Hill Financial Group

Second Quarter Newsletter

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Dear Valued Client,

As the world markets have had a very robust advance since the March 2009 lows, we have recently seen our Advance & Protect models starting to move to the protect mode.

We applaud Dennis Coon, CFP®, for recently completing the Certified Financial Planner Board of Standards rigorous experience, education, and ethical requirements. Dennis now joins a group of CERTIFIED FINANCIAL PLANNER™ Professionals, who have voluntarily agreed to abide by high standards of ethical conduct and client service.

Dennis is our Financial Planner and Portfolio Manager who joined the firm in 2010.

Sincerely,

Your Hill Financial Group Team

June 2011

Inflation or Deflation: Watching for Warning Signs

Deciphering Health Savings Vehicles

Rising Interest Rates: The Downside of Economic Recovery

Can I make charitable contributions from my IRA?

Inflation or Deflation: Watching for Warning Signs

There's been much debate in investing circles over the last year about whether inflation or deflation represents a more likely threat to the future of the U.S. economy. With a recovery that's still tentative compared to previous recessions, measures designed to stimulate the economy or cut spending to rein in the budget deficit provoke warnings about their potential to create one or the other.

The case for inflation

As the economy has begun to recover, worries about the potential for future inflation have become widespread. The Fed has undertaken extraordinary measures to make sure there is plenty of money in circulation, but some experts worry that the increased money supply will eventually cut the dollar's purchasing power, especially if interest rates are kept at historically low levels for too long. They cite the easy availability of money as contributing to the late-1990s tech bubble and the mid-2000s housing bubble, and fear that another could be on the way.

The Federal Reserve Board's monetary policy committee maintains that inflation currently is too weak to support normal economic growth, let alone launch an inflationary spiral. However, those who see inflation in our future watch for warning signs such as increased Treasury yields, particularly on longer-term bonds. Higher yields when bonds are auctioned suggest that investors are increasingly wary of tying up their money for long periods at a fixed interest rate if they feel that inflation is going to erode the buying power of those fixed payments over time. Wholesale prices also are watched closely; higher prices at the wholesale level can be a precursor of higher prices at retail (that is, if retailers are able to pass those costs along to buyers, which is not always the case).

The case for deflation

At first blush, the falling prices that characterize deflation don't sound like such a bad thing. Who wouldn't like to be able to buy things for less than they cost now, especially when times are tough? The problem is that those falling prices can harm the economy in several ways, as Americans were reminded during the recent recession. When prices are dropping, people tend to postpone purchases, hoping to pay less in the future (consider what's happened with real estate since 2007). Delayed spending puts pressure on corporate profit margins and companies tend to cut spending themselves, creating financial difficulties for companies that rely on business spending. Cutbacks begin to ripple through the economy.

Deflation typically affects not only prices but wages; scarce jobs can lead to pay cuts even for those who stay employed. And lower incomes can start a new round of cost-cutting by both consumers and business. If this process sounds familiar, it's because for much of 2009, the U.S. experienced negative annual inflation rates for the first time since 1955.

Though consumers have loosened their purse strings in recent months, deflationistas argue that if another financial crisis were to reduce credit availability, or if high ongoing unemployment once again begins to weigh on consumers' willingness and ability to spend, the threat of deflation could return. Those concerned about the possibility of a new round of deflation at some point keep an eye on consumer spending, the state of the credit and housing markets, and the stability of banks and other financial institutions.

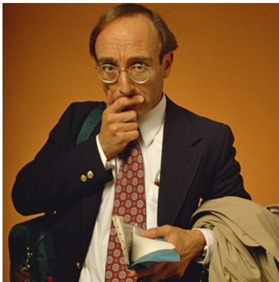
Seeing shades of gray

Inflation and deflation aren't necessarily an either-or proposition. It's possible to have inflation in some areas and deflation in others; anyone who has watched food prices or health-care costs increase while their paycheck stayed the same and the value of their house declined can vouch for that.

From an investing standpoint, inflation isn't black-and-white, either. Some industries and asset classes benefit from inflationary forces, while companies that are highly dependent on both commodity prices and cheap labor can be more challenged by rising prices.

Deciphering Health Savings Vehicles

Beginning January 1, 2011, for HSA, MSA, FSA, and HRA programs, a drug or medicine is considered a qualified medical expense only if it is obtained with a prescription, or is insulin.



Effective January 1, 2013, contributions to a flexible spending account will be limited to $2,500 per year, increased annually by cost-of-living adjustments.

Health savings accounts (HSAs), Archer medical savings accounts (MSAs), health reimbursement arrangements (HRAs), and flexible spending arrangements (FSAs) are all personal health accounts that may help you control your health-care costs. But trying to figure out what's what can be confusing. Here's a brief description of each type of account, including some of their major features and benefits.

MSAs/HSAs

As of January 1, 2008, the MSA program expired and no new MSAs can be established, although if you already participate in an MSA, you can continue to receive contributions. HSAs have generally taken the place of MSAs because of their greater flexibility and options. In fact, in most instances you can roll over an existing MSA into an HSA. MSAs and HSAs are set up in a trust account with a financial entity. Contributions made through your employer are pretax dollars (or you can contribute to the account directly and deduct the contribution), no tax is due on funds in the account, or on any earnings until withdrawn, and if funds are used for qualified medical expenses, the withdrawals are not taxed. However, account withdrawals that aren't used for qualified medical expenses are subject to a tax penalty of 20%, in addition to regular income tax. Your account is portable, meaning if you change employers or leave the workforce, you can keep the account. To be eligible, you must be insured by a high deductible health plan (HDHP) that you maintain (if self-employed) or that's provided through your employer.

However, there are also differences between MSAs and HSAs. Generally, anyone with an HDHP can participate in an HSA. But to qualify for an MSA, you must have been either an employee of a company that employs 50 or fewer people, or be self-employed (or the spouse of such an employee or self-employed person). With an HSA, contributions can be made by you, your employer, or anyone else on your behalf within the same plan year. But MSA contributions can only be made by either your employer or yourself, but not both, in the same plan year. Contribution amounts also differ. In 2011, maximum HSA contributions are limited to $3,050 for single HDHP coverage and $6,150 for family HDHP coverage. MSA contributions can be up to 75% (65% if you participate in a self-only plan) of the annual deductible of your HDHP, but no more than your annual earnings from employment.

FSAs

If you don't participate in an HDHP, you still can set money aside for uninsured medical expenses through an employer-established FSA. Unlike an HSA, you must be an employee of the employer providing the FSA in order to participate (self-employed persons are not eligible and certain limitations may apply if you are a highly compensated participant or key employee). Pretax contributions can be made by either you, your employer, or both of you (except employer contributions used to pay long-term care premiums must be included in income). You determine how much money you want deposited each year up to the plan's maximum dollar amount or percentage of compensation; funds in the account are not subject to tax; and distributions are tax free if used to pay for qualified, unreimbursed medical expenses you've incurred (no advance payments for anticipated expenses). Unlike HSAs, if you leave your employer, you can't keep the money in the account or take it with you to another employer (it's not portable). Also, what you don't spend on medical expenses by the end of the plan year is forfeited and not available the following year (i.e., you must use it or lose it).

HRAs

Like FSAs, HRAs are only available to employees, not to self-employed individuals. And HRAs must be funded solely by an employer; you can't contribute directly to the account. The terms of the HRA are generally determined by the employer. For example, your employer's plan may or may not require you to have health insurance in order to participate. The plan sets the maximum amount of contributions, and determines whether a credit balance in the account can be rolled over from year to year, and if so, how much of the account can be rolled over. But contributions and reimbursements for qualified medical expenses are tax free. Reimbursements can be made to current and former employees, including spouses and dependents of employees and deceased employees. However, if the plan allows for any distribution to you or anyone else (e.g., spouse, dependent, estate at your death) for other than reimbursement for qualified medical expenses, then any distribution, whether for qualified medical expenses or not, is included in gross income.

Rising Interest Rates: The Downside of Economic Recovery

Bonds don't respond uniformly to interest rate changes. The differences, or spreads, between the yields of various types of debt, such as corporate, government, emerging market, and municipal debt, can mean that some bonds are under- or overvalued compared to others. Don't forget that the total return on bonds is a combination of yield and price return. Financial professionals have many ways to adjust a bond portfolio to help you cope with rising rates.

Over the last several years, investors have grown accustomed to historically low interest rates. Ever since the Federal Reserve Board's target fed funds rate--the rate at which banks lend to one another--hit a high above 19% in mid-1981, the long-term direction of rates has been downward. In the last decade, the Fed's data* shows the target rate has never been much higher than 6%. And since December 2008, the Fed has kept it at a previously unheard-of level between 0.25% and zero to try to ensure that credit would be available to promote economic recovery.

Because bond prices typically rise when interest rates fall, that decline in yields has produced a bull market in bonds over the last decade. But what happens when the trend reverses? Even if they continue to remain relatively stable for a while, ultra-low interest rates have nowhere to go but up. When the economic recovery begins to show signs of strength, at some point the Federal Reserve Board will begin to raise the target rate again. When that happens, bond prices also will begin to reverse their long-term direction.

Here are some factors to consider in anticipation of a future with rising interest rates.

Bond maturities: when short is sweet

When interest rates rise, longer-term bonds typically feel the impact the most. In an extended period of rising interest rates, bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future; the later the bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. If you own individual bonds, you always have the option of holding them to maturity; in that case, you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield. Laddering also can be used with certificates of deposit (CDs).

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average maturity. The longer a fund's duration, the more sensitive it may be to interest rate changes.

Rising rates and other assets

Higher interest rates often are an attempt to prevent rising prices. When prices go up, purchasing power goes down, including the purchasing power of a bond's fixed interest payments. That can make bonds less attractive to buyers. However, not all investments are hurt by higher prices. For example, commodities such as oil and wheat typically do well in inflationary periods; in fact, increases in commodity prices are often what trigger a bout of inflation. If you're primarily interested in the overall value of your portfolio rather than a regular income stream, your financial professional can help you explore whether you should consider diversifying into asset classes that tend to benefit from inflation and that might help counteract the potential impact of falling bond prices.

Though bonds are affected most directly, equities aren't necessarily immune to rate increases. Though many companies borrowed money in recent years to take advantage of low rates and postpone the need to issue bonds for some time, those that haven't may see their borrowing costs increase, which could affect their bottom lines. Even those that squirreled away cash could be hit when they return to the bond markets eventually. Also, if interest rates rise to a level that's competitive with the return on stocks, that could reduce investor demand for equities.

Higher rates aren't all bad news

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash, higher rates could be a boon. Savings accounts, CDs, and money market funds are all likely to do better at providing income than they have in recent years. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices. And bear in mind that a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money investing in a money market fund.

**Source: Federal Reserve Statistical Release Historical Data for Fed funds rate weekly since 1954.*

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Ask the Experts

Can I make charitable contributions from my IRA?

Yes, if you qualify. The law authorizing "qualified charitable distributions," or QCDs, has recently been extended through 2011.

You simply direct your IRA trustee to make a distribution directly from your IRA (other than a SEP or SIMPLE) to a qualified charity. You must be 70½ or older, and the distribution must be one that would otherwise be taxable to you. You can exclude up to $100,000 of QCDs from your gross income in 2011. If you file a joint return, your spouse (if 70½ or older) can exclude an additional $100,000 of QCDs in 2011. But you can't also deduct QCDs as a charitable contribution on your federal income tax return--that would be double dipping.

QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA in 2011, just as if you had received an actual distribution from the plan. However, distributions that you actually receive from your IRA (including RMDs) that you subsequently transfer to a charity cannot qualify as QCDs.

For example, assume that your RMD for 2011 is $25,000. In June 2011, you make a $15,000 QCD to Qualified Charity A. You exclude the $15,000 of QCDs from your 2011 gross income. Your $15,000 QCD satisfies $15,000 of your $25,000 RMD. You'll need to withdraw another $10,000 (or make an additional QCD) by December 31, 2011, to avoid a penalty.

You could instead take a distribution from your IRA and then donate the proceeds to a charity yourself, but this would be a bit more cumbersome, and possibly more expensive. You'd include the distribution in gross income and then take a corresponding income tax deduction for the charitable contribution. But the additional tax from the distribution may be more than the charitable deduction, due to IRS limits. QCDs avoid all this by providing an exclusion from income for the amount paid directly from your IRA to the charity--you don't report the IRS distribution in your gross income, and you don't take a deduction for the QCD. The exclusion from gross income for QCDs also provides a tax-effective way for taxpayers who don't itemize deductions to make charitable contributions.

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