a career change?
- Will your income or expenses substantially increase or decrease this year?
- Are you concerned about the performance of your investment portfolio?
- Do you have any needs or concerns that you would like to address?

Tax planning

Completing a mid-year estimate of your income tax liability can reveal tax-planning opportunities. You can use last year's tax return as a basis, then make any anticipated adjustments to your income and deductions for this year. Check your withholding, especially if you owed taxes when you filed your most recent income tax return or if you received a large refund. Doing that now, rather than waiting until the end of the year, will help you avoid a big tax bill or having too much of your money tied up with Uncle Sam. If necessary, adjust the amount of federal or state income tax withheld from your paycheck by filing a new Form W-4 with your employer.

One of the easiest things you can do right now to help avoid missed tax-saving opportunities for the year is to set up a system for saving receipts and other tax-related documents. This

can be as simple as dedicating a folder in your file cabinet to this year's tax return so that you can keep track of important paperwork.

Retirement planning

If you're working and you received a pay increase for this year, don't overlook the opportunity to increase your retirement plan contributions by asking your employer to apply a higher percentage of your salary. This year, you may be able to contribute up to \$16,500 to your retirement plan at work (\$22,000 if you're age 50 or older). If you have a traditional IRA, you may also want to weigh the benefits of converting it to a Roth IRA this year, when you may be able to take advantage of a special deferral rule that applies only to 2010 conversions. This deferral rule gives you the option of reporting half of any resulting taxable income that results on your 2011 tax return and half of the income on your 2012 return.

If you're already retired, take a new look at your retirement income needs and whether your current investments and distribution strategy will continue to provide enough income.

Investment planning

Have you recently reviewed your portfolio to make sure that your asset allocation is still in line with your financial goals, time horizon, and tolerance for risk? Though it's common to rebalance a portfolio at the end of the year, if the market is volatile, you may need to rebalance more frequently.

Insurance planning

Do you know exactly how much life and disability insurance coverage you have? Are you familiar with the terms of your homeowners, renters, or auto insurance policies? If not, it's time to add your insurance policies to your summer reading list. Insurance needs frequently change, and it's possible that your coverage hasn't kept pace with your income or family circumstances.

Evaluating Risk in Your Portfolio

If you're like most people, you probably evaluate your portfolio in terms of the return it earns. However, as we were all reminded in 2008, returns aren't the only factor you should consider when determining whether your portfolio is allocated appropriately. Also important is the level of risk you take in pursuing those returns.

There are a number of ways to estimate the level of risk in a portfolio. The term "risk" is often used interchangeably with "volatility" (the tendency of a portfolio's value to rise or fall sharply, especially within a relatively short period of time). However, for most people, a portfolio is simply a means to an end—paying for retirement or a child's college tuition, for example. In that context, "risk" also means the risk of not meeting your financial needs.



Volatility measures

One of the most common measures of volatility is standard deviation, which gauges the degree of an investment's up-and-down moves. It shows how much the investment's returns have deviated from time to time from its own average. The higher the standard deviation of an investment or portfolio, the bumpier the road to those returns has been.

Another way to assess a portfolio's volatility is to determine its beta. This statistic compares a portfolio's ups and downs to those of a benchmark index, such as the S&P 500, and indicates how sensitive the portfolio might be to overall market movements. An investment or portfolio with a beta of 1 would have exactly as much market risk as its benchmark.

The higher the beta, the more volatile the portfolio. A beta of 1.05 means the portfolio involves 5% more market risk than the benchmark to which it's compared. If the benchmark rises 10%, a portfolio with a beta of 1.05 should theoretically rise 10.5%; a fall of 10% in the benchmark should mean a corresponding 10.5% decline in the portfolio.

A 0.95 beta means a portfolio has 5% less market risk than that index; in theory, the portfolio would rise and fall 5% less than the benchmark. (However, remember that investments also have unique risks that are not related to market behavior. Those risks can create volatility patterns that are different from the underlying benchmark.)

The risk of not achieving your goals

Another way to evaluate risk is to estimate the chances of your portfolio achieving a desired financial goal. In this case, "risk" means not volatility but the odds that your portfolio will succeed in meeting a specific financial liability. A technique known as Monte Carlo simulation uses computer modeling based on multiple scenarios for how various types of investments might perform based on their past returns. Though past performance is no guarantee of future results, such a projection can estimate how close your plan might come to meeting a future target amount.

Let's look at a hypothetical example. Let's say Bob wants to retire in 15 years. A Monte Carlo simulation might suggest that, given his current level of saving and his portfolio's asset allocation, Bob has a 90% chance of achieving his retirement target. If he chose to save more, he might increase his odds of success to 95%. Or Bob might decide that he's comfortable with having an 85% chance of success in reaching his target amount if that also means his portfolio might be less volatile. (However, be aware that though a projection might show a high probability that you'll reach your financial goals, it can't guarantee that outcome.)

Are you getting paid enough to take risk?

Another approach to thinking about portfolio risk involves the reward side of the risk-reward tradeoff.

You can compare a portfolio's return to that of a relatively risk-free investment, such as the inflation-adjusted return on a short-term (3 months or less) U.S. Treasury bill. Modern portfolio theory is based on the assumption that you should receive greater compensation for taking more risk (though there's no guarantee it will work out that way, of course). A stock should offer a potentially higher return than a Treasury bond; the difference between the two returns is the equity's risk premium. A small-cap stock that's relatively new should offer a higher risk premium than a well established, dividend-paying stock. While understanding risk premium doesn't necessarily minimize risk, it can help you evaluate whether the return you're getting is worth the risk you're taking.

Whatever your approach to portfolio risk, understanding the nature and level of the risks you face can be critical in sticking to a long-term investing strategy.



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How Much Life Insurance Is Enough?

Your life insurance needs often depend on a number of factors, including whether you're married, the size of your family, the nature of your financial obligations, your career stage, and your goals.

There are a number of approaches you can use to figure out how much insurance you should have. One method, called the "family needs approach," focuses on the amount of life insurance it would take to allow your family to meet its various financial obligations and expenses in the event of your death.

Family needs approach

With the family needs approach, you divide your family's financial needs into three main categories:

- Immediate needs at death, such as cash needed for estate taxes and settlement costs, credit card and other debts including mortgages (unless you choose to include mortgage payments as part of ongoing family needs), an emergency fund for unexpected costs, and college education expenses.
- Ongoing income needs for expenses related to food, clothing, shelter, and transportation, among other things. These income needs will vary in amount and duration, depending on a number of factors, such as your spouse's age, your children's ages, your surviving spouse's capacity to earn income, your debt (including mortgages), and whether you'll provide funds for your surviving spouse's retirement.
- Special funding needs, such as college funding, charitable bequests, funding a buy/sell agreement, or business succession planning.

Once you determine the total amount of your family's financial needs, you subtract from this total the available assets that your family could use to defray some or all of their expenses. The difference, if any, represents an amount that life insurance proceeds, and the income from future investment of those proceeds, can cover.

Example: John and his wife, Wendy, are estimating the appropriate amount of life insurance to buy on John's life. They first estimate their immediate needs as follows:

- Final medical expenses: \$5,000
- Estate settlement costs including funeral and burial expenses: \$37,500

- Debts, including credit cards and mortgages: \$317,000

- Emergency fund: \$100,000

Subtotal: \$459,500

Next, they estimate ongoing income needs, such as:

- Providing for their dependent children's needs for a period of time: \$500,000

- Wendy's income needs until her retirement: \$450,000

- Wendy's retirement income needs: \$380,000

Subtotal: \$1,330,000

Adding the sub totals together, John and Wendy estimate that, should John die, their family would need \$1,789,500. They then determine that assets available to offset their needs include:

- Bank savings: \$40,000

- Investments: \$220,000

- Retirement assets: \$250,000

- Existing life insurance on John's life: \$300,000

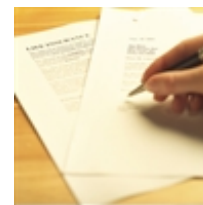
Subtotal: \$810,000

The difference between their family needs (\$1,789,500) and their available assets (\$810,000) equals their life insurance need (\$979,500).

Review your coverage

Trying to figure out how much life insurance is enough isn't always easy, and that amount will likely change with your changing circumstances. By examining your family's anticipated expenses during various periods after your death, you get a more realistic estimate of your life insurance needs.

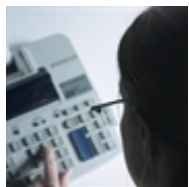
Unfortunately, many people underestimate their insurance needs and are underinsured. Often, the purchase of life insurance is based on cost instead of what's needed. By the same token, it's possible to have more insurance than you need. You may have purchased a large policy during a particular point in your life, and then didn't adjust your coverage when your insurance need was reduced. Both of these circumstances are reasons to review your insurance coverage periodically with your financial professional. Doing so can reveal opportunities to change your levels of coverage to match your current and projected life insurance needs.



An insurance coverage review is a periodic reassessment of your insurance needs. The main objectives are to confirm that the level of insurance coverage you have is still adequate, to alert you to shortages in coverage that can occur due to changes in your life, and to ensure that any cash value policies are performing as expected.



Ask the Experts



I started a business that lost money this year. Do I have a net operating loss (NOL)?

If you're a sole proprietor and your business expenses exceed your business income, you have a reportable loss for income tax purposes. You're generally able to apply this loss against any wage income or other business income that you have (wages are considered business income) and any nonbusiness income (e.g., interest) that remains after taking your allowable nonbusiness deductions. If you still have a business loss remaining after offsetting all your income, you have a "net operating loss" for the year. The net operating loss (NOL) calculation is very complicated, though. For example, certain items, like personal exemption deductions and other nonbusiness deductions, aren't allowed in calculating an NOL.

The general rule is that you get to carry back an NOL for 2 years. This means that you can apply the NOL as a credit against income that was earned in--and reported on the tax returns

for--the 2 years preceding the year in which you have the net operating loss. Any remaining loss is carried forward for up to 20 years after the year in which you have the NOL. You can, however, choose not to carry back the NOL to the prior 2 years and simply carry forward the entire NOL.

While NOLs are generally allowed to be carried back 2 years, special rules apply to NOLs incurred in 2008 and 2009 that allow NOLs to be carried back for up to 5 years. There are also exceptions to the general 2-year carryback rule, and alternative minimum tax (AMT) implications. Even in the most straightforward cases, NOLs are complicated.

If you have an NOL, you'll want to read IRS Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*, and the instructions for IRS Form 1045, *Application for Tentative Refund*. You should also consider discussing your situation with a tax professional.

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Is it too late to take advantage of the special 2009 net operating loss (NOL) rules?

The Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA) included a provision that allows almost all taxpayers with business losses to make an irrevocable election to carry back losses incurred in *either* 2008 *or* 2009 for up to 5 years (the election can only be made for 1 year, however). Specifically, you're able to elect to extend the general 2-year NOL carryback period to 3, 4, or 5 years; NOLs carried back 5 years can offset up to 50% of the taxable income from the fifth year, and 100% of the taxable income from the other carryback years.

Even if you took advantage of a similar provision in earlier legislation to carry back a 2008 NOL, you're still able to elect to carry back a 2009 NOL under the provisions of the WHBAA. Certain taxpayers are specifically excluded from making the election, however. For example, any business in which the federal government acquired an equity interest pursuant to the Emergency Economic

Stabilization Act of 2008 (i.e., a "TARP" recipient) is not eligible. Special rules apply to insurance companies.

If you're a calendar-year filer, you have to make the WHBAA election by the due date of your 2009 federal income tax return, including extensions. This deadline applies regardless of whether you're making the election for a 2008 NOL or a 2009 NOL. If you filed your 2009 federal income tax return by April 15, 2010, without making an election, you have until October 15, 2010, to do so.

You can make the election in one of two ways. You can attach an election statement to the federal income tax return or amended return for the tax year in which the loss is incurred. Or, you can attach the election statement to the carryback form itself (1040 filers would use Form 1045 or Form 1040X). Your election statement must contain specific language. You can find more information by checking the IRS website (www.irs.gov) or by talking to a tax professional.

