February 2013 | Vol. No. 1 | Investment Updates

# Risk, Not Volatility, Is the Real Enemy

What would you do if your investments lost 10% in a single day? A) Add more money to my account. B) Hold steady with what I've got. C) Yank my money; I wouldn't be able to stand any more losses.

If investors buy the right investments but sell them at the wrong time because they can't handle the price fluctuations, they may have been better off avoiding those investments in the first place. Most investors are poor judges of their own risk tolerance, feeling more risk-resilient in up markets and more risk-averse after market losses. However, focusing on an investor's response to short-term losses inappropriately confuses risk and volatility. Understanding the difference between the two and focusing on the former is a potential way to make sure you reach your financial goals.

Volatility encompasses the changes in the price of a security, a portfolio, or a market segment, both on the upside and downside, during a short time period like a day, a month, or a year. Risk, by contrast, is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. So how can investors focus on risk while putting volatility in its place? The first step is to know that volatility is inevitable, and if you have a long enough time horizon, you may be able to harness it for your own benefit. Diversifying your portfolio among different asset classes can also help mute the volatility. It helps to articulate your real risks: your financial goals and the possibility of falling short of them. Finally, plan to keep money you need for near-term expenses out of the volatility mix altogether.

Investing in securities always involves risk of loss. Diversification does not eliminate the risk of experiencing investment losses.

## Advisor Corner

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New Year, new look! Please let us know what you think of our new format. We will continue to strive toward providing value to our clients by keeping you informed on important updates.

Due to the increase in electronic statements, we are no longer adding our newsletter to our quarterly statement mailings. Electronic versions of the newsletter will be sent by email and available at www.citystatebank.com under "News & Alerts." We will also maintain paper copies in each of our branch locations. If you have not received an electronic copy by email, please contact us at the following email address to be added to our distribution list. Also, please make sure your spam filter has approved the following email address: trustandinvestments@citystatebank.com.

Thank you for helping make 2012 a great year, we look forward to an even better 2013!

# Dividend Income During Downturns

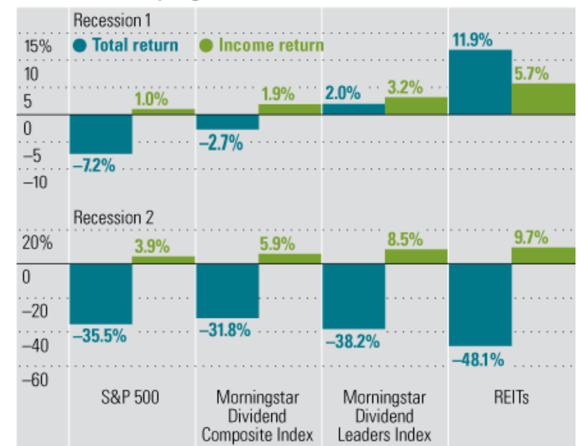
During a recession, the stock market can lose significant value. This could have a large impact on portfolio returns. Predicting the duration and extent of recessionary periods is almost impossible. During such times, income-producing investments such as dividend -paying stocks and REITs may soften losses, particularly when investors incur negative returns. This means that, if and when dividends are paid out, they have the potential to act as a cushion and are positive whether stock returns are positive or negative.

The image compares the total return and income return for the S&P 500 index, Dividend Composite index, Dividend Leaders index, and REITs for the past two recessions in 2001 and 2007. As seen in the image, dividend-paying stocks and REITs produced higher income returns relative to the S&P 500 over the given time periods (however, keep in mind that REITs are far more risky than their typical common stock counterparts). Stocks that pay dividends may serve as an income source while also providing investors with exposure to the growth potential of the stock market.

Dividends are not guaranteed and are paid at the discretion of the stock-issuing company. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks and REITs are not guaranteed and have been more volatile than the other asset classes. REITs are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. REITs must distribute at least 90% of taxable income annually to shareholders.

The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index that have a consistent record of dividend payment and have the ability to sustain their dividend payment. Stocks in the index are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Leaders Index captures the performance of the 100 highest yielding stocks that have a consistent record of dividend payment and have the ability to sustain their dividend payments. Stocks in the index are weighted in proportion to the total pool of dividends available to investors. Recession data is from National Bureau of Economic Research (NBER) and defined by the periods March 2001–November 2001 and December 2007–June 2009. NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is a recurring period of decline in total output, income, employment, and trade usually lasting from six months to a year and marked by widespread contractions in many sectors of the economy.

## Returns of the S&P 500®, Dividend-Paying Stocks, and REITs




Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. S&P 500 is represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. REITs are represented by the FTSE NAREIT All Equity REIT Index®. Morningstar Dividend Composite is represented by the Morningstar Dividend Composite Index, and Morningstar Dividend Leaders by the Morningstar Dividend Leaders Index. Income return and total return are represented by the compound annual return over the given time period.

# What the Tax Deal Means for Your Portfolio Plan

The tax deal passed on January 1st, 2013 included something for everyone to revile: Tax hawks decried higher taxes on the wealthy, while many on the left rued that Bush-era tax cuts were made permanent. In any case, the newfound certainty in tax rates makes matters of investment, estate, and tax planning significantly easier.

Higher Rates for High Earners: Higher income, dividend, and capital gains taxes will kick in for those individuals earning more than $400,000 and married filers earning more than $450,000. Starting in 2013, those high earners will pay a top tax rate of 39.6% on ordinary income and 20% on both dividends and long-term capital gains. For individuals in the aforementioned higher income tax bands for 2013 and beyond, many best practices for tax management like maximizing contributions to tax-sheltered accounts (IRAs and 401(k)s) while placing assets with high year-to-year income production in tax-sheltered vehicles may make more sense.

Conversions from Traditional 401(k)s to Roth 401(k)s: The fiscal cliff deal now allows all employees with traditional 401(k) balances to convert them to Roth 401(k)s, provided their 401(k) plan allows for such a conversion and includes a Roth 401(k) feature. Before, the Small Business Jobs and Credit Act of 2010 enabled only a limited subset of individuals (those who have left or retired from their former employers, are age 59 1/2, or are disabled or dead) to do so. Because in-plan conversions allow workers to pay taxes on their balances at today's tax rates in exchange for tax-free withdrawals during retirement, such a maneuver may make the most sense for those who have reason to believe their tax rates will be higher in the future.

Long-Term Care Provision: Originally a component of the landmark 2010 health-care reform law, the Community Living Assistance Services and Supports (CLASS) Act was designed to create a national insurance pool, offered through employers, to help workers pay for long-term care. The recently passed budget agreement finally repealed the CLASS Act. However, there have been dramatic increases in long-term care insurance premiums, owing to both low interest rates and misguided actuarial assumptions. In the face of these headwinds, would-be long-term care insurance purchasers can (1) skinny down long-term care insurance buy, purchasing a policy that provides a baseline of long-term protection but has a longer elimination period (that is, higher deductible) or a lower dollar limit on the amount of benefit, or (2) younger folks might consider delaying their purchases in the hope that higher interest rates will help tamp down premiums in the future. However, this could result in higher premiums as you age, or the possibility of developing a health condition that could make insurance costly.

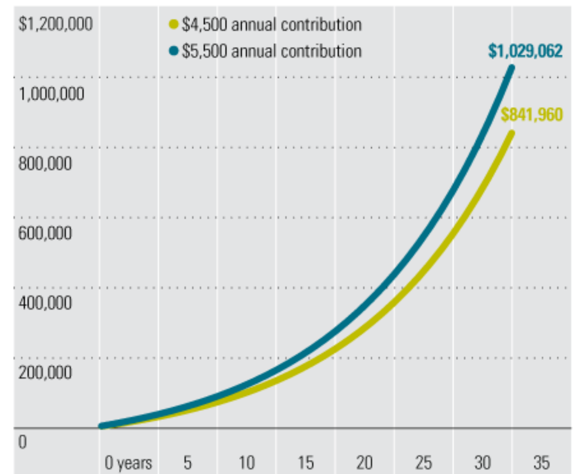
Alternative Minimum Tax (AMT): With this new deal, Congress put in place an inflation-adjusted exemption amount for the alternative minimum tax. Had Congress failed to take action, an estimated 28 million new taxpayers would have been subject to the AMT for the 2012 tax year, according to IRS estimates. It is important to note that a host of factors affect a taxpayer's vulnerability to the AMT, both on the tax deductions, exemptions, and credits side as well as on the income side of the ledger, and those items change from year to year.

Estate Tax: Although the estate tax exemption was set to drop to $1 million in 2013 and the estate tax was set to rise to 55%, the estate tax exemption will remain $5.12 million per individual, and the top estate tax rate will increase to 40% from 35% in 2013. However, regardless of the status of the estate tax, everyone needs to mind basic estate-planning matters, including properly drafted beneficiary designations, guardianships for minor children, and powers of attorney for financial and health-care matters.

# Don't Forget to Raise Your IRA Contribution

In 2013, contribution limits for both traditional and Roth IRAs (individual retirement accounts) will increase to $5,500 a year for those 49 years of age or younger. If you are 50 or older, the maximum contribution is $6,500. This limit can be split between a traditional and a Roth IRA. These annual contribution limits are imposed by the Federal Government.

The graph shows both a $4,500 and $5,500 annual contribution growing at a hypothetical 8% annual return. Notice the dramatic impact on the ending value of the portfolio. This may be a great time to re-evaluate your financial situation and increase your annual investment to your IRA. Even if you are unable to max out your contribution, any increase you can afford may help you reach your savings goals more easily in the long run.




This is for illustrative purposes only and not indicative of any investment. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free as money withdrawn is not taxed. Penalties may apply for withdrawals prior to the age of 59 1/2.

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