Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

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Expenses And Behavior Are Key To Investment Success

John Bogle, 84, is a hero to investors. His common sense message about controlling investment expenses helped him build The Vanguard Group into one of the world's largest mutual fund companies.

Bogle, for decades, has decried high fees extracted by Wall Street for managing mutual funds, and his message about the importance of low-expense investing is well-known. Nonetheless, the picture of retirement savings painted by Bogle in the PBS news-documentary series, *Frontline*, in March 2013, was astonishing. In a segment aptly titled, "The Retirement Gamble," Bogle shows that Americans, who save for retirement for their entire working lives in 401(k)s and IRAs, often wind up paying most of their nest eggs to Wall Street.

Using the accompanying chart, Bogle showed the ravaging effects of paying high fees on mutual funds. Paying 2% annually to a mutual fund that earns a return of 7% annually for 50 years, results in 63% of your nest egg going to pay Wall Street fees. Because of the magic of compounding, much of your retirement savings can go to paying mutual funds to manage your money.

Bogle shows why low-cost mutual funds can be crucial to retirement success. He criticizes the use of "actively managed" funds that try to pick the right stock or bond to hold in a portfolio in favor of the use of index funds and Exchange Traded Funds (ETFs), which offer much lower expenses.

Bogle and *Frontline* did a great service and low-expense investments are a no-brainer. Where it gets complicated, however, is in choosing the right allocations for low-expense investments. Creating a mix of investments that is less likely to prompt you to sell a strategic holding after it has dropped sharply can be just as crucial to achieving retirement success as maintaining low expenses. In fact, research indicates that "behavioral finance" issues actually lower investor returns more than the use of high-expense investments.

In the 20 years that ended December 31, 2012, the average annual return of all investors in U.S. stock mutual funds was 4.25%, according to a study by Dalbar, a Boston-based financial research group. Over the same period, the benchmark Standard & Poor's 500-stock index returned an annualized gain of 8.21%. That's a huge gap—nearly four-percentage points every year for over two decades. To be clear, failing to make a long-term investment plan and stick to it caused fund investors to lose four percentage points a year—twice the drag of high-expense funds.

Why do fund investors fare so poorly? Because they tend to buy high and sell low. Dalbar and academic studies have shown repeatedly that investors become rattled when stock prices fall and they sell what were intended to be long-term holdings. In a pattern that keeps repeating itself, investors historically and repeatedly overreacted to short-term emotional volatility. How do you avoid doing this?

There is no perfect answer because

(Continued on page 4)

Rebalancing Plays An Important Role In Producing Returns

The U.S. equity market has more than doubled in value over the past few years. Has your portfolio been rebalanced to take this change into account?

Diversification and asset allocation require periodic rebalancing. That's because 90% of returns are attributable to asset class choices rather than to specific securities.

Let's say your portfolio originally contained 50% U.S. stocks, with the rest split among bonds, real estate, and other alternatives. Between March 2009 and March 2013, the Dow Jones Industrial Average of U.S. stocks rose 129%, following the historic downturn of 2008. If you haven't made any adjustments, the value of the stocks in your portfolio likely has risen well past 50% of the overall value.

It's important to bring that share back down because that increased emphasis on equities has added risk to your portfolio. Stocks eventually will have a down year, and if they make up too great a share of your portfolio your losses could be proportionally higher than what you expect when the market drops.

When it comes to portfolio design, getting the recipe right is more important than the ingredients you choose. We will help you get the right mix of asset classes and ensure that your portfolio is rebalanced regularly to keep that mix intact, while taking into account your risk tolerance, changing situation, and the need to keep investment costs low.

Steven L. Kane, CPA/PFS, CFP®

3.8% Surtax Hits Passive Investors

If you own a sizable interest in a business, you no doubt already pay close attention to the federal income taxes that your stake in the company generates. But now there's a new tax wrinkle to contend with: the 3.8% Medicare surtax on investment income. Depending on your level of business activity, you might have to pay this new tax in addition to any other federal income tax you owe.

Beginning with the 2013 tax year, the 3.8% Medicare surtax applies to the lesser of (1) net investment income (NII) or (2) the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. That threshold is $200,000 for single filers and $250,000 for joint filers.

NII includes items such as interest, dividends, annuity distributions, rents, royalties, and net capital gains on property you sell. Significantly for business owners, it also includes income derived from passive activities. Net investment income doesn't include salaries, wages, or bonuses; distributions from IRAs or qualified plans; income used to calculate self-employment tax; gains from selling an active interest in a partnership or S corporation; and income from tax-exempt bonds and other items not subject to income tax.

As you can see, it makes a big difference for tax purposes whether you're characterized as an "active" or "passive" investor in a business. As a passive investor, the income you receive counts as NII for purposes of the 3.8% surtax.

The tax law provides some basic rules governing passive activities. Generally, a passive activity is a business activity in which you do not "materially participate." Material participation occurs when you're involved in the activity's operation on a regular, continuous, and substantial basis. Rental activities—including renting out real estate—are generally treated as passive activities, even if you materially participate. However, rental real estate activity isn't passive if you qualify as a real estate professional.

There are several tests for qualifying as a material participant. For instance, you are treated as materially participating if you're involved in the activity for more than 500 hours during the year; your participation accounts for virtually all of the participation of anyone involved in the activity for the tax year; or if you participated in the activity for more than 100 hours during the tax year and participated at least as much as any other person (including those who don't own any interest in the activity) for the year.

The rules for real estate professionals are even more stringent. Typically, to qualify as materially participating you have to log more than 750 hours.

If it's a close call, put in the extra time to qualify as an active investor. It may help you avoid the 3.8% surtax. ●

Saving For Retirement At All Ages

Financial planners often are asked, "When should I start saving for retirement?" Although everyone's circumstances differ, the answer usually is a variation on this theme: As soon as possible. But that doesn't mean it's ever too late to begin, or that you'll have the same financial priorities at every age. When you're embarking on a career, you may not have much extra income to set aside, but you can work on establishing sound financial habits. Later, though you'll likely earn more, you'll also likely have greater obligations—supporting your family, paying a mortgage note, and, yes, saving for retirement. Still other factors may come into play as you approach your golden years.

Consider these basic approaches during different financial stages of your life.

In your 20s. Retirement may seem several lifetimes away. What's more, the salary you earn during your early working years likely won't provide much cushion for savings. But you may be surprised by how much you can accumulate if you're dedicated, thanks largely to the power of tax-deferred compounding. For instance, if you save $1,000 a month and earn 8% on your savings compounded annually for 40 years until retirement, you will amass a staggering $3,271,022.95. (These figures are hypothetical and not indicative of any particular investment.)

The easiest way for most people to sustain tax-deferred growth is through a 401(k) or another tax-advantaged retirement plan. If your employer provides matching contributions, try to contribute at least as much as you need to qualify for the maximum match.

In your 30s and 40s. These are prime earning years, but you also might incur substantial expenses raising the kids, buying and maintaining a home, and paying for

13 Of The Best Midyear Tax Moves For '13

Now that you've put your 2012 tax return to bed, it's time to focus on 2013. Because of tax rate increases for upper-income taxpayers and a new surtax on investment income, it is especially important to get an early jump on tax planning. If you wait until the end of the year, it may be too late.

Although everyone's situation is different, and not all of these may apply to you, consider these 13 midyear tax strategies for '13:

1. Harvest capital losses. For your 2013 return, the usual 15% maximum tax rate for long-term capital gains is boosted to 20% for single filers with income above $400,000 and joint filers above $450,000. But you still can use capital losses recognized during the year to offset capital gains, plus up to $3,000 of ordinary income that now will be taxed at rates as high as 39.6%.

2. Realize capital gains. Conversely, remember that your capital gains are effectively tax-free up to the amount of your annual losses. That could be particularly valuable now that the capital gains rate is higher for some taxpayers and you also could face the new 3.8% Medicare surtax, which applies to the lesser of your net investment income or your modified adjusted gross income above $200,000 for single filers and $250,000 for joint filers.

3. Avoid the wash-sale rule. If you acquire "substantially identical" securities within 30 days of selling an investment at a loss, the loss can't be deducted on your tax return. Avoid this harsh "wash-sale" result by waiting at least 31 days to buy back the same securities. Alternatives are to buy more of the holding first and wait at least 31 days to sell the original shares or to replace them with an investment that's similar but not identical.

4. Invest in dividend-paying stocks. Qualified dividends still are taxed at a maximum 15% rate for most investors, although a 20% rate applies to those above the same income thresholds for long-term capital gains. To qualify for a favorable tax rate, you must hold the dividend-paying shares for at least 61 days.

5. Arrange an installment sale. Generally, you can defer tax on the sale of real estate or other property if you receive payments over two years or longer. Not only do you stretch out your tax payments, but you also might reduce the effective tax rate if you stay below the thresholds for capital gains and the 3.8% surtax.

6. Contribute to your 401(k). One sure-fire way to lower your tax liability is to increase contributions to a 401(k) plan where you work. For 2013, you can elect to defer as much as $17,500 to your account ($23,000 if age 50 or over). Not only do you avoid tax on the contributions, they can compound tax-free until you withdraw the money during retirement.

7. Convert to a Roth IRA. If you have funds in a traditional IRA, you can convert some or all of that money to a Roth IRA. Future "qualified" Roth distributions won't be taxed. To avoid absorbing a big income-tax hit—due on money you transfer—all at once you could spread out conversions over several years.

8. Transfer IRA funds to charity. For 2013, someone age 70½ or over can withdraw up to $100,000 from an IRA and give it directly to charity without any tax consequences. This tax break, which had expired recently, now has been extended through the end of 2013.

9. Sell the old homestead. The tax law allows you to exclude tax on a gain of up to $250,000 for single filers and $500,000 for joint filers if you've owned and used the home as your principal residence at least two of the past five years. The excluded amount is exempt from the 3.8% surtax.

10. Rent out a vacation home. You can write off certain rental activity costs, plus depreciation, but you must be careful. If your personal use exceeds the greater of 14 days or 10% of the days the home is rented out, deductions are limited to the amount of rental income. Keep summertime personal use below the threshold.

11. Give grads generous gifts. Generally, you can claim a $3,900 dependency exemption for a child graduating from college in 2013 if you provide more than half of the child's support. Figure out the amount of a gift needed to put you over the half-support mark.

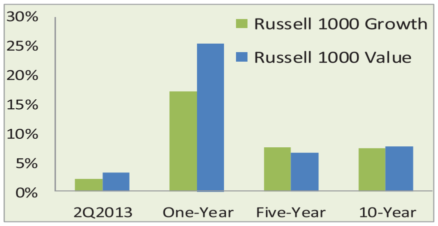
12. Install energy-saving devices. The tax credit for energy-saving improvements in a home—such as central air conditioning—is restored for 2013. But the maximum credit of $500 is reduced by expenses claimed in prior years.

13. Adjust your withholding. Finally, due to all the tax-law changes in 2013, you may not be withholding enough income tax from your paychecks. Make the adjustments needed to avoid an "estimated tax penalty" this year. ●

college. Nevertheless, you should do your best to stay disciplined and contribute as much as you can to your retirement plans. For 2013, you can defer up to $17,500 of salary to your 401(k). In addition, if you establish an IRA, the annual contribution limit is $5,500. Meanwhile, although contributions to a Roth IRA are never tax-deductible, future payouts may be tax-free. ï€†

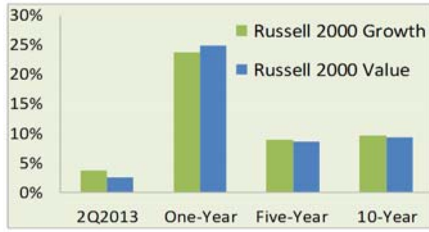
In your 50s and 60s. This may be when you earn the highest salary of your career. If the kids are out of college and the mortgage is paid off, it's truly time to make hay while the sun shines. Although you might not have been as diligent at retirement saving in the past as you would have hoped to be, you can recover lost ground quickly by socking away more in your retirement plans at this point in your life. For 2013, you can contribute an extra $5,500 to a 401(k) and an additional $1,000 to an IRA, above the limits already discussed. And you can save still more in taxable accounts outside your retirement plans. ●

Market Data Bank: 2nd Quarter 2013



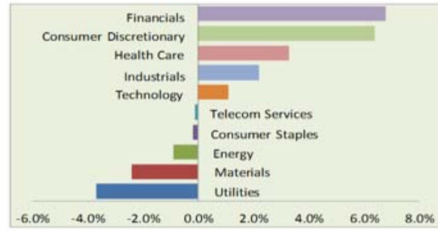
LARGE VALUE VS. LARGE GROWTH

2Q2013 was a good quarter for U.S. stocks. Large caps with low price-earnings ratios beat large-growth companies. The financial-crisis bear market hurt 5-year returns but 10-year gains approached the 76-year norm.



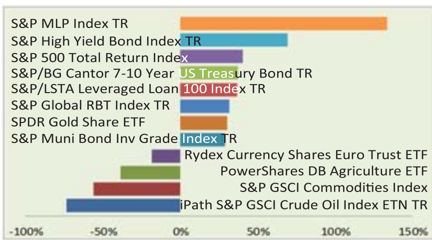
SMALL VALUE VS. SMALL GROWTH

The stock market rally continued and small-cap growth companies showed total return of 3.7% in 2Q2013. Despite the financial crisis, the 5-year average annual return on small-cap growth stocks was a respectable 8.9%.



LARGE-CAP STOCKS BY INDUSTRY

Utilities lagged as interest rates rose and made dividend-yield less attractive. Financial stocks and companies that benefit from discretionary consumer spending rose in value on expectations of continued economic growth.

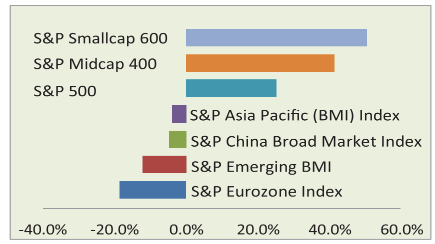


ASSET CLASSES±

A third of the 12 major asset classes fell in value over the last five years ended 6/30/13—demonstrating the importance of diversification and Modern Portfolio Theory. Master Limited Partnerships, which mainly invest in oil and gas businesses, led in five-year cumulative returns.

S&P 500 INDEX VS. EARNINGS¥

Estimated S&P 500 earnings per share as of July 24, 2013 was $111.05 for 2013 and $123.59 for 2014. Unexpected events could derail stocks at any time, but the trajectory of stock prices versus earnings estimates remained positive at the start of the summer.



FOREIGN VS. U.S. STOCKS

In the 5-years ended 6/30/13, U.S. stocks outperformed foreign stocks, as the U.S. economy far more resilient than most foreign markets. Ironically, that's made globally diversified portfolios look bad versus U.S. stocks. But that's a price you must pay for diversification.

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. ¥Actual S&P 500 index data through 6/30/2013 and actual earnings through 3/31/2013. Estimated 2013 and 2014 S&P 500 earnings per share as of July 24, 2013. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates; Standard and Poor's for index prices through 6/30/2013 and actual earnings data through March 31, 2013.

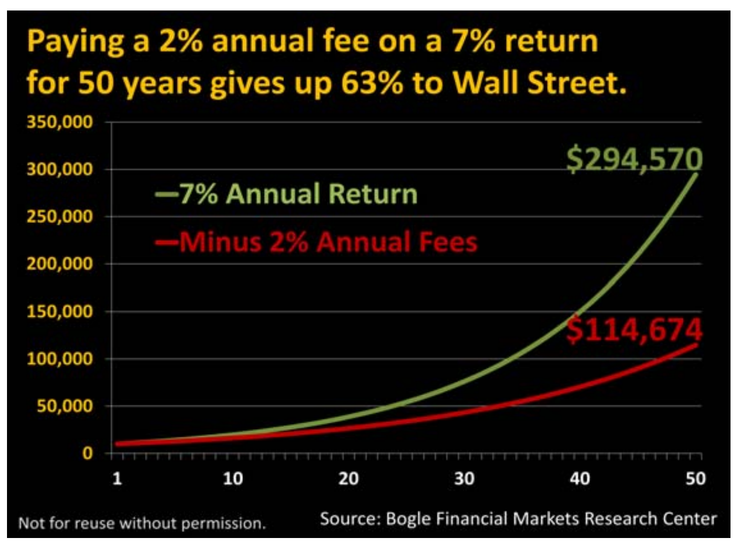
Key To Investment Success

(Continued from page 1)

we're all subject to human foibles. In good or bad times, people have a natural tendency to extrapolate recent events into the future. People forget that, in the past, better times have always returned after bad times. While there is never a guarantee that good times will return after every downturn, betting on a rebound was statistically and historically the right choice in the past. To fight the human predilection for selling when a market is bottoming, three pillars seem crucial to support your effort.

1. An investment policy statement written in unemotional times that commits you to holding on through downturns and that is in tune with your risk profile and how much money you need to fund your goals in life.

2. Spreading investments across a range of markets that are not highly correlated with one another to try to dampen the effects of the next investment downturn and make you less susceptible to reacting emotionally in bad financial times.



3. A relationship with a financial professional who tracks markets daily but understands their history and who can help you stick with your long-term strategy, even in tough times. ●

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