



## Fullerton Tax & Planning

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*"Real People provide Real Service"*

**August, 2011**



It is August and we have experienced a new piece of history. Our Congress has decided to air their dirty linen for the world to see. As if Greece and Portugal were not good enough examples of how to not do it.

So all market action has been shut down until Wall Street gives Congress the green light. By the end of this first week of August, we will have something to move forward on. Wall Street is busy buying all the cheap Blue Chip stocks and will make another cool multi billion profit on the inevitable rally. So much for insider trading. Now Wall Street has so much power over Washington, that they can move markets through politicians.

Meantime, the prudent action is to sit in cash until the initial action is done on the Debt Ceiling. Then we need to see what sectors will experience more unemployment when the government cuts its budget by a trillion dollars.

Remember, this is a demand side action. No revenue increases are anticipated in the forthcoming cuts. Tax reform is promised, which has been a perennial request by many Congresspersons. Any good business leader can tell you that if you cut spending, but don't attempt to raise revenue, you will eventually be out of business.

As to the Social Security Trust Fund, the pundits have always referred to it as a separate fund from general government processes. So why is it that come the 3rd of August, the "Trust Fund" will not have enough monies to pay Seniors their monthly check?

On to other items.

### Planning Ahead

Advance directives allow patients make their-end-of-life wishes known in the event they are unable to communicate. Here are some typical directives.

- A **living will**: This instructs family and medical providers on the treatments that a patient wants to receive. The most common decision involve these life-sustaining treatments.
  - a) Cardiopulmonary resuscitation (CPR): Used when a patient's heart or breathing stops.

b) A Do Not Resuscitate (DNR) order. A written physician's order that prevents the health-care team from initiating CPR.

c) A Do Not intubate (DNI) order: Intubation is the placement of a tube into the nose or mouth in order to have it enter the windpipe (trachea) to help the patient breathe.

d) Artificial nutrition and hydration: Used when patients are no longer able to take food and fluid by mouth.

- **Medical power of attorney** lets patients select someone else, usually a family member or close friend, to make care decisions when patients are temporarily or permanently unable to communicate or make decisions on their own.
- **Physician Orders for Life-Sustaining Treatment**, or Polst, is a medical order form signed by the patient and the doctor. It becomes part of the patient's medical record and provides specific instructions to the medical team on such issues as the use of mechanical breathing machines and feeding tubes.

## For fee-conscious, mutual funds and ETFs are a winning parlay

### BERKSHIRE HATHAWAY

Michael D. Stark, director of client services for American Financial Advisors LLC, helps keep investment costs low by putting a portion of his portfolio in shares of Berkshire Hathaway Inc., the diversified company run by Warren E. Buffett. Berkshire Hathaway has been compared to a mutual fund because of the diversity of its investment portfolio, and there is no annual expense ratio on equity shares.

Mr. Stark said that he uses the stock to complement the rest of his portfolio, which is invested in low-cost funds.

Putting the right investments in the right accounts for tax management is another way to cut costs for clients, Mr. Marotta said. One strategy that saves money is to put the foreign-investment portion of the portfolio into a taxable account so that investors can take advantage of the income tax deduction for taxes paid on foreign investment income, he said.

## What Will It Take for Companies to Unlock Cash Hoards?

There is cash crisis incorporate America although it comes not from as shortage of the stuff, but from surplus.

In the first quarter, the five companies with the greatest cash hoards—**Microsoft, Cisco Systems, Google, Apple** and **Johnson & Johnson**—added \$15 billion in cash and marketable securities to their balance sheets. Microsoft alone packed away roughly \$9 billion, or \$100 million a day. All told, the companies in the standard & Poor's 500-stock index are sitting on more than \$960 billion in cash, a record.

To be sure, at many companies the cash piling up is at global operations that generate "undistributed foreign earnings" that can't be brought home, under U.S. law, without incurring taxes of up to 35%. But hundreds of billions in cash remain available and idle.

Meanwhile, the payout ratio the proportion of earnings paid out as dividend income to shareholders fell to 28.9% for the past four quarters. That, say S&P senior index analyst Howard Silverblatt, is the lowest level since 1936. Dividends are going up—**Intel, United Health Group** and **WellPoint** have recently raised them but cash is still piling up faster than most industrial giants can possibly find a prudent use for it. Of course, investors themselves might have a better use for the cash, if they could get at it.

As Daniel Peris, co manager of the Federated Strategic Value Dividend fund, says, "The likelihood of spending money poorly is increased by having a surplus of it."

Microsoft's purchase price for the online telecommunications firm Skype, widely criticized as too rich at \$8.5 billion, almost precisely matches the amount of cash that Microsoft raked in last quarter. Was that torrent of cash burning a hole in Microsoft's pocket?

“No way,” says Bill Koefoed, general manager of investor relations at Microsoft. “We see this as being a very strategic acquisition,”

The heart of the problem, as the great investor Benjamin Graham pointed out decades ago, is that the best interests of corporate management and outside investors are at odds. That is especially true for giant companies whose growth has been slowing.

“The more dubious the company’s prospects the more anxious management is to retain all the cash in the business,” Graham wrote. “But the stockholders would be well advised to take out all the capital that can be safely spared, because these funds are much more valuable to them if in their own pockets, or invested elsewhere.”

Amnesia is another culprit. In the past, companies paid out vastly more of their profits as dividends, and they should again. “If there were a greater historical sensibility among investors and managers,” Mr. Peris says, today’s low payouts “would be called out as an abnormal situation that’s likely to lead to that money being less well-spent than it otherwise might be.”

Dividends have gotten short shrift in recent years as investors have come to favor companies that instead use cash surpluses to buy back their shares. Meanwhile, with the economic recovery barely out of the sickbed, many companies are reluctant to invest heavily in expansion. Others want to keep cash handy for potential acquisitions. So cash sits idle even as interest rates, after inflation, are so low that cash often produces negative real returns.

Benjamin Graham made three simple proposals in 1951 that deserve to be reviewed.

First, investors need to realize that a company’s cash is a valuable asset, even when interest rates are low; if management won’t put it to good use, investors must speak up. As Graham wrote: “When the results on capital are unsatisfactory, it is appropriate for stockholders to insist that it be returned to stockholders on an equitable basis.”

Second, companies should set formal dividend policies. Rather than paying or raising dividends out of the blue, they should state in advance what proportion of earnings they expect to pay out as cash dividends. If, instead, they plan to use excess cash to buy back shares, they should offer hard evidence that the stock is undervalued.

Finally, Graham advocated that leading companies should pay out two-thirds of their earnings as dividends.

That rate isn’t as radical as it might sound, even though it would amount to more though it would amount to more than a doubling from today’s levels. The dividend payout, as a percentage of total profits, has averaged 52.3% since 1936 and 46% over the past tow decades, according to Standard & Poor’s.

If the companies in the S&P 500 raised their payout ratio to 50%, Mr. Silverblatt estimates, that would put an extra \$207 billion into investors’ pockets at a time when shareholders’ dividend income is taxed at historically low rates.

:Companies are basically earning more than they’ve ever made before, but their payouts are nowhere near that high,” says Mr. Silverblatt. “They’re holding their cash really tight. You can call them Scrooges if you want.”

## **Self-Employed Are-Frozen Out Of Mortgages**

### **Efforts to Jump-Start Lending Bypass Those Without W-2s; The Trouble With Jumbos**

The government’s recent moves to backstop the mortgage market have made it easier for many people with decent credit scores to get a loan. But for many self-employed people even those with pristine credit the mortgage freeze has yet to thaw.

A reversal of the loose lending practices that led to the banking industry’s current woes was certainly expected. But some economists and mortgage brokers say lending standards have become overly restrictive, which could be exacerbating the credit crunch and helping push down home prices further.

“Underwriting criteria have swung from foolish ease to tighter than any in modern times,” says Lou Barnes, a mortgage banker in Boulder, Colo.

The changes are increasingly frustrating a group of borrowers whom banks once coveted: affluent self-employed professionals such as doctors, lawyers, accountants and small-business owners.

Hubert Noguera, a 38 year old medical-device engineer who also owns a small business, is one of them. He can't get approved for a loan, even though he has a strong 800 credit score and is prepared to make a 40% down payment on a house near San Francisco in the \$800,000-to-\$900,000 range. Mr. Noguera says he has assets worth three-times the \$500,000 loan he's requesting and is in the process of selling his share of a recently inherited residence in Saratoga, Calif., worth \$1.1 million.

Banks have turned down the loan because the amount he's requesting appears high relative to the portion of his income that he can full document and they won't consider his other income, says his mortgage broker, Connie Madrid.

“My blood type is O positive. What else do they want?” Mr. Noguera recalls asking Ms. Madrid.

The chief problem for self-employed people is that they don't have W-2 forms from an employer to document their full wages. For proof of income, they must rely solely on their income tax returns. But income for self-employed is often understated for tax purposes, in part because they tend to take large business-related deductions. Self-employed borrowers who don't take any big deductions won't likely face the same difficulty getting a loan.

“When you're self-employed, the write-offs that you use help at tax time but that means when you apply for a loan, your income won't reflect your cash flow,” says Richard Redmond, a mortgage broker in Larkspur Calif.

On the Markets.....

THE MONTHLY INDEX REPORT FOR JULY 2011				
Index	July 2011	QTD	YTD	Description
S&P 500 Index	-2.0%	-2.0%	3.9%	Large-cap stocks
DJIA	-2.1%	-2.1%	6.4%	Large-cap stocks
Nasdaq Comp	-0.6%	-0.6%	4.4%	Large-cap tech stocks
Russell 1000 Growth	-1.0%	-1.0%	5.8%	Large-cap growth stocks
Russell 1000 Value	-3.3%	-3.3%	2.4%	Large-cap value stocks
Russell 2000 Growth	-3.9%	-3.9%	4.3%	Small-cap growth stocks
Russell 2000 Value	-3.3%	-3.3%	0.3%	Small-cap value stocks
EAFE	-1.6%	-1.6%	3.7%	Europe, Australasia & Far East Index
Barclays Capital U.S. Aggregate	1.6%	1.6%	4.4%	U.S. Government Bonds
Barclays Capital U.S. High Yield	1.2%	1.2%	6.2%	High Yield Corporate Bonds
Calyon Financial Barclay Index*	2.5%	2.5%	-1.5%	Managed Futures
3-month Treasury Bill	0.0%	0.0%	0.0%	

*All returns are estimates as of 7/29/11; Return numbers include reinvestment of dividends.  
\*Returns are estimates as of 7/28/11.*

From Standard & Poors...

**U.S. JOB RECOVERY COULD TAKE YEARS:** More than two years after the recession ended, 9.2% of Americans are still unemployed, the highest unemployment has been since it hit 9.4% in December 2010. Unfortunately, it may take until 2016 — longer than after any post-World War II downturn — to replace the 7 million jobs that were lost, according to a recent report by management consultant McKinsey. Following the recessions from World War II to

November 1982, it took about six months for employment to return to prerecession peaks, the study says. After the 1990-91 recession it took 15 months, and after 2001 it took 39 months. This time, it could take 60 months or more for employment to fully recover from the 2008-2009 recession, the report says. Standard & Poor's sees U.S. GDP rising 3.4% in 2014 and 2015, but more help may be needed to spur job growth. One idea would have the government offer tax breaks to companies that "boost their payrolls," says Alan Blinder, professor of economics and public affairs at Princeton University, and a former vice chairman of the Federal Reserve, in the Wall Street Journal. / Art Epstein

## **ETFs EXPECTED TO JUMP:**

Exchange-traded funds (ETFs) have been very popular with U.S. investors since the first ETF debuted in 1993, with assets now totaling \$1.09 trillion spread among 1,045 products as of May 2011, according to Investment Company Institute data. U.S. ETF assets are expected to double to \$2 trillion before the end of 2015, says a report by BNY Mellon and consultant Strategic Insight. The share of the market held by passively managed, index-tracking ETFs is projected to decline as non-traditional and alternative funds grow, report says; between the end of 2008 and March 31, 2011, non-traditional U.S. ETFs rose from 18% of the market to an estimated 30% of the market. "Non-traditional ETFs will continue to increase their share of the ETF market," said Loren Fox, senior research analyst at Strategic Insight and an author of the report. "Commodity, leveraged, inverse, actively managed and hedge-fund-like ETFs are among the non-traditional ETF types that should see market share growth between now and 2016." / Art Epstein

## **IRS: No Charitable IRA Do-Over**

### **Taxpayers Can't Roll Back Payouts, to Their Frustration**

It is official: Many taxpayers who were hoping to make charitable IRA donations for 2010 won't be able to do so.

The Internal Revenue Service issued a statement saying that the law doesn't allow taxpayers to return payouts taken last year in order to make direct charitable Individual Retirement Account donations for 2010.

The questions arose after lawmakers tacked a provision into the giant December tax package that retroactively extended the IRA charitable donation. This highly popular rule, which had expired at the beginning of 2010, allows taxpayers, who are 70 ½ or older to donate up to \$100,000 a year of IRA assets directly to a charity. There isn't a deduction for the gift, but it doesn't count as income and it can satisfy the Required Minimum Distribution, or RMD.

Lawmakers, recognizing that their own delays had caused problems, gave taxpayers until Jan. 31 of this year to make 2010 donations.

But the law didn't address the predicament of those who wanted to make IRA donations last year but took required payouts instead, often at the last minute, because they were afraid Congress wouldn't extend the law.

Taxpayers like Earl Kirk of Houston are still angry, however. Mr. Kirk says he "waited all year" to see if Congress would extend the provision.

"I gave up on Dec. 12, five days before they acted, and made my contribution from taxable sources," he wrote in an email. "The practice of extending tax rules two years at a time makes long-range planning impossible, and adds measurably to my fury with Congress,"

On Jan 5, the IRS released a statement through a spokesman citing the law, which prohibits required payouts from being rolled back into an IRA for any reason.

It added, "There's no provision in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, nor any hint in the Committee Report for such RMD recontribution."

Translation: The IRS has no authority to allow taxpayers to roll their payouts back into their IRA and then make the allowed donation.

Experts expected this answer. "This won't help the many who already took their 2010 RMD's," says Blanche Lark Christerson, a Managing director at Deutsche Bank Private Wealth Management. "But it does allow those who really want to help charities to double up in 2011, provided one of the gifts is made in January and they make the appropriate election."

## Stock Picking Gets Trickier

A year ago, stocks were moving in such unison that traditional fund managers couldn't hope to beat the market. Now stocks are trading much more on their fundamentals but managers still are having a tough time outperforming.

The average large-cap fund has returned just 4.52% this year, according to investment-research firm Morningstar Inc., compared with the Standard & Poor's 500-stock index's 4.96% rise. And only 31% have outperformed their relative benchmarks in the first six months of 2011, less than the historical six month average of 41%.

So what is going wrong now? Company-specific factors like the quality of management and earnings performance account for only about half of a stock's movement, says Adam Parker, chief U.S. equity strategist at Morgan Stanley. The other half can be explained by other factors, including market capitalization and valuation measures that are subject to the whims of investor sentiment. Such factors are having a larger effect on stocks than at any time since the early 1990s, Mr. Parker says.

"You have to pay attention to other variables," he says. "Why spend 100% of your time on something that matters just 50%?"

Among the biggest variables affecting a stock's performance these days is its sector. Some 75% of consumer-staples and health-care stocks have beaten the S&P 500 this year, according to Birinyi Associates. On the other hand, only 43% of tech stocks have outperformed.

Size almost matters. The 50 biggest stocks in the S&P 500 have gained just 2.93% this year, while the 50 smallest have advanced 4.45%. The middle 100 meanwhile, have gained 9.1%, more than double the S&P 500 overall.

But strong short term performance doesn't necessarily translate into long term gains. Just a quarter of large cap growth, value and blend funds have beaten the S&P 500 this year and over the past 10. The big winners include **Wells Fargo Advantage Growth**, which is up 13.3% this year and has gained 5.9% annually during the past 10 years, and the **Sequoia Fund**, which gained 11.1% this year and is up 6.1% during the past 10. The S&P has returned a total of 2.61% annually over the past 10 years.

Bottom line: "It's really hard for an actively managed large cap fund to add a whole lot of extra value," says Matthew Tuttle, chief investment officer at Tuttle Wealth Management in Stamford, Conn.

So, here's to a better August and Fall. Less heat in Texas and more rain for all. Have a great month, stay cool and we will see you in September. You can find us on Facebook and Twitter.



Mary Ahart

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