The COMPASS Chronicle

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Congress Leading Us to Fiscal Cliff Dive?

By Louis E. Conrad II, CFA

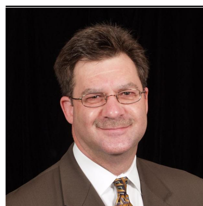
- As disappointing as the current political bickering may be over the fiscal cliff, COMPASS expects that a minimal agreement will be reached within the next few weeks.
- Consequently, we have not made adjustments to client portfolios as we have believed that any negative market reaction would be transitory.
- The real fiscal decisions that need to be made will be deferred as long as possible.

I have used these pages in the past to review the fiscal cliff ("The Fiscal Cliff" in June 2012) and the precarious state of our nation's debt level ("In Debt We Trust?" in November 2012). Not surprisingly, we find Congress and the Administration have taken us to the brink of yet another financial crisis created by their own dysfunction—their inability to make the necessary decisions through compromise that would place our country on a path toward fiscal responsibility. As I stated last month, "While politicians may bicker about whether tax increases or spending cuts are needed, the reality is that both will be required. In the future you will pay more for reduced services and programs from the federal government."

The impact of traveling over this cliff, which is a combination of broad-based tax increases and spending cuts scheduled to take effect beginning on January 1st, is widely expected to lead to a recession and significant job losses. All of this from an artificial construct created by Congress.

My expectation is that Congress will reach a minimal agreement by the end of the year or early in January that will attempt to reduce the negative effects of the fiscal cliff (e.g., maintain current income tax rates for everyone, except those in the top two tax brackets), but that the real decisions of tax rates and tax reform, as well as entitlement cuts will be deferred as long as our politicians lack the leadership to make the decisions that are required. Unfortunately, the longer they delay, the greater the pain we will all ultimately suffer.

Advisor Corner



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Teaching Your Kids About Money

By Louis E. Conrad II, CFA

- Our ability to make financial decisions as adults is based on an accumulation of our experiences, beginning with what we were taught about money as children.
- This article addresses some steps that you might want to consider with your children or grandchildren to build their financial decision making skills.

Children rely on us to teach them how to be financially responsible. A financial education should begin early and, since we know children model behaviors, however you handle money will likely have a direct impact on how your children or grandchildren will handle money. Educating your children on personal finances can have a positive impact for the balance of their lives—a lifetime of healthy financial habits.

I remember thinking I had some work to do as a parent when my son, a preschooler at the time, thought you could just drive up to the ATM and retrieve your free money. He has since learned that the cash that appears from an ATM is the result of hard work. In addition, the supply of cash is limited and choices often need to be made as to how to spend or save that hard-earned cash.

Your family's values and approach to money will dictate how you educate your children about money, but below are some general thoughts that may be appropriate depending on the age of your children:

* Allowance—Besides building responsibility, an allowance provides a direct connection for your children between work and money. The tasks involved to earn the allowance will vary based on your household, but examples include picking up their toys, making their bed, feeding the pets, taking the dog for a walk, loading and emptying the dishwasher, and mowing the lawn. If your children are especially young, you might want to make a list and keep a chart of their chores and whether they have been completed.

* Saving—Once your children have received money through an allowance, a job, or as gifts, you may want to encourage them to save a certain percentage of that cash (e.g., 25%) and allow them to spend the remainder. The amount saved could be placed in a savings account with your local bank or in a Uniform Transfers to Minors Act (UTMA) account with a financial institution.

* Spending—For the amount slated to be spent, you may want to assist your children in establishing short- and long-term spending goals. For example, a short-term spending goal may be to purchase a relatively low-cost item, such as a sweatshirt, while a longer term goal may be to purchase a more expensive item, like the latest electronic gadget. The short-term goal allows for some immediate gratification as a reward for the work involved in earning the money. The longer term spending goal builds the concept of delayed gratification. Whether working with a short- or long-term spending goal, the concepts of differentiating between needs and wants, as well as prioritizing purchases are good lessons to incorporate here too.

As your children get older, you will probably want to introduce the reality of taxes and tipping for services. One way to initiate these concepts is when visiting a restaurant share the bill with your children, explaining the cost to purchasing meals, the taxes that are added, and that tipping the wait staff is customary for the service (work) they have provided. Explain why taxes are paid and what our government offers as a result, such as the roads we travel on and the schools our children attend.

One of the gifts you can provide your children is a healthy appreciation for the value of work and money. Introducing these concepts at an early age can provide them with the foundation for a financially secure life.

Monthly Market Commentary

November and early December saw Hurricane Sandy's destructive powers sweep their way through a series of economic data, including new home sales, personal income, and same store sales, making them difficult to interpret. These economic data will likely remain muddled for the next few months. With the U.S. presidential election done, earnings season done, and minimal news coming out of Europe and China, all attention is now focused on whether the U.S. can avoid the fiscal cliff. Similar to how markets made wide swings during the debt ceiling negotiations in 2011, investors may experience déjà vu should Congress fail to come to an agreement by the end of December.

GDP: The second estimate for third quarter real GDP growth was revised sharply higher to a very robust 2.7%, up from an initial estimate of 2.0% and up from the second quarter real GDP growth rate of 1.3%. This positive revision was mostly attributed to higher inventories and higher exports. Higher inventories are generally not a good thing as they could indicate slumping sales. Consumer spending and business investments were also revised downward.

Employment: November's employment report came in far better than expected, with job growth of 146,000: 147,000 private-sector jobs were added, while 1,000 government jobs were lost. The Bureau of Labor Statistics also indicated that Hurricane Sandy had minimal impact on the November job numbers. Overall, the job market has been relatively stable over the last 12 months, adding an average of 161,000 new jobs per month. At that rate, it will still take about another two years to gain back all the private-sector jobs lost in the recession. Unfortunately, job growth has not been distributed evenly across industries, with services strongly outperforming manufacturing and construction. The unemployment rate fell slightly to 7.7% from 7.9% in October.

Housing: Overall housing data continued to be positive, with homes prices expected to be up as much as 5% for 2012. November's Builder Sentiment, which is compiled by the National Association of Home Builders and tends to be a good predictor of housing starts and new home sales in the months ahead, is now at its best level since May 2006 and marks the seventh consecutive month of improvement. Even the Northeast region, which was hit by Hurricane Sandy during the survey period, showed improvements. More importantly, home inventories fell 1.1% in October to 2.14 million units, their lowest level since 2006.

Auto: Auto sales were up significantly in November. As a recap, Hurricane Sandy caused a dip from 14.9 million units in September to 14.2 million in October, but sales rebounded sharply to 15.5 million units in November. Morningstar economists believe that, with vehicles damaged by Sandy still in need of replacement, auto sales may remain above the 15-million mark again in December.

Retail: November's same-store sales (excluding drugstores) were only up a miserly 1.7%, a far cry from expectations of 3%-4%. Many economists had believed that a strong Black Friday would offset the earlier-in-the-month effects of Hurricane Sandy. Unfortunately, they failed to realize that even though previous storms may have been more damaging than Sandy, this was one of the few times that a storm has made a direct hit on such a highly populated, high-income, and high-spending part of the country. Also, sales from cyber Monday will count in December's report this year versus November last year.

Looking forward to next year and hopes of Congress reaching a settlement, consumers should realize that such a settlement may mean bad short-term news for the economy. Some tax increases will likely still occur, impeding growth in the first half of the year. On the other hand, even if no settlement is reached, the worst of the immediate impacts can probably be delayed by some sort of administrative action (for example, defense cuts can be saved for later in the year).

Retirement Contribution Limits for the New Year

By Louis E. Conrad II, CFA

- The contribution limits for retirement accounts set by the IRS are increasing for 2013.
- If your cash flow allows, be sure to increase your contribution amounts to reflect the new limits.

The forthcoming New Year will bring changes to the contribution limits of 401(k) and similar accounts, as well as IRAs. Here we review these changes.

Employer-Sponsored Accounts

The amount that you may contribute to an employer-sponsored retirement account has increased slightly for 2013. For 401(k), 403(b), and 457 plans, offered by corporate, non-profit, and government employers, respectively, the maximum you may contribute via payroll deduction to such plans has increased by $500 to $17,500 annually. The increase is due to the cost-of-living index, which met the statutory threshold that allows for an adjustment in the maximum contribution level.

If you will be 50 years of age or older by December 31, 2013, you may contribute an additional $5,500 in 2013 (also known as the "catch-up" provision), though this amount is unchanged from this year. Consequently, if you will be at least 50 years of age during 2013, you may contribute a total of $23,000 to an employer-sponsored retirement account. Contributions to your employer-sponsored retirement account, when made on a pre-tax basis, have the benefit of lowering your taxable income (and thus your taxes), as well as assisting in saving for your retirement.

For those with SIMPLE IRAs, the maximum annual contribution also has increased slightly for 2013 to $12,000 from $11,500. The "catch-up" provision of an additional $2,500 remains unchanged, however, for those individuals over 50.

IRA Accounts

Similar to the $500 contribution increase allowed for employer-sponsored accounts, the contribution limit has increased for Traditional and Roth IRAs in 2013. For such IRAs, you may contribute a total of $5,500 as your 2013 tax year contribution up until April 15, 2014. If you will be at least 50 years old at any time during 2013, you may contribute an additional $1,000, an amount which is unchanged from this year. To qualify to make an IRA contribution, your taxable compensation must be equal to or greater than the contribution you wish to make.

In addition, to contribute to a Roth IRA, you must be income eligible. To make the full contribution to which you are otherwise entitled, your modified adjusted gross income (MAGI) during 2013 must be $112,000 or less as a single filer and $178,000 or less as a married individual, filing jointly. If your MAGI is between $112,000 and $127,000 as a single filer, or between $178,000 and $188,000 as a married individual, filing jointly, you are entitled to make a prorata contribution to a Roth and a Traditional IRA as long as your total contribution does not exceed the applicable limit.

[Continued on next page.]

	Retirement Account Contribution Limits	
	2012	**2013**
Under Age 50		
401(k), 403(b), and 457s	$17,000	$17,500
SIMPLE IRAs	$11,500	$12,000
Traditional or Roth IRAs	$5,000	$5,500
Age 50 or Older*		
401(k), 403(b), and 457s	$22,500	$23,000
SIMPLE IRAs	$14,000	$14,500
Traditional or Roth IRAs	$6,000	$6,500

* Includes "catch-up" provision

Source: www.irs.gov

Retirement Contribution Limits for the New Year, continued

If your MAGI exceeds the upper end of the applicable MAGI range, then you may contribute up to the allowed maximum to a Traditional IRA. You must be less than 70½ years old to contribute to a Traditional IRA.

Under current law, if you do not qualify to contribute directly to a Roth IRA because your MAGI exceeds the allowed limits, you may contribute to a Traditional IRA and then convert the contribution (and other retirement assets, if you desire) to a Roth IRA, subject to limitations and possible taxes, which are beyond the scope of this article.

One other difference between Roth and Traditional IRAs is worth noting. Contributions to a Roth IRA cannot be used as a deduction to reduce the income taxes you pay, while contributions to a Traditional IRA may or may not be used as a deduction. Whether or not a Traditional IRA contribution can be deducted is dependent on your income level and whether you or your spouse participates in an employer-sponsored retirement plan.

If you have not yet retired and have sufficient cash flow, consider increasing your retirement contributions in order to be better prepared financially for your retirement. You may also reduce the taxes you would otherwise pay.

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