Nicholson Financial Services

Did You Know...???

GREECE!!!

I recently joked with a client: "I am going to tell my kids that as we approach Halloween, if they want to scare someone, instead of yelling "BOO" they should yell "GREECE!" As silly as that sounds, it has worked for the markets. Recently, the markets have been exceptionally schizophrenic as positive or negative comments regarding the European debt crisis drove the daily mood and direction. Over the last couple of months, investors have been pummeled by the downgrade of the US credit rating, resumed fears over Europe's debt, the slow economic recovery and stagnant unemployment here in the US, and fears of a global economic slowdown. It is hard to account for such large scale "fear of the worst case scenario" environments except to say they happen and they end. As I said in my intro piece, "the market is fear, hope and greed loosely connected to the business cycle." This seems especially true these days. Contrary to the opinions in the news media, I have been advising clients that I am bullish on stocks. The reasons are many and I will cover a few.

1) Greece and the European Debt Crisis (EDC): Is anyone else as sick of hearing about this as I am? The fact is that based on 2010 numbers, Greece ranks #32 in the world by GDP (from Wikipedia). Although they are not the only culprit in the EDC, they are the hardest hit and the focal point. I have not believed, and still do not believe, that Germany and France (ranked 4 & 5 in 2010 GDP) and some of the other stronger economies in Europe will let the EDC pull down all of Europe. This fear of the "worst case scenario" is anxiety what *could* happen. The reality is that a bailout or recapitalization of European banks is far more likely. As I write this in early October, the markets are starting to respond positively to negotiations over exactly such a scenario.
2) Compelling Stock Valuations: As a result of the August/September sell off, the S&P 500 Index was recently trading at a P/E of under 12.5 X (times) earnings, well below the index's long-term average of 16.43 X dating back to 1954. Jeff Saut recently pointed out that the "valuation low" usually occurs a couple of years after the point low of a bear market. The point low appears to have been in March 2009 and the valuation low may very well prove to be August 2011.
3) Large companies are doing very well: For the second quarter, over 67% of companies in the S & P 500 index BEAT earnings expectations. Over 70% BEAT REVENUE expectations (showing this is not all about cost cutting or lay-offs). I hear many analysts being cautious about third quarter earnings, setting up what I believe will be opportunities for companies to beat expectations.
4) As a result of the 2008 credit crisis, companies are hoarding cash: There is more cash on US balance sheets than ever before. I believe that is what is holding back the economy. However, at the same time, I look at it as a big "ace in the hole" for the markets. Last week, I had dinner with Ron Sloan, CIO of Invesco Funds and manager of the Invesco Mid-Cap Core Equity Fund and Invesco Charter Fund. I had the opportunity to discuss this issue with Ron and hear his opinions. He said that Invesco's estimate is that there is now over $2 Trillion in CASH on US corporate balance sheets. Moreover, he concurred with my assessment that the cash balance is holding the economic recovery back, but going forward could turn into a tremendous positive as the cash is put to work.
5) Attractive Dividends: As of the third week in August, for only the second time in over 40 years, the dividend yield on the S&P 500 Index surpassed the yield of the 10-year U.S. Treasury bond. High dividend yields from stocks usually represent a value opportunity.
6) Federal Reserve Action: More to the point, lack of action. The Fed recently confirmed that they will not raise interest rates for another 2 years, until at least summer 2013. Low interest rates are very positive for corporations and make fixed investments less attractive to institutions. My thought is that in the not too distant future, large businesses will use that cash to either hire, invest, or to make acquisitions. Any and all would help the economy.

As always, please contact me if you would like to discuss this information or my opinions.

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Jeff Saut, Chief Investment Strategist at Raymond James, has a saying that I like to quote often: "The market is fear, hope and greed loosely connected to the business cycle." Put simply, stocks never exactly represent the true value of the underlying company. They either overvalue it or undervalue it, and often by a wide margin. Over the last couple of months, we have once again had an environment where macro (big picture) fears have pulled the whole market down. Yet, at the same time that their stocks were dropping, many companies have continued to recover and others are thriving. It is times like this, when such a "disconnect" exists, that potential opportunities are created. We just have to recognize and act on them.

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All about Indices

No doubt you've seen headlines reporting that a particular index is up or down. But do you know how an index works, and why understanding the nuts and bolts of a specific index can make a difference to your portfolio?

An index is simply a way to measure and report the fluctuations of a securities market or a particular segment of a market. An index is developed by a company that sets specific criteria to determine which securities are included in the index--factors such as a company's size or location, or the liquidity of its stock. For example, the S&P 500 is a collection of large-cap U.S.-based companies that Standard and Poor's considers to be leading representatives of a cross section of industries.

The company that develops the index tracks the performance of its components and aggregates the data to produce a single figure that represents the index as a whole. Virtually every asset class has at least one index that tracks it, but because of the size and variety of the stock market, there are more stock indexes than any other type.

How indices are used

In addition to providing valuable information needed to monitor how a particular market is faring, an index can serve as the basis for mutual funds or exchange-traded funds that attempt to replicate its performance; that process is known as indexing. An index also can be used as a benchmark for funds that invest in the same asset class, regardless of whether a fund includes the same specific securities. Finally, some investment products do not attempt to replicate an index's performance but represent a bet on the index's general movements, though such investments can be challenging and are not appropriate for every investor.

You can't invest in an index

You cannot invest directly in an index. You could always purchase each and every security in the index and do the necessary trading to ensure that the portfolio continues to mirror the index, but the financial services industry has saved you the trouble. As noted above, investment products such as index mutual funds and exchange-traded funds are used by investors to try to capture a particular market's performance.

However, an index-based investment may not match the return of an index exactly. One reason is what's known as "tracking error." Costs such as taxes, operating expenses (even minimal ones), and transaction costs can differ among mutual funds. As a result, your return may be slightly different from that of the index or even other funds based on the same index, even though most index funds try to keep tracking error to a minimum.

Indices don't stay static

Though an index adheres to a set of guidelines for selection of the securities it includes, the company that oversees the index generally reviews the security selection periodically. For example, some indices are rebalanced if an individual security grows so large that it dominates the index. Others have a limit on how much of the index can be devoted to a particular sector or industry, and rebalance if the proportion gets skewed. And in some cases, an index is altered because of serious problems with one of its components (for example, Flowserve Corp. replaced Washington Mutual Inc. in the S&P 500 after WaMu was closed by the Office of Thrift Supervision in 2008).

Weight watching

Even indices that include the same securities may not operate in precisely the same way. Why? Because different indices may weight the relative importance of the same securities in different ways. The way an index is weighted determines how much of each individual security is included in it--for example, how many shares of stock. That weighting in turn can affect the overall index's performance.

Some indices are weighted based on market capitalization; the companies with the highest market cap (total value of stock outstanding) make up a larger share of the index than companies with a smaller market cap. As a result, those companies can have a disproportionate impact on the performance of an index weighted by market cap. For example, a 10% decline in the price of the largest company in the S&P 500 index would affect the index's overall return more dramatically than a 10% drop in the price of a much smaller company, because the S&P 500 is weighted by market cap.

Other indices are weighted by price; the most expensive stocks receive greater weight than lower-priced stocks. The Dow Jones Industrial Average, which includes 30 large, blue-chip industrial stocks and is commonly referred to as the Dow even though there are several Dow indices, is price-weighted. A relatively new approach to weighting an index is to use certain fundamental attributes, such as dividends or cash flow, as the basis for weighting the stocks that comprise the index.

Before investing in a mutual fund, you should carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. And don't forget that any investment involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

To produce a figure that indicates the value of the aggregated securities, an index divisor is typically applied to produce a more manageable figure that is easier to quote than the index's actual value.

Getting an Early Start on Saving for Retirement

It's obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off your retirement savings. For example, if you retire at age 70 instead of age 65, and save an additional $22,000 per year at a hypothetical 6% rate of return, you can potentially add $124,016 to your retirement fund (and any existing savings will have five more years of potential growth). (This is a hypothetical example and not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Many people assume they can hold off saving for retirement and make up the difference later. But this can be a costly mistake. Waiting too long to start saving can make it very difficult to catch up, and only a few years can make a big difference in how much you'll accumulate. This doesn't mean there's no hope if you haven't set aside anything for retirement yet. It just makes it all the more important that you implement a plan today.

Start saving now

Start saving as much as you can, as soon as you can. The earlier you start, the longer compounding can work for you. For example, a 20 year old who saves $200 a month until age 65 and earns exactly 6% on saved funds annually would have accumulated around $550,000. But a 40 year old contributing the same amount each month at the same earnings rate would have accumulated only $138,600 by age 65.

Contribute $200/month to age 65 at different hypothetical earnings rates

	Start at age 20	Start at age 30	Start at age 40	Start at age 50
2%	$174,931	$121,510	$77,764	$41,943
4%	$301,894	$182,746	$102,826	$49,218
6%	$551,199	$284,942	$138,599	$58,164
8%	$1,054,908	$458,776	$190,205	$69,208

(This is a hypothetical example and is not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Take advantage of employer plans

Chances are your employer offers a 401(k), 403(b), or similar retirement savings plan. You can contribute up to $16,500 to a 401(k) plan in 2011. And if you're 50 years old or older, you can make additional "catch-up" contributions of up to $5,500, for a total of $22,000 in 2011.

Since pretax contributions are excluded from your paycheck, you'll enjoy an immediate tax savings when you contribute to one of these plans. For example, if your effective income tax rate is 30%, a $22,000 annual pretax contribution will only "cost" you $15,400 once the tax benefit is factored in. Of course, you'll have to pay income tax when you start receiving distributions from the plan, but it's possible you'll be in a lower tax bracket at that time (note that distributions made prior to age 59½ may be subject to a 10% additional penalty tax unless an exception applies). Your employer's plan may also allow you to make Roth contributions. There's no immediate tax benefit (contributions are made with after-tax dollars), but qualified distributions are entirely free from federal (and most states') income tax.

Even if you can't contribute the maximum allowed, you should at least try to contribute as much as necessary to get any matching contributions that your employer offers. This is essentially "free money." However, you may need to work up to six years before you're fully vested in (that is, before you fully own) any employer matching contributions.

Don't forget IRAs

You can contribute up to $5,000 to an IRA in 2011. You can also make catch-up contributions to an IRA if you're 50 or older--up to an additional $1,000 in 2011.

Your contributions to a traditional IRA may be deductible if neither you nor your spouse are covered by an employer retirement plan, or (if either of you are covered) your income falls within specified limits. Like pretax 401(k) contributions, deductible IRA contributions can result in an immediate tax savings, and as with 401(k) plans, withdrawals made prior to age 59½ may be subject to an additional 10% penalty tax unless an exception applies.

But even if you can't make deductible contributions to a traditional IRA, you can generally make nondeductible (after-tax) contributions. There are no up-front tax benefits, but your contributions will be tax free when withdrawn, and any earnings will grow tax deferred until distributed.

If your income is within prescribed limits, you can also make after-tax contributions to a Roth IRA. In this case, even the earnings are tax-free if your distribution is "qualified." Distributions are qualified if you satisfy a five-year holding requirement, and the distribution is made after you reach age 59½, become disabled, or die, or the funds are used to purchase your first home (up to $10,000 lifetime).

Make saving a priority

Saving even a little money can really add up if you do it consistently. Consider ways to free up more money to save for retirement--by reducing discretionary spending, for example. And, put retirement ahead of competing goals, even important goals like saving for your child's education.

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Ask the Experts

I'm retiring to a state with no income tax. Can my former state tax my retirement benefits?

The short answer is "no."

In the past, several states enacted "source tax" laws that attempted to tax retirement benefits if they were earned in that state, regardless of where a taxpayer resided when the benefits were ultimately paid. For example, if you earned a $50,000 annual pension while working in California, and then retired to Florida, California would attempt to tax those benefits, even though you were no longer a California resident.

But, in 1996, a federal law was enacted (P.L. 104-95) that prohibited states from taxing certain retirement benefits paid to nonresidents. As a result, if your retirement benefits are covered by the law (most are, see below), only the state in which you reside (or are domiciled) can tax those benefits.

Whether you're a resident of, or domiciled in, a state is determined by the laws of that particular state. In general, your residence is the place you actually live. Your domicile is your permanent legal residence; even if you don't currently live there, you have an intent to return and remain there.

The law applies to all qualified plans (this includes 401(k)s, profit-sharing plans, and defined benefit plans), IRAs, SEP-IRAs, Internal Revenue Section 403(a) annuities, Section 403(b) plans, Section 457(b) plans, and governmental plans.

The law provides only limited protection for nonqualified deferred compensation plan benefits. Benefits paid from nonqualified plans that are designed *solely* to pay benefits in excess of certain Internal Revenue Code limits (for example, Section 415 excess benefit plans) are covered by the law. Also covered are nonqualified plan (for example, top-hat plan) benefits that are paid over the employee's lifetime, or over a period of at least 10 years.

Examples of benefits that are not covered by the law include stock options, stock appreciation rights (SARs), and restricted stock.

What state tax issues should I consider when deciding where to retire?

If you're retired, or about to retire, you may be thinking about relocating to a state that has low (or no) income taxes, or that provides special tax benefits to retirees. Here are some state tax issues to investigate before making your move.

State income taxes typically account for a large percentage of the total taxes you pay. So, consider yourself lucky if you're planning a move to one of the seven no-income-tax states--Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming (New Hampshire and Tennessee impose income tax only on interest and dividends).

If you're considering a state that does impose an income tax, you'll need to know how that state treats Social Security and retirement income. Social Security is completely exempt from tax in more than half the states. Some states tax your Social Security benefits only if your income is above certain levels. Still others provide a general retirement income exclusion that takes Social Security benefits into account. Most of the remaining states tax Social Security benefits to the same extent they're taxed for federal income tax purposes.

Most states with an income tax fully or partially exempt retirement income--only California, Indiana, Nebraska, Rhode Island, and Vermont do not. But the exemptions vary considerably by state. Some states exempt public pensions from taxation but tax private pensions, or exempt public pensions earned in that state, but not public pensions earned in another state.

Some states exempt employer retirement benefits from tax, but not IRA income. Other states exempt a specific dollar amount of retirement income, but only if you've reached a certain age or have income within certain limits. In certain states, military pensions are fully or partially exempt, while in others they're fully taxable. Some states exempt defined benefit pension payments, but tax 401(k) benefits.

Remember that states may also impose many other kinds of taxes (for example, sales, real estate, and gift and estate taxes). Check to see if the state you're considering offers tax breaks to seniors, like property tax reductions, or additional exemptions, standard deductions, or credits based on age.

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