The Thoughtful Investor™

James W. Olsen, CFP® | Legacy Investment Strategies | First Quarter 2013

Be Wary of Too Conservative of an Investment Approach

There are a number of reasons to be wary of the financial markets in 2013, from the difficult economic and political decisions facing the President and Congress to the potential of the U.S. economy dropping back into recession, violence in the Middle East, and economic uncertainty in Europe and China. Add in the *presidential cycle*, where stocks have historically performed worse in the first and second years of a president's term and a conservative investment posture looks even more attractive.

Except when it doesn't.

The problem with taking a too conservative approach to investing in 2013 is the loss of opportunity. For the financial markets, the last decade has been one of minimal returns. Many retirement plans are underfunded, goals have been postponed, and quality of life reduced in response to economic concerns. If there is an opportunity for investment gains, the conservative investor is likely to miss those gains …keeping in mind that reverse is also true, a conservative posture may avoid losses.

Markets are not always logical, nor do they necessarily meet expectations.

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The Human Factor Adds Uncertainty to Economic Planning

The best laid schemes o' mice an' men
Gang aft a-gley, [often go awry]
An' lea'e us nought but grief an' pain,
For promised joy.

From Robert Burns' poem *To a Mouse*, 1786

One of the most amazing aspects of listening to plans for tax increases and government revenue projections is the assumption that people will not change their behavior in response to economic incentives or penalties.

This is where the best laid plans of those arguing for *tax the rich* will go awry.

"In testimony before the Senate Committee on Finance…the Joint Committee on Taxation (JCT) explained that, '*A tax expenditure calculation is not the same as a revenue estimate for the repeal of the tax expenditure provision*.' For one thing, '*unlike revenue estimates, tax expenditure calculations do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision*.'"[1]

One reality that needs to be a part of any legislative attempt or projection is that people will act in what they perceive is their best economic interest. Since paying more taxes is rarely in one's best economic interest, as soon as tax legislation is passed (and often before) the search begins to find

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What is in Your "To Go" File?

Fortunately, disasters on the level of super storm Sandy don't happen very often. But if you are the one in the midst of the disaster, it doesn't matter how large it is, you need to have a "to go" file ready.

The purpose of the "to go" file is to make recovering from a disaster easier. You want to have readily accessible the documents and contacts you will need in the event you are unable to access your records and you need help. This should include copies of hard-to-replace documents that you keep in a safe deposit box away from your home or the originals:

- Vital papers including passports, birth certificates, wills, deeds, automobile titles, loan documents, insurance policies
- Copies of stock certificates, Treasury notes, bonds, and other proof of investments
- Investment, savings, checking and credit card account numbers and contact information
- Copies of prescriptions and medical information that might be needed by a medical provider
- An inventory of home possessions with photographs on computer disk or usb stick
- Phone numbers and addresses of insurance agents, investment advisers, family members, and key people in your life
- Login IDs and passwords to online files and accounts

Everyone in your family should know where to find the file and be prepared to take it should evacuation be required or your home threatened.

Be Wary of Too Conservative of an Investment Approach — *continued from page 1*

The number of highly paid and highly respected market analysts who have been 100% wrong increase each year.

All of which adds up to the reason we believe an active approach to investing is essential. Active investment management is the effort to identify and invest in sectors of the market that are increasing in value and to avoid investments that are losing value. A typical active investment approach relies on technical analysis – looking at what the market is actually doing at the moment versus expectations or forecasts. An active investment strategy cannot guarantee profitability. Not every buy or sell decision will be on the right side of the trade. But active management is the only investment approach that allows the investor to react to current market action to limit losses or position assets to strive to take advantage of rising trends.

The common argument against active investment management is the "Miss the Best" analysis. In this rebuttal of the active management advantages, the critic points out that there has never been a perfect investment approach and that by taking an active approach to the market the investor runs the risk of "missing the best days of the market," resulting in a significant reduction in returns.

What "missing the best" proponents carefully overlook is the power of "missing the worst." The table below shows what the impact would have been of missing the 10, 20 or 40 best, worst, and both the best and worst days over the last 25 years.

Impact on Average Annual Return
S&P 500 – 25 Years Ending Dec. 31, 2012
Average Annual Return 7.26%

	Miss the Best	Miss the Worst	Miss Both Best and Worst
10 days	3.54%	9.74%	7.03%
20 days	1.60%	14.63%	7.50%
40 days	-1.59%	18.31%	7.76%

Source: Hepburn Capital Management 2012 Study. The S&P 500 is an index and as such cannot be invested in directly.

Keep in mind this is a hypothetical example. Statistically, missing only the best or worst days of the market is virtually impossible. In fact, because the best days tend to closely follow the worst days, sometimes occurring back to back, a likely scenario is that an investor would miss both the best and worst days. Which isn't a bad thing based on the hypothetical returns. Missing both the best and worst days outperforms a buy-and-hold position with significantly less volatility/risk. With that said, there is a lot more to the market's ability to produce gains than a limited number of days. The goal of active management is to make certain investors are participating in upward trends, the longer the better.

What is perhaps most important about an active management approach is its focus on minimizing losses should the market turn against a position. By having the ability to respond to market declines, portfolios can leave the shelter of conservative, low-return investments and take on more risk in uncertain markets.

With that said, the active management approach needs to be the right one. That means talking with your investment adviser to understand how investment decisions are made, when sell signals result and the potential for drawdowns (i.e. losses) in the portfolio. While the goal of an active investment approach is always to return alpha – excess return over the market or benchmark – its ability to limit risk is crucial in the uncertain markets ahead in 2013.

The Human Factor Adds Uncertainty to Economic Planning — *continued from page 1*

ways to reduce the tax bite. If your income is the result of a paycheck, reducing the tax bite requires reducing employment income through deductions such as retirement plan contributions, income deferral, using vacation and sick leave time rather than being compensated those hours, etc.

Since income for the "rich" is typically not a paycheck, different strategies come into play, the first of which is to avoid realizing capital gains by holding on to investments or offsetting gains with tax losses. Instead of a vacation home, one invests in a working ranch with a really nice ranch home where costs can all be offset against ranch operations. Interest can be sheltered from taxes by moving from taxable debt instruments to municipal bonds, which (as of now) do not incur federal income taxes in exchange for lower interest rates, lowering borrowing costs for municipalities. Rather than invest in dividend paying equities, one invests in companies with a policy of stock buybacks, which has the potential to increase share values.

Deductions for state income and property taxes, as well as charitable contributions are another means of reducing income. With access to top tax advice, wealthy individuals tend to be more aggressive at taking advantage of deductions. And, there is always the opportunity of investing in other countries.

All of which is why it is best to plan ahead for higher taxes for the "no so rich" as well if current social programs are to be maintained and the deficit reduced.

1 "Tax Breaks Under Fire," by Laura Saunders, The Wall Street Journal, November 2, 2012.

Time for an Annual Check of Your Credit Report

In 2005, the Fair and Accurate Credit Transactions Act (FACT Act), took effect, enabling consumers — by contacting a single number, Web site or address — to request their credit reports from the three major credit bureaus at no charge once a year. We recommend everyone make a habit of doing so every year.

Credit reports are used by lenders, rental agencies, potential employers and even to qualify you for some volunteer positions, so it's important to make certain your credit is as clean as possible. Checking your credit report is also one way to find out if you are a victim of identity theft.

You can order your free annual credit report

- online at www.annualcreditreport.com,
- by calling 877-322-8228,
- or by completing the Annual Credit Report Request Form (available online at www.annualcreditreport.com) and mailing it to: Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.

www.annualcreditreport.com is the only authorized source for your free annual credit report from the three nationwide consumer reporting companies, so don't fall for marketing pitches from other organizations offering to provide you with a free credit report. Those offers typically come with strings attached. When you contact the site, request credit reports from all three of the major credit bureaus – TransUnion, Experian and Equifax.

If there are any inaccuracies on your report, talk with a representative of the credit bureau immediately and find out what needs to be done to correct the information. But don't stop there. If you suspect identity theft, request that the consumer credit reporting companies place "fraud alerts" in your file to let potential creditors and others know that you may be a victim of identity theft. A fraud alert can make it more difficult for someone to get credit in your name because it tells creditors to follow certain procedures to protect you. It also may delay your ability to obtain credit. File an identity theft report with your local police at once. Notify any creditors you don't recognize that there is a problem with the account.

Under federal law, you are also entitled to a free report if you are denied an application for credit, insurance, or employment. You must ask for the report within 60 days of receiving notice of the action. You're also entitled to one free report a year if you're unemployed and plan to look for a job within 60 days; if you're on welfare; or if your report is inaccurate because of fraud, including identity theft. Otherwise, a consumer reporting company may charge you up to $9 for another copy of your report within a 12-month period.

Making Better Decisions Requires Accepting Change

At 48, Jeff Bezos, founder of Amazon, is one of the world's richest men, with a net worth in excess of $32 billion. Yet, he continues to seek out new investments, looking for people who are "right a lot."

According to Bezos, these are *people who often changed their minds*. Based on his observations, the smartest people are constantly revising their understanding, reconsidering a problem they thought they'd already solved. They're open to new points of view, new information, new ideas, contradictions, and challenges to their own way of thinking.[2]

The people who are wrong most of the time, says Bezos, are those who are obsessed with details that only support one point of view; they don't see the issue from multiple angles. Behavioralists call this cognitive filtering, in which, to reduce dissonance or stress, we unconsciously filter out facts that don't agree with our preconceived ideas.

How do you open your mind to change? Start by altering your routines, challenging your perception of "me." Routines tend to be grooves in our lives. The more we do something the same way, the more ingrained that pattern becomes and the harder it is to change. Then you need to change the stories you tell yourself as to who you are. Our identities are in the stories we tell ourselves about ourselves. To encourage a change in who we are, our openness to new ideas or new patterns of behavior, we need to identify emotionally with a version of ourselves that is open to change. Sounds like psycho babble? Perhaps, but the *story* has much greater selling power than facts and figures.

2 "Jeff Bezos: People Who Are Right Are People That Change Their Mind A Lot," by Jay Yarow |Business Insider, Oct. 19, 2012- http://www.businessinsider.com/jeff-bezos-on-people-who-are-right-2012-10#ixzz2CJrbyKi8

LEGACY INVESTMENT STRATEGIES

RETURN SERVICE REQUESTED

James W. Olsen, CFP®
Legacy Investment Strategies
1601 Belle Chasse Hwy. Ste. 200
Gretna, LA 70056
PH: (504) 361-7788
Fax: (504) 361-8844
Toll Free: 800-592-4011
www.legacyinvestment.net

Maximize Retirement Plan Contributions

When it comes to building financial security, there is no substitute for setting aside and investing a portion of your earnings every year. Retirement plans are an ideal vehicle for savings due to their ability to defer taxes on gains until withdrawn at retirement. In addition, contributing to a retirement plan may lower your current income, reducing your income taxes.

If you are over 55, you can take advantage of "catch up" contributions of $1,000 to $5,500, designed to help individuals nearing retirement set aside tax-deferred funds at a higher rate.

Employer-sponsored retirement plans may also offer matching contributions, adding to the value of your savings.

With that in mind, the following table provides employee contribution limits for the dominant retirement plans.

Tax-Deferred and Tax-Exempt Plan Employee Contribution Limits for 2012 and 2013

Type of Retirement Plan	Maximum Annual Contributions			
	2012		2013	
	Under Age 50	50 and Older	Under Age 50	50 and Older
Individual Retirement Plans*				
Traditional and Roth IRA	$5,000	$6,000	$5,500	$6,500
Employer-Sponsored Retirement Plans				
401(k), Roth 401(k), 403(b), 457 and SARSEP Plans	$17,000	$22,500	$17,500	$23,000
Small Business or Self-Employed Retirement Plans				
Self-Employed 401k (a.k.a., Solo-401k, Individual 401k, Roth 401k)	100% of compensation up to $17,000	100% of compensation up to $22,500	100% of compensation up to $17,500	100% of compensation up to $23,000
SIMPLE (Savings Incentive Match Plan for Employees) IRA or 401(k)	$11,500	$14,000	$12,000	$14,500
Coverdell Education Savings Account*				
Per beneficiary under age 18	$2,000		$500**	
Health Savings Account				
		55 and Older		55 and Older
Individual Family	$ 3,100 $ 6,250	$4,100	$3,250 $6,450	$4,250
Annual Gift Tax Exclusion				
Amount that can be given from an individual to an individual without incurring gift taxes	$13,000	$13,000	$14,000	$14,000

**Traditional and Roth IRAs and Coverdell Education Savings Accounts have income phase-out ranges for determining tax deductibility or eligibility. Please check with your tax adviser or review literature on these retirement accounts to make certain you qualify.*

Employer sponsored retirement accounts are subject to limitations with respect to employee elective contributions. Employees classified as "Highly Compensated" may be subject to contribution limits based on their employer's overall participation and the participation of other employees. Check with your firm's human resources department if you have questions about your plan. Anyone age 50 or older is eligible to make catch-up contributions. Employers are not required to permit catch-up contributions; however, since these contributions are not subject to nondiscrimination rules and eligibility is easily established, most permit catch-up contributions. The preceding information is not intended as tax or legal advice. Please check with your appropriate advisers if you have questions regarding your retirement accounts.

*** Unless Congress intervenes, these accounts will be a lot less attractive in 2013.*