Our Two Cents

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The New Tax Package and Your Portfolio

On Dec. 16, 2010, Congress approved $801 billion in tax cuts and $57 billion for extended unemployment insurance. It includes other tax breaks, such as college tuition credit for some families, an expanded child tax credit, and the earned income tax credit. Here is how some of these changes may impact your portfolio.

Social Security Tax: The one-year payroll tax cut would reduce the Social Security tax to 4.2% from 6.2%. Although this was intended to increase consumer spending levels and stimulate the economy, a better option would be to increase your contribution to your 401k plan to match your employer's contribution, at a minimum, if you do not need extra cash in the near future. The contribution limit for 401k plans remains at $16,500 for those under 50, and $22,000 for those age 50 or older.

Dividends/Capital Gains Tax Rates: Dividend and long-term capital gains taxes will remain at 15% for the next two years. Many had suggested selling securities in your portfolios that were projected to have huge capital gains before the end of 2010, since the capital gains tax rate was projected to increase to 20%. Now, you can sell your securities if your investment strategy dictates.

Estate Taxes: The new tax package sets new estate tax parameters with an exemption of $5 million per person, or $10 million per couple, and a maximum rate of 35% for the next two years. You should speak to your financial advisor about creating an estate plan that will detail how you would like your assets distributed after you are gone, and who should act on your behalf should you become disabled.

Dividends are not guaranteed and are paid solely at a company's discretion. Please consult with your tax professional for specific tax advice.

Advisor Corner

RFM Financial Solutions, LLC
Registered Investment Advisors

Michael Harter
CPA/PFS, CFP®
mharter@robertfmurray.com
989-772-1209
www.rfmfinancialsolutions.com

This will prove to be critical year for investors.

Much of the volatility in last year's markets was a direct connection to the European financial woes. This has not been solved to date.

We have in front of us one of the most important presidential elections. Never before does there appear to be such a divided direction for our country. The recent economic woes have pushed people and industries to look at the government for solutions and support.

Our capital markets while not perfect have allowed investors and businesses a mechanism to grow to be rewarded for risk that they incurred.

I encourage you to get involved in this year's political events. Do your own research and make your voice known!

What Is Up with Gold?

With the runup on gold during the past few years, many investors have been enamored with its short-term performance and are aching to jump into it. Never mind that gold itself has almost no intrinsic value or that the price is largely determined by what other buyers are willing to pay. The past decade, with market crashes and uncertainty, has caused many investors to flee to the safety of gold, but looking longer term, gold might not be as attractive as it appears. An investment of $100 in stocks beginning in 1980 would have grown to $2,838 by November 2011. That $100 invested in bonds over the same time period would now be $2,186. And if one had invested that $100 in gold in 1980, it would be a measly $333 today.

History has shown that given the volatility of the price of gold, both stocks and bonds outperformed gold in the long run over the past 30 years by providing higher average returns. Stocks and bonds also outperformed gold over a 20-year time period. A starting point of 1980 was chosen because, not unlike today, the price of gold was then at all time highs. With gold fervor rampant, a speculative investment in gold, then, would have resulted in not-so-stellar results today, even with gold's recent performance.

Gold is not without its merits. It has traditionally been considered a good hedge against rising inflation rates, given its ability to preserve purchase power. Gold is also commonly considered a safe haven in times of political and currency crises. As fears of a double-dip recession mount, gold may be considered a tool for diversification, because it generally does not react identically to the same economic or market stimuli as stocks and bonds. A well diversified portfolio of stocks, bonds, and gold has the potential to produce a more appealing risk-and-return trade-off over various time periods.

Compound Annual Returns

	1 yr	3 yrs	5 yrs	10 yrs	20 yrs	30 yrs
Stocks	7.8	14.1	–0.2	2.9	8.3	10.8
Bonds	19.4	8.5	9.5	8.4	9.0	10.6
Gold	26.2	28.9	22.0	20.3	8.1	4.9
60/40 portfolio	12.9	13.2	5.3	6.2	9.4	11.4
50/40/10 portfolio	14.7	14.6	7.4	7.9	9.5	10.9
50/30/20 portfolio	15.3	16.5	8.5	9.0	9.4	10.4

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Gold, like any other coin or bullion, is subject to investment risks like perceived scarcity, its quality, current demand, market sentiment, and economic factors. There are material differences between investing in gold versus investing in stocks and bonds. Such differences may include investment objectives, costs and expenses, liquidity, safety, fluctuation of principal or return, insurance, tax features, and any other investment characteristics.

Source: Data as of November 30, 2011. Stocks in this example are represented by the S&P 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 20-year U.S. government bond. Gold is represented by the Federal Reserve (2nd London fix) from 1980-1987 and the Wall Street Journal London P.M. closing price thereafter. Portfolios are rebalanced every 12 months.

Are Bonds Adding to Your Equity Exposure?

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

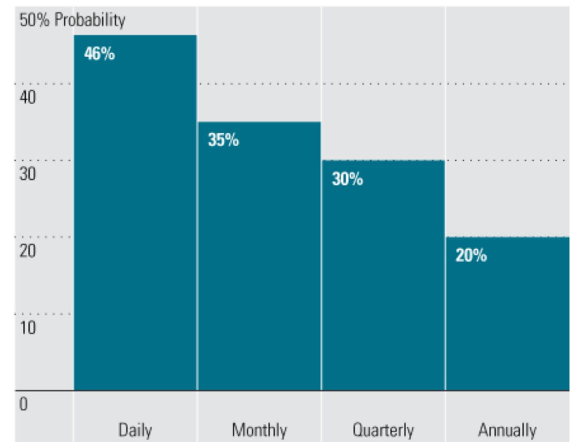
Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

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RFM Financial Solutions, LLC
Registered Investment Advisors

Michael Harter
CPA/PFS, CFP®

805 N Brown St
Mt Pleasant, Michigan 48858

mharter@robertfmurray.com
www.rfmfinancialsolutions.com

Tel:989-772-1209