

Lighthouse Monthly

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Taxing Issues

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Uncertainty

Here we are again in the midst of a tax season where uncertainty about tax rules are swirling at our feet. Of primary importance this tax season is a number of tax breaks that expired at the end of 2013. If Congress does not draw up an extension tax bill, we could be missing the following breaks going forward after 2013:

- Tuition deduction - This deduction allowed parents of children in college to deduct tuition and related fees.
- State and local taxes - Prior to 2014, one could choose to deduct state and local sales taxes instead of state and local income taxes. This option, if not extended, will be missed by residents of states with no state income tax or low state income tax.
- IRA transfers to charity - An individual 70.5 or older could transfer up to \$100,000 tax-free to a charity and the distribution counted toward required distributions.

- Residential energy credit - A homeowner could claim a credit for part of the cost of energy saving improvements to his home that were made in 2013.
- Health coverage credit - In 2013, individuals who paid 50% of premiums, with qualifying health plans, could take a tax credit of 72.5% of health insurance premiums paid.
- Mortgage insurance premium - Previously, taxpayers could deduct mortgage insurance premiums paid on qualifying residences or second homes. The deduction was phased out for AGI between \$100,000 and \$110,000.

Government thinking

House Ways and Means committee chairman Dave Camp (R-MI) has released his version of a revamped tax code. In all, his plan calls for lowering individual and business tax rates while at the same time clipping or taking away some tax breaks. Although a tax overhaul is low on the government priority list, it is worth paying attention to the proposals from Mr. Camp. Below is a small list of proposals from Mr. Camp: [» More](#)

- Tax brackets - There would be two - 10% and 25%. The 10% rate would run up to \$71,200(married) and \$35,600(single) and indexed to an inflation index.
- High income earners - 10% surtax kicks in with a Modified AGI over \$450,000(m) and \$400,000(s). This essentially makes a 35% bracket. Modified AGI is AGI plus tax-exempt interest. So, in this bracket there is a 10% tax on things such as 401k deferrals, HSA paying, donations, etc.
- Standard deductions - Would rise 75% to \$22,000(m) or \$11,000(s).
- Capital gains and dividends - For capital gains and dividends from domestic companies, rates would be 6% for those in the 10% bracket, 15% for those in the 25% bracket and 21% for those in the 35% bracket. And, the 3.8% Medicare surtax would stay on for upper-income tax payers.
- Alternative Minimum Tax (AMT) - would be eliminated.
- Itemized deductions - Mr. Camp's proposal cuts many deductions such as write-offs for state and local taxes, mortgage interest deductions and charitable contributions which would be adjusted to amounts in excess of 2% of AGI.
- Education tax credits - a single tax credit would be provided for education payments of \$2,500 and a quicker phase out for such credit. All other education credits would be repealed.

Again, the above from Mr. Camp are just proposals. But, they do give some guidance on the thinking in Washington regarding tax reform.

So, while there are no large immediate changes for 2014 there may still be some retroactive changes coming and certainly we should keep an eye on discussions in Washington as well as where tax reform falls on the priority list.



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The “New” Leg of the Three-Legged Stool

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Cause

Retirement is often explained with the use of a metaphor: the three-legged stool. The three-legged stool represents the three pots of income many retirees have in common: Social Security, Employee Pension, and Personal Savings. While the relevance of the metaphor could be argued in the wake of many companies foregoing costly pension plans, it is widely accepted that retirement is indeed made up of more than just Social Security. For many Americans the weakest, or missing, leg of the stool is Personal Savings.

In the most recent State of the Union, President Obama introduced a new initiative to help low and middle-income households address this problem. At its core, the initiative proposes the creation of a new retirement savings vehicle known as a MyRA. We examined this new investment product and show the facts and our findings below.

The facts:

1. Who is affected? In the pilot phase, the MyRA will be targeted towards low- and middle-income

households that do not currently have access to an employer-sponsored savings plan such as a 401(k) or 403(b).

2. What is the MyRA? The MyRA is essentially a Roth IRA that is backed by the full faith and credit of the US Government.
3. When will it be available? Pilot programs are slated to start towards the end of 2014 at select employers who choose to participate.
4. Where do you open a MyRA? Employees will find access to a MyRA through their employer.
5. How does it work? Accounts are created by employers sharing direct deposit information of employees who want to participate. Employers are not required to administer or contribute to the MyRA accounts of employees and contributions are made directly from the employee's paycheck. The minimum amount per paycheck is \$5 after the initial minimum contribution of \$25. ➤ [More](#)

The Differences

The MyRA is different than a regular Roth IRA in that the contributions are deducted directly from a savers paycheck, which mimics a 401(k) or 403(b) contribution. The MyRA only invests in Government treasuries which limits growth potential; however, it is backed by the full faith and credit of the United States. The MyRA has no administration fees and the employers play a vital role in providing direct deposit information for accounts. Finally, the MyRA does have an account value cap of \$15,000, or 30 years. Once either of these milestones is surpassed, the saver will be forced to roll the MyRA into a private Roth IRA.

The Similarities

The MyRA shares some features of a Roth IRA including the eligible age of 59.5 when tax-free withdrawals can take place without possible penalties and taxes. All contributions are made with after-tax money. The account offers flexibility in that it does not have to move or be rolled over in the event of a job change or loss. The MyRA has the same phase out income threshold of \$191,000 for a household. Finally, both savings vehicles have an annual contribution cap of \$5,500 for 2014.

Effect

The creation of the MyRA is a first step towards helping Americans develop a personal savings account and a process through which they can save through direct deposit from their paycheck. There is

value in this financial regiment and education. However, investing purely in Government bonds provides no diversification for the portfolio and also does not offer the opportunity for growth of the portfolio. In fact, based on our assumed inflation rate of 3%, a saver actually would lose some of her principal not due to market risk, but due to inflation and a negative real rate of return. Additionally, while the Government is encouraging households to spend (hence, low interest rates), it does have an incentive to offer a savings plan. Why? The Government needs buyers of US treasuries, outside of itself. By offering US treasuries as the only investment in the MyRA, more buyers are automatically brought to the table.

Our Findings

While the creation of the MyRA could be an important first step in teaching Americans about the value of personal savings, the opportunity for growth as well as the account value cap do not foster an account that will “fix” the personal savings issue many Americans are facing.



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Market Review

The tug of war goes on

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About two years ago I came up with a cartoon image that I think accurately depicts the struggle in the global economy. That struggle is the tug of war between inflation and deflation (see image center). To be clear, the true definition of economic inflation is the expansion of the money supply with the effect of rising prices. However, in today's world inflation has been morphed into mean rising prices. In economic terms deflation means the reduction of the money supply with the effect of declining prices. Also in today's world, the definition has morphed into falling prices.

So, who are the players in this epic economic battle? On the inflation side we have the major central banks of the world who are expanding money supplies (inflation) and looking for rising prices. On the opposite side we

have consumers where demand for money is falling and prices want to follow. Additionally, we have consumers that have been impaired from paying more as the economy has been subpar and incomes stagnant.



The US government and The Federal Reserve (Fed) do not want deflation. The Fed's stance is that deflation is bad and inflation is good. Hence, we continually hear from the Fed about its inflation target of 2%. Do you really want to pay 2% more for anything year over year? Why does the Fed want inflation? The

answer is quite simply that for those in debt (like the US government) there is no better way to repay debt than with devalued money (via expansion of the money supply - inflation). ➤ [More](#)

The misdirecting rhetoric from the Fed and government would have you think that deflation is tantamount to economic recession or depression. However, in the volumes of papers of the Fed itself, we find that there really is little (almost no) evidence that deflation and economic funks are related. Consider the following quote from a paper written by the Federal Reserve Bank of Minneapolis

“Our main finding is that the only episode in which we find evidence of a link between deflation and depression is the Great Depression (1929-34). We find virtually no evidence of such a link in any other period. ... What is striking is that nearly 90% of the episodes with deflation did not have depression. In a broad historical context, beyond the Great Depression, the notion that deflation and depression are linked virtually disappears.”

- Deflation and Depression: Is There an Empirical Link? January 2004. - Atkeson, Andrew and Kehoe, Patrick

Clearly, someone at the Fed has seen evidence that deflation does not equal economic hardship. Quite frankly, some of the most prosperous times of US history came during periods of falling prices. None-the-less the Fed is targeting inflation because it fears debt-deflation. The debt-deflation theory is the recognition that if an economy suffers a dramatic decline in prices and wages at a time when debt levels are high, the resulting increase in real indebtedness can cripple the economy and the banks.

In the end, not just the Fed but all westernized central banks are fighting broad economic deflationary tendencies with money supply expansion. The expansion of the money supply is not translating into higher prices across the board because consumers are not demanding credit and

banks are being very stingy in their lending. Hence, the tug of war goes on.

As of now, the match between the inflationary central banks and the deflationary consumer demand is resulting in a stalemate with a slight edge to the central banks. The reason for the nod to the central banks is that they are getting inflation but not at the levels they seek.

What does all of this mean to the markets? As we have seen in the recent past, the money printing has successfully levitated investing markets. Accordingly, such actions should continue to underpin the markets so long as investor confidence in global central banks remain. It is important to remember that the fight between inflation and deflation is not in itself a bad thing. Actually, it is a good thing. The inflation/deflation gridlock is much like congressional gridlock in that it is good for the markets.

Like a real tug of war, the current economic tug of war looks like nothing is happening. This can go on for a long time then, all of a sudden, one side may give. For investors, portfolio stances should look different in a deflationary environment versus an inflationary one. Therefore, we continue to monitor global economic data to find any shift in this global economic tug of war and will act accordingly when a strong indication of either is observed. In the meantime, investors should cautiously participate in the relative calm of economic gridlock.



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White Paper Review

What is an advisor worth?

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According to Vanguard, the answer to the title of this article, is that it could be as much as 3%. As you might imagine, I read a lot of research papers, articles and industry white papers. Honestly, most of the topics that I read would likely put the lay person to sleep. But in the course of my reading regimen, I came across an interesting white paper produced by Vanguard titled Putting a value on your value: Quantifying Vanguard Advisor's Alpha. Now keep in mind, this piece was written with the professional investment advisor in mind.

Before I get into my executive summary of the white paper, I want to clarify what Vanguard means with the term 'alpha.' Alpha, in the financial universe, often refers to value added. So, advisor alpha refers to the value an advisor adds to clients relative to average client experience. Vanguard is uniquely positioned to have competent research on investor experience and behaviors as the company has been dealing with investors (both retail and professional advisors) for a long time.

We, as financial professionals (and clients alike) sometimes struggle with fully understanding (let alone quantifying) the value an advisor brings to clients. In this white paper Vanguard does the heavy lifting of trying to quantify the value of something as subjective

as investment advice. The struggle is better said by a quote from the opening of the white paper. *"The value proposition for advisors has always been easier to describe than define."*

Vanguard used its proprietary Advisor's Alpha strategy to try to quantify the answer to the question of investment advisor alpha. To do so, it broke down investment advice into components and studied how advisors may add value. Keep in mind the goal was to see how advisors added alpha to clients with a long-term investment horizon, not short-term trading decisions. Below are the component areas and a few comments about those areas.

- Suitable asset allocation using broadly diversified funds/ETFs - This was the hardest place to quantify an answer since all clients have different risk preferences and time horizons. Regardless, an investor's asset allocation is a key determinant of returns. Certainly, advisors will add value in this area as they strive to position clients for appropriate risk/return and therefore peace of mind.
- Cost effective implementation - Essentially, Vanguard weighed the benefit of using low-cost investments such as index funds and exchange-traded funds versus the average mutual fund cost expense ratio. There is plenty of research [» More](#)

that debates the value of using funds versus individual securities, as well as index funds versus active funds. The reality is an advisor can add alpha by looking for opportunities such as where indexing makes more sense than active management or where active managers tend to outperform indexes.

- Rebalancing - Although not everyone subscribes to the idea of buying and holding an allocation, if one does regular reallocation from winners to losers, he can add significant value to a portfolio over the long-term.
- Behavioral coaching - By far this is the most challenging area to quantify. However, Vanguard's research shows that this is the area that advisors can add the most value. More or less this can be chalked up to the saying of 'saving one from themselves.' The suggestion here is that the discipline and guidance of an advisor can help keep clients on track versus chasing markets or sitting on their hands. More specifically, this area can be summed up best by a quote from the paper.

"...as some of the most significant opportunities to add value occur during periods of market duress or euphoria when clients are tempted to abandon their well-thought-out investment plan."

- Asset location - The types of accounts client own matters. The primary driver in the previous statement is taxes. By owning certain asset classes in taxable accounts versus tax-deferred accounts an advisor can enhance returns by reducing tax drag.
- Withdrawal order for client spending from portfolios - Similar to asset location mentioned above, where clients remove money from a portfolio for spending needs matters and again taxes are at the heart of the decision.
- Total-return versus income investing - With interest rates firmly resting at all-time lows, safe

and reliable income sources are few and far between. Such conditions, for income seeking investors, warrant either a large jump in risk to achieve the desired income from investments or investors can look to total-return investing. Total return investing looks to increase the value of a portfolio by both capital appreciation and income sources. The benefit is an overall reduction in risk and dependency of a single source for income needs.

Summary

Vanguard's goal was to find an advisor alpha number; the paper does provide bands of value for each of the component areas. My interest in sharing this overview was to point to the myriad of ways advisors can add alpha that you may not see in numbers. It is this hidden value that drove Lighthouse to create the COMPASS program that looks at clients complete financial pictures.

Surely, if there is hidden alpha in the investment process alone then something like our COMPASS program through estate planning, tax planning, retirement planning, college planning and general financial planning must have loads of hidden advisor alpha. Similar to many things in today's world, value can be very subjective even more so with something you cannot see, touch or easily quantify.

For those that would like to read the paper themselves here is a link.

<https://advisors.vanguard.com/iwe/pdf/ISGQVAA.pdf?cbdForceDomain=true>



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