Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

Kane Company, P.C. 515-270-2727 Summer 2009

What A Difference A Year Makes In 10-Year Returns

Would you invest in an asset that has been in the red for an entire decade? That's the question a lot of investors will be asking themselves during the year ahead. The stock market rout in late 2008 resulted in the average annual return for stocks during the past 10 years to be a negative number, and that's bound to make many people hesitate to commit the lion's share of their portfolios to such a seemingly underwhelming investment. But the future for stocks looks much brighter than the recent—and not so recent—past.

Ten-year returns don't exactly lie, but their story is much more complicated than you'd expect, according to a recent report from Vanguard Investment Counseling and Research—"The 'Lost Decade': Rational Expectations in Uncertain Markets," by Francis M. Kinniry Jr. and Christopher B. Philips. Kinniry and Philips point out that during the past decade, the stock market has gone through several extraordinary periods—first, the runaway bull market of the late 1990s, then the brutal bear of 2000 through 2002, and finally the vertigo-inducing dive during the last months of 2008. For years, the great markets of the late '90s buoyed long-term performance numbers. But now, as they fall out of 10-year calculations, the results begin to look pretty bleak.

For the decade ending June 30, 2008, the broad U.S. stock market returned just 3.53% a year—and that, of course, was before the end-of-year meltdown. That's worse than bonds, which had an average annual gain of 5.68% during the same period. But just a few years earlier, long-term stock performance looked much better, according to the Vanguard report. At the end of 2002, coming out of the most punishing bear market in 70 years, the 10-year average annual return for stocks was a respectable 8.74%, and just two years later, as 2004 came to a close, that average had risen to 11.92%. Three years later still, however, the average annual return for the preceding 10 years had plunged by almost half, to 6.29%. The reason? Returns from 1995 through 1997, three years during which annual gains averaged nearly 30%, had dropped out of the equation.

Those returns from the 1990s, though exceptional, came during a decade that saw average returns of almost 20% a year, according to the Vanguard report. That's starkly different from the 2000s, which may well produce average annual returns of less than zero. Looking at those numbers, you might logically conclude that owning stocks isn't what it used to be, and that you ought to pare back your portfolio's equities, perhaps replacing them with bonds, which have outperformed all other asset classes so far this decade.

But that would be the wrong conclusion, suggest Kinniry and Philips. There's nothing you can do about what has already occurred; what's important for investors is what's to come, and Vanguard, one of the world's biggest fund managers, is

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2009 Updates

I'm using this issue to provide some general updates and important reminders for the remainder of 2009. First, the standard mileage rate for business travel is now 55 cents per mile. The allowance for charitable travel remains at 14 cents per mile while travel for medical and moving is now 24 cents per mile.

Maximum IRA contributions are unchanged at $5,000 ($6,000 if you're 50 or older). Maximum 401(k) contributions have increased to $16,500 ($22,000 at age 50).

The maximum Iowa tax-deductible contribution to College Savings Iowa for 2009 is $2,800 per beneficiary. If you are an Iowa taxpayer, this deduction can start your year with an immediate return rate of up to 9% in tax savings!

The Iowa legislature did not eliminate the deductibility of federal income tax—but beware: The issue *will* come up again. Our recommendation is to pay all federal taxes on or before December 31 even if they are not actually due until January 2010.

Please take note that we will again be closing the office at 4:00 Monday through Thursday and 3:00 on Fridays between now and December. Please be sure to call us at 270-2727 if you have any income tax, accounting, or investment questions, or if you would like to proceed with any financial planning.

Have a great spring and summer, and thank you for your continued patronage!

Steven L. Kane, CPA/PFS, CFP®

New Law Suspends RMDs For Just One Year

There's good news and bad news for retirees in the new pension law—the Worker, Retiree and Employer Recovery Act of 2008. The good news is that you don't have to take the usual "required minimum distribution" (RMD) from tax-qualified plans and IRAs. The bad news: The RMD exemption applies only for the 2009 tax year. The normal rule wasn't suspended for 2008—when you probably needed it most.

If you own assets in a tax-qualified plan such as a 401(k), an IRA, or both, you ordinarily must begin taking RMDs by April 1 of the year following the year in which you turn age 70 1/2. For instance, if your 70th birthday was January 1, 2008, you became 70 1/2 on July 1 of that year, so you must take your first distribution by April 1, 2009. That's actually the distribution for the previous year, and you have to take a second by the end of 2009. However, if you are still working and you don't own five percent or more of the company that employs you, you may postpone distributions from qualified plans—but not from IRAs—until you actually retire.

The amount of the annual RMD is based on your life expectancy and the balance in your account on the last day of the prior year. Unfortunately, that means that RMDs for 2008 must reflect the account balance on December 31, 2007, even though that's probably much more than the account is worth now, after the late-2008 stock market plunge.

Some retirees were hoping Congress would provide last-minute relief for 2008 RMDs. But the technical hurdles proved too daunting, as most retirees had already received their annual distributions before the law was signed. Moreover, the IRS has indicated it won't change the rules retroactively. To compensate for being stuck with disproportionately large distributions for 2008, try investing your distributions in stocks in a taxable account and reap the rewards when the market rebounds.

At least the new law suspends the requirement for the 2009 tax year. If you can afford to leave your retirement nest egg untouched this year, you may be able to recoup some of the value you lost during the stock market downturn. With this temporary reprieve, you could stockpile more cash if the market rebounds.

But first-timers who turned age 70 1/2 in 2008 aren't off the hook. Your first distribution, due by April 1, 2009, is actually for 2008, and you'll still have to take it this year. But you won't have to make a withdrawal for 2009. If you're turning age 70 1/2 in 2009, you'd ordinarily have to take an RMD by April 1, 2010—a withdrawal the new law permits you to skip. But you'll still have to take a distribution for the 2010 tax year by December 31, 2010.

Keep in mind that not taking the RMD (other than in 2009 when you don't need to) is unwise. The penalty tax for failing to take an RMD is 50% of the amount of the required distribution you didn't take. ●

The Tax Rules Of Buying Or Selling A Home

Though the mortgage-interest deduction may be the most obvious example of the government's largesse to home-owners, other significant breaks apply when you buy or sell a home. People buy or sell a home for lifestyle reasons and not for tax reasons. But knowing the tax rules can save you a bundle on a house sale by keeping your tax bills to a minimum. Consider these strategies.

Don't sell too soon. With the way that home prices have appreciated over time (despite the recent decline), selling your house could net you a major profit with no tax bill—unless you make your move too soon. If you've lived in a home for at least two of the past five years, you can exclude up to $250,000 of your gain from capital gains taxes; if you are married, you and your spouse can avoid taxes on a profit of up to $500,000. If you sell after just a year, however, you'll be taxed on your profit at the 15% rate for capital gains—and if you sell a place you've lived in less than 12 months, your gain is considered short-term, and taxed at your ordinary income rate of up to 35%.

Plead hardship. So-called hardship sales—necessitated by medical problems, divorce, job loss, or multiple births—could win you a tax break even if you sell before living in your home for two years. If you qualify, you'll get a reduced home-sale exclusion based on your amount of time in the house, expressed as a fraction of the ordinary two-year minimum. If you sold after 18 months, for example—three-quarters of the minimum—you could exclude a profit of up to three-quarters of the usual $250,000 or $500,000 exclusion.

Minimize your gains. If you have to pay tax on your profit, look for ways to increase your home's tax

Markets Often Rebound Before The Economy

Given the extreme recent volatility of the stock market and the worsening economy, it's no wonder investors are on edge. Most have suffered significant setbacks during a recession that is already at record length and could continue for another year or more. It hardly seems like the right time to buy stocks. Yet while no one can know for sure when markets will turn around, that typically happens well before the economy gets going again.

The numbers don't lie. One recent study examined nine recessionary periods defined by the official arbiter, the National Bureau of Economic Research (NBER). According to NBER data charting recessions from 1953 through 2001, the stock market typically declines until sometime during the middle of the downturn and then begins to strengthen. Starting at the low point of each recession and continuing until six months after its official end, the Standard & Poor's 500 stock index averaged a gain of 36%. That compares with an average decline of 21% for the S&P during a period starting six months before the official onset of each recession and ending at its low point. The average return for an entire recessionary period, including the six months before and after the actual recession, was 8%, and the average recession lasted 11 months. The positive return is due to the role of the markets as a leading indicator, meaning that by the time the recession grips the economy, the markets are already looking forward to the eventual recovery. Similarly, much of the drop in the markets occurs in anticipation of the recession, many months before it is made official.

Throwing in the towel. Despite the hard data showing its benefits, buying stocks during the depths of a recession is bound to feel counterintuitive, particularly if you've spent months watching current holdings steadily lose value. Psychologically, it feels better to jump into the market after prices are already surging and getting out when they're falling. But it's exactly when most investors have finally given up on stocks—a situation market pros call capitulation—that the market is likely to bottom out and start climbing. Capitulation tends to happen when economic news is most dire.

Indications of things to come. In the end, of course, market movements are driven by supply and demand, and stocks won't improve this time just because they've risen under similar circumstances in the past. Still, history can provide important clues about where the economy and markets are likely to go, and economists consider the stock market a leading indicator—a preview of what may be to come for the economy.

Other *lagging* economic indicators reflect what has already occurred. For example, a higher unemployment rate typically develops because the economy is struggling; when demand for goods and services slackens, companies often respond by reducing their payrolls. Similarly, inflation may keep rising for months after upward pressure on prices, reflecting an economy at its peak, has already largely dissipated.

Stock prices, in contrast, are based on what investors consider to be a company's prospects. When the economy is at its worst, the road ahead may begin to seem comparatively bright, and company earnings could start to rebound even while current statistics continue to paint a gloomy picture. And when investors finally stop selling and start buying, rising demand for stocks will push up prices.

Chances are that this time, as in the past, the stock market will strengthen well before the economy and point the way forward for investors. But keep in mind that the sample size of this study is very small; only nine recessions occurred between 1953 and 2001. Also, the current economic crisis is largely viewed as the worst since the Great Depression, so the rebound may take longer than past recessions.

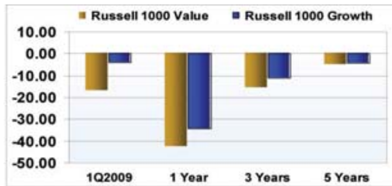
As always, it's crucial to stick with a long-term investment plan that reflects your goals, timetable, and risk tolerance. We are closely following developments in the economy and investment markets and would be happy to discuss whether any adjustments to your portfolio might be in order. ●

basis—for example, by including the closing costs you paid when you bought the house. A higher basis means a smaller gain. However, if you depreciated a portion of the house because you used it for business purposes—such as for a home office—you'll generally owe capital gains tax on some or all of the depreciated amount.

Latch onto a new tax credit. If you're a first-time homebuyer—someone who has not owned a principal residence for the prior three years—you can claim a credit of up to $8,000 for a home purchased after 2008 and before December 1, 2009. But the credit is phased out for high-income taxpayers.

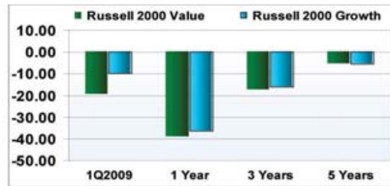
Get the points. When you take a mortgage for a new home, you may pay "points" in exchange for a lower interest rate. Because the IRS considers points to be prepaid mortgage interest, you may be able to deduct them from your income for the year of the purchase. For instance, two points paid on a $500,000 mortgage—that is, 2% of the half-million—would give you a $10,000 deduction. However, if you finance the points along with the mortgage balance, you must deduct them over the life of the loan. Spread over the term of a 15-year mortgage, for example, that same $10,000 would mean a deduction of only $667 a year. ●

Market Data Bank: 1st Quarter 2009



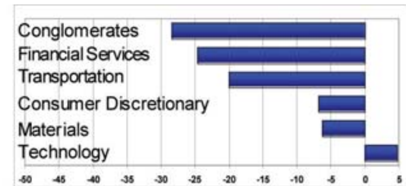
LARGE VALUE VS. LARGE GROWTH

The bear market kept its grip on the biggest banks in 1Q09, pushing large-cap value portfolios down another 16.77%. Large growth stocks resisted the worst of the selling, ending down a "mere" 4.94%.



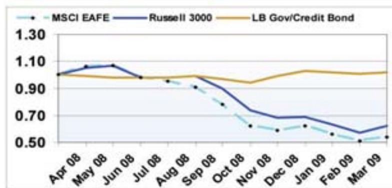
SMALL VALUE VS. SMALL GROWTH

Smaller and more economically sensitive companies faltered in the gloom. Small value shares plunged 19.64%, while small growth fell 9.74% as hope for a near-term economic recovery ebbed.



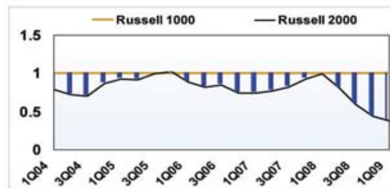
THREE BEST AND WORST SECTORS

Only technology, seen as a haven from the credit crisis and dimming consumer spending, ended the quarter in positive territory. Every other major sector suffered significant to severe losses.



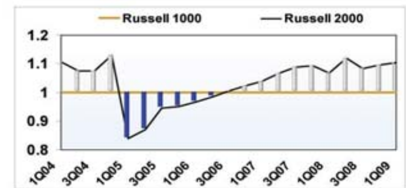
FOREIGN, US STOCKS & US BONDS

With U.S. and foreign stocks shedding 38% and 46% of their respective value on a year-over-year basis, investors sought relative safety (and accepted scant gains) in the Treasury bond market.



LARGE VS. SMALL STOCK EARNINGS

US corporate profits expanded at their slowest rate since late 2002 in 1Q09. Starved for both revenue and credit, smaller companies found it especially difficult to add to their bottom-line results.



PRICE-TO-EARNINGS RATIO

Declining stock prices made both large and small companies cheaper on a fundamental basis. Investors remain willing to pay a premium for small-cap profits and the potential growth they represent.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do not represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Difference A Year Makes

(Continued from page 1)

decidedly bullish on stocks. Though equities are indeed riskier than bonds, that's exactly why they tend to outperform fixed-income investments, and Vanguard's analysts believe the current market offers an equity risk premium of seven. By definition, that's a return seven percentage points higher than the return on "risk-free" Treasuries. Vanguard expects that during the next 10 years, stocks could potentially produce average annual real returns, ie., net of inflation, of 9.5%.

The risk premium is based on the idea that for investors to take on stocks' higher risks, they need the motivation of potentially higher returns. And the market's recent volatility only drives home the point that stocks do bring real risks, and that short-term returns often fall as well as rise. From 1982 through 1999, there was only one down year in the stock market. But that was an anomaly, a departure from the stock market's long history of producing a negative return one year in every four.

That fact, in turn, reminds investors of another truism—that to benefit from stocks' long-term returns, you have to be in the market long term. If you sell when stocks fall, you will have paid the price of investment risk but you won't be there for the gains that inevitably follow. To contain the risk of the market going still lower before it rebounds, a prudent strategy may be to "average" into the markets over the next six to 12 months, meaning that you should keep adding to your investments over time, rather than all at once.

Vanguard's optimism about stocks is based on several factors. Price-to-earnings ratios are low, and though the economy may not recover for a few years, the stock market typically rebounds well in advance of a return to economic growth. But there's also the fact that stocks, statistically speaking, are due for a nice run after such a steep fall.* Investors miss it at their own peril. ●

***Past performance is not a guarantee of future return.**

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