KALORAMA Wealth Strategies
A Beautiful View To Your Financial Future℠

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Fourth-Quarter and Full-Year 2012 Market Review

Fiscal Bungee Jumping

January 2013 - The fiscal cliff, a combination of federal tax increases and spending cuts totaling about $600 billion, was averted with a bungee jump as lawmakers reached a deal during the New Year holiday (hopefully we taxpayers didn't pay them time and a half for work they should have completed weeks before…). See below for a summary of the upside, downside and in between of the outcome.

After generating somewhat mixed fourth-quarter returns, stocks closed 2012 on a jubilant note as all broad-market measures finished the year with double-digit advances. Despite an uncertain economic outlook, both domestic and international stocks posted mid to high-teen returns for the year. The two more-narrow stock sectors we follow had the best and worst performance: Global Real Estate surged 29.9%, while Commodities slipped 1.1%.

During the year, the Federal Reserve implemented unprecedented "quantitative easing" through the purchase of U.S. Treasury bonds and agency mortgage-backed securities (MBS). At its most recent meeting in December, along with no change to its short-term interest rate policy, the Fed announced that it would tie future monetary policy to specific economic measures, as well as continue ongoing monthly purchases of U.S. Treasury bonds ($45 billion) and MBS ($40 billion). The central bank expects to maintain its current policies until the unemployment rate drops to 6.5% or when inflation exceeds 2.5%. The Fed's outlook is for short-term interest rates to remain near zero through mid-2015.

With the European sovereign-debt crisis simmering in July's summer-heat, investors drove U.S. Treasuries to record-low yields. The coupon on five, ten and thirty-year U.S. government bonds sank to 0.54%, 1.39%, and 2.45%, respectively. At year-end, the yield on the 10-year Treasury note was 1.76%, up 13 and down 12 basis points for the quarter and year, respectively (the yield as of January 17th was 1.88%).

Lower interest rates sent investors scurrying for yields and propelled the returns on the most risky bond sectors. As they have for the entire year, leading the pack for 2012 were International Emerging Markets and U.S. Corporate High Yield, swelling 18.0% and 15.8%, respectively. Next in line was U.S. Treasury TIPs, gaining 7.0%, followed by Municipals, rising 6.8%.

On the next page are rates of return for selected market indices for the fourth quarter of 2012, full-year 2012, and the three, five, and 10-year compound annual returns as of December 31, 2012.

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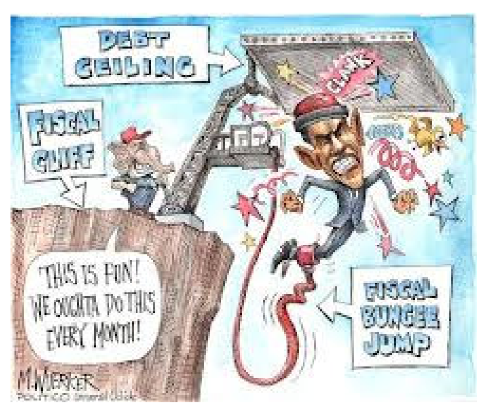
	4Q:2012	2012	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	-1.32%	15.26%	11.35%	3.12%	7.52%
Russell 1000 - Value	1.52%	17.51%	10.86%	0.59%	7.38%
Russell 1000 - Blend	0.12%	16.42%	11.12%	1.92%	7.52%
Domestic Small Cap					
Russell 2000 - Growth	0.45%	14.59%	12.82%	3.49%	9.80%
Russell 2000 - Value	3.22%	18.05%	11.57%	3.55%	9.50%
Russell 2000 - Blend	1.85%	16.35%	12.25%	3.56%	9.72%
Real Estate (FTSE EPRA/NAREIT Global)	6.31%	29.85%	12.71%	0.66%	NA
Dow Jones - UBS Commodity	-6.35%	-1.14%	-0.03%	-5.54%	2.35%
International					
MSCI EAFE Developed Large Cap	6.60%	17.90%	4.04%	-3.21%	8.70%
MSCI EAFE Developed Small Cap	6.05%	20.42%	7.52%	-0.51%	12.34%
MSCI Emerging Markets	5.61%	18.63%	4.98%	-0.61%	16.88%
Global - MSCI All Country IMI	3.12%	17.04%	7.57%	-0.20%	9.14%
Fixed-Income (Bond) Indices					
Barclays Capital					
Global Aggregate	-0.48%	4.32%	5.26%	5.50%	6.00%
U.S. Aggregate	0.22%	4.22%	6.19%	5.95%	5.18%
U.S. Treasury TIPs	0.69%	6.98%	8.90%	7.04%	6.65%
U.S. Corporate High Yield	3.28%	15.81%	11.86%	10.33%	10.62%
Municipal	0.68%	6.78%	6.57%	5.91%	5.10%
International Emerging Markets	3.29%	17.95%	12.50%	10.25%	11.63%

Source: russell.com, reit.com, djindexes.com, msci.com, barcap.com

Fiscal Bungee Jumping

The nation did a year-end fiscal bungee jump as Congress spent the New Year's holiday working to avoid the fiscal cliff. At 2:07am (yes, that's a.m.) on New Year's day, the Senate voted in favor of various provisions to avert tax increases and spending cuts. This was followed by a late-evening vote in the House to seal the deal and send the legislation to the White House for the President's signature. The American Taxpayer Relief Act of 2012 avoids tax hikes for most by permanently setting Bush-era tax rates, while reinstating Clinton-era rates for the highest-earning taxpayers. Most of the changes are permanent in the sense that there is no sunset provision that would cause them to lapse. However, Congress could, of course, change the rules again in the future!



First the good news (for most):

- Taxes rates for individuals with taxable income of $400,000 or less a year ($450,000 or less for married couples) will remain permanently set at 2012 rates. Taxpayers with income above these levels will see their top rate rise from 35% to 39.6%.

- The tax rate for qualified dividend and capital gains will remain fixed at 15% for everyone at or below the $400,000/$450,000 thresholds, including 0% for those in the 10% and 15% brackets. Those in the highest bracket will see a jump to 20% (effectively 23.8% with the new Medicare surtax on net investment income of 3.8%).
- The Alternative Minimum Tax (AMT) has finally been permanently dealt with to avoid capturing an estimated 28 million in the AMT system. The exemption amounts ($50,600 for singles and $78,750 for married couples in 2012) will now be indexed to inflation so that Congress does not have to enact an "AMT patch" each year.
- The estate tax exemption will remain at $5.12 million and be indexed to inflation (approximately $5.25 million for 2013). However, the top tax rate for excess amounts will increase to 40% from 35%. Provisions for spousal portability and reunification of the estate and gift tax are also permanently extended.

Perhaps the best news to come out of this fiscal skirmish is that, by cancelling a cost of living adjustment, the legislation freezes pay for members of Congress during fiscal year 2013.

There was other good news in the form of extensions through 2013:

- Federal unemployment insurance has been lengthened to benefit those unemployed for longer than 26 weeks.
- Homeowners who pay mortgage insurance premiums will be allowed to deduct the payments as qualified residence interest.
- Below-water homeowners who engage in short sales or foreclosures are provided assistance with the exclusion from income of discharged mortgage debt.

A new rule will allow 401(k)-type plan participants to complete intra-plan Roth conversions. Individuals will be allowed to convert their existing 401(k) plan assets to a Roth 401(k) plan, if the employer offers the option under the plan, regardless of whether the individual is allowed to take a distribution out of the plan. The transaction will be taxed in a similar manner to any other Roth conversion. This provision is notable because, under previous law, a 401(k) plan could only be converted if a participant was eligible to take a distribution from the plan (generally meaning you had to be 59 1/2, dead, disabled, or separated from service, unless the plan allowed in-service withdrawals). (Note: this provision was added to partially cover the cost of the two-month delay of the budget sequester (see below).)

The not so good news (for high-income taxpayers) is the phase out of personal exemptions and itemized deductions returns for individuals with "Adjusted Gross Income" (AGI) of more than $250,000 a year ($300,000 for married couples).

The bad news (depending on your perspective…) is the end of the "payroll tax holiday." This reduced the employee portion of Social Security tax by 2.0% (from 6.2% to 4.2%). These taxes are used to fund the theoretical Social Security Trust Fund, so it is a case of pay me now or pay me later…

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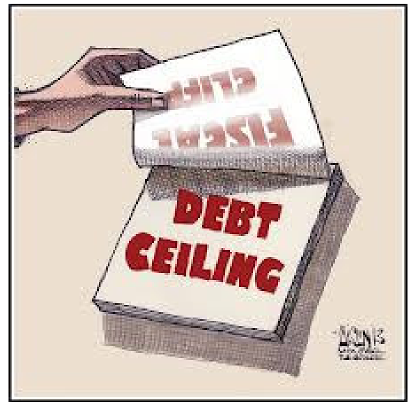

From Cliff to Ceiling
Fasten your seat belts, more fiscal tussles are on the horizon:

- Next up is a battle over the nation's deficit and debt ceiling limit, which sent markets reeling in the summer of 2011, as the debt ceiling is hit some time in late February.
- At the same time, the recent deal deferred the so-called "sequestration" (i.e., automatic domestic and defense spending cuts) by only two months.
- The ongoing debate regarding tax and entitlement reform is certain to continue in the headlines.

Certainty Creates Complexity
Although the new tax act provides certainty by making many provisions permanent, it creates complexity with the addition of brackets, thresholds and phase-outs. Please contact Kalorama Wealth Strategies if you would like to discuss how the tax changes might affect your financial planning. For more information on our investment advisory and financial planning services, please see our web site at www.kaloramawealth.com.

Thank you for your continued business and referrals. Please feel free to forward this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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Fee-Only Investment Advisory And Financial Planning

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