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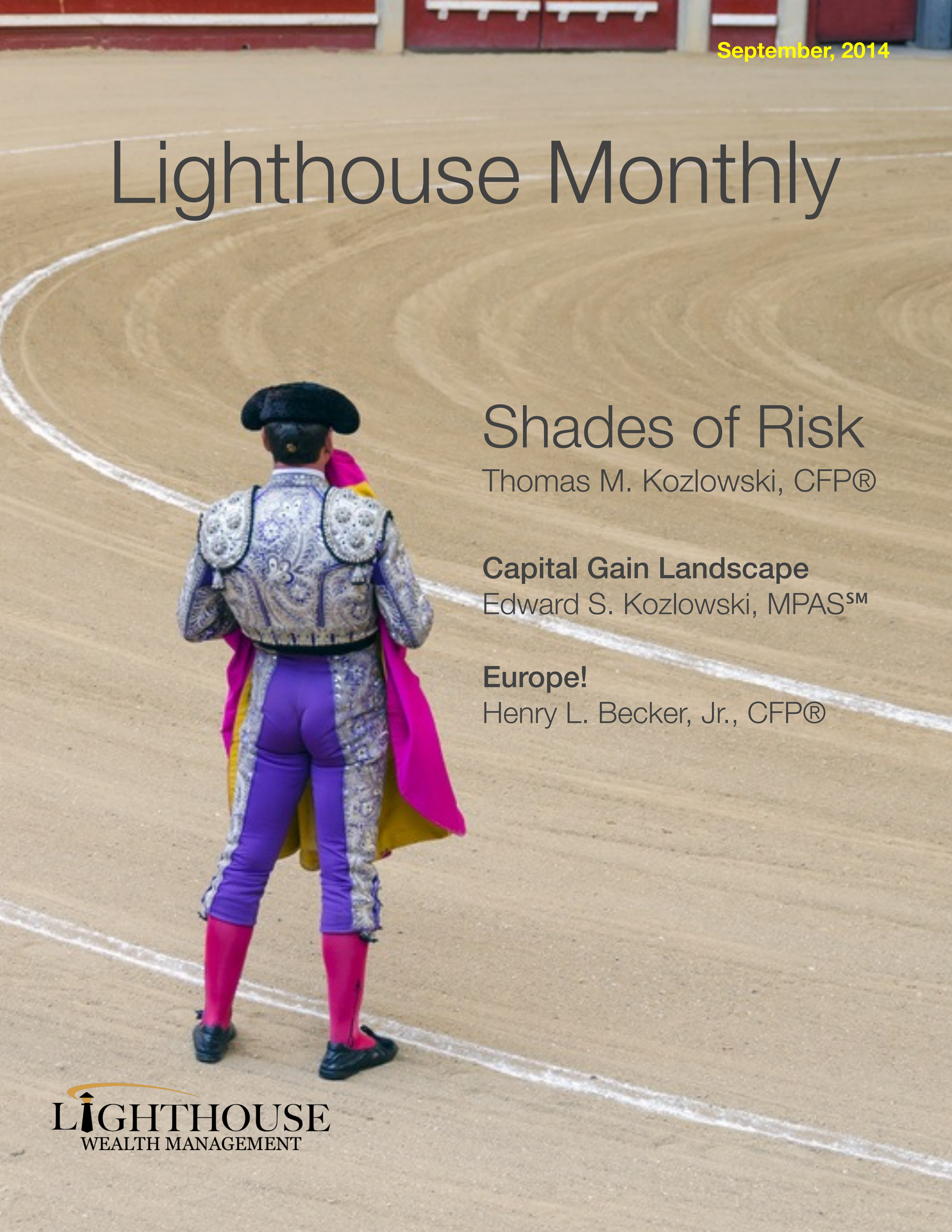
Lighthouse Monthly



Shades of Risk

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Edward S. Kozlowski, MPAS℠

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LIGHTHOUSE
WEALTH MANAGEMENT

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164 W. Main Street
Suite F
New Market, MD 21774
P: 301.865.9740
TF: 1.800.944.5852
F: 301.865.9741
www.LighthouseWlth.com

Shades of Risk

Thomas M. Kozlowski, CFP® - Founding Partner

Some things in life are just accepted. In the financial services industry there are a number of norms, accepted practices and things people just do not question. More times than not, those that work in the financial services industry stay close to the accepted practices and norms as they are typically the result of regulations.

The approach to evaluating investment risk is linked directly with the regulatory environment of the financial services industry. More specifically, risk evaluation as it stands today is about suitability.

Measuring risk

Before we go further, it is important to be clear on some terms. Your attitude about losing money is what is called risk tolerance and your ability (can you afford to take risk) is called risk capacity. The reading of a client's risk make up is traditionally derived by looking at the client's age, the client's attitude about risk and his ability to take risk.

Typically, the ruler used to measure a client's investment risk make up is a questionnaire. Such questionnaires ask questions regarding a client's attitude about losing money, time horizons and their ability to take risk. The result of the questionnaire is a summation score of all the questions.

As we see it, the problem with the traditional methods of measuring risk via questionnaires is that a client's risk capacity gets lost in the process. Our opinion is that risk capacity must be considered separately and first. If you cannot afford to take risk, you should not take it. And, if you think that you may be able to afford to take risk, it does not mean you should. Consider a few hypothetical examples:

Joe

Joe is 50 years old and plans to retire in 15 years. His portfolio of invested assets are projected to be worth approximately $2 million in 15 years. Joe plans to withdrawal $30,000 per year from his portfolio in retirement which equates to a withdrawal rate of 1.5% (30,000/2,000,000). Joe is very risk adverse. When asked what he would do if stock indexes dropped 20% and given a range of answers to choose from he would choose to sell everything as soon as possible.

Now consider that in most cases, Joe would have answered a series of questions on a risk questionnaire. The results of the questionnaire would have shown high scores on risk capacity and time horizon and low scores on risk tolerance. The likely outcome would be a recommended portfolio in the moderate growth area. ➳ More

If we analyze Joe's situation and results, we find that Joe has a high capacity for risk as his portfolio could be cut in half and he would still be able to achieve his goals. Additionally, his time horizon to retirement of 15 years points to an ability to assume risk. But, Joe's attitude toward risk (risk tolerance) is very low. So, if Joe's portfolio were placed in a moderate growth oriented portfolio, an advisor would all but ensure that at some point Joe would not be very unhappy when a down draft comes. Joe is an example of someone that can afford to take risk but should not take it.

Linda
Linda recently retired and has a $1,000,000 portfolio and needs $65,000 per year from the the portfolio for living needs. Linda's withdrawal rate of 6.5% ($65,000/$1,000,000) is high. The high withdrawal rate means she has a low capacity for risk.

Consider that if her portfolio lost money her goals would be in serious jeopardy. The results of a traditional risk questionnaire would indicate low scores for time horizon and risk capacity but high scores for income needs. In the end, Linda would likely see a portfolio recommendation of a very conservative portfolio of bonds.

Problems
As you can see from two simple examples, primary drivers of portfolio considerations can often become buried by general, mixed approaches to risk assessment. In the examples above we see Joe who had little tolerance for losses moved into a moderate growth portfolio because of time horizon and wealth accumulation. In Linda's case, we saw a person with little capacity for risk have her lofty goals put in jeopardy by a portfolio that is likely too conservative for her goals.

Bottom Line
Unfortunately, the mixture of risk tolerance and risk capacity into a single risk assessment approach has a very strong ability to distort outcomes and bury important information. In our opinion, it is important that risk capacity and risk tolerance be considered separate from one another.

Here are Lighthouse we spend time getting to know client attitudes about risk, capacities and time horizons in our initial and on going meetings. We feel that it is in those conversations combined with financial analysis that we can best determine the different shades of risk that a client faces in relation to his or her goals.

Thomas M. Kozlowski, CFP® is a founding partner at Lighthouse

Email: tom@lighthousewlth.com

Capital Gain Landscape

Edward S. Kozlowski, MPAS℠ - Partner & Director of Tax Services

You know the old sarcastic saying that there are only a few certainties in life - dying and paying taxes. Perhaps it is not so much that one has to pay taxes that is a certainty but that tax laws will continually change.

Until 2013 we only had to contend with capital gains rates of 0% and 15%. Now, with the maximum capital gains rate of 20% and the addition of the Medicare surtax on investment income of 3.8%, we have four capital gains rates. The chart below will explain the details.

In the chart below the first column shows ordinary income, the second shows the applicable long-term capital gains rate, and the third column shows the gains rate from the second column with the Medicare surtax 3.8% added. The result, as you can see, is four capital gains tax rates. ➳ **More**

Married Filing Joint Income	Tax rate on Qualified Dividends & Long-Term Capital Gains	Medicare Surtax of 3.8%	Total of Capital gains and Medicare Surtax
$0 - $18,150	0%	0%	**0%**
$18,150 - $73,800	0%	0%	**0%**
$73,800 - $148,850	15%	0%	**15%**
$148,850 - $226,850	15%	0%	**15%**
$226,850 - $405,100	15%	**3.8%	****18.8%**
$405,100 - $457,600	15%	3.8%	**18.8%**
$457,600 +	20%	3.8%	**23.8%**
	** Medicare Surtax for Married Filing Joint is for AGI over $250,000		

New Landscape

In most recent years with effectively one capital gains rate at 15%, it made sense to delay taking gains as long as one could. The issue became why bother paying 15% now if you can pay the same in the future? With a four bracket capital gains scenario, the customary tax strategy of harvesting capital losses to offset gains gets trickier.

The bottom line implication of the new system is that in years that income is low it may make sense for investors to harvest gains. Conversely, in years when income is high it may make sense to harvest losses. For some, delaying capital gains indefinitely into the future may increase the total dollar outlay toward taxes.

If one pushes gains far into the future it is true you pay no taxes currently; however the larger the gains, the larger the likely tax later. This could be true now because we are looking at multiple, income-related capital gains bands.

So, while in the past one would indefinitely delay gains, today for those in the middle income brackets ($73k to $246k) it may be wise to harvest gains in an ongoing fashion. By harvesting gains in an ongoing fashion an investor can potentially keep himself out of the upper capital gains tax bands in the future. Thereby, lowering total tax dollars out the door. Or more simply put, you may pay less over time versus outright delay and pay more in the future.

As well, by doing ongoing long-term capital gain harvesting the investor is keeping his or her cost basis higher which minimizes a capital gain pile-up in the future.

Financial professionals are all too familiar with clients that have large capital gain holdings that they just do not want to sell because of taxes. Just as a landscaper would rather continually prune versus having to use heavy machinery, so too should investors look to tax pruning versus tax clear cutting.

This information is intended for informational purposes only and is not intended to be a substitute for professional tax advice.

Edward S. Kozlowski, MPAS℠ is a partner and Director of Tax Services with Lighthouse

Email: ed@lighthousewlth.com

Market Review

Europe!

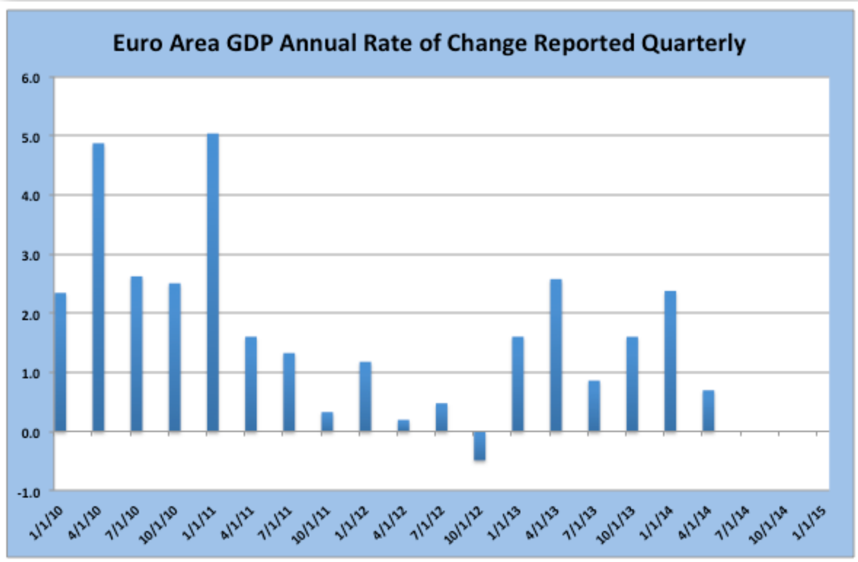
Henry L. Becker, Jr., CFP® - Director of Investment Research, Partner

It has been more than three years now that Europe has seemed to vacillate between stable and critical condition. Back in 2011, Greece suffered a sovereign bond crisis that started to ripple around Europe. Since 2011 we have seen major banks in Belgium, Portugal and Spain in need of bailouts. Additionally, we have seen countries such as Cyprus put their entire financial system on lock down and confiscate bank deposits.

For 2014, we have heard reports both good and bad coming from Europe. As an analyst, sometimes the easiest and best way to understand a situation is pictures. So, we will look at Europe through some high level economic data point charts.

Chart one present at right shows the Euro Area Annual Rate of Change in GDP reported quarterly. As you can see from the chart, the 'recovery' in Europe is weak to nonexistent if we also consider inflation. ➣ **More**

Chart one



Source: US Federal Reserve

Chart two shows the Euro Area Unemployment Rate which still hovers near its post-2008 high. In some countries the unemployment rate is much higher. Additionally, in countries such as Spain the unemployment rate of the under-25 population is north of 50%.

Chart three is one of the most concerning to the European Central Bank (ECB) economists. In chart three we see bank lending to the private sector (Households) continues to be very low. Some point to little demand while others point to tight credit conditions as a cause of the lack of household lending. The reality is that the ECB created negative deposit rates to spur the banks to lend. Recall that banks can place money on deposit at their respective country's central bank versus lending. The fact that the banks are choosing to pay to leave funds on deposit at the ECB versus lending it out makes a loud statement.

All of the above commentary is why the ECB is now (and has been) racking its collective brains to figure out a way to stimulate the European economy with a quantitative easing (QE) program of its own.

Just as we had bad news be good news here in the US leading up to QE three, Europe may be on the cusp of a similar scenario. The European stock market as a whole has struggled through 2014 thus far and could certainly get a short-term boost from stimulative efforts from the ECB. The question is can the Europeans work around the rules that prevent them from buying sovereign bonds with printed money? If they can figure that one out there may be hope for Europe escaping their economic struggles. We remain cautiously optimistic on Europe and see Europe as a better valuation play than the US. However, global economic risks at this point are trumping many investors from jumping too far on low European valuations.

Chart two

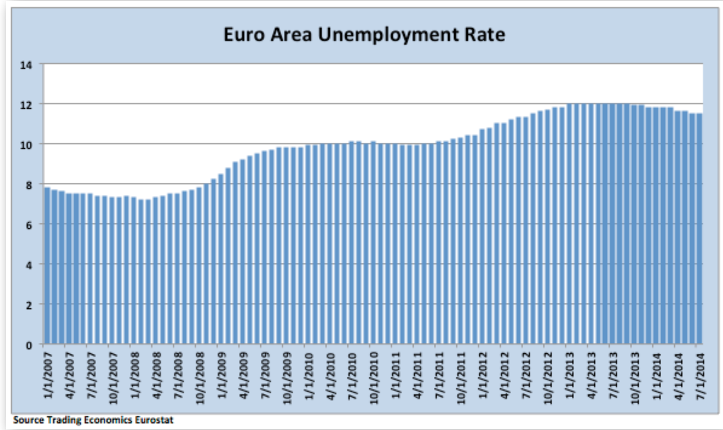
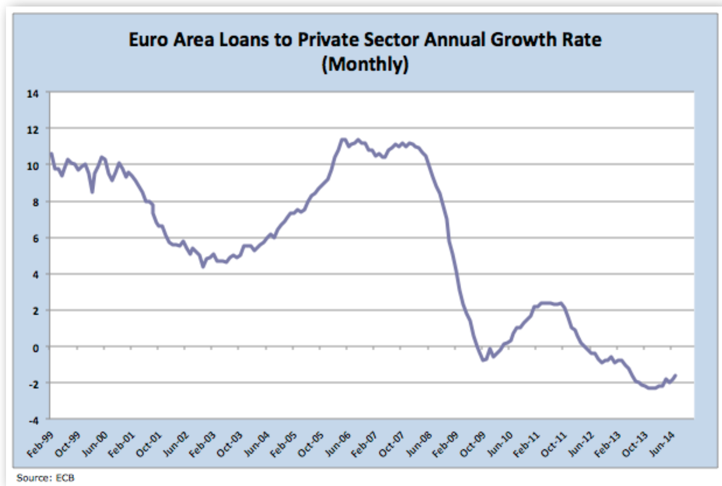


Chart three



Henry L. Becker, Jr., CFP® is a partner & Director of Investment Research with Lighthouse

Email: henry@lighthousewlth.com

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