THIRD QUARTER
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DEIGHAN
WEALTH ADVISORS

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MARKET COMMENTARY

When asked to come up with a list of potential investment risks, investors often mention business risks: corporate bankruptcy, company mismanagement, recession, fraud, etc. However, more pernicious than business risks are the risks from bad public policy: political risk, interest rate risk, and inflation. These risks are often underappreciated and misunderstood by investors, leading to incorrect assumptions and unfortunate decisions. In fact, if we assume for a moment that all investment risk can be broadly defined as "the risk of permanent loss of purchasing power over time" then we find that, for an otherwise well-diversified investor, public policy is arguably one of the biggest sources of investment risk.

The reasons are many. Bad public policy can negatively affect multiple asset classes at the same time, meaning it can have long-lasting ramifications that are difficult to avoid via diversification. Further, the fallout is not always recognized at the outset, making it hard for investors to proactively protect themselves or understand the risks at hand. Perhaps an example is best. Let's look at John, a typical low-risk investor in retirement:

John has spent the past several years trying to eke out reasonable gains in his conservatively managed investment portfolio. However, because of the Federal Reserve's low interest rate policy, his income has been greatly reduced. He knows he could try taking on more investment risk, but he lost a lot of money in stocks when the last Fed-fueled investment bubble popped in 2008. Therefore, he's reluctant to go down that road again. After all, he needs his portfolio to last him for the next 30 years.

Back in early May, John bought what he thought was a low-risk investment: a 10-year U.S. Treasury Note yielding 1.63%, which was the going rate at the time. Though it was a lower interest rate than he might have liked, John saw little other alternative.

What John didn't realize was that, if inflation averages 3% over the next decade, then his purchasing power will actually decrease by 1.37% every single year. Each year, his portfolio will buy a little less than it did the year before.

John's friend, Carl, points this sad fact out to him over lunch. Disheartened, but ever the optimist, John rationalizes his decision: he might be losing a bit to inflation each year, but that's better than losing a lot all at once in the stock market, right?

Not necessarily. John thinks that, because he bought a Treasury Note backed by the full faith and credit of the U.S. government, it is essentially risk free. Come July, however, thanks to a few inopportune comments by the Federal Reserve, the going rate on a brand new 10-year U.S. Treasury Note is 2.71%. John's bond has lost almost 10% of its value in two months. What happened?

John didn't realize that rising interest rates can be a significant source of risk for bonds, especially long-dated bonds. Now, no one wants to pay full price for John's crummy 1.63% bond when they can buy a brand new one and receive 2.71%. If interest rates continue to rise, then the value of John's bond will continue to fall. True, if John waits until maturity in 10 years then he will eventually get the full nominal value of his bond. But that doesn't count the opportunity cost of holding a low yielding investment for a decade.

"PUBLIC POLICY IS ARGUABLY ONE OF THE BIGGEST SOURCES OF RISK"

Frustrated, John decides to sell his bond and accept the 10% loss. The stock market is up nearly 20% for the year, so he figures he can easily make his money back

and then some by switching into stocks. Unfortunately for him, the federal government shuts down a week later over a budget impasse, and stock market volatility increases significantly. John begins to wonder if he made the right choice, and whether he can handle the additional risk he's taken in his account.

John's situation is a common one. Like many investors, he has had a difficult time navigating the economic ups and downs of the past decade. These ups and downs have been largely caused, and/or amplified, by government policy, both legislatively and monetarily. More so than companies like Lehman, the government has been responsible for economic volatility, because the government created the policies that allowed such corrupt companies to thrive and become systemic risks. Therefore, investors need to be wary of how public policy might impact their portfolios.

"GOVERNMENT POLICIES AND BEHAVIORS ARE UNSUSTAINABLE"

The federal government's shutdown this week is but the most recent example of why this is the case. The political climate in Washington is highly partisan and increasingly unstable, meaning that, even in the absence of a continued shutdown or default, investments risk being caught in the crossfire. Congress has shown itself unable to compromise or legislate on a variety of fronts, and if the shutdown continues over the coming weeks then markets will become increasingly fearful of a government default. Though we do not anticipate a default, there is a first time for everything.

This leaves investors in a catch-22 situation. Many worry they should reduce their investment risk and let the political climate settle down. But, while reducing risk might lower the possibility of incurring large, short-term losses, it almost certainly guarantees, like it did for John, that smaller losses will be locked in long term. This is because "safe" investments, like bonds and cash, currently offer negative returns after inflation. Therefore, an investor looking to de-risk must be willing to pay this premium, which is essentially a hidden tax.

The Fed would argue that, because inflation is tame, it's okay for interest rates to remain artificially low. This is disingenuous. There is a big difference between 2% inflation when interest rates are in a more normal 4-6% range, as opposed to 2% inflation when interest rates are in a 0-3% range. In a more normal situation, a bond investor might still earn a positive return net of modest inflation. Today, investors are forced into flat or negative returns after just a little inflation is factored in.

The Federal Reserve, of course, knows this and is okay with it. That's because the government owes too much money, and a negative real return is a conveniently inconspicuous way to make savers pay some of it back. Low interest rates also force savers out of safe assets and into riskier assets, like stocks, against their better judgment. A rising stock market provides the appearance of a more healthy economy.

But there comes a point when interest rates must rise naturally, and we may have reached that point whether the Fed likes it or not. This poses a risk for investors. Interest rates spiked this summer at the mere possibility that the Fed might start tapering its bond purchases. This caused an immediate, significant price correction in bond markets, illustrating that the Fed may not be able to control interest rates in the end.

As both market observers and participants, one thing is obvious to us: current government policies and behaviors are unsustainable and inherently unstable. Investors are right to want to protect themselves from fickle politicians; but the question remains, how? We believe that holding tight and sticking to a long-term investment discipline is the only plausible option out of a range of lesser options. We don't want to be like John, continually reacting to changes in public policy and jumping between stocks and bonds. We don't believe in our ability, or anyone's ability, to get the timing perfect, as would be required to make John's tactics work. Instead, it is our opinion that, though we might have little control over how investments move on any given day, we do have control over how we react to those movements. "First, do no harm" seems to be a good motto at a time when both uncertainty and the opportunity for self-harm are significant.

Only time will tell what comes to pass in the weeks ahead, but we encourage you to call us should you have questions or concerns along the way. In the meantime, let's hope for some political sanity. Until next time, may you and yours have a healthy and prosperous upcoming holiday season.

Matthew T. Skaves, CFA
Chief Investment Officer

GIFTING FROM YOUR IRA

1974 was quite a year: Nixon resigned, *Blazing Saddles* came to theaters, the Beatles disbanded, *People* magazine hit the stands, and Frank Sinatra released *Bad, Bad Leroy Brown* so he could haunt us at every wedding reception for decades to come. Pop culture aside, the 1974 event that may have had the greatest impact on the Baby Boom generation was the rollout of the Individual Retirement Arrangement (IRA). 40 years later, many Boomers have substantial IRAs, ballooned by tax deferred savings, earnings, and rollovers from retirement plans.

Account owners may begin taking penalty-free distributions from their IRAs as early as age 59½, but many choose not to. Either they simply don't need the income, or they prefer to let

the account grow while they spend down other assets. Of course, the government eventually wants its tax money, so it requires that all account owners begin taking annual distributions no later than the year in which they turn 70½. These distributions are based on actuarial tables published by the IRS and are called Required Minimum Distributions (RMDs).

For many account owners, RMDs are unwelcome. First, few self-respecting Boomers like to be reminded that they have reached their eighth decade. Second, since most IRA distributions are taxable at ordinary income rates, RMDs can kick account owners into higher marginal tax brackets. Fortunately, for those who are charitably inclined, the American Taxpayer Relief Act of 2012, which was reinstated by Congress for 2013, allows for what's called an "IRA Charitable Rollover." First created in 2006, the IRA Charitable Rollover has been allowed only in certain tax years. When the law is in force, it lets account owners who would otherwise be subject to RMD requirements transfer as much as $100,000 of their RMD to a qualified charity or charities. This is called a Qualified Charitable Distribution (QCD).

When a QCD is made, the account owner does not receive a tax deduction for the charitable contribution, as they might if making the gift from a taxable account. However, the QCD need not be reported as part of the account owner's taxable income, amounting to a tax free distribution from an IRA. QCD tax benefits are available to account owners even if they don't file an itemized return. In the final analysis, many taxpayers may find that gifting from their IRA is the most advantageous way to give to a qualified charity.

The IRS is fairly rigid in its requirements for QCDs. In order to qualify, a distribution must meet the following standards:

- The account owner must be 70½ or older by the date of distribution.

- The distribution must be a direct contribution to the charity. In order to be eligible, account owners must ask the account custodian to transfer the distribution directly to the charity.

- The distribution must be an outright gift to a qualified 501(c)(3) organization. Donors have a free hand in selecting the qualified charity of their choice, but donors may not keep strings attached or make directives. Specifically, donor advised funds and private foundations do not qualify to receive QCDs.

- Distributions cannot be made from retirement accounts other than Traditional IRAs and qualified IRA Rollovers. Employer plans, such as 401(k), 403(b), SEP IRA, and SIMPLE IRA plans, are not eligible.

- There are special rules pertaining to QCDs taken from Inherited IRAs.

Although taking advantage of the IRA Charitable Rollover provision may not make sense for everyone, it can be a useful tool for charitably-minded account owners who'd like to reduce their tax liability. If you're interested in making a Qualified Charitable Distribution from your IRA, we recommend that you first consult your tax professional. Once you've gotten the green light, we stand ready to help facilitate any distributions to your favorite charitable organization(s). Inquire soon, as this opportunity is scheduled to expire after the close of 2013.

Jean M. Deighan, JD, CFP®
Chief Executive Officer

SOUNDBYTES

Thank you to all who were able to attend our annual Seasons of Maine art event on September 20th! Special thanks to each of the artists for sharing their wonderful works. We enjoyed fantastic weather, great music (thanks to the Colin Graebert Jazz Trio), fine food, friends and fun. Best of all, Deighan Wealth Advisors will contribute 10% of the proceeds from art sales to the Maine Masters Series documentary project on our 2012 artist, Jon Imber.

We've all been busy these past few months with community and board commitments: Jean with Maine Community Foundation; Matt with Maine Seacoast Mission; Lucie with the Bangor Symphony Orchestra; and Jenifer as President of Bangor Rotary Club. We're deeply committed to our community and enjoy giving back to the area that has given so much to us!

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YEAR-END TAX TIPS

October is here and pretty soon we'll be closing the books on 2013. Fall is the perfect time to pause before the busy holiday season and do a little end-of-year tax planning. Following are a few of our favorite annual tax tips. We recommend that you check it twice, because you may find something nice to discuss with your tax preparer.

Pay Yourself First

Take full advantage of any tax-deferred retirement accounts you might own, such as a 401(k), 403(b), SEP IRA, SIMPLE IRA, or Traditional IRA. Remember, your contribution will reduce your taxable income dollar for dollar. It might be a good idea to contribute to a Roth IRA too, if you're eligible. Even though Roth IRAs don't provide immediate tax gratification, they do allow account owners to withdraw distributions tax-free in retirement.

Give Wisely

When making charitable contributions from a taxable account, be sure to use appreciated securities. Donors who gift appreciated securities "in kind" to qualified charities may deduct the full amount of the gift without recognizing a capital gain.

If you're charitably inclined, are over 70½, and own a Traditional IRA or IRA Rollover, then you might be able to gift from your IRA directly to a charity of your choice in lieu of taking a Required Minimum Distribution (RMD). Read more about this opportunity elsewhere in this newsletter.

Increase Your Itemized Deductions

Check with your tax preparer to see if it makes sense to shift certain deductions forward to this tax year, such as the second half of your real estate taxes. Also, portfolio management fees, like tax preparation fees, may be deductible as miscellaneous expenses to the extent they exceed 2% of your adjusted gross income. One caveat: management fees deducted directly from IRAs or qualified retirement accounts are not deductible, unless paid for by an after-tax account such as an investment management account.

The foregoing tax tips are just some of the many ways that enterprising taxpayers can save a little money. We encourage you to meet with your tax preparer in the months ahead to be sure you're doing everything you can to be tax savvy. For our part, we will continue to be tax sensitive when managing your portfolio, offsetting gains with losses whenever it makes investment sense. Should you have any questions, please call us or your tax professional for more information.

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