February 2013 Volume 18.1

BFAS Money Line

Bull Market?

With the fiscal cliff behind us, **the market has climbed 5% thus far this year**. Does that mean we are in a new bull market? Is it time to dump bonds and move to stocks?

Bonds have certainly gone nowhere thus far this year. Plus, we've heard for years that bonds are going to fall in value when interest rates start back up. However, the Federal Reserve has stated that interest rates won't be raised until unemployment drops below 6.5%. That is unlikely to happen this year. Thus, **bonds should be relatively safe for this year with returns roughly equal to their interest rates**.

With stocks taking off, why not just put all our chips on them and eliminate the lower returns of bonds? As stocks have risen (**S & P 500 at 1510 as I write this**), commentators have pointed out that the **market was at 1527 in March 2000 and 1565 in October 2007**. The assumption is that buying now would be buying high with the inevitable drop to come soon.

Are stocks overvalued, undervalued or fairly valued? Based upon price alone, you might think stocks are once again overvalued. However, the **price should be considered in the context of earnings**. The long term average price-to-earnings (P/E) ratio is 15. Back in March 2000, the forward P/E was 25.6. In October 2007 the P/E was 15.2; today it's 13.3.

The market was very overvalued in 2000 and subsequently dropped 49% over 2 1/2 years. In 2007, the market wasn't overvalued, but dropped anyway due to corporate earnings being in freefall. Corporate earnings are currently at historic highs; hence the relatively low forward P/E currently.

So, the question is, are stocks overvalued because earnings are about to drop due to a recession, undervalued due to a lower than normal P/E, or fairly valued due to corporate inability to increase earnings much more than they are today? **My take is stocks are fairly valued**.

The reason I'm not ready to pile on the stock bandwagon is Congress. They have the sequestration and deficit fights to resolve in the next two months. Decisions Congress makes could tip us into recession or lay the foundation for sustained improvement in the economy. Once Congress comes to some sort of agreement, I'll be a lot more comfortable with which direction to move portfolios.

I believe that, **if the appropriate policies are put into place this spring, it would be prudent to move from US bonds to US and foreign stocks and foreign bonds later this year.**

As you see below, smallcap and midcap stocks as well as foreign stocks have caught up with large cap stocks. Commodities continue to lag:

Asset Class	1 Yr Rtn (01/31/13)
S & P 500	+ 16.78%
NASDAQ	+ 11.67%
Lg Cap Gwth	+ 13.70%
Lg Cap Val	+ 16.48%
Mid Cap Gwth	+ 13.47%
Mid Cap Val	+ 17.51%
Sml Cap Gwth	+ 12.39%
Sml Cap Val	+ 15.52%
Foreign	+ 15.65%
Interm Corp Bds	+ 5.52%
Foreign Bds	+ 5.11%
Commodities	- 1.13%

Odds and Ends

New Tax Laws – The fiscal cliff compromise left most tax rates the same for those making $200k (single) or $250k (married). For those making over $400k (single) or $450k (married), there is a new 39.6% tax bracket and they will pay 20% on capital gains. Those with incomes below those amounts will continue paying 15% on capital gains (0% for those in the 10% and 15% tax brackets). Qualified dividends will continue to be taxed at capital gains rates.

After patching the Alternative Minimum Tax exemption amount year after year, Congress finally set the exemption amount to a higher level and added inflation adjustments. This will keep many middle income tax payers from having to pay Alternative Minimum Tax.

The new law reduces itemized deductions and personal exemptions for married couples making over $300k. The itemized deduction reduction doesn't apply to medical expenses, investment interest, casualty or theft losses or gambling losses. Your other itemized deductions are reduced by 3% of the amount by which your Adjusted Gross Income (AGI) exceeds the threshold. However, you can't lose more than 80% of your itemized deductions.

Your personal exemptions are reduced by 2% for every $2,500 over the $300k threshold; **thus you lose all of your personal exemptions at $425k for married folks.** ***For planning purposes, if you are at that income level and have a child in college, you might come out ahead if you don't claim a dependency exemption for that child. Since your income will be too high to claim an education credit for tuition, you might have the child pay tuition (assuming they earned enough taxable income) even if the money comes from you. Then the child can take the education credit on his or her return. Dollar for dollar, this will probably save more taxes for the family.***

Those making over $250k married/$200k single will also pay an additional 0.9% Medicare tax on income above those amounts. Note: Obamacare also imposes a **3.8% tax on investment income if you make over $250k/$200k per year**. *These two taxes, as well as the higher bracket when you hit $450k/$400k, are worth some additional tax planning.* ***If you have the opportunity to reduce your AGI by deferring more of your income into a 401(k) or similar plan, you should seriously consider taking advantage of that option.***

Estate Tax – One of the biggest uncertainties as the fiscal cliff neared was the estate tax. It was scheduled to go from taxing estates above $5.12 million to taxing estates of $1 million. I'm happy to report that the compromise set the **new estate tax exemption to $5.25 million for 2013 and will adjust it for inflation going forward**!

That means **a couple can shield up to $10.5 million before the new 40% estate tax comes into play**. In addition, they made permanent the option of one spouse carrying over the exemption from the other spouse. Say one spouse had $1 million in assets before passing away. If the executor files an estate tax return (required to get the portability even if no taxes are owed), the remaining spouse will be able to exempt $6.25 million instead of just $5.25 million.

By making portability of the estate tax exemption permanent, estate planning is somewhat simpler. Many of us have Bypass Trusts set up in our estate documents to "protect" the estate tax exemption of the first spouse to die. **Portability makes the use of Bypass Trusts unnecessary to protect the second exemption. However, there are other reasons to keep a Bypass Trust (protection from**

creditors, protecting assets in blended families, etc.) See your legal counsel to discuss the new estate tax law on your estate plans.

The **gift tax annual exclusion is now $14,000 ($28,000 for couples**). Please remember that paying tuition or medical expenses directly does NOT count towards this $14,000 limit.

One option that was only extended to 2013 is the option to gift up to $100,000 from your IRA directly to a charity if you are over 70 1/2. Thus, charitable distributions from your IRA can fulfill your Required Minimum Distribution this year.

I like this option because it reduces income on the first page of your tax return, thus lowering your AGI. That might have a better impact than taking the distribution from the IRA and then gifting to a charity. In that case you realize the income on your 1040, then deduct the charitable deduction on Schedule A (if you itemize). With the new phase out rules for itemized deductions, you might not even get all of that charitable deduction.

Thus, if you are over 70 1/2 and give to charities, give serious consideration to doing it from your IRA this year!

Social Security – Some people have worked and saved enough to contemplate retiring early. They often **wonder how early retirement might affect their Social Security benefits later on**. You can find out just how much (or little) the impact will be by going to **www.socialsecurity.gov/OACT/anypia/anypia.html**. This detailed calculator allows you to put in a few bits of data and show you what you can expect in retirement benefits whenever you choose to retire. Since Social Security calculates your benefit based upon your 35 highest earning years, you'll probably be surprised at how little early retirement will change your future Social Security retirement pay.

Remember that **taking SS retirement at 62 reduces your income by 25% from your full benefit while waiting until age 70 increases your benefit by 32% higher than your full benefit.** The difference between age 62 benefits and age 70 benefits can dramatically change your standard of living while in retirement (making the difference between living at the poverty level or at twice the income of the poverty level)!

Are divorced spouses eligible for Social Security benefits from a former spouse? Yes! If you were married at least 10 years, divorced for two years and did not remarry, you are eligible for your benefits from your former spouse's SS record.

If you did remarry and divorced your second spouse (after 10 years), you can choose whichever spouse would provide the higher SS spousal benefit. If one of your former spouses died, you get the higher of a spousal benefit from the living ex-spouse or widow's benefit from the deceased ex-spouse. Note: If you did remarry after age 60 and are still married, you are eligible for spousal benefits from your current spouse OR a survivor benefit from your deceased ex-spouse, whichever is higher!

Some have worried that taking such a benefit lowers the amount this ex-spouse and/or their current wife/husband might receive. That is not the case. A divorced spouse's benefit has NO affect on the former spouse's benefits.

Some people have worked for federal, state or municipal governments that chose not to participate in Social Security. They may receive a government pension while their spouse might receive a SS retirement benefit. They may be surprised to find that they are not eligible to receive a full spousal or widow's benefit.

This is because Congress passed a law that established a **Government Pension Offset (GPO**). This says that since one spouse worked but never contributed to SS, your SS spousal or widow's benefits will be reduced by 2/3 of your government pension. This is something you might want to check out before retirement so that you will be prepared for the lower income than you might have expected!

Behavioral Finance - Some people use financial advisors because they are too busy with their lives to spend time focusing on financial issues. They hire people like me to focus on issues like investments, retirement planning, college planning, tax planning, estate planning, insurance planning. They depend upon the financial advisor to keep up-to-date on all the myriad changes in all the above areas.

Most people have the intelligence to do that themselves. However, those who try to do it themselves often fall victim to behavioral issues.

Three big things that financial advisors bring to financial advice are: helping to clarify goals, holding you accountable to the goals you set, getting between you and your emotions.

Goal setting can be hard. You have to deal with risk and the chance of failure. If married, you have to deal with a spouse's feelings also. An outside person help you deal with what can be emotionally complex discussions, push you harder to commit to goals and provide a reality check.

Goals are just that if they are set and forgotten. Having an outside person ask about the progress you've made towards your goals helps keep you on track.

Every human is susceptible to greed and fear emotions as they watch the stock markets gyrate or hear a seductive pitch for the next "hot" financial product. **Having an advisor can put someone between your emotions and your money!**

How Things Work

A couple of years ago, I wrote about a then-new concept of Microboards (26 existed then) for people with disabilities. **Microboards act as a Circle of Support (including having Guardianship), can select whatever provider agency is best for the person AND can oversee the housing either in the parent's home or in a home purchased by the Microboard**.

Those using Microboards are setting up small corporations (LLC, S Corp or C Corp) to have a formal structure for the person's support. If housing is needed, the Microboard can apply for loans from the Virginia Housing Developmental Authority (VHDA). **Typically, people using Microboards are eligible for a Medicaid Waiver but it's not a requirement. There also may be more than one person with disability living in the house and each might have their own Microboard.**

Knowledge of how to set up and operate a Microboard has resided in a handful of individuals who have been working the process already. However, **a state-wide association, Virginia Microboard Association (VMA) is currently forming.**

VMA's mission is to promote the creation of Microboards for individuals with disabilities in keeping with the principles of self-worth, dignity, advocacy, person-centered planning and freedom of choice. The VMA plans to provide training and assistance, education, administrative assistance and a method to connect to other Microboards.

They are interested in attracting members who are currently using Microboards, those considering using them, and those who might facilitate the process. To learn more about VMA email virginiamicroboards@gmail.com or call 757-460-1569.

Edited and Published by:

Ronald S. Pearson, CFP®, AEP®

Beach Financial Advisory Service

6204 Ocean Front Ave.

Virginia Beach, VA 23451

(757) 428-6634

E-mail: ron@beachfas.com