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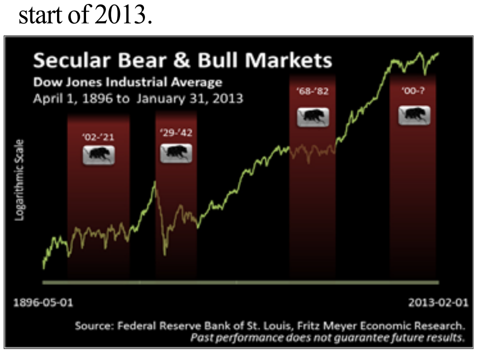
Second Quarter 2013

The Case For A New Secular Bull Market

A secular bull or bear market is a paradox. Despite its long-term status—or perhaps because of it—it's difficult to say when a secular bear wave is ending and a bull wave has begun.

A secular market is different from a cyclical one. A cyclical bear or bull market is when stocks rise or fall 20% or more. You objectively know when you're in a cyclical bear market based on a single number. In contrast, a secular bull or bear market is identified based on more nebulous criteria: optimism and pessimism. How do you measure investor optimism? A key measure is the price-to-earnings (p/e) ratio of stocks.

Secular bull markets are characterized by an expansion of the p/e multiple. People are willing to pay more for stocks because they believe they will appreciate. What's fascinating is that we may right now be at the start of a new secular bull market. A recent rise in the p/e ratio and a confluence of other positive influences makes a case that a new secular bull market began at the start of 2013.



Source: Federal Reserve Bank of St. Louis, Fritz Meyer Economic Research.
Past performance does not guarantee future results.

U.S. stocks have endured four secular bear markets, as shown in the accompanying chart. (Periods between bear markets are all bull markets.) After the financial crisis, pessimism about stock investing was so rampant that companies in the Standard & Poor's 500 index, America's blue-chips, were valued at less than 12 times every dollar of profit they earned.

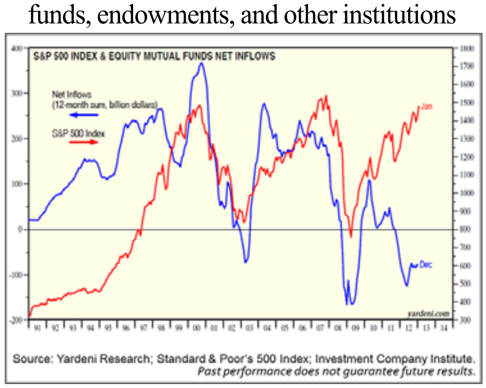
After hitting a low in March 2009, however, the S&P 500 index rose 120% through mid-February 2013. That restored the stock market's p/e ratio to a level in line with the historical norm, but still only at the low end of the historical norm. The market multiple p/e expanded from 12 to 14.6.

In the first quarter of 2013, a confluence of events unfolded that could lead to continued expansion of the market p/e multiple. While there is no certainty this will happen, growing evidence of the shift to a secular bull market should not be ignored. According to a Feb. 9, 2013 article in *Barron's,* we might be on the cusp of a "great rotation into stocks" for several reasons:

Low Yields. The Federal Reserve Bank has kept interest rates low, making stocks relatively more attractive than bonds.

Housing Prices. With housing prices reverting to the historical norm, the "wealth effect" could make homeowners less risk-averse.

Institutional Investors. Pension funds, endowments, and other institutions



Source: Yardeni Research; Standard & Poor's 500 Index; Investment Company Institute.
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Sell In May . . . And Go Where?

An adage for investing is that the best market returns come from November through May. History suggests that the stock market is typically weaker from April through September. Add this to the realization that the U.S. market is establishing all-time highs, and the average investor is understandably nervous.

Safe money investing at the bank will produce returns of one percent or less, bond yields are falling and even could result in a negative return when the Federal Reserve starts to unwind its aggressive policies.

Another factor to consider is that not all markets have risen as fast as the U.S. market. International stocks, commodities, small stocks and bonds all have trailed the large blue chip U.S. stocks so far in 2013. Investors are beginning to rotate their safer investments toward higher returns. There is so much cash sitting around that overall market values easily could push higher as more conservative folks become worried that they are being left behind.

Market valuations remain reasonable and earnings in 2013 have been positive. But one thing we have learned over the years is to proceed with caution, as volatility also can increase as investors become more excited about investing again.

Ron Dickinson

Avoid These 7 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. ●

Owning REIT Shares Can Help Minimize Risk

Diversification has been touted as the best way to avoid the steep ups and downs that can hit investors who rely too much on a narrow range of investment types. But the financial crisis of 2008-2009 ripped a huge hole in the diversification safety net, as most assets plunged together.

In the wake of the crisis, many investors are understandably concerned about the right mix of assets—stocks, bonds, real estate, cash, and other investments. For most people, it's not just a question of maximizing returns, but also of minimizing risk.

Investing in real estate through real estate investment trusts (REITs) can be part of the answer, especially when it comes to reducing volatility and risk, according to a new study commissioned by the National Association of Real Estate Investment Trusts (NAREIT).

"Diversifying the global portfolio to include real estate stocks alongside other stocks and bonds can potentially increase risk-adjusted returns and minimize expected losses for both risk-averse and moderate-risk investors," concludes the study based on 20 years of data from Morningstar Inc.

"The Role of Real Estate in Weathering the Storm" suggests that placing 14% to 20% of a global investment portfolio in real estate equities benefits those with low to moderate risk tolerance, especially when extreme risks such as a broad financial collapse are factored in.

Even including the real estate crash that started in 2006, REITs returned 10.63% from 2000 to 2009, compared with a negative 0.95% for the Standard & Poor's 500 stock index. That's partly due to the special tax status of REITs that forces the investments to return 90% of income as taxable dividends. Those dividends accounted for 56% of REIT total returns, compared with the 23% that dividends contributed to the returns of S&P 500 companies (between 1989 and 2012).

New Law Poses Tax Risks For Wealthy Investors

It will take time for investors to absorb exactly what happened—and what did not happen—in the new tax law enacted to avert the "fiscal cliff." Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

1. Ordinary income. The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than $400,000 and joint filers with income above $450,000. That means that a short-term capital gain on the sale of a stock you've owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

2. Capital gains and qualified dividends. Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn't passed, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income thresholds—$400,000 for single filers and $450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

3. Medicare surtax. This "add-on" tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA. But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—$200,000 for single filers and $250,000 for joint filers. These figures will not be indexed for inflation.

For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

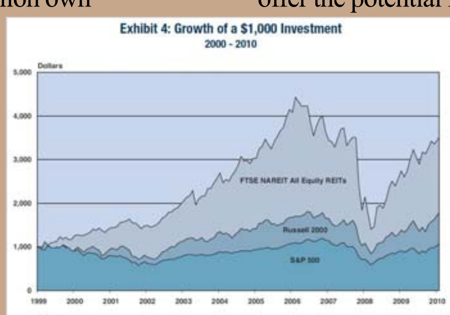
Now let's see how these tax changes might affect taxes on investment income:

Example 1. You're a joint filer with an annual MAGI of $170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of $10,000 and long-term capital gains of $40,000, for a total of $50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so you don't have to pay the 3.8% Medicare surtax.

Example 2. You're a single filer with an annual MAGI of $500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of $25,000 and long-term capital gains of $75,000, for a total of $100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is $100,000, triggering a Medicare surtax of $3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●

Many wealthy investors are on board. According to Spectrem, one third of investors with a net worth between $5 million and $25 million own REIT shares, and two-thirds of those with $15 million to $25 million own REITs. The average REIT stake of those investors is valued at $1.2 million.



A REIT is a company that owns and manages income-producing real estate. Most invest in specific types of property, such as offices, apartments, shopping centers, malls, industrial facilities, hotels, self-storage facilities, health-care properties, and more specialized properties.

According to Morningstar, REITs offer the potential for high yields, simplified tax issues, liquidity, and diversification. Drawbacks include a tendency for shares to lose value when demand rises for other high-yield assets such as U.S. Treasury bonds, and the potential for high property tax costs.

We can help you determine what portion of your portfolio to invest in REITs and what types of REITs best suit your financial goals. ●

Roundup Of New Estate Tax Changes

For more than a decade, estate planning has harkened back to the "wild, wild west," a time when even the best hired guns didn't know what would happen next. Now, finally, there's more certainty, thanks to the estate tax provisions in the American Taxpayer Relief Act (ATRA). The new law, signed as the country teetered on the brink of the "fiscal cliff," extends several favorable tax breaks, with a few modifications.

Before we explore ATRA's main provisions, let's recap the events dating back to 2001, the year the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted. Among the changes, EGTRRA gradually increased the federal estate tax exemption from $1 million to $3.5 million in 2009 while decreasing the top estate tax rate from 55% to 45%. It also severed the unified estate and gift tax systems, creating a lifetime gift exemption of $1 million unrelated to the estate tax exemption. Then the law repealed the estate tax completely, but just for 2010. After that year, the estate tax provisions were scheduled to "sunset," restoring more onerous rules that had been in effect before EGTRRA unless new legislation dictated otherwise.

The Tax Relief Act of 2010 generally postponed the sunset for two years. It hiked the estate tax exemption to $5 million (indexed for inflation), lowered the top estate tax rate to 35%, and reunified the estate and gift tax systems. That law also allowed "portability" of exemptions between spouses.

Now, at long last, ATRA brings permanent clarity. Here are the key estate changes:

- The estate tax exemption remains at $5 million with inflation indexing. For 2013, the exemption is $5.25 million. Also, portability of exemptions between spouses is made permanent, so a married couple can effectively pass up to $10.5 million tax-free to their children or other non-spouse beneficiaries, even if the exemption of the first spouse to die isn't exhausted.
- The top estate tax rate is bumped up to 40%. Not as low as the 35% rate in 2011 and 2012, but still better than the 55% rate slated for 2013 prior to ATRA.
- The estate and gift tax systems remain reunified. This means that the lifetime gift tax exemption is equal to the estate tax exemption of $5.25 million in 2013. (That's now the maximum exemption for combined taxable lifetime gifts and estate bequests.) Other provisions, including the generation-skipping tax that applies to most bequests and gifts to grandchildren, are coordinated within the system.

As a result of these changes, now is a good time to examine wills, trusts, and other aspects of your estate plan. Depending on your situation, revisions may be required or you might create a new trust to take advantage of the current estate tax law. ●

New Secular Bull Market

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have allocated just 30% of their portfolios to equities since the financial crisis and can't meet their investment goals unless they take more risk by boosting equity allocations.

Retail Investors Return. Since the financial crisis of 2007-2009, retail investors shunned stocks. The accompanying chart shows inflows into stock mutual funds since that time have been anemic recently relative to two previous times when the S&P 500 neared a high point of 1500. According to independent economist Ed Yardeni, the 120% rebound in stock prices that began in March 2009 was fueled by stock buybacks by corporations sitting on cash. Main Street investors were not in on the recent bull run—until December 2012. Then net inflows into stock mutual funds abruptly reversed, according to Investment Company Institute.

If Main Street investors return to stock mutual funds, that would be sign of a major shift in sentiment, a shift toward optimism, which is the mark of a secular bull market. Secular bull markets are characterized by an expanding price multiple on corporate earnings. Optimism makes investors more willing to pay more for earnings. How much can sentiment boost stock prices?

According to economist Fritz Meyer, when the U.S. inflation rate has averaged 2% to 3%, investors have historically valued stocks in the S&P 500 in a range of 15 to 20 times their earnings. In February 2013, when inflation was hovering at about 2%, the S&P 500 was trading at 14.8—the low end of its historical p/e ratio range.

Thus, if a new secular bull market is under way—a scenario bolstered by the great rotation into stocks—gradually increasing optimism could propel expansion of the p/e ratio back into the normal range. Past performance does not indicate your future result, and the case for a new secular bull market could be overly optimistic. But ignoring the favorable data carries a risk of missing out. ●