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The Financial Solutions Advisor

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Economic & Market Perspectives

The United States emerged from 2014 as the best house on a troubled block. Civil war in Ukraine, a slowing Chinese economy, a stagnant Europe worried about potential deflation, a new recession in Japan, the threat of a new Russian economic meltdown triggered by plummeting oil prices--it all made an improving situation at home look even brighter by comparison. Even apart from the troubles overseas, the United States by almost any measure was stronger than it's been in years. The labor and housing markets improved, corporate profits were solid, Congress managed to avert another government shutdown, and the Ebola threat had little impact domestically. All in all, it was a Goldilocks economy: not too hot, which could have brought on higher interest rates from the Federal Reserve, and not too cold, which let the Fed end the QE3 bond purchases begun in the wake of the 2008 financial crisis. That domestic strength fueled more gains for domestic stocks than had been envisioned for the fifth year of this bull market. However, in the coming year, investors will almost certainly be faced with the start of long anticipated interest rate increases. Though the Fed has promised patience in implementing rate hikes, higher borrowing costs and a strong dollar that makes U.S. goods more expensive overseas could create a headwind for domestic corporations. The question is whether that wind might blow the economy off its current promising course or will merely keep the game interesting.

2014 Recap

The Economy

Unemployment: Improvement in the U.S. job market was slow but steady. The unemployment rate ended the year at 5.8%, its lowest level since July 2008.

GDP: After a slump during the first quarter, when the U.S. economy contracted by 2.1%, by Q3 the U.S. economy was growing at its fastest pace in 11 years.

Inflation: Inflation remained well under historical averages, which allowed the Fed to postpone any interest rate hike until 2015.

Housing: The most recent home prices measured by the S&P/Case-Shiller 20-City Composite Index were up 4.5% from a year earlier, and the National Association of Realtors® said that by November, new home sales were slowing but still up 2.1% year over year.

Manufacturing: Manufacturing was a fundamental component of the economy's strength during the year. The Federal Reserve said that by the end of the year, usage of the nation's industrial capacity had finally reached its long-term average.

International markets: Economic problems overseas contributed to the Fed's caution with interest rates.

The Markets

Stocks: After a discouraging start, large-cap domestic equities spent much of the year climbing to new heights. However, little of that love spilled over to the small caps. The Russell 2000, which had soared in 2013, had trouble scaling the proverbial "wall of worry" and spent much of 2014 either flat or down before a Q4 rally returned it to positive territory. The NASDAQ proved the strongest of the four indices. Beset by weakness worldwide, the Global Dow barely managed a positive return for the year.

Bonds: The bond market confounded those who had feared bond prices would suffer from the unwinding of Federal Reserve support. Challenges overseas, the fading of the threat of an imminent Fed rate and falling oil prices lured investors to the safety of U.S. Treasuries.

Currencies: Falling oil prices coupled with the expectation of higher interest rates helped boost the U.S. dollar, which rose almost 11% over the course of the year. The dollar also benefited from interest rates abroad, some of which were even lower than those for Treasuries.

Gold: After plummeting in 2013, gold managed to stabilize a bit last year. The precious metal ended the year at roughly $1,180--not far from where it began in January.

2015 Outlook

2015 is likely to be the year investors transition from disbelief to belief or from skepticism to optimism. Sir John Templeton coined the phrase, “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria,” and we believe we are entering the “optimism” phase. 2015 should result in another decent year for U.S. stocks as we experience (1)

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2014 Returns

S&P 500	*13.69%*
NASDAQ	*19.40%*
Russell Small Cap	*4.89%*
Russell Mid Cap	*13.22%*
MSCI EAFE	*-4.90%*
MSCI World	*4.94%*
Barclay US Agg	*5.97%*
Barclay Muni.	*9.05%*

Leaving Assets to Your Heirs: Income Tax Considerations

An inheritance is generally worth only what your heirs get to keep after taxes are paid. So when it comes to leaving a legacy, not all property is created equal--at least as far as federal income tax is concerned. When evaluating whom to leave property to and how much to leave to each person, you might want to consider how property will be taxed and the tax rates of your heirs.

Favorable tax treatment for heirs

Roth IRAs

Assets in a Roth IRA will accumulate income tax free and qualified distributions from a Roth IRA to your heirs after your death will be received income tax free. An heir will generally be required to take distributions from the Roth IRA over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is your beneficiary, your spouse can treat the Roth IRA as his or her own and delay distributions until after his or her death. So your heirs will be able to continue to grow the assets in the Roth IRA income tax free until after the assets are distributed; any growth occurring after funds are distributed may be taxed in the future.

Note: *The Supreme Court has ruled that inherited IRAs are not retirement funds and do not qualify for a federal exemption under bankruptcy. Some states may provide some protection for inherited IRAs under bankruptcy. You may be able to provide some bankruptcy protection to an inherited IRA by placing the IRA in a trust for your heirs. If this is a concern of yours, you may wish to consult a legal professional.*

Appreciated capital assets

When you leave property to your heirs, they generally receive an initial income tax basis in the property equal to the property's fair market value (FMV) on the date of your death. This is often referred to as a "stepped-up basis," because basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

If your heirs sell the property with a stepped-up (or a stepped-down) basis immediately after your death for FMV, there should be no capital gain (or loss) to recognize since the sales price will equal the income tax basis. If they sell the property later for more than FMV, any appreciation after your death will generally be taxed at favorable long-term capital gain tax rates. If the appreciated assets are stocks, qualified dividends received by your heirs will also be taxed at favorable long-term capital gain tax rates.

Note: *If your heirs receive property from you that has depreciated in value, they will receive a basis stepped down to FMV and will not be able to claim any loss with respect to the depreciation before your death. You may want to consider selling depreciated property while you are alive so that you can claim the loss.*

Not as favorable tax treatment for heirs

Tax-deferred retirement accounts

Assets in a tax-deferred retirement account (including a traditional IRA or 401(k) plan) will accumulate income tax deferred within the account. However, distributions from the account will be subject to income tax at ordinary income tax rates when distributed to your heirs (if there were nondeductible contributions made to the account, the nondeductible contributions can be received income tax free). An heir will generally be required to take distributions from the tax-deferred retirement account over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is the beneficiary of the account, the rules may be more favorable. So your heirs will be able to defer taxation of the retirement account until distribution, but distributions will generally be fully subject to income tax at ordinary income tax rates.

Note: *Your heirs do not receive a stepped-up (or stepped-down) basis in your retirement accounts at your death.*

Even though distributions are taxable, your heirs will nevertheless generally appreciate receiving tax-deferred retirement accounts from you. After all, they do get to keep the amounts remaining after taxes are paid.

Toxic or underwater assets

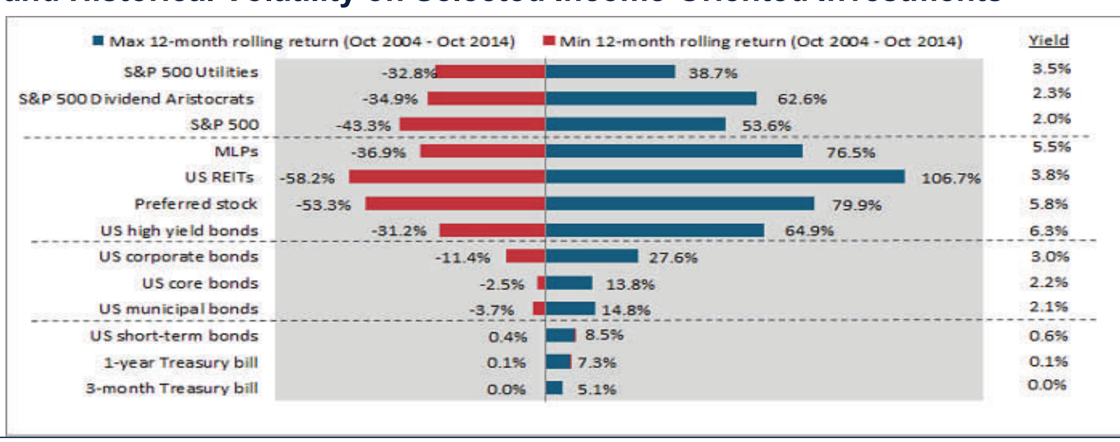
Your heirs might not appreciate receiving property that is subject to a mortgage, lien, or other liability that exceeds the value of the property. In fact, an heir receiving such property may want to consider disclaiming the property.

Always nice to receive

Life insurance and cash

Life insurance proceeds received by your heirs will generally be received income tax free. Your heirs can generally invest life insurance proceeds and cash they receive in any way that they wish. When doing so, your heirs can factor in how the property will be taxed to them in the future.

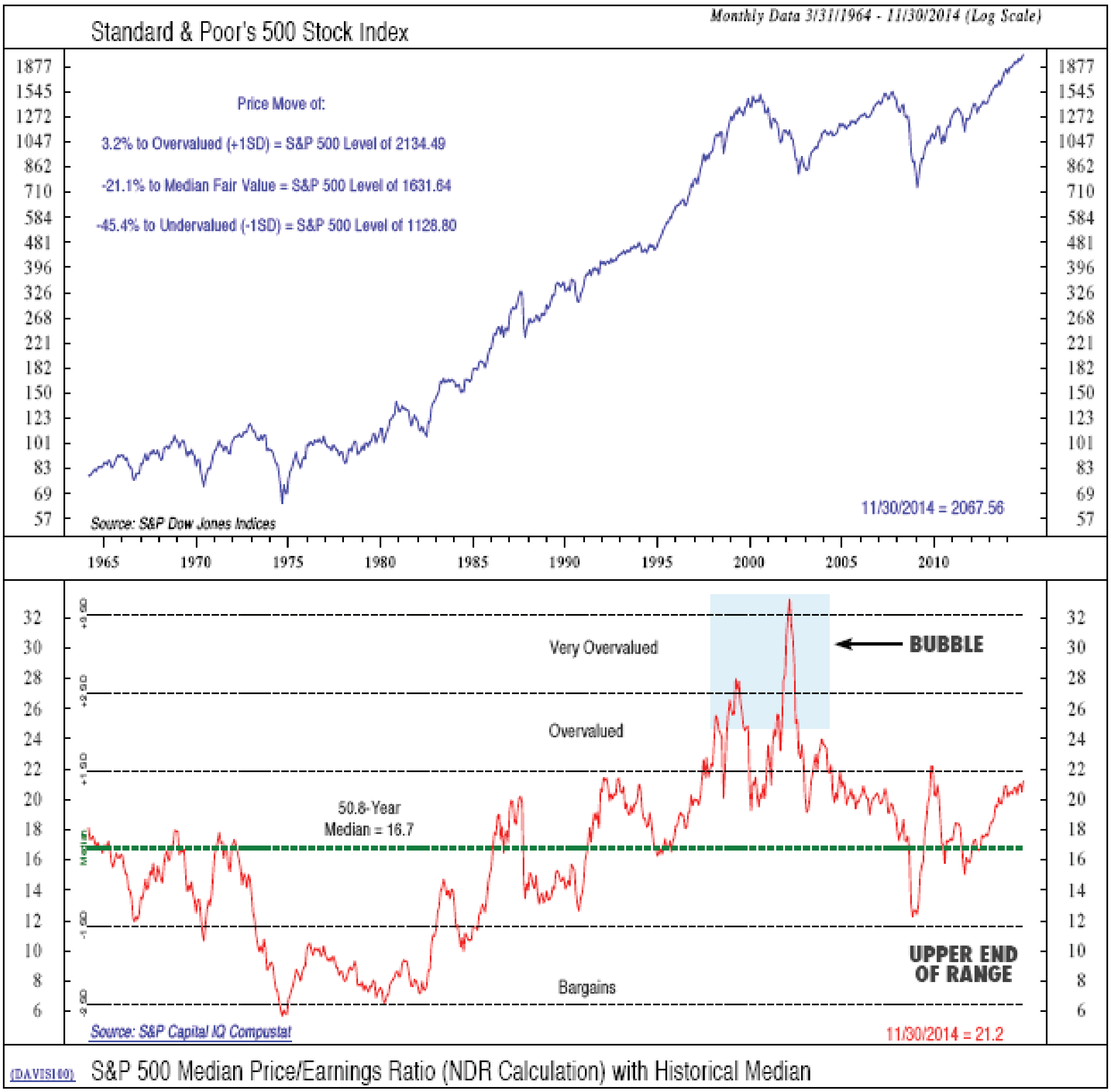
Yield and Historical Volatility on Selected Income-Oriented Investments



Valuation Risks Remain

Our single biggest concern continues to be stretched valuations. The median P/E ratio for the S&P 500 is 21.2. If the bubble period from the late 1990s/early 2000s is excluded, the market has been unwilling to push the median P/E much above 23, suggesting that there is not much room for multiple expansion.

Valuations can remain stretched for extended periods. The same concerns could have been raised a year ago (we did). After two years of multiple expansions, the median P/E plateaued in 2014. Our conclusion is the same as a year ago: stretched valuations do not necessarily mean that a bear market is imminent, but they place increased importance on earnings growth.



Source: Ned Davis Research Group

Saving for College: 529 Plans vs. Roth IRAs

529 plans are vehicles tailor-made for college savings. But some parents like the flexibility of using Roth IRAs. So how does a favorite of the college savings world stack up against a favorite of the retirement savings world when it comes to putting money aside for college?

Contributions

529 plans: People at all income levels can contribute to a 529 plan. Lifetime contribution limits are high, typically $300,000 and up. And if certain requirements are met, 529 plans let you gift large lump sums gift-tax free--up to five years worth of the $14,000 annual gift tax exclusion, which would be up to $70,000 for single filers and $140,000 for married joint filers (in 2014).

Roth IRAs: Not everyone is eligible to contribute to a Roth IRA. Income must be below $129,000 for single filers or $191,000 for joint filers (in 2014). In addition, Roth IRAs have annual contribution limits--$5,500 per year, or $6,500 if you're age 50 or older (in 2014).

Bottom line: Only 529 plans offer unlimited eligibility and the ability to make large lump-sum gifts in a single year.

Federal tax benefits

529 plans: Earnings accumulate tax deferred and are tax free if account funds are used to pay the beneficiary's qualified education expenses (a broad term that includes tuition, fees, room, board, and books). States generally follow this tax treatment, and some offer an additional tax benefit: a deduction for 529 plan contributions.

But if 529 plan funds are used for any other purpose, the earnings portion of the withdrawal is subject to income tax *and* a 10% federal tax penalty. Essentially, Uncle Sam is telling you to use the money for college.

Roth IRAs: Earnings in a Roth IRA also accumulate tax deferred and are tax free if a distribution is qualified. A distribution is qualified if a five-year holding period is met *and* the distribution is made: (1) after age 59½, (2) due to a qualifying disability, (3) to pay certain first-time homebuyer expenses, or (4) by your beneficiary after your death.

If your distribution is not qualified, the earnings portion is subject to income tax and, if you're younger than 59½, a 10% early-withdrawal penalty (unless an exception to the penalty applies). Again, Uncle Sam is encouraging you to wait and use the money for retirement. One exception to the early-withdrawal penalty is when a withdrawal is used to pay college expenses.

So it comes down to your age. Once you've met both the age 59½ and five-year holding requirements, money you withdraw from your Roth IRA to pay your child's college expenses is tax free. But if you withdraw funds before age 59½ to pay college expenses--the likely scenario for most parents--you might owe income tax on the earnings but not an early-withdrawal penalty. (Nonqualified distributions draw out contributions first and earnings last, so you could withdraw up to the amount of your contributions and not owe income tax.)

Bottom line: 529 plans offer more potential tax benefits *if* the funds are used for college. But Roth IRAs offer greater flexibility for parents over age 59½ who are paying college bills.

Investment choices

529 plans: With a 529 plan, you're limited to the investment options offered by the plan. Most plans offer a range of static and age-based portfolios (where the underlying investments automatically become more conservative as the beneficiary gets closer to college) with different levels of risk, fees, and management goals. If you're unhappy with the market performance of the option(s) you've chosen, you can generally change the investment options for your future contributions at any time. But you can change the options for your *existing* contributions only once per year (per federal law).

Roth IRAs: With a Roth IRA, you can generally choose from a wide range of investments, and you can typically buy and sell investments whenever you like.

Bottom line: The 529 plan rule of "one investment change per year" on existing contributions may restrict your ability to respond to changing market conditions.

Financial aid

529 plans: Under federal aid rules, 529 accounts are counted as parental assets (assuming the parent is the account owner), and 5.6% of parental assets are deemed available for college expenses each year. Colleges also consider the value of 529 plans when distributing their own institutional aid.

Roth IRAs: Under federal aid rules, retirement assets are not counted at all, so Roth IRAs don't impact federal aid in any way. However, colleges may consider retirement plan balances when distributing their own aid.

Bottom line: Only 529 plans count in both federal and college financial aid calculations.

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solid momentum in U.S. economic growth with low inflation, (2) a pickup in consumer spending, (3) solid earnings growth, (4) a boost from low commodity prices and financing costs and (5) a relatively solid liquidity environment aided by stimulus from non-U.S. central banks. Halting recoveries in much of the rest of the world will dampen U.S. export growth but keep commodity and interest costs low. Deflation threats in Europe and Japan should start to ease, while China's economic growth is likely to slow. Although stocks are no longer a bargain, they offer better value than other financial assets and should outperform cash, bonds, inflation and commodities. Core inflation should remain contained, but wage gains will likely increase. Risks include: swiftness of the oil price decline could cause dislocations and credit issues, occasional deflation threats, unease associated with monetary tightening and unknown consequences of the significant decoupling in growth between the United States and the rest of the world. Even though stocks are likely to advance further, the pace of gains that occurred during the massive run-up since the 2009 market low is likely to falter.

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