Pettinga Insights and Outlook

April 2013 | Vol. No. 1 | Investment Updates

The Tax Impact of a 529 Rollover

Indiana Tax Break

- Indiana residents qualify for a 20% state tax credit for contributions to the Indiana 529 plan, with a maximum credit of $1,000. You can't get a better return on your investment than a guaranteed 20%, so we highly recommend Indiana resident parents and grandparents contributing to the Indiana 529 plan for the benefit of their children and grandchildren.

Thirty-four states offer some sort of tax deduction or tax credit for contributions made to a 529 plan. But in 29 of those 34 states, the tax break is available only for contributions made to an in-state plan. Only Arizona, Kansas, Maine, Missouri, and Pennsylvania give residents a tax break for contributing to any state's plan. If you own an out-of-state 529 plan, you may be missing out on this tax break advantage, and it may be worthwhile to do some research and consider rolling your out-of-state plan to an in-state one.

The tax break can be a real plus, but the quality of the 529 plan (its investment options and fees, in particular) is important, too. If you've already opened an out-of-state 529 plan a while ago, you may want to revisit that decision because 529 plans can change over time. If your state now offers a better plan, check with the plan or a tax professional to see if there are tax advantages to rolling funds over. Many states do not provide a tax break for inbound 529 rollovers, but some do. States that do may limit deductions to just the contribution portion of the out-of-state 529 or let you deduct the entire amount including earnings.

529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax. An investor should consider the investment objectives, risks, and charges and expenses associated with municipal fund securities before investing. More information about municipal fund securities is available in the issuer's official statement, and the official statement should be read carefully before investing. Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a legal, tax, or financial professional with any questions or concerns.

Monthly Market Commentary

Recovery, full steam ahead? It would appear so. The stock market returned 11.02% during the first quarter of 2013, and the U.S. economy continues to grow at a slow but steady pace, despite apparent volatility and instability displayed by most major economic indicators.

GDP: For starters, real GDP growth rates have been highly volatile from quarter to quarter; for example, from 3.1% in Q3 2012 to only 0.1% in Q4 2012. However, it's important to keep in mind that the data includes some measurement and seasonal-adjustment issues that may blur the big picture a little bit. Morningstar economists forecast that GDP will grow at a slow, but sustainable 2.0%–2.5% rate in 2013, very similar to 2011 and 2012.

Employment: The private sector added only 95,000 jobs in March (compared with 254,000 in February). At first glance, this number is discouraging, and the lowest in nine months. However, similar to the case for GDP above, month-to-month data is volatile, influenced by weather and other seasonal factors, and often subject to revisions. Three-month average employment growth (YOY), a more reliable data point, does show slow erosion, but no catastrophic decline (2.1% in December, 2.0% in January, and 1.9% in February and March).

The Big Four: Given all the fiscal scares, Hurricane Sandy, volatile gasoline prices, and new taxes, the U.S. economy is doing surprisingly well, according to the Big Four economic indicators (private employment growth, retail sales, manufacturing, and real disposable income). Private sector year-over-year employment growth has been steady at 2% for almost two years, while retail sales growth (adjusted for inflation and excluding autos and gasoline) has been in the 2%–3% range for almost as long. Even U.S. manufacturing data hasn't been particularly volatile, especially if weather events are removed. Of the Big Four, only real disposable income has been very volatile, and most of that volatility is due to ever-shifting inflation rates (with food and energy showing the most volatility) and changes in government tax policy, not changes in wages.

Consumer: Consumer spending continues to drive the economy, constituting about 70% of GDP. Unfortunately, consumers were severely hit early in 2013 with soaring gasoline prices, a higher payroll tax, and delayed tax refunds. On the other hand, they also have a lot going for them, including lower inflation in many categories, better employment prospects, increasing home prices and related construction activity, and a much higher stock market and related wealth effects. While consumer spending is not as robust as it once was, it is clearly not falling apart in the middle of all the economic headwinds, either.

Quarter-end insights: A lot of fiscal issues were at least temporarily "settled" this quarter, helping to reassure both consumers and businesses. The fiscal cliff negotiations and the March sequestration resulted in a total deficit reduction of about $300 billion slated for 2013. The Fed plans on maintaining a relatively loose monetary policy, assuring investors that low interest rates and bond buybacks would continue to fuel further growth. As slow as this growth may be, the U.S. economy is better positioned and growing faster than many other developed economies. Some of the factors providing a longer-term advantage include newfound supplies of oil and gas, low electricity prices, more available land for building, and an improving auto industry.

In Europe, however, the situation isn't getting better, even when excluding the effects of the Cyprus situation. The Chinese economy seems to have bottomed, and future Chinese growth (if any) will likely be lower than previous peaks, and more likely to be consumption based than focused on infrastructure. Last, but not least, U.S. corporations are starting to invest for growth again (capital spending and acquisitions), which could prove to be an effective engine for further stock market appreciation.

A Look at the Five Gamma Factors

Do You Have a Personal Financial Plan?

- Pettinga Financial has acquired a new financial planning software application, and we would like to prepare a detailed financial plan for you.
- Our new software contains Monte Carlo (variable simulations) analysis, which enables us to evaluate the probabilities of multiple scenarios. Ask us about this opportunity, and how you might benefit from having a personal financial plan of your own.

The recent Morningstar whitepaper “Alpha, Beta, and Now…Gamma” examines the potential value, or gamma, that can be obtained from making intelligent financial planning decisions during retirement. Morningstar researchers ran a series of simulations based on different scenarios to compare a base-case portfolio (20% stocks, 80% bonds) that did not apply the gamma factors and a “gamma-optimized” portfolio that did for five gamma factors. Some of the findings are outlined below.

Total Wealth Asset Allocation: Morningstar used human capital in conjunction with financial capital to determine the optimal equity allocation, factoring in both an investor’s risk preference and risk capacity. By making more intelligent total wealth asset allocation decisions, the gamma optimized portfolio achieved an additional 6 cents for every $1 generated in retirement income, when compared with the base-case portfolio.

Dynamic Withdrawal Strategy: Instead of a traditional static withdrawal method, where the annual withdrawal during retirement is based on the initial account balance at retirement, increased annually for inflation, Morningstar used a dynamic withdrawal strategy for the gamma optimized portfolio. A dynamic withdrawal strategy does not base the annual withdrawal amounts on just the initial income target, but also considers market performance and expected investor longevity. As a result, the gamma optimized portfolio achieved an additional 9 cents for every $1 generated in retirement income.

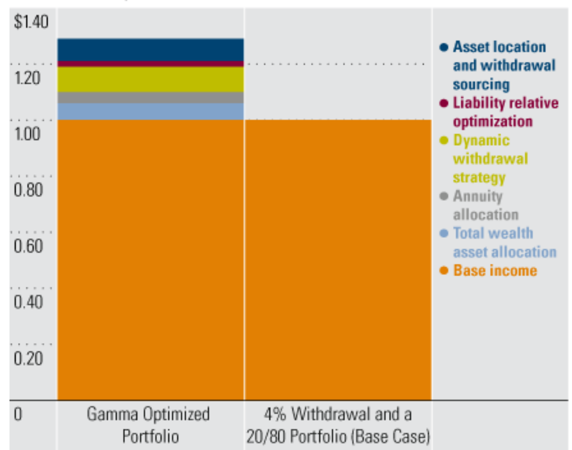
Annuity Allocation: Annuities may allow a retiree to hedge away the risk of outliving one’s savings, which may improve the overall efficiency of a retiree’s portfolio. By considering annuities within a total portfolio framework (benefit, risk, and cost), the gamma optimized portfolio was able to achieve an additional 4 cents for every $1 generated in retirement income.

Asset Location and Withdrawal Sourcing: By making intelligent decisions in terms of placing appropriate assets in the most tax-efficient account type, and withdrawing them in a tax-efficient sequence, the gamma optimized portfolio achieved an additional 8 cents for every $1 generated in retirement income.

Liability-Relative Optimization: From a retirement income perspective, liability-driven portfolios may be more efficient as they are better able to hedge the risks faced by retirees. The gamma optimized portfolio was able to achieve an additional 2 cents for every $1 generated in retirement income by incorporating liabilities into the portfolio optimization process.

Each gamma factor can potentially add value independently of the others. When added together, a gamma of 29% is achieved ($1.29 for every $1 generated by the base case), representing a sizeable improvement in portfolio efficiency for a retiree.

Potentially More Income with Gamma Optimization



Source: David Blanchett, CFA, CFP & Paul Kaplan, Ph.D., CFA. Alpha, Beta, and Now…Gamma, Morningstar Whitepaper, September 8, 2012

Social Security for the Self-Employed

If you thought that running a successful business on your own was hard enough already, think again. As a self-employed individual, defined by the IRS as someone who operates a trade, business or profession, (either by yourself or as a partner), you are required to pay self-employment tax as well as income tax. Self-employment tax consists of Social Security and Medicare taxes, similar to those withheld from the pay of most wage earners. Failure to comply with IRS regulations may result in your business operations being jeopardized. The following are a few key facts to keep in mind:

1. The Social Security tax rate for 2013 is 15.3% on self-employment income up to $113,700. Should your net earnings exceed $113,700, you continue to pay only the Medicare portion of the Social Security tax, which is 2.9%. Starting this year, the Medicare tax rate for net earnings in excess of $200,000 ($250,000 for joint filers) is increased to 3.8%.

2. You need to have worked and paid Social Security taxes for a certain length of time to get Social Security benefits (no more than 10 years of work, which is equivalent to 40 credits). In 2013, if your net earnings are $4,640 or more, you earn the yearly maximum of four credits. If your net earnings are less than $4,640, you could still earn credit (depending on how you report your earnings).

3. Certain income does not count for Social Security and should not be included in figuring your net earnings. These include dividends from shares of stocks and interest on bonds, interest from loans, rentals from real estate, and income received from limited partnerships.

Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns.

Pettinga
Get there.

Pettinga Financial Advisors
519 Main Street
Suite 100
Evansville, Indiana 47708