Capital Advice

Capital Financial Advisors of New York, LLC

Fall 2010

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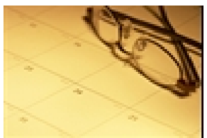
Will You See Higher Tax Rates in 2011?



The year was 2001. The top marginal federal income tax bracket was 39.6%, and the tax rate that applied to most long-term capital gains was 20%. Then came the Economic Growth and Tax Relief Reconciliation Act of 2001, followed two years later by the Jobs and Growth Tax Relief Reconciliation Act of 2003. By mid-2003, the top marginal tax rate was 35%, and the 20% capital gains rate had dropped to 15%. But this tax relief was designed to be temporary--the provisions that established lower rates were crafted to self-expire after a period of time. And now, in 2010, we're only months away from seeing those provisions expire.

Federal income tax brackets

Right now, there are six marginal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. For 2010, these brackets apply to married couples filing joint federal income tax returns in the following manner:

2010 Marginal Income Tax Brackets

Married Filing Jointly

Taxable Income	*Marginal Tax Rate*
Not over $16,750	10%
Over $16,750 to $68,000	15%
Over $68,000 to $137,300	25%
Over 137,300 to $209,250	28%
Over 209,250 to $373,650	33%
Over $373,650	35%

As it stands now, these marginal tax brackets will expire at the end of 2010. There would be no 10% bracket for 2011, and the remaining bracket rates would return to their original 2001 levels: 15%, 28%, 31%, 36%, and 39.6%.

Long-term capital gain tax rates

For 2010, if you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, generally taxed at a maximum rate of 15%. If you're in the 10% or the 15% marginal income tax bracket, however, you'll pay no federal tax on the long-term gain (a 0% tax rate applies). That means if you're a married couple filing a joint federal income tax return, and your taxable income is $68,000 or less, you'd pay no federal tax on the gain.

However, these rates are also scheduled to expire at the end of 2010. Absent new legislation, in 2011, a 20% rate will generally apply to long-term capital gains. Individuals in the 15% tax bracket (remember, there won't be a 10% bracket in 2011) will pay the tax at a rate of 10%. Special rules (and slightly lower rates) will apply for qualifying property held for five years or more.

Finally, while qualifying dividends are taxed in 2010 using the same capital gain tax rates described above (i.e., 15% and 0%), in 2011 they'll be taxed as ordinary income.

Will Congress take action?

In the proposed 2011 budget submitted to Congress in February, President Obama asked for a permanent extension of the current 10%, 15%, and 25% marginal income tax brackets, and an expansion of the current 28% tax bracket. The current 33% and 35% brackets would be allowed to expire, resulting in the top two marginal rates for 2011 returning to 36% and 39.6%. The expanded 28% bracket would be calculated in a way that would allow individuals earning less than $200,000 (less the standard deduction amount and one exemption) and married couples filing jointly earning less than $250,000 (less the standard deduction and two personal exemptions) to escape taxation at the top rates.

The President also proposed making the current tax rates that apply to long-term capital gain (i.e., the 0% and 15% rates) permanent, but adding a new 20% rate for those in the newly reestablished 36% and 39.6% brackets.

Will Congress act, or will it simply let current rates expire? There's plenty of time before 2011, so stay tuned …

Social Security: File-and-Suspend for Higher Benefits

Although many people think of Social Security as only a retirement program, Social Security also provides survivor's benefits that can provide substantial income to your spouse after your death.

For more information, contact the Social Security Administration at 800-772-1213 or visit www.socialsecurity.gov.

If you're married and looking for opportunities to increase retirement income, you may want to look closely at your Social Security benefits. One opportunity for maximizing Social Security income, called "file-and-suspend," may enable a married couple to boost both their retirement and survivor's benefits.

What is file-and-suspend?

Generally, a husband or wife is entitled to receive a Social Security retirement benefit based either on his or her own earnings record (a worker's benefit), or on his or her spouse's earnings record (a spousal benefit), whichever is higher. But under Social Security rules, a husband or wife who is eligible to file for retirement benefits based on his or her spouse's record cannot do so until his or her spouse begins receiving benefits. However, there is one exception--someone who has reached full retirement age may choose to file for retirement benefits, then immediately request to have those benefits suspended, so that his or her eligible spouse can file for spousal benefits.

File-and-suspend is a strategy that may be used in a variety of situations, but is commonly used when one spouse has much lower lifetime earnings, and thus will receive a higher retirement benefit based on his or her spouse's earnings record. (A husband or wife's spousal benefit may be as much as 50% of what his or her spouse is entitled to receive at full retirement age.) Using this strategy not only allows the eligible spouse with lower earnings to immediately claim a higher (spousal) retirement benefit, but can also increase the amount of available survivor protection. The spouse with higher earnings who has suspended his or her benefits can accrue delayed retirement credits at a rate of 8% per year (the rate for anyone born in 1943 or later) up until age 70. Because a surviving spouse will generally receive a benefit equal to 100% of the retirement benefit the other spouse was receiving (or was entitled to receive) at the time of his or her death, suspending a benefit to accrue delayed retirement credits may substantially increase the survivor's benefit.

Example

Let's look at one hypothetical example of how filing for, then suspending, Social Security benefits might help a married couple increase their retirement income and survivor's benefits. Henry is about to reach his full retirement age of 66, but he wants to postpone filing for Social Security benefits. At full retirement age his monthly benefit will be $2,000, but if he waits until age 70 to file, his benefit will be $2,640 (32% more) due to delayed retirement credits. However, his wife Julia, who has had substantially lower lifetime earnings than Henry, wants to retire in a few months at her full retirement age (also 66). Based on her own earnings record, Julia will be eligible for a monthly benefit of $700, but based on Henry's earnings record she will be eligible for a monthly spousal benefit of $1,000 (50% of Henry's entitlement).

So that Julia can receive the higher spousal benefit as soon as she retires, Henry files an application for benefits, but immediately suspends it. That way, he can also continue to earn delayed retirement credits, which will result in a higher monthly retirement benefit for him later.

Using the file-and-suspend strategy not only increases Julia and Henry's retirement income, but it also offers increased survivor protection. Upon Henry's death, Julia will be entitled to receive 100% of what Henry was receiving (or was entitled to receive) at the time of his death. So by suspending his own retirement benefit in order to increase it through delayed retirement credits, Henry has ensured that Julia will receive a survivor's benefit that is up to 32% higher for the rest of her life should he die first. (Note, though, that this hypothetical example is for illustrative purposes only and does not account for cost-of-living adjustments or taxes.)

Points to consider

- Deciding when to begin receiving Social Security benefits is a complicated decision. You'll need to consider a number of scenarios, and take into account factors such as both spouses' ages, estimated benefit entitlements, and life expectancies. A Social Security representative can help explain your options.
- Ask a tax professional to help you weigh the tax consequences of delaying Social Security income.
- Using the file-and-suspend strategy may not be advantageous when one spouse is in poor health or when Social Security income is needed as soon as possible.
- The spousal benefit will be reduced if the spouse claiming it is under full retirement age.

Using Yield to Evaluate Stocks and Bonds

A core consideration for income investors is an investment's yield, which indicates the value of the payments you'll receive. Yield can be a useful tool in considering whether you'd rather try to generate future income from bonds or stocks, and whether its price is appropriate.

Dividend yield

Dividend yield reflects how much of a company's value gets passed on to shareholders. To calculate it, divide the annual dividend by the price for a share of the company's common stock. For example, if a stock offers a $1.75 annual dividend and its share price is $50, its dividend yield would be 3.5%.

A stock's yield also can help you determine whether a stock is undervalued or overvalued relative to its projected income. The dividend discount model uses dividend yield to calculate what the current value of a stock should be based on its anticipated dividends in the future. If dividends are expected to grow rapidly, the present value of a stock should be higher than if dividends are expected to remain relatively static.

Dividend yield only goes so far as a valuation tool. Obviously, a company isn't necessarily worthless just because it may not pay dividends, and the calculation is only as good as the assumptions it's based on. A company can always cut its dividend (just ask shareholders of the nation's banks), in which case the present value of that income stream--and presumably the stock's price--would also drop. A company's growth rate may vary over its life cycle; trying to guess when dividends might change and by how much makes the dividend discount calculation even more challenging.

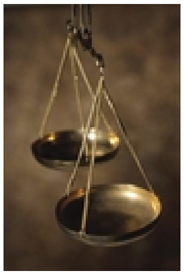
Bond yields

There are many different measures of yield on a bond. Current yield can tell you what your periodic interest payments represent as a percentage of your initial investment. However, for purposes of comparison with other investments, you may also want to consider the value of those interest payments over the life of the bond, including what you could earn by reinvesting those payments at the yield available when you bought it. That's measured by a bond's yield to maturity.

Comparing stock and bond yields

In addition to being a tool for evaluating individual stocks and bonds, yield can be used to assess the relative value of the stock and bond markets as a whole. A method informally known as the Fed model can help you estimate whether stocks are overvalued or undervalued relative to bonds. (However, the so-called Fed model is not officially endorsed by the Federal Reserve.)

Though there are variations on the method, the original model compares the yield on the 10-year Treasury note to the forward-earnings yield per share of the S&P 500. Earnings yield is calculated in much the same way as dividend yield is: by dividing the per-share earnings forecast (rather than the anticipated dividend) for the next 12 months by the current share price. If the result is lower than the yield to maturity on a 10-year Treasury note, stocks might be overpriced. Why? Because the Treasury note offers a higher yield that involves less risk. On the other hand, if the forward-earnings yield on stocks is higher, then you're at least being compensated for the higher risk involved with stocks.



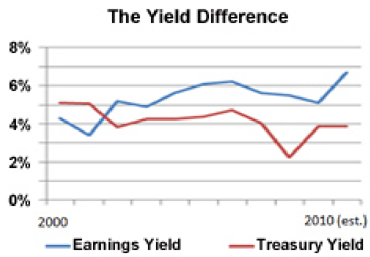


Chart calculated on 10-year Treasury yields and 12-month actual operating earnings for S&P 500 as of December 31 of each year, plus current yield and forward earnings forecast as of April 2010. Data sources: Standard & Poor's, U.S. Treasury.

However, for the average investor, the model also has flaws. If earnings prove weaker than predicted, actual stock yield might not be as high, which would throw off the comparison. Also, using trailing earnings over the previous 12 months rather than forward earnings as your yardstick would give you a different result. Dramatic swings in Treasury prices can make stocks seem less expensive than they might be when compared to their historical performance. And even if equities or bonds appear cheap, there's no guarantee either one won't be an even better bargain in the future.

Yield shouldn't be the only factor in your decision, but it can help you compare apples and oranges.

"In addition to being a tool for evaluating individual stocks and bonds, yield can be used to assess the relative value of the stock and bond markets as a whole."

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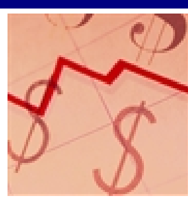
Ask the Experts



How have stocks performed after a recession?

Mark Twain said it best: "History doesn't repeat itself; at best it sometimes rhymes." Past performance is no guarantee of future results, and history can be an uncertain guide in terms of what might happen with stocks this time around as the economy begins to stagger out of a recession.

That said, it's fascinating to look at how various subsegments of the stock market have behaved relative to one another. Particularly interesting is the comparison between the performance of small-cap stocks and that of large caps after each of the last six recessions. In each case, small caps led the way out of those downturns. During the 12 months after the recession came to an end, as declared by the National Bureau of Economic Research (NBER), small caps beat large caps every time.

The average difference over the six recovery periods was 14.5%. In some cases, the difference was dramatic; in others, small caps were barely ahead. Here are the percentages by which small caps beat the S&P 500*:

- December 1970-November 1971: 1.3%
- April 1975-March 1976: 23.2%
- August 1980-July 1981: 28.4%
- December 1982-November 1983: 14.4%
- April 1991-March 1992: 14.8%
- December 2002-November 2003: 5.2%

Will history rhyme this time? It's hard to say. Many economists feel the current recession ended sometime in summer 2009. Small-cap stocks have certainly done well since then, but some experts feel large caps are best equipped to navigate a credit crisis. However, until the NBER retroactively declares an official end to this recession, there's no way to know for sure. And don't forget that small caps historically have involved greater risk from market fluctuation, so a double-dip downturn could hit them hardest.

*Percentages calculated based on data from Ibbotson SBBI *Market Results for Stocks, Bonds, Bills, and Inflation* for small company stocks and the S&P 500 Composite Index.