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An Example Of The Power Of Diversified Portfolios

When it comes to investing your hard-earned dollars, the recipe you use can be more important than the ingredients you use. In other words, how you allocate your funds into different asset classes can have a bigger impact on your returns over time than what you put into your portfolio.

That's why portfolio experts stress the importance of diversification, asset allocation, and periodic rebalancing, rather than touting the latest "can't miss" stock buy. However, due to the fact that hot stock tips often seem more interesting than diversification strategy, many investors continue to play the market-timing game rather than maintain a solid long-term strategy.

In a recent presentation on bond performance, Craig L. Israelsen, an associate professor of finance at Brigham Young University, provided a clear and convincing example of the power of asset allocation to improve returns over time. He compares the performance of portfolios with one asset, two assets, and four assets from 1948 through 2012 to show that portfolio diversification trumps securities or fund selection.

The accompanying chart, "Bond Performance in a Portfolio Context," analyzes returns from three different portfolio mixes under conditions of rising interest rates and declining interest rates. The analysis shows that market performance doesn't affect returns nearly as much as diversification of a portfolio.

The 34-year period from the start of 1948 through 1981 was a time of rising interest rates, and U.S. bonds averaged an annualized return of 3.83%. During that period, the Standard & Poor's 500 stock index averaged 11% annual gains while U.S. Treasury bills averaged 4.49%.

The 31-year period from 1982 through 2012 was a time of declining interest rates, during which U.S. bonds averaged an 8.82% gain annually, the S&P 500 averaged 11.14%, and U.S. Treasury bills averaged 4.72%.

So the background to this portfolio comparison is the fact that U.S. bonds clearly performed much better during the latter period. Because analysts expect interest rates to rise during the next few years, it may be reasonable to conclude that bond returns likely will fall. "The question is how much does (this) matter in terms of building an overall portfolio," Israelsen

(Continued on page 4)

Bond Performance in a Portfolio Context

Portfolio	Period of Rising Interest Rates 34-Year Period from 1948 to 1981	Period of Declining Interest Rates 31-Year Period from 1982 to 2012
1-Asset Portfolio 100% US Bonds	3.83% Annualized Return 4.32% Standard Deviation	8.82% Annualized Return 6.99% Standard Deviation
2-Asset Portfolio 60% Large US Stock 40% Bonds	8.52% Annualized Return 10.49% Standard Deviation	10.56% Annualized Return 11.33% Standard Deviation
4-Asset Portfolio 40% Large US stock 20% Small US Stock 30% Bonds 10% Cash	9.52% Annualized Return 11.80% Standard Deviation	9.99% Annualized Return 10.98% Standard Deviation

Craig Israelsen, Brigham Young University

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Is Good News Good Or Bad?

During the second quarter, good news seemed to be perceived by the market as bad news.

Whenever economic reports were positive, traders became concerned about the Federal Reserve potentially lessening the amount of monthly bond purchases it has been making. Such a move would begin to reduce some of the life support the Fed has been providing since the near implosion of financial markets in 2008.

Because we are investors, rather than traders, we believe good news is good news. The economy, while still fragile, is showing consistent signs of being able to sustain itself. We would much rather see an economy of this nature than one unable to be sustained without the unprecedented Fed intervention we have seen for the last several years.

We believe the Fed will be cautious in its unwinding of accommodative monetary policies and be sensitive to new economic data as it comes available.

We are most grateful for the ongoing business we have and for the new clients with whom we are working. Our firm continues to grow.

We thank you for your continued confidence and for your kind referrals of others like yourselves.

Happy summer!

Judy

Roundup Of New Estate Tax Changes

For more than a decade, estate planning has harkened back to the "wild, wild west," a time when even the best hired guns didn't know what would happen next. Now, finally, there's more certainty, thanks to the estate tax provisions in the American Taxpayer Relief Act (ATRA). The new law, signed as the country teetered on the brink of the "fiscal cliff," extends several favorable tax breaks, with a few modifications.

Before we explore ATRA's main provisions, let's recap the events dating back to 2001, the year the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted. Among the changes, EGTRRA gradually increased the federal estate tax exemption from $1 million to $3.5 million in 2009 while decreasing the top estate tax rate from 55% to 45%. It also severed the unified estate and gift tax systems, creating a lifetime gift exemption of $1 million unrelated to the estate tax exemption. Then the law repealed the estate tax completely, but just for 2010. After that year, the estate tax provisions were scheduled to "sunset," restoring more onerous rules that had been in effect before EGTRRA, unless new legislation dictated otherwise.

The Tax Relief Act of 2010 generally postponed the sunset for two years. It hiked the estate tax exemption to $5 million (indexed for inflation), lowered the top estate tax rate to 35%, and reunified the estate and gift tax systems. That law also allowed "portability" of exemptions between spouses.

Now, at long last, ATRA brings permanent clarity. Here are the key estate changes:

- The estate tax exemption remains at $5 million with inflation indexing. For 2013, the exemption is $5.25 million. Also, portability of exemptions between spouses is made permanent, so a married couple can effectively pass up to $10.5 million tax-free to their children or other non-spouse beneficiaries, even if the exemption of the first spouse to die isn't exhausted.
- The top estate tax rate is bumped up to 40%. Not as low as the 35% rate in 2011 and 2012, but still better than the 55% rate slated for 2013 prior to ATRA.
- The estate and gift tax systems remain reunified. This means that the lifetime gift tax exemption is equal to the estate tax exemption of $5.25 million in 2013. (That's now the maximum exemption for combined taxable lifetime gifts and estate bequests.) Other provisions, including the generation-skipping tax that applies to most bequests and gifts to grandchildren, are coordinated within the system.

As a result of these changes, now is a good time to examine wills, trusts, and other aspects of your estate plan. Depending on your situation, revisions may be required or you might create a new trust to take advantage of the current estate tax law. ●

How To Bridge A Retirement Shortfall

Suppose you've scrimped and saved for retirement but you still haven't met your goals. Or perhaps an illness or a business venture that went south has exhausted your discretionary funds. Or maybe you just didn't count on costs rising so quickly. In any event, you're standing on the precipice of retirement, but you don't think you'll have enough to live comfortably for the next 20 or 30 years. These four practical suggestions might help:

1. Relocate to a less expensive home. According to the Social Security Administration, housing is the largest component of living expenses for people over age 55, accounting for 35% of the cost pie. One of the best ways to save money during retirement may be to downsize your home. Do you really need that rambling four-bedroom colonial in which you raised your kids? You probably do not.

And it's not just size that matters. You might consider moving to a location where the climate is agreeable and the costs are lower than what you're currently paying. Just don't forget to factor in state income taxes and other taxes. For the adventurous, a move out of the country could be an option.

Here's another thing to add to the equation if you're considering relocation—it's usually less expensive for people to live together than alone. A recent study by the Pew Research Center, based on 2011 Census Bureau data, reveals that the number of Americans living in multi-generational family households increased 4.9 million from 2007 to 2009. You could move in with your children, pay your share of the housing costs, and still come out ahead.

2. Refinance your mortgage. With interest rates near historic lows, now's a good time to refinance an existing mortgage if you don't plan on moving anytime soon. If you can cut

IRS Reveals The Dirty Dozen Tax Scams

In what has become an annual drill, the IRS has released the "Dirty Dozen" tax scams to watch out for in 2013. The list for this year is essentially the same as last year's, with a few minor tweaks. The scams are:

1. Identity theft. Once again, identity theft tops the list. Identity theft occurs when someone uses your personal information—such as your name, Social Security number, or other identifying information—without your permission, to commit fraud or other crimes. In many cases, an identity thief uses a legitimate taxpayer's identity to file a fraudulent tax return to claim a refund. If you believe you're at risk, contact the IRS immediately.

2. Phishing. Phishing is a scam usually carried out with the help of unsolicited emails or a fake website that prompts people to provide personal and financial information. Armed with this information, a criminal can commit identity theft or financial theft. You should report incidents to phishing@irs.gov.

3. Return preparer fraud. Most return preparers are honest, but some unscrupulous preparers prey on unsuspecting taxpayers. Choose carefully when hiring an individual or firm to prepare your return. Only use only preparers who sign the returns they prepare and enter their IRS Preparer Tax Identification numbers.

4. Hiding income offshore. Numerous people have been caught trying to evade U.S. taxes by hiding income in offshore banks, brokerage accounts, or nominee entities, using debit cards, credit cards, or wire transfers to gain access to the funds. Others employ foreign trusts, employee-leasing schemes, private annuities, or insurance plans. The IRS uses information gained from its investigations to pursue the crooks.

5. "Free money" from the IRS. Flyers and advertisements for free money from the IRS, suggesting you can file a tax return with little or no documentation, have been appearing in community churches around the country. These schemes promise refunds to people who have little or no income. They often are spread by word of mouth by unsuspecting and well-intentioned people.

6. Impersonation of charitable organizations. Following major disasters, such as Hurricane Sandy, it's common for scam artists to impersonate charities to obtain money or information from taxpayers. Some scammers operating bogus charities may contact people by telephone or email. They may contact disaster victims and claim to be working on behalf of the IRS.

7. False or inflated income and expenses. Including income that never was earned, either as wages or as self-employment income, in order to maximize refundable credits is another popular scam. Those who get caught could have to pay back erroneous refunds, including interest and penalties, and may be prosecuted.

8. False Form 1099 refund claims. Individuals have made refund claims based on the bogus theory that the federal government maintains secret accounts for U.S. citizens and that taxpayers can gain access to these accounts by issuing 1099-OID forms to the IRS. Typically, the perpetrator files a fake information return, such as a Form 1099 Original Issue Discount (OID), in an attempt to justify a false refund claim on a corresponding tax return.

9. Frivolous arguments. Promoters of frivolous schemes encourage taxpayers to make unreasonable and outlandish claims to avoid paying the taxes they owe. The IRS has a list of frivolous tax arguments that taxpayers should avoid. These arguments are false and have been thrown out of court.

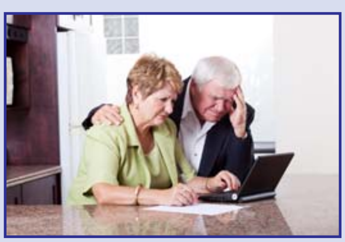
10. Falsely claiming zero wages. A Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 may be used to reduce taxable income improperly to zero. The taxpayer also might submit a statement rebutting wages and taxes reported to the IRS.

11. Disguised corporate ownership. Third parties are used improperly to request employer identification numbers and form corporations that obscure the true ownership of the business. These entities can be used to underreport income, claim fictitious deductions, avoid filing tax returns, participate in listed transactions, and facilitate money laundering and financial crimes.

12. Misuse of trusts. While there are many legitimate uses of trusts in tax and estate planning, some highly questionable transactions promise to reduce the amount of income subject to tax, to increase deductions for personal expenses, and to reduce estate or gift taxes. Such trusts rarely deliver the tax benefits promised. You always should seek the advice of a trusted professional before creating a trust. ●

your monthly bill by hundreds of dollars or more, it won't take too long to recoup the refinancing costs.

3. Figure out your bottom line. Budgeting isn't exciting, but making realistic projections of your likely expenses in retirement can be crucial. Frequently, costs for life insurance and spending on children will disappear as you move closer to traditional retirement age, only to be replaced by travel expenses or other new costs.



4. Go to work part-time. Being "retired" doesn't mean you have to quit working completely. The job market for seniors has been improving, with the Bureau of Labor Statistics showing a 5.6% unemployment rate for those 55 and older in February 2013, compared with 6.1% the year before. Getting a paycheck, even a relatively small one, can remove some of the pressure and supplement your income from investments, Social Security, and distributions from retirement plans.

Finally, take stock of your situation while you're still employed full-time. Planning ahead is the best solution for bridging a potential retirement shortfall. ●

Power Of Diversified Portfolios

(Continued from page 1)

asked in his presentation.

To find out, he analyzed the performance of a simple two-asset portfolio during those same two time periods, cutting bonds to 40% of the portfolio and adding large U.S. stocks as 60%. Not surprisingly, adding returns from the more volatile equities market increased the portfolio's annualized return to 8.52% during the 1948-1981 timeframe and to 10.56% during the later period.

Then Israelsen moved into a more diversified portfolio with four asset classes: 40% large U.S. stocks, 20% small U.S. stocks, 30% bonds, and 10% cash. That resulted in a 9.52% annualized return in the earlier period and a 9.99% return in the later period.

The increasing rates of return for the earlier period—and the decreasing differences between returns for the two time periods—clearly shows the benefits of diversification. Bonds alone produced positive returns, but when combined with equities, the returns rose – regardless of which way interest rates were moving.

Some investors may look at these figures and wonder why they shouldn't simply eliminate bonds and put all their assets into equities. The answer involves risk and an investor's time horizon. In general, U.S. equities tend to have two to three years of negative returns during every 10-year period. That increases the risk your portfolio might take a hit just before you intend to retire or before you need to make a withdrawal for other reasons.

Bonds experience an average of two very slight negative-return years per decade, so they provide a stabilizing influence that can smooth out your portfolio's performance. That's the whole point of diversification, to avoid putting all of your investment dollars at risk at the same time.

A final point: Periodic rebalancing is vital, because as asset classes rise and fall in value, your portfolio mix will change. If you start with 30% in large U.S. stocks and this class performs well, that portion of your portfolio may grow to 35% or 40% of the whole, throwing off the balance in the portfolio. So you have to rebalance, either by selling some of the large-stock holdings or buying more in your other asset classes.

Our firm can help you with each aspect of meaningful portfolio design—asset allocation, risk management, and rebalancing – within the context of your overall financial situation and life goals. ●

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