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Winter 2013

INSIGHTS FROM THE BRIDGE

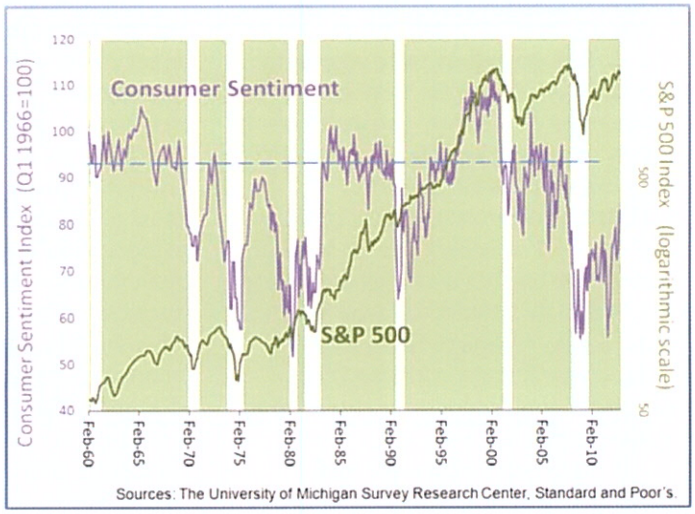
Investors Flee Stocks At Precisely The Wrong Time

The percentage of American households owning stock mutual funds dropped to 46.4% in 2011, and it has fallen every year since 2008, according to Investment Company Institute. In addition, outflows from domestic stock mutual funds in 2012 neared the record-breaking pace of 2008, the worst year ever for outflows.

Pessimism has been rampant. As 2013 begins, worries persist over the long-term federal deficit. Modern Portfolio Theory, the intellectual underpinning embraced by academia for evaluating investments for the long run, is now derided by many pundits. The Wells Fargo/Gallup Investor and Retirement Optimism Index turned negative at -8 in November 2012, down from double-digit positive scores earlier in 2012. A belief that America's best days are behind her seems pervasive.

How worried should you be? Maybe not as worried as so many others seem to be. Looking back at the historical performance of the consumer sentiment index versus the Standard & Poor's 500 stock index indicates that periods of extreme pessimism are actually good times for stocks.

The most recent data from University of Michigan's consumer sentiment index shows that that you would have to go back more than 30 years — to 1980 — to find consumer sentiment as low as it has recently dipped.



Sources: The University of Michigan Survey Research Center, Standard and Poor's

The accompanying chart shows the consumer sentiment index dating back to 1960, and about the only time sentiment was as negative as it has been over the past couple of years was in 1980. The plunge in consumer sentiment in 1980 followed a recession, an oil shortage sparked by the American hostage crisis in Iran, an annual inflation rate of 14%, and the bursting of a bubble in the price of silver after the Hunt brothers failed to corner the market in the precious metal. That confluence of calamities in 1980 kicked off a raging bull market.

Today's economic worries are similar in many ways to 1980's woes. Global turmoil related to America's struggle with terrorism and Muslim

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Time To Trade Snow Shovel For Roller Coaster?

For many of us, spring is the time to relocate our snow shovel from the front to the back of the garage. This spring, investors may be trading the snow shovel for a roller coaster.

The market sailed through the year-end fiscal cliff concerns with virtually no market volatility. A last-minute deal in Washington temporarily avoided the cliff.

It may be a different story in coming weeks. There are three dates that may impact investors: March 1 is the deadline for $85 billion of across-the-board spending cuts to take effect (sequestration); March 27 is the deadline for funding government operations (debt ceiling); and April 15 is the deadline for Congress to vote on a budget. Failure to do so will result in lawmaker's pay ceasing. These three issues have been complicated further by a recent Congressional Budget Office (CBO) report revealing America's budget crisis will worsen in future years. Most of us did not need a CBO report to tell us the obvious.

Thanks in part to our government continuing to print new money, the stock market started 2013 on a high note. We should not be surprised in the near term if market volatility increases. It should be temporary and then fade away just as snowfalls do each year.

Rich Locke
Lead Portfolio Manager

Avoid These Investment Mistakes

One thing that can be puzzling about stock market investors who have struggled in the past: They make some of the same mistakes over and over. Here are seven prime examples.

1. You try to "time" the stock market. Typically, timing strategies are based on selling stocks when you believe the market has topped out and buying when you think it has hit rock bottom. The problem is that nobody—and we mean NOBODY—has a crystal ball that's foolproof. It's far better to stick with a well-diversified, balanced portfolio based on your personal circumstances.

2. You have zero patience. If you're looking for instant gratification, the stock market will disappoint you more often than not. Just as for the tortoise and the hare, slow and steady usually wins the race, while those who act too swiftly finish behind. Be content to hold some stocks for a long time before you reap rewards.

3. You refuse to recognize reality. All too often, investors operate with blinders on, but the cold hard facts can't be ignored. If you have a favorite stock you were convinced would turn a profit and it simply hasn't worked out, don't throw good money after bad. Dump the losers and hold on to the winners without allowing emotion to rule the day.

4. You put all of your eggs into one basket. No matter what the projections are for any particular stock, sector or asset type, it's not smart to bet your entire wealth on its performance. Diversification is a key element of a sensible plan for virtually every investor. It's all about balancing the search for reward with the need to reduce risk. Although there's less chance you'll make a killing if you diversify, you reduce your exposure to a catastrophe.

5. You overemphasize past performance. It may be boilerplate language in investment prospectuses and related materials, but it's also true: "Past performance is not necessarily indicative of future results." Don't build your portfolio around particular stocks just because they've been profitable without evaluating their current and future prospects.

6. You ignore the impact of taxes. It only makes sense to consider the tax ramifications of your investment decisions—especially now, with higher income tax and investment tax rates for high-income investors and the arrival of a new 3.8% Medicare surtax in 2013. But it also can be a mistake to let taxes drive your decisions. Weigh all of the relevant economic factors when you buy or sell stocks.

7. You don't have a plan. Many investors take a hit-or-miss approach to their portfolio. They buy and sell on whims without coordinating their activities. But you're more likely to be successful if you develop an overall plan that is suitable for your situation. Having a strategy and having the discipline to stick with it is the hallmark of successful investing. We would be glad to provide whatever assistance you need. ●

"Ghost Story" Can Haunt Your IRA

The rules for contributing to an IRA are relatively simple. You put in the money for each tax year by the required deadline—the tax return due date for the year of the contribution—and tell the account custodian how you want the funds invested. In addition, you might roll over funds to an IRA from a 401(k) or another kind of "qualified plan" at work when you change jobs or retire. That way, your money can continue to grow without being eroded by taxes until you make a withdrawal.

The rules for *distributions*, in contrast, are extremely complex. In particular, complications may arise as you approach the time for taking "required minimum distributions" (RMDs) from your IRA. Make the wrong moves and your heirs might be forced to receive payouts based on your "ghost life expectancy."

For IRA owners, the "required beginning date" (RBD) for RMDs is April 1st of the year after the year in which they turn age 70½. For instance, if someone reaches that age on June 1, 2013, the RBD is April 15, 2014. The amount of the RMD is based on the value of your accounts on December 31st of the tax year of the RMD—in this example, 2013—and is calculated according to an IRS-approved life expectancy table. And here's where things get complicated.

If you die *before* the RBD and have designated a "qualified beneficiary" such as a child or spouse, the RMDs are generally based on the beneficiary's life expectancy. (Surviving spouses also have the option of rolling over the funds into their own IRAs.) However, if you haven't designated a beneficiary or you named a "non-qualified beneficiary" such as your estate, the IRA must be emptied out in five years. Conversely, if an IRA owner dies *after* the RBD, payments to a beneficiary are still based on the beneficiary's life

10 Reasons For The IRS To Flag Your Return

What sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 "red flags" that could increase the chance you'll be tapped for an audit.

1. High income. The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of $200,000 or more. That's almost one out of every 25 returns. The IRS tends to chase the "big money," and while that's no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

2. Unreported income. The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You're likely to draw IRS scrutiny if you don't report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

3. Large charitable gifts. Besides providing personal satisfaction, deductions for charitable gifts can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

4. Home office deductions. If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office "regularly and exclusively" as your principal place of business. Simply doing work at home when your main office is elsewhere won't cut it.

5. Rental real estate losses. Generally, "passive activity" rules prevent investors from deducting losses on rental real estate. But a special exception allows a loss deduction of up to $25,000 for "active participants," subject to a phase-out between $100,000 and $150,000 of adjusted gross income (AGI). Another exception applies to qualified real estate professionals. The IRS may zero in on taxpayers claiming losses under either exception.

6. Travel and entertainment expenses. This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

7. Business use of cars. Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called "luxury car" rules. IRS agents have been trained to ferret out taxpayer records that don't measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn't available for personal use.

8. Hobby losses. As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can't claim a loss for the activity, unless your involvement rises to a level of a bona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

9. Foreign bank accounts. The IRS has started clamping down on taxpayers with offshore accounts in "tax havens" in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.

10. Cash businesses. Finally, if you operate a small business in which you're generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don't mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●

expectancy, but payments to a non-qualified beneficiary must use the owner's ghost life expectancy.

A ghost life expectancy isn't as scary as it sounds. It's how long the IRA owner would be expected to live—if he or she hadn't already died. But using an older owner's life expectancy table will still drain the IRA faster than usual.

Suppose that Walter Mason, age 80 and single, has $750,000 in his IRA. Walter named his estate as the beneficiary of his IRA. He dies on July 1, 2013 without taking an RMD for the 2013 tax year.

Because Walter designated a non-qualified beneficiary, RMDs for 2013 and future years will be based on his ghost life expectancy. The payment for 2013 under the single-life expectancy table is $40,107. Under this method, payments will be greater than the amounts that would have been required if Walter had designated a qualified beneficiary.

Good planning can minimize the impact of RMDs and help preserve your retirement nest egg. ●

Avoid Five Pitfalls In Refinancing

Mortgage interest rates are at historic lows, but does that mean you should refinance an existing mortgage? A "refi" may pay off, but you should consider all of the relevant factors, including these five potential problems:

1. You're back to square one. Starting over is hard to do if you're close to paying off a mortgage. For instance, if you take out a 30-year loan, the monthly payments in the first seven years will reduce your principal by only 5% or so, with the rest going to interest. Instead of beginning to make a dent in their principal debt, homeowners who refinance after seven years are effectively starting from scratch. Figure out how much you're really saving if you shave only a percentage point or less off your current rate.

2. Closing costs can pile up. Depending on how long you stay in a home, the expenses of a new loan can outpace the savings. Figure on closing costs equal to about 1.5% of the mortgage amount. Then calculate your monthly savings to see how long it will take you to break even on the cost of the mortgage. For example, if you refinance a $300,000 mortgage, closing costs will run about $4,500. If the new mortgage interest rate is 1 percentage point lower than your current rate, you will save $178 a month and will need just over 25 months to recoup your closing costs. So if you're not planning to stay in the house for more than two years, you could end up losing money. Reduce these costs by paying the prepaid items out of pocket. You'll get that money back when the escrow accounts on your old loan are paid back to you.

3. Terms can be confusing. With refis so popular now, they can take a long time to process, and it may not be clear when you should stop paying your current mortgage. If you inadvertently fall behind, it could throw a monkey wrench into the works. Generally, lenders offer a two-week grace period after a mortgage payment is due and then charge a 5% penalty. Even worse, your credit score might plummet by 100 points or more if you're 30 days past due—and that change could affect your refi.

4. The appraisal may be too low. Before the refi is approved, the lender will require an independent appraisal to confirm the home's value. The numbers now are trending lower than expected for many homeowners, especially those who reside in areas hit by numerous foreclosures. If the appraised value is too low and you don't have enough equity in the home, the lender could raise the rate or deny the loan altogether.

5. You could pay hidden fees. Under federal law, lenders must provide a good-faith estimate of the fees needed to complete the refi, and that statement could reveal costs you hadn't expected. Also, some low-interest mortgages require you to pay "points," and each point is equal to 1% of the mortgage amount. That could delay your break-even point even longer. ●

Investors Flee Stocks

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fundamentalists dominates the headlines, threatening oil production in the Arab world. Massive monetary stimulus by the Federal Reserve has sparked inflation fears and the price of gold spiked higher than ever in the last couple of years. America seems unable to muster the strength to fight its fiscal crisis.

But just as happened in 1980, stocks over the past couple of years have marched higher. And, as the accompanying chart assembled by Fritz Meyer Economic Research illustrates, it's not unusual for stocks to rise steadily higher precisely when consumer pessimism is at its worst.

Investor perceptions and consumer sentiment are often at odds. Wall Street reality—earnings growth and rising stock prices—governs stock prices. As a result, even as consumer sentiment plunges, you could see a rally in stocks.

To be sure, economic and political problems plaguing the U.S. are serious and must be addressed. The federal debt, downgrading of the U.S. Government's credit rating, and threat of terrorism remain very real problems. But the pessimism these problems engender doesn't necessarily stop the stock market from rising if corporate earnings growth holds up, and that's what occurred in recent months.

In the aftermath of the 2008 global financial crisis, consumer sentiment has recovered. As history shows, however, it can take years for a full recovery in consumer sentiment to take hold. In fact, stock prices must rise for an extended period before consumer sentiment fully recovers following economic trauma. Stock prices are always out in front of consumer perceptions.

So, when you hear news about the extreme pessimism over the economy and record outflow from stock mutual funds, remember these lessons from history. The stock market in 2012 showed an astounding total return of 16%, while investors fled stock mutual funds in droves. Investors historically leave the stock market and become pessimists at precisely the wrong time. While past performance is never a guarantee of future results, it appears that familiar pattern was repeated in 2012. ●

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