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Fourth Quarter 2014

It Certainly Was Five Years For The History Books

Time passes fast, and you might not have noticed the extraordinary financial history we all witnessed in the past five years.

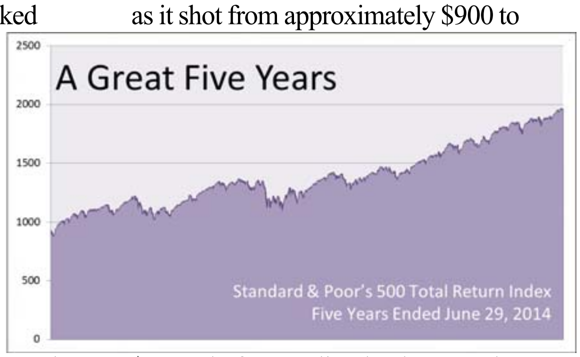
The second quarter of 2014 marked the sixth year — and the sixth quarter — in a row in which stocks climbed higher. It was a bull-market run sure to be talked about for at least a few generations to come.

Five years is a good, long stretch. In this case, it was a great, long stretch. The end of the first half of 2014 marked the bull market's fifth anniversary.

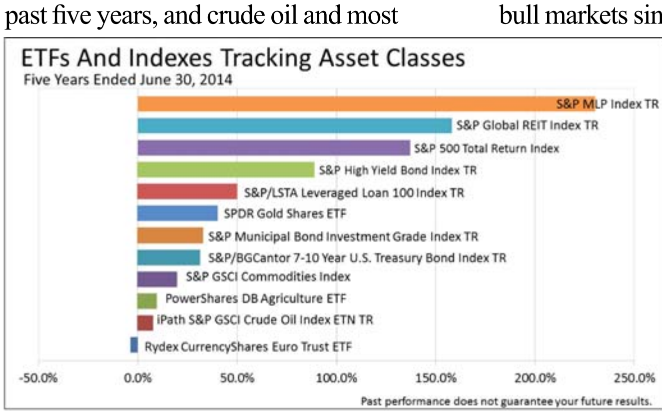
It was a five-year about-face from the financial-crisis trough. When stock prices rose from the S&P 500's intraday low of 666 on March 9, 2009, stocks were less than two percentage points shy of tripling!

Looking at the performance of a broad range of asset classes over the five-year period ended June 30, 2014, the dispersion in returns is startling. At the top are Master Limited Partnerships, global REITs and the S&P 500 with gains of +230%, +158% and +137%, respectively. The euro currency has actually declined fractionally in value versus the U.S. dollar over the past five years, and crude oil and most other commodities are approximately flat. The bond total return indices, both U.S. Treasury and municipals, are a smidge more than +30%, or about +6% per year.

Over the course of the five-year period ended June 30, 2014, investors experienced unprecedented volatility in gold, as it shot from approximately $900 to $1,800 before settling lately around $1,300. The gold predictions said that QE would ultimately result in massive inflation and debasement of the U.S. dollar. Happily, such predictions have come undone as inflation and bond yields have trended much lower than anybody, including the Federal Reserve, had anticipated.



All this positive news has to make you wonder how much longer the good times can last. Only three out of the 23 bull markets since 1900 lasted six years or longer. However, the S&P 500 index gained +4.7% in the second quarter of 2014, soaring after a brief sell-off in early April on Ukraine-Russian tensions. And, as the end of the third quarter of 2014 approached, the bull run



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Lessons From Charles Schwab Conference

I recently attended two national conferences and listened to a lot of great speakers including former Federal Reserve Chairman Ben Bernanke and Charles Schwab's chief investment strategist, Liz Ann Sonders. There were a lot of great takeaways that can help in positioning your portfolios for the next year.

1. Stocks have done well but are not overvalued. Stocks are not cheap either, so future profits will come from growth in corporate earnings; and the U.S. economy is starting to grow.

2. Inflation is not an immediate threat and we can anticipate that the earnings from deposits at your bank and lower-risk bonds will stay low.

3. Diversification still matters. Yes, the U.S. stock market has been outstanding and a portfolio that is diversified has turned in a lower performance as other asset classes have returned less, but diversification of your irreplaceable life savings is an important protection device.

4. The U.S. economy is the tallest midget in the room. Everything may not be perfect, but we are a shining example when compared to the rest of the world.

5. Washington, D.C., is broken. No explanation needed.

I'm looking forward to sharing additional insights in the months ahead.

Ron Dickinson

Taking RMDs Into Your Own Hands

IRS rules on required minimum distributions (RMDs) are aimed at people who can afford to pile up savings in tax-favored retirement accounts without ever again having to take out most of that money. In most cases, however, you eventually have to start taking annual RMDs whether you want to or not. But moves you make at year-end can help reduce the tax damage.

Although savings in employer-sponsored retirement plans such as 401(k)s, as well as in traditional IRAs, can grow without being eroded by current taxes, eventually the money must come out. RMDs have to begin by April 1 of the year after the year in which you turn 70½. (Roth IRAs are exempt from RMDs.) Then you must take an RMD by December 31 every year. Those withdrawals generally are taxed at ordinary income tax rates.

If you're still working full-time at a company you don't own, you may be able to postpone withdrawals from that company's plan until retirement. But this exception doesn't apply to IRAs.

The amount of the RMD is based on life expectancy tables and the value of your accounts on the last day of the previous tax year. Suppose you're 75 and the value of all your IRAs on December 31 of last year was $500,000. If your spouse is the sole beneficiary and he or she isn't at least 10 years younger than you are, the withdrawal factor under the appropriate table is 22.9. With an online calculator, you can determine that your RMD for the current tax year is $21,834.

If you have multiple IRAs, you can take the money from any one of them or from several in whatever proportions you choose. But the penalty for failing to take the full RMD is severe—equal to 50% of the amount that should have been withdrawn (or the difference between the required amount and any lesser amount you did withdraw). For instance, if you failed to make any withdrawal in the example above, the penalty would be $10,917, plus regular income tax.

Finally, taking an RMD can trigger other tax complications, including liability under the 3.8% "net investment income" (NII) tax. Although RMDs don't count as NII, they do increase your overall taxable income—and that, in turn, can make you subject to the NII tax.

One way to begin reducing your exposure to RMDs is to convert funds in traditional IRAs to a Roth IRA. Because Roth IRAs are exempt from RMD rules, you'll have more protection for the future, even though you'll owe tax on the conversion for the year in which it occurs. Another potential strategy is to transfer funds to a life insurance trust that isn't subject to the RMD rules. Just keep in mind that such arrangements generally require professional assistance.

The main point is that you don't have to sit back and accept dire tax consequences. Some astute year-end planning can give you more room to maneuver. ●

Social Security: Taxes In And Out

It seems like the IRS has you coming and going on Social Security. While you are working for a living, you must pay taxes into the system to provide benefits for current retirees. Then, when you finally retire, you're entitled to receive retirement benefits but they might be subject to tax as well.

Don't confuse the two taxes. The Social Security tax you pay as an employee is a payroll tax that applies to wages, commissions, and other compensation as part of the FICA tax. An employee's combined FICA rate for Social Security and Medicare in 2014 is 7.65% on the first $117,000 of compensation and 1.45% (Medicare only) above that. But the tax that may apply to Social Security benefits you get in retirement is a federal income tax that is reported along with other items on Form 1040. It's more complicated than the payroll tax.

Here's how it works: You're liable for tax on Social Security benefits if your provisional income (PI) exceeds certain thresholds in the tax law. For this purpose, PI is the total of (1) your adjusted gross income (AGI), (2) your tax-exempt interest income (for example, from municipal bonds), and (3) one-half of the Social Security benefits you received. For example, if the combined AGI of you and your spouse is $100,000 and you collect $5,000 in municipal bond income and $20,000 in Social Security benefits, your PI is $125,000 ($100,000 + $5,000 + $20,000).

There are actually two thresholds for computing the tax on Social Security benefits.

Threshold 1: For a PI between $32,000 and $44,000 ($25,000 and $34,000 for single filers), you're taxed on the lesser of one-half of your benefits or 50% of the amount by which PI exceeds $32,000 ($25,000 for single filers).

Threshold 2. For a PI greater than

Will The Driver Of The Bull Market End?

Ultimately, what drives stock prices is profits. Profit margins in recent years expanded beyond historic norms, leading to speculation lately about what might happen if margins were to revert to their long-term mean. It almost certainly would be a disaster for stocks. When you look at the facts, however, it seems unlikely profit margins will come under pressure anytime soon. To the contrary, economic fundamentals indicate that profit margins could continue to expand.

Profit margins have expanded by three percentage points since the 1970s, according to Fritz Meyer Economic Research. The share of gross domestic income that goes to compensation of employees, or labor costs, declined by 6½-percentage points. Meanwhile, the share of domestic income going to pay for fixed capital increased by 3%. The difference—3.5 percentage points of U.S. gross domestic income—has been accrued by corporations, pumping up their profit margins. An historic replacement of labor with capital, which has been an astounding period for productivity growth, has unfolded over the last four decades.

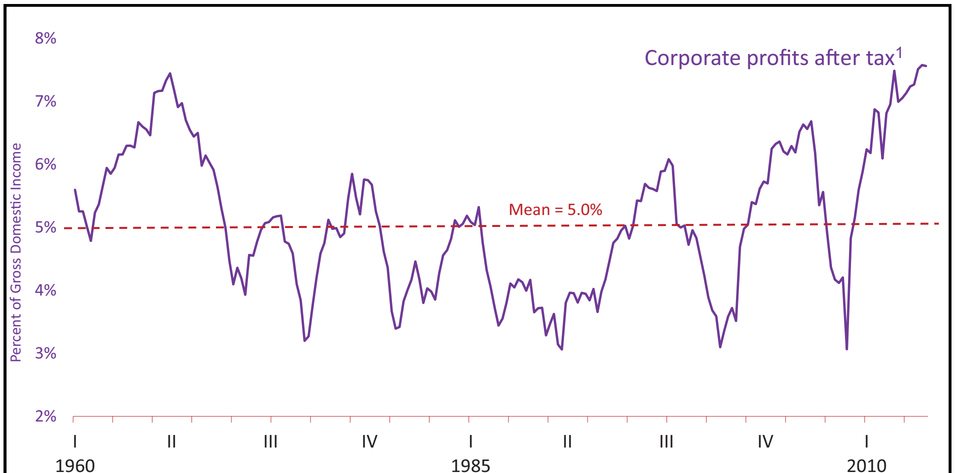
And that's not the only factor causing an expansion of profit margins in corporate America. The other reason profit margins have grown fatter—and provided a bullish backdrop for investors in stocks—is that net interest expense has declined by four percentage points, which likewise boosted corporate profit margins by four percentage points. On top of that, a gradual decline in corporate income taxes helped to boost profit margins further. Altogether, this confluence of economic circumstances created an economic and investment climate propelling profit margins to record levels. Better still for investors, these fundamental factors are unlikely to reverse, much less suddenly collapse.

The drivers of profit-margin growth is that companies are realizing that lowering labor expense by buying capital is a tradeoff well worth making, and the trend is accelerating. While these broad trends cause massive changes in people's lives and families, they are good overall for the economy in the long haul.

The relentless substitution of capital for labor over the last few decades can continue even as the economy makes gains in employment. In fact, unemployment, the stubborn problem hampering the economy since The Great Recession of 2008-2009, has at long last been settling toward its long-term norm of 4%.

At the same time, interest expenses are unlikely to rise sharply anytime soon. "With inflation low and some slack still present in the job market, sharply higher interest rates are unlikely right around the corner," says Fritz Meyer, an independent economist. Meanwhile, pressure is mounting on Congress to lower corporate taxes in order to bring U.S. corporate income tax rates in line with those of other developed nations. This sets the stage for the continued expansion in profit margins, a bright spot in a complicated and often frightening world for investors.

And that's how you should think of this good news: as a bright spot in a complex and unpredictable world that could change anytime. Assuming that the world remains largely the same, however, the news on profit margins is good for long-term stock investors. ●



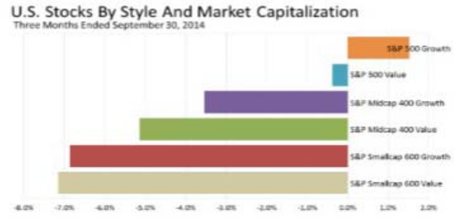
[1] Corporate profits after tax with inventory valuation and capital consumption adjustments.
Source: U.S. Department of Commerce, Bureau of Economic Analysis. Data through 2013.

$44,000 ($34,000 for single filers), you're taxed on 85% of the amount by which PI exceeds $44,000 ($34,000 for single filers) plus the lesser of the amount determined under the first tier or $6,000 ($4,500 for single filers). Silver lining: You'll never owe tax on more than 85% of your total benefits.

These two thresholds aren't indexed annually for inflation. If your PI exceeds a relatively low level of $32,000 ($25,000 for single filers), you'll owe the tax year in and year out. And you'll get hit with the higher tax rate every year that your PI exceeds just $44,000 ($34,000 for single filers).

What can you do about it? You might lower your PI by harvesting capital losses to offset capital gains or deferring taxable income to the following year. But remember that the income from tax-free municipal bonds counts against you in the calculation of PI. Consider all the relevant factors, including the potential tax implications for Social Security benefits, in your investment decisions. ●

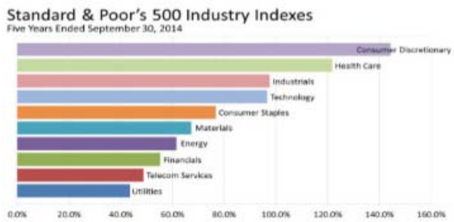
Market Data Bank: 3rd Quarter 2014 Ψ

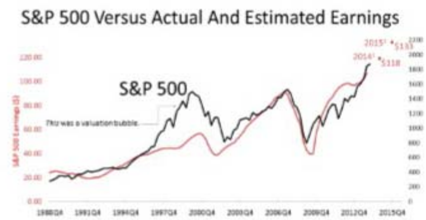


THE BIG PICTURE
Since 1900, only three of 23 bull markets have lasted six years or longer. Chances of a bear market — a correction of at least 20% — increase as the bull market grows older. But economic conditions that accompanied bear markets in the past were not present as the end of 2014 neared.

U.S. STOCKS
Europe's slower than expected growth cast new doubt on the strength of the global economy caused periodic jitters over the Federal Reserve's "taper" — the winding down of longstanding monetary policy liquefying economy. But the stream of improving economic data continued.

FOREIGN VS. U.S. STOCKS
"American exceptionalism," the theory that the U.S. is different from all other nations because of ita unique traits — like freedom, entrepreneurship and an abundance of natural resources — was bolstered again last quarter as US stocks outran foreign again.





LARGE-CAP U.S. STOCKS BY INDUSTRY
Over the past five years, cumulative returns on consumer discretionary stocks led the 10 S&P 500 industry sector indices, followed by health care and technology stocks, as growth investors were rewarded. Utilities trailed as income oriented investments remained weak. No industry was hit for a loss over the period.

ASSET CLASSES±
Looking at the cumulative return on broad group of 12 asset classes for the five years ended September 30, 2014 shows master limited partnerships at the top of the heap. But second best was the return on U.S. stocks. Stocks tied to commodities prices and foreiogn equity markets trailed.

S&P 500 INDEX VS. EARNINGS¥
Red squares show expected earnings on the S&P 500 index of blue-chip companies, based on a 10/2/2014 forecast of Wall Street analysts, for $118 per share in 2014 and $133 in 2015. Unless there's a crisis or sudden and surprising bad news, the trajectory of earnings growth could continue to propel stocks higher.

Past performance does not indicate future results. ±Indices and ETFs representing asset classes are unmanaged and not recommendations for any specific investment. Foreign investing involves special risks, including political or economic instability and currency fluctuation. Bonds offer a fixed rate of return while stocks fluctuate. ¥Estimated bottom-up S&P 500 earnings per share as of October 2, 2014 was $118.28 for 2014 and $132.91 for 2015. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through October 7, 2014; and actual earnings data through June 2014.

Five Years Of History

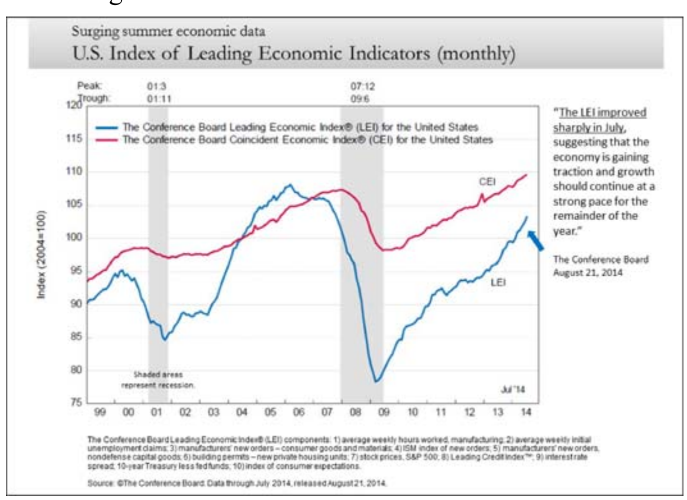
(Continued from page 1)

was chugging along, with the S&P 500 up a very respectable 8.8% with just 10 calendar days left in September.

As the third quarter neared an end, it had been well over three years since the stock market had last experienced a 10% correction. As usual, more and more of the talking heads on TV began predicting a drop in stock prices.

However, economic data suggested continued strength in the months and quarters ahead. The Conference Board's index of Leading Economic Indicators improved sharply in July, suggesting the economy was gaining traction. Growth should continue at a strong pace for the remainder of the year, according to the Conference Board data released August 21, 2014. Historically, the LEI has turned down definitively before a recession.

Indices are unmanaged and not available for direct investment. Investing in small companies involves greater risks than those associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity. Foreign securities have additional risks, including exchange rate changes, political and economic upheaval and the potential lack of strict financial and accounting controls and standards. Emerging markets involve still more risk. Fluctuations in the price of gold and precious metals often dramatically affect the profitability of the companies in the gold and precious metals sector. ●



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