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BFAS Money Line

Improving?

The economy and the market finished last year on the up-swing. **After dropping by 7% the first six months of last year, the market rose 23% in the second half** on expectations of the election outcome in November and the tax extension in December. With the federal stimulus running out and business not yet picking up the slack, the economy will likely slow down this year.

Jobs are improving very slowly but the **unemployment rate will stay high for years** (notwithstanding the recent drop caused by millions of people no longer looking for work). The job outlook in private business is improving but massive budget problems will cause reductions in government jobs at all levels.

Housing is still stuck in neutral, except locally where the prediction is for a further 18% drop in prices (I hope they are wrong). Housing has such a large impact on jobs that the slow housing market will continue to retard job growth.

Then, there is the **threat of overseas problems**, like the current Middle East turmoil, impacting our economy. Any potential disruption in the Middle East causes oil prices to shoot up and that hurts our economy.

Having said all that, a number of commentators are bullish on our stock market. I'm much more moderate in my bullishness. **I think we might have an up year, but expect gains to be modest**.

I believe the **Federal Reserve policies are inviting inflation and forcing the dollar to drop**. This makes our exports cheaper, raising exports and improving jobs. It also allows us to repay our huge debt to foreigners in depreciated dollars. From an investing standpoint, **a dropping dollar should make foreign stocks and bonds especially attractive in the next year or two.**

U.S. bonds have been doing well for a long time. With interest rates at their lowest in many decades, U.S. bond returns of the past were much better than you can expect in the future. Interest rates have nowhere to go but up. With interest rates rising, bond values will come down. Bonds will still pay their coupon interest, their prices will just decline. Bill Gross, manager of PIMCO Total Return fund says to expect U. S. bond returns of 2% - 3% in the next year or two.

Bonds are an important diversifier in portfolios. Should you bail on bonds due to low expected returns? Should you hold more stocks since they have been doing well lately?

While stocks have done well recently, no one has suspended the business cycle where recessions happen every four years on average. So, another recession is in our future even though we don't know when. What we do know is that bonds cushion the

portfolio when stocks are dropping. Thus, holding bond positions gives you modest returns when stocks are soaring and provides an anchor when stocks are in stormy waters.

The question, then, is **what bonds to hold?** Some argue that you should hold short term bonds since they are least affected by rising interest rates. But, these bonds are paying very little today. Others say hold high yield bonds, but these low-quality bonds typically drop right along with stocks (thus not a good diversifier). I would argue that **holding foreign bonds make more sense since they are not affected by our interest rates and they may be the beneficiaries of a dropping dollar.**

Some of you may remember the debt crisis in Greece, Ireland and other European countries and not look kindly on foreign bonds. However, looking at what foreign bond managers are purchasing, I don't see these countries represented. That's what we pay the bond managers to do, avoid those poor performing bonds in countries in trouble.

Some people see individual company "winners" in the recovery and are tempted to "pick" individual stock winners. There is certainly no shortage of talking heads or print commentators who encourage this. I will remind those so inclined that **General Electric lost 86% in the last recession and Bank of America lost 93%.** These are not obscure companies; they are long established bell weathers. The S & P 500 index was down 56% while corporate bonds were only down 4% and high yield bonds were down 28%.

Congress is considering reducing the current budget by $100 billion. While this is better than nothing, it represents only 3% of the federal budget. For every dollar of revenue this year, the federal government is spending $1.66. Great Britain, faced with similar debt situation, made 20% cuts to spending. Many people demonstrated there.

Our Congress does not appear to have the intestinal fortitude to make similar cuts here, much as they are needed. If virtually everyone isn't impacted and there aren't demonstrators on the streets, the cuts aren't nearly deep enough. **Currently, Congress is just proposing modest changes around the edges, not the wholesale cuts including entitlement programs that are desperately needed.**

As you see below, the last year was good for equities, especially small and midsized ones.

Asset Class	1 Yr Rtn (01/31/11)
S & P 500	+ 22.19%
NASDAQ	+ 25.74%
Lg Cap Gwth	+ 23.77%
Lg Cap Val	+ 19.77%
Mid Cap Gwth	+ 32.40%
Mid Cap Val	+ 27.60%
Sml Cap Gwth	+ 33.55%
Sml Cap Val	+ 29.40%
Foreign	+ 17.53%
Interm Corp Bds	+ 6.33%
Foreign Bds	+ 6.38%
Commodities	+ 27.27%

Odds and Ends

Income Tax Impact – Congress in December extended the current income tax law while drafting higher exemptions for estate taxes. Although the extension and new estate tax law only apply to 2011/2012, there are a number of planning opportunities to address.

Roth IRA conversions are still a worthy strategy since tax brackets will stay the same. Consider converting just enough to stay in the same tax bracket and only as much as you have cash to pay the taxes.

Social Security (FICA) tax is reduced 2% this year. Use that extra money to **contribute to your 401(k)/403(b) plan or a Roth or Traditional IRA.**

Dividend and capital gains tax rates stay at 15% for 2011/2012. Continue deferring paying these taxes. Don't sell unless there is a legitimate investment reason to do so.

The **estate tax continues but only for those with estates greater than $5 million for individuals, $10 million for couples and only at a 35%** tax rate for the amount over $5 ($10) million. Since this estate tax rate only covers 2011/2012, you have two years to do some planning. The current law would bring back a $1 million exemption in 2013 with a 55% estate tax rate. Spouses can carry over the unused portion of the $5 million exemption. Thus, a spouse dying with $3 million allows the remaining

spouse to exempt $7 million with no “special” legal language.

With estate tax law possibly in flux, I don’t recommend making permanent changes in your estate planning just to take advantage of this two year window of opportunity. **One exception though, would be those who have sufficient resources to live on and are interested in gifting to younger generations. You can gift up to $5 million this year or next year.** Then, if the estate tax exemption drops to $1 million in 2013, you have a much smaller estate to possibly be taxed at 55%

What if you have life insurance set up to pay estate taxes? Due to the temporary nature of the increased exemption, I don’t recommend changing your life insurance plan. **If Congress makes these new changes permanent, then you might want to revisit your life insurance plan.**

College Planning – Remember to fund your college 529 plans. One change this year; you **can’t spend 529 money on computers, software or internet connections (unless specifically required by the college).**

Reverse Mortgages – these mortgages have been around for years. However, they have been improved recently and are worth a second look. A regular mortgage typically costs about 2% - 3% of the loan in closing costs. A reverse mortgage cost 6% - 7% in the past but has recently dropped to about 5% - 6%.

Due to the high cost, getting a reverse mortgage is not a short term solution to a money problem. It can, however, be a solution for a healthy person who wants to stay in the home for an extended time. The money from the reverse mortgage can be used for anything (pay for taxes, home repairs, medical expenses, new car, living expenses, etc.).

You **must be 62** or older to qualify and you **must either have no mortgage or must use the reverse mortgage to pay off your existing mortgage.** Here are some situations where a reverse mortgage makes sense:

- **You are in good health, plan to stay in your house at least five – to –ten years, have no mortgage, need additional income to meet living expenses.**
- **Your income just meets your needs but your house needs a new roof or windows or siding.**

Here are some situations where a reverse mortgage might NOT make sense:

- **You are in ill health and may not be able to stay in your home much longer**
- **You foresee moving closer to relatives or to a retirement community soon.**
- **Your insurance agent has recommended this to pay for a life insurance policy or annuity**
- **Your existing mortgage is higher than the amount available**

from a reverse mortgage

Indexed Annuities – I have written about indexed annuities before. These are heavily promoted to seniors by insurance agents using marketing practices that would be illegal if an investment advisor did the same thing. Often, this pitch is made over a meal at a fine restaurant. The unsophisticated seniors are told (falsely) that the indexed annuity will provide market returns with no downside risk. Who could say no to that?

A recent paper by Kent Smetters, a professor of insurance at Penn's Wharton School says, "these annuities are terrible ideas for older people even though they are peddled to them". The psychology of downside protection with upside potential sells really well, but **the products are very complicated and expensive**.

These annuities pay the agents **commissions of up to 12%, may lock up your money for 15 years just when you need it, and cap the upside so that you never really get the market return**. One contract sold to a 75 year old tied up her money until she was 87 unless she paid a 15% penalty to withdraw her own money. During the five years she owned it, the market rose 35% but her return was 15%.

William Reichenstein, professor of investments at Baylor Univ. says **indexed annuities tend to underperform a lower-risk strategy of rolling over CDs, "because of the high cost embedded in these things".**

Recently, the SEC tried to regulate indexed annuities and make them conform to investment standards. The insurance lobby scotched the effort. Be warned, if it sounds too good to be true, it probably is! Don't suspend your common sense!

Tax Benefits for Special Needs

Medical Expenses: if your child has medical diagnosis of a neurological disorder (intellectual disability, autism, ADHD) the following may qualify:

- **Tuition at private school**
- **Tutoring by specially trained individuals**
- **Diagnostic evaluations**
- **Specialized materials (books, software, etc.)**
- **Therapy (physical, speech, remedial reading)**
- **Transportation expenses to private school**

Other medical expenses that may qualify:

- **Exercise program (if prescribed by Dr.)**
- **Diapers**
- **Special beds, car seats, etc.**
- **Parent's attendance at a disability related conference (admission, transportation, books and materials)**
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Special diets (gluten-free or casein-free) are deductible to the extent the cost is higher than similar item at grocery store.

Child and Dependent Care Credit – if your child has a disability, the age 13 limit may not apply. This credit (20% - 35% (varies by family adjusted gross income) of expenses up to $3,000 per child) covers regular child care, after-school programs, and daytime summer camps. Payments to a relative for child care count as long as the relative is not a dependent of the taxpayer.

Earned Income Credit – Low income families may qualify based upon the number of children and filing status. There is no age limit for the children if they are severely disabled and live with parents.

Remember that related caretakers, such as grandparents, or aunts, and non-relative caretakers such as foster parents may also qualify for some tax benefits. Expenses claimed as a medical expense deduction, then later reimbursed by an insurance company must be reported as taxable income (in the year received).

Remember that medical expenses must exceed 7.5% of adjusted gross income to be deductible. Also, you can file an amended return for unclaimed tax benefits for up to three years (refund for 2007 can be filed by April 2011).

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