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## Market Commentary

It's 98° in Burlington, the entire East Coast is socked in with the heat wave, the dog days of summer are here and everyone's attention span is a little short; I'll be brief this quarter.

I don't believe that the equity markets have been taking a random walk across the charts lately. While it seems as though there's been more "talking head" babble lately and a lot of news static, there has been a lot more chaff generated than wheat. The kernels of truth are there but they need to be carefully separated. Perhaps this will surprise you, but I believe the markets have in fact done a pretty good job of sifting through the dross and have reacted appropriately, at least *directionally*.

I emphasize *directionally* because I think what has increasingly complicated matters over the past several years has been the ever larger share of daily market volume created not by investors but by "black box" trading—hedge funds and most significantly the so called "high frequency traders". Most of this trading is done on, literally, a millisecond by millisecond basis and has **absolutely nothing to do with earnings, dividends, or even the name of the company.** High frequency trading operates on such a short time line that it tends not to alter the direction of the market longer term (for them this is an hour or a day), but because they



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trade billions of shares a day they can influence the size of the change over a shorter period. In electrical terms they might represent a lot of volts but no amps. Most of the time they operate unseen to the average market watcher, but the "flash crash" of May 6th was a day when they became all too apparent. (For the record, I am opposed to high frequency trading.)

Therefore, I can't blame the market direction on a technicality. The upswing from March 2009 through late April 2010 was *directionally significant* because it recognized that the markets shouldn't price for the end of the world; earnings would in fact recover. I do think

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**Special points of interest:**

- Updated Privacy Notice enclosed
- Markets Closed September 6 (Labor Day)
- **Summer Vacation week: July 26-30 (Office Closed)**
- Time to schedule a mid-year review! Call us for an appointment.

## Second Quarter 2010 Market Wrap

<u>Market Indexes</u>	<u>% Change from 3/31/10</u>
S&P 500	-11.9%
DJIA	-10%
NASDAQ Comp	-12%
MSCI EAFE	-14.9%
Russell 2000	-10.2%

<u>Mutual Fund Yardsticks</u>	<u>% Change YTD</u>
Equity Income	-10.1%
Large Cap Growth	-12.3%
Balanced	-6.3%
Gen US Taxable	+2.4%
Intermediate Inv Gr Bond	+2.9%



## Market Commentary (cont from page 1)

the hedge funds and high frequency traders exacerbated the move downward into March 2009. Likewise, the last surge of the up move from perhaps February 2010 through April was a bit extended, but did represent the monetization in the stock market of better news in the economy.

This quarter's correction has been choppy, confused at times, and volatile. I think if we stand too close to it, we could construe the down move as just more trading static, as much ado about nothing; but I believe that once again the directional move is important and that only the amplitude is wrong.

If the markets change in direction is correct and the short-term sentiment turned negative this quarter the question is-why? First, remember that the markets are a discounted pricing mechanism. The valuation equation basically pits the required rate of return

(accounting for perceived risk) against dividends, growth and the expected growth rate (+/-) in each. Simply put, we will pay more today for higher after-tax dividends and greater earnings and we will pay less today when either (or both) are diminished. If we add positives to the economy and earnings improve, the stock market will go up. If we subtract from the economy, stock markets will fall.

While the run up from March 2009 initially was an oversold reaction, I think the second half of the run up (Q4 2009 through Q1 2010) was a positive valuation adjustment that recognized some real strengths in the world economy. Unfortunately, the Q2 2010 correction was, I believe, a negative discounting of some newly perceived costs and risks in the economy. To wit:

1. A government coordinated slowdown in China to prevent inflation.

2. The realization that Greece can (and perhaps will) fail.
3. A realization that Greece is a cautionary tale for the US.
4. Concern for the unintended consequences of Health Care Reform on the US economy.
5. The added cost to the economy of the Health Care Reform tax hikes (see page 3).
6. Estimates that the Financial Reform bill (also known as FINREG), if passed, will depress bank earnings by 10-20%.
7. That the Bush (EGTRRA of 2001) tax cuts will be allowed to expire in their entirety and without beneficial modification raising income, capital gains, and dividend taxes across all tax brackets, which reduces

spendable income flowing back into the economy.

8. A realization that unemployment has not improved, and of more concern, that small and mid-sized businesses are particularly risk adverse when it comes to adding new hires (see above).

I don't currently think that any of the above derails the recovery that began last year, but in the minds of those in the market that vote with their cash the added costs and uncertainties change the valuation equation lower, at least versus where we were at the start of the first quarter. Given the changing realities that will likely slow us down, the markets realized they were a bit ahead of themselves.



## Our Gift to Your Graduates

One of the most rewarding parts of our job is helping our clients navigate financially through the various stages of their lives. Because many of you have been with us since our inception in 1998, and even before that with Roy at Merrill Lynch and Paine Webber, we have seen your children grow from toddlers, through elementary school and even on to college.

As your children set off on their own we would like to offer them the opportunity to come in and talk to us about their financial future as our gift. Unfortunately personal finance is often not part of the high school or college curriculum. And, although you may have covered this in family discussions, sometimes people benefit from hearing the same message from an informed third party. We will be happy to discuss topic such as:

- Personal Savings Rates- what is appropriate?
- Retirement Plans- start now
- Credit Card Debt-how to control
- Pre-Marital Home Purchases-beware!
- Individual Insurance Needs
- Basic Asset Allocation theory
- FICO Credit Score-what you need to know

The lessons of the Great Recession have reinforced for us the need for people to get back to basics with their personal finances and there is no better time to get started on this than upon graduation. Call us to set up an appointment.

## Health Care Reform and Tax Consequences

### MARKET TALK

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Wealth Management  
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[www.siawealthadvisors.com](http://www.siawealthadvisors.com)

On March 23rd President Obama signed the *Patient Protection and Affordable Care Act (PPACA)* more familiarly referred to in the press as Health Care Reform. This sweeping piece of legislation has far-reaching consequences which will be phased in over the next 8 years. What will this cost and how will this affect you?

The main purpose of the reform was to mandate universal health coverage by requiring individuals to obtain health insurance. To “encourage” participation there are both carrots and sticks. On the plus side, there is a tax credit for premiums paid by eligible small employers (with 25 employees or less and average annual wages of less than \$50,000) for the years 2010-2013. Large employers (50+ employees) are subject to the stick—penalties of up to \$2000 per employee if minimum essential coverage is not provided. Self-employed or unemployed? The PPACA imposes a non-deductible penalty per person of up to \$695 or 2.5% of income (whichever is greater) for the uninsured who are not otherwise eligible for Medicaid or Medicare.

Extending health care benefits to the millions of uninsured Americans is certainly laudable. Those of us with teenagers were happy to learn that the PPACA extended employer provided coverage to adult children to age 26 (as long as they are still dependents). However, there is a price to pay. The Health Care Reform package contains over **\$400 billion** in revenue raisers and new taxes. Here are some of the increased taxes:

- Medicare payroll taxes will increase from 1.45% to 2.35% for individuals with wages over \$200,000 (or \$250,000 for joint filers). These amounts are not indexed for inflation. Starts in 2013.
- Medicare taxes will also be levied on investment income for this “high income” group. This is an additional 3.8% tax on dividends, interest, capital gains, rent and passive income. All unearned income is subject to the tax even if you are \$1.00 over the threshold.
- 40% non-refundable excise tax on group insurers for “Cadillac Plans” (individual coverage of \$10,200/ family coverage \$27,500). The insurer would be free to pass the tax along to the insured in the form of higher premiums. Starts in 2018.

- The threshold for the medical expense deduction has been raised from 7.5% to 10%. Starts in 2013 with an exemption for seniors (65+) through 2016.
- New business reporting requirements have been imposed which require separate 1099 reporting by business owners for all payments in excess of \$600 to providers of property and services (such as telephone, shipping, cleaning, etc). Similar requirements may be extended to rental property owners. Starts in 2010.
- The penalties for taking non-qualified distributions from health savings accounts and Archer MSA’s have been increased to 20% (from 10% and 15% respectively) and the deductibles have been limited to \$2000 for individuals and \$4000 for families. Starts in 2011.

In addition, the expiration of the 2003 tax cuts will most likely lead to the following additional tax increases:

- ⇒ The top 2 tax brackets will likely revert back to 36% and 39.6%, respectively (from 33% and 36%). Expected in 2011.
- ⇒ Capital gains will increase to 20% (or more) from the current 15%. Projected for 2011.
- ⇒ Dividends will be taxed at ordinary income rates as high as 39.6% for high income earners from the present 15%. Forecast in 2011.

**Prepare for the future now.** If you are a business owner, review your health insurance coverage now. Consider raising your deductibles before lower caps become mandatory. Tap into rewards for small employers by spinning off companies or downsizing to fall under the minimums. If your income is flexible, accelerate it into 2010 while the tax rates are lower. Use tax-reduction strategies (such as maximizing your retirement account funding) going forward to stay under the \$200,000 (or \$250,000 if married filing jointly) adjusted gross income level.