CYPRESS FINANCIAL REVIEW

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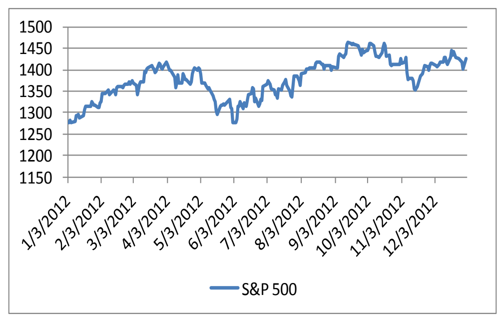
We're Still Here!: A Look Back at 2012 and a Peek at What Lies Ahead

Despite apocalyptic predictions based on interpretations of the ancient Mayan calendar, not to mention teetering on the brink of a Fiscal Cliff, we have survived into 2013! 2012 was a very memorable year on many fronts: unprecedented actions were taken to keep the Euro Zone intact, ever-popular social media site Facebook launched an ill-received Initial Public Offering, the US won a record setting 46 gold medals in the London Summer Olympics, and Barack Obama was elected to a second term, remaining our Nation's 44th President. Unfortunately, a few tragedies scar deeply in our memories, including Superstorm Sandy that pummeled parts of New York and New Jersey and a shooting rampage at an elementary school in Newtown, CT. With all of these headlines flashing across our screens, the financial markets marched on and on, and up and up, helping to make up the ground we lost in the weak performance of 2011.

US Stock Market Performance



Coming off of a lackluster -0.003% performance in 2011 as measured by the S&P 500 index, investors were cautious but hopeful that the economy would pick up steam and take share prices with it. While many individual investors were scared off by the late summer carnage the year prior, those brave enough to stay invested in 2012 were rewarded with a handsome 13.4% return, the best since 2009. Few would have guessed we would finish the year so well back in the early summer. Fears that Spain and Italy would default on their sovereign debt coupled with weakening domestic data caused the market to tailspin 10% from their April highs. Have no fear, our brave Federal Reserve Chairman Ben Bernanke always comes to the rescue! Along with his trusty sidekick, European Central Bank President Mario Draghi, Bernanke fired up the printing presses and launched stimulus programs of unprecedented scale. These were designed to keep interest rates low, encourage individuals and corporations (and governments) to borrow and spend, and to convince nervous investors that the Euro Zone would avert implosion. For the near term at least, this strategy worked extremely well. Fears subsided, US GDP growth kicked into a higher gear, and stocks zoomed over 14% in less than four months! Election season proved a bit rocky, culminated by a 313 point drop in the Dow Jones Industrial Average the day after President Obama won a second term. Stocks teetered through the finish line with the looming December 31st fiscal cliff deadline, but never suffered the significant free fall that many had feared. Small cap stocks typically exhibit amplified performance relative to their larger counterparts, mainly due to their higher sensitivity to market cycles and greater risk. This year was no different with small cap stocks besting large caps by clocking in at a very healthy 16.7% return.

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International Stock Market Performance

In late spring, things looked very bleak in Europe. Citizens swarmed their local banks, demanding all their deposits returned to them in scenes reminiscent of our Great Depression. If a country were to exit the Euro Zone, their currency would revert to their pre-euro denomination and see significant devaluation instantly. Borrowing rates for Spain and Italy were skyrocketing to unsustainable levels and Germany was resisting calls for a bailout. The MSCI EAFE index of international developed countries plummeted almost 17% during this two month period. While few investors had the stomach to purchase European stocks around this time, hindsight shows us that it would have been an ideal entry point. International stocks finished the remainder of the year up 22% from those lows. For 2012 as a whole, the developed international markets of Europe, Japan and Australia finished up 15.0%. Emerging market stocks in countries such as China, South Korea and Brazil hugged their developed counterparts tightly throughout the year, and then edged slightly ahead at the end to finish up 16.5% in 2012.

Bond Market Performance

For the last few years, economists and investment managers alike have been fearful that interest rates had sunk too low and were poised to spike, inflicting pain and carnage to an asset class known for low volatility and safety. 2012 was not to be that year, as interest rates remained at historic lows. No data point is more indicative of this than the record low yield of 1.404% on a 10-year Treasury Bond reached on July 24th. A conservative investor with a portfolio of US Treasury Bonds would have received a modest 2.0% return for the 2012 year. Taking on a slightly higher amount of risk through municipal bonds would have boosted the total return to 6.8%, despite the fact that interest on municipal bonds is free from federal taxation. An investor willing to lend her money to corporations as opposed to governmental entities was rewarded with a total return of 9.8%, on par with even the loftiest expectations for a stock-like return.

Alternative Investment Performance

The so-called smartest investors came off a year of significant underperformance in 2011 with a thud. Hedge funds are an asset class where investment managers have significant flexibility to place bets for or against any type of security. However, their inability to accurately predict market movements resulted in a mediocre 3% gain through November, compared with 18% for the S&P 500 over that time frame. The S&P 500 has now outperformed its hedge fund rival for ten straight years, with the exception of 2008 when both fell sharply. Gold finished in positive territory for its twelfth consecutive year. Its closing price of $1,676/oz was 6% higher than the start of the year. Oil also moved higher for a fourth straight year, rising a modest 3.5% and setting a record for the highest average daily price of over $111/barrel. The biggest loser of the year was Arabica coffee, falling nearly 40%.

State of the Economy

Despite many of the risks mentioned above, including a Greek exit from the euro and US potentially falling off a fiscal cliff, most key economic indicators improved throughout the year and many currently paint a relatively optimistic picture. Third quarter Gross Domestic Product, the most recent time period available, clocked in at a 3.1% annual growth rate, up from 1.3% in the second quarter. The unemployment rate has dipped to 7.8% through December, the lowest level in four years. Home prices rose 0.7% in October, marketing the ninth straight price increase nationwide. Additionally, new single-family home sales accelerated in November to the fastest pace in 2 ½ years. All of these figures point to a recovering economy.

Outlook for 2013

As with the beginning of any other year, we sit at the beginning of 2013 with a list of strengths and challenges for the global economy. At the top of the former list sits central banks' efforts to bring the cost of money down to encourage growth. Coupled with corporate cash flows at multi-decade highs, low government and household debt service and rapidly increasing emerging markets consumption, there are many reasons the stock market could continue to march higher toward the peaks set in October 2007. Challenges to this forecast include a looming US debt ceiling and spending cut debate, expiration of a 2% payroll tax holiday for US workers, high sovereign debt levels in developed countries including the US, Iranian nuclear enrichment, and fading growth benefits from the stimulus efforts. Reaching a fiscal cliff agreement at the 11th hour is by no means a resounding victory in US politics. The upper bracket tax hikes make only a small dent in our national deficit, and Federal debt is headed to levels only exceeded during World War II.

Stock market gains are driven by three factors: 1) corporate earnings growth, 2) the multiple that an investor pays for a dollar of earnings, and 3) dividend payouts. Top economists predict that 2013 will be a very strong year for earnings growth for US companies, at 10% growth compared to around 6% that 2012 will likely show when finally tallied. The Price/Earnings multiple currently stands at a relatively average level of 12.7x and may modestly add or detract to stock performance throughout the year based on investor sentiment. Dividend payout ratios are near all-time lows, but dividend growth rates are the highest in six decades. All told, economists across the board are predicting high single digit returns for the market in 2013.

On the bond front, investors should be a little more cautious. Owners of bonds and bond mutual funds earn a return in two ways, through interest received and through changes in the prices of the bonds. The interest received is always a positive return, but the price can rise or fall. Over the past few decades, declining interest rates have led to surging bond prices, creating a strong positive environment for bond investors. Going forward, if an investor desires to lend her money to the US government for 10 years, she will be rewarded with a 1.86% return before taxes. 30 years will offer a 3.07% return. Meanwhile, if interest rates begin to rise from these historically low levels, the prices of bonds and bond mutual funds will decline, possibly negating the positive yield.

Key Points of the Fiscal Cliff Deal

Late on New Year's Day, Congress approved legislation to address the year-end tax hikes and spending cuts known as the fiscal cliff. This deal to avert the initial stages of a potential economic disaster and renewed recession was received warmly by the markets in the early days of 2013. What does this mean for your financial future? According to The Tax Policy Center, approximately 77% of American households will face higher federal taxes in 2013. Let's look at a few of the key points that will affect your tax liability in the near term and also how this deal may affect the market going forward.

- **Higher taxes on individuals earning $400,000 and on families making $450,000 or more.** Any excess income above these levels will now be taxed at 39.6%. This represents the largest income tax rate increase in nearly two decades. Under that threshold, the Bush-era tax cuts will remain in effect. The $450,000 threshold for families is an increase from Democrats' initial proposal to raise taxes on Americans making $250,000 or more, but it is lower than Republicans' proposal to raise taxes on households making $1 million or more.

- **Higher tax rates on capital gains and dividends for wealthier households.** The tax rate on capital gains and dividends will rise to 20% from 15% for incomes above the levels described above. These tax rates will remain at 15% for all other applicable taxpayers below these thresholds. Avoiding the taxation of dividend income at ordinary income rates is viewed as a major positive for investors–especially those with dividend oriented investment strategies in their portfolios.

- **Personal exemptions phased out for individuals making over $250,000.** Personal exemptions will be phased out and itemized deductions will be limited for taxpayers making over $250,000 and families earning more than $300,000.

- **40 percent estate tax.** The estate tax will rise to 40 percent from its current 35 percent level, with the first $5 million in assets exempted. Democrats had earlier sought a higher increase to 45 percent and a lower exemption of $3.5 million.

- **Business tax breaks.** A lengthy list of these targeted business tax provisions that are known to those in the legislative trade as "tax extenders" was also passed as part of the deal. Some call them vital incentives for job creating investment and others call them special interest loopholes. The idea behind them is to spur economic growth and innovation for the future, but it is done so at the cost of billions of dollars of tax revenue estimated to be lost over the next ten years.

- **Expiration of the payroll-tax cut.** A temporary, 2-percentage-point cut to the payroll tax expired at midnight on Dec. 31, 2012, and was not renewed. As a result, the rate of payroll taxes for workers used to fund Social Security will increase from 4.2% to 6.2%.

While the deal addressed revenue and helped to lessen the initial taxable impact that would have been experienced by many taxpayers and investors had no deal had been reached at all; the deal merely "kicked the can down the road" as it delayed any decisions on all important spending cuts for another two months. We are nowhere near clear on the Fiscal Cliff front. A second deal will need to be reached within the next two months addressing the larger issue of rampant spending. If we are to go off of what we've seen in the past, this deal will most likely come down to another "11th hour" scenario with market volatility increasing as we get closer to the new deadline.

If an agreement between the two political parties on spending cuts cannot be reached in that timeframe, the highly contentious debt ceiling debate would return to the forefront as more debt would be needed to fund the existing federal budget imbalance. Last time, the negotiations resulted in a downgrade of the U.S. credit rating and whipsaw volatility in markets. This time the stakes will be just as high, if not higher.

What's The Truth About Life Insurance?

Financial planning presents challenging decisions, particularly when it comes to selecting the appropriate financial product or vehicle for a given financial problem. Mutual funds or ETF's? 15 or 30 year mortgage? While questions like these deserve a full debate, this edition of the Cypress Financial Review will tackle perhaps one of the most polarizing of all financial planning product debates: term or permanent life insurance? This issue has caused such controversy partly because financial advisors come from various industries and sell different products. Insurance agents can provide financial planning and also sell insurance. Many investment advisors work for securities firms and do not sell insurance. Financial planners come from various industries and may or may not sell insurance. In full disclosure, Cypress Financial Planning is an independent, fee-only firm and does not sell life insurance. Nonetheless, this article will attempt to provide an unbiased framework and important pointers for choosing the best type of life insurance as we do not believe financial planning is a "one size fits all" proposition.

So how should an individual, family, or business owner approach the issue of life insurance? The individual should always start with questions of need. What is the need and how much insurance will cover that need?

- **Dependent well-being** – Do I have children or other dependents that rely on my income or wealth for their well-being? If so, if I were to pass away today, how much cash would my husband need to pay for that well-being including normal annual expenses as well as our goal to fund 50% of our two children's college tuition?

- **Pay off Debts** – What debts do we have that my surviving spouse may struggle to pay each month if my income disappeared? What would it cost to pay off the remaining balance on our primary mortgage, our vacation condo, and our cars?

- **Insurance for Business Related Issues** – Will my business partner, in my absence, struggle to operate this business and would I want my wife to rely on the success of my business partner for her and our children's livelihood? What growth do we expect in the business each year and what is a reasonable amount to expect my partner to need to buy my wife out of our shares if I were to pass away? Do I want to pass on my stake in the business to my son that works in the business if my wife and I were to both pass away? How much insurance proceeds would our son need to ensure the estate taxes are paid so that he can continue to operate the business?

For most individuals, identifying and aggregating a rough estimate of insurable needs like these should not require too much effort . Of course, deeper financial planning always allows individuals to better forecast future needs to strategically and dynamically manage a life insurance strategy over time.

The more difficult challenge often comes when determining what type of insurance is the right fit. So let's briefly outline the types of insurance and a few examples of appropriate situations for each type:

Term Life Insurance
Term insurance is the most basic form, typically covering an individual's life for a set time period, or term (e.g. 1, 3, 5, 10, or 30 years). The cost is fairly simple as it is sold for an annual premium. As an example, a healthy 32 year old male may purchase a $1m, 30 year term policy for only a few hundred dollars annually. So from the day of purchase until he is 62, as long as he pays his annual premium, let's just say $400, his wife as beneficiary is entitled to receive $1m income tax free upon his death. For income replacement and paying down debts, term insurance makes a lot of sense. For this reason, most people will find it easy to solve their issues using a simple term policy. Given term policies are fairly cheap and flexible also makes them attractive.. As the need for insurance decreases over time, an individual can allow this policy to lapse and only give up the previous year's premiums. The underwriting process is straightforward and reputable websites allow for easy gathering of quotes for healthy individuals (e.g. www.quickquote.com).

Permanent Life Insurance
Permanent life insurance policies, in contrast with term policies, protect a policy holder throughout the insured's entire life. If a policy holder lives to 90 and continues to keep the policy paid up, she will be entitled to a death benefit indefinitely. Term policies typically become prohibitively expensive as individuals approach retirement age. There are several popular forms of permanent insurance including traditional whole life, universal life, and variable life.

- **Whole Life** – a fixed annual premium and guaranteed minimum annual cash value growth
- **Universal Life** – flexibility to raise or lower the annual premium and resulting cash value
- **Variable Life** – policy holder chooses investment risk, transferring some risk to policy holder

The commonality between each type of permanent life insurance is that they typically combine a life insurance component with a savings or investment component that builds what is known as "cash value." Therefore, permanent life insurance has two intentions: 1) a primary intention to protect the policy holder's beneficiary in the case of the insured's unfortunate death and 2) to grow a cash value during the policy holder's lifetime to provide potential cash value through loans or outright surrender of the policy. One of the most important aspects of permanent life insurance to keep in mind is that premiums are much higher than those of term policies. Also, due to high fees and surrender charges, they usually require 15 to 20 years of premiums paid before the cash value and rate of return in the investment portion make economic sense. For example, a healthy 35-year-old man who pays $500 a year for a $1,000,000 term policy may pay $6,000 annually for a $1,000,000 cash value policy. A portion of that large premium is going toward the investment component of the policy. While the owner who allows a term policy to lapse after 10-years would lose $5,000 of premiums, a reasonable cost for 10 years for $1,000,000 of insurance, the owner of the permanent policy would give up a significant percentage of the roughly $60,000 he paid into it. Studies show that more than 50% of permanent life insurance policy holders do allow the policies to lapse prior to 10 years. Therefore, a buyer should do very thorough research and analysis before purchasing a permanent life insurance to ensure he can afford to continue the policy long-term, has the willingness and discipline to do so.

Permanent insurance is usually ideal when a financial need exists that will likely outlive its current provider. Examples include:

- Individuals and families with disabled, dependent children that will always have the need to be cared for and are expected to outlive their caregivers
- Businesses insuring against the absence of key executives due to death. Insurable needs may include income replacement for the spouse of deceased executive, proceeds to provide the family of the deceased with ample liquidity for estate tax on the value of the business, or proceeds to buy out the shares of a surviving spouse.
- Individuals that start families later (40s and 50s) where term insurance has become prohibitively expensive and permanent insurance is the only option.

Beyond a permanent need, high income earners or wealthy individuals may like the combined benefits of an income tax-free death benefit and potentially tax-deferred lower risk returns over 15 or 20 year periods. Insurance agents highlight these benefits frequently, and in the right situation, it may make sense. However, evaluating permanent life insurance policies thoroughly requires fairly complex analysis to determine a realistic rate of return. Experts say that many permanent life insurance products can produce 3% to 5% rates of returns over long periods. However, the rates of return are very dependent on several factors. Breaking down permanent insurance into its two component parts: a term life insurance policy and an investment account allows an "apples-to-apples" comparison between holding either a permanent life insurance or holding a term life insurance policy and investing the would-be additional premium in a separate investment portfolio outside of the insurance. The best analyses can also help determine how much of the cash value is available to the policy holder at any given year in the life of the policy, either through a loan or surrender, determining the holding period required to make the hypothetical rate of return breakeven or economically beneficial. We recommend someone who feels the need for a permanent policy seek professional help as the analysis requires a deep dive into the policy itself and the financial models to plug in various assumptions.