



# BUTTONWOOD

*Financial Group, LLC*

QUARTERLY REPORT • WINTER 2010

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## FOR THE SECOND TIME IN TWO YEARS WE GET TO SAY, “WHAT A YEAR IT HAS BEEN!”

The events of 2009 were no less extraordinary than those of 2008. We started the year with people wondering how much worse things could get, and ended with a spectacular stock market climb that erased a good portion of the decline we experienced last year.

Always easier said than done, but removing emotions from decision, we should have expected just the year we had given where we were at the end of 2008. As we have regularly commented, markets and economies tend to move in cycles. While it's hard to predict just when and how these things occur, the awful contraction in the economy in 2008 made 2009's market and economic behavior not unexpected. In our Quarterly Newsletter – Fall 2008 we provided a series of charts to illustrate just this cyclical point and we maintained the fact we were staying invested utilizing a two pronged investment strategy: “Sticking with what works: Asset Allocation,” in conjunction with “exposure to non-traditional stock and bond markets” through the use of alternative investment asset classes. As we look back on the last couple of years this has turned out to be an excellent strategy.

In our **Quarterly Newsletter – Spring 2010** we outlined three possible outcomes for the economy: A Base case as well as both an Optimistic and Pessimistic case. We structured investments around our Base case. “The financial panic of 2008 would subside in early 2009 allowing a normalization of financial markets by mid-year 2009. We believe the economy will emerge from recession in the second half of 2009.” We argued that “the recent travails in the marketplace have created abundant opportunities for investors.

Most major asset classes are now priced at the most attractive levels they have seen in years or decades.” Of course we didn't know how soon other investors would perceive these bargains and begin to normalize prices, but with the alternative investments in place we believed we didn't have to. We simply knew that asset prices were very cheap, and at some point in the future they wouldn't be.

In January of 2009, economists and pundits were talking about the possibility of a sustained market drop similar to the slow investment torture the Japanese have experienced since 1989. Kiplinger's magazine identified the people who had been most right in their 2008 predictions and asked them what they thought was going to happen in 2009. Not a one of them predicted what actually happened: a dramatic rise in stock prices, a sharply falling dollar and an end to the economic recession. Most were very pessimistic about the economic and investment outlook.

The financial press is generally filled with stories and articles meant to sell more papers and magazines. Journalists don't want to go out on a limb giving sensible advice like “Don't sell at the bottom.” Since the financial press is a bit myopic, generally it is safe to expect them not to share ideas that might take years to bring to fruition. And of course the media feels the politically correct need to include all

# 2010 Buttonwood Focus

**January**  
Retirement Management/  
401k&Pension

**February**  
Retirement Planning

**March**  
Tax Preparation &  
Planning

**April**  
Simplification &  
Spring Cleaning

**May**  
College Savings/529

**June**  
Investment Strategies

**July**  
Debt & Liability  
Management/Cash Flow

**August**  
Insurance

**September**  
Identity & Credit  
Protection

**October**  
Estate Planning

**November**  
Multi-Generational  
Gifting

**December**  
Charitable Gifting

sorts of “opposing views.” Both sides of the story are dutifully presented and the result is simply more “noise” to confuse the very people who are mistakenly looking for wisdom among various pieces of disconnected news.

At the start of each year we like to take a good look at how assets are positioned and where we feel we will be best served as we move forward into the future.

*2009 was a year of tremendous opportunities and we made a number of changes in portfolios to position you to take advantage of them.*

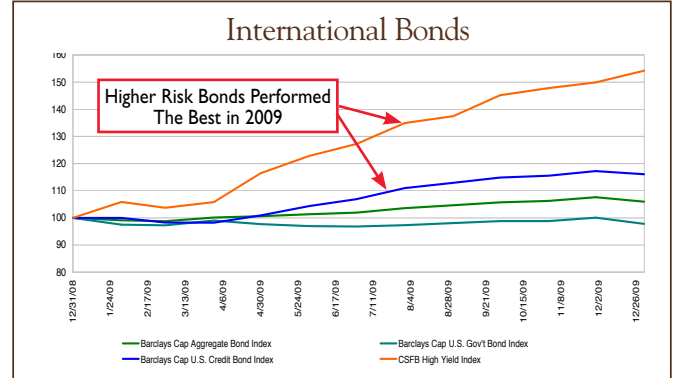
In the next few pages we provide a summary of the major investment asset classes, what they have done, what we believe they will do going forward and how we have approached each for the best opportunity we believe possible. After reviewing investments, we will also provide some 2010 highlights from the Kiplinger team related to both Tax and Estate Planning

## Investments: Traditional Asset Classes

Think of the big three and you will have just defined the traditional asset classes: Bonds, Stocks and Cash. As there isn't much to talk about in the 'Cash' or Money Market world we will focus here on Bonds and Stocks...

2010, the one area that we don't find compelling is Treasury bonds. The simple fact that Treasury bonds were the sole safe haven in 2008 meant they were not likely to do well in 2009. It was high grade and high yield corporate bonds that performed best last year. Other parts of the bond market - municipals, mortgages and convertibles also did very, very well. We took advantage of this fact by reducing Treasury bond exposure and by increasing high corporate bonds as well as adding to high yield and convertible bond allocations.

We enter the new year with the distinct possibility that interest rates will rise. Rising interest rates ought to concern bond investors because rising rates translate into falling bond prices. We believe the future will not treat investors in Treasury bonds all that well because Treasury bonds have very low current interest rates and any rise in rates will make Treasuries a poor investment vehicle. Other parts of the bond market will likely fare better as the current interest rates spreads will offer some protection from rising rates for a while at least. That said, expect more changes in the bond portion of your portfolio in the upcoming year.



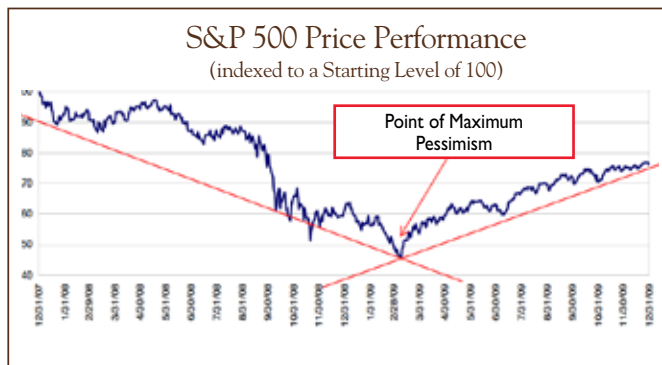
Over the years we have increased and reduced exposure to the International Bond sector. Today we feel that many foreign bond markets provide better opportunity than the US Treasury market. Because interest rates are generally tied to economic cycles, having exposure to other economic cycles than just our own gives us some opportunity coupled with some challenges. Both Europe and Japan seem to be stuck at slow growth rates for the time being and this should give their bond markets more breathing room before their rising interest rate cycles begin. Besides the developed markets there are also the emerging markets, which are in a much different spot in their economic cycles and provide much

The bond market entered 2009 with very attractive values and even now many parts of the bond market are still quite attractive. As we start



higher interest rates improving currencies. As 2010 progresses we will once again continue to increase allocations to foreign / emerging market bonds.

## US Stocks



The story for US stocks this past year has been all about the perception of risk. Early in 2009 the fear was that the economy would continue to slip and possibly accelerate downward. Obviously that fear proved unfounded. Once the worst case scenario was discounted, anything better was going to lead to a higher stock market. Investors didn't have to know what the future held, only that it wasn't going to be worse than what we experienced in the first quarter. The fear was transformed into relief and the early rally from March through May could be seen this way. Once we had priced some sort of future into stock prices, the latter part of the rally has been about which segments of the market would do best in the unfolding future – the light at the end of the tunnel. The next stage will likely happen when the fear of being out of the market finally gets bigger than the fear of being in it. That usually happens nearer the top of a market cycle than the bottom.

The muted improvement we have seen so far in corporate revenues, earnings and dividends portend far greater improvement over coming years. We continue to believe this economic cycle will likely be a lot more normal than most folks currently expect. We expect to see improvement in most parts of the economy over the next several years. However, with the increasing national debt, political uncertainty and various other factors, we believe the pace of that growth may not be quite what we have grown accustomed to - but it will be growth nonetheless.

Our emphasis on high quality growth stocks has been based on the notion that stable demand sectors of the economy would show better growth than the wildly cyclical parts of the economy. Both our valuation work and our economic outlook argue that the more cyclical industries may not get the solid growth they need to justify their current valuations. At the same time, the less cyclically dependent stocks can improve regardless of the economic climate. Our demand for band-aids and soda pop goes on while our need for a new car or major remodel can wait. Since 2007 we have maintained our overweight of growth stocks over value stocks and expect that to continue over the coming year as it has in the past three.

As we enter 2010 we also believe companies with a global reach will have better opportunities than those with a domestic only focus. We especially like companies that sell products to the developing middle classes in the emerging markets and we believe that group will have the highest growth in demand of any group in the world.

## International Stocks

Historically, the US has been the dominant economy and dominant market in the world. We believe that dominance is slipping. We think this is a critical and permanent change in the investment environment. We are no longer the only game on the planet. As we move into 2010 we plan on increasing exposure to international stocks not only for the short term, but with a higher international component actually added to investment policy statements.

The international world has traditionally been divided into developed and emerging markets. The developed ones, largely Europe and Japan, are growing slowly while the emerging ones are growing much faster. The populations of these emerging markets are enormous and slowly gaining purchasing power. Even if the gains are slow they are like the tide, inexorable. In late 2009 and moving into 2010 we are increasing exposure to both international stocks and bond markets. For those investors who are comfortable with additional risk this will include exposure to both the developed and emerging market sectors.

## Investments: Alternative Asset Classes

We often hear the question, “What are alternative investments?” There are many ways to answer this question but to keep it simple, we view alternative investments as asset classes that do not move in correlation with traditional stock and bond markets. We believe exposure to this sector has the ability to bring many benefits to investors.

For bond investors: Returns on bonds are a combination of two components; current interest payments and the increase or decrease in value of the bond. Bond values rise as interest rates decline, and bond prices fall as interest rates rise. Interest rates have been on the decline since the end of the Carter administration in 1981 and this has made the “average rate of return” for bonds look very attractive for the last 30 years. (See the chart of the long term trend in interest rates above.) If inflation returns and the trend toward lower and lower interest rates should change, conservative investment portfolios heavy in bonds could suffer. Alternative investments have the potential to provide additional diversification for bond investors. This diversification provides the ability to hedge against higher interest rates as well provide less volatility than traditional stock market investments.

For stock investors: Full decades like 2000 through 2009 expose the risk of having nothing but stock investments in an investment portfolio. Increased volatility and nominal returns have left many investors unsure of the stock market as a core investment class for the majority of their assets. Investments in the alternative asset classes have helped to reduce the volatility associated with stock heavy portfolios yet still allow for the potential of greater-than-bond-market type gains.

Since the founding of Buttonwood we have included at least some exposure to alternative assets in investment portfolios. As time has progressed so has our inclusion of alternative investments. As we move into 2010, we are now at a point where we have about 25% of all investment dollars invested in alternative investments. As we look forward we believe this asset class will continue to provide benefits to both conservative as well as aggressive investors.

## Commodities/ Managed Futures

Commodity markets have seen several violent swings in the past year. Oil went from well over \$100 a barrel to under \$40 and now back to \$70 in a little over a year. Gold went from about \$700 per ounce at its low to almost \$1200 an ounce. Many industrial metals and agricultural commodities had swings that make these look tame by comparison. But, in the last half of 2008, it seemed like all commodities were falling together and then they all started moving up in rough tandem in early 2009. We suspect that 2010 will show more divergence among and between the commodities. But, the broad commodity indexes ought to show some continued improvement. As the world continues to return from the abnormal decline to the more normal growth we will need more of nearly everything, and nearly everything starts with commodities.

For extended portfolios, rather than an outright bet on the commodity markets we have opted to invest in the sector through an index fund made up of both currency and commodity exposure – the Dow Jones Diversified Trends Index. We believe this approach will help to smooth volatility yet still provide upside of the sector.

## Real Estate

The primary investment vehicle for real estate exposure for most investors is the real estate investment trust, or REIT. REITs invest in mostly commercial real estate, shopping malls, hotels, downtown office buildings, industrial parks and the occasional apartment building. More often than not, when we are talking about real estate, we are not talking about your home and its price. Residential real estate is a completely different discussion.

We believe commercial real estate is going to make a very slow recovery after a rough couple of years. On the liability side, occupancy for office buildings has been under pressure as corporate America tries to reduce its headcount, especially banks and brokerages. In our discussion with

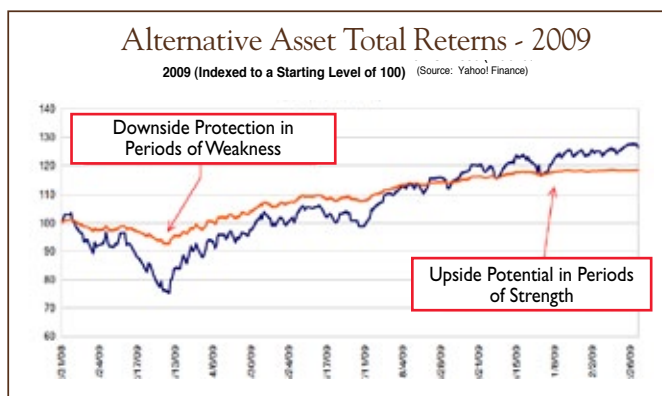


REIT providers, many are reporting the trend has moved from renewal requests of short term leases and rebates to longer term lease requests with the thought being to take advantages of a distressed market before the market rebounds. On the asset side, there are a lot fewer cranes dotting the skylines of most major cities as many projects have been postponed or cancelled due to the poor market conditions in the last couple of years. This may not mean much in the short term, however over time if there is no new building and demand continues to increase this is a positive from a supply / demand standpoint. To gain exposure to this market we have utilized both private REITs for extended portfolios as well as international REIT's. In today's global economy we can go all over the world looking for real estate. Asian real estate is in much better shape due largely to the strong growth in China and elsewhere in East Asia that has kept those markets tight. In 2009 we made no material changes in real estate holdings and simply held what we had.

concerned with default risk, the US Government continues to spend like there is no tomorrow, and the fuse continues to shorten on various powder keg political situations around the world – specifically the middle east. If, and maybe we should be so bold to use the term “when,” the fuse does reach the keg; volatility will be back in a flash.

### Global Unconstrained

The “unconstrained” term in the title of this sector is what exposure to this sector is all about. Managers in this sector may invest in almost any market they believe offers a high probability of return or, alternatively, markets they feel provide a high degree of safety in uncertain times. This is the sector, along with Commodities / Managed Futures, where we have obtained our exposure to gold and other non-traditional investments around the world for the last few years. Asset managers have the ability to move assets almost anywhere they feel there is opportunity.



### Long-Short

When an investor believes a stock will appreciate they buy the stock – they are “long.” When an investor thinks a stock will fall in value they can borrow shares and sell them today with the idea they will buy them back in the future at a lower price and return the borrowed shares – they are “short.” The vast majority of investors and managers work only on the ‘long’ side of the market.

### Absolute Return

The objective for the absolute return sub-sector is to not only protect assets in down markets but to provide upside in rising markets. With this in mind, we were once again glad to see the results for our holdings in 2009. Of the various alternative asset classes, absolute return was the asset class that provided portfolios the largest return in 2009.

In 2008 as market volatility was increasing we moved a portion of ‘long only’ investment dollars into investments where managers can not only buy stocks they think are going to go up in value but they could sell stocks short that they thought would decrease in value.

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*In 2008, as the major stock markets were posting significant losses of 30% – 40%, our long / short holdings held their value with declines less than 10%.*

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We are optimistic on this volatility thriving sector for the future as well. While it has been nice to see the both the traditional stock and bond markets rise and stabilize, we do not believe by any means that we are “all clear” from financial, economic, or political troubles. Spreads in the debt markets no longer seem to be

In 2009 gains were back in both the major stock markets as well as the long / short sector.

# Outlook

*After two very volatile years in the investment markets it may be time for a little normalcy. On the optimistic side, we expect to see continued growth in the economy; however this growth may be less traditional than we have seen in times past. We believe we will see the start of a recovery in jobs, but possibly not until later in the year. We also believe it's very likely we will see some recovery in both consumer and business spending. We look for some recovery in housing, though not back to the levels of a few years ago. And we believe exports will likely grow as well as our imports.*

Over on the pessimistic side, we believe the Government and uncertainty that lies within will continue to be the biggest wildcard of the year. Failure to accomplish passage of healthcare reform, failure to address the estate tax, and the fact that the US Government continues to try to 'run' many of the businesses that it invested in during the crisis in 2008 will simply lead to more uncertainty as debates continue into 2010. One thing we think is clear: The Government will continue to spend like there is no tomorrow, which, unfortunately is the day the bills come due.

We believe the big stories this year in the financial markets might revolve around a corporate earnings revival as well as tracking of interest rates as they begin to rise from the historically low levels of the crisis days. Corporations are lean and mean. They have cut spending, cut jobs and cut advertising all in reaction to the environment they faced last year. Having those all return to more normal levels in the years to come will be

a big boost to the economy and the bottom line. Absent the stream of one-time write-offs and losses, earnings ought to be higher a year from now and we believe this ought to push stock prices higher as the recognition sinks in that the recession is really over.

As the recovery does get some traction, the Federal Reserve will slowly begin to reverse its easy money policies in hopes of avoiding a return of virulent inflation. The question is when, not if, the Fed will begin to raise interest rates and withdraw some of the other stimulus they have been using to turn the economy around. We also believe that when the time comes and traders start to see the end of the lower interest rate cycle the stock markets could once again experience increased volatility.

We think that the odds of a relapse back into what has now been coined the "Great Recession" are unlikely and are receding every day. And as such we continue to have investment assets positioned in an "optimistically defensive" mode.

## Tax and Estate – Facts and Figures

In 2009 Congress ignored some very big issues including key elements on the Tax and Estate side of the equation. We believe it is very likely, while we are starting out with one set of tax laws in 2010, we will see changes that will modify these laws so by December we may have very different set of rules.

Starting with the expired estate tax, Kiplinger Tax Letter reports, "Lawmakers will reinstate it this year, and will make its revival retroactive to Jan. 1. The same goes for the generation-skipping tax, which was allowed to expire at the end of 2009, too. Congress also will keep

this year's top gift tax rate from falling to 35% and will prevent the replacement of the date-of-death value rule as the basis for inherited assets with a system that starts with the decedent's basis. Under that carryover basis regime, when the inherited assets are sold by heirs, they could exclude up to \$1.3 million of gain...\$4.3 million for surviving spouses. But a return to 2009's \$3.5-million exemption and 45% rate isn't assured. A group of Senate Republicans and moderate Democrats want a \$5-million exemption with a 35% maximum rate, and they may have enough votes to force a compromise.



There are also a number of tax provisions that lapsed without attention on January 1, 2010 as well. Popular tax breaks such as the R&D credit, tax free IRA payouts to charity and write-offs for state sales tax, college tuition and teachers' supplies. In addition, taxwriters must boost the AMT exemptions so they don't revert to pre-2001 levels. Two key write-offs for business lapsed: 50% bonus first-year depreciation, and the higher ceilings on expensing. So right now, companies can expense only \$134,000 of assets that are put in use in 2010, down from \$250,000 last year. And the ability to claim expensing in lieu of depreciation phases out dollar-for-dollar once over \$530,000 of assets are placed into service, down from \$800,000 in 2009.

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*Those with higher incomes seem to be safe in 2010 from the loss of any itemized deductions and personal exemptions. However, write-offs will be trimmed again in 2011.*

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After a break this year, itemized deductions other than medical expenses, investment interest and casualty losses are again targeted to be cut by 3% of the amount by which AGI exceeds about \$170,000. Personal exemptions cuts are slated to be reduced by 2% for each \$2,500 of adjusted gross income over about \$255,000 for married filers, \$170,000 for singles and \$210,000 for heads of households. The exact figures for 2011 will depend on how much the Consumer Price Index increases this year.

Tame inflation in 2009 left the standard deduction amounts mostly unchanged. Married filers continue to claim \$11,400. If one spouse is age 65 or older, \$12,500. If both are, \$13,600. Singles can take \$5,700. Those 65 and up can deduct \$7,100. Household heads get \$8,400, a \$50 boost, plus \$1,400 once they reach age 65. Two add-ons to the standard deduction expired with 2009: The allowance of up to \$1,000 of property taxes paid and the addition of casualty losses incurred in presidentially declared disaster areas. Also, the \$500 floor for casualty losses on personal assets in regions not declared disaster areas declines to \$100 this year. Personal exemptions remain \$3,650 for filers and their dependents.

It's also safe to assume your paycheck will be modified as new tax withholding tables apply for 2010. Last year's tables were revised for the

Making Work Pay Credit...a 6.2% credit on earned income, capped at \$400 for singles, \$800 for couples. The tax savings were packed into the last nine months of 2009. The 2010 tables spread the credit over 12 months, so the monthly savings from the credit will be less. Thus, on the same pay, withholding will be a bit larger.

### *Social Security changes*

*There's no cost-of-living hike for Social Security beneficiaries this year. So there is no change in the Social Security wage base for the first time since 1971.*

It will stay at \$106,800 for 2010 because by law, the taxable wage base can't rise if there's no cost-of-living increase. The tax rates don't change, either: 6.2% for FICA tax and 1.45% for Medicare. For self-employed taxpayers...15.3% on the first \$106,800 of their net earnings and 2.9% on any amounts above that.

The earnings limits don't change, either. Folks who turn 66 this year do not lose any benefits if they earn \$37,680 or less before they reach that age. Individuals between ages 62 and 66 by the end of 2010 can make up to \$14,160 before they lose any benefits. There is no earnings cap once a beneficiary turns 66. The amount needed to qualify for coverage inches up...to \$1,120 a quarter. So earning \$4,480 anytime during 2010 will net the full four quarters of coverage.

For most, the basic Medicare Part B premium remains \$96.40 a month in 2010. However, the premium increases to \$110.50 a month for folks who sign up for Part B in 2010 and for those whose premiums are paid by Medicaid. Upper income seniors still must pay a significantly higher amount, meaning couples with adjusted gross incomes exceeding \$170,000 and singles with AGIs over \$85,000. Their fee is based on their 2008 AGI, plus any tax-exempt interest, EE bond interest that's used for education, and excluded foreign earned income. The maximum monthly premium for high incomers is four times the basic premium."

*We appreciate your confidence and your business, and as always, it is you we are here to serve. If you have any questions or would like to schedule time to review any part of your financial life please don't hesitate to contact us!*





## YOUR BUTTONWOOD RESOURCES

JON MCGRAW -  
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VINCE PASTORINO -  
*Senior Vice President*

WENDY MCGRAW -  
*Office Manager*

BILL RYAN -  
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## 2009 Tax Return and Legal items

Your Non-Retirement-Plan Account is subject to income tax in various ways. These taxable transactions and distributions are reported to you on two different kinds of reports (A, B) described below.

A.) Realized Gains & Loss Reports. "Realized" Capital Gains (or losses) - These are gains (or losses) created (realized) when we sell an investment in your account. We have enclosed a report that reflects your "realized" gains or losses for 2009 for your taxable account(s).

In 2006 the IRS issued a clarification of the rules regarding the entering of gains and losses on your Schedule D. This clarification allows the entering of summary data on Schedule D and also requires the submission of the details. Most CPA's recommend you enter the totals from the reports in the appropriate sections on Schedule D of your tax return and attach a copy of the gain/loss reports to your return in order to provide the detail required by the IRS. You should use "LPL Financial" and/or "Charles Schwab" respectively as the source. If you are filing electronically, you will still need to submit the detailed realized gain and loss reports through the mail via a transmittal memo.

B.) Year-End Tax Summary Report - (Form 1099). You will soon receive this report from LPL Financial and/or Charles Schwab. This summary reports all of the interest, dividends, distributed capital gains etc. for your taxable account(s) for 2009.

*Corrected "Year-End Tax Summaries"* As you may know, the mutual fund companies are required to report their dividends to custodians and broker / dealers by January 31st, and they are also required to mail your 1099 by February 15th. However, it is common for some mutual funds to correct and/or reclassify dividends. These reclassifications cause the custodians to mail corrected 1099s. Although we encourage you to provide your tax information to your tax preparer as soon as possible, it may be wise not to finalize and file your return until after April 1st to allow for any corrections that may result in amended 1099's.

IRA Accounts: Since these accounts are tax deferred, you will not receive a 1099 or realized capital gains report on them. However, if you have taken distributions from these accounts during 2009, you will receive a Form 1099-R from after February 15, 2010. The 1099-Rs report the amount of money you have withdrawn and the amount of taxes withheld on the withdrawal.

*Legal* On a disclosure note, we are required by the Securities and Exchange Commission to offer to send you a copy of our ADV Part II disclosure form once each year. If you would like a copy of this delightful and entertaining government form, please give us a call, and we'll be happy to send it to you. We are also required to provide you with a copy of our privacy policy and have enclosed it for your reading pleasure.



## BUTTONWOOD IN THE COMMUNITY

Buttonwood Art Space continues with multiple shows in 2010. The first of these, our early Spring show: *New Beginnings*, will open in conjunction with *First Fridays* on **February 5th**. Art Space is here to expand the presence of Art in Kansas City as well as introduce the community to Buttonwood. The Artist Open House events are always posted on the website and we will send postcard invitations ahead of the event. Buttonwood Art Space is open from 9am to 5pm weekdays and "by appointment" on the evenings and weekends. We open our doors to 501(c)3 non profit groups as a free event space as well. Visit our newly renovated website: [www.ButtonwoodArtSpace.com](http://www.ButtonwoodArtSpace.com) to review both current and previous artists and their exhibited work.

At Buttonwood Financial Group, LLC, our mission is to positively impact each of our clients by providing on going consultative assistance allowing them to organize and take control of their financial lives. We accomplish this through education, financial planning, and the development and supervision of unique personalized portfolios for individuals, corporations and financial institutions. *Our growth comes from referrals, so please feel free to share our name and numbers with your friends and family.*