BATES Briefings

Summer 2013

from George's Desk

I recently attended a meeting of investment professionals and heard a number of people talking about the impact of the United States' dramatic increase in developing new reserves of natural gas and oil.

Let me share some of the thoughts and ideas I heard:

• These new reserves will almost certainly lead the U.S. to energy independence in the next 5 to 10 years.

• We almost certainly will be a net exporter of energy within the next 10 years.

• Those energy exports will make a huge positive impact on our balance of trade deficits.

• That improving balance of payments deficit will likely have a positive impact on the value of the dollar against some major foreign currencies (our trading partners).

• All of these activities surrounding the discovery, development, transportation and ancillary services have, are, and will continue to create tens of thousands of new jobs.

• It will likely change the fuel used by the transportation industry (e.g., trucks and trains) that will make them much more environmentally friendly.

In addition to the subject of energy there were a number of other subjects discussed:

• Over the next several years there will be the most dramatic increase in the number of people entering the "middle class" in the history of the world. It is estimated that approximately 300 million people in China will be moving into the cities in the next 10 years, and as one speaker suggested, "That's like creating a new New York City every few months."

• This dramatic shift in people moving into the middle class will have a profound effect upon consumer spending, public education, medical services, housing, and numerous other areas of life.

• Some of the central banks of the world have embarked on stimulus monetary policies which in some cases are more expansive than our own Federal Reserve Bank.

• Some of these things will most likely lead to higher interest rates, higher rates of inflation, and expanding stock markets as more and more companies go public in an effort to raise capital to finance the growth.

As an admitted life-long optimist, I must admit that I grow progressively more concerned that when inflation and interest rates increase (probably not for another year or two), cash will be diluted, bonds will decrease in value, but assets such as real estate and stocks will increase.

As always, if you have any questions, concerns, or disagreements, I am always interested in those discussions. Please do not hesitate to raise the subject anytime.

F.Y.I.

- *If you have a Southwest Securities account, do not file your tax return before April 1st.*
- *For those who make Qualified Charitable Distributions (QCD) from your IRAs, it is important to type: QCD and the amount on your tax return.*

KIDS…
Making a Difference

As many of you know my wife Carol's parents were missionaries in Latin America for 35 years. Thus, Carol was born in Guatemala. After her sister (who was a school teacher) was murdered, Carol decided that she wanted to establish a memorial for her sister in the country of their birth. One of the projects was to build some playgrounds for children in cooperation with an organization in Rockford called Kids Around the World (KIDS). Several years ago, a Christian businessman in Rockford took an idea of reaching out to poor children around the world by building playgrounds. Thus, KIDS was created, and they built playgrounds in scores of countries with the focus being on developing countries.

Recently, I received a heartwarming letter (from which I am including an excerpt) from KIDS, about a 10 year old boy in Shanghai. I hope you enjoy it:

> *Our project in Liberia started with a simple phone call from a 10 year old American living in Shanghai. Through a friend, he heard about Liberia's civil war, poverty and corruption. And, being a 10 year old, he also heard how the kids in the country turn to being child soldiers and guns because there is nothing for them to do. He decided to do something about it! He called the Senate of Liberia and told them he wanted to build the Liberians a playground… and he received a response from the only Christian senator within 48 hours. The Senator was overjoyed, and the boy and his friends started to raise the funds.*
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> *Once the money was raised, the boys and our team travelled to Liberia to build the playground. While driving to the site 3 hours south of the capital, they noticed a lot of conversation along the way. They asked what it was all about, and the Liberians answered, "We are building a new paved road to the playground, of course!" During the construction, hundreds of Liberians came to help and showed their appreciation to the team. The Vice President came to the dedication, the VP told the Christian Senator that was helping us that he would love for the Senator to run for President…and he would be honored to be his VP!*
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> *After the team left and went to the capital of Monrovia, they were invited to be part of a Congressional session. They were the first foreigners ever to be invited to something like this! While there, they were invited on stage and presented with honorary citizenship of the country. The leaders also proclaimed that they were going to have a similar playground project in each of their 15 states.*
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> *This is all amazing, but one of the coolest things happened as the team was leaving Liberia. The village we were working in had been praying for a school for 100 years! Just before the team left, they had heard that the government broke ground to build the village a school… finally! Hope came to Liberia through the simple idea of a playground…and Kakata, Liberia will never be the same. In fact, from our future plans there, the country of Liberia may never be the same! What was once a country of war, violence and corruption… has now seen an incredible example of peace, love and joy which has truly started the transformation of the country.*

ATTENTION!

For those of you over 70 -1/2 that take required minimum distributions from your IRA, there is good news. The legislation passed on New Years' Day by the U.S. Congress, to renew the provision for you to make charitable contributions directly from your IRA without paying income tax, which can be part or all of your RMD. It can be a significant tax savings for many people under one or more of the following:

- You do not itemize deductions on your tax return
- If you would not have enough deductions without your charitable contributions to help through itemizing
- You are on the bubble of paying tax on none or 25% of your Social Security or 85% of your Social Security.
- It reduces your total income to lower your Medicare premiums.

Please feel free to call if you have any questions as to how this might save you taxes.

NONQUALIFIED ANNUITY DEATH BENEFIT OPTIONS

Non-Spousal Beneficiary

At your death, the death benefit will be paid to the non-spousal beneficiaries you have designated. By doing so, the transfer will avoid probate. Unlike most other securities, there is no step-up in cost basis at your death. Instead, any deferred income in the policy will be taxable to the beneficiaries as ordinary income at their tax rates. If a death benefit is paid out that is higher than the account value, the difference between the death benefit and the amount you invested, adjusted for any withdrawals, will be taxable as ordinary income to the beneficiaries. The value of the variable annuity policy also will be included in your estate for estate tax purposes. Beneficiaries have the choice of taking a lump sum payment or receiving the payments over a period of time, thereby spreading out the income tax liability.

When a non-spousal beneficiary, including an adult child, assumes ownership of a deferred annuity contract, the beneficiary generally has three distribution options:

1. **Lump Sum Payout** – Immediate payout of the entire death benefit

2. **Five-Year Payout** – Payout of the entire interest in the contract no later than five years from the death of the owner

3. **Stretch Payout** – Payout over the beneficiary's life expectancy
   This is commonly referred to as a "stretch" option.

A "stretch" is the method in which the death benefit from a nonqualified annuity is paid out over a period of time based on the life expectancy of the beneficiary. Beneficiaries can choose to elect to "stretch" payments over their lifetime rather than receive the entire death benefit in one lump sum or within five years of the owner's death. The owner must have died prior to his or her annuity start date before a beneficiary can elect the stretch option.

The calculation is based on the Policy Value divided by the Life Expectancy Factor (reduces by one each year after the first year):

$$\frac{\textbf{Policy Value}}{\textbf{Life Expectancy Factor}}$$

The factor is determined based on the beneficiary's age on the date of the first stretch payment. It is then fixed on that date. Each year following, one is subtracted from that initial factor for use in the calculation formula. (This formula is used for non-spouse beneficiaries. A spouse beneficiary who elects to take payments rather than continue the policy is eligible to use a "recalculation formula" which differs from the formula non-spouse beneficiaries must use).

Trusts and Nonqualified Annuities

The IRS has not sanctioned the use of "look through" trusts with nonqualified annuities. If a trust is named as a beneficiary of a nonqualified annuity, the annuity must payout in its entirety to the trust within five years as measured from the death of the contract owner. Any gains that are not distributed from the trust will be subject to trust tax rates, which escalates much faster than individual's rates.

We are sad to announce that Erica Amenda will be leaving our firm. Erica's husband accepted a position in Milwaukee, Wisconsin where they will be moving at the end of August. We wish you well, Erica!

My friend Carl Stuart, an Investment Advisor in Austin, Texas put some statistical information together which I think you may find interesting:

Adjusted After-Tax Corporate Profits (% of GDP)
Includes inventory and capital consumption adjustments

1Q13	9.7%
50 year average	6.2%

Total Leverage
S&P 500 Ratio of total debt to total equity, quarterly

1Q13	107%
50 year average	172%

Source: Standard & Poor's Compustat, BEA, J.P. Morgan Asset Management

Light Vehicle Sales
Millions, seasonally adjusted annual rate

May 2013	15.2
20 year average	15.2

Source: BEA, FactSet, J.P. Morgan Asset Management
Data as of 6/30/13

Housing Starts
Thousands, seasonally adjusted annual rate

May 2013	194
20 year average	1,377

Source: Census Bureau, FactSet, J.P. Morgan Asset Management.
Data as of 6/30/13

Monthly rent vs. Monthly Mortgage Payment
2nd quarter 2013

Monthly rent	$727
Monthly mortgage payment	$529

Source: Census Bureau, J.P Morgan Asset Management. Monthly mortgage payment assumes a 20% down payment at prevailing 30-year fixed-rate mortgage rates;analysis based on median asking rent and median mortgage payment based on asking price.
Data as of 6/30/13

Household Debt Service Ratio
Debt payments as % of disposable personal income, seasonally adjusted

1st quarter 1980	11.1%
3rd quarter 2007	14.0%
2nd quarter 2013	10.5%

Source: BEA, FRB, J.P. Morgan Asset Management. *2Q13 household debt service ratio and household net worth are J.P. Morgan Asset Management estimates.
Data as of 6/30/13

Natural Gas Prices by Country
U.S. dollars per mmBTU

United States	$4.03
United Kingdom	$10.11
China	$13.70
Japan	$14.10

Source: EIA, J.P.Morgan Asset Management. *mmBTU represents 10,000 million British thermal units.
Natural gas prices are as of June 2013.

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WE WELCOME THREE NEW EMPLOYEES TO OUR FIRM:

Marina Lamberti
Executive Assistant

Marina started in the financial industry at the Bank of Rantoul in Rantoul, IL, in 2000. Throughout her time there, she worked in different departments eventually working in mortgage processing. Marina continued working in the financial industry when she returned to Rockford to be closer to her family in 2008. Marina became a Registered Representative at Edward Jones in 2012 before coming to Bates Financial Group.

Laura Pechacek
Associate Advisor

Laura obtained her BBA in finance and financial planning from University of Minnesota Duluth. She interned with Northstar Resource Group in Minneapolis before moving to Rockford in June of 2013. Laura will be studying for the CFP exam and working toward having 3 years of experience in order to become certified. Her Series 7 and Series 66 licensure will follow.

Virginia "Ginny" Whittington
Executive Assistant

Ginny has a Bachelor of Arts Degree from Judson University. She is a fully-licensed Registered Representative (Series 7) and an Investment Advisor Representative (Series 66), and has worked in the financial services industry since 1996. She and her husband live in Rockford and enjoy spending time with family and friends.