INCOME & ASSET ADVISORY INC.
Registered Investment Advisor
Financial Planning and Investment Management

The ADVISORY

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Commentary:

Where we've been; Where we are; What to expect in 2011

The year that just ended was a volatile one as it relates to the Investment Markets. The Dow Jones Index finished up 11% while the S&P 500 closed up 12.8%.* In both cases the indexes suffered major reversals in January, May-July and again in August but rallied to end the year with decent returns.

The Fixed Income Markets were also volatile as the bank and debt crisis in Europe, the Quantitative Easing (QE2) of the Federal Reserve and China's attempts to cool its economy all riled the markets at different times during the year. Nonetheless, the 10Yr. US Treasury Bond ended the year with a yield of 3.299%, 535bp less than it started the year but almost 90bp higher than its low in October. Many investors fled the bond market in November & December as rates began to rise.

Municipal bond markets also suffered in the 4th Quarter after rallying for most of the year. Much of the negative sentiment was associated with the extension of Bush Tax Cuts. The bill Congress passed did not include an extension of the Build America Bonds (BABs) in which the Federal Government subsidized the interest rate for the issuing municipality. There is also fear that there could be defaults of weaker credits in 2011. California, Illinois, and New York lead the parade of profligate states that are facing extremely difficult budgets.

* (Source: Wall Street journal 1/3/11)

Commodities and metals gained primarily from demand pressures while gold, the dollar and other currencies strengthened because of their safe haven qualities while the Euro, the pound and other currencies affected by inflation declined against the dollar.

Publicly traded Real Estate Investment Trust (REITs) rebounded from their early 2009 low but non-traded REITs (such as Inland & Cole) were required to mark to market during 2010 lowering their reported values. This was really a recognition of reality in the sector but still came as a surprise especially when much of the investment world was showing gains.

WHAT TO EXPECT IN 2011

EQUITIES - The equity markets in the US and selected foreign markets have been on a positive streak that has continued into 2011. China, India Brazil and other resource centered economies have suffered recent declines in their stock markets primarily due to raising interest rates and inflation pressures as the monetary authorities try to dampen inflation by raising rates. This is only one of the major issues facing the equity markets this year. Others are: the ability for companies to keep up the pace of profit expansion in the face of still weak demand, rising costs, and higher savings rates of consumers. The debt crisis in Euroland, though in recent weeks Portugal, Spain and Italy were able to sell debt at rates they can still afford to pay. These successful auctions eased some concern in the markets sparking a rally in the equity markets. Inflation will call forth measures to reduce demand putting pressure on profits and sales. At IAA we are presently allocated to

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take advantage of the inflationary bias currently present, yet remain ready to move out of falling markets, if the S&P 500 continues on its upward trajectory we will commit more of the portfolios to the sector.

FIXED INCOME - As has been mentioned several times previously we are already seeing the effects of QE2 and rising inflation expections in fixed markets. The short and intermediate parts of the curve will hold up better during the run up in rates but may still suffer some price erosion. We will be proactive in trying to preserve capital while still earning a reasonable dividend or interest return in this sector. Investment Grade Corporate bonds and High Yield bonds that are structured to take advantage of rising rates are areas we will focus on as well as dividend paying stocks.

Please remember that bonds are securities that guarantee to pay a certain interest until maturity and then repay principal. That does not mean that their daily value is always the same should an investor wish to sell. It fluctuates depending on the level of current interest rates. We are in a period when rates are rising and expected to rise more, so we want to be especially aware of the consequences.

MUNICIPALS - As stated earlier the last quarter of 2010 saw a drop in municipal bond prices, mainly on the long end of the curve, 20-30yr. bonds. A good deal of the decline can be traced to the run up in Treasury rates during this period. Creditworthiness issues across the country and the additional supply of new bonds brought to market in the last few weeks of the year also contributed to the declines. The flood of new bonds was caused by states and municipalities attempting to take advantage of the interest rate subsidy offered by the Build America Bonds (which were not part of the Tax Cut bill extensions). We've now had nine straight weeks of price declines but expect that the supply issue will decline in importance. Interest rates are likely to rise during the year and there are many reports by analysts of expected defaults. However, very few have transpired to date.

We have already reduced exposure to New York State issues and will be recommending that most clients reduce their exposure to the Municipal sector at least in the short term. If prices decline further and then stabilize, very decent returns will be a possibility. We may want to take advantage of this opportunity but timing will be very important.

REITs & ALTERNATIVES - Those who have held traded or nontraded REITs should expect to continue to hold these investments. Most traded REITs rebounded very nicely in 2010 and as the economy improves we expect that they should recover in 2011. Most of the decline in value actually took place in 2008 & 2009, so as the markets stabilize we expect to see upward valuations by mid-year.

At various times in 2010 we have invested portions of the portfolios in alternative sectors. We expect to continue to utilize these investments when the conditions are favorable and will not hesitiate to trade when conditions turn against us.

If you are a client who holds only mutual funds or Variable Annuities please contact either Eileen Hawe or Jim McCauley to discuss your personal investments. We usually don't have investment discretion on directly held funds so we would need your authorization to transfer to safer pastures.

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More on Estate Planning...

We work hard to have our financial house in order, knowing where our money is, how it is invested, our net worth and cash flow (money in/money out). Every so often it is also important to review our "important papers". Here are the important documents to include in estate planning:

Our Will – a statement of our wishes for the distribution of personal property. If young children are involved, it will include the guardian we wish appointed for their care. It will also name the executor for our estate.

Letter of Instruction – where we state the particulars of our interment - to be buried or cremated, the services, music, attire, minister, pallbearers, etc. We may also include suggestions for a charity or foundation in lieu of flowers. The LOI can also include those persons to whom you want distributed personal items like jewelry, pictures, and mementoes. These would be simple wishes and items that would not be appropriate to include in your will.

Trusts – Revocable (Living) or Irrevocable – written to contain specific assets (property and/ or finances) to provide for income and care during our life and the terms of distribution at our death.

Durable Power of Attorney – appoints a family member, friend or attorney to act as an agent in prescribed legal and financial matters. It goes into effect only when you are incapacitated.

Health Care Proxy – authorizes a relative or friend to make medical decisions on your behalf.

Living Will – or advance health directive states preferences for end-of-life care. It may describe specific conditions for DNR (do not resuscitate) or other final medical techniques.

HIPAA release – gives permission to doctors/hospitals to share your medical records.

It is critical that these documents be readily available and easily accessed when needed. Keep them in a safe place and inform family members of the location. Also, review and update the documents as time passes. Information, assets, wishes change with time. Make sure everything is current.

“Hypothetical Case Study”

Jenny and Sal are a young couple in their late 30’s with two children, 7 & 10, living in lower CT. Sal works full time at a business he and his brother bought from their father. Jenny, though she would like to be a full time homemaker, works part-time at a local business.

They came to us because Sal wants to save more for retirement by establishing a 401k for himself and his employees. After an “information gathering” meeting we learned that Jenny and Sal had a few gaps in their financial plan.

We discovered that Sal was underinsured for his capacity as a business owner and as a husband and father. For Sal’s business we determined the cost of the business through a business broker and then recommended that he and his brother buy “Key Man” insurance where the insurance would buy out the family of the deceased partner. This would ensure business continuity and provide income replacement for the deceased partner’s family. He should consider a disability insurance policy as the primary provider and president of his company. We also suggested that he increase his personal insurance to provide for Jenny and the kids should he die young. Jenny also needed life insurance to provide for childcare, education and income replacement should she pass on prematurely.

For his business, we constructed a 401k plan that would allow Sal, his brother and their employees to make pre-tax or after-tax contributions towards retirement. Depending on how successfully the business grew, they could, at some point in the future, offer a matching contribution for their employees. Having a 401k is an added benefit to attract and keep valuable employees.

Jenny and Sal had also accumulated several thousands of dollars in their checking and savings accounts on which they were earning very little interest. Occasionally, Jenny would take the time to buy a few CD’s but with rates so low, she had not bothered to make that effort lately. Both Jenny and Sal revealed no specific goal for this money (well maybe remodel the kitchen) but knew that it was important to save for the future. After running a few scenarios on our “college planning” calculator, we determined that 15% of these savings would be deposited in a 529 College Savings plan for the two children. Sal, Jenny and both sets of grandparents would be committed to contributing to this account; Sal and Jenny through automatic checking account contributions and their parents through gifts for birthdays and special occasions.

After allowing for an emergency fund and college planning, we took the balance of those savings and structured a portfolio providing for both growth and income. The couple was too busy to actively manage this money and chose to open a ***managed account*** **were we would make changes according to movements in the markets. They understood the benefits of paying the management fee.** We reviewed with them all aspects, of opening a managed account, both the risks and benefits.

At our third meeting Sal expressed concern about his parents’ situation. At this time both were reasonably healthy, financially stable and content living nearby in their own home, the house where Sal grew up. But Sal was worried about the future; what if they needed assisted living or long-term care? He knew his parents resources were limited and that he and his brother would bear the burden of the cost. We posed a few solutions for his consideration and set a time to meet with Sal and his parents.

“This hypothetical illustration is for educational use only. Actual results may vary.”

To convert, or not...
The pros and cons of converting your traditional IRA to a Roth IRA

Financial services firms and the media have made the conversion to a Roth sound appealing. The question is "is it right for you"?

New rules apply to the conversion starting in 2010:
Income limits have changed – individuals in any income level may convert and taxes owed on the conversion may be extended and paid over two years.

Pros

- Money withdrawn from a Roth is free from state and federal taxes if all rules regarding withdrawals are followed (taken after an account has been open 5 years and after 59 1/2)
- Heirs may take funds from the Roth and pay no taxes.
- Heirs have no RMD (required minimum distribution)
- Taxes may be paid over two years – 2011 & 2012
- A conversion will reduce your taxable estate by the amount you paid to convert
- Income from a Roth does not count as taxable income and may avoid paying taxes on your SS income

Cons

- The tax bill must be paid money other than that from the IRA
- Money converted is counted as income which could push you into a higher tax bracket, causing you to pay more taxes
- Higher tax bracket could disqualify you for tax benefits or tax credits
- For older folks, there will be less time to make up the funds lost to taxes
- A lower tax rate in retirement means you pay less in taxes
- If already taking SS, a conversion might push you into a higher bracket causing you to pay more taxes, including taxes on SS

Remember, conversion is not all or nothing. You may convert a partial amount, just enough to keep your income under the radar. If you have an IRA and plan to convert it to a Roth IRA, give us a call to determine the most beneficial move for you.

Tax Season: preparing for that fateful day (in 2012)

As April approaches it is important to determine the best way to pay Uncle Sam only what he is owed. By examining the way we file our returns we may find a few opportunities to keep more of our hard earned money in our pockets. Be aware that the filing deadline is April 18 for 2011.

With 2010 behind us and April just ahead, here are a few tips you might consider in preparation for 2012:

1. Visit your Human Resources office to adjust your deductions. Getting a return can make you feel good but you are potentially giving Uncle Sam an interest free loan. Endeavor to deduct only what covers your income.
2. Keep all receipts in one place. Many items are deductible. Make sure you can produce proof.
3. Increase deductions to your 401k (or 403b) especially to qualify for your employer's match. Increase the amount you contribute annually, even by a small percentage, until you reach the maximum allowable amount.
4. Open and fund a Roth IRA once you have maxed out on your 401k (or 403b) contributions.
5. Fund a state-sponsored 529 plan for your children or grandchildren. States like New York offer a tax deduction on contributions up to $5000 for an individual; $10,000 for couple.
6. Review your will or trust with your attorney now that estate laws have changed to make sure your heirs inherit as much as legally possible.
7. Consult with your financial advisor about tax-efficient investments that limit annual turnover reducing annual capital gains distributions.
8. Find a local charity (church, thrift shop, Salvation Army) and clear out your basement, attic and garage by donating usable items. Organizations will give you a receipt allowing you to deduct the donation on your tax return. Again, file that receipt in a safe place!
9. If you are currently receiving Social Security, discuss your MAGI (modified adjusted gross income) to avoid paying higher taxes on your SS income and higher Medicare premiums.

Market Activity

Market Indicator	*Prices* 12/31/2009	9/30/2010	12/31/2010	*Percent Changes* Last Year	Last Quarter
1 Ounce of Gold ***(London PM Fixing)***	**1100.50**	**1297.00**	**1405.50**	**17.9%**	**8.4%**
Technology Oriented Stocks ***(NASDAQ Index)***	**2269.15**	**2381.22**	**2652.87**	**4.9%**	**11.4%**
Small Company Stocks ***(Russell 2000 Index)***	**625.39**	**671.01**	**783.65**	**7.3%**	**16.8%**
International, Global Stocks ***(EAFE Index)***	**1580.77**	**1564.68**	**1658.30**	**-1.0%**	**6.0%**
Large Company Stocks ***(S&P 500 Index)***	**1115.10**	**10860.26**	**11577.51**	**873.9%**	**6.6%**
Higher Yielding Stocks ***(DJ Utilities Index)***	**398.01**	**399.93**	**404.99**	**0.5%**	**1.3%**
High Yield Bonds ***(M.L. High Yield Index)***	**978.23**	**1089.79**	**1127.29**	**11.4%**	**3.4%**
Tax Free Municipal Bonds ***(Bond Buyer Index)***	**112 5/32**	**119 29/32**	**109 1/32**	**6.9%**	**-9.1%**
Long Term US Gov't Bonds ***(Lehman Index)***	**1751.94**	**1979.68**	**1829.21**	**13.0%**	**-7.6%**
Inflation ***(Consumer Price Index)***	**216.00**	**218.40**	**219.20**	**1.1%**	**0.4%**

Source: Wall Street Journal, Barron's and Yahoo Finance. An Index is an unmanaged group of securties considered to be representative of the stock and bond mrkets in general. An index connot be invested into directly and assumes dividends are not reinvested. In addition, past performance is not indicative of future results.

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