

## Investors Flee Stocks At Precisely The Wrong Time

The percentage of American households owning stock mutual funds dropped by 46.4% in 2011. In fact, it has fallen every year since 2008, according to Investment Company Institute. In addition, outflows from domestic stock mutual funds in 2012 neared the record-breaking pace of 2008, the worst year ever for outflows.

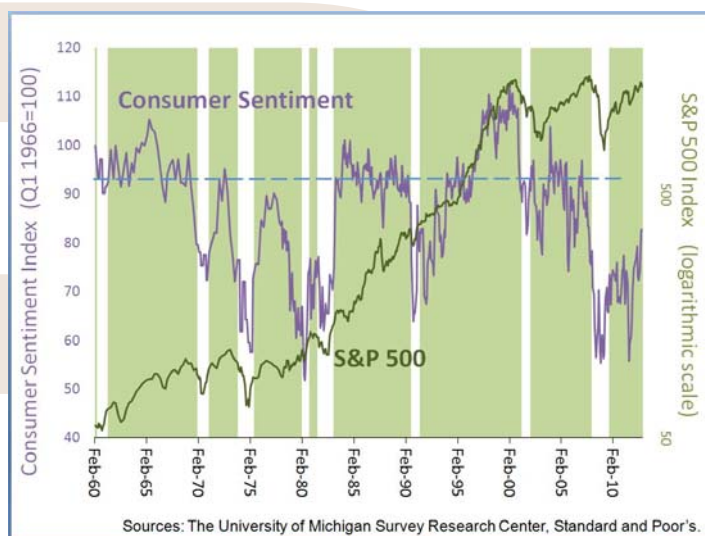
Pessimism has been rampant. Worries persist over the long-term federal deficit. Modern Portfolio Theory, the intellectual underpinning embraced by academia for evaluating investments for the long run, is now derided by many pundits. The Wells Fargo/Gallup Investor and Retirement Optimism Index turned negative at -8 in November 2012, down from double-digit positive scores earlier in 2012. A belief that America's best days are behind her seems pervasive.

How worried should you be? Maybe not as worried as so many others seem to be. Looking back at the historical performance of the consumer sentiment index versus the Standard & Poor's 500 stock index indicates that periods of extreme pessimism are actually good times for stocks.

The most recent data from

University of Michigan's consumer sentiment index shows that you would have to go back more than 30 years — to 1980 — to find consumer sentiment as low as it has recently dipped.

The accompanying chart shows the consumer sentiment index dating back



to 1960. The only other time sentiment was as negative as it has been over the past couple of years was in 1980. The plunge in consumer sentiment in 1980 followed a recession, an oil shortage sparked by the American hostage crisis in Iran, an annual inflation rate of 14%, and the bursting of a bubble in the price of silver after the Hunt brothers failed to corner the market in the precious metal. However, that confluence of calamities in 1980 kicked off a raging bull market.

Today's economic worries are similar in many ways to 1980's woes. Global turmoil related to America's

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## Plan Well And Thrive

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We aspire to become our clients' most trusted advisor. We are the ones that our clients and their families turn to for the complete record and understanding of their financial situation. We are in constant contact with our clients to ensure we are all on track to achieve their financial goals.

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# A Realistic Look At A Hot Topic: Dividend Stocks

**W**all Street pundits are lining up to tout the prospects for dividend-paying stocks in 2013, but prudent investors need to understand the bigger picture before rushing into this hot area of the market.

It's true that dividend-paying stocks made a solid comeback in 2012 and offer good prospects for 2013, but it's important to keep this trend in perspective. The percentage of profits paid out by companies in the form of dividends remains far below historical averages, and an economic downturn could prompt U.S. firms to pull back on dividends again at any time.

As an investor, you also need to consider dividend stocks relative to other income-producing investments, in the context of a low-interest environment and your own portfolio. Because no one can say for sure which investments will outperform others, it's important to strike a prudent balance among possible choices.

A number of analysts believe dividend-paying stocks will produce solid returns this year for several reasons, starting with the fact that many large companies have built up huge cash reserves as they proceeded

cautiously through the wreckage of the 2008 fiscal crisis. "While companies are paying out record dividends, these amounts are still significantly below historical payout rates," wrote Standard & Poor's analyst Howard Silverblatt in the firm's annual dividend report in January. "It's not a matter of companies being cheap. It's a matter of them being nervous about the economy and their resources, similar to most of us."



Companies in the S&P 500 index paid out a record \$281.5 billion in dividends in 2012, 17% more than in 2011. Yet the payout ratio—the percentage of profits that companies devoted to dividends—was just 36%, far below the historical

average of 52%.

That leaves companies with a lot of room to increase dividend payments, according to Silverblatt, who predicted another record for regular cash dividends in 2013. "The 2.8% overall equity yield remains relatively high, even at the higher dividend tax rate (now 20% for certain upper-income investors), when compared to competing income producers such as corporate bonds, Treasuries, or bank

CDs," Silverblatt wrote in the report. "Given the range of yields within equities, from lower yielding growth issues to higher yielding income producers, this leaves investors with one of the few remaining areas of choice with measurable degrees of stability."

Still, the potential for the economy to turn downward dictates continued caution for investors. It doesn't

take much of a decrease in stock prices to more than offset whatever income you derive from dividends. In any event, dividend-paying stocks may play a positive role as part of a well-balanced portfolio tailored to your individual goals. ●

## Find Extra Benefits in Disability Income Insurance

**T**he odds that you'll suffer a disabling injury or illness are far greater than the likelihood of you dying prematurely. A disability income (DI) insurance policy, used to supplement life insurance coverage, could help protect you from loss of income if you're unable to work. Indeed, a DI insurance policy might provide even more benefits than you expect.

Typically, a private DI insurance policy can pick up some of the slack if you're disabled for an extended time. Should you no longer be able to work, you will begin receiving a monthly disability benefit. Normally, the

benefit is a predetermined amount, unlike employer-provided coverage, in which the benefit equals a percentage of compensation.

As with life insurance, DI terms can vary widely from policy to policy. Some key variables include the amount of the benefits you'll receive; the length of the coverage; the requirements for receiving full benefits; the definition of "disability"; the length of the waiting period before benefits begin; any cost-of-living adjustments; availability of partial benefits; and possible non-cancellation features. Naturally, the premiums also will vary, depending mainly on those

variables.

But don't assume that you must be bedridden to collect any benefits. Frequently, a DI insurance policy will provide "residual benefits" in the event you can work some of the time or if you're slowly getting back on your feet. Some policies even offer benefits after you've returned to work if you are earning less than you did before your disability.

The residual benefits generally kick in when the loss of income is greater than 20% of previous earnings and the decline is due to the medical condition underlying the disability. This feature could be especially

# Understanding Common IRS Audit Triggers

**W**hat sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 “red flags” that could increase the chance you’ll be tapped for an audit.

**1. High income.** The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of \$200,000 or more. That’s almost one out of every 25 returns. The IRS tends to chase the “big money,” and while that’s no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

**2. Unreported income.** The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You’re likely to draw IRS scrutiny if you don’t report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

**3. Large charitable gifts.** Besides providing personal satisfaction, charitable gifts provide deductions that can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is

valuable to small business owners, including self-employed entrepreneurs, and professionals in fee-based practices, such as physicians, attorneys, and accountants.

For example, suppose a surgeon recovering from a severe illness returned to practice but had to see fewer patients. If the surgeon’s income was reduced from \$50,000 a month to \$30,000, the residual benefit could restore income to 80% of the pre-disability level—in this case, \$40,000 a month. Similarly, if the side effects of chemotherapy make it too hard for a litigator to appear in



disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

**4. Home office deductions.** If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office “regularly and exclusively” as your principal place of business. Simply doing work at home when your main office is elsewhere won’t cut it.

**5. Large investment expenses.** The IRS flags large investment expense deductions. Investment management fees fall under this category. If you own a substantial portfolio and it is managed professionally, the fees deducted may be outsized compared to your taxable income and attract unwanted attention. Your investment manager should be able to provide you with all the backup information you need in an appropriate format in order to justify the deduction.

**6. Travel and entertainment expenses.** This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and

court or for a CPA to handle a company’s books, the residual benefits can soften the economic blow.

To see what your coverage may or may not include, take a close look at existing DI policies or any new policy you’re considering. We are available to help you understand your coverage better. The policy might be more valuable than you imagined or the residual benefits may be too restrictive. Those provisions could be a key component of your DI insurance coverage. ●

entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

**7. Business use of cars.** Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called “luxury car” rules. IRS agents have been trained to ferret out taxpayer records that don’t measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn’t available for personal use.

**8. Hobby losses.** As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can’t claim a loss for the activity, unless your involvement rises to a level of a bona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

**9. Foreign bank accounts.** The IRS has started clamping down on taxpayers with offshore accounts in “tax havens” in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.

**10. Cash businesses.** Finally, if you operate a small business in which you’re generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don’t mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●



# When Do You Need An Appraisal?

**A**re you planning to donate real estate to charity? The tax law allows you to claim deductions, within generous limits, for giving property to qualified charitable organizations, but you have to meet strict requirements, including the necessity to obtain an independent appraisal for property valued at more than \$5,000.

In fact, in a new case, a taxpayer who donated real estate worth approximately \$18 million failed to provide the required appraisal, and after an audit, the IRS challenged his charitable deductions. The Tax Court's verdict? His deduction was zero!

The basic rules for deducting gifts of property say you can't use those donations to write off more than 30% of your adjusted gross income (AGI). Overall, your charitable deductions can't exceed 50% of your AGI for the year. But if you exceed those levels, you can deduct the rest in future tax years.

If you donate property that has gained value, the deductible amount is equal to the fair market value (FMV) of the property at the time of the

donation, as long as you've owned it for more than one year. For shorter-term gifts of property, the deduction is limited to your "basis" (usually, what you paid for it).

However, the IRS requires you to jump through a few hoops

before you can pocket any tax deductions. When you file your tax return, you must include a detailed description and other information for property valued at more than \$500.

Also, if you claim the FMV is more than \$5,000, you must obtain a written appraisal of its worth.

In the case of the above disallowed deduction, Mr. Mohamed was a prominent entrepreneur, real estate broker, and certified real estate appraiser. He donated several parcels of property to a charitable remainder trust during a two-year period. When he completed his tax returns for those two years, he attached Form 8283

(Noncash Charitable Contributions). Based on his own appraisals, the total FMV of the properties exceeded \$14 million (although his initial deduction was "only" \$3.8 million due to the AGI limits).

But Mohamed didn't read the form's instructions explaining that self-appraisals aren't permitted. He also omitted important information such as the basis of the properties. The IRS challenged the deductions. When Mohamed appealed to the Tax Court,

the IRS disallowed the entire deduction, despite subsequent independent appraisals establishing the total FMV at more than \$18 million. In the end, the Tax Court agreed with the IRS, although it acknowledged the result was harsh.

The moral of this story is that if you donate appreciated property, you need to make sure you observe the strict letter of the law. ●



## Investors Flee Stocks

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struggle with terrorism and Muslim fundamentalists dominates the headlines, threatening oil production in the Arab world. Massive monetary stimulus by the Federal Reserve has sparked inflation fears and the price of gold spiked higher than ever in the last couple of years. America seems unable to muster the strength to fight its fiscal crisis.

But just as in 1980, stocks over the past couple of years have marched higher. And, as the accompanying chart assembled by Fritz Meyer Economic Research illustrates, it's not unusual for stocks to rise steadily precisely when consumer pessimism is at its worst.

Investor perceptions and consumer

sentiment are often at odds. Wall Street reality—earnings growth and rising stock prices—governs stock prices. As a result, even as consumer sentiment plunges, you could see a rally in stocks.

To be sure, economic and political problems plaguing the U.S. are serious and must be addressed. The federal debt, downgrading of the U.S. Government's credit rating, and threat of terrorism remain very real problems. But the pessimism these problems engender doesn't necessarily stop the stock market from rising if corporate earnings growth holds up, and that's what occurred in recent months.

In the aftermath of the 2008 global financial crisis, consumer sentiment has recovered. As history shows, however, it can take years for a full

recovery in consumer sentiment to take hold. In fact, stock prices must rise for an extended period before consumer sentiment fully recovers following economic trauma. Stock prices are always out in front of consumer perceptions.

So, when you hear news about the extreme pessimism over the economy and record outflow from stock mutual funds, remember these lessons from history. The stock market in 2012 showed an astounding total return of 16%, while investors fled stock mutual funds in droves. Investors historically leave the stock market and become pessimists at precisely the wrong time. While past performance is never a guarantee of future results, it appears that familiar pattern was repeated in 2012. ●