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FINANCIAL MARKET OVERVIEW

Financial market performance ended the first quarter about where it started as of the first day of the year. Most stock indexes fell about 4%-5% during the month of January and then recovered all of those losses during February. March gains were modest – about 1%-2%. By the end of the quarter, most investment accounts were up slightly ranging from 0% - 2%. If the same performance continued for the rest of 2014, the approximate annual return for U.S. stocks would range between 4% to 8%.

While the Dow Jones Industrial Average posted a small negative return (-0.72%) during the first quarter, the Wilshire 5000 Total Market Index, the broadest measure of U.S. stock prices, was up about 2%.

Value stocks outperformed growth stocks in all three categories - large, mid-size and small-companies. International stock price performance was flat and emerging markets (smaller international markets) were down slightly. Within the stock category, the first quarter performance was uneventful.

Interest rates fell slightly during the first quarter giving a small boost to fixed income or bond investments. The 10-year Treasury yield fell from about 3% to 2.8%, therefore U.S. Treasury Bonds posted positive returns ranging from 0.2% for bonds with short maturities to 2% for longer-term bonds. The small positive return for fixed income investments was a welcome relief as nearly all bond funds posted negative returns in 2013 ranging from -2% to -8%.

The U.S. dollar traded in a narrow range – nothing compelling in either direction. Gold prices jumped during the first quarter as tensions with Russia became headline news. Gold was up 6.45% during the first quarter. Real estate (REIT's) also posted an exceptional return during the first quarter – up 10% over the 3-month period.

The following chart displays sample returns of various asset categories during the first quarter of 2014:

1st Qtr. 2014	Index Return (*includes dividends reinvested*)
- 0.72%	**Dow Jones Industrial Average (^DJI)**
+ 1.70%	**Standard & Poor's 500 Index (^GSPC)**
+ 2.06%	**DJ U.S. Total Stock Market (VTI)**
+ 1.02%	**Large-company stock-Growth (IWF)**
+ 2.99%	**Large-company stock-Value (IWD)**
+ 1.95%	**Mid-Size Stocks – Growth (IWP)**
+ 5.06%	**Mid-Size Stocks – Value (IWS)**
+ 0.58%	**Small-company stock- Growth (IWO)**
+ 1.71%	**Small-company stock- Value (IWN)**
+ 0.15%	**International (EFA)**
- 1.89%	**Emerging Markets (EEM)**
+ 10.10%	**Real Estate Investment Trusts (VNQ)**
	Fixed Income
+ 0.13%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 2.85%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
	Alternative Investment Category
+ 6.85%	**Gold (GLD)**

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ECONOMIC AND FINANCIAL MARKET OUTLOOK

Overall, the U.S. economy is growing at a slower-than-desirable pace, but slow growth is better than no growth. The global economy is barely growing at all – some countries have economic growth exceeding the U.S. while most others are trying to stop their economic decline.

Steady and small gains in the employment picture are expected by most economists. Inflation expectations continue to be modest – most economists expect about 2% during 2014. Corporate profits are expected to grow at the same 4%-5% pace in 2014 and consumer confidence is still up modestly. Long-term interest rates are likely to increase up to 1% and short-term rates may see small increases over the next year. Gross Domestic Product will likely rise modestly again this year but will likely stay below the target 3% long-term average rate of growth.

In summary, the concern that the U.S. economy was susceptible to a decline in 2012-2013 has faded and the financial markets appear to have correctly anticipated a modest recovery by boosting stock prices by nearly 40% over the past two years.

The focus has transitioned from concern about further economic decline to whether or not the recent two-year advance in stock prices will hold under an expected slow-growth environment. From an economic perspective, continued slow growth or even a slight improvement appears likely.

The big question is whether an unexpected, noneconomic, political, global or exogenous (outside and unpredictable) event will spook the markets and cause prices to adjust to a more reasonable level reflective of a slow-growth economic environment. This latter risk is something individuals and portfolio managers cannot predict and is part of the uncertainty investors must accept in pursuit of investment returns above the safe rate of return (bank savings rate, certificates of deposit and short-term Treasury bonds).

The risk and uncertainty of exogenous events are easier to accept following a significant market decline such as the 38% correction in stock prices in 2008. Following a decline, prices are reasonable and in most cases, below fair market value. The risk is much greater following a 40% advance in stock prices (2012-2013) if the economy does not continue to improve and justify such a significant advance.

Our portfolio management strategy will continue to focus on holding large and established companies. At the same time, we expect to gradually move a portion of client portfolios back into more assertive and faster growing growth companies. The transition will occur without regard to a specific timeline. We do not feel a need to rush as the U.S. stock market has moved up significantly over the past two years and the global economy and equity markets are still trailing the U.S.

SOCIAL SECURITY: WHEN TO APPLY FOR BENEFITS AGE 62 TO 70

Beginning in 2011, ten thousand baby boomers retire at age 65 *every day* and this trend will continue for the next 19 years. Baby Boomers represent 25% of the entire U.S. population. Increasingly, one of the most common questions clients are now asking is: When should I apply and begin taking Social Security benefits?

Currently, *Normal* or *Full Retirement Age* is age 65 to be eligible for **un**reduced benefits for those born in 1937 or earlier, however the normal retirement age is gradually increasing to age 67 for individuals born in 1960 or later. The earliest individuals may apply and start drawing reduced benefits is age 62. If a taxpayer elects to apply and begin receiving benefits at age 62, the monthly benefit will be reduced by 20%. The benefit reduction is equivalent to about ½% for each month prior to age 65 or nearly a 7% reduction per year.

Conversely, the longer you defer (wait to claim and receive monthly benefits), the larger the future monthly checks will be. For each year a taxpayer delays taking Social Security benefits, the retirement credit or increase is 8% per year up to age 70.

There are three primary factors to consider whether to delay receiving benefits: 1) Your health and expected longevity, 2) Financial ability to forego Social Security income benefits now by using other assets and income sources to replace the benefits during the delay period and 3) personal preference.

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The crossover or breakeven point between taking scheduled benefits at normal retirement (assume age 65) verses deferring and waiting up to five years to receive larger benefits is about age 79 to 81. In other words, someone who receives his benefits at age 65 would be "ahead of the game" (received more money from the government) compared to someone waiting to age 70 (five years) and then receiving larger monthly benefits until about age 80. A person who waited and deferred benefits for five years would then be "ahead of the game" at about age 80.

For many taxpayers, the idea of betting or gambling that their life expectancy will be long enough to justify deferring benefits is an uncomfortable proposition. Further, some taxpayers feel it's appropriate to begin collecting benefits at the "normal" time after decades of contributing FICA taxes from every payroll check.

In the end, each person has to decide whether to "gamble" on expecting an above average life expectancy, determine whether she has other financial resources to use during the deferral period and lastly whether to accept payments at age 65 as normal and preferable. Consider your specific situation, as there isn't one best choice that fits all circumstances.

There is one specific opportunity that should be mentioned for couples who are the same age or have less than 2 years age difference. The strategy is often referred to as "file and suspend." The older spouse, and usually the one with higher earnings history and benefit, will file for benefits at age 65 and immediately suspend or defer receiving benefits until age 70. Once the older spouse has "filed" for benefits, the younger spouse (and let's assume he/she has a lower earnings history) can then file for his/her benefit. Each spouse is entitled to receive a benefit based on his/her own earnings history, **or if higher**, the spouse can elect to receive an amount equal to 50% of the other spouse's benefit. This strategy allows one spouse to receive some benefits right away while the older or other spouse delays until age 70 to receive a much higher benefit.

Another twist to this strategy is for the primary wage earner to claim a spousal benefit (50% of the lower-earnings spouse's benefit) starting at age 66 and then switch to his or her own (higher) benefit at age 70. Thus, the primary earner can effectively get paid something during the delay period until he or she reaches age 70 and then switch to his/her higher delayed benefit. Both versions of this strategy only work for couples who are about the same age. In order to apply and receive a 50% spousal benefit, the other spouse must be eligible for SS benefits.

REVERSE MORTGAGES: PART OF A RETIREMENT PLAN?

Eighty million baby boomers are expected to retire over the next 18 years and surveys show that Americans tend to store more than two-thirds of their wealth in their homes. Home equity values have become a growing portion of retirees' total assets. If pension income, Social Security benefits and current assets are insufficient to maintain a reasonable standard of living, should home equity values play a role in having alternative sources of retirement income? Reverse mortgages are playing a greater role in getting access to your home equity value, but easier access shouldn't supersede other important considerations.

Homeowners can access up to a maximum of $625,500 of home equity through a reverse mortgage and the ability to obtain a reverse mortgage is not dependent on credit history, income level or health. The home must be your primary residence and the youngest borrower (spouse), must be at least 62 years old.

Unlike a traditional mortgage that requires monthly *payments* and has a maturity date, a reverse mortgage provides homeowners with a monthly *income* and access to additional withdrawals. There is no maturity date until the last surviving borrower moves out of the home, dies, or if the home is not occupied as a principal residence for more than 1 year. Essentially the reverse mortgage is a credit card secured by the home equity value with a very high limit and without the requirement to make monthly payments or pay off the balance while living. Essentially, homeowners are spending their home equity over a period of time without selling the home.

Home equity values can also be considered as a source of funding or as a reserve for potential long-term health care expenses. The mistake to avoid is planning on using home equity as both a source of retirement income AND a reserve for long-term care.

In general, obtaining a reverse mortgage as a source of funds for a <u>short period of time</u> is not recommended. If you plan to move within a few years or health issues are likely to result in a move to a retirement or care facility,

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the better choice is to sell the property outright or obtain an equity line of credit. The costs of obtaining and maintaining a reverse mortgage are much higher than a traditional mortgage.

Loan origination fees range between $2,500 and $6,000. In addition, there are third-party fees such as appraisal, title search and recording fees. The total third-party fees can range from $1,000 to $3,000. In addition, borrowers must pay for mortgage insurance which ranges from ½% of the home value up to 2.5%. For a $200,000 reverse mortgage, up front insurance premiums can range between $1,000 and $5,000. Together, these costs are very expensive and reverse mortgages should be avoided if homeowners are not planning to stay in their primary residence for 5 years or longer. The better choice for a five-year or less time period is to apply for a home equity line of credit or simply sell the home outright and rent or buy a less expensive residence.

COPIES OF 2013 INCOME TAX RETURNS

Please send paper or electronic (email) copies of your 2013 income tax returns to our office at your earliest convenience. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

2013 was the first year of higher income tax rates for taxpayers in the top income brackets, additional taxes for high-income taxpayers for the Affordable Care Act (Obamacare) and a return of phase outs of valuable deductions for high income taxpayers. Some taxpayers will lose all or a portion of these deductions: personal exemptions ($3,950 per person), reduction of itemized deductions, increased tax on investment income, increased tax on earned income (wages/salaries, self-employed income), and a decrease in deductible medical expenses. Simply stated, your income tax situation should be reviewed to keep taxable income as low as possible. The three income areas that taxpayers have some control over are: taxable IRA or other retirement plan distributions, sale of investments and income generated on investment portfolios. Please call our office to make an appointment if you would like to discuss your tax situation.

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Best regards

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