March 2013 | Vol. 3 No. 3 | "Morningstar's Best Client Newsletter" in 2012

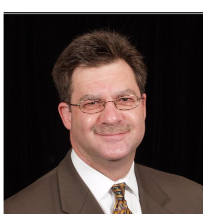
Conrad Named FIVE STAR Wealth Manager for Fourth Year

Lou Conrad, CFA, founder and president of COMPASS Wealth Management, LLC, was recently named a 2013 FIVE STAR Wealth Manager as announced in the February issue of Boston magazine. This is the fourth consecutive year that Lou has been honored to be named a FIVE STAR Wealth Manager.

The award is the result of a thorough evaluation process overseen by Crescendo Business Services, an independent research firm, in partnership with Boston magazine. Less than 4% of the wealth managers in the Boston area were named as a 2013 FIVE STAR Wealth Manager. The selection was based on ten objective criteria, including a favorable regulatory and complaint history review.

Before founding COMPASS Wealth Management, LLC more than 12 years ago, Lou was a mutual fund portfolio manager, as well as the director of Fidelity Investments' Fund Analysis and Research Group. He has been a member of Fidelity Institutional Wealth Services' Advisor Council, as well as Putnam Investments' Advisory Council, both comprised of a select group of advisors who provide feedback to these leading companies on their current and contemplated products and services. From 2007 – 2009, Lou served as president of the American Association of Individual Investors' Boston chapter, a nonprofit organization devoted to the education of investors. From 1997 – 2009, he served on the Board of Directors for Cooperative Elder Services, a nonprofit daycare program for seniors, based in Lexington. Lou is also a member of the Lexington, Massachusetts Chamber of Commerce.

Mr. Conrad, who received an MBA in finance from The University of Chicago, is a Chartered Financial Analyst (CFA) and a member of the CFA Institute, the Boston Security Analysts Society, the Boston Estate Planning Council, and the Financial Planning Association.



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More about COMPASS Wealth Management, LLC

COMPASS Wealth Management, LLC is a client-focused wealth management firm dedicated to providing superior advice to individuals, families, and corporate retirement plans.

Our wealth management services include investment management, retirement and gift planning, education funding, and other advisory services.

We take pride in offering you expert financial advice along with personalized service. Assisting you in reaching your financial goals is our business and we take that responsibility very seriously.

For details on the selection criteria used to determine the recipients of the FIVE STAR Wealth Manager award, please visit our web site.

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What the New Tax Law Means for You

By Louis E. Conrad II, CFA

- Despite the name of the new federal tax law (American Taxpayer Relief Act of 2012), it neither relieved the existing tax burden Americans incur nor was it passed into law in 2012 (it was actually signed into law shortly after we fell over "the fiscal cliff").
- All workers who pay into the Social Security system are paying a 2% higher tax in 2013 than in 2012 and higher earners will pay meaningfully more taxes as outlined in this article.

As you prepare to file your 2012 tax returns, your tax burden may be top of mind. If you are presently working, you probably have already seen the impact of higher taxes in your recent paychecks. Despite statements from Congressional leaders that taxes were raised on the "rich," however defined, in reality, if you pay into the Social Security system, your taxes increased by 2% with the advent of the New Year.

The American Taxpayer Relief Act of 2012, signed into law on January 2, not only increased taxes on nearly every wage earner, but also increased the complexity of the federal tax code, despite ongoing pronouncements from Congress that simplifying the tax code remains a goal.

Taxes Increased for Workers

If you work and contribute to the Social Security system through the FICA tax, your tax increased as of January 1 from 4.2% to 6.2% on the first $113,700 in wages. This tax, frequently called the "payroll tax," had been reduced by 2% for 2011 and 2012 in an effort to reduce workers' tax burden.

However, the Social Security system has been woefully underfunded for years, so it did not make practical sense, from the perspective of the Social Security system, to reduce the tax revenue that supports the system. This 2% tax increase beginning in 2013 has a marginally negative impact on the economy since consumers will now have less money available for consumption.

Taxes Increased for Higher Earners

In addition to the 2% payroll tax increase imposed on workers, those with higher incomes will pay more taxes this year.

For adjusted gross income in excess of $200,000 for individuals and $250,000 for couples, filing jointly, the Patient Protection and Affordable Care Act, which was passed in 2010 and is commonly referred to as Obamacare, imposes a 3.8% Medicare tax beginning in 2013 on the lesser of all net investment income or the income in excess of the threshold. (The details of the calculation are beyond the scope of this article.) An additional 0.9% Medicare surtax is imposed on wages and self-employment income above the same $200,000 and $250,000 thresholds, respectively.

For adjusted gross income in excess of $250,000 for individuals and $300,000 for couples, filing jointly, you will incur the tax changes indicated above, plus limitations on itemized deductions and a phase out of personal exemptions. For 2012, limitations on itemized deductions and the phase out of personal exemptions had been suspended, but are now reinstated for 2013, which effectively increase the taxes you will pay at this income level.

And finally, for taxable income in excess of $400,000 for individuals and $450,000 for couples, filing jointly, you will be impacted by the taxes, limitations, and phase outs already reviewed, plus the following tax increases in 2013: (1) marginal federal income tax rate increases from 35% to 39.6%; (2) long-term federal capital gain tax rate increases from 15% to 20%; and (3) qualified federal dividend income tax rate increases from 15% to 20%.

Other Changes

A variety of other changes were also made as part of the American Taxpayer Relief Act, including (1) a permanent fix for the Alternative Minimum Tax (AMT) exemption amount so that it is automatically indexed for inflation and (2) the federal estate tax exemption was maintained at $5 million per individual, indexed to inflation ($5.25 million for 2013), but the federal estate tax rate was increased from 35% to 40%.

This is just a summary of some of the tax changes that have been imposed. Contact us or your tax preparer to determine how these changes impact your situation.

What Investors Can Learn From Their Tax Returns

- When managing taxable investment accounts (e.g., individual, joint, and trust accounts), COMPASS Wealth Management, LLC is focused on generating the highest after-tax return for a given level of risk.
- The strategies we employ to reduce the tax consequences of our investment decisions include (1) placing bond and REIT investments in IRAs, where their income is not taxable (also known as the "asset location" decision); (2) employing tax-efficient mutual funds in taxable accounts to minimize taxable distributions; (3) using losses in taxable accounts to offset gains; and (4) rebalancing portfolios within IRAs so that taxable gains are not incurred.

Your 1040 can reveal a lot about your investment habits. Are you withholding too much or too little? Taking advantage of all the credits available to you? Before you stash a copy of your tax return in a drawer, take note of the following line items on your 1040.

Line 8-Interest Income: The raw dollar amounts of your interest income are shown on line 8 of your 1040 form; line 8a shows taxable income and line 8b shows tax-exempt income, generally from municipal bonds. If you have a high level of taxable interest income, pay careful attention to asset location and assess whether taxable bonds, rather than municipals, are truly the better bet once the tax effects are factored in.

Line 9-Dividend Income: Line 9a shows the total amount of ordinary dividends you received last year; dividends on line 9b count as qualified, meaning that they are subject to more favorable tax treatment. As with taxable interest above, take a hard look at any investments, such as REITs, that are paying nonqualified dividends; those investments may be better housed in a tax-sheltered account such as an IRA.

Line 13-Capital Gain (or Loss): Capital gains are often a sign of investment success. But if you see a big number on this line, make sure you're paying due attention to proper tax management. Do you periodically scout around your taxable portfolio for losing positions that you can use to offset gains? If your losses exceed your gains, you can use them to offset up to $3,000 in ordinary income. If one of your fund holdings made a big capital-gain distribution last year, have you considered whether that fund might be a better fit in a tax-sheltered account?

Line 25-Health Savings Account Deduction: Have you evaluated whether a health savings account, used in conjunction with a high-deductible health-care plan, is a good fit for you? For those who are relatively healthy and have cash on hand to cover out-of-pocket expenses that might arise until they hit the maximum for the year, HSAs can serve as supplemental savings vehicles. You'll enjoy tax benefits on your contributions and the money in your HSA will roll over from one year to the next.

Line 32-IRA Deduction: If you are closing in on retirement, haven't saved much, and can deduct your contribution, funding a traditional IRA may be a better bet than putting money into a Roth IRA. If you're not contributing to a company retirement plan, you can deduct your traditional IRA contribution regardless of income level. Individuals earning less than $68,000 in 2012 who are covered by a company retirement plan can make at least a partially deductible contribution to a traditional IRA. Married couples filing jointly can make at least a partially deductible IRA contribution if they earn less than $112,000.

The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. Please consult with your financial professional regarding such services. Dividends are not guaranteed. REITs typically provide high dividends plus the potential for moderate, long-term capital appreciation. A REIT must distribute at least 90% of its taxable income to shareholders annually. Real estate investment options are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes would apply to any capital gains distributions. Stocks and REITs are not guaranteed and have been more volatile than bonds. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free as money withdrawn is not taxed. Penalties may apply for withdrawals prior to the age of 59 1/2.

Monthly Market Commentary

February and early March saw markets continue to reach new recovery highs as investor confidence stayed strong. This occurred despite concerns with the payroll tax increase, the sequester, and the Federal Reserve Open Market Committee meeting minutes (the minutes hinted that the Fed might indeed stop easing by the end of 2013.) While consumer woes did hit low -end retailers and restaurateurs hard, home and auto sales continued to move ahead despite less-than-optimal weather. The manufacturing sector took a surprise turn for the better with some of the best data in a couple of years, and housing continued to improve. Although housing contribution currently represents only about 2% of GDP, the historical long-term average has been closer to 5%, which means there's still a lot of room for improvement.

GDP: The second estimate of real GDP in the fourth quarter of 2012 was revised upwards to 0.1% from negative 0.1%. For reference, real GDP increased by 3.1% in the third quarter. Although this is not a big numerical difference, fourth quarter GDP has gone from showing contraction to growth. The revision mainly resulted from higher exports and more business spending.

Employment: February's private sector job growth exceeded expectations, with 246,000 jobs added. The improvements were unusually broad-based, with almost no declining categories across industry sectors. Unfortunately, government employment continued to decline, with an additional loss of 10,000 jobs. To date, the U.S. has lost more than 600,000 government jobs since the recovery began. Morningstar economists believe that in an average economic recovery, the government sector would have been expected to contribute more than 600,000 jobs. Had the U.S. not lost so many government jobs, it would have replaced more than 80% of the jobs lost during the recession instead of just 65%. The unemployment rate in February fell to 7.7% from 7.9% the month before.

Housing: December's home prices, January's pending home sales, and January's new home sales all continued to show improvements. Year-over-year home prices from December 2011 to December 2012 (three-month average) were up 6.9%. Home prices most recently bottomed in March 2012, and anyone who purchased a home before mid-2003 or after late 2008 is at least at break-even levels before commissions and expenses. In addition to home price increases over the past year, the National Association of Realtors has continued to raise its price forecast from 5.75% to 7% for 2013, citing a lack of supply to meet the increasing demand.

Manufacturing: Although manufacturing is not a key economic driver at this point of the recovery, the recent string of good news can no longer be ignored. Durable goods orders (excluding aircrafts) showed surprising strength, which Morningstar economists believe may be driven by the resolution of the fiscal cliff and the better than expected consumer data late last year. These factors contributed to corporations' increased spending. Other manufacturers also reported business improvement, with the purchasing managers' survey showing its highest reading since mid-2011.

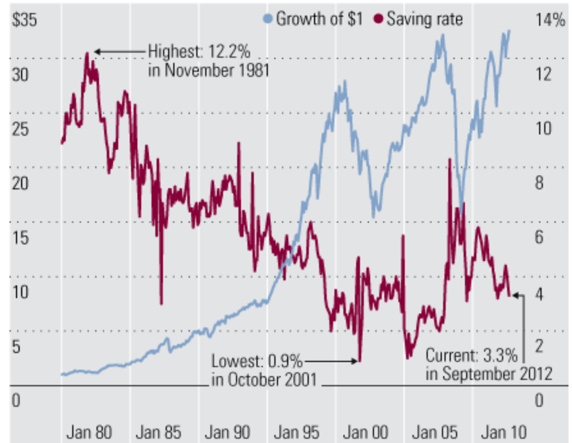
Auto: Auto sales in February came in at 15.36 million units, representing the fourth month in a row with more than 15 million units sold. Considering that this was achieved despite the government's tax and spending tightening, auto sales have shown a strong positive trend and have been the bedrock of the U.S. recovery.

Gas: Gasoline prices soared in February by almost $0.50 a gallon, caused by a combination of potential tightening from the Fed, a weaker European economy, and weather related issues (too much snow to drive.) Considering that gasoline makes up 5% of consumer purchases, large swings in prices are a big deal, especially if food prices are moving up at the same time.

The Personal Saving Rate

Saving is an important part of any sound financial plan. In order to measure consumer spending and saving, the Bureau of Economic Analysis publishes personal income, expenditure and saving statistics, including the personal saving rate. This saving rate is calculated by taking disposable income (income after taxes), subtracting personal consumption expenditures, and dividing the result by personal disposable income. The saving rate has been generally trending downward for the past few decades. Recently, the saving rate was 3.3% in September 2012, extremely low when compared with previous levels. As the image illustrates, it would seem that when the market is in trouble, consumers get scared, spending less and saving more; the opposite happens when the market is doing well. However, even if the economy is now on the way to recovery, it's probably not a good idea to stop saving.

Personal Saving Rates and the Market
January 1980–September 2012



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Source: The market is represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Saving rate data from the U.S. Department of Commerce, Bureau of Economic Analysis, through the Federal Reserve Bank of St. Louis (FRED® database).

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