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Securities offered through:  
Coordinated Capital Securities, Inc.  
Member FINRA/SIPC

**Winter 2013**

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# Client Newsletter

Past market performance is not indicative of future results

## The Fallacy of Predictions

*Article Courtesy of Bob Veres*

One of the more interesting myths in the investment world is that large financial institutions, with their access to mountains of data pored over by teams of staff economists, can determine where the markets are going and profit accordingly. Gullible investors believe this even though, every year, we can go back to the confident predictions of brokerage firm leaders and leading hedge fund managers and see a hard-to-explain gulf between expectation and reality.

This past 12 months, the broad U.S. markets delivered roughly a 16% return, depending on which of the indices you're measuring--a good year by any standard. So let's jump into a time machine and see whether the brokerage firms were telling us to go all-in on stocks and take full advantage of this nice little bull market run.

They weren't. Adam Parker, who serves as the U.S. equity strategist for the mighty Morgan Stanley organization, boldly predicted that the S&P 500 index would fall 7.2% in 2012. He recently said that he underestimated the impact of central bank stimulus.

Credit Suisse's "strategist" Andrew Garthwaite, Wells Fargo "strategist" Gina Martin Adams and Bank of America/Merrill Lynch "strategist" Savita Subramanian forecast essentially flat returns for U.S. equities.

David Kostin of Goldman Sachs, meanwhile, predicted that the S&P 500 would drop 25% in the midst of a Euro collapse, and boldly predicted that Europe's sovereign debt crisis would worsen "almost daily." John Paulson, founder of what may be the most famous global hedge fund, based in NY, told clients in April that he was wagering heavily against European sovereign bonds. UBS economist Jonathan Golub forecast struggling equities in the face of European recession.

In fact, the Eurozone became practically the epicenter of bad Wall Street predictions; crafty traders watched in dismay as Greek bonds surged in value in 2012, and the Euro itself strengthened about 9.4% from its July 24 low against the dollar. Germany's DAX Index

managed to survive the predicted freefall by returning 29% to investors who ignored their brokers and stayed the course in Europe. The most dire predictions came from Citigroup economist Willem Buiter in London, who told reporters last February that there was a 50% chance Greece would leave the euro within 18 months. In May, he raised the risk to 75%, and cited a 90% chance of departure in July--and said he was assuming that there would be an exit by January 1.

2012 is not an isolated incident; in fact, last year a company called CXO Advisory Group--which tracks more than 60 market "gurus" (the company's term)--calculated that the average Wall Street expert forecaster had been accurate only 48% of the time over the long term. Translated, that means that a coin flip is a slightly more accurate predictor of the future than the experts you see on cable's financial TV channels.

But of course this is the season when, once again, the experts, economists and visionaries put on their gypsy shawls, get out their crystal balls, and tell you with calm

certainty where the markets are going in 2013. You are about to be deluged with confident predictions from Wall Street, along with Money Magazine telling you "the smart place to put your money now," and once again it will all sound believable. Perhaps the best advice is to imagine, as these gurus come on the tube, that they are wearing tall, floppy wizard hats with a bright crescent moon inscribed on the front.

Or you can turn off the TV and pull out a more reliable guide to the future: any one of the coins in your pocket that happens to have a head and a tails.



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# Notable Highlights of the American Taxpayer Relief Act of 2012 (or ATRA)

Article Courtesy of Michael Kitces

## Tax Brackets

The top tax bracket rises to 39.6%, and applies to income in excess of \$400,000 for individuals, and \$450,000 for married couples. *These thresholds are indexed for inflation* (in a similar manner to all the other tax bracket thresholds). Notably, the \$450,000 threshold for married couples is actually a slight form of marriage penalty release, as in the past the top tax bracket threshold was the same for both individuals and married couples. It's also notable that in practice, this change is effectively the same as just allowing the top tax bracket to lapse back to the old rates, as the top tax bracket was already at \$388,350 in 2012 (and would have been just shy of \$400,000 with the 2013 inflation adjustment). (Note: bear in mind that tax brackets are based upon *taxable income* after all deductions, not Adjusted Gross Income.)

The remaining tax brackets are extended at their current levels. Notably, this means the 35% tax bracket is still in effect, although it's now one of the smallest tax brackets, applying for only \$388,350 to \$400,000 (for individuals; or \$388,350 to \$450,000 for married couples).

The changes listed here to the tax brackets are *permanent* - i.e., there is no sunset provision that would cause them to lapse (although Congress could still change the rules in the future, of course!).

## Phaseout of Itemized Deductions and Personal Exemptions

The phaseout of itemized deductions and personal exemptions returns for 2013. In point of fact, this change was already scheduled to happen with a lapse of the Bush tax cuts, but ATRA applies new thresholds to the rules.

The phaseout for itemized deductions (also known as the Pease limitation) reduces total itemized deductions by 3% of excess income over a threshold. The threshold amounts are now an Adjusted Gross Income of \$300,000 for married couples, and \$250,000 for individuals. These amounts are indexed for inflation.

The personal exemptions phaseout (also known as the PEP), reduces personal exemptions by 2% of the total exemptions for each \$2,500 of excess income over a threshold) returns for 2013. The threshold for this phaseout will be the same as the threshold for the Pease limitation (AGI of \$300,000 for married couples, and \$250,000 for individuals, indexed for inflation). Notably, in the past the PEP had a different phaseout threshold than the Pease limitation, but the new rules under ATRA unify these thresholds.

The net impact of the PEP and Pease limitations is that each rule increases an individual's marginal tax rate by about 1% (with a greater impact on larger families that phaseout more exemptions at once).

## Estate Taxes

The new rules of ATRA make the current estate tax laws permanent, including the \$5,120,000 (in 2012) gift and estate tax exemption (which will rise further to approximately \$5.25M with an inflation adjustment for 2013); the Federal gift and estate tax exemptions remain unified. This outcome is not entirely surprising; **as I wrote earlier this year, the estate tax exemption has not actually been allowed to decline since the Great Depression.** However, the top estate tax (and gift, and GST) rate is increased from the prior 35% to a new maximum rate of 40%.

Notably, the **portability rules** for a deceased spouse's unused estate tax exemption amount are made permanent, **which may significantly impact (i.e., reduce) the use of bypass trusts for all but the wealthiest of families.**

## Capital Gains and Dividends

ATRA makes permanent the 0% and 15% long-term capital gains tax rates, but increases the tax rate to 20% for any long-term capital gains that fall in the top tax bracket (the new 39.6% bracket with the \$400,000 / \$450,000 thresholds noted earlier).

Qualified dividend treatment is also made permanent (as the provision was would have caused it to sunset has been eliminated), although notably because qualified dividends are tied to the long-term capital gains rate, the top tax rate for qualified dividends has now risen to 20%.

Notably, individuals who are subject to the new 20% top long-term capital gains and qualified dividends tax rate will actually find their capital gains and dividends taxes at 23.8%, due to the onset of **the new 3.8% Medicare tax on net investment income** that would also apply at this income levels.

## Miscellaneous Extension Provisions

The American Opportunity Tax Credit (the \$2,500 tax credit for college expenses that replaced the prior Hope Scholarship Credit in 2009) is extended 5 years - it was scheduled to lapse at the end of 2012, and will now run until 2017. The Child Tax Credit and the Earned Income Tax Credit were also extended over the same 5-year time period. A series of "extender" rules are retroactively patched for 2012 and extended one year through 2013, including:

- Deduction for up to \$250 expenses for elementary and secondary school teachers
- Exclusion from income of discharged mortgage debt (necessary to prevent a short sale from triggering income tax consequences for the amount of debt that was discharged)
- Deduction of mortgage insurance premiums as qualified residence interest
- Deduction for state and local sales taxes paid (in lieu of state and local income taxes paid, useful in states that have little or no income taxes)
- Above-the-line deduction for up to \$4,000 of higher-education-related expenses (although in practice, this provision is rarely used due to the availability of the American Opportunity Tax Credit, which was also extended)
- Exclusion from income for Qualified Charitable Distributions from an IRA to a charity (still with the age 70 1/2 requirement and the \$100,000-per-taxpayer-per-year limitation). Notably, **a special rule allows qualified charitable distributions made by February 1, 2013 to be counted retroactively for the 2012 tax year**, for those who want to take advantage of the rule for 2012 and 2013.
- Business provisions, including the Work Opportunity Tax Credit, the increased Section 179 expense deductions for small businesses, and 50% bonus depreciation for larger businesses.

Notably, the 2% payroll tax cut that has been in place for the past 2 years was *not* extended, and has lapsed. Payroll withholding will need to be adjusted for employees in 2013 (and per the **recent Treasury regulations, high income individuals will also need to adjust withholding later in 2013 for the new 0.9% Medicare tax on earned income**).

Separately, the favorable treatment of **Coverdell Education Savings Accounts** (so-called "education IRAs") created under EGTRRA, including both the higher contribution limits (\$2,000/year), and the ability to use qualified distributions for eligible K-12 expenses, has been extended *and made permanent* under the new law.

## AMT Relief

The ongoing series of AMT exemption patches over the past decade are made permanent, and fixed retroactively (since the last patch expired in 2011). The new AMT exemption amount will be \$78,750 for married couples and \$50,600 for singles in 2012 (these are essentially the 2011 amounts adjusted for inflation). The AMT exemption amounts will be indexed for inflation in the future. In addition, several key AMT thresholds are now also indexed for inflation, including the \$175,000 threshold for the 28% AMT tax bracket, and the \$112,500 and \$150,000 (for individuals and married couples, respectively) thresholds for the phaseout of the AMT exemption.

In a separate but related provision, the rules that allow nonrefundable tax credits to be used for both regular and AMT purposes (subject to some restrictions) is also retroactively patched for 2012 and made permanent going forward.

Source:  
<http://www.kitces.com>

# A Year of Anxiety (And Excellent Returns)

## Dear Clients,

Many of you reading this will be surprised to discover that 2012 was a great year to be an investor. Amid the unhappy headlines, anxiety over America's finances, a highly-partisan presidential election, worries about the Eurozone and the potential for recession, stocks quietly rewarded patient investors with double-digit gains.

The Wilshire 5000--the broadest measure of U.S. stocks --rose 16.06% for the year. The other stock market sectors moved in a very similar pattern. Large cap stocks, represented by the Wilshire U.S. Large Cap index, were up 15.74% for the year. The widely-quoted S&P 500 index of large company stocks gained 13.41% in 2012. Meanwhile, the Wilshire U.S. Mid-Cap index rose 16.25% after gaining 3.92% in value in the fourth quarter of the year.

Small company stocks also posted significant gains. The Wilshire U.S. Small-Cap gained 3.10% in the fourth quarter to finish the year up 18.76%. The technology-heavy Nasdaq Composite Index was up 15.91% for the year.

Every single industry sector in the S&P 500 except utilities posted gains in calendar 2012, led by telecommunication stocks (up 12.50%), information technology (up 13.15%), consumer discretionary goods manufacturers (up 21.87%), and financial stocks (26.26% gains for the year).

Global stocks provided comparable returns. The broad-based EAFE index of larger companies in developed economies rose 13.56% for year, after a strong 5.38% quarterly return. The stocks across the Eurozone economies returned a robust 17.45% for the year, outpacing the Far East economies (9.11% for 2012). The EAFE Emerging Markets index of lesser-developed economies rose 15.21% for the year.

The dark clouds were relatively small. Commodities barely eked out positive returns, with the S&P GSCI index rising 0.08% for the year, led by agriculture (up 6.46%) and precious metals (up 6.21%). Energy stocks were down 1.37%. Real estate investments were among the biggest gainers, with the Wilshire REIT index posting a 17.59% gain for the year.

Investors who believed the negative headlines and pulled their money out of equities into safer havens suffered accordingly. Treasury bonds are still mired in near-record low-return territory; if you lend the U.S. government money by purchasing a 2-year Treasury, your current coupon rate is 0.25% a year. Five-year yields are still below 1% (0.72%), and 10-year (1.76%/year) and 30-year (2.95%) T-bonds are not in danger of enriching their purchasers. Muni bonds are sporting aggregate yields of 0.20% (1-year), 0.29% (2-year), 0.84% (5-year) and 1.69% (10-year). The aggregate of all AAA corporate bonds is yielding 0.72% for bonds with a five-year maturity; 1.76% if you go out ten years.

It is helpful to remember that the year started off with dire predictions and a lot of uncertainty about the prospects for the U.S. and global economies. The housing market was weak, unemployment was high, the Euro economies were in recession (or, in the case of Greece, bankrupt), and it was not hard to find blogs and even economic reports that predicted a catastrophic year. Investors who ignored the gloom and doom were rewarded with returns approximately twice as high as the historical averages.

Meanwhile, Washington policymakers finally reached a so-called "fiscal cliff" deal that seems to have pleased nobody except giddy investors on the following trading day. Among other things, it appears that our lawmakers are creeping closer to reality about how to define "the rich:" rather than \$200,000 (single taxpayers) or \$250,000 in adjusted gross income (joint returns), as specified in many prior proposals, "the rich" are now defined as making more than \$400,000 (single) or \$450,000 (joint). For taxpayers whose income falls below those thresholds, the temporary Bush-era tax cuts have been made permanent, and marginal tax rates will remain the same this year as they have been for the past two. Taxpayers who fit this new definition of "the rich" will experience a new 39.6% upper tax bracket, and pay taxes on capital gains and dividends at a 20% tax rate. (The 15% rate still applies to taxpayers below the thresholds.) In addition, the law borrows something from the Clinton era tax code: itemized

deductions and the personal exemption begin phasing out for individuals with more than \$250,000 in adjusted gross income, or couples with more than \$300,000 AGI. At \$122,501 of income beyond the threshold, personal exemptions are phased out in their entirety.

The tax bill also maintains the current \$5.12 million estate and gift tax exemptions (\$10.24 million for couples), but raises the tax rate for money transferred to heirs above that amount from 35% to 40%. And it offers a permanent fix to the alternative minimum tax problem by inflation-indexing the threshold (currently \$78,750 for joint filers; \$50,600 for individuals) at which people have to calculate their AMT, exempting all but about 5 million taxpayers from this chore now and in the future.

Also eliminated, the two percentage point reduction in the Social Security payroll tax--a stimulus measure enacted in 2010, which is likely to be the biggest impact of the legislation on most taxpayers. The payroll tax rises from 4.2% last year and returns to 6.2% in 2013.

Finally, the new tax law makes \$24 billion in federal spending cuts, while giving Congress two additional months to decide what to do about \$109 billion of automatic spending cuts that were scheduled to begin taking effect at the start of this year.

It is clear that the U.S. and global economy are still in a slow-growth recovery period, but there is some reason to be optimistic that 2013 could be a turning point in the long climb out of the Great Recession. After six years of decline, the housing market appears to have finally bottomed out in 2012. The inventory of homes on the market is down 20% or more from a year ago, and sales of existing single-family homes jumped 11% in 2012. Bank of America Merrill Lynch economists expect at least a 3% gain from the housing sector this year, which would flip this large sector of the economy from a drag on economic growth to a boost, along the way creating construction jobs and boosting sales of appliances and other products that go with home purchases.

At the same time, the National Association for Business Economics is forecasting a slow but steady increase in employment this year, and consumer debt is shrinking. The still-weak global economy seems unlikely to cause gas prices to rise dramatically, and some economists have pointed to the record amount of money parked in Treasuries (hence the low rates), which, if people become more confident in the stock market, could be redeployed into equities and cause prices to rise.

None of this, of course, is guaranteed, and it would be nice if our government policymakers would finally settle on a plan to reduce the federal debt without wrecking the economy in the process. But those who ignored the optimistic outlook for 2012, and looked at the headlines instead of the millions of workers who got up every day and went to work to build (or rebuild) the economy, probably regret it today. The same could be true for 2013.

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# Projected Tax Brackets for 2013

## Individuals

### Taxable Income Tax Liability

- Up to \$8,925 10% of taxable income
- Over \$8,925 but less than \$36,250  $\$892.50 + 15\%$  of excess over \$8,925
- Over \$36,250 but less than \$87,850  $\$4,991.25 + 25\%$  of excess over \$36,250
- Over \$87,850 but less than \$183,250  $\$17,891.25 + 28\%$  of excess over \$87,850
- Over \$183,250 but less than \$398,350  $\$44,603.25 + 33\%$  of excess over \$183,250
- Over \$398,350 but less than \$400,000  $\$115,586.25 + 35\%$  of excess over \$398,350
- More than \$400,000  $\$116,163.75 + 39.6\%$  of excess above \$400,000

## Married Couples (Filing Jointly)

### Taxable Income Tax Liability

- Up to \$17,850 10% of taxable income
- Over \$17,850 but less than \$72,500  $\$1,785 + 15\%$  of excess over \$17,850
- Over \$72,500 but less than \$146,400  $\$9,982.50 + 25\%$  of excess over \$72,500
- Over \$146,400 but less than \$223,050  $\$28,457.50 + 28\%$  of excess over \$146,400
- Over \$223,050 but less than \$398,350  $\$49,919.50 + 33\%$  of excess over \$223,050
- Over \$398,350 but less than \$450,000  $\$107,768 + 35\%$  of excess over \$398,500
- More than \$450,000  $\$125,846 + 39.6\%$  of excess above \$450,000
- Tax bracket thresholds are estimates based on projected inflation adjustments.

Source: <http://www.kitces.com/>