Comprehensive
FINANCIAL PLANNING
INC.

October 11th, 2012

Here is our newsletter for the 4th quarter of 2012.

The Markets

The 3rd quarter was a positive one for almost all asset classes. Equity indexes were up 5 to 6.5%. The returns were in Europe with a gain of almost 9% and commodities with a 9.7% gain. Core investment grade bonds gained 1.5% but high-yield and emerging market bonds gained almost 5%.

The strong stock market over the last year seems to suggest that things are pretty good with the economy. We would agree that the fundamentals have improved some here in the U.S. However, our analysis warns us that serious risks and challenges remain going forward. In the short-run the markets have responded positively to actions by the Federal Reserve and the European Central Bank (ECB).

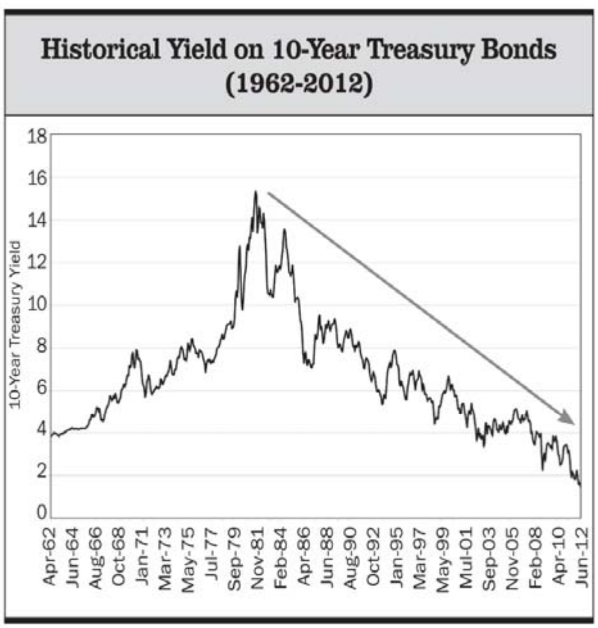
The ECB signaled it will "do whatever it takes to preserve the euro", which is their attempt to prevent the type of Lehman moment we had here in the U.S. back in 2008. They launched an open-ended commitment to buy the bonds of distressed euro zone governments (Spain and Italy most notably) in exchange for them agreeing to various conditions which they hope will improve the chances that they can pay back their debts. The problem is the ECB actions do not solve the underlying structural problems in the eurozone, they just buy more time. It will take many years for Europe to get out from under their problems and the current recession they are experiencing could deepen over the next year.

Here in the U.S. the Fed launched their own open-ended commitment to buy $40 billion a month in government-backed mortgage bonds. They also extended their near-zero interest rate policy, saying they expect to keep interest rates as low as they can at least thru mid-2015. (I can recall back in 2009 they said they intended to keep rates low into 2012.) This is intended to improve the housing market, encourage investors to move into riskier assets and, as in Europe, buy more time for us to get our fiscal house in order. We will have to take our debt-deficit reduction medicine eventually and the immediate impact of doing so will be a slowing economy. If we delay further the markets may force our hand, potentially leading to higher interest rates for U.S. Treasuries.

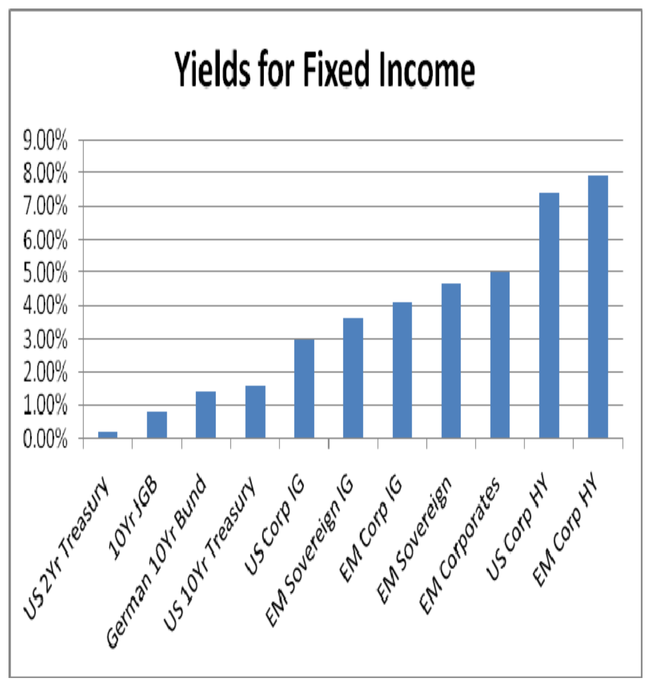
Why Would Anyone Invest In Bonds?

I get questions from clients concerning our overweight to bonds vs. equities in our portfolios. The answer is in the makeup of our bond allocations. We're actually underweight government bonds and overweight higher-yielding alternatives. The current yield on the bond portion of our portfolios is around 4.5 to 5.0%. These higher- yield bonds are subject to additional risks not associated with low yielding bonds but we feel these risks are more than compensated for by their higher returns and added diversification. When market interest rates rise these alternatives will also hold up better than the lower-yielding bonds.

The first chart below illustrates how the U.S. 10-year Treasury bond rate has dropped for over 30 years and has been below 2% for much of the last year. It's the same story in Great Britain and Germany. The chance of earning a real return, meaning a return that is higher than inflation, is very small. Even if rates were to drop further (probably during a stock market downturn) there simply isn't enough potential upside in their price to offer good downside protection to our portfolios. The rates can go no lower than zero.



For the past 30-plus years, interest rates have trended lower. With falling bond yields come higher prices, which has resulted in a massive bull market for bonds. Today, interest rates are near all-time lows. This low-rate environment is great for borrowers, but lousy for investors. Going forward, we don't think investors are being compensated for the risk of rising interest rates.



Investment grade corporate rates are also much lower than normal at 3.0%. On the other hand yields are significantly higher for emerging market sovereign and for U.S. and emerging market corporate high-yield. Most of our bond holdings are in those shown in the middle and right side of the above chart.

Year-End Tax Planning

We're approaching another one of those moments when temporary tax cuts enacted in the past are about to expire. Below is a summary of income tax rates on ordinary income for 2012 and the scheduled increased rates for 2013.

Ordinary Income-Starting Points for Tax Brackets (2012)		Statutory Tax Rate on Ordinary Taxable Income	
Single Filers	Joint Filers	2012	After 2012
$0	$0	10%	15%
$8,700	$17,400	15%	15%
$35,500	$70,700	25%	28%
$86,650	$142,700	28%	31%
$178,650	$217,450	33%	36%
$388,350	$388,350	35%	39.6%

Also, starting in 2013, as part of the Health Care Act, individuals will pay an additional 0.9% in payroll taxes on earned income over $200,000 ($250,000 if married, filing jointly).

Here is what could happen to long-term capital gains and qualified dividend income for 2012 and 2013 unless current law is changed.

Scheduled Investment Income Tax Rates			
	2012	**2013 and beyond (with Medicare tax)***	**2013 and beyond (Bush-era tax cut expires)**
Short-term capital gains (assumes top tax bracket)	35%	38.8%	43.4%
Long-term capital gains	15%	18.8%	23.8%
Qualified dividends (assumes top tax bracket)	15%	18.8%	43.4%

**The Health Care Act adds a 3.8% Medicare tax on investment income(taxable interest, dividends, capital gains) for those with modified adjusted gross income in excess of $200k for individuals and $250k for married taxpayers filing joint returns..*

There are many steps one should consider before year end to help reduce your potential tax burden. Call me if you would like to discuss these and other changes that may impact you.

Sincerely,

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