The Thoughtful Investor

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A "To Do" List Before 2012 Ends

Don't leave money on the table
In uncertain economic times, many employees put off contributions to retirement accounts, reasoning that they will make up lost ground when times improve. Doing so, however, could result in leaving what is virtually "free" money on the table. If you have a 401(k) or comparable retirement account where your employer matches your contributions always contribute enough each year to receive your full employer match. Not doing so leaves money on the table. Taking full advantage of an employer match is the best no-risk return you will ever find.

If you are over 70 ½…
You must take a required minimum distribution from your traditional IRA account(s) by year end. Failure to do so could result in a 50% excise tax on the amount required, but not actually withdrawn. If you turned 70½ during 2012, you have some flexibility. You could take your 2012 distribution by December 31st or you could delay it until April 1st of 2013. If you opt for the latter, you still must make your 2013 distribution by December 31, 2013, resulting in two distributions during the calendar year. Every year thereafter, the distributions must be made by year-end.

Convert Traditional IRAs to a Roth IRA
If you are considering converting a Traditional IRA to a Roth IRA and will be paying taxes to convert, make that conversion in 2012 while you know what your tax rate will be. With the Bush tax cuts expiring and new healthcare taxes beginning to take effect in 2013, there's a chance it could cost you more to convert next year. See article below on the benefits of a Roth IRA.

Establish self-employment retirement accounts
If you have self-employment income and are eligible to establish an Individual 401k plan or Roth 401k plan, those plans must be established by December 31st, although you will have until your tax deadline in 2013 to fund the account.

Make your gifts
You may think that your money is yours to give away as you please, but the federal government tends to look on excessive gifting as estate tax evasion. Currently you can gift up to $5 million ($10 million for couples) over your lifetime without incurring federal gift taxes of 35%. The maximum you can give one person each year without tax implications is $13,000 ($26,000 for couples.) This could change in the future, but for now, if you intend to make non-charitable monetary gifts, do so before year end.

Push deductions into 2013
If you expect to be paying higher income taxes in 2013, you might want to look at postponing paying deductible expenses to push them into next year.

Talk to your tax adviser
Before the end of the year, we should have a pretty good idea of some of the tax changes to anticipate in 2013 based on election results. That makes it particularly important to talk with your tax adviser and make certain your finances are set up to minimize the tax bite as much as possible. Paying your fair share shouldn't mean overpaying.

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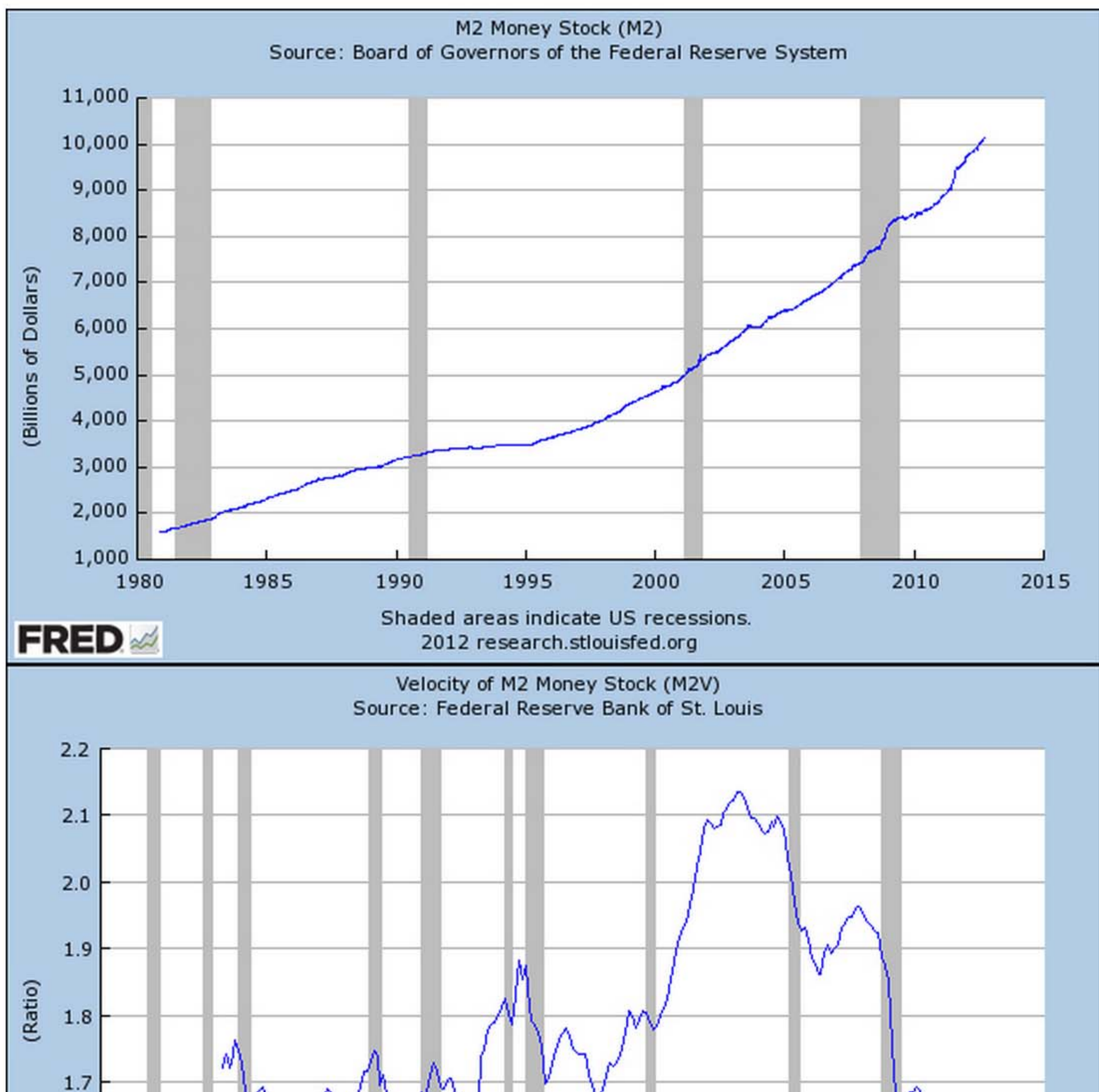
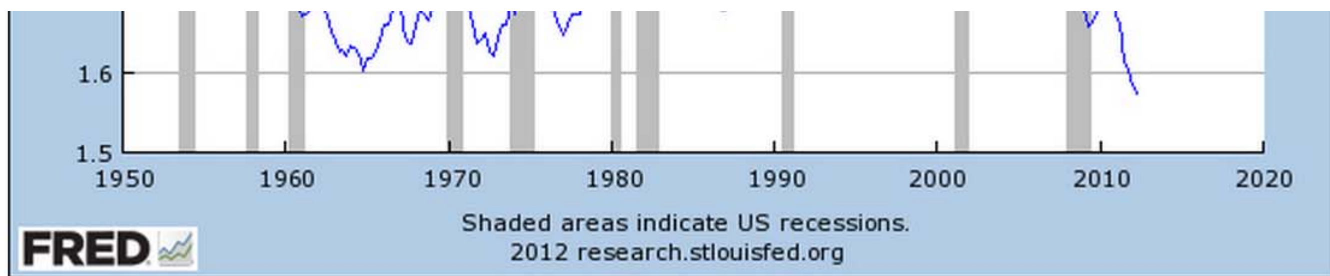
Money Velocity Goes Missing

When will the current economic crunch end? Will the next infusion of government spending, new money from the Fed or debt forgiveness put the U.S. economy back on track?

It's doubtful. The reason can be found in two very interesting graphs from the Federal Reserve Bank of St. Louis. The first shows the explosive growth of money using the broad indicator M2. The second shows the velocity of all that money in a nose dive.





For a succinct definition of the velocity of money, we turned to Wikipedia - *The velocity of money is the average frequency with which a unit of money is spent on new goods and services produced domestically in a specific period of time.*

The U.S. economy is awash in money right now. Banks have largely rebuilt their capital reserves and businesses are holding record amounts of cash. Total U.S. money market mutual fund assets topped $2.569 trillion in October 2012 according to the Investment Company Institute. Consumers have reduced debt levels. In the U.S., household debt has now fallen to 84% of GDP from a peak of 98%. Nonfinancial corporate debt has fallen to 77% from a peak of 83%. Financial sector debt has plunged from 123% of GDP to 89%.[1] While many experts believe debt needs to fall further to reach a sustainable level, private balance sheets are looking much better.

The federal government has poured money into the financial system through government borrowing (public debt has risen to 89% from 56% of GDP) and Federal Reserve purchases of long-term debt from banks and government lenders. If money does indeed make the world go around, the economy should be humming. But it isn't.

The reason why shows up very clearly when you look at the velocity of money.

Why has velocity fallen so dramatically? The typical rationale is that banks are refusing to lend the infusion of capital they have received since the first TARP funds. But the banks claim they would gladly make loans if qualified borrowers would just apply. Retail merchants would gladly sell, if buyers would just buy. What seems to be missing is confidence…confidence that spending money today makes sense in terms of what's coming down the road. And that is where we see our clients struggling. For consumers the question really is "Can I afford to spend this money or am I going to need it for essential expenses next year or the year after?"

What will it take to restore consumer confidence? Steady improvement over time of economic indicators, employment data and personal income.

There are no quick fixes. There are opportunities, however. Active management will rarely outperform the market indices in bull markets, when investments are riding the tide up. It is in difficult markets, markets where paying attention to what areas of the economy are seeing growth and which are faltering; which investments are outperforming and which are losing ground, that active management makes the most difference.

Active management can't assure profitability. All investment approaches have the potential for loss as well as gain. But with active management, we have the flexibility to seek opportunity. We believe that ability can make all the difference in these markets.

[1] U.S. debt load falling at fastest pace since 1950s," By Rex Nutting | MarketWatch – Jun 8, 2012.
Data Source: FRED, Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

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Take Advantage of Roth IRA Benefits

For many investors, a Roth IRA is a good idea to add to their investment portfolios. A Roth account offers a number of advantages to investors:

(1) No taxes on earnings.
Roth IRA deposits are made on an after-tax basis so there is no tax deduction each year, however, earnings can be withdrawn free of federal taxes (state tax may apply) as long as the account holder is over age 59½ and has held the account for at least five years. Earnings can be withdrawn tax free regardless of age if you've had your Roth IRA for at least five years, and the distribution is due to your death or disability or for a first-time home purchase ($10,000 lifetime maximum). A 10% federal penalty tax applies on withdrawals of

earnings before age 59½ unless an exception applies.

You must have earned income to contribute to a Roth IRA, and there is a maximum annual contribution limit of $5,000; $6,000 if you are over 50 years of age. But over time tax free earnings can become a significant benefit.

(2) Ability to Withdraw Deposits without Tax Impact.
Because contributions are made after-tax, distributions from contributions are tax-free and penalty free, regardless of the age of the account holder.

(3) No Minimum Withdrawal Requirements.
Unlike a Traditional IRA, there are no minimum withdrawal requirements at age 70½. This can make the Roth IRA ideal for passing assets on to heirs. The catch is that there are income limitations. Opening and contributing to a Roth IRA is currently restricted to those with an adjusted income limit (AGI) of $122,000 (individuals) and $179,000 (couples). While it exists, there is a loophole for individuals who have an existing Roth IRA but exceed the income limits to make contributions. Traditional IRAs, including non-deductible contribution IRAs can be converted to a Roth IRA regardless of income levels. If the IRA contributions were made before tax, you would need to pay taxes on the rollover amount. But with a non-deductible IRA, contributions are made after tax allowing a non-deductible contribution IRA to be converted to a Roth IRA without any tax impact.

Before you convert a traditional IRA to a Roth, review your options with your financial consultant and make certain the numbers make sense given your future expectations.

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Credit Card or Debit Card?

When it comes to carrying plastic, which is better, a credit card or a debit card?

For individuals who pay off their credit cards in full each month, there are some definite advantages to using credit over debit. The exception…if you are prone to overspending and need the discipline of a debit card to keep your purchases under control.

Security Issues
Debit card thefts can wipe out a cardholder's bank account, and potentially any linked savings account. If your physical card goes missing, you have just two business days after learning of the loss to notify the card issuer in order to limit your losses to just $50. If you wait longer than 60 days after receiving a checking account statement that shows fraudulent withdrawals – whether from a lost card or use of your debit card numbers - you could be at risk of never recovering that money. Your best protection is to check your account activity every couple days and review statements when they arrive.

Credit cards typically offer better security. Most credit cards offer 100% protection from fraud or theft. You have the ability to dispute a particular charge with your credit card company and to delay paying for a transaction or fees while the item is in dispute. Many cards also offer insurance to cover damages to charged items in transport, life and disability insurance when airline tickets are purchased with the credit card and even rental car damage insurance.

No Credit Reporting
Unlike credit cards, banks do not report activity on checking accounts and debit cards to the national credit reporting agencies. As a result, using a debit card will not build a credit history or improve your credit score.

Rewards Are Better With Credit
Debit cards became considerably less profitable for banks when new regulations went into effect in October of 2011 that cut the fee banks charge merchants to process debit card purchases to an average of around 24 cents. As a result, banks are pushing more profitable credit cards through richer rewards programs.

Fees Are Higher With Most Debit Cards
Lower processing fees have contributed to increases in checking account fees, fees to use debit cards to withdraw cash from ATMs, overdraft protection fees, and individual transaction fees. Minimum balance

requirements can also increase the cost of using debit cards.

Credit cards aren't without their own risks, foremost of which are overspending and high interest rates on unpaid balances. Some cards have annual fees, many have fees such as late fees, over-limit fees, balance transfer fees, cash withdrawal fees, card replacement fees, etc. Miss a payment and it will end up on your credit report. You also still need to be alert to fraudulent charges. And not all stores and restaurants accept all credit cards because of the higher processing fees for these cards.

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Can Spending Money Create Money?

Foul cankering rust the hidden treasure frets,
But gold that's put to use more gold begets.
~William Shakespeare, Venus and Adonis, 1593

The multiplier effect is often used to justify the expansion of social programs. For example, according to Agriculture Secretary Tom Vilsack, food stamps are an "economic stimulus" in that "every dollar of benefits generates $1.84 in the economy in terms of economic activity."

So here's our challenge to you…work your way through the thought process of the multiplier effect and let us know if it makes sense to you.

$1 is taken from your paycheck in taxes and given to another individual in the form of food stamps (or borrowed in which case interest must be paid every month, reducing the value of the $1).

That individual purchases food transferring the $1 to the store.

The grocer takes the $1, pays 50¢ to the food producer, 45¢ to salaries and overhead, and from the remaining 5¢ pays 2¢ in taxes and 3¢ to the shareholders. But it still adds up to $1, just moved around.

The problem is that somewhere along the line, value has to be created, not just churned if the expenditure of $1 is to have a 1.85 times effect. In a barter economy you create new value by growing crops or building products from raw materials for which others are willing to trade their goods and labor. In a cash economy, new money comes into existence through debt. Money can be created by governments through debt instruments by issuing bonds, IOU's offered for sale. A bank can loan out a multiple of the amount it has on deposit, thereby creating virtual money. But simply spending money cannot create money.

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Don't Worry, Be Happy

Indian mystic and sage Meher Baba (1894-1969) often used the expression "Don't worry, be happy" along with fuller versions of the quote including "Do your best. Then, don't worry; be happy. Cards and posters of the 1960s featured the phrase, which is said to be where musician Bobby McFerrin found inspiration for his hit song in 1988, *Don't Worry, Be Happy*.

While many critics deride the philosophy of denial in the song, it's not a bad way to live a life, particularly when preceded by "Do your best."

It's easy to become depressed in today's economy, when bad news seems to dominate everything we read and watch (except for the Olympics, thank goodness!). Too many headlines and you start viewing your life as a downhill slide as well. In reality, we have in our lives much to be grateful for, much to celebrate and much yet to enjoy. In the end, we can only do our best. And then we have to find a way to be happy and not worry (at least too much) about things that are beyond our control.

Do your best. Then, don't worry, be happy.

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