INTEGRAL FINANCIAL SOLUTIONS, LLC

Market Review Third Quarter and Year-To-Date

What a difference a quarter makes! After a sharp drop in equity markets in the second quarter, returns were positive in the third quarter. Although most of that return occurred only in September, it was enough to bring year-to-date equity benchmarks back into the black.

Index	3rd Quarter	Year to Date
S&P 500 (U.S. large cap)	11.29%	5.22%
Russell 2000 (U.S. small cap)	11.29%	9.11%
MSCI EAFE – USD (developed markets equity)	16.48%	1.43%
MSCI Emerging Markets – USD (emerging markets equity)	18.03%	14.59%
Barclays US Aggregate Bond Index (U.S. bond)	2.48%	7.94%

The pessimism that dominated the second quarter extended through a large part of the third quarter. Through August, economic reports (i.e. unemployment, housing) were negative and there was a "consensus" prediction among economists of a double dip recession. It wasn't until an unexpectedly positive manufacturing report in early September was released that sentiment turned the market positive. Now most agree, as we predicted in our last commentary, that a double dip recession seems much more unlikely.

Despite a strong end to the quarter, there are many challenges ahead that may prevent the recovery from becoming truly apparent until 2011. A high deficit, high unemployment and depressed housing will continue to be a drag on markets.

Government seems to be at a stalemate on how to solve these problems long term. For example, there is widespread agreement in Congress that the US deficit is unsustainably high and must be addressed. (The US current debt as a percentage of GDP is 80% and is predicted to increase to 120% of GDP by 2020; source: PIMCO). However, there is little consensus on the remedy (a persistent theme in our country, aggravated by the contentious nature of politicians as we approach mid-term elections).

And, despite concerns over our high deficit levels, the Federal Reserve recently announced it may take further action, called quantitative easing, out of concern over a short term deflationary outlook. The economic challenges are of course world-wide and although markets are reacting positively to coordinated efforts among the Fed and central banks in England and Europe, many are concerned the central banks are throwing more money at the problem and that the easing won't be as effective as markets currently anticipate.

In addition to the coordinated efforts of central banks, countries are undergoing austerity plans. The "peripheral" European countries (Portugal, Ireland, Greece, Spain) that dominated the headlines during the second quarter were able to work out a deal with the European Central Bank (ECB) and International Monetary Fund (IMF). This coordinated effort enabled these countries that had trouble refinancing their debt through the public markets to buy some more time to enact their austerity plans.

Even "advanced" countries, such as England and Germany, have introduced austerity programs. For example, the new English government has introduced an extensive program that involves some tax increases but mostly spending cuts. While these programs will benefit their respective countries in the long run, the short term deleveraging process is controversial, as evidenced by widespread and sometimes violent demonstrations, such as the demonstrations and strikes in France over pension reforms.

While most of the markets had positive third quarter returns, emerging markets outpaced all markets both in the third quarter and on a year-to date basis, as most of these countries emerged from the world recession with quite strong balance sheets. However, there is a longer term concern that as investors seek higher returns, increased investment in emerging markets will create a bubble.

On the other extreme, fixed income mutual funds have also experienced record inflows, driven by those investors seeking more safety. Ironically, this flight to quality has caused concern about yet another bubble.

Clearly, there isn't a consensus on how to solve our current economic challenges, or a consensus on the direction of the market.

Market Outlook

As the U.S. and other developed markets emerge from the worst recession since the Great Depression, one thing is clear - there are still many obstacles to overcome before we will see a full recovery.

Our unemployment rate and the decline of housing values will continue to be a drag for the foreseeable future. For example, despite high cash balances, companies are reluctant to spend capital on new hires, prolonging unemployment. Additionally, pending foreclosures of homes remains significantly high; this excess inventory needs to be sold before we begin to see a stabilization of housing prices.

We urge caution and encourage our clients to maintain a long term outlook – it is premature to assume that one month of positive returns represents a buying signal. We continue to recommend that investors not pay too much attention to the short-term market; keep your long-term goals in focus and try not to be swayed by headlines. Remember, as we advise our clients, we do not control the market, you do not control the market. Focus on what you can control, such as when you retire, and how much you spend and save.

Year-End Tax Strategies

Although this is the time of the year that we would typically alert clients to potential year-end tax planning strategies, it is difficult to make suggestions this year given some significant tax law changes expected in 2011.

The uncertainty stems from the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), sometimes referred to as the Bush era tax policies. These two laws changed income tax brackets, capital gains taxes, tax-free retirement contributions and estate taxes for a limited time. Unfortunately, many of the provisions expire in 2011.

Despite the scheduled expirations, we do not expect Congress will take any action until after the November elections, if then. Following are some guidelines that you can consider during this period of uncertainty, which you may want to discuss with your accountant.

Accelerate/Defer Income or Accelerate/Defer Deductions

Conventional wisdom has generally been to delay income and accelerate deductions to lower taxable income for the current year. Typical examples include making an extra mortgage payment and paying more in state taxes (both to increase your itemized tax deductions, thereby reducing your taxable income). However, these strategies may not be the best choice for 2010 if the scheduled income tax brackets for 2011 take effect.

The current tax brackets range from 10 to 35 percent based on taxable income. However, these rates are set to expire at the end of 2010. If Congress does nothing, all the tax brackets will revert to the pre-EGTRRA rates, ranging from 15 to 39.6 percent.

Not everyone can control the timing of their income or deductions. However, for those who can, you may want to consider accelerating 2010 income and deferring your deductions until 2011. Assuming tax rates are higher in 2011, you will reduce your 2011 taxable income.

Some individuals may also want to take early IRA distributions, or if you are already making IRA withdrawals you may want to increase the amount of your withdrawals this year.

Capital Gains or Losses

Capital gains rates are scheduled to increase in 2011.

JGTRRA (2003) reduced capital gains rates. As a result, the current capital gains rates are 0 percent for taxpayers in the 10 to 15 percent income tax bracket and 15 percent for tax payers in higher tax brackets. Next year, the capital gains rates could revert to pre-JGTRRA rates, increasing to 10 and 20 percent, respectively.

Assuming Congress doesn't take any action, which will result in the higher capital gains rates in 2011, taxpayers may want to realize gains in 2010 and realize losses in 2011.

Roth IRA Conversion

Prior to 2010, the ability for taxpayers to convert IRA accounts to Roth IRAs was restricted to taxpayers earning less than $100,000. Beginning this year, taxpayers are allowed to convert funds from their traditional IRAs, 401(k)'s (in some cases) or other qualified plans to Roth IRAs, regardless of income. While the income restriction is lifted beginning this year forward, taxpayers making a conversion in 2010 have the added bonus of being able to choose between either paying all the income tax on the converted amount in 2010 (based on 2010 rates) or splitting the tax bill evenly over 2011 and 2012 (and paying taxes based on the rates in effect at that time).

Despite the opportunity for more individuals to make Roth conversions, it's important to remember Roth conversions are not for everyone. Since the amount you convert will be added to your ordinary income, you will be required to pay ordinary income tax on the conversion amount. As a general guideline, making a conversion is not advisable if you do not have adequate cash available to pay the taxes. Additionally, Roth conversions are generally not appropriate for older individuals or individuals who anticipate spending all of the funds in their retirement accounts during their lifetime.

While we try not to let tax strategy drive our investment strategy (*don't let the tax tail wag the dog*), we do believe in many cases in diversifying our clients' assets across different tax characteristics as a way to protect against the uncertainty of future tax rates. We will continue to monitor changes in tax laws so we are prepared to discuss them with you and your accountant.

Estate Planning and Estate Taxes

The Bush era tax policies will also affect estate taxes, but no one yet knows what the changes will be.

Since 2001 when EGTRRA passed, estate planning has been in flux because of the ongoing changes and uncertainty caused due to the expiration of the rules in 2011.

The estate tax exemption amount has steadily increased, peaking in 2010 with currently no estate tax. Although few in the estate or financial planning communities thought Congress would let 2010 arrive with no estate tax fix, here we are

Based on the law, the maximum estate tax rate dropped from 55 percent in 2001 to 45 percent in 2009. In addition, during that same period, the amount of property excluded from the estate tax rose in phases from $675,000 to $3.5 million per person.

For 2010, there has been a full repeal of the estate tax. However, the estate tax will return to pre-EGTRRA rate of at least 55 percent in 2011, plus a 5-percent surcharge on large estates, with a per person exclusion amount of $1 million.

Proposed changes to the estate tax laws run along party lines, with many Republicans wanting to keep the current full repeal and Democrats wanting to bring it back. The Obama administration is proposing to maintain the 2009 rate of a maximum of 45 percent on estates of $3.5 million or greater.

If Congress does nothing to modify the current laws, the estate tax exemption will revert to a $1M per person exemption in 2011. Thus, about all we can conclude for now is if Congress doesn't act and the estate tax applies to people with estates of $1 million or more, many more taxpayers will need to revisit their estate planning documents in 2011 to be sure their documents still reflect their intent.

We remind our clients that we are not accountants or attorneys. If you have tax related or estate planning questions we recommend you contact your accountant or attorney. If you need a referral, we are always happy to provide the names of accountants and attorneys. Recognizing that tax planning and estate planning are integral to financial planning and investment management, we work closely with a strong network of professionals, making it a point to understand their practices so we can make referrals based on your individual circumstances.

Financial Regulation

One final update: as of our last quarterly commentary, President Obama was about to sign broad financial regulation reform legislation. One of the goals was to make investments more transparent to investors. A provision of particular interest to us at IFS relates to "fiduciary standard." Currently, independent advisors like IFS are held to a "fiduciary standard", meaning we always put our clients' best interests before our own. Broker/dealers are currently held to a less stringent "suitability standard”. An example is a mutual fund recommendation that is in the appropriate asset class (e.g. US large cap) but is the firm’s proprietary fund which has a load and a higher expense ratio. That particular mutual fund is not necessarily the best choice for the client but it can be defended as suitable. This provision was so controversial that a House and Senate compromise resulted in a six month feasibility study. The outcome of this study is still uncertain. Here again, we will continue to monitor developments.

In closing, as we reviewed this quarter's commentary we were struck with how much the contentious nature of politicians as we approach mid-term elections is adding to the uncertainty of our economic recovery and changes in the tax laws. The following quotation from Farmer's Almanac seems appropriate...

"If Patrick Henry thought that taxation without representation was bad, he should see how bad it is with representation."

During such times, we encourage you to work more closely with the professional resources available to you. Thank you for your confidence in us. As always, please don't hesitate to call us anytime.

Barry and Janet

Sources: Morningstar, DFA, PIMCO, Bureau of Economic Analysis, Wall Street Journal, The Economist, Financial Times, Financial Planning Association (FPA), Capitol Update, CCH