Dear Clients & Friends of Patriot Investment Management

Spring has arrived, and already first quarter 2013 is in the books. The Dow and the S&P 500 continue to break records, surpassing their October 2007 peaks, and finished the quarter up 8.7% and 7.3%, respectively. While the bull market began 4 years ago this month, psychologically, "getting back to where we started" has renewed investor optimism in the markets.

And, there is good reason for that optimism – overall consumer stress has dropped to its lowest level since 2008, and household net worth is within striking distance of its all-time high as consumers have reduced debt, and real estate prices have risen in many areas. U.S. manufacturing is poised for a comeback as factories and plants are reaching capacity, and aging equipment will likely prompt investment in new construction and upgrades in the near future. The U. S. is moving towards energy self-sufficiency, and both energy and manufacturing sectors tend to be job multipliers in that as these sectors grow, they create new jobs in related industries.

From an investment standpoint, inflows into stocks are coming not from bond funds, but from cash on the sidelines; the amount of investor cash sitting in bank deposits and CDs since the financial crisis began numbers in the trillions of dollars. And, by any measure – PE ratios, dividend yields, or equity risk premiums – valuations on stocks are still relatively cheap.

From a government standpoint, the Fed is giving clearer guidance for raising rates in the form of measurable economic indicators, thereby reducing investors' uncertainty. The fiscal cliff has turned into more of a slope, with sequestration cuts not hitting at once. Instead, some cuts are spread out over the coming months, while others will likely be somewhat renegotiated in Congress later in the year.

Given all these factors, and as the economy continues to show signs of strengthening in 2013, that is reason for optimism, indeed.

Income Tax Changes Hit the High Income Brackets

With the exception of a 2% increase in social security employee payroll taxes, those with incomes below $200,000 (or $250,000 if married and filing jointly) will see little change in their income taxes in 2013. It is another story for people with income above these levels, and particularly for those with incomes above $400,000 (or $450,000 if married and filing jointly).

First, the Medicare surtax of 3.8% will be added to all taxable investment income (rents, dividends, annuities, interest income, capital gains) for those earning above $200,000

($250,000 for married filing jointly). An additional .9% Medicare payroll tax on wages and self-employment income will also apply at this income level.

For 2013, the highest tax bracket was raised from 35% to 39.5% for those earning above $400,000 ($450,000 for married filing jointly). This tax bracket will also see an increase in the tax rates on dividends and long-term capital gains from 15% to 20%. Combined with the Medicare surtax, this income group will pay a tax rate of 43.4% on taxable interest income, and 23.8% on dividends and capital gains! For high earners, these tax increases magnify the value of tax exempt and tax deferred investments. See next article…

Higher Contribution Limits Help Savers

Here is a brief synopsis of the changes in contribution limits for various retirement plans for 2013.

401(k), 403(b) and most 457 plans

- Elective deferral (employee contribution) has risen from $17,000 to $17,500.
- $5,500 catch-up contribution for individuals over age 50 is unchanged.

SIMPLE IRA for small businesses

- Contribution limit has risen from $11,500 to $12,000
- $2,500 catch-up contribution for individuals over 50 has not changed.

Individual Retirement Accounts (IRA)

- Annual contribution limit has risen from $5,000 to $5,500.
- $1,000 is the catch-up amount allowed for individuals over 50.
- Deductions for IRA's: Some individuals who have a workplace retirement plan are also allowed a tax deduction for IRA contributions. Deductibility is based on the level of adjusted gross income.

Roth IRA

- Individuals with income limits below a certain level are allowed to contribute to a Roth IRA. Income from a Roth IRA grows tax-free and is not taxable when withdrawn in retirement (there are no RMD's).
- The annual contribution limit is the same as a regular IRA. Individuals may contribute to either a traditional IRA or a Roth, but not both.
- The 2013 adjusted gross income phase-out range for Roth IRA contributions is:
  Married filing jointly: $178,000 -188,000
  Single: $112,000 -127,000

There are additional rules for IRA's, so please check with us or with your tax preparer before making adjustments to your retirement contributions.

Bond Investing in a (near) Zero Interest Rate Environment

Historically, owning bonds has been a great tool for investors to gain interest income while decreasing the overall risk of their portfolios. The tradeoff is that less risk usually means less reward. This has never been more evident than the current interest rate environment, where the Federal funds rate, set at just one-quarter of one percent, has driven interest rates on bonds to record lows. The 10-year Treasury note currently yields less than 2 percent, and the 30-year bond yields less than 3 percent. This unique and challenging bond environment has made it very difficult for bond investors needing income to find it. Put another way, "safety" has never been more expensive.

Bond investing also carries another risk, one that is magnified in the current environment - interest rate risk. What exactly is interest rate risk? First, it is important to note that interest rates and the value of bonds move in opposite directions. For example, when interest rates rise, bond values fall; and when interest rates drop, bond values rise. However, with the Federal funds rate set near zero, the concern is that interest rates can only go up, resulting in losses for bond and bond fund investors. The latest input from the Fed is that they will raise the Federal Funds rate when inflation rises above 2.5%, and unemployment drops to 6.5%. Does this mean we should all sell our bond holdings and invest in all-stock portfolios? Of course not, and we only have to go back a few years to understand why.

Many investors remember that the S&P 500 was down 37% in 2008. That same year, a portfolio built of 60% stocks and 40% bonds was down less than 20%, and an all-bond portfolio (measured by the aggregate bond index), was actually up 5%. In addition to income, the purpose of bonds is to provide overall risk reduction in a portfolio. Investors nearing or already in retirement can benefit from the insulation bonds provide from major swings in the market.

Holding bonds and bond funds of shorter duration reduces interest rate risk, and dividend-paying stocks are an attractive alternative for investors seeking income. Proper asset allocation, or the mix of stocks and bonds, is key to successful, long-term investing and should be based on each individual investor's risk tolerance, time horizon, and realistic expectations. We at Patriot do caution that given this low yield environment, it is prudent to have lower, more reasonable expectations for future bond returns. But this does not make investing in bonds obsolete.

Patriot News & Community Events

Congratulations to Patriot's own Lee Sherbakoff for winning first place in his age group in the Covenant Health Knoxville Marathon held Sunday, April 7th. Lee finished the 26.2 mile race in 3 hours and 25 minutes! Way to go, Lee!

The Dogwood Arts Festival is in full swing - Running through the month of April, the festival has grown over the years, with a mission to promote and celebrate our region's art, culture and natural beauty. With numerous art, music, and outdoor activities, there is something for everyone to enjoy this spring. Check out their calendar of events at www.dogwoodarts.com.

HonorAir Knoxville will be making its 14th flight to Washington D. C. on April 24th. Patriot is a proud supporter of this worthy cause, whose goal is to fly every East Tennessee WWII veteran to see the WWII memorial. Flights are also open to Korean War veterans. Come out to McGhee Tyson airport at 8pm on the 24th to welcome our veterans home! You can learn more at www.honorairknoxville.com.

We Appreciate You!

Thank you for placing your trust and confidence with us, and we greatly appreciate the opportunity to serve you.

Our mission is helping people reach their financial goals, so please introduce us to your family, friends or colleagues and we will be happy to assist them in any way we can.