In This Issue...

What's Better: Saving or Paying Off Debt?
2013: The Year of Higher Taxes
Rebalancing Your Portfolio
How Much Can You Withdraw?
Financial Data
News and Announcements

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What's Better: Saving or Paying Off Debt?

The Great Recession has drilled home a lesson many people seemed to forget: debt can be dangerous to your financial health. For some, those who lost their jobs and ran out of savings, it was a lesson relearned the hard way. But for those who have managed to hang on or were young and had low levels of debt, it raises the question: is it better to save or pay down your debt first?

The answer depends on a lot of things that are unique to each individual, such as how old you are, how much you've already saved, what rate of interest you're paying, and more. A review of the basics of investment planning is a good way to approach the subject. Here we outline how you should use income not dedicated to day-to-day expenses, in order of priority.

First Priority: Insurance

One of the best routes to financial ruin is to not have adequate insurance, so your first priority should be to have the right kinds of policies in the right amounts that protect you and your family. If you're young and unmarried, this means having basic health insurance. Beyond that, if you have a family, you need life insurance as well as short- and long-term disability insurance. In each case, you're looking to provide yourself or your survivors with a replacement for the income you and they count on. The bottom line: if you have debt, make the minimum payments until you're properly insured and you have the next two priorities covered as well.

Second Priority: An Emergency Fund

Even if you don't have a family, you need to protect yourself against job loss or a major unexpected expense. The rule of thumb is to create an emergency savings fund equal to three to six months of your income. Not only does this give you breathing space against hardships, it also affords you the flexibility to move should you want to change jobs.

You should make creating an emergency savings fund a priority. If you can't take care of priorities one and two at the same time you pay for basic necessities, like groceries and gasoline, you're living beyond

Continued on page 2

2013: The Year of Higher Taxes

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012, and the next day, President Obama signed it into law. What relief the act gives is to low- and middle-income households, largely by extending the Bush-era rates on income taxes and capital gains (although everyone lost the two-year, two-percentage-point reduction in payroll taxes). The law keeps intact the rates on the lower six brackets (10%, 15%, 25%, 28%, 33%, and 35%). However, rates were raised for higher-income earners.

What the Taxpayer Relief Act Means

- **A new highest income tax bracket.** The Act reestablishes the 39.6% tax bracket for the highest incomes. It applies to single filers with taxable income of $400,000 or more and married couples who file jointly and have taxable income of at least $450,000. As unpopular as the very idea of raising taxes is, it's important to keep in mind that the new highest income tax bracket is below the century-long average of just over 59% (Source: Tax Foundation, 2013).

Continued on page 3

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What's Better?

Continued from page 1

your means and need to cut back on your spending.

Third Priority: Retirement Savings

Finally, before you even think about making more than the minimum payments toward your debts, it's imperative that you start saving for retirement, as soon as possible. Time is both the best ally and worst enemy of the saver. Start saving too late, and it's possible that you'll need a rate of return you can only achieve in your dreams in order to accumulate enough for a worry-free retirement. On the other hand, even small amounts — as little as $25 a month — put away early enough can grow to sizable amounts by the time you're ready to retire.

With these three priorities covered, if and when you have money left over, it's time to consider making extra payments to tackle your debt.

Guidelines for Debt Reduction

There are a number of factors to consider when you're ready to start accelerating the pace at which you pay down debt:

- **Start with the debt with the highest interest rate.** Instead of paying more on every one of your debts, concentrate on the one that charges the highest interest rate. In general, these will be store credit cards, followed by bank credit cards like Visa and MasterCard. Use all your spare cash flow to pay down one at a time.
- **Is it tax deductible?** Debt that you can write off against your taxes is generally considered "good debt." In effect, the tax deduction reduces the interest rate by your marginal tax rate. In most cases, this means home mortgage interest.
- **What rate of return can you expect?** The most important consideration is whether you can earn more by investing your money than the interest rate you're being charged on your debt. If you can earn more in the financial markets than your interest rate, you should invest your money instead of paying off the debt. If not, it's worth it to pay off the debt.
- **How long until you retire?** This is a key consideration when you're thinking of paying off your mortgage, especially if it's near the end of its term. At that point, the tax benefits are minimal because most of your payments consist of principal, not interest. In addition, if you're 50 years old or older, the monthly cash flow you'd free up could be devoted to the extra $5,000 a year you can contribute, pretax, to an IRA or 401(k).

On the other hand, if you have 10 years or more to go on your mortgage, it could be smarter to keep making the minimum payments to retain the tax advantages. As an alternative, consider the advantages of refinancing the remaining balance. At the reduced principal amount and with mortgage interest rates near historical lows, you may be able to reduce your monthly payments such that you can save nearly as much as you would if your mortgage were paid off.

Smart debt management is often overlooked as a way to improve your finances, yet it can be as powerful as smart investment management.

Please call if you'd like to discuss this in more detail. ❍❍❍

Rebalancing Your Portfolio

The purpose of rebalancing is to restore an investor's portfolio to the structure that fits his/her objectives. Here's how you do it: you sell off a portion of any asset class that has increased beyond its target percentage and reinvest the sale proceeds in more asset classes that have shrunk below their target percentage.

The calculation is simple: multiply the new market value of your portfolio by your target mix percentages and compare them to the values in your account.

Aside from maintaining the level of investment risk that's right for you, rebalancing has two additional benefits. However, it does not guarantee profit or protect against loss in declining markets and cannot eliminate the risk of fluctuating prices and uncertain returns.

First, it forces you to lock in your gains, which many investors fail to do. Second, rebalancing can add as much as one-half percent or more to your long-term investment returns. That may not sound like much, but over 20 years, it could mean thousands of dollars more in your pocket.

A good rule of thumb for rebalancing is once a year. But, depending on market performance, it could be more or less often than that. The best advice is to check your portfolio several times a year and rebalance whenever there have been significant changes in the weighting of its constituent parts.

This is just an overview of rebalancing. It can apply not only to asset classes, but to subasset classes as well.

Finally, there's always the chance that changes in your portfolio may coincide with changes in your objectives — you may actually need to be taking more or less risk than in the past.

Please call if you'd like to discuss this in more detail. ❍❍❍

2013: The Year

Continued from page 1

Secondly, it's a marginal rate, which means that the effective income tax rate is weighted for lower levels of income taxed at lower rates. Finally, the effect of the Act is to lower taxes or keep them flat for most Americans.

❍ **Higher taxes on capital gains and investment income.** While the Act retains the favorable long-term capital gains tax rate of 0% for those in the lowest two income brackets and 15% for the middle-income brackets, it raises it to 20% for households in the new 39.6% bracket. The 2010 Affordable Care Act also ushers in a new net investment income surtax tax of 3.8% for single filers with adjusted gross income above $200,000, and for married couples filing jointly, above $250,000. The surtax, designed to support Medicare, applies to dividend and interest income, rent, royalty, annuity, and trust income in addition to capital gains.

❍ **Higher Medicare payroll tax rate.** In addition to the Medicare surtax, under the new law, an additional Medicare payroll tax of 0.9% applies on income above $200,000 for single filers and above $250,000 for married couples filing jointly.

❍ **Limits on itemized deductions and personal exemptions.** By reinstating these limits — suspended the last two years — the new tax law exposes more of high-earners' income to taxation. Broadly called the Pease limitation for the Congressman who proposed it in the 1990s, it phases out the ability to take personal exemptions and limits the ability to take the full amount of itemized deductions for single filers with $250,000 or more and married couples filing jointly with $300,000 or more in adjusted gross income (AGI). The tax code allows most Americans to claim a $3,900 exemption for themselves, their spouses, and dependents. But under the new law, the value of personal exemptions is reduced by 2% for every $2,500 of AGI above the relevant threshold. That means that if you have adjusted gross income (AGI) of $125,000 above those thresholds, the personal exemption is zeroed out. As for itemized deductions, they apply to every category except medical expenses. The limit kicks in at the applicable thresholds, and limits those filers to the lesser of the results of either a reduction in the itemized deductions of 3% of adjusted gross income above the threshold or 80% of the deductions.

❍ **Higher estate tax rate.** The new tax law raises the federal estate and gift tax rate from 35% to 40% and sets the threshold for taxability at $5,000,000. That threshold is now permanently indexed for inflation, with the limit set at $5,250,000 for 2013.

Not every feature of the act is more costly for high-income households. For one thing, it indexes the alternative minimum tax threshold to inflation, and it extends the portability of a spouse's unused estate tax and uniform gift exclusion to the surviving spouse's estate. Nevertheless, the new tax may necessitate a variety of changes in your tax strategy. Now is the time to begin mapping out your strategies to minimize their bite. Please call your tax advisor to assess your tax situation. ❍❍❍

How Much Can You Withdraw?

It's probably one of the most important decisions you'll make when you retire — how much to withdraw annually from your retirement assets. Take out too much every year and you may have to seriously reduce your living standard late in life or even deplete your assets. Take out too little and you may unnecessarily reduce your standard of living.

Consider these tips when deciding how much to withdraw from your retirement funds:

❍ **Use a modest withdrawal percentage to ensure you don't deplete your assets.** While you should certainly go through the process of determining how much to withdraw based on your unique circumstances, be prepared for modest withdrawal percentages. With a $1,000,000 portfolio, a 4% withdrawal equals $40,000.

❍ **Stocks should remain a significant component of your portfolio after retirement.** While the recent stock fluctuations have been difficult to deal with, especially for recent retirees, consider stocks to remain a significant component of your portfolio. Always review your risk tolerance before altering your portfolio.

❍ **Review your calculations every year.** This is especially important during your early retirement years. If you're depleting your assets too rapidly, you can make changes to your portfolio, reduce your expenses, or consider going back to work.

❍ **Work as long as you can.** Supporting yourself for a retirement that could span 25 or 30 years requires huge sums of money. Consider working at least a couple of years longer than originally planned. During those years, you can continue to build your retirement assets and delay making withdrawals from those assets. Once you retire, consider working at least part-time to reduce your withdrawals from your retirement assets. ❍❍❍

FINANCIAL DATA

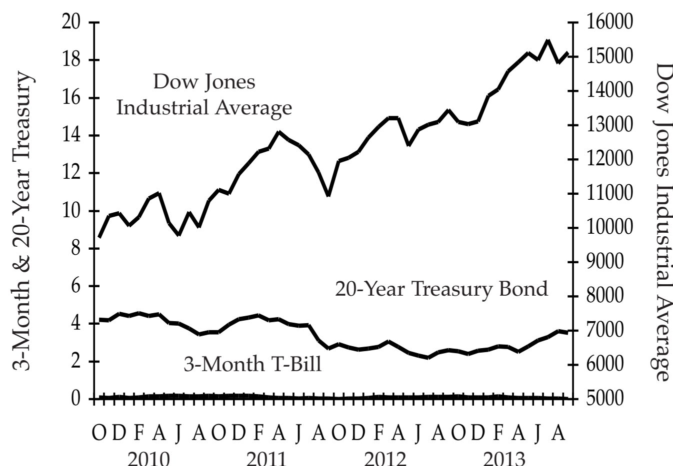
Indicator	Jul-13	Aug-13	Sep-13	Dec-12	Sep-12
	Month-end				
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.42	0.44	0.42	0.51	0.51
3-month T-bill yield	0.03	0.04	0.01	0.09	0.11
20-year T-bond yield	3.28	3.61	3.53	2.56	2.60
Dow Jones Corp.	3.05	3.17	3.09	2.70	2.72
30-year fixed mortgage	3.95	4.11	3.86	2.81	2.68
GDP (adj. annual rate)#	+0.40	+1.10	+2.50	+0.40	+1.30

Indicator	Jul-13	Aug-13	Sep-13	YTD	12 Mon.
	Month-end			% Change	
Dow Jones Industrials	15499.54	14810.31	15129.67	15.5%	12.6%
Standard & Poor's 500	1685.73	1632.97	1681.55	17.9%	17.3%
Nasdaq Composite	3626.37	3589.87	3771.48	24.9%	21.9%
Gold	1314.50	1394.75	1326.50	-20.2%	-25.3%
Consumer price index@	233.50	233.60	233.90	1.6%	1.5%
Unemployment rate@	7.60	7.40	7.30	-6.4%	-9.9%
Index of leading ind.@	95.40	95.90	96.60	3.4%	1.4%

— 4th, 1st, 2nd quarter @ — Jun, Jul, Aug Sources: *Barron's, Wall Street Journal*

4-Year Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

October 2009 to September 2013



Past performance is not a guarantee of future results.

News and Announcements

A Budget for Your College Student

Many students will first handle money without parental supervision during college. To help keep expenses down and avoid conflicts, you might want to develop a budget to guide your child's spending. As you go through the process, consider the following:

- First consider all potential expenses, including food, travel, clothing, entertainment, phone, periodicals, computer expenses, medical and dental expenses, and insurance.
- Develop a preliminary budget for the first couple of months of college. You may find that you forgot about certain items. After your child has lived on his/her own for a couple of months, you can develop a more realistic budget.
- If your child has trouble sticking with the budget or can't account for large sums, have him/her keep a journal for a couple of weeks that details all expenditures. Go over the journal together to determine how expenses can be reduced.
- Consider providing your child with a debit card rather than a credit card. Since your child's spending will be limited to the amount on deposit, it is harder to overspend.
- Explain the basics of credit cards. Make sure your child doesn't use a credit card as a means to overspend. Go over which types of items your child can use the credit card for and which items should not be charged. Make sure your child understands that if the balance isn't paid in full each month, a significant amount of interest will have to be paid.
- Have your child provide you with a written comparison of his/her actual expenses to budgeted amounts.

While the entire process might seem like a lot of work, keep in mind that you are teaching your child money basics that will help him/her for a lifetime. ❍❍❍

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