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The Financial Solutions Advisor

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Contact us:

8700 W. Bryn Mawr Ave.
Suite 410-N
Chicago, Illinois 60631
773.714.1540 *Main*
773.714.1550 *Facsimile*
www.fsadvisorygroup.com

Economic & Market Perspectives

After a rocky start, the 2nd quarter eventually made up for domestic equities' earlier losses. As winter weather finally lost its chokehold on the U.S. economy, investors also grew increasingly comfortable with the Federal Reserve's slow and steady approach to unwinding quantitative easing. As a result, they were willing to take on risk again, handing the Dow and S&P their 11th and 22nd all-time record closes of the year. As technology and biotechnology stocks rebounded from their early-spring slump, they helped push the Nasdaq back to a level it hadn't seen since March 2000. By June, the small-capitalization stocks of the Russell 2000, which suffered the most in April, had managed to climb back into positive territory for the year, and the Global Dow's year-to-date performance was more than triple that of its U.S. counterpart. Bond investors continued to confound Fed-wary pundits, sending the benchmark 10-year Treasury yield down as demand pushed up prices. With Iraq joining Ukraine as a source of geopolitical anxiety, concern about oil supplies helped send the spot price above $107 a barrel. And despite some volatility that took the price of gold down to roughly $1,240 an ounce, a June rally allowed it to end the quarter at roughly $1,320.

The housing market is improving, and we think we're on track to surpass one million housing starts. Private employment already hit an all-time high in May. Revised gross domestic product (GDP) numbers indicated the U.S. economy shrank at an annualized pace of nearly 3% in the first quarter, much worse than originally anticipated. The numbers were distorted by a brutal winter and a downward revision of health care spending, which in turn could indicate behavioral changes due to the Affordable Care Act. Regardless of the distortions, the key take-away is that even if the economy rebounds strongly from here, growth will once again be 2%, or probably less, for 2014.

The one segment of the economy that still appears to be lagging is the biggest: household consumption. In May, personal spending again disappointed, up just 0.2%, versus expectations for a 0.4% increase. There are several explanations as to why personal spending remains anemic. First, consumers are still struggling in an environment in which they are trying to pay down their debts and credit availability is limited. Debt helped power consumption for four consecutive decades and, without it, consumers have relatively shallow pockets. Second, the savings rate appears to have stabilized at around 4%. While consumers could theoretically spend more by saving less, at this level, the savings rate probably won't go down much more. Finally, as we have stated on many occasions, most households are not experiencing much, if any, growth in real income. After inflation, disposable income is up just 1.9% year-over-year, roughly 1.5 percentage points below the long-term average. Unless wages accelerate or consumers decide to dip further into already meager savings, spending is likely to remain subdued.

On a global basis, stocks have gained more than 40% from the summer of 2012 and 150% from the 2009 lows. Even emerging markets, laggards for most of the past three years, have more than doubled since early 2009. Most traditional measures of value show stocks to be sporting fairly lofty price tags. Putting the current environment in perspective, we would focus on those areas of the market that offer good value and downside protection and avoid, or trim positions in, small-capitalization stocks. The areas that offer good value and downside protection are large- and mega-cap stocks, as well as cyclical sectors like energy and international strategies. Broadly speaking, U.S. investors tend to prefer the comfort of home and are biased toward U.S. stocks over the international alternatives. We believe investors should rethink this. Increasing international exposure makes sense in general, but even more so these days when most of the stock market bargains are found overseas. U.S. stocks are no longer cheap, and that has stocks outside U.S. borders looking even more reasonable.

Stocks are no longer cheap, neither bonds nor cash offer compelling value, and all could be vulnerable to increases in interest rates. By incorporating non-traditional, or alternative, strategies into your investment portfolio, you can

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2014 Returns

S&P 500	*7.14%*
NASDAQ	*7.87%*
Russell Small Cap	*3.19%*
Russell Mid Cap	*8.67%*
MSCI EAFE	*4.78%*
MSCI World	*6.18%*
Barclay US Agg	*3.93%*
Barclay Muni.	*6.00%*

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Top 10 Tax Breaks You'll Miss in 2014

You probably didn't notice, but when the clock struck midnight on December 31, 2013, a number of popular tax benefits, commonly included in the list of provisions referred to as "tax extenders" expired. While it's possible that Congress could retroactively extend some or all of these items, you'll have to evaluate your 2014 tax situation based on the fact that they're no longer available.

1. Qualified charitable distributions

For the past few years, a qualified charitable distribution (QCD) of up to $100,000 could be made from an IRA directly to a qualified charity if you were age 70½ or older. Such distributions were excluded from income *and* counted toward satisfying any required minimum distribution (RMD) that you would otherwise have had to take from your IRA for that tax year. QCDs aren't an option for 2014, however.

2. Qualified small business stock exclusion

For qualified small business stock issued and acquired after September 27, 2010, 100% of the capital gain resulting from a sale or exchange could be excluded from income, provided certain requirements, including a five-year holding period, are met. For qualified small business stock issued and acquired after 2013, however, the amount that can be excluded from income drops to 50%.

3. Deduction for higher education expenses

The above-the-line deduction for qualifying tuition and related expenses that you pay for yourself, your spouse, or a dependent is not available for 2014.

4. Classroom educator expense deduction

The above-the-line deduction for up to $250 of unreimbursed out-of-pocket classroom expenses paid by qualified education professionals also expired at the end of 2013.

5. State and local sales tax deduction

If you itemize deductions for the 2014 tax year, you won't have the option of claiming a deduction for state and local sales tax in lieu of the deduction for state and local income tax.

6. Depreciation and expense limits

The maximum amount that can be expensed under Internal Revenue Code Section 179 drops significantly from its 2013 level of $500,000 to $25,000 for 2014. The special 50% "bonus" first year additional depreciation deduction has also ended.

7. Mortgage insurance premiums

Starting in 2014, individuals who itemize deductions will no longer have the ability to treat premiums paid for qualified mortgage insurance as deductible interest on IRS Form 1040, Schedule A.

8. Employer-provided commuter expenses

For 2013, you could exclude from income up to $245 per month in transit benefits (e.g., transit passes) and $245 per month in parking benefits. For 2014, the monthly limit for qualified parking increases to $250, but the monthly limit for transit benefits drops to $130.

9. Energy efficient home improvements and property

The nonbusiness energy property credit offset some of the costs associated with the installation of energy efficient qualified home improvements (e.g., insulation, windows) and qualified residential energy property (e.g., water heater, central air). Specific qualifications and limits applied, and an overall lifetime cap of $500 was in effect for 2013. The credit is not available at all in 2014.

10. Discharge of debt on principal residence

Since 2007, individuals have generally been allowed to exclude from income amounts resulting from the forgiveness of debt on their principal residence. This provision expired at the end of 2013.

What is duration, and why should I pay attention to it?

The Federal Reserve's actions over the next year could be important to bond markets, particularly if and when the Fed decides to increase its target interest rate. Since bond prices typically move in the opposite direction from yields, rising bond yields will translate into a decline in bond prices.

If you have bonds or bond mutual funds in your portfolio, you might want to pay attention to the duration of each one. Technically, a bond or bond fund's duration calculates the length of time it will take to receive the full true value of the investment; duration takes into account the present value of expected future payments of interest and principal.

However, duration's biggest value to an investor is as a gauge of how sensitive a bond might be to changes in interest rates. The longer a bond's duration, the more its price is likely to be affected by an interest rate change. A mutual fund's duration can be found in its prospectus; for an individual bond, you'll probably need to ask your broker or the bond's issuer.

To estimate the impact of an interest rate change on a specific bond holding, simply multiply its duration by the change in interest rates. For example, for a bond fund with a duration of 5 years, a 1% increase in interest rates would generally result in a 5% drop in the fund's value (1% x 5 years = 5%). Though the Fed's target rate is already at its historic low, the same principle would apply in reverse if interest rates were to fall. A 1% decline in interest rates would likely result in a 3% gain for a bond holding with a duration of 3 years.

Bear in mind that duration can work somewhat differently for specific types of bonds--for example, floating-rate bonds whose interest payments get reset. That's also true for mortgage-backed bonds, since interest rate changes can cause homeowners to refinance their loans.

Note: *These hypothetical examples are intended as an illustration only and do not reflect the performance of any specific investment. They should not be considered financial advice. Before investing in a mutual fund, consider its investment objective, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.*

Some Things to Consider about Gifts to Children

If you make significant gifts to your children or someone else's children, or if someone else makes gifts to your children, there are a number of things for you to consider.

Transfers that are not taxable gifts

There are a variety of ways for you to make transfers to children that are not treated as taxable gifts for gift tax purposes. Filing a gift tax return is generally required if you make gifts (other than qualified transfers) totaling more than $14,000 to an individual during the year.

Providing support. When you provide support to a child, it should not be treated as a taxable gift if you have an obligation to provide support under state law. This may provide a large umbrella for parents of minor children, college-age children, boomerang children, and special needs children.

Annual exclusion gifts. You can generally make gifts of up to $14,000 per child gift tax free each year. If you split gifts with your spouse, the amount is effectively increased to $28,000. In the case of a gift to a qualified tuition program (529 plan) for a child, the annual exclusion can be effectively increased to five times the above amounts (i.e., to $70,000, or $140,000 if you split gifts with your spouse).

Qualified transfers for medical expenses. You can make unlimited gifts for medical care gift tax free, provided the gift is made directly to the medical care provider.

Qualified transfers for educational expenses. You can make unlimited gifts for tuition gift tax free, provided the gift is made directly to the educational provider.

The same exceptions for transfers that are not taxable gifts generally apply for purposes of the generation-skipping transfer (GST) tax. The GST tax is a separate tax that generally applies when you transfer property to someone who is two or more generations younger than you, such as a grandchild.

Income tax issues

A gift is not taxable income to the person receiving the gift. However, when you make a gift to a child, there may be several income tax issues regarding income produced by the property or from sale of the property.

Income for support. Income from property owned by your children will be taxed to you if used to fulfill your obligation to provide support.

Kiddie tax. Children subject to the kiddie tax are generally taxed at their parents' tax rate on any unearned income over a certain amount. For 2014, this amount is $2,000 (the first $1,000 is tax free and the next $1,000 is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support. If the child's income would be taxed at the parents' high tax rates, it may make sense to invest in ways that can produce nontaxable income (e.g., tax-exempt bonds) or defer taxation (e.g., Series EE bonds) until after the kiddie tax period.

Basis. When you make a gift, the person receiving the gift generally takes an income tax basis equal to your basis in the gift. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over your basis in the gift immediately before the gift). The income tax basis is generally used to determine the amount of taxable gain if the child then sells the property. However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

Gifts to minors

Outright gifts should generally be avoided for any significant gifts to minors. In that case, you may wish to consider a custodial gift or a trust for a minor.

Custodial gifts. Gifts can be made to a custodial account for the minor under your state's version of the Uniform Gifts/Transfers to Minors Acts. The custodian holds the property for the benefit of the minor, generally until an age (often 21) specified by state statute. Generally, any adult or trust company can be the custodian, but check state law.

Trust for minor. A Section 2503(c) trust is a trust specifically designed to obtain the gift tax annual exclusion for gifts to a minor. Principal and income can be distributed to the minor before age 21, but there is no requirement of any distribution to the minor before age 21. The minor does generally gain access to undistributed income and principal at age 21.

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potentially enhance diversification and amplify your portfolio's growth potential. Diversification doesn't guarantee profits or prevent loss (nothing does), but it does allow you to spread your risk across a broader set of investments that may respond differently to a given set of market conditions. In short, alternative asset classes and strategies provide patterns and sources of risk and return that are different from those offered by traditional assets. For example, real estate (a popular alternative asset) does not trade exactly like stocks and bonds. And a long/short approach (a popular alternative strategy) is used by flexible managers in an effort to profit from up, down and sideways markets. Long/short strategies can pose the risk of losses larger than the invested capital, but within a well-rounded portfolio, we believe they can offer a differentiated source of return and the potential for more consistent results over time. Ultimately, the goal in adding alternatives to your portfolio is to enhance diversification, seek out returns and smooth out volatility over time.

For the coming months, the main issues to watch include the pace of economic and earnings growth, geopolitical hot spots and the continued debate on the Fed's normalization process (tempered by the new discussion around inflation). Our view is that we expect bonds to reverse their first half strength, equity markets to be more volatile and stock selection to be a key driver of performance.

Sources: BlackRock, Nuveen

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Please contact us if you would like to receive this publication by e-mail.

8700 W. Bryn Mawr Ave.
Suite 410-N
Chicago, Illinois 60631
773.714.1540 *Main*
773.714.1550 *Facsimile*
www.fsadvisorygroup.com

Will rising interest rates impact my pension benefits?

If you're nearing retirement and plan to elect lifetime payments from your pension plan, rising interest rates won't have any impact on your benefits. But if you're considering a lump-sum payment, rising interest rates can be critical.

Pension plans calculate your lump sum by determining the present value of your future pension payments. The two primary components in this calculation are your life expectancy, and interest rates. Life expectancy is determined using IRS tables. These tables are unisex (that is, the same life expectancy factors apply to both men and women). This results in women getting lump sums that are slightly smaller than they would otherwise get based on true gender-based factors, and men getting slightly larger lump sums.

Until recently, the interest rate plans used to calculate lump-sum payments was the U.S. 30-year Treasury bond rate. However, employers can now use a higher corporate bond rate. What's important to understand is that the amount of your lump sum payment is inversely proportional to interest rates--that is, the higher the rate, the smaller your lump sum.

If your plan offers lump-sum payments, there are two questions you need to ask yourself. First, "Is a lump-sum right for me?" This is a difficult question, and the answer depends on a number of factors. Is the pension your primary source of retirement income? How is your (and your spouse's) health? Will you be giving up valuable subsidized benefits built into the plan's benefit payments, or cost-of-living increases? A lump sum gives you control over your retirement dollars and removes the risk of early death, but shifts the investment risk from the plan to you. Remember that you'll be giving up a benefit payment that's guaranteed for your (and if you're married, your spouse's) life. Will you be able to make your lump sum last for a retirement that may last 30 years or more?

If you decide a lump sum is the right choice, the second question is, "When should I take the money?" Interest rates remain near historic lows, and it's only a matter of time before they start heading back up. If you're approaching retirement and believe interest rates will rise in the near future, you may want to consider taking the lump sum sooner rather than later. Your plan can provide you with an estimate of your lump sum based on various interest rates.

S&P 500 vs. S&P 500 EPS

Sources: Haver Analytics and Citi Research-US Equity Strategy