4Q14

The Financial Solutions Advisor

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Economic & Market Perspectives

MARKET CORRECTION FEARS ARE RISING

Equity prices have been falling for the past couple of weeks. Since economic and market fundamentals haven't shifted notably in recent weeks, it appears that this pullback is being driven by a heightened focus on previously existing risks, chiefly worries about global growth, geopolitical tensions and a pending shift in monetary policy.

Although these worries are not new, they are coinciding with a general sense among investors that markets are overdue for a correction. We anticipate that relatively higher levels of volatility will persist as markets continue to look sloppy.

A distinguishing characteristic of recent equity market moves is the growing divergence across market segments. Since reaching their highs in recent months, U.S. large caps have never been down more than 5%, but U.S. small caps and emerging markets entered correction territory (defined as a decline of 10% or more). The recent weakness in small caps and emerging markets is partly attributable to the pending change in monetary policy, which has had the added effect of strengthening the dollar, now at a four-year high.

THE U.S. ECONOMY CONTINUES TO OUTPACE OTHER REGIONS

U.S. economic growth has been uneven, but continues to accelerate. We have seen a number of potential stumbling blocks over the past few years, but this economy has proven to be highly resilient, and we do not believe its current trajectory will be derailed.

Outside of the U.S., in contrast, economic risks appear to be rising. Europe is a notable global weak spot and the engineered slowdown in China remains a concern. Divergence between the U.S. and other markets remains a growing theme. Slower global growth is benefitting the U.S. economy in some ways, such as via lower commodity prices. But at some point this divergence could put pressure on U.S. multinational corporate earnings and act as a headwind for U.S. growth through such factors as declining exports.

In any case, we believe the current backdrop should be supportive for most risk assets (with commodities being a notable exception). Volatility is rising, and periodic market setbacks are inevitable, but the long-term case for equities remains sound.

Against this backdrop, some still find it plausible that the Federal Reserve may begin raising interest rates — specifically, the federal funds rate or short-term target rate — by the end of the first quarter of 2015, which is earlier than markets currently anticipate.

The aforementioned structural issues will have an impact on what happens after that. To the extent an aging population and stubbornly low wages suggest slower growth for the U.S. economy, the Fed is likely to move rates more gradually than it has in past tightening cycles. In addition, the so-called terminal level of the federal funds rate — in other words, the point where the Fed stops hiking — is likely to be lower than in the past.

THE BOND MARKET'S READ ON ALL OF THIS HAS BEEN MIXED

U.S. Treasury prices rallied while yields fell, although they did rise on Friday. While U.S. yields continue to be held down by a variety of factors — including ultra-low yields in Europe, where German 10-year Bunds were just auctioned at a yield of less than 1%—short-term rates are likely to keep moving higher. In light of this, we would reiterate our view that investors should adopt a flexible approach within their fixed income portfolio.

Sources: Nuveen Investments, BlackRock

2014 Returns

S&P 500	*8.34%*
NASDAQ	*13.83%*
Russell Small Cap	*-4.41%*
Russell Mid Cap	*6.87%*
MSCI EAFE	*-1.38%*
MSCI World	*3.89%*
Barclay US Agg	*4.10%*
Barclay Muni.	*7.58%*

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Quiz: How Much Do You Know about Social Security?

You're probably covered under Social Security--according to the Social Security Administration, an estimated 165 million workers are*--but how much do you know about this program? Test your knowledge by answering the following questions.

Questions

1. If you decide to collect your retirement benefit starting at age 62, your benefit will be how much less than if you wait until your full retirement age?

a. 5% to 10% less

b. 15% to 20% less

c. 25% to 30% less

d. 35% to 40% less

2. Your spouse and children may be eligible for benefits if something happens to you.

a. True

b. False

3. The Social Security taxes that are collected from your paycheck are called:

a. FUTA taxes

b. FETA taxes

c. FICA taxes

4. Once you reach full retirement age, you can work and earn as much as you want without reducing your Social Security benefit.

a. True

b. False

5. Once you begin receiving your retirement benefit, it will never increase.

a. True

b. False

Answers

1. c. If you were born in 1943 or later, you'll see a 25% to 30% reduction in your retirement benefit if you claim Social Security benefits at age 62, rather than waiting until your full retirement age (which is 66 to 67, depending on your year of birth). This reduction is permanent.

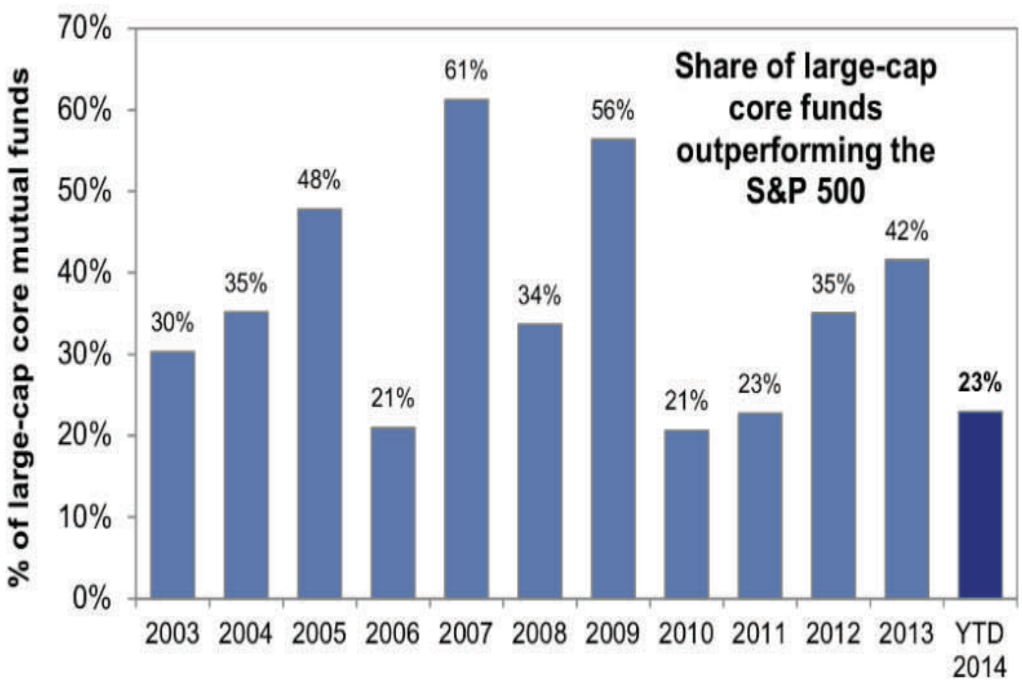
2. a. Social Security isn't just for retirees. Your spouse and dependent children may be able to receive survivors or disability benefits based on your earnings record if certain eligibility requirements are met.

3. c. Social Security payroll taxes are called FICA taxes because they are collected under the authority of the Federal Insurance Contributions Act. FICA includes two separate taxes: Social Security and Medicare. The Social Security portion is withheld from your pay at a rate of 6.2% (matched by your employer), but only on earnings up to the maximum earnings limit for the year ($117,000 in 2014).

4. a. Before you reach full retirement age, your benefit will be reduced if your earnings exceed certain limits, but these earnings limits no longer apply once you reach full retirement age.

5. b. There are several reasons why your benefit might increase after you begin receiving it. First, you'll generally receive annual cost-of-living adjustments (COLA). Second, the Social Security Administration recalculates your benefit every year to account for new earnings, so your benefit might increase as a result. Your benefit might also be adjusted if you qualify for a higher benefit based on your spouse's earnings once he or she files for Social Security.

Mutual funds are on pace to match their worst results in the past decade



Only 23% of large-cap core mutual funds have outperformed the S&P 500 benchmark YTD, rivaling their worst performance in the past decade. This figure has averaged 37% on an annual basis since 2003, with only 2006, 2010 and 2011 equal to or below the current 23% figure. Large-cap growth and value managers fare even worse vs. their respective Russell 1000 style benchmarks, with less than 20% of each universe outperforming. Small-cap funds are the exception, with 62% of core funds beating the Russell 2000 YTD.

Sources: Lipper, FactSet, and Goldman Sachs Global Investment Research

10 Basic Tax To-Dos for the Rest of 2014

Here are 10 things to consider as you weigh potential tax moves between now and the end of the year.

1. Make time to plan
Effective planning requires that you have a good understanding of your current tax situation, as well as a reasonable estimate of how your circumstances might change next year. There's a real opportunity for tax savings when you can assess whether you'll be paying taxes at a lower rate in one year than in the other. So, carve out some time.

2. Defer income
Consider any opportunities you have to defer income to 2015, particularly if you think you may be in a lower tax bracket then. For example, you may be able to defer a year-end bonus or delay the collection of business debts, rents, and payments for services. Doing so may enable you to postpone payment of tax on the income until next year.

3. Accelerate deductions
You might also look for opportunities to accelerate deductions into the 2014 tax year. If you itemize deductions, making payments for deductible expenses such as medical expenses, qualifying interest, and state taxes before the end of the year, instead of paying them in early 2015, could make a difference on your 2014 return.

Note: *If you think you'll be paying taxes at a higher rate next year, consider the benefits of taking the opposite tack--looking for ways to accelerate income into 2014, and possibly postponing deductions.*

4. Know your limits
If your adjusted gross income (AGI) is more than $254,200 ($305,050 if married filing jointly, $152,525 if married filing separately, $279,650 if filing as head of household), your personal and dependent exemptions may be phased out, and your itemized deductions may be limited. If your 2014 AGI puts you in this range, consider any potential limitation on itemized deductions as you weigh any moves relating to timing deductions.

5. Factor in the AMT
If you're subject to the alternative minimum tax (AMT), traditional year-end maneuvers such as deferring income and accelerating deductions can have a negative effect. Essentially a separate federal income tax system with its own rates and rules, the AMT effectively disallows a number of itemized deductions, making it a significant consideration when it comes to year-end tax planning. For example, if you're subject to the AMT in 2014, prepaying 2015 state and local taxes probably won't help your 2014 tax situation, but could hurt your 2015 bottom line. Taking the time to determine whether you may be subject to AMT before you make any year-end moves can save you from making a costly mistake.

6. Maximize retirement savings
Deductible contributions to a traditional IRA and pretax contributions to an employer-sponsored retirement plan such as a 401(k) could reduce your 2014 taxable income. Contributions to a Roth IRA (assuming you meet the income requirements) or a Roth 401(k) plan are made with after-tax dollars, so there's no immediate tax savings. But qualified distributions are completely free from federal income tax, making Roth retirement savings vehicles appealing for many.

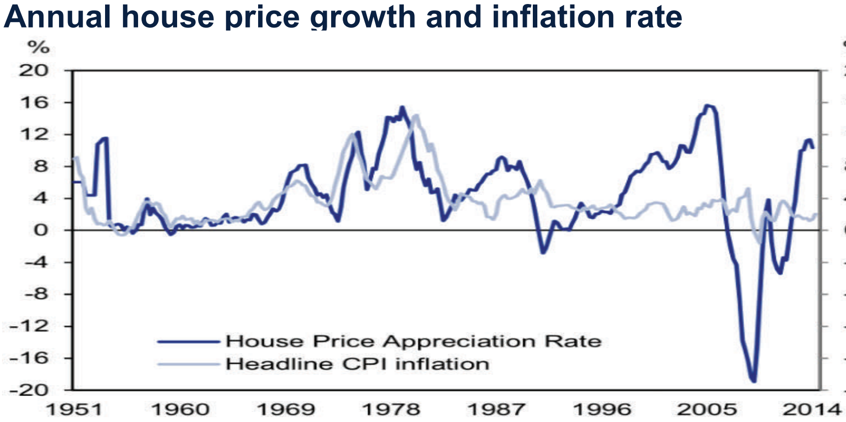
7. Take required distributions
Once you reach age 70½, you generally must start taking required minimum distributions (RMDs) from traditional IRAs and employer-sponsored retirement plans (an exception may apply if you're still working and participating in an employer-sponsored plan). Take any distributions by the date required--the end of the year for most individuals. The penalty for failing to do so is substantial: 50% of the amount that should have been distributed.

8. Know what's changed
A host of popular tax provisions, commonly referred to as "tax extenders," expired at the end of 2013. Among the provisions that are no longer available: deducting state and local sales taxes in lieu of state and local income taxes; the above-the-line deduction for qualified higher-education expenses; qualified charitable distributions (QCDs) from IRAs; and increased business expense and "bonus" depreciation rules.

9. Stay up-to-date
It's always possible that legislation late in the year could retroactively extend some of the provisions above, or add new wrinkles--so stay informed.

10. Get help if you need it
There's a lot to think about when it comes to tax planning. That's why it often makes sense to talk to a tax professional who is able to evaluate your situation, keep you apprised of legislative changes, and help you determine if any year-end moves make sense for you.

Annual house price growth and inflation rate



Sources: Robert Shiller, Haver Analytics, BLS.

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Have the rules for 401(k) in-plan Roth conversions changed?

Yes. Thanks to the American Taxpayer Relief Act of 2012 (ATRA), the rules for making 401(k) in-plan Roth conversions have gotten substantially easier. (These rules also apply to 403(b) and 457(b) plans.)

A 401(k) in-plan Roth conversion (also called an "in-plan Roth rollover") allows you to transfer the non-Roth portion of your 401(k) account into a designated Roth account within the same plan. The amount you convert is subject to federal income tax in the year of the conversion (except for any nontaxable basis you have in the amount transferred), but qualified distributions from the Roth account are entirely income tax free. The 10% early distribution penalty doesn't apply to amounts you convert (but that penalty tax may be reclaimed by the IRS if you take a nonqualified distribution from your Roth account within five years of the conversion).

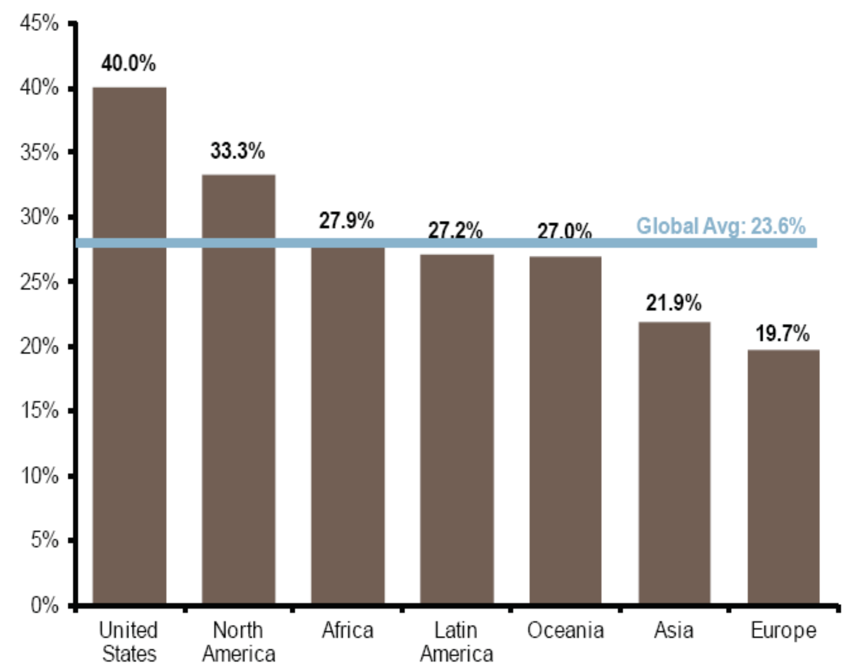
While in-plan conversions have been around since 2010, they haven't been widely used, because they were available only if you were otherwise entitled to a distribution from your plan--for example, upon terminating employment, turning 59½, becoming disabled, or in other limited circumstances. But in that case, you already had the option of rolling your funds over (converting) into a Roth IRA.

ATRA eliminated the requirement that you be eligible for a distribution from the plan in order to make an in-plan conversion. Now, if your plan permits, you can convert any vested part of your 401(k) plan account into a designated Roth account regardless of whether you're otherwise eligible for a plan distribution. The IRS has also just recently issued regulations that provide additional clarity on how in-plan conversions work.

Caution: Whether a Roth conversion makes sense financially depends on a number of factors, including your current and anticipated future tax rates, the availability of funds with which to pay the current tax bill, and when you plan to begin receiving distributions from the plan. Also, you should consider that the additional income from a conversion may impact tax credits, deductions, and phaseouts; marginal tax rates; alternative minimum tax liability; and eligibility for college financial aid.

Elevated U.S. corporate tax rates are driving inversions

2014 corporate tax rates, including state and local taxes



Last week, the U.S. Treasury Announced that it would begin working on a regulatory framework to slow, if not stop, corporate tax inversions. A corporate tax inversion occurs when a company reincorporates itself abroad in an effort to reduce its tax burden. In 2014, the U.S. had the second highest corporate tax rate in the world, as shown in this week's chart. Simply letting inversions occur without regulation or lowering the corporate tax rates in the U.S. may seem like the logical solution. However, doing so would reduce U.S. government revenues at a time when a subsequent reduction in spending is not set to occur. At the same time, restricting inversions could prevent positive cross-border synergy creation and the formation of potentially more efficient and innovative companies through M&A transactions.

Sources: KPMG, J.P. Morgan Asset Management

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