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FINANCIAL ASSOCIATES

Fourth Quarter 2012

Guide...Protect...Preserve

Housing Sector Becomes A Bright Spot In Economy

One of the main reasons the U.S. has suffered such a deep recession was the mortgage crisis, of course, and the plunge it caused in housing prices and construction activity. Lately, however, housing is shaping up as one of the main contributors to the economic recovery.

While home prices remain depressed in many areas of the nation and homeowners continue to struggle to pay mortgages in amounts greater than the value of their homes, encouraging fundamental factors are working in favor of the housing sector and the long-term picture for new construction seems bright.

Between January 1, 2012 and August 17, the Standard & Poor's Homebuilders Index showed an astounding total return of 37%. Why is housing, the most shunned and feared investment just a couple of years ago, so hot? The answer lies largely in simple demographics.

The U.S. population grows by about three million people per year, net of deaths, according to the U.S. Census Bureau. To keep up with population growth, America needs to build about 1.5 million new units per year.

In the 15 years leading up to the real estate bubble, housing starts soared as the nation went on a building spree. Housing prices soared but so did new-home construction. When the bubble burst, housing prices tumbled and housing starts plunged. The excess supply of housing that accumulated during that 15 year real estate frenzy would need to be absorbed for housing starts to rebound.

In recent months, signs are starting to appear that the excess supply is being exhausted. As shown in the accompanying chart, housing starts reversed the dramatic plunge associated with the financial crisis.

It's impossible to say with certainty that housing starts will continue to rise. The path to growth could be uneven and choppy. However, economists say it is reasonable to believe that, based on simple demographic trends, housing starts will revert to their long term mean rate of growth of about 1.5 million annually.

"The US housing sector is

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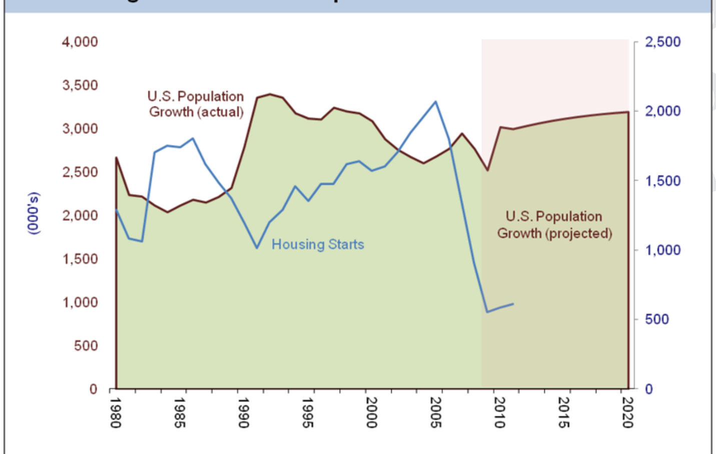
Housing Starts Versus Population Growth



Source: Fritz Meyer Economics, U.S. Census Bureau.
Actual population data through 2008; projections 2009-2020.

Look Out America, Here Come Millions Of Baby Boomers!

The first wave of the massive baby boom generation has reached retirement age at a time of great financial uncertainty. There were an estimated 79 million people born in the United States from 1946 through 1964, and in 2008, the oldest in that group turned 62, the earliest age of eligibility for Social Security retirement benefits. But 2008 also marked the height of the global economic crisis, and though conditions have improved since then, the economy has been growing fitfully, unemployment remains high, and home prices, which plunged during the crisis, have just begun to recover.

Against that backdrop, the question of when to begin receiving Social Security income has become more complicated—and more crucial. As recently as a decade ago, half of those who were eligible started at 62. But these days, more people are opting to delay their benefits. Waiting until full retirement age—66 for those born from 1943 through '54—means higher monthly payments, which can be increased further by waiting until as late as age 70 to claim benefits. Getting a bigger check can be particularly helpful for today's retirees, whose longer life expectancies increase the odds that they will outlive their assets.

Making the right decisions about Social Security and other retirement issues has never been more important. We can help you take stock of your situation.

Mary Jane Callaghan &
Mitch Glicksman

Entrees For The "Sandwich Generation"

Bob and Marcy Tannenbaum both have hectic lifestyles. Bob, who is 45, works in the city for a public relations firm. He commutes from the suburbs each day. Marcy, who is employed closer to home, is the director of a nonprofit organization. She'll turn 43 before the end of the year. They're making ends meet, but haven't set aside nearly as much as they'd like for their future needs.

The couple's three children are 15, 12, and eight. Getting them to soccer practices, dance recitals, and religious-education sessions keeps their parents hopping—especially Marcy, who bears the brunt of the carpooling.

As if things weren't complicated enough, Bob received a panicky phone call last week from his mother. Bob's 70-year-old father had been hospitalized after taking a spill. His mother wanted Bob to come "home" immediately, but "home" is 1,000 miles away. And he can't just leave his family and job behind—not to mention the economic ramifications if he did.

This kind of scenario is all too familiar to those stuck in the middle of helping elderly parents and raising their own children. These people have come to be known collectively as the "sandwich generation." And if you're not careful in these situations, the challenges can swallow you.

Nevertheless, you may be able to minimize potential problems with advance planning. Consider these four basic steps:

1. Get all the facts. Job one is to avoid unpleasant surprises. Talk to your parents about their financial situation and their plans if they become ill or incapacitated. At the same time, examine your own finances. If you haven't already done so, figure out how much you'll need to save for retirement and college for the kids. What will you have left for emergencies?

2. Seek "the power." In case of a dire emergency, you'll have to act fast on behalf of your parents. The best approach is to have a durable power of attorney in place. This allows you to make decisions regarding their financial considerations. For more protection, supplement a power of attorney with a health-care proxy and a living will relating to medical decisions.

3. Face up to long-term needs. The cost of an extended stay at an assisted-living facility or nursing home can be a financial back-breaker for families. Check to see what coverage, if any, your parents would receive from long-term care insurance. If they don't have policies, examine your options. Of course, the longer someone waits to buy such a policy, the more it will cost per year.

4. Don't forget about yourself. As much as you want to help your parents, you can't ignore your own needs. It usually doesn't make sense to erode a college savings or retirement fund to support your parents. Stick to your priorities and develop a plan that incorporates all of these factors. ●

Should You Consolidate Your IRAs?

Everyone's financial situation is different, but people at various stages of life often share similar concerns. Here's a question from a client we encountered under such circumstances:

"I am in my 60s and recently retired from my full-time job. Over the years, I've opened several traditional IRAs and a Roth IRA. Also, I have a 'rollover IRA' with funds from a 401(k) at a previous job. Should I consolidate all of these IRAs into one for tax purposes, or should I just leave things the way they are?"

While there is no real tax benefit one way or the other, there is a trap to watch out for if you do consolidate. Combining the assets of your traditional IRAs into a single IRA could provide a few advantages, however.

For starters, it may be more flexible and cost-efficient to have just one IRA, as well as relieving you of considerable clutter if you're still receiving paper statements from all of your IRA custodians. Also, if one IRA has provided better investment returns than the other or offers other advantages, it might make sense to shift more funds to the IRA with those advantages. (Of course, past performance is no guarantee of future results.) And you may find it easier to coordinate your plans for retirement, and focus on your main objectives, with a consolidated IRA.

Moreover, consolidating accounts might help you avoid a complication that can arise when you start taking "required minimum distributions" (RMDs) from your traditional IRAs. The law mandates that you begin taking RMDs no later than Apri1 1 of the year following the year in which you turn age 70½. These withdrawals from your account, the amount of which is based on life expectancy tables, must continue annually for the rest of your life. If you have several

New Medicare Surtax Spurs Year-End Action

No one ever said year-end tax planning in 2012 would be easy. For starters, the elimination of the "Bush tax cuts" will result in higher federal tax rates for income, capital gains, and dividends, beginning in 2013 (unless Congress enacts new legislation). But there's another major tax change in store for next year: a new 3.8% surtax that will hit some high-income investors.

The 3.8% Medicare surtax applies to the lesser of your "net investment income" or the amount by which your modified adjusted gross income (MAGI) exceeds either $200,000 for single tax filers or $250,000 for joint filers. Net investment income includes interest, dividends, royalties, rents, gains from sales of property (other than property held in an active trade or business), and income from passive activities, but not tax-exempt interest or distributions from IRAs and qualified retirement plans.

Facing this prospect, high-income investors may want to take steps before the end of this year to reduce the sting of the surtax next year. Here are several ideas to consider:

• **Sell assets soon or hold on**. If the law doesn't change before 2013, you might decide to sell stocks, rental real estate, or other assets in 2012. That will help you avoid both the higher tax rates on capital gains and the 3.8% surtax that will kick in next year. Of course, any asset sale also needs to make sense from a financial perspective. If you decide to hold on to most of your investments for now you could still sell them later during a year in which your income is relatively low (and you'll be in a lower tax bracket).

• **Sell property on an installment sale basis.** If you've decided to sell property such as rental real estate and you have a good offer in hand, you might arrange an installment sale. As the name implies, the buyer will make regular payments over two or more years. (Most buyers will agree to this gladly.) By paying capital gains tax only on the portion of the payment received in a particular year, you'll spread out the tax liability and you may be able to stay below the threshold for triggering the 3.8% surtax. Alternatively, you can elect to be taxed on the entire gain in the year of the sale.

• **"Hide" income in IRS-approved tax shelters.** It's a myth that there are no more tax shelters. For instance, if you invest in life insurance or annuities, you don't owe any current tax on the funds building up in your account. Life insurance proceeds aren't paid until the insured person dies, while a deferred annuity may let you "leapfrog" your high-income years and receive taxable distributions when you're earning less. Also, income from municipal bonds is completely free of federal income tax. Other investment opportunities, such as rental real estate and oil gas and deals, may provide tax breaks that reduce net investment income for purposes of the 3.8% surtax.

• **Convert to a Roth IRA.** The usual payoff for converting funds in a traditional IRA to a Roth is that future distributions can be 100% tax-free. But you have to pay current tax on the value of the assets you move into the new account. By converting before the 3.8% surtax hits in 2013, you can reduce the overall tax bite. Or you could decide to make the conversion over several years to minimize the effect on your income (and your tax rate).

• **Establish a charitable remainder trust (CRT).** A CRT lets you transfer assets to a trust that eventually will benefit a designated charity—and that will, in the meantime, provide income to a beneficiary you designate. The beneficiary receives income from the assets over the trust term, thereby spreading out the tax liability and reducing the likelihood that the beneficiary will be subject to the surtax. When the term expires, the remainder goes to the charity. Just keep in mind that this is a complex deal that needs to be considered as part of your overall estate plan.

• **Put family members on the payroll.** Remember that "net investment income" includes income from sales of passive investments—but not from property that's part of an active trade or business. By hiring younger family members to work for your firm, you can significantly reduce their "net investment income" for the surtax calculation. The savings can be enormous for those involved with highly valued businesses. Of course, the family members must perform bona fide duties.

These are just several ideas for minimizing the impact of the 3.8% Medicare surtax. We can work with your tax advisor and your attorney to help you plan steps that make sense in your situation. ●

IRAs, you'll have to choose the source of your annual RMD. It can come from one or multiple IRAs. But no matter how you arrange the distribution, the IRS treats it for tax purposes as coming from all of your IRAs on a "pro-rata" basis.

Let's say you have four IRAs with a combined value of $500,000, and this year you withdraw $20,000 from one of them. The applicable percentage is 4% ($20,000 divided by $500,000), so it's calculated as if you had withdrawn 4% of the balance in each IRA. Consolidating your IRAs would eliminate any confusion.

Finally, be aware that you can't commingle the funds in traditional and Roth IRAs. This is the trap we alluded to earlier. Because Roths have an edge over traditional IRAs—qualified Roth distributions are tax-free and you don't have to take lifetime mandatory distributions—you wouldn't want to put them together anyway. Should you consolidate all of your Roth IRAs? Many of the same considerations that apply to combining traditional IRAs also are applicable to Roths. ●

Two Investment Principles In Tandem

Diversification and asset allocation are twin building blocks of a solid investment foundation. Though the concepts are closely related, understanding each rather than just mixing them together can help you make the most of both. Consider these basics:

Diversification. This is the method of spreading out investment dollars among different categories, or "baskets," in order to reduce your overall risk. For instance, even if you're 99% sure that a particular stock is about to take off, you don't want to invest your life's savings in only one stock. There's still a chance it will tank, leaving you in a financial hole you may never get out of. Similarly, you want to avoid putting all of your investment dollars in a single basket—stocks, bonds, or copper, say—no matter how fundamentally sound the category may seem.

Diversification may work because different kinds of investments tend to rise and fall at different times. If you hold a variety of investments, some may do well when others stumble. Additional benefits can come from diversifying within categories—by spreading your stock investments over many industries and also holding shares in foreign companies. By the same token, you'll probably want to own different kinds of bonds with various maturities. Yet while broad diversification may help your investments weather a worst-case scenario, it can't protect you from losses, especially in a declining market.

Asset Allocation. Closely related to diversification, asset allocation goes a few steps further. Here, you seek to divide your holdings among major investment categories based on a set percentage for each category. Because each group has a unique combination of historical risks and returns, it's expected that each also will perform differently in the future.

This is diversification with a little more science. Because it's likely that if one category loses value, another may be on the upswing while a third holds steady, devoting an appropriate percentage of your portfolio to each can keep your portfolio in balance.

Yet there's also a lot of art involved in asset allocation. Choosing the best percentages for your circumstances requires looking at several variables, such as your objectives, age, health status, amount of assets, and tolerance for risk. And because your goals are likely to shift, allocations need to be reevaluated and adjusted periodically. Typically, your choices will become more conservative as you near or reach retirement.

Asset allocation provides a rigorous method for achieving diversification in your investment portfolio. Having the two ideas working smoothly together can help you move closer to your financial goals. ●

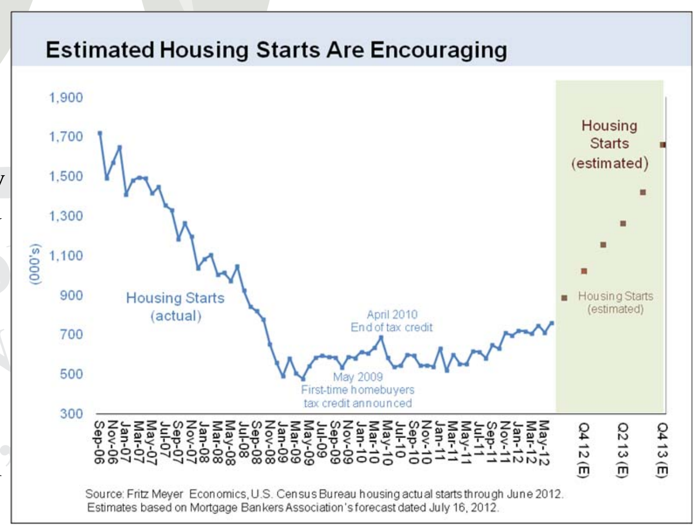
Housing Sector A Bright Spot

(Continued from page 1)

now a relative bright spot, with several solid data points in the past month," according to a July 2012 commentary from the Mortgage Bankers Association. "There has been steady improvement in single-family starts, in line with what we are seeing in terms of new home sales, builder sentiment data, and anecdotal reports from builders. Year over year single-family starts growth is running at almost 22%."

Meanwhile, the National Association of Realtors (NAR) in its July 2012 economic forecast predicted housing starts will rise by 25% in 2012 and jump 50% in 2013. NAR says multifamily units, which are predominately rentals, are likely to experience a stronger recovery because of rising rent trends.

In addition, the NAR's quarterly Housing Affordability Index rose to a record high of 205.9 in first quarter of 2012. It was the first time the quarterly index broke the 200 mark since NAR began tracking the index in 1970. The index is based on the relationship between median home prices, median family income, and the average mortgage interest rate. A higher index reading indicates greater household purchasing power.



While the quarterly index fell back to an estimated 185.1 in August 2012, housing remains inexpensive by historical standards. ●

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