



Nicholson Financial Services

Did You Know...?

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Due to my eventful winter (see the first article), I didn't get to do a Winter Newsletter with Year End commentary until now. Although last year started out fairly strong, we endured a correction in August and September. The markets digested the downgrade of the US credit rating and the fear of financial crisis part 2, this time centered in Europe. As those concerns dissipated, the domestic markets rallied in the 4th quarter, but not enough to produce anything more than a flat year. The international markets fared significantly worse. As we entered 2012, we have seen a continued improvement in the economy with positive news about unemployment, housing, and consumer spending. Add the Federal Reserve's announcement that they will likely keep interest rates low until late 2014, and the US equity markets turned in their best Q1 in over 10 years.

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Spring 2012

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The Importance of Trust

Even though I have been in my chosen career for over 18 years, I still feel honored and humbled that so many clients trust me with their finances. I recognize that even if a client was referred to me by a credible source, they are still taking a *leap of faith* when they start working with me. They have to trust that I will have their best interests at heart, and I work hard to honor that trust. This past January I had to make my own leap of faith. Sitting at my desk at home one day I spontaneously went deaf in my left ear (imagine an old fashioned alarm clock ringing constantly in your ear). After seeing a couple of doctors, I went to an ENT specialist. Her opinion was that I had "sudden onset hearing loss." I never knew such a thing existed. She said they *think* it was caused by a viral infection of the inner ear, but they can't see in there to know for sure. The treatment she recommended was a heavy dose of Prednisone (steroid) for two weeks. Anyone who has been on Prednisone knows that the side effects can be worse than what you are trying to cure. Basically, I had to trust the doctor's advice that the steroids would get my hearing back, even though she did not know for sure that it was a viral infection. She even said that it was possible that I would finish the steroid regimen, deal with the side effects, and still not get my hearing back. We would then move on to plan B. I decided to trust her advice and took the steroids. As an aside, I did ask her if they would make me stronger, jump higher and play better basketball. She laughed and unfortunately said "no."

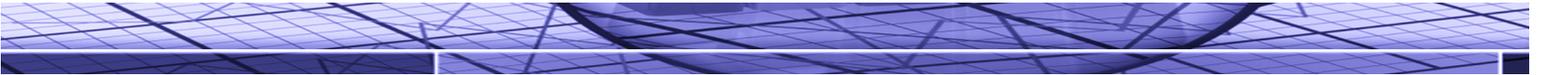
The side effects were brutal for me. I was wired all the time so I couldn't sleep at night. Fortunately, my hearing came back to almost 100% and the side effects eventually dissipated. Cheers, Doc. Couldn't have done it without you.

This experience made me think even more about the trust my clients place in me. My ENT doctor could have been wrong, but her education, experience and intuition didn't fail me.

Along the same line, much of financial planning is based on assumptions and estimates. However, we have no idea what the stock markets will do in the short or long term future. We draw on our experience and knowledge that historically, stocks have outperformed every other investment class. As long as there are economies around the globe that continue to grow, their stock markets should reflect that growth. A main focus of my service to my clients is monitoring that economic growth over time and advising if/when changes are necessary.

I am still amazed that so many people choose to handle their own investments. Some people can do so successfully, but my experience has taught me that most cannot. Most people do not have the time, knowledge or inclination to do so. It is relatively easy to buy a stock or invest in a mutual fund online. It is shocking to me, however, that some individuals attempt complex investment planning without professional advice. This is akin to being your own physician or attorney (see the next article). I have asked myself why people would not seek the advice of a professional, whose full-time job is focused on the area where they need help. I believe in many cases it is an issue of *trust*. Those individuals are unwilling or afraid to trust their finances to a professional advisor. Any trust is earned, but that is difficult to do without that *leap of faith*.

I didn't want to take the steroids, but trusted my doctor had my best interests in mind. She knew what to do to treat me and it reinforced for me how important it is to seek out an expert. She had the education and experience that I needed. Losing my hearing was stressful, but my doctor did all she could to put my mind at ease. Many people come to me stressed about their finances. By educating and advising them, I seek to give clients financial confidence, but that wouldn't be possible without trust. For those of you who have placed your trust in me, I sincerely thank you.



The Problem with Do-It-Yourself Estate Planning



The one-size-fits-all fill-in-the-blank forms that do-it-yourself estate planning sources provide may be attractive to some individuals because they cost a fraction of what attorneys typically charge. But is saving a few dollars worth the risk and potentially high cost of doing things incorrectly?



As the number of Internet websites and software packages have quickly multiplied, along with the many books and stationery store kits that have always been available, do-it-yourself (DIY) estate planning is on the rise. The one-size-fits-all fill-in-the-blank forms that these sources provide may be attractive to some individuals because they cost a fraction of what attorneys typically charge. But is saving a few dollars worth the risk and potentially high cost of doing things incorrectly?

Cheap, easy, and better than nothing?

Proponents of DIY estate planning typically have two arguments:

1. It's cheap and easy: A will, for instance, can be completed online in about 15 minutes for about \$69. In comparison, working with an experienced attorney to create common estate planning documents (wills, trusts, health-care directives, and powers of attorney) may cost you anywhere from \$800 to \$3,000 or more, depending on the complexity of your estate.
2. It's better than nothing: The consequences of dying without estate planning documents are that the state will make important decisions for you, such as how your property will be distributed, who will care for your minor children, and what medical care you'll receive if you are unable to make your wishes known.

These points are valid; for those who cannot afford to pay an attorney, DIY may be the only economical alternative available. For others, a poorly drafted will is better than no will at all, especially where the naming of a guardian for minor children is involved. But the chances that DIY estate planning will effectively accomplish exactly what you intend is slim. Here's why.

It's too easy to make mistakes

DIY sources typically only handle simple estates, and can't deal with even the most common complexities such as children from a prior marriage, children with special needs, property that has appreciated in value resulting in capital gains, or estates that are large enough to be subject to estate taxes. And, DIY sources generally fail altogether to take advantage of sophisticated estate planning strategies because they typically can't account for an individual's unique circumstances.

Further, you may make an error by failing to understand the instructions or by following the instructions incorrectly.

The result is that the documents you create could be invalid, ineffective, or contain legal language having consequences you never intended. You might not know if that is the case during your lifetime, but at your death your loved ones will find out and may suffer the lasting consequences of your mistakes.

You're not getting legal advice

DIY sources provide forms but not legal advice. In fact, these sources clearly state that they are not a substitute for an attorney, and that they are prohibited from providing any kind of legal advice.

Estate planning involves a lot more than producing documents. It's impossible to know, without a legal education and years of experience, what the right legal solution is to your particular situation and what planning opportunities are available. The actual documents produced are simply tools to put into effect a plan that should be specifically tailored to your circumstances and goals.

Estate planning laws change

Laws are not static. They constantly change because of new case law and legislation, especially when it comes to estate taxes. Attorneys keep up with these changes. DIY websites, makers of software, and other sources may not do as good a job at keeping current and up-to-date.

Fixing mistakes can be costly

As previously stated, estate planning documents can be obtained from a lawyer for \$800 to \$3,000 or more, depending on the complexity of your estate. But these costs are minor in comparison to the costs that your loved ones may incur if there are serious errors in your DIY estate planning. Many more thousands of dollars may have to be spent by your loved ones to undo what was done wrong.

The bottom line

There are obvious savings in legal fees by using form wills and trusts, but there are also risks involved. One of them is that problems such as defective forms, violations of state law, or improper witnessing will not be apparent to you when the documents are signed. It may be only after death occurs many years later when the problems are discovered, and at that point it may be very costly, or even worse, too late to revise the documents.

Non-Equity Alternatives to Rock-Bottom Yields



Foreign bonds

Yields overseas can be attractive, and they don't necessarily involve investing in countries whose economies or governments are in flux. For example, as of late December, AAA-rated Australian sovereign bonds were paying 3.7%. However, remember that in addition to the risks involved with all bonds, such as interest rate risk, inflation risk, and credit risk, investing overseas involves currency risk; a change in the value of the U.S. dollar relative to its Australian counterpart could eliminate any yield advantage. Also, just as government-sponsored enterprise bonds are not necessarily backed by the full faith and credit of the U.S. Treasury, all foreign bonds are not necessarily backed by their sovereign governments.

Before investing in an MLP or mutual fund, make sure to carefully consider the objectives, risks, charges, and expenses contained in its prospectus, which is available from the fund or partnership. Read it carefully before investing.

As interest rates have fallen to record lows and stayed there in recent years, the yield on your savings may be stuck in neutral. If you've focused on capital preservation and kept your assets in U.S. Treasuries, a money market account, or certificates of deposit, you may have minimized the chance of the financial equivalent of a car crash. However, you also may not be happy letting your portfolio's engine idle forever.

Dividend-paying stocks are one solution, but last year's volatility has made many investors wary of committing more money to equities. Though past performance is no guarantee of future results, for those who need something more than 2% 10-year Treasury yields and who can handle the additional risks involved, there are other alternatives that could potentially boost overall yield.

Corporate bonds

Many corporations have taken the opportunity presented by low rates to refinance their corporate debt and lower borrowing costs. Though any company could still default on its obligations, of course, and all bonds face market risk, stronger balance sheets have helped lower the overall risk of corporates as a whole. The spread between the yield on Moody's Aaa-rated industrial bonds and 10-year Treasuries at the end of 2011 was roughly 2 percentage points. For a Baa bond (one notch above noninvestment-grade), the difference was over 3 percentage points. Yields on noninvestment-grade bonds (so-called high-yield or "junk" bonds) were higher still, roughly 5% above 10-year Treasuries.

Bank loans

Floating-rate bank loans (also known as senior loans, leveraged loans, or senior secured loans) are a form of short-term financing for companies that usually do not rate an investment-grade credit rating. The rate is typically tied to the London Interbank Offered Rate (LIBOR) and adjusts with it, generally quarterly. As with high-yield bonds, the lack of an investment-grade credit rating means bank loans must offer a higher yield.

As with all debt, investors still run the risk of default. However, bank loans also have benefitted from the favorable corporate finance picture noted above. And because bank loans typically are a company's most senior debt obligation and are secured by some form of collateral, investors have typically recovered a higher percentage of their investment in the event of default than with high-yield bonds secured only by a company's promise to pay.

Finally, as with all bonds, as bond yields rise, the price falls, which could cut overall return enough to offset any yield advantage. For the majority of investors, the most accessible way to invest in floating-rate bank loans is through a mutual fund or exchange-traded fund.

Master limited partnerships

Master limited partnerships (MLPs) can not only offer an income stream in the form of quarterly cash distributions; they also may offer tax benefits. An MLP that receives 90% of its income from qualified passive sources such as oil, natural gas, real estate, or commodities may qualify for tax treatment as a partnership rather than a corporation. If it does so, the MLP is not taxed at the partnership level, and may pass on a greater share of its earnings to the limited partners (i.e., individual investors), who also receive a proportionate share of any depreciation, depletion allowances, tax credits, and other tax deductions.

Many MLPs are managed so as to ensure that those tax benefits offset or eliminate any current tax liability on the cash distributions, which are considered a return of capital and used to adjust the individual partner's cost basis upon sale of the MLP units. An MLP that pursues this strategy successfully can in effect provide a tax-deferred ongoing income stream, which can be particularly appealing to investors in a high income tax bracket. Yields on MLPs vary greatly, depending on the particular MLP's assets and the way in which the general partner manages the business.

MLPs have risks. Because they can be relatively illiquid, an investor should plan to stay invested for a number of years, and individual investors' collective share of cash distributions may decrease over time. Also, the tax issues involved can be complex; for example, MLPs can create problems if held in a tax-deferred retirement account. Finally, commissions and other front-end costs can reduce the amount available for investment.

Data sources: *Corporate bond spreads: Federal Reserve System report on selected interest rates (H.15) as of December 29, 2011. Rates quoted are for Moody's Aaa- and Baa-rated bonds. High-yield bond spread: calculated based on Merrill Lynch High-Yield 100 as quoted on Wall Street Journal Market Data Center as of December 29, 2011.*

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Can reducing my credit card debt actually lower my credit score?

Most lenders use an automated credit scoring system to help determine your creditworthiness. The higher

your credit score, the more creditworthy you appear.

One of the factors built into credit scoring systems is your credit card balance-to-limit ratio (the amount of debt you owe compared to your total credit limit for all cards). Lenders like to see ratios indicating you're indebted for balances approximating no more than 30% of your total limit. Generally, if your balance-to-limit ratio is higher than that, then reducing your debt will improve your credit score. But how you reduce your debt can make a difference.

You may have heard that you should consolidate several credit card balances on one card with a low interest rate, then close the paid (usually higher-rate) accounts. Doing so, the claim goes, not only minimizes the risk that you'll "dig the hole" of indebtedness

even deeper, it also reduces your exposure to identity theft through the fraudulent use of inactive open lines of credit.

But if you do this, you could:

- Lower your total credit limit available without lowering your total debt, thus raising your balance-to-limit ratio--and potentially lowering your credit score in the process
- Make your credit history appear shorter by canceling accounts you have had open longest--and a shorter credit history also may lower your credit score

While it makes sense to transfer balances subject to high interest rates to accounts with lower rates (and then concentrate on paying down what you owe), consider waiting to close the paid accounts. Keeping them open may actually improve your credit score by lowering your balance-to-limit ratio (since you'll have the same amount of debt, but a higher total credit limit) while maintaining the longevity of your credit history.



How can I tell if I have too much debt?

It may sound like a bad joke to say that you have too much debt when you find you're unable to borrow more, but there is more truth than humor

in the flippancy.

In determining your ability to repay debt, lenders will examine your debt-to-income ratio. Calculating this ratio can involve a couple of different variations. Your "debt service ratio" compares your total monthly debt payments (including your mortgage payment) to your gross monthly income. Your "debt safety ratio" compares your monthly consumer debt payments (not including your mortgage) to your take-home income.

You will generally qualify for a conventional mortgage if your debt-to-income ratio (including the potential mortgage payment) is 36% or less. Federally guaranteed mortgage programs may allow debt-to-income ratios of up to 41%. And unsecured lenders (like credit card companies) allow even higher debt-to-income ratios--and then charge you higher interest rates to compensate themselves for the potential risk you represent to them.

To be on the safe side, however, your debt service ratio should ideally be 25% or less and should be no greater than 35%, while your debt safety ratio shouldn't exceed 20% and should preferably be 15% or less.

While it can be difficult to live in today's society without incurring debt, it also can be difficult to live with too much debt. Here are some warning signs indicating that you may be too close to the edge:

- You can't maintain an emergency fund to cover 3 to 6 months of normal expenses
- You make only minimum monthly payments on your consumer debt
- You're at or near your credit card limits
- You use credit cards to pay for things you used to buy with cash (this may not be a concern if you're paying off your credit cards every month)
- You take cash advances against your credit cards to pay other bills