The
FINANCIAL UPDATE

DAY & ENNIS, LLC
FEE-ONLY FINANCIAL PLANNING

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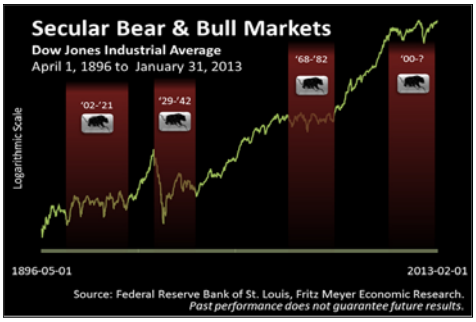
The Case For A New Secular Bull Market

A secular bull or bear market is a paradox. Despite its long-term status—or perhaps because of it—it's difficult to say when a secular bear wave is ending and a bull wave has begun.

A secular market is different from a cyclical one. A cyclical bear or bull market is when stocks rise or fall 20% or more. You objectively know when you're in a cyclical bear based on a single number. In contrast, a secular bull or bear market is identified based on more nebulous criteria: optimism and pessimism. How do you measure investor optimism? A key measure is the price-to-earnings (p/e) ratio of stocks.

Secular bull markets are characterized by an expansion of the p/e multiple. People are willing to pay more for stocks because they believe they will appreciate. What's fascinating is that we may right now be at the start of a new secular bull market. A recent rise in the p/e ratio and a confluence of other positive influences, makes a case that a new secular bull market began at the start of 2013.



U.S. stocks have endured four secular bear markets, as shown in the accompanying chart. (Periods between bear markets are all bull markets.) After the financial crisis, pessimism about stock investing was so rampant that companies in the S&P 500 index, America's blue-chips, were valued at less than 12 times every dollar of profit they earned.

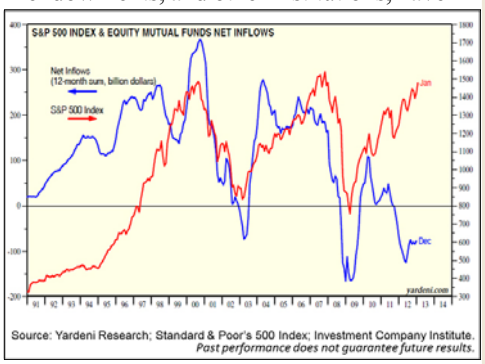
After hitting a low in March 2009, however, the Standard & Poor's 500 index rose 120% through mid-February 2013. That restored the stock market's p/e ratio to a level in line with the historical norm, but still only at the low end of the historical norm. The market multiple p/e expanded from 12 to 14.6.

In the first quarter of 2013, a confluence of events unfolded that could lead to continued expansion of the market p/e multiple. While there is no certainty this will happen, growing evidence of the shift to a secular bull market should not be ignored. According to a Feb 9, 2013 article in Barron's, we might be on the cusp of a "great rotation into stocks" for several reasons:

Low Yields. The Federal Reserve Bank has kept interest rates low, making stocks relatively more attractive than bonds.

Housing Prices. With housing prices reverting to the historical norm, the "wealth effect" could make homeowners less risk-averse.

Institutional Investors. Pension funds, endowments, and other institutions, have



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Improved Communication And Reporting

We continue our efforts to improve client service and keep you informed of your progress toward your financial planning goals. Our latest development allows clients to access information about their accounts through a portal encrypted for security.

You'll find a tab on the home page of www.dayandennis.com which says "Client Log-in". We'll send you a password to get started. Once there, you will find:

--A dashboard that summarizes Performance, Holdings, Asset Allocation and Documents. You can view each of your accounts individually or as a group through the Accounts dropdown menu.

--Additional reports that are available from the Reports dropdown menu. These include Capital Flows, Income and Expense, Projected Income, Realized Gains/Losses, Transactions and Unrealized Gains/Losses.

--Quarterly reports which are posted to the site with immediate notification that the documents have been added to your vault.

--Important documents stored on the site including Financial Plans and Updates, Investment Policy Statements, Wills and Trust documents, and Powers of Attorney.

This new site should ensure that important documents are always available to you. Please let us know if you have any questions or comments about the new service.

Sincerely,
Day & Ennis, LLC

Owning REIT Shares Can Help Minimize Risk

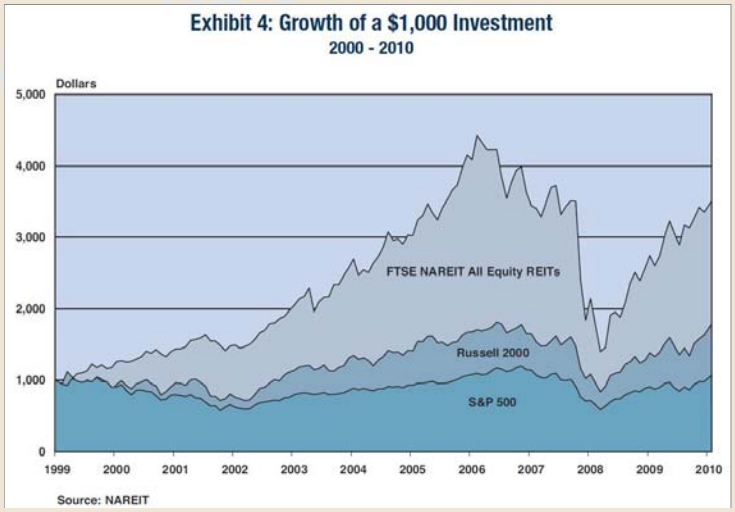
Diversification has been touted as the best way to avoid the steep ups and downs that can hit investors who rely too much on a narrow range of investment types. But the financial crisis of 2008-2009 ripped a huge hole in the diversification safety net, as most assets plunged together.

In the wake of the crisis, many investors are understandably concerned about the right mix of assets—stocks, bonds, real estate, cash, and other investments. For most people, it's not just a question of maximizing returns, but also of minimizing risk.

Investing in real estate through real estate investment trusts (REITs) can be part of the answer, especially when it comes to reducing volatility and risk, according to a new study commissioned by the National Association of Real Estate Investment Trusts (NAREIT).

"Diversifying the global portfolio to include real estate stocks alongside other stocks and bonds can potentially increase risk-adjusted returns and minimize expected losses for both risk-averse and moderate-risk investors," concludes the study based on 20 years of data from Morningstar Inc.

"The Role of Real Estate in Weathering the Storm" suggests that placing 14% to 20% of a global investment portfolio in real estate equities benefits those with low to moderate risk tolerance, especially when extreme risks such as a broad financial collapse are factored in.



Even including the real estate crash that started in 2006, REITs returned 10.63% from 2000 to 2009, compared with a negative 0.95% for the Standard & Poor's 500 stock index. That's partly due to the special tax status of REITs that forces the investments to return 90% of income as taxable dividends. Those dividends accounted for 56% of REIT total returns, compared with the 23% that dividends contributed to the returns of S&P 500 companies (between 1989 and 2012).

Many wealthy investors are on board. According to Spectrem, one third of investors with a net worth between $5 million and $25 million own REIT shares, and two-thirds of those with $15 million to $25 million own REITs. The average REIT stake of those investors is valued at $1.2 million.

A REIT is a company that owns and manages income-producing real estate. Most invest in specific types of property, such as offices, apartments, shopping centers, malls, industrial facilities, hotels, self-storage facilities, health-care properties, and more specialized properties.

According to Morningstar, REITs offer the potential for high yields, simplified tax issues, liquidity, and diversification. Drawbacks include a tendency for shares to lose value when demand rises for other high-yield assets such as U.S. Treasury bonds, and the potential for high property tax costs.

We can help you determine what portion of your portfolio to invest in REITs and what types of REITs best suit your financial goals. ●

Pros and Cons Of Section 529 Plans

A Section 529 college savings plan can be a tax-smart way to help your children pay for their higher education. But you should also be aware of several potential pitfalls of this planning device. Here's a brief rundown on the main pros and cons.

The Pros

The account can make money. A Section 529 plan works much like a mutual fund, with account assets typically invested in equities by professional money managers. They do the hard work while you sit back and watch the account grow.

Count on the tax benefits. Contributions to the plan are gift-tax-free, the earnings within the plan are income-tax-free and any distributions that are used for qualified education expenses are also income-tax-free. That's a hard combination to beat.

Funds may be invested automatically. Frequently, a plan will let you have funds automatically withdrawn from your checking or savings account. Not only is this convenient, it also takes some of the guesswork out of saving for college.

Contribution limits are generous. State law effectively controls the amount you can sock away in a Section 529 plan, but the limits are favorable. In some states, you can contribute as much as $200,000 to your child's account, which should be sufficient to cover tuition for four years at most schools.

Account assets are portable. Although 529 plans are sponsored by individual states, the money can be used to pay for college wherever your child attends. Also, if funds are left over when your son or daughter completes school, you can use the excess to pay college expenses for another child.

The Cons

Funds must be used to pay qualified expenses. If you make a withdrawal and use the cash for any

10 Reasons For The IRS To Flag Your Return

What sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 "red flags" that could increase the chance you'll be tapped for an audit.

1. High income. The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of $200,000 or more. That's almost one out of every 25 returns. The IRS tends to chase the "big money," and while that's no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

2. Unreported income. The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You're likely to draw IRS scrutiny if you don't report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

3. Large charitable gifts. Besides providing personal satisfaction, deductions for charitable gifts can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

4. Home office deductions. If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office "regularly and exclusively" as your principal place of business. Simply doing work at home when your main office is elsewhere won't cut it.

5. Rental real estate losses. Generally, "passive activity" rules prevent investors from deducting losses on rental real estate. But a special exception allows a loss deduction of up to $25,000 for "active participants," subject to a phase-out between $100,000 and $150,000 of adjusted gross income (AGI). Another exception applies to qualified real estate professionals. The IRS may zero in on taxpayers claiming losses under either exception.

6. Travel and entertainment expenses. This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

7. Business use of cars. Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called "luxury car" rules. IRS agents have been trained to ferret out taxpayer records that don't measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn't available for personal use.

8. Hobby losses. As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can't claim a loss for the activity, unless your involvement rises to a level of a bona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

9. Foreign bank accounts. The IRS has started clamping down on taxpayers with offshore accounts in "tax havens" in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.

10. Cash businesses. Finally, if you operate a small business in which you're generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don't mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●

other reason—say, to pay emergency medical expenses—the distribution attributable to earnings is taxed on both federal and state levels, and you'll owe a 10% penalty. You'll also be taxed on any leftover amount you receive after closing the account.

The investments are out of your hands. This is the flip side of having professional money management. If you're a savvy investor, you may prefer to have greater control over the funds. Should you be inclined to use a different investment option outside of a 529 you've established, you'll be taxed and penalized if you withdraw funds and invest them elsewhere.

It might affect financial aid eligibility. The impact of a Section 529 plan is usually negligible if held by a parent. Nevertheless, it must be factored into the equation to determine the "expected family contribution" (EFC) for college costs.

For most families, Section 529 plans are a good deal, but they're not for everyone. We can provide the necessary guidance. ●

Dust Off Life Insurance Policies

When was the last time you reviewed your life insurance policies? If you're like most people, you've probably stashed your policies in a drawer, filing cabinet, or safe deposit box where they've been gathering dust. But you should review your policies periodically to see whether they still meet your needs. Depending on the outcome, you might adjust your coverage.

In particular, you should examine your policy if you've experienced one or more major "life events" during the past year. What sort of events are we talking about?

- There may have been a birth, death, or disability in the family.
- You got married, divorced, or separated.
- You bought or sold a principal residence, vacation home, or other real estate property.
- Your child completed college or graduate school.
- You acquired property as a joint tenant.
- You have switched jobs, retired, or started up a new business.
- There was a significant economic change affecting your business operation.
- You need to revise the beneficiaries of your insurance policies due to a change in circumstances.

Note that other changes that might trigger a life insurance review could be less obvious. For instance, you may need additional coverage if you're now taking on financial responsibilities for an elderly or disabled relative. Conversely, your financial responsibilities may decrease somewhat if you have finished paying off a home.

Furthermore, you should try to view your family's needs as if you were buying life insurance for the first time. It's your current and future circumstances that are the critical factors—not how things were last year or several years before. And don't forget to review all of your life insurance policies, including any group coverage that your employer (and your spouse's employer) might be providing.

Needless to say, this is an on-going process. A main function of life insurance is to replace lost income that your family relies on if you should die prematurely. When your financial obligations are small, the amount of life insurance coverage you require is also small. However, as those obligations grow, so does your need to acquire more coverage.

Typically, your life insurance needs will be at their greatest when your children are relatively young and you're in the midst of your career. Once your children have flown the coop, or you have retired, your insurance needs will likely not be as great.

Best approach: Assess your life insurance needs at regular intervals. You may want to do so at the start of a new year or on some other "anniversary" date. In any event, don't let too much time go by without a regular check-up. ●

New Secular Bull Market

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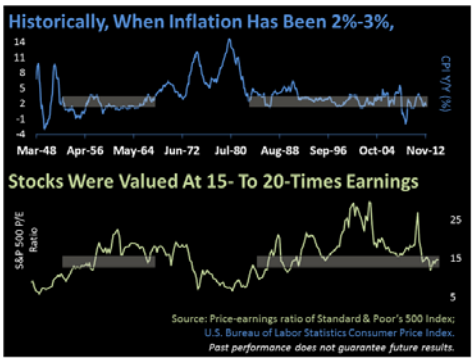
allocated just 30% of their portfolios to equities since the financial-crisis and can't meet their investment goals unless they take more risk by boosting equity allocations.

Retail Investors Return. Since the financial crisis of 2007-2009, retail investors shunned stocks. The accompanying chart shows inflows into stock mutual funds since that time have been anemic recently relative to the previous two times the S&P 500 neared its all-time high of 1500. According to independent economist Ed Yardeni, the 120% rebound in stock prices that began in March 2009 was fueled by stock buybacks by corporations sitting on cash. Main Street investors were not in on the recent bull run—until December 2012. Then net inflows into stock mutual funds abruptly reversed, according to Investment Company Institute.

If Main Street investors return to stock mutual funds, that would be sign of a major shift in sentiment, a shift toward optimism, which is the mark of secular bull market. Secular bull markets are characterized by an expanding price multiple on corporate earnings. Optimism makes investors more willing to pay more for earnings. How much can sentiment boost stock prices?

According to economist Fritz Meyer, when the U.S. inflation rate has averaged 2% to 3%, investors have historically valued stocks in the S&P 500 in a range of 15 to 20 times their earnings. In February 2013, when inflation was hovering at about 2%, the S&P 500 was trading at 14.8 – the low end of its historical p/e ratio range.

Thus, if a new secular bull market is under way—a scenario bolstered by the great rotation into stocks—gradually increasing optimism could propel expansion of the p/e ratio back into the normal range. Past performance does not indicate your future result, and the case for a new secular bull market could be overly optimistic. But ignoring the favorable data carries a risk of missing out. ●



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