Wealth Management

KANE COMPANY

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Top Wall Street Strategists Wrong Again On Sectors

Every December, Wall Street's top strategists launch a media blitz to tell investors where to put their money. Articulate, attractive and extremely high-paid spokespeople appear on Fox Business News, CNN, and CNBC and get quoted in magazines, newspapers, and financial websites. How do their picks pan out? Not too well.

Among the most respected financial publications to ask Wall Street for its most favored and feared stock sectors is Barron's, a jewel in the Dow Jones & Company media empire owned by Rupert Murdoch that includes *The Wall Street Journal*. Founded in 1921, Barron's is named after Clarence W. Barron, described on Wikipedia as "one of the most influential figures in the history of Dow Jones and considered the founder of modern financial journalism." Barron's is known for its investigative reporting, incisive analysis, and cutting commentary from Alan Abelson, one of financial journalism's all-time great columnists.

But for all its sophistication, Barron's falls into the trap that most financial media succumb to: it quotes experts who try to predict the future.

Maybe it's because it sells papers and gets viewers, or maybe the financial press actually believes some people can predict the future. While you could speculate about the motive, what's certain is that the vast majority of the financial press wants investors to believe that these gurus can tell you which industry will soar over the next year and which will plunge.

For the record, it is the opinion of this firm that no one can predict the future. We certainly can't. Our prescription for investment success relies on broad diversification rather than trying to pick the hottest sector. That's one of the reasons why this firm is independent and not part of the Wall Street forecast machine. While Wall Street's top ranked strategists may get some bets right some of the time, we are not in the prediction business. Data from Fritz Meyer Economics Research confirms our approach is correct.

Fritz Meyer, an independent economist who has worked in the investment business for over 30 years, including a long stint as a strategist at a large mutual fund company, has methodically tracked Barron's annual interviews with Wall Street's top strategists for over a decade. His scorecard shows just how bad Wall Street's strategists are at predicting the best and worst industry sectors.

The accompanying table compiled by Meyer shows the picks and pans of 10 senior strategists from Wall Street largest firms in a Barron's article from December 19, 2011. Telecommunications, for example, was favored by just two of the 10 strategists in the weekly magazine's 2012 investment outlook. One strategist suggested avoiding the sector while seven — a majority — voiced no opinion on telecom. Surprise: As of mid-August 2012, telecom was the No. 1 performing sector, with a 19% return. "That's a big miss," says Meyer.

Conversely, nine of the 10 strategists in the story liked technology stocks, and this sector gained 18%, as measured by Standard & Poor's 500 Industry Sectors. That happens. It's random, however, and unpredictable. "If you think that even the smartest strategists on Wall Street can successfully and systematically pick the right asset classes, you'd be mistaken,"

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Start Planning Now For This Year's Tax Return

Being organized and planning ahead can save time, money and headaches. Here are some things you can do now to make April 15 easier: Review your paycheck and adjust your withholding. Now is a good time to review your withholding and make adjustments for next year, including retirement or HSA contributions and charitable payroll deductions. Organize your recordkeeping. Establish a central location for your supporting documents so you can easily find mileage logs or charity receipts. Strategize tuition payments. The American Opportunity Tax Credit is set to expire after 2012. It may be beneficial to pay 2013 tuition in 2012 to take full advantage of this tax credit (up to $2500) before it expires. Prepare to itemize deductions. If you just fall short of itemizing, it may be beneficial to prepay property tax payments, make extra charitable donations, or pay an extra mortgage payment in 2012 to get you over that threshold.

We would like to help you prepare for this year's taxes. Our tax planning service includes a conference to project and minimize your 2012 income taxes, as well as providing assistance with any 2012 estimated tax payments and payment vouchers or electronic payments.

Steven L. Kane, CPA/PFS, CFP®

Don't Forget The 'Other' Surtax

In the wake of the Supreme Court ruling upholding the constitutionality of the 2010 health-care law, much of the focus has shifted to the 3.8% Medicare surtax that will apply to some high-income investors beginning in 2013. And this is with good reason. Those who are in the top 39.6% tax bracket then may pay an effective federal rate of as much as 43.4% on a portion of their investment income. Add in state taxes, and the new levy could be truly painful.

Yet there's another new Medicare surtax that hasn't received much attention. Beginning in 2013, you will have to pay an extra 0.9% tax on "earned income" which exceeds an annual threshold—$200,000 for single filers and $250,000 for joint filers. It's a relatively straightforward calculation—unlike the larger new tax, which depends on how much income you receive from your investments as well as your overall earnings.

And while this additional new tax may seem small, it comes on top of the 3.8% Medicare surtax, plus your regular federal and state income tax liability. What's more, if your income is high enough, you might owe this tax year in and year out. It really can add up.

Take the example of a single filer who earns $500,000 a year. Starting in 2013, this person will have to pay an extra 0.9% surtax on the $300,000 that exceeds the $200,000 threshold, or $2,700 (0.9% of $300,000). Now assume that the figures stay the same for the next 10 years. As a result, this taxpayer will have to fork over a total of $27,000 (10 years x $2,700).

For the purpose of calculating the surtax, you can rely on the usual IRS definition of "earned income," which includes the following:

- Wages, salaries, tips, and other taxable employee earnings,
- Union strike benefits,
- Long-term disability benefits received prior to minimum retirement age,
- Net earnings from self-employment if you own or operate a business or if you're a minister or member of a religious order,
- Gross income received as a statutory employee.
- On the other hand, the IRS says the following items are not included under its definition of earned income:
- Pay received for work while an inmate in a penal institution,
- Interest and dividends,
- Retirement income,
- Social Security benefits,
- Unemployment benefits,
- Alimony,
- Child support.

Finally, business owners don't have to fret about doubling up on the surtax. The 0.9% levy applies only to employees who exceed the income threshold, not to the business entity that provides their salaries. At least that's a small consolation if you're stuck with this extra tax liability. ●

Two Investment Principles In Tandem

Diversification and asset allocation are twin building blocks of a solid investment foundation. Though the concepts are closely related, understanding each rather than just mixing them together can help you make the most of both. Consider these basics:

Diversification. This is the method of spreading out investment dollars among different categories, or "baskets," in order to reduce your overall risk. For instance, even if you're 99% sure that a particular stock is about to take off, you don't want to invest your life's savings in only one stock. There's still a chance it will tank, leaving you in a financial hole you may never get out of. Similarly, you want to avoid putting all of your investment dollars in a single basket—stocks, bonds, or copper, say—no matter how fundamentally sound the category may seem.

Diversification may work because different kinds of investments tend to rise and fall at different times. If you hold a variety of investments, some may do well when others stumble. Additional benefits can come from diversifying within categories—by spreading your stock investments over many industries and also holding shares in foreign companies. By the same token, you'll probably want to own different kinds of bonds with various maturities. Yet while broad diversification may help your investments weather a worst-case scenario, it can't protect you from losses, especially in a declining market.

Asset Allocation. Closely related to diversification, asset allocation goes a few steps further. Here, you seek to divide your holdings among major investment categories based on a set percentage for each category. Because each group has a unique combination of historical risks and returns, it's expected that each also will perform differently in the future.

Who's Going To Pay The 3.8% Medicare Surtax?

Unless you've been stranded on a desert island, you've probably heard about the 3.8% Medicare surtax scheduled to take effect in 2013. This provision was included in the controversial health-care law—the Patient Protection and Affordable Care Act of 2010—upheld recently by the U.S. Supreme Court. Barring any late reprieve from Congress, investors will have to cope with this add-on tax for the foreseeable future.

How does it work? You must use a two-part test when you complete your tax return. The 3.8% Medicare surtax applies to the *lesser* of (1) "net investment income" or (2) the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. Net investment income includes interest, dividends, royalties, rents, gains from selling property (other than property held in an active trade or business), and income from passive activities, but not tax-exempt interest or distributions from IRAs and qualified retirement plans.

For single tax filers, the threshold is $200,000; for joint filers, it's $250,000. The way the law is applied might result in an unexpected tax for some individuals, while others could escape unscathed. Here are six simplified examples:

Example 1. Alan is a single filer who each year earns $100,000 in wages and $50,000 of net investment income. Because his MAGI doesn't exceed the $200,000 level, Alan doesn't have to worry about the 3.8% Medicare surtax. It applies to investment income only if MAGI goes beyond the threshold.

Example 2. Barbara is a single filer who is retired. She has no wages and her entire MAGI comes from $225,000 of net investment income. Barbara does have to pay the 3.8% surtax on the MAGI part, even though she has no wages, because her $25,000 that exceeds the threshold is less than her investment income of $225,000. Her bill for the Medicare surtax is $950 (3.8% of $25,000).

Example 3. Charles and Donna, a married couple, are joint filers. They earn a total of $300,000 in wages, but have no net investment income. As a result, the couple doesn't have to pay the 3.8% Medicare tax, even though their MAGI exceeds the threshold for joint filers by $50,000. Their net investment income, which is the lesser of the two applicable amounts, is zero.

Example 4. Edward and Florence, a married couple, are joint filers. They earn a total of $200,000 in wages and have $150,000 of net investment income. Their $350,000 MAGI exceeds the threshold of $250,000 by $100,000. Because that's less than their investment income, it's their excess MAGI that is subject to the Medicare surtax. The couple must pay $3,800 (3.8% of $100,000).

Example 5. Gerard is a single filer who is retired. He has no wages and $200,000 of net investment income in 2013, but he also will receive a "required minimum distribution" (RMD) from his IRA of $125,000. The RMD doesn't add to his investment income, because IRA distributions don't count as investment income for the purposes of computing the Medicare surtax. But the money from his retirement plan does increase Gerard's MAGI to $325,000. The $125,000 by which that amount exceeds the $200,000 threshold is less than his $200,000 of investment income, so his surtax is calculated on the $125,000—leaving Gerard with a Medicare surtax of $4,750 (3.8% of $125,000).

Example 6. Hillary is a single filer who is retired. She has no wages and each year receives $100,000 in tax-exempt interest from municipal bonds, a $200,000 RMD from her IRA, and a $300,000 RMD from her 401(k) plan. As a result, none of the annual income that Hillary receives is treated as net investment income. She doesn't have to pay the 3.8% Medicare because her net investment income is zero, which is lower than the $300,000 by which her MAGI exceeds the $200,000 threshold. (Tax-free interest also doesn't count toward MAGI.)

Note that the 3.8% Medicare surtax also applies to trusts and estates. In those cases, the threshold for single or joint filers is replaced by the dollar figure at which the top tax rate for trusts and estates begins ($11,650 in 2012). That means that if all of the trust income is net investment income and the undistributed net investment income exceeds the dollar threshold by, say, $100,000, the trust must pay a Medicare surtax of $3,800 (3.8% of $100,000).

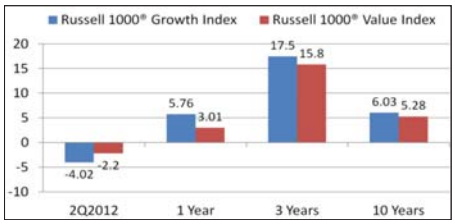
Are you among the unfortunate ones who will have to pay the 3.8% Medicare surtax? Don't just sit back and wait for it to happen. With advance planning, you may be able to reduce your MAGI or your net investment income—or both—to help offset the impact of the surtax. ●

This is diversification with a little more science. Because it's likely that if one category loses value, another may be on the upswing while a third holds steady, devoting an appropriate percentage of your portfolio to each can keep your portfolio in balance.

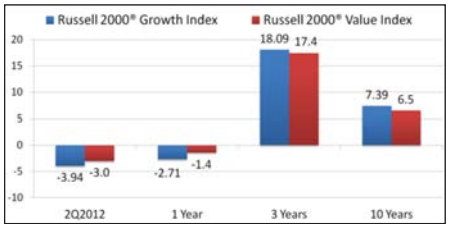
Yet there's also a lot of art involved in asset allocation. Choosing the best percentages for your circumstances requires looking at several variables, such as your objectives, age, health status, amount of assets, and tolerance for risk. And because your goals are likely to shift, allocations need to be reevaluated and adjusted periodically. Typically, your choices will become more conservative as you near or reach retirement.

Asset allocation provides a rigorous method for achieving diversification in your investment portfolio. Having the two ideas working smoothly together can help you move closer to your financial goals. ●

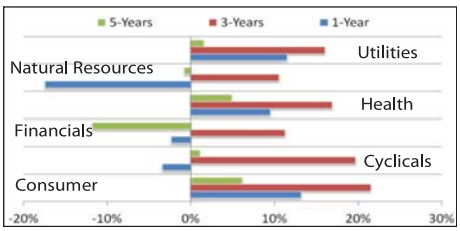
Market Data Bank: 2nd Quarter 2012



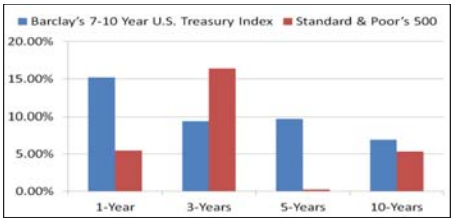
LARGE VALUE VS. LARGE GROWTH
Large-growth stocks underperformed in 2Q2012 but outperformed value stocks over longer time periods. Growth stock lagged in recent months as economic weakness lingered.



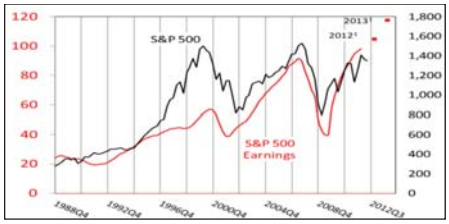
SMALL VALUE VS. SMALL GROWTH
Small-caps stocks only slightly outperformed large caps over 10– and 5-year periods, belying the benefit of the "small-cap effect." The difference between value and growth is not as great as in previous long-term periods.



INDUSTRY SECTORS
Underscoring the risk of concentrating in an industry sector, natural resource stocks were pummeled in the year ended June 30, 2012. Consumer and utilities stocks gained in 1-, 3– and, 5-year periods, while cyclicals lately were hurt by a slow economy.



US STOCKS & US BONDS
Bond returns were extraordinary in the 12 months ended June 30, as interest rates traced a 30-year downtrend to unprecedented lows from an historic 1980 peak. But what if stocks and bonds revert to their historical means?



S&P 500 VS. EARNINGS
Predicting economic activity is very difficult. Still, you may take heart in remembering stock prices are thought to reflect corporate earnings. The red squares indicate Wall Street's expected earnings growth for 2012 and 2013.

FOREIGN STOCK MARKETS
China grabs headlines, but emerging markets and Europe over the long haul have actually outperformed. The foreign indexes have directionally performed similarly but periodically diverged over short-term periods.

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 nott 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

Wall Street Stratagists Wrong

(Continued from page 1)

says Meyer. "Forecasts, even by the top-ranked strategists, are extremely problematic."

Point is, no one has shown the ability to predict systematically that growth stocks will beat value stocks, small caps will beat large-caps, or dividend-paying stocks will outperform. Anyone can have a hot hand, but it's unsustainable. "There has not been a year that the Wall Street strategists, as a group, have added return with their calls to outperform the S&P 500 stock index," says Meyer.

Broad diversification, periodic rebalancing, and choosing low-expense investments — while relying on the precepts of Modern Portfolio Theory — is a prudent path. ●

Wall Street's Top Strategists Wrong Again

	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Technology	Materials	Telecom Services	Utilities
Federated	👍	👎	👍	👎		👍	👍	👍		👎
Blackrock				👎	👍		👍			
Barclays Capital		👎	👍	👎	👍		👍	👎		👎
Putnam				👎[1]		👍	👍			
Goldman Sachs	👎	👍				👎	👍	👎	👍	
JPMorgan	👍	👎		👍	👍	👍	👍	👍	👎	👎
Citibank	👎	👍				👎	👍		👍	
Morgan Stanley	👎	👍			👍	👎				👍
Prudential	👍			👎		👍	👍	👎		
Merrill Lynch		👍		👎			👍	👎		
2012 Sector Returns YTD[2]	+14%	+10%	+4%	+15%	+11%	+9%	+18%	+7%	+19%	+4%
Sector Ranking By YTD Return	4	6	9	3	5	7	2	8	1	10
Comment	Big Miss		Mistake	Big Miss			Good call		Big Miss	Good call

Source: Fritz Meyer Economic Research

Forecasts published in Barron's, Dec. 19, 2011. [1] Big money center financials. [2] Through August 13, 2012.

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