Our Two Cents

October 2011 | Vol. 5 | Investment Updates

New 1099 and Cost Basis Reporting

Beginning with the 2011 tax reporting year, clients will see cost basis and other information for each tax lot sold on their revised Form 1099 Composite and Year-End Summary for the first time. Schwab's Form 1099 Composite has been revised to include new IRS required information and new enhancements to make tax preparation easier for clients.

The revised 1099-B will now include cost basis information for both covered (reported to the IRS) and uncovered (not reported to the IRS but reported to clients as a service). Cost basis information includes cost basis, date of acquisition, wash sale disallowed loss amount, covered status and holding period information.

There are some instances when cost basis information may not be available. Most likely it is because the security was transferred from another financial institution to Schwab without cost basis information. Other reasons could be that the security was purchased at Schwab more than 10 years ago or impacted by a corporate action since its original purchase. If cost basis is missing, it means that either it was not included with a transfer from another broker, or it was unavailable at the time. We recommend that clients try to provide the missing cost basis for all their positions by checking their past statements and trade confirmations for the original purchase dates and prices. We can also assist with tracking it down if necessary.

If clients are unable to determine the cost basis for a sale transaction, the IRS requires them to use a cost basis of zero, so their sales proceeds will be a taxable gain.

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Advisor Corner

It is really sad to see how the economic pressures have incited discussions and now demonstrations about income distribution and "paying their fair share". Many of these issues have been statistically twisted and politicized.

Rather than pointing fingers and drawing up sides, we should be working together. Our country was built on innovation and the freedom to work hard and be rewarded. I hope we don't come to a point when that is no longer the foundation of our country.

Dividends and Total Return

Income is important to consider when choosing an investment. Especially important for investors approaching retirement, income can add meaningfully to one's total return, which comprises income and price return (capital appreciation). Investors can pursue income returns in many ways including bonds, real estate investment trusts, and stocks.

Stock income is typically paid in the form of a monthly, quarterly, annual, or special cash dividend, which can be used to finance current consumption or to reinvest. Dividends are typically expressed in terms of yield. Like an interest rate, yield is represented as a percentage rate and is calculated by taking the annual cash dividend divided by a stock's current price. For example, a stock trading at $20 with a future annual cash dividend of $1 would have a dividend yield of 5%.

Keep in mind, though, that there is no guarantee a dividend will be paid, even if a certain company has a consistent dividend-paying track record. A company can increase, decrease, and even eliminate dividends altogether, depending on its financial situation. Furthermore, if a dividend is declared, the company has to pay dividends for preferred shares first, before any common share dividends can be paid.

Although stocks can be a source of income return, not all stocks are created equal in this regard. Some companies distribute significantly more of their profits in the form of dividends than others, and some don't distribute dividends at all. The following image demonstrates this point. Historically, dividend-earning stocks—represented by Morningstar's Dividend Composite Index—have had compound annual returns of 6.9%, while large stocks have had compound annual returns of 5.0%. Additionally, higher-yielding companies—represented by Morningstar's Dividend Leaders Index—have outperformed large stocks: Dividend Leaders Index components had a compound annual return of 9.0% compared with 5.0% for large stocks during the period studied. For investors looking both for income and total returns, dividend-paying stocks can be a reasonable place to invest.

Although higher-yielding stocks have demonstrated an ability to outperform large stocks, all that glitters is not gold. Dividends are paid at a company's discretion, and exceptionally high yields can indicate a potential dividend cut. For example, had investors been lured to many high-yielding bank stocks in late 2008, they would have been sorely disappointed when many banks subsequently cut their dividends as profitability declined during the credit crisis. When looking at dividend-paying stocks, investors should focus on reasonable dividend yields with companies that have the earnings power to increase their dividend distributions over time. Many large companies with recognizable brand names have demonstrated an ability to offer this slow and steady income distribution to shareholders.

Dividend-Paying Stocks May Provide Better Returns

This is for illustrative purposes only and not indicative of any investment. Assumes reinvestment of all income and no transaction costs or taxes. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. Dividends are not guaranteed and are paid solely at a company's discretion.

Source: Large Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Dividend-Paying Stocks—Morningstar Dividend Composite Index; High-Yield Dividend-Paying Stocks—Morningstar Dividend Leaders Index. Stocks in both indexes have a consistent record of dividend payment, have the ability to sustain their dividend payments and are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index. The Morningstar Dividend Leaders Index captures the performance of the 100 highest-yielding stocks.

Government Health-Care Spending: Medicare

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of government health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years.

Medicare and Medicaid were both created in the mid-1960’s as part of Lyndon Johnson’s Great Society agenda. As of 1970, 62% of total health-care spending was still private, with out-of-pocket spending the single most significant source. During the subsequent forty years, however, Medicare and Medicaid each expanded by more than 11% annually due to benefit expansions and demographic change, pushing public-sector spending up to nearly 50% of total health-care expenditures. During the same time, private-sector spending also grew at a robust 8.7% annually, as employer-sponsored insurance became the predominant conduit of health-care spending.

Looking forward, the Centers for Medicare & Medicaid Services (CMS) project 6.5% annual health-care spending growth over the next decade. Public sector growth is again expected to outpace private spending growth, with a 6.9% growth rate compared to 6% for the private sector. Combined, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010 and 17% in 1970.

Medicare is a federal government program that provides health insurance to people over age 65, and people with certain disabilities. In 2009, more than 43 million people received health insurance benefits through Medicare at a total cost of approximately $510 billion. Medicare benefits are divided into three parts: Part A Hospital Insurance, Part B Medical Insurance, and Part D Prescription Drug Insurance. Part C created a private version of Medicare, now called Medicare Advantage. More details about these benefits can be found in the attached table.

Original Medicare’s relatively high cost-sharing provisions and lack of a limit on out-of-pocket spending can leave beneficiaries exposed to potentially devastating expenses in the case of a serious adverse health event. For this reason, most Medicare beneficiaries also carry supplemental insurance. Employer-sponsored retiree health plans, though becoming less common, still cover approximately 30% of the Medicare population. 20% of Medicare beneficiaries purchase individual supplemental policies, also called Medigap policies. Medicaid helps pay Medicare’s premiums and cost-sharing for another 20% of the Medicare population. Only about 10% of Medicare beneficiaries are estimated to be completely without supplemental coverage.

Medicare Benefits Breakdown

Benefit	Approx. % of Spending	What Does It Cover?	What Does It Cost Beneficiaries?
Part A	39	Inpatient hospital care, skilled nursing facilities, and in some cases hospice or home care.	Generally no monthly premium as long as the beneficiary paid sufficient payroll taxes while working. Deductible and co-insurance for hospital stays exceeding 60 days.
Part B	26	Physician services, outpatient care, and in some cases physical or occupational therapy and home health care.	Monthly premium, deductible, and 20% co-insurance after the deductible is met.
Part C	23	Same benefits as Part A, Part B, and often Part D. Medicare Advantage plans are offered by private insurance companies as an alternative to original government-run Medicare.	Monthly premium, deductibles, co-pays, and co-insurance.
Part D	11	Prescription drugs.	Part D benefits are only offered through private insurance companies, which charge a premium in addition to deductibles, co-pays, and co-insurance.

Source: Kaiser Family Foundation and Medicare.gov

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

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