BATES Briefings

Winter 2014

from George's Desk

As 2013 draws to a close, I am filled with mixed emotions and conflicting anticipations for the future.

Twenty to thirty percent returns on the stock funds, with primarily U.S. stocks, have been a "breath of fresh air" compared to the past decade. And though most international stock funds underperformed their U.S. counterparts, double digit returns were common with the exception of stock funds invested in emerging market countries.

There has been a significant amount of commentary about the stock markets reaching new highs, and many fear that it is "too high." Frankly, I do not agree. Historically, the price earnings ratios (PE Ratios) have averaged between 15-16 in a 4% inflation environment, which is about where the PE Ratio is today in a 2% inflation environment.

Having said that, I have been expecting a ten to fifteen percent correction for several months and still think that is likely. The good news is that I do not think the decline will be very long and would present an opportunity to put cash to work.

There is concern that when the Federal Reserve reduces its purchases of U.S. Treasury Bonds, there will be a significant reaction in the stock market. In my humble opinion, I do not think it should matter that much since according to what I have read, only about ten percent of that money has actually been put to work in the economy. The bulk of that "Quantitative Easing" money is sitting on the balance sheets of banks. Most potential borrowers do not qualify for loans under new banking rules, according to my friends in the banking world, and those who do qualify do not need it. Since I first wrote this, the Feds did announce an easing or "tappering" and the Dow Jones jumped over 200 points in one day.

Looking forward to 2014 is at best a guessing game. As I have said repeatedly, political policy has significant impact on financial markets. With the looming deadline of February 7th for raising the debt ceiling, I am apprehensive to say the least.

The Republicans will likely be conflicted by the need to be fiscally responsible but not responsible for another government shut-down. The Democrats have further poisoned the atmosphere by passing the "nuclear option" in the Senate. Thus, I am very uncertain about what may happen in the financial markets.

The art of compromise so embedded in a democratic system has disappeared in Washington. Ideologues on both sides of the political spectrum have frozen constructive governance; yet, an ever-enlarging debt continues

(continued on pg. 2)

CHANGE OF VENUE:

This year's ***CLIENT APPRECIATION DAY*** *will be held on* ***March 22, 2014,*** *at the* ***Radisson Hotel & Conference Center*** *located at 200 Bell School Road, Rockford, IL 61108.*

From George's Desk *(continued from pg. 1)*

– and the fifty plus trillion dollars of unfunded liabilities in programs such as Social Security, Medicare, and Medicaid seem to go unnoticed by the majority of both parties.

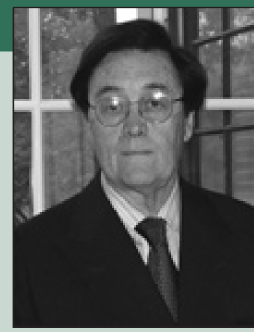
On that rather sour outlook, I believe there is more to be optimistic about than pessimistic. Corporate profits continue to grow. As measured by the Standard & Poor 500, company earnings have increased by 32% since the end of 2007, and the index has only increased by about 15%. My outlook for 2014 is corporate profits continue to grow, though possibly at a slower rate, and financial markets typically do well in election years.

On a more somber note, 2013 has been an emotional roller-coaster for my clients and me. I have lost an unprecedented number of clients to death, in addition to my friend and long-time company board member John Mink. John has been an extraordinary advisor, frequently asking challenging questions in our board meetings, and I will sorely miss him. My heart and prayers continue to go out to his dear wife Robbie and their daughters Barb and Pam.

Though I have great confidence that God does not make mistakes, and He is never "surprised" by what happens, it is still heart wrenching when we lose loved ones and friends. It is also tempting to ask God WHY, as my wife and I learned when her sister was murdered 10 years ago. However, I place my faith in God's promises that He loves us and knows the end from the beginning. It is our responsibility to be ready to meet Him when our time on earth comes to an end.

On a final note, my friend, confidant and most valued associate, Barb, has renewed health challenges. Thus, my new associates Ginny, Marina, Laura, and Felicia will be helping me to serve you in the future. Barb will be in when she is able, but her health is my principle concern, and she has earned the flexibility to assist me and you as she is able.

Announcing the Bates 2014 Client Appreciation Day Speaker



HORACE "WOODY" BROCK, Ph.D.

President, Strategic Economic Decisions, Inc.

Dr. Horace "Woody" Brock, one of the world's foremost economists, is the author of the new book, ***American Gridlock – Why the Right and Left Are Both Wrong, Commonsense 101 Solutions to the Economic Crises.*** As the founder and president of Strategic Economic Decisions, a renowned economic think tank, Dr. Brock has spent more than 25 years counseling global corporations and other institutions that benefit from his in-depth analysis of ongoing structural changes in the global economy.

Dr. Brock earned his B.A., M.B.A. and M.S. from Harvard University, and his M.A. and Ph.D. from Princeton University (mathematical economics and political philosophy). He studied under Kenneth J. Arrow, Stanford University, and the late John C. Harsanyi, University of California, Berkeley, both winners of the Nobel Prize in Economics.

As a celebrated public speaker, he is well known for his ability to take complex and counter-intuitive concepts and make them easily comprehensible to a broad range of people. His speaking engagements have included audiences such as the World Economic Forum in Davos, the CIA, The Aspen Institute, board of directors of corporations and banks, high net-worth family offices, private equity groups, and hedge funds. In addition to speaking and authoring SEDs periodic publications and numerous publications in professional journals, Dr. Brock is also the author of a series of Opinion Editorial pieces in the New York Times and the International Herald Tribune.

Dr. Brock is an avid collector of fine arts and has written extensively on the topics of esthetics. His contributions to the field of Distributive Justice are widely recognized and he developed one of the first mathematical theories applied to the concept of social justice.

STATE ESTATE & INHERITANCE TAXES 2013

With the passage of the American Taxpayer Relief Act of 2012, Congress has adopted federal transfer tax rules that taxpayers can use in their wealth transfer planning for the forseeable future.

States With Estate Taxes 2013

	Exemption Amt.	Maximum Tax Rate
Connecticut*	$2,000,000	12%
Delaware	$5,250,000	16%
D.C.	$1,000,000	16%
Hawaii	$5,250,000	16%
Illinois	$4,000,000	16%
Maine	$2,000,000	12%
Maryland	$1,000,000	16%
Massachusetts	$1,000,000	16%
Minnesota	$1,000,000	16%
New Jersey	$675,000	16%
New York	$1,000,000	16%
North Carolina	$5,250,000	16%
Oregon	$1,000,000	16%
Rhode Island	$ 910,725	16%
Vermont	$2,750,000	16%
Washington	$2,000,000	19%

States With Inheritance Taxes 2013

	Exemption Amt.	Maximum Tax Rate
Iowa	$0	15%
Nebraska	$10,000	18%
Indiana**	$25,000	20%
Kentucky	$500	16%
Pennsylvania	$0	15%
Tennessee***	$1,250,000	15%

States With Both Estate & Inheritance Taxes 2013

	Exemption Amt.	Maximum Tax Rate
Maryland	$150	10%
New Jersey	$0	16%

* Connecticut is the only state that currently levies a gift tax.
** Indiana is gradually phasing out its inheritance tax; full phase out set for 1/1/2022.
*** Tennessee is gradually phasing out its inheritance tax; full phase out set for 1/1/2016.

Sources: CCH, A Wolters Kluwer business, and McQuire Woods LLP State Death Tax Chart

HOW SAFE ARE BONDS?

Historically people have allocated a percentage of their investment assets to bonds as a hedge against the volatility of stocks. In addition, it was a common belief that as you get older you should put more in bonds and less in stocks. However, "times are changing." Interest rates fluctuate much more now than any time in my memory. In addition, with life expectancy rising, the risk of inflation makes bonds less desirable in my opinion. Recently I came across this chart which gives examples of how much bonds can decline in value as interest rates rise after factoring in the interest the bond would earn.

IF RATES RISE

Annualized returns over time for potential rate increases, using the Barclays Aggregate Bond Index, with a starting yield of 2.3% and a 5.6 - year duration

Potential Rate Increases / YEAR	1	2	3	4	5	6	7	8	9	10
0%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%
1%	-2.8%	0.2%	1.2%	1.7%	2.1%	2.3%	2.4%	2.5%	2.6%	2.7%
2%	-7.9%	-2.0%	0.1%	1.1%	1.7%	2.2%	2.5%	2.7%	2.9%	3.0%
3%	-13.0%	-4.3%	-1.2%	0.4%	1.4%	2.0%	2.5%	2.8%	3.1%	3.3%
4%	-18.1%	-6.7%	-2.5%	-0.4%	0.9%	1.8%	2.4%	2.9%	3.3%	3.6%
5%	-23.2%	-9.2%	-4.0%	-1.3%	0.4%	1.5%	2.3%	2.9%	3.4%	3.8%
6%	-28.3%	-11.9%	-5.6%	-2.3%	-0.3%	1.1%	2.1%	2.9%	3.4%	3.9%
7%	-33.4%	-14.7%	-7.3%	-3.4%	-1.0%	0.6%	1.8%	2.7%	3.4%	4.0%
8%	-38.5%	-17.6%	-9.2%	-4.7%	-1.9%	0.1%	1.5%	2.5%	3.4%	4.0%
9%	-43.6%	-20.8%	-11.3%	-6.1%	-2.8%	-0.6%	1.0%	2.2%	3.2%	4.0%
10%	-48.7%	-24.1%	-13.5%	-7.7%	-4.0%	-1.4%	0.4%	1.8%	2.9%	3.8%

INTERMEDIATE vs. SHORT-TERM BONDS

Incremental annualized return differential earned in the two types of bond funds if rates increase

Potential Rate Increases / YEARS	1	2	3	4	5	6	7	8	9	10
0%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
1%	-1.5%	0.0%	0.5%	0.7%	0.9%	1.0%	1.0%	1.1%	1.1%	1.2%
2%	-4.5%	-1.6%	-0.6%	-0.1%	0.2%	0.4%	0.6%	0.7%	0.8%	0.8%
3%	-7.4%	-3.3%	-1.8%	-1.0%	-0.5%	-0.2%	0.0%	0.2%	0.4%	0.5%
4%	-10.4%	-5.0%	-3.0%	-1.9%	-1.3%	-0.8%	-0.5%	-0.3%	-0.1%	0.1%
5%	-13.3%	-6.9%	-4.3%	-3.0%	-2.1%	-1.6%	-1.1%	-0.8%	-0.6%	-0.4%
6%	-16.3%	-8.8%	-5.7%	-4.1%	-3.0%	-2.3%	-1.8%	-1.4%	-1.1%	-0.9%
7%	-19.3%	-10.9%	-7.3%	-5.3%	-4.0%	-3.2%	-2.5%	-2.1%	-1.7%	-1.4%
8%	-22.2%	-13.1%	-8.9%	-6.6%	-5.1%	-4.1%	-3.4%	-2.8%	-2.3%	-2.0%
9%	-25.2%	-15.4%	-10.7%	-8.1%	-6.3%	-5.1%	-4.3%	-3.6%	-3.1%	-2.6%
10%	-28.1%	-17.9%	-12.7%	-9.7%	-7.7%	-6.3%	-5.3%	-4.5%	-3.9%	-3.4%

FOR YOUR INFORMATION

One of the periodicals that I read regularly is Bloomberg BusinessWeek. They published a special issue the end of November that I found to be a profound report on current and future events in the areas of finance, energy, technology, healthcare, retail, and defense.

I can only include a few comments due to the space I have and the hundred plus pages of information:

FINANCE

Banks are hoping for higher interest rates because their future profits growth is being challenged. Though most of us do not have much sympathy for big banks profits, it goes without saying that the ability for banks to make profitable loans is integral to economic growth in our country.

Economic growth will be modest in the area of 2 to 3% for some time. Industries such as housing, automobiles, agriculture, energy, and technology will likely do well. However, the lack of job growth due to tax increases, lack of educationally prepared workers, government regulations, and unknown healthcare costs are some of the inhibitors to robust economic growth.

ENERGY

The unprecedented growth of oil and gas reserves due to hydraulic fracturing (AKA "fracking") has raised the United States to be the "fueling station of the world." We are sending abroad more gasoline, diesel, and other refined petroleum products than ever before. Our exports of these fuels have almost tripled in the last ten years. In 2011, the U.S. became a net exporter of refined oil products for the first time since World War II.

The success of fracking is now expanding around the globe. It is estimated that 400 new shale wells will be drilled in 2014 outside of the U.S.

In the area of solar energy, there is expected a shakeout amongst the winners and loser in this arena. In 2012, there were 90,000 homeowners and businesses that installed roof top photovoltaic systems which generate the equivalent of one large coal-fired power plant.

Also, in the area of deep sea drilling, there is a rush back to the Gulf region with new discoveries at deeper levels. New technology has bolstered both the drilling at these deeper levels and safety since the disastrous oil spill in 2010. The U.S. Department of Interior estimates the Gulf has 48 billion barrels of oil yet to be discovered.

TECHNOLOGY

There is so much to cover in this area that I am going to reduce my comments to just mentioning some of the things to come. Smart phones (much to the consternation of our older generation) are going to be the medium through which dramatic changes are going to take place. Areas such as customized orders at the grocery store with reduced prices will come. Using new in-home health appliances to report our current health status to doctors and hospitals will be done through smart phones. Same day delivery will occur in numerous areas. Recently in a "60 minutes" article, Jeff Bezos of Amazon demonstrated a miniature drone that will deliver ordered goods to our front steps within minutes of the placed order. He admits that this might be 5 years in the future.

In summary, cloud technology has unprecedented applications and will continue to recreate how we do business and conduct a sizeable portion of how we do things.

HEALTHCARE

Dr. Bill Frist, which many would recognize as the former Senator and majority leader from Tennessee, discussed how in-home devices will allow many to incorporate personalized medicine. It will not just come from genetic data but from sensors that we will wear. Transmitted data will be sent to our healthcare providers without even going to doctors' offices or hospitals. Much of this will provide a significant cost savings in healthcare.

There was so much information in this issue from Bloomberg that it took me four hours to read it, and I feel like I may have retained only 5% of what I read. If you would like to read more about the year ahead you can go to www.businessweek.com/yearahead.

Medical Expenses As An Itemized Deduction

by Laura Pechacek

Medical bills can be a huge expense especially if you experience an unforeseen emergency! Thankfully, the government gives us a break by allowing a deduction on our tax returns if medical bills become large enough. Starting on your 2013 tax return (filed by April 15, 2014), the IRS issued a new rule to follow.

The old rule:
If you itemize on your tax return, you can deduct on Schedule A (Form 1040) only the unreimbursed amount of medical and dental expenses that exceed 7.5% of your adjusted gross income (AGI). For example, if your AGI was $40,000 and medical expenses of $4,000, the first step would be to find 7.5% of your $40,000 AGI which is $3,000. This means your medical expense would need to be in excess of $3,000 to be allowed to take a deduction. In this case you have expenses of $4,000 which is $1,000 over the $3,000, meaning the deduction you could take is $1,000.

The new rule:
Beginning January 1, 2013, you can claim deductions for medical expenses not covered by your health insurance that exceed 10% of your adjusted gross income. For example, say in 2013, you have the same $40,000 AGI and $4,000 of medical expenses. 10% of $40,000 is $4,000. So for your 2013 tax return you would need an extra $1,000 of medical expenses to be able to take a deduction. In this example your deduction would be $0.

The good news is if you are 65 or older, the IRS put in a temporary extension to the 7.5% rule until December 31, 2016.

The temporary exemption:
If you or your spouse are 65 years or older or turned 65 during the tax year, you are allowed to deduct unreimbursed medical care expenses that exceed 7.5% of your AGI. The threshold remains at 7.5% of AGI for those taxpayers until December 31, 2016.

This means, with the current rule (beginning January 1, 2017), ALL taxpayers may only deduct the amount of the total unreimbursed allowable medical care expenses that exceeds 10% of your AGI.

One common question in your mind may be the following: What happens if I am not 65 yet but will be before 2017?
Say you will turn 65 in the year 2014. When you file your 2013 tax return by April 15, 2014, you would use the 10% of AGI rule. However, you will turn 65 in 2014, so when you file your 2014 return by April 15, 2015, you would be allowed to use the 7.5% of AGI rule. This rule goes for you OR your spouse if you file a joint tax return.

The take away:
- If you or your spouse are under 65 and will not turn 65 before December 31, 2016, remember the new AGI limit to deduct medical expenses is 10%.

- If you or your spouse are over 65, the old 7.5% of AGI will remain the same for you until the start of 2017 where it will increase to 10% of AGI.

- If you or your spouse turn 65 between 2014-2016, you will need to use the new 10% of AGI until the year you or your spouse turn 65 when you can go back to the 7.5% of AGI rule.

- Starting 2017 EVERYONE must use the 10% of AGI rule.

For questions on this issue, or to find out if you qualify, call the office or talk to your tax advisor. More information can also be found at www.irs.gov.

BATES
Financial Advisors, Inc.
8437Northern Avenue • Rockford, Illinois 61107
RETURN SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
ROCKFORD, IL
PERMIT NO. 885

George E. Bates
Mark Jones
(815) 332-4020
(800) 223-2137

8437 Northern Avenue
Rockford, IL 61107

Beckie Ethell

(217) 525-8833

901 South Second Street
Springfield, IL 62704

Mark A. Jones

CONGRATULATIONS

to two of our valued employees, Mark Jones and Laura Pechacek, for passing their Certified Financial Planner exams.

Both Mark and Laura stand ready to help you with your financial planning needs.

Laura Pechacek