Mullaney Keating & Wright

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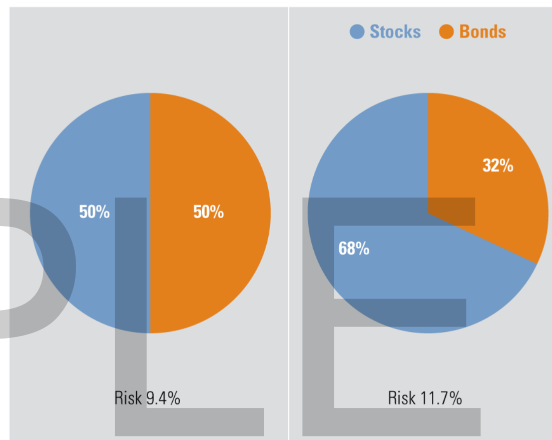
The Importance of Rebalancing

Over time, your asset-allocation policy can veer off track because of market ups and downs. This is illustrated quite clearly in the image below; a strong stock performance can cause a simple 50/50 portfolio mix to become unbalanced over time. After 30 years, what was once a 50% allocation to stocks now sits at 68%—quite a jump. Moreover, not only does the portfolio's allocation change, but the portfolio's risk also changes, rising sharply from 9.4% to 11.7%. If your needs and/or risk tolerance have not changed, your allocation shouldn't either.

But why would anyone want to sell investments that have done great in order to purchase laggards? While rebalancing might seem odd at first, it is all about risk control. If more and more of your total portfolio winds up in one investment, you risk losing a lot should that investment stumble.

Change of Portfolio Allocation: January 1980–December 2009



Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The sale of an investment for the purposes of rebalancing may be subject to taxes. Risk is measured by standard deviation. Standard deviation is a statistical measure of the extent to which returns vary from the expected returns. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and is considered to be representative of the stock market in general; Bonds—five-year U.S. Government Bond.

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Prior to joining Mullaney, Keating & Wright in 2003, Fran was a Portfolio Manager for 6 years with Olson Mobeck Investment Advisors, Rocky Hill, CT, where he managed over $100 million in investments for clients that included individuals, corporations, and not-for-profit endowment funds. Additionally, Fran was a member of the firm's Investment Policy Committee.

Prior to Olson Mobeck, Fran served as Senior Investment Specialist for Fleet Investment Advisors for 5 years. Prior to Fleet, he served as Trust Investment Officer for Lafayette Bank and Trust Company.

Fran became a Principal with Mullaney Keating & Wright in 2005. He is a Certified Financial Planner, a member of NAPFA (National Association of Personal Financial Advisors) and a graduate of Quinnipiac College with a Bachelor of Science degree in Finance. He resides in Litchfield with his wife Kim, and serves as a member of the Litchfield Pension Commission. He formerly served as an Alternate Commissioner on the Prospect, CT Planning and Zoning Commission.

Monthly Market Commentary

Recent weeks' economic conditions included a weak jobs report, an increase in consumer spending that was largely fueled by spending in the electronics segment, a recovery in the retail sales segment, and stronger earnings reports as earnings continue to power ahead at a robust rate. At the one-year mark, however, the recovery appeared slower than normal. Since the bottom in June 2009, the inflation-adjusted gross domestic product (the broadest measure of economic activity) grew at an anemic pace-about 3%. A disappointing jobs report in July was largely attributed to weakness in the government sector, with overall payroll jobs declining by 131,000. Initial unemployment claims rose by 19,000 and now stand at 479,000.

GDP: Gross domestic product grew by 2.4%. Inventories, exports, and imports were contributing factors to the volatility in the overall GDP figures. A 29% increase in imports was the primary reason that the GDP growth rate fell between March and June. Electronics, which are mostly manufactured overseas, comprised a large portion of consumer spending. This resulted in the dramatic increase in the U.S. import bill.

Consumer income and spending: The recent GDP report contained many revisions to the previous three years of economic data. The revisions were small and generally showed that the recovery was modestly smaller than previously thought. Recent data showed that consumers decreased their spending by 2.4% during the recession and have now increased spending by about 1.6% during the recovery. In other words, consumers have recovered about two thirds of what was lost. During the most recent quarter, the savings rate increased to 6.2%, a big increase from the low of 1.8% in the third quarter of 2007. The reported savings rate was 5.5% last quarter.

Retail sales: Of the four major indicators of current economic activity, only the retail sales category, adjusted for inflation, made a significant recovery. Employment and real income were up but still dangerously close to the worst levels of the recession. Industrial production, meanwhile, made a bounce off of the bottom, but it still has recovered only about half of what was lost during the recession.

Earnings: Overseas sales continue to be a contributing factor in corporate revenue and earnings. Revenue growth at many large companies remained in the 5%-10% range, while earnings growth was greater than 20%. While manufacturing results were generally robust across all geographies, heavy-duty results in developing markets were clearly an important driver of strong news out of the manufacturing sector. Outstanding earnings, combined with powerful forward-looking statements from many manufacturers, helped allay market concerns over other manufacturing indicators. Apple's earnings report showed positive signs that consumer electronics was moving the economy forward. Caterpillar's earnings report was impressive, with a 31% increase in sales and 82% increase in earnings per share for the second quarter. Earnings reports from companies such as 3M and UPS were indicative of an improving manufacturing environment during the second quarter.

Morningstar economists believe that U.S. businesses have underinvested in capital goods and may need to sharply ramp up spending in the months ahead. Such an increase can be a potential source of strength for the economy. A few companies such as Microsoft and Intel, which both benefited from the recent increase in consumer spending, reported an increase in corporate spending during the second quarter. While the focus remains on consumer spending and housing, the bright spots in the months ahead are likely to come from corporate spending.

The Future of Taxes

Now that our 2009 taxes have been filed and the lucky ones have received their refunds, nobody even wants to think about next year's returns. The Obama administration is pushing for major tax increases in 2011, which is causing many unhappy Americans to take to the streets in so-called tea-party rallies. It is important that you, as a taxpayer, be informed about these changes and consider which ones will affect you most.

Income Tax: The current tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are set to expire at the end of 2010. The proposed change for next year will eliminate the bottom bracket of 10% and change the remaining five to 15%, 28%, 31%, 36%, and 39.6%. The income thresholds that define these tax brackets will also change. It is highly likely that we will all pay more taxes next year.

Capital Gains Tax: Currently, long-term capital gains on investments are taxed at 0% for taxpayers in the two lowest brackets, and at 15% for everyone else. When these rates expire at the end of 2010, capital gains tax is projected to become 10% for taxpayers in the lowest tax bracket, and 20% for everyone else.

Dividend Tax: Whenever you receive dividends from your investments, you're supposed to pay tax on those dividends. In 2003, President George W. Bush signed a law under which qualified dividends were taxed at the same rate as long-term capital gains: 15%. This tax law is also set to expire in 2011; the current plan is to bring dividend taxes in line with ordinary income tax rates. So, if you're in the top tax bracket, you will pay 39.6% dividend tax, as opposed to only 15% last year.

Estate Tax: In 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001, a 10-year tax act that would expire in 2011. This act eliminated the federal estate tax for people dying in 2010. However, there is talk of maintaining the 2010 estate tax at its 2009 parameters. What will happen in 2011 is also uncertain. Unless changed beforehand, 2011 estate taxes will revert to pre-2001 rates, which could mean a marginal rate of up to 55%.

Other Taxes: For families with children, it may be good to know that the $1,000 child tax credit will revert to $500 after 2010.

After reading and understanding in detail which changes will apply to your situation, the next step is to decide how you want to reorganize your investments in order to minimize the impact of these tax increases. One option you might want to consider is municipal bonds, which are generally exempt from federal income taxes. These bonds can also be exempt from state and local taxes, but different states have different rules, so be sure to check before investing.

Another option would be relocating your investments, for example putting high-tax investments in your 401k (tax-deferred) account and low-tax investments in your taxable one. Since you will probably fall under a lower tax bracket in retirement, tax-deferred retirement plans can be a valuable investing tool.

Proposed Changes to Tax Rates

	2010	2011
Personal income tax	10% to 35%	15% to 39.6%
Long-term capital gains tax	Maximum of 15%	Maximum of 20%
Qualified dividends tax	15%	Ordinary income tax rate
Estate tax	Maximum of 45%	Maximum of 55%

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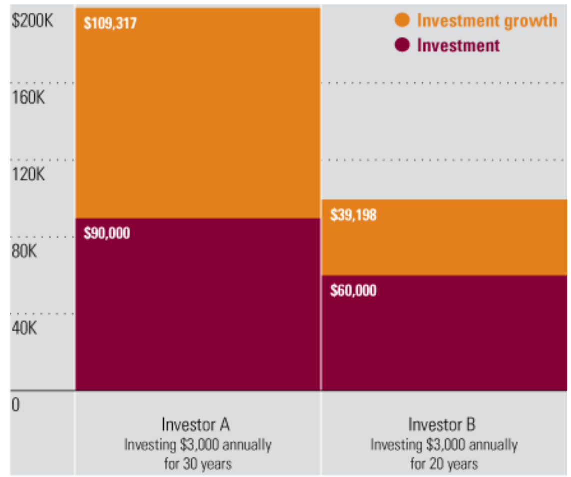
The Costs of Financial Procrastination

Retirement usually doesn't start until you're in your 60s but there is a good reason to start saving much sooner. The earlier you contribute to your nest egg, the more time your portfolio will have to grow in value.

The image illustrates the ending wealth values and effects of compounding of two investment portfolios. Consider two hypothetical investors who begin investing $3,000 at an average annual rate of return of 5%. Investor A invests $3,000 for a 30-year period, which results in an ending wealth value of $199,317. On the other hand, investor B invests $3,000 for a 20-year period, which results in an ending wealth value of $99,198. Investor A invested an additional $30,000 compared to Investor B. However, a large difference in the ending wealth value can be attributed to the compounding effect of the $30,000 for the additional 10 years. In other words, your dollars saved now will be worth a lot more than your dollars saved in retirement.

The Effect of Compounding



Source: This is for illustrative purposes only and not indicative of any investment. The image represents a hypothetical rate of return of 5%. The values represented do not account for inflation or taxes. Past performance is not a guarantee of future results. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment advice. Please consult with your financial professional regarding such services.

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