November 2012 Volume 17.4

BFAS Money Line

Election Impact

Now that the annoying phone calls have stopped, pretty much everyone is focusing on the **fiscal cliff**. With virtually the same make up in Congress, will they find common ground on major issues that have languished for four years? The can has been kicked down the road about as long as it possibly can be. **The day of reckoning is January 1st and only a lame-duck Congress stands in the way.**

Why is the fiscal cliff important? Virtually **every economist says that the sharply increased taxes and spending cuts scheduled to commence in January will spark another recession**. Recessions generally cost millions of jobs and stimulate stock market drops of 30% - 40%.

Thus, the worst case scenario is for us to go over the fiscal cliff. I don't believe a lame-duck Congress will forge a "grand compromise" during the two weeks they have available for legislating. I believe the **best case scenario will be for Congress to defer the fiscal cliff for a short period of time (six months?) to give the new Congress an opportunity to develop the "grand compromise".**

What sort of "grand compromise" might we see? I have no clue. However, whatever comes out needs to reduce the uncertainty that is preventing businesses from expanding, needs to reduce the deficit by trillions, and needs to do all this in a way that allows the economy to continue growing.

The economy is currently limping along too slowly to reduce unemployment very much. The government is out of stimulus bullets. Instead of trying "incentivize" business into hiring more people, the government would achieve far better results with more business-friendly policies.

Consequently, **investing in the current situation is fraught with danger.** Worst case scenario is a recession with a steep market drop; best case is continued below-normal economic growth with modest market increases. **Thus, for investments, there is great downside risk and not a lot of upside unless/until we make some hard choices on tax and spending policies**.

Note that neither party ran on a platform of reforming our entitlement programs. Currently, entitlement programs absorb 2/3 of every dollar of government revenue. Everything else (defense, education, housing, etc.) is funded by the remaining 1/3 plus borrowing ($1 trillion last year).

Even the most ambitious fiscal compromises (tax increases/spending cuts) would only reduce the deficit $4 trillion over ten years, or $400 billion/year. This leaves

us with unsustainable and continuing $600 billion/year deficits. To get to fiscal balance would require extremely painful reductions of about 25% in entitlement programs.

Congress doesn't get elected by making the hard choices so they will avoid them until bond holders will no longer buy Treasury bonds because they see a default in our future. Then, interest rates will rise steeply and our interest on the national debt will gobble up dramatically larger amounts of government income. The solutions then will be far harder than the painful ones available now.

I do believe that there are some policy choices that could stimulate the economy and be the **beginning of the next bull market**. Yes, there is a bull market in our future; the only question is how soon. The housing market is recovering already. If we **eliminated tax and spending uncertainty, put the economy on a glide-path to fiscal balance, and stabilized the regulatory regime, we could spark a strong and sustained recovery**.

As you see below, QE3 has driven the dollar down which helped foreign stocks but not commodities. Large companies have performed better than mid and small companies:

Asset Class	1 Yr Rtn (10/31/12)
S & P 500	+ 15.21%
NASDAQ	+ 10.91%
Lg Cap Gwth	+ 10.10%
Lg Cap Val	+ 13.70%
Mid Cap Gwth	+ 7.72%
Mid Cap Val	+ 12.57%
Sml Cap Gwth	+ 8.95%
Sml Cap Val	+ 11.42%
Foreign	+ 4.61%
Interm Corp Bds	+ 7.32%
Foreign Bds	+ 7.04%
Commodities	- 4.44%

Odds and Ends

Working in Retirement – Those in the 55 - 69 age group have gained nearly 3.5 million jobs in the last four years while everyone else has lost just over 2.5 million. Surprising isn't it?

In 2008, 35% of people 65 - 69 were working while 53% were retired. For those 70 - 74, 21% were working and 70% were retired. There were 13% still working for the 75 - 79 group.

The Census Bureau doesn't say whether those seniors still working were doing so because they loved to work or to make up for market losses in their retirement accounts. I encourage working after 65 for those who derive psychological and social benefits from doing so. Additionally, for those who have either not saved enough for retirement or who need to regain from market losses, each year of work after 65 dramatically improves their ability to retire successfully.

Real Estate – One of the bright spots in our economy these days is real estate. Prices seem to have bottomed out. New home inventory is back to historical norms. Mortgage rates are at historic lows.

Real estate values recently rose 10% in hard-hit California. While the overall improvement is uneven and very local, I believe **real estate is probably the best buy we have seen in many years**.

Having evaluated real estate investments for clients over many years, I am finally seeing properties that make sense financially (positive cash on cash returns). **Does that mean you should dump your stock market investments to purchase real estate? No!**

Real estate is not a liquid investment. You can't carve off a corner of a house to pay for a new car. Also, as we recently learned, real estate doesn't always go up. **I usually don't recommend more than about 30% of a person's net worth be invested in real estate**. Typically, a person's home makes up a larger percentage of their net worth than that. Thus, real estate investing is probably not the best choice for most people.

Immediate Annuities – In today's up and down market purchasing an immediate annuity can certainly seem to be safer while providing a steady income stream. For example, John and Martha, ages 64 and 62, purchase an immediate annuity that will pay them a **guaranteed 6% return every year.** They **put $500,000 into the annuity and will receive $30,000 every year for the rest of their lives**. This income plus their Social Security will support their lifestyle.

This certainly sounds reasonable since earning 6%

annually while eliminating the uncertainty of the markets sounds better than what the stock market has been doing. But, while the stock market has been on quite a roller coaster, it has earned 6.34% over the past ten years.

On the other hand, **the annuity does not really have a 6% return. When you buy the annuity, you lose 100% of your original investment. Thus, for the first 15 years, the annuity is simply giving you back your original purchase price.**

The biggest selling point for an annuity is a lower return in exchange for a guarantee. But, when you analyze the transaction, you see the purchase price is a loss you can never recover from. If you calculate the internal rate of return (IRR) of the annuity, for the first 15 years, the IRR is 0% because the insurance company simply hands you back your own money.

Most immediate annuities are not indexed for inflation. Much of their appeal is have at least some stream of guaranteed spendable income. But, guaranteed to buy what? The $30,000 guaranteed to John and Martha loses buying power to inflation every year.

How does buying power affect you? $5,081 in 1970 had the same buying power as $30,000 today. Imagine thinking in 1970 that your future was guaranteed by purchasing an immediate annuity. Now, here you are at 104 and you are **trying to live off of a sixth of what you needed when you began retirement! In Martha's case, at 4.5% inflation, her $30,000 per year would have the buying power of $11,000 when she is 85.**

Most financial advisors would recommend that John and Martha spend only 4% - 5% ($20,000 - $25,000 per year) of a diversified $500,000 portfolio. A 4% - 5% withdrawal rate, rising with inflation every year, would maintain purchasing power over John and Martha's lifetimes. The 4% withdrawal rate has a 100% success rate based upon historical portfolio returns (even including the Great Depression). The 5% withdrawal rate has a failure rate of about 30%, which some people find an acceptable risk trade off for the higher annual income. **Yes, the annuity provides higher income in the early years but much lower income (spending-wise) in later years**.

Taxes – The following table shows the new maximum tax rates for 2013:

	2012	**2013**
Ordinary Income	35%	43.4%
Dividends	15%	43.4%
Capital Gains	15%	23.8%
Payroll Tax	4.2%	6.2%
Estate Tax	35%	55%
Estate Tax Exemption	$5.12 million	$1 million

In the August newsletter, I discussed the possibility of harvesting capital gains this year to pay a lower tax rate than is coming in 2013. I also discussed the possibility of converting ordinary IRAs to Roth IRAs. Finally, I discussed the

possibility of gifting assets to heirs this year to take advantage of the higher Estate/Gift tax exemption amount. Each of these options may or not make sense depending upon your specific situation (current tax bracket, tax bracket in retirement, cash to pay taxes incurred, need for the income now versus leaving assets for heirs, etc.).

I recommend each of you discuss the pro's/con's of using these techniques with your advisors before the end of the year (I will be contacting my ongoing clients).

College Planning - In today's world, there are many blended families. Children from these families have some additional complications when applying for college financial aid.

For public colleges, financial aid calculations in a divorce situation usually only consider the "custodial family" of the student. On the other hand, private colleges may well ask for the non-custodial parent's financials. Thus (all other things being equal)**, if the student is considering a public college, living with the lower asset/earning parent will likely maximize financial aid**.

Another consideration, though is that the **step-parent's income/assets will be counted as part of the household's finances**. Also, step-siblings are counted as members of the student's household if they reside with the student. Finally, the number of college students in a household may reduce the family's Expected Financial Contribution (EFC) by 40% to 50%. Thus, having multiple college age student siblings in the same household would be better financially than having them split between their divorced parents.

How Things Work

Correction!! Last quarter I pointed out that there are some new rules for trustees of **Special Needs Trusts (SNTs)**:

- **the trust may no longer compensate certain family members who provide care to the beneficiary with a disability**
- **the trust may no longer pay for travel costs of relatives to visit the beneficiary**
- **if the trust purchases a house or a car, they must be owned by the beneficiary or the trust.**

While this is true, **it ONLY applies to self-settled trusts (SNTs set up with the beneficiary's own money).** Third party trusts (set up with money from parents, grandparents, etc.) MAY pay for travel costs, etc.

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Many people prefer to **use a family member as a trustee of their Special Needs Trust because it is less expensive than paying a commercial trustee and the family member will know the special needs child better.** Unfortunately, family members have minimal experience as trustees.

Family member trustees might not understand their obligations to keep accurate and detailed records, invest the money responsibly, refrain from "self-dealing" as well as commingling trust assets with the trustee's assets, and filing trust tax returns. The family member also must understand the limitations that Supplemental Security Income (SSI) and Medicaid put on spending the trust's assets. Mistakes could cause loss of benefits and/or make the trustee personally liable for the financial consequences.

Oftentimes, a family will choose a caregiver as trustee to simplify the process of enhancing the child's quality of life. However, a gentle and loving caregiver may not have the financial sophistication to understand the SSI/Medicaid rules as well as keeping detailed records of the trust, investing it, and filing taxes for it.

A caregiver might have their hands full just care giving. Adding the trustee task might be more than they can handle. Sure, most family members will do the job for free; but once they see the work involved, they can legally take a fee from the trust if they choose to do so.

I'm not saying you should never have a family member trustee. I'm just saying **you should give the decision careful thought**. Don't be penny wise and pound foolish!

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