financial focus

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OUR NEW INVESTMENT REALITY

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Can we realistically expect returns on our investments to be on a par with those enjoyed by past generations? Over the past 80 years, long-term historical U.S. stock market returns over 20-year periods have remained relatively stable at 7–9% appreciation plus 2% in dividends, or 9–11% total returns. When combined with intermediate bonds, a portfolio with 50% stocks and 50% bonds would reliably average a 7–8% return over a 20-year period.

However, the recent historic decline in interest rates has hurt total returns. Unless we see a marked increase in the stock market in the next three to four years, which would be a "reversion to the mean," the 20-year historical average used for projections will have to be revised. Given the current economic environment, near-term inflation is not likely to be much of a concern. The challenge will be to adapt to possible lower total portfolio returns.

There would be several sobering results from lower long-term total portfolio returns. One is that clients will either need to work longer to accumulate a larger investment retirement portfolio, or they will have to plan to downsize at retirement. This is particularly true for the so-called echo-boom generations born in the late 1960s and later. They are not likely to have reliable Social Security benefits, and guaranteed pension benefits are relics. It is also likely that children will not inherit as much wealth from their parents because more parents will use up those assets as they live to older ages. To round out this scenario, we have to remember that governments are inclined to rescue every segment of society by increasing the money supply. Printing more money is a long-term inflationary strategy that is likely to compound the financial stress on at least the next two generations.

There is no easy way out of this situation if the economic duress continues and is exacerbated by public resistance to austerity. As a result, it becomes imperative that we teach our children these important basics to survive in the new reality:

- ***Each family must produce more than they consume.***
- ***Our futures depend on saving at least 10% of our earnings throughout our lifetime to support us in old age.***
- ***Future citizens will have to recognize that longer life expectancies will mandate older retirement ages.***

Now you might be nodding your head and saying "Ain't it awful!" with like-minded friends. But if you present these three points to your grandparents, they are likely to look at you and say "Duh!" Wasn't it commonplace for families to lead productive lives? Wasn't it known that living below your means rather than beyond your means was bound to put you on a better financial footing? And weren't pensions originally keyed to life expectancies? The point is that the important changes have to be endogenous and start with the factors we control in our lives. We can't really wait for our lives to be dictated by exogenous changes, whether they be Republican, Democrat, policy based, Supreme Court sanctioned, or anything else beyond our immediate control.

What can you do now? We don't advise immediate and precipitous portfolio revamping. Retired clients who have experienced the benefits of completed bond ladders already know that they are well protected financially for the next 15 to 20 years.

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SEVEN PRACTICAL STEPS TO PREVENT IDENTITY THEFT

by Tim Sullivan, EA Columbia, MO

According to recent research, 11.6 million Americans had their identities stolen in 2011. These crimes vary from the unauthorized use of a credit card number to buying a car with a stolen identity. Here are some steps you should take to protect yourself.

1. *Safeguard your Social Security number.* Take your Social Security card out of your wallet. Never give out your Social Security number to anyone who calls, e-mails, or texts requesting personal information. In general, your bank, insurance company, doctor's office, or anywhere else you have an existing relationship will not call you for personal information. If a business you work with calls requesting personal information, politely hang up, look up their contact information independently, and call them back.

2. *Clean up your trash.* Shred documents containing personal information before you throw them away. A mortgage application, for example, includes your name, birthdate, and Social Security number. Also, remove your name from unsolicited credit and insurance offers at www.optoutprescreen.com.

3. *Keep your computer tidy.* Make sure your online passwords are protected and unique. Keep your information secure using passwords that are hard to break. Many experts recommend passwords at least 8 characters long containing a minimum of one uppercase, lowercase, numeric, and special character (such as $ or #). Others recommend using longer password phrases, for example, "I love chocolate." You can now find apps for your computer or smartphone that will help you store and organize login information securely.

4. *Review your credit reports regularly.* Visit www.annualcreditreport.com for a free report from each of the three major reporting agencies (Transunion, Experian, and Equifax), and look for any unauthorized activity. You are entitled to one free report per year per agency.

5. *Consider your payment options carefully.* VISA and MasterCard require any bank issuing a debit card with their logos to provide zero liability for fraudulent charges. However, this is not a requirement of federal law. By law, if someone makes unauthorized charges to your credit card, you have 30 days to report the fraud with a maximum $50 liability for fraudulent charges. With a debit card, the liability is the same, but the reporting time is reduced to just two days. If you wait longer, you can be on the hook for up to $500. Regardless, if fraudulent purchases are made using your debit card, you are the one without those funds until the bank restores your account. This poses the risk of bounced checks and high overdraft fees. With a credit card, none of your money has disappeared until you pay your account.

Debit cards aren't the only threat to your bank account. According to a recent report, check fraud is still the second most costly fraud activity faced by financial institutions, despite a significant decrease in the number of checks written. Canceled checks contain most of the information criminals need to wreak havoc on your bank account. Every time you pay by check, you are giving a stranger your name, address, checking account number, and routing number.

6. *Catch ID theft quickly*. Use your credit card's website to monitor how your card is used. Set a dollar notification amount for your purchases. Any time your credit card is used for a purchase larger than that amount, the system will e-mail or text you. Nearly all cards offer this service at no cost.

7. *Consider freezing your credit.* A credit freeze prevents anyone from establishing a new line of credit in your name. The costs vary by state. Consider freezing your credit if you are not routinely increasing it, moving often, or have any major purchases. If needed, you can thaw your credit for a small fee, and then refreeze it when you are done. Even a credit freeze is no guarantee of identity protection. You still need to monitor existing accounts. Because some new accounts (like a utility service) might not require credit, a credit freeze would not prevent all fraudulent activity. But it is still the lowest cost and strongest protection currently available. If a credit freeze isn't for you, consider monitoring your credit with a service such as creditkarma.com. They provide, at no charge, a Transunion credit score and notify you of any inquiries to your credit report.

For additional information regarding identity theft or for what to do if you are a victim, call the Federal Trade Commission at 1-877-ID-THEFT or visit their website: www.ftc.gov/bcp/menus/consumer/data.shtm.

UTMA and UGMAs: WHAT ARE THEY?

by Troy Von Haefen, CFP® Nashville, TN

As a holistic financial advisor, I must view the big picture for my clients, and a very important piece of it is their children. We all want the best for our children, for them to have a life better than the one we had at their age. But sometimes our well-meaning actions do not end up as we intended.

Grandparents often gift money or assets to their grandchildren with the intention that those assets be used for college, or parents simply set aside money for that proud day when their children go off to college. Most often these gifts end up in the child's name in the form of a custodial account with a parent acting as the custodian of the assets. There are two types of custodial accounts: Uniform Transfer to Minors Act (UTMA) and Uniform Gift to Minors Act (UGMA). The state where you live will require one or the other. Essentially, they are identical and operate just like a bank or brokerage account (they are taxable), but the tax liability is the child's.

These accounts have several issues that keep me from recommending them. The money becomes the child's at the age of majority. The child has the right to use the money in any way he or she sees fit, and the parents are in no position to do otherwise. Although we all intend to raise our children to be respectful of our wishes and do the right thing, it's best not to give an 18-year-old power over a substantial sum of money.

You can borrow for college, but you can't borrow for retirement. This is an important point. Again, we want the best for our children. But we shouldn't sacrifice our retirement so our children can go to college without paying a dime. Sending a child to college with some skin in the game (the child partially paying) will set a great example of what lies ahead in life. A student loan is much better than becoming a financial burden to your children later in life.

Money in the child's name can hurt in the financial aid process. UTMA and UGMAs are considered the child's asset when it comes to the financial aid process for college, which can hurt the financial aid process much more than assets in the parents' name.

Sometimes gift issues are involved in custodial accounts. Many times these accounts are started as a gift from a relative (e.g., stock from grandparents). The cost basis of the person giving the gift is transferred to the person receiving it. This must be tracked and handled appropriately. It's not difficult, but it does need to be done correctly.

Another gift issue is gift tax. The federal gift tax exclusion is $13,000 a year, so any gift from one person to another in an amount over $13,000 incurs a gift tax liability. Some states, like Tennessee, have stricter gift tax limitations, so gifts should only be made with the full understanding of the applicable state and federal gift tax laws.

With the cost of college skyrocketing, many parents are working hard to ensure that their children's future involves a college education, so it's more important than ever not to make mistakes along the way. A custodial account may have unintended consequences, especially if set up incorrectly. Money is money, and money in the children's name is still an asset that needs to be viewed as part of the big picture.

If you are looking for ways to save for college while keeping your financial plan intact, ACA is a great place to find an advisor who will keep the big picture in mind!

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For clients who are still accumulating assets and building their retirement bond ladders, a reduction in the total portfolio return will likely have an impact on retirement planning. During regular investment review appointments, we have generally done retirement projections using market rate of return at 7–8%. We are now also looking at the impact of long-term market rates of return falling to 5–6% (assuming a portfolio of 50% interest earning and 50% stocks). Finally, we urge clients to remember that it is a mistake to take more portfolio risk to offset the decline in market rates of return.

We are not predicting the future will unfold as just outlined. But we do think there is a new reality that has been set in motion that is not going to be reversed in the next generation or two. Most of it is based on modern longevity and will require a change in financial expectations.

Remember the wisdom of your grandparents' ways, and ignore the basics at your peril. Although there are some long-term possibilities that we should consider in our decision making today (like less Social Security for the young), we can only fruitfully focus on the three issues outlined here that we can control. We are comfortable thinking that the actions needed to adapt to the new investment reality will have a very familiar sound.

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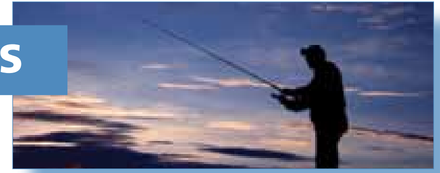


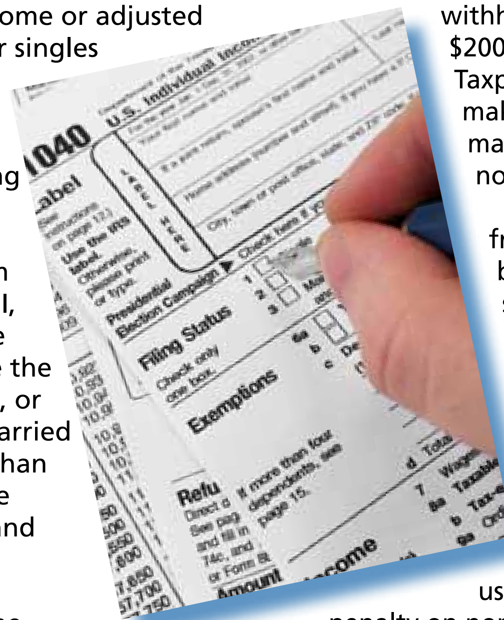
TAXMAGEDDON

by Erin Baehr CDFA, CFP®, EA Stroudsburg, PA

Forget the zombie apocalypse or the Mayan calendar; we've got ourselves a Taxmageddon on the horizon with some big tax changes taking effect on January 1, 2013. The planned expiration of the Bush tax cuts may not happen, but we do know (now the Supreme Court has ruled) that the tax increases as part of the Affordable Care Act will happen.

Despite the Internet rumors, let me reassure you there is no new tax on all home sales. This tax only applies in some very specific circumstances.

The Affordable Care Act includes a 3.8% Medicare contribution tax on investment income: interest, dividends, rents, royalties, passive activity income, or net gain from disposition of property. This tax will apply to the lesser of investment income or adjusted gross income (AGI) over $200,000 for singles and $250,000 for joint filers. For example, if you have an AGI of $260,000 and it is solely from wages with no investment income (assuming you file jointly), you would not owe this additional tax (but wait, there's more). However, if your income from wages was only $150,000 of that AGI, and investment income made up the remaining $110,000, you would owe the surtax on the amount over $250,000, or $10,000. On the sale of a home, a married couple would have to realize more than a $500,000 profit for the sale to have an impact on their tax return at all and $250,000 for a single person.



The expiring Bush tax cuts also have an impact on investment income. Currently, some dividends are taxed as "qualified," meaning they are taxed at the same rates as capital gains: either 0% for those in the 0%, 10%, and 15% tax brackets or 15% for everyone else. As of January 1, 2013, we will return to the taxation of all dividends as ordinary income at each taxpayer's individual tax bracket. Marginal tax rates are also scheduled to return to the pre-Bush tax cut numbers. Many people, especially retirees, were receiving dividends tax free, but they will now see the tax go up to match their tax bracket (10% or 15%), assuming they have taxable income at all. High earners (the $200,000 singles/$250,000 joint filers) in the 35% tax bracket could now see their dividends taxed at potentially 43.4% (new 39.6% bracket plus the 3.8% Medicare tax) versus the current 15%. That's close to triple the rate.

Capital gains were also taxed at 0% for taxpayers in the 0%, 10%, and 15% brackets, and all others were capped at 15%. Unless Congress rules otherwise, as of January 1, they will be taxed at either 10% for those paying 0% before or 20% for all others (slightly lower rates may apply to property held for five or more years) and 23.8% for those subject to the Medicare surtax.

The Affordable Care Act also created an increase in the Medicare payroll tax from 1.45% to 2.35% on wages and income from self-employment in excess of $250,000 for taxpayers married filing jointly; $200,000 for single taxpayers. Employers will be required to withhold the additional tax beginning at $200,000 for everyone, married or not. Taxpayers subject to this tax will need to make sure enough is being withheld and make additional estimated payments if not.

Here are some additional provisions from the Affordable Care Act: beginning in 2013, healthcare flexible spending account contributions will be limited to $2,500. For those itemizing deductions, the "floor," or minimum amount of medical expenses you must incur before getting a tax deduction, will increase from 7.5% of AGI to 10%. Taxpayers age 65 before the end of 2012 can continue to use the 7.5% floor through 2016. The penalty on nonqualified distributions from health savings accounts will rise from 10% to 20%.

Should the Bush tax cuts in fact expire, we will see marginal tax rates rise. The 10% bracket will be eliminated and combined into the 15% bracket; the 25% rate will go to 28%; 28% to 31%; 33% to 36%; and 35% to 39.6%. For joint taxpayers with $50,000 in taxable income (all wages), taxes will go from $6,630 in 2012 to $7,500 in 2013. That's an 11% increase. The child tax credit is scheduled to revert to $500 and the marriage penalty will make a comeback.

What exactly will happen with the tax code in 2013 is still uncertain. We do know for sure that we will see the tax increases originating with the Affordable Care Act, but it's anyone's guess what will happen with the Bush tax cuts.