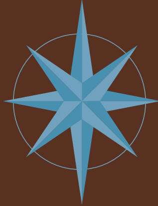


602-212-1040 Third Quarter 2013

An Example Of The Power Of Diversified Portfolios

When it comes to investing your hard-earned dollars, the recipe you use can be more important than the ingredients you use. In other words, how you allocate your funds into different asset classes can have a bigger impact on your returns over time than what you put into your portfolio.

That's why portfolio experts stress the importance of diversification, asset allocation, and periodic rebalancing, rather than touting the latest "can't miss" stock buy. However, due to the fact that hot stock tips often seem more interesting than diversification strategy, many investors continue to play the market-timing game rather than maintain a solid long-term strategy.

In a recent presentation on bond performance, Craig L. Israelsen, an associate professor of finance at Brigham Young University, provided a clear and convincing example of the power of asset allocation to improve returns over time. He compares the performance of portfolios with one asset, two assets, and four assets from 1948 through 2012 to show that portfolio diversification trumps securities or fund selection.

The accompanying chart, "Bond Performance in a Portfolio Context," analyzes returns from three different portfolio mixes under conditions of rising interest rates and declining interest rates. The analysis shows that market performance doesn't affect returns nearly as much as diversification of a portfolio.

The 34-year period from the start of 1948 through 1981 was a time of rising interest rates, and U.S. bonds averaged an annualized return of 3.83%. During that period, the Standard & Poor's 500 stock index averaged 11% annual gains while U.S. Treasury bills averaged 4.49%.

The 31-year period from 1982 through 2012 was a time of declining interest rates, during which U.S. bonds averaged an 8.82% gain annually, the S&P 500 averaged 11.14%, and U.S. Treasury bills averaged 4.72%.

So the background to this portfolio comparison is the fact that U.S. bonds clearly performed much better during the latter period. Because analysts expect interest rates to rise during the next few years, it may be reasonable to conclude that bond returns likely will fall. "The question is how much does (this) matter in terms of building an overall portfolio," Israelsen

(Continued on page 4)

Bond Performance in a Portfolio Context

Portfolio	Period of Rising Interest Rates 34-Year Period from 1948 to 1981	Period of Declining Interest Rates 31-Year Period from 1982 to 2012
1-Asset Portfolio 100% US Bonds	3.83% Annualized Return 4.32% Standard Deviation	8.82% Annualized Return 6.99% Standard Deviation
2-Asset Portfolio 60% Large US Stock 40% Bonds	8.52% Annualized Return 10.49% Standard Deviation	10.56% Annualized Return 11.33% Standard Deviation
4-Asset Portfolio 40% Large US stock 20% Small US Stock 30% Bonds 10% Cash	9.52% Annualized Return 11.80% Standard Deviation	9.99% Annualized Return 10.98% Standard Deviation

Craig Israelsen, Brigham Young University

Here Are 4 Quick Tax Reasons To Invest In Munis

Congress has talked in recent years about repealing the favorable tax treatment afforded to investments in municipal bonds ("munis"), but so far munis have retained their tax advantages, and they remain an attractive option, particularly for upper-income investors.

What's so appealing about munis? Here are four key tax benefits:

1. Muni interest is exempt from federal income tax. For example, if you're in the 25% tax bracket and you earn 6% interest on a taxable bond, you normally realize only a 4.5% after-tax return. With munis, there's no federal tax erosion.

2. Muni interest is exempt from state income tax if the bonds are issued by an authority within the state where you live. This also can increase the after-tax return on some munis.

3. Muni interest generally doesn't increase your adjusted gross income, or AGI. Because AGI is used to determine other taxes and tax breaks, having less of it could be an advantage.

4. Muni interest doesn't trigger the new 3.8% Medicare surtax. This surtax applies to the lesser of your net investment income (NII) or your modified adjusted gross income (MAGI) above $200,000 for single filers and $250,000 for joint filers. But munis don't count as NII and won't raise your MAGI, either.

Conversely, note that munis may trigger or increase tax on Social Security benefits for some retirees.

Of course, taxes aren't the only consideration in making investment decisions. But munis certainly have their advantages at a time when taxes are rising.

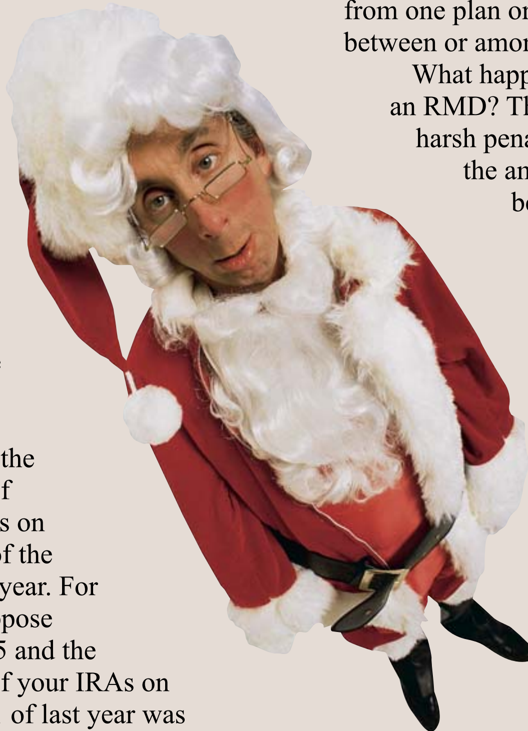
‘Tis The Season To Receive RMDs

When you’re putting together this year’s holiday shopping list, don’t forget to add one gift that you may need to give to yourself: a required minimum distribution (RMD). If you’ve reached age 70½, you’ll have to take an RMD from your 401(k), traditional IRA, or any other retirement plan that lets you shield your contributions from taxes. And the penalty for missing this obligation is a lot worse than getting a lump of coal in your stocking.

The funds that remain in your employer-sponsored retirement plans and IRAs can continue to grow without current investment or income taxes, but you must begin taking RMDs by April 1 in the year after the year in which you turn 70½. Thereafter, you must make the required withdrawal by December 31 of each and every succeeding year. So if you turned 70½ in 2012, you had to take the RMD for the 2012 tax year by April 1, 2013—and now you must withdraw another RMD for the 2013 tax year by December 31, 2013. You’ll pay federal income tax on these distributions, plus you may owe state income tax, too.

There’s an exception for employer-sponsored plans that may apply if you’re still working full-time and you don’t own 5% or more of the company. In that case, you can postpone withdrawals until your retirement. But you’ll still have to take RMDs from your IRAs.

How much do you have to withdraw? First, look up your life expectancy in the special IRS tables. If your spouse is the sole beneficiary for an account, his or her age also may enter into the equation. Distributions are based on the value of all of your accounts on the last day of the previous tax year. For example, suppose you’re age 75 and the value of all of your IRAs on December 31 of last year was $500,000. If your spouse is the sole beneficiary and is less than 10 years younger than you are, the withdrawal factor under the appropriate table is 22.9 Using an online calculator, you can determine that the RMD for the 2013 tax year is $21,834.



Though the IRS requires you to take these withdrawals, if you have multiple 401(k)s or IRAs, it doesn’t care which account the money comes from. You can take the entire amount from one plan or divide up the RMD between or among other accounts.

What happens if you fail to take an RMD? The IRS can impose a harsh penalty equal to 50% of the amount that should have been withdrawn (or the difference between the required amount and any lesser amount that was distributed).

For instance, if you failed to take the RMD in the example above, the penalty would be $10,917. That penalty is in addition to the regular income tax you owe on the RMD.

To be on the safe side, arrange to receive your RMD well before the December 31 deadline. You don’t want to be hit with a hefty penalty if there are any glitches. ●

Managing Your Tax Bracket Now Crucial

Four tax law changes that took effect in 2013 are driving high-income earners to manage their tax brackets more carefully.

1. A new top income tax rate for ordinary income of 39.6% (previously 35%) has been added for single filers with taxable income above $400,000 and joint filers above $450,000.

2. For investors who exceed those same thresholds, the maximum tax rate on long-term capital gain has increased from 15% to 20%.

3. A new 3.8% surtax applies to the lesser of “net investment income” (NII) or the amount by which modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers. The definition of NII includes capital gains and dividends, but not payouts from retirement plans and IRAs.

4. The tax benefits available for itemized deductions and personal exemptions are phased out for taxpayers above certain income limits.

Faced with this changing tax landscape, you need to be especially vigilant to keep “bracket creep” in check. At the same time, it could make sense to realize year-end income up to the next bracket threshold. Here are several tax strategies to consider in this environment:

• Make the most of your capital gains and losses. If you’ve taken losses during the year, it could make sense to realize capital gains now, using those losses to offset extra income that could put you in a higher bracket or subject you to the 3.8% surtax. Or, if you have existing gains, taking capital losses could offset them and up to $3,000 of ordinary income.

• Convert a traditional IRA to a Roth IRA—but stagger the amount

The Renaissance In Life Insurance Trusts

An age-old estate planning technique is enjoying a revival of sorts due to recent tax law developments. If you don't already have an irrevocable life insurance trust (ILIT) in place, you might consider creating one, or you might add a policy to an existing trust. Despite some cracks in the foundation, this remains one of the top tax shelters available to upper-income individuals.

Start with the premise that life insurance proceeds paid from a policy on your life are exempt from estate tax only if you don't possess any "incidents of ownership" in the policy. Naturally, that applies if you own the policy outright, but that's not all. For instance, you will be treated as having incidents of ownership in life insurance if you retain the legal right to:

- Change or name the beneficiaries of the policy;
- Borrow against the policy or pledge any cash reserve it has;
- Surrender, convert, or cancel the policy, or;
- Choose a payment option for beneficiaries (that is, you determine whether payments will be made in a lump sum or installments).

Be aware that these rules apply if you have *the right* to do any of these things regardless of whether you actually do them. If you have a policy with a large death benefit and the proceeds end up being part of your estate, this could have tax consequences for your heirs.

Fortunately, it's relatively easy to avoid problems. All you have to do is establish an ILIT and transfer ownership of the policy, including all of the legal rights discussed above, to the trust. You'll also need to designate someone—a professional, family member, or friend—to serve as trustee. If you acquire additional life insurance protection, you can designate the ILIT as the owner of your new policies.

An ILIT can be "funded" or "unfunded." If it's funded, not only do you transfer ownership of the life insurance policy to the trust, you also transfer other assets that may be used to pay the premiums. The additional property may be in the form of cash, securities, or some other asset. The major drawback of this approach is that the income the trust generates is generally taxable to you.

Unfunded trusts are more typical. In this case, you don't transfer assets to the trust to pay for the premiums, but rather you make annual gifts to the ILIT for this purpose.

The ILIT technique provides some other benefits that may appeal to wealthy taxpayers. With the appropriate wording of trust documents, you can protect the money from spendthrift children or grandchildren (or spouses of your heirs). Furthermore, the proceeds may be used to cover estate tax liability without diluting other assets intended for the family.

How much estate tax flexibility do you have under current law? Plenty. Thanks to the American Taxpayer Relief Act of 2012 (ATRA), an exemption of $5 million (indexed to $5.25 million in 2013) effectively shelters bequests to non-spousal beneficiaries like your children and grandchildren. In other words, if you remove life insurance proceeds from your estate through an ILIT, you can still leave another $5.25 million to your heirs free of estate tax. ATRA also establishes a top federal estate tax rate of 40%.

For example, consider the implications if you have a policy with a $1 million death benefit. Without an ILIT, your family might have to forfeit $400,000 of the proceeds to Uncle Sam.

Keep in mind that to qualify for this estate tax break, the life insurance trust must be "irrevocable"—you can't change your mind once you pull the trigger on the deal. Also, if it's a policy on your life, you can't be the trustee. If you don't observe those rules, the life insurance proceeds could end up back in your taxable estate.

Finally, when you set up an ILIT, the proceeds don't have to go through the probate process, and your heirs should have access to the cash in a relatively short time. But there's one last wrinkle to consider: Under a little-known tax rule, the proceeds still will be subject to federal estate tax if you die within three years of transferring ownership to the trust. Because of this three-year rule, don't delay if you think an ILIT is advantageous for your situation. Set up the trust now to start the clock running.

Tax law crackdowns have eliminated some traditional tax shelters—and Congress has its eye on others—but the benefits of life insurance trusts remain intact. We can help you determine whether an ILIT would be helpful in your situation. ●

you convert each year to avoid rising into a higher tax bracket. The converted amount is taxable as ordinary income, but it may pay off in the form of future tax-free distributions.

- Stay in a lower bracket by shifting taxable income to the younger generation. For instance, you might give dividend-paying stock to a child in a low tax bracket. Just keep in mind that under the "kiddie tax," unearned income above $2,000 received by a dependent child in 2013 generally will be taxed at your top rate.

- Reduce your taxable income by making charitable gifts. The tax law generally allows you to deduct the fair market value of donated property that you've held for more than a year. However, deductions for charitable gifts are among those that may be reduced for upper-income taxpayers. ●

Standard & Poor's 500 Index Versus Earnings

This is arguably the single most important picture for investors to focus on.

The green line shows the value of the S&P 500 index of 500 blueâ€chip U.S. companies, and the purple line shows the earnings—profits—per share was averaged by the 500 companies In the index dating back to 1988. Corporate earnings are the single most important determinant of stock prices.

The red markers, in the upper right corner, show that the consensus forecast of Wall Street analysts for earnings on the S&P 500 stock index, as of July 24, 2013, was for $111.05 per share for 2013 and $123.59 per share for 2014.

That earnings forecast, which seems reasonable given the recent strength of the economy, would propel the price of the S&P 500 in 2013 and 2014 in the trajectory shown in the red square markers.

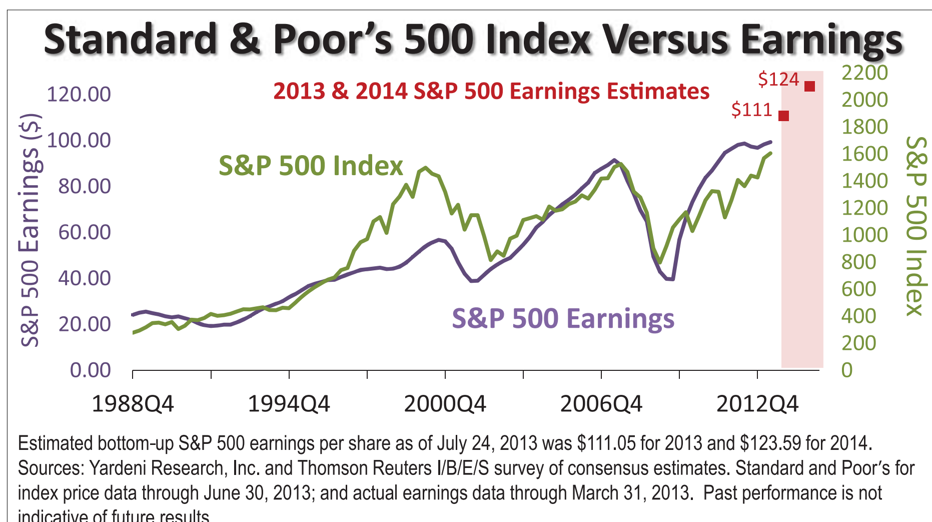
If the economy continues to grow, as the Fed's staff of economists and private forecasters recently predicted it would, then corporate earnings are likely to continue on the trajectory shown. If stock prices always follow earnings, this would be good for stock prices.

It's important to note that, in the period of irrational exuberance around 2000, stock prices shown in the green line and corporate earnings shown in the purple line, did not stay correlated. That gap shows a classic example of how stock prices can become disconnected from fundamentals due to human emotion.

However, if you look at the relationship between the green and purple lines now, stocks are actually trading at the low end of their historical valuation relative to earnings.

Keep in mind, the red squares are not meant as a prediction of where stocks prices will go. Unexpected events could derail stocks from staying on track.

But barring some major event like that, the trajectory of stock prices remains favorable and economic growth at the end of the second quarter appeared to support this trajectory. ●



Estimated bottom-up S&P 500 earnings per share as of July 24, 2013 was $111.05 for 2013 and $123.59 for 2014. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through June 30, 2013; and actual earnings data through March 31, 2013. Past performance is not indicative of future results.

Power Of Diversified Portfolios

(Continued from page 1)

asked in his presentation.

To find out, he analyzed the performance of a simple two-asset portfolio during those same two time periods, cutting bonds to 40% of the portfolio and adding large U.S. stocks as 60%. Not surprisingly, adding returns from the more volatile equities market increased the portfolio's annualized return to 8.52% during the 1948-1981 timeframe and to 10.56% during the later period.

Then Israelsen moved into a more diversified portfolio with four asset classes: 40% large U.S. stocks, 20% small U.S. stocks, 30% bonds, and 10% cash. That resulted in a 9.52% annualized return in the earlier period and a 9.99% return in the later period.

The increasing rates of return for the earlier period—and the decreasing differences between returns for the two time periods—clearly shows the benefits of diversification. Bonds alone produced positive returns, but when combined with equities, the returns rose – regardless of which way interest rates were moving.

Some investors may look at these figures and wonder why they shouldn't simply eliminate bonds and put all their assets into equities. The answer involves risk and an investor's time horizon. In general, U.S. equities tend to have two to three years of negative returns during every 10-year period. That increases the risk your portfolio might take a hit just before you intend to retire or before you need to make a withdrawal for other reasons.

Bonds experience an average of two very slight negative-return years per decade, so they provide a stabilizing influence that can smooth out your portfolio's performance. That's the whole point of diversification, to avoid putting all of your investment dollars at risk at the same time.

A final point: Periodic rebalancing is vital, because as asset classes rise and fall in value, your portfolio mix will change. If you start with 30% in large U.S. stocks and this class performs well, that portion of your portfolio may grow to 35% or 40% of the whole, throwing off the balance in the portfolio. So you have to rebalance, either by selling some of the large-stock holdings or buying more in your other asset classes.

Our firm can help you with each aspect of meaningful portfolio design—asset allocation, risk management, and rebalancing – within the context of your overall financial situation and life goals. ●

Vestpointe Wealth Management, LLC
8800 East Raintree Drive, Suite 135 Scottsdale, AZ 85260
Phone: 602-212-1040 • Email: joem@vestpointe.com

©2013 API