The Financial Navigator – March Newsletter

In this issue of the Navigator we discuss some tax increases that you may be impacted by starting in 2013 and some ideas on avoiding them. It might be wise to start planning now, as this is an election year and there is a high likelihood the whole issue of whether the "Bush tax cuts" will be allowed to expire will be punted down the road; therefore, we all could be looking at tax increases in 2013. In addition, included is an article that discusses the tradeoffs between preserving one's investments versus preserving one's purchasing power. It is a little lengthy and detailed, but well worth the read as it presents an interesting perspective on the whole issue of wanting safe, risk free investments while also maintaining a standard of living. Thanks to Brad Steiman of Dimensional Fund Advisors for the use of this article.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

Bill Simpson, CFP®, MBA
Azimuth Financial Planning, LLC
(603) 373-8793
bsimpson@azimuthplanning.com
www.azimuthplanning.com

Tax Outlook for 2013

This will be the year to closely watch the happenings in legislative and political developments in the nation's capital and to possibly take action based on the resulting tax policies.

As it stands today the "Bush tax cuts" will expire at the end of 2012; the result is federal long-term capital gains tax will increase from 15 percent to 20 percent, and ordinary income rates will increase across the board. In addition, the so called "Medicare Tax", a 3.8% surtax on investment income and gains for taxable incomes above $200,000 single and $250,000 joint returns, will go into effect, the purpose is to fund healthcare reform.

For the first time in history income from interest, dividends, annuities, rents, royalties, gains from securities and commodities trading, and gains from certain dispositions of business property will incur the Medicare tax. (Items not included for the calculation are retirement income from pensions, IRA distributions, Social Security, life insurance proceeds, and municipal bond interest.)

While pensions, IRAs, and company provided annuities are not covered by the healthcare surtax, they do count toward the income threshold that would trigger the tax liability. For example, if $250,000 of family income comes from pensions and/or IRA distributions, all investment income would be subject to the Medicare tax on a joint return.

The Medicare tax also can apply to the sale of a personal residence. The calculation of the gain on a primary residence will be the sales price minus the cost basis minus the primary residence exclusion ($250,000 single, $500,000 joint filer). No exclusion exists on secondary residences. Any gain over the $200,000 on a single return and $250,000 on a joint return would be subject to the 3.8% tax.

Meanwhile, watch out for the tax rate on qualified dividends, which will rise from the current 15% to as high as 39.6 % in 2013.

Tax Planning Ideas

What is the best way for you to respond if these new taxes are enacted? One idea might be to take long-term capital gains on investments in 2012 to lock in a 15% capital gains tax rate versus the 20% to 24% rate in 2013. Another option is to perform a Roth IRA conversion in 2012 so that you can pay taxes now at lower rates for those retirement funds, rather than the increased rate in 2013 and later. This also avoids having investment income in 2013 that will put you over the income threshold limits and subject your investment income to the Medicare tax.

Another option is buying tax-free municipal bonds for fixed-income needs if the funds are located in taxable investment accounts. In addition, consider locating individual bonds, bond funds, and high dividend paying stock funds in tax deferred retirement accounts to avoid the increased dividend tax rate.

Additionally, you might consider accelerating income into 2012, which is possibly the last year when the current rates and rules will be in effect. As always, remember that the best decision is based on your individual circumstances, so discuss this with a financial advisor or CPA.

The Tradeoff: Preserving Capital or Preserving Purchasing Power

Brad Steiman, Northern Exposure, Director and Head of Canadian Financial Advisor Services and Vice President

Many aspects of life require careful consideration and balancing of the tradeoffs that arise from competing demands. For example, a common lifestyle tradeoff is working longer hours versus spending more time with your family. The competing demands within this decision are the income necessary to provide a suitable quality of life for your family versus the immeasurable benefits of quality time with your family. There is no right answer, but most people understand the tradeoff and attempt to find the balance that is right for them.

Successful investing and financial planning also require balancing tradeoffs. For example, a common investment tradeoff is that of risk and return. One of the competing demands is preservation of capital versus preservation of purchasing power. The former may allow for a better night's sleep during periods of heightened uncertainty and corresponding volatility, but the latter helps ensure you'll have a comfortable bed in the future when accounting for rising prices from inflation. Once again, there is no right answer, no "optimal" solution. Understanding the tradeoffs between preserving capital and preserving purchasing power will help investors find the balance that is right for them. This balance will depend on their definition of risk and attitude towards it.

Some investors may consider risk to be volatility. They have difficulty stomaching the daily ups and downs associated with investing in asset classes that experience significant price fluctuations, such as equities, because declining prices are often accompanied by predominantly negative headlines. Although information will be reflected in prices before one can react to it, this is little solace to investors who extrapolate the recent past into the future and see the bad news as an indicator of what's to come rather than a commentary on what has already happened. These investors yearn for short-term preservation of capital.

Other investors may define risk as a diminishing standard of living. They have long-term financial obligations, such as spending during their retirement years, and their primary goal is building wealth to meet those future expenses. They recognize that, while the cumulative effects of inflation are sometimes glacially slow or even undetectable in real time, inflation can be the silent killer of a financial plan. These investors desire long-term preservation of purchasing power.

Investing is relatively straightforward when the definition of risk and attitude toward it are so black and white. For example, you can virtually guarantee the preservation of capital by investing in the equivalent of Treasury bills as long as you accept the corresponding potential for the loss of purchasing power. On the other hand, you can preserve purchasing power by investing in asset classes with expected returns exceeding inflation, providing you accept price fluctuations that can temporarily impair your capital.

Unfortunately, in practice, investing isn't that simple. Individual investors rarely have black and white objectives or well-defined definitions of and attitudes towards risk. Some expect long-term preservation of purchasing power and short-term preservation of capital. Making matters worse is the tendency for the priority and relative importance of their competing demands to change through time, often in response to what's happened in the recent past.

Investors who succumb to the cycle of fear and greed end up chasing a moving target. Advisors can try to mitigate this destructive behavior by focusing investors on the tradeoffs that were made at the outset when determining their balance between assets that are expected to grow faster than inflation and those that stabilize the portfolio and reduce its fluctuations. So if an investor is now fearful and therefore more focused on capital preservation, it is time to reframe the tradeoffs by emphasizing why growth assets were in the portfolio to begin with and how the so-called "riskless" asset (i.e., bills) can actually be extremely risky in the long run.

For example, Table 1 contains annualized returns from Australia, Canada, the US, and the UK for more than a century. Bills only slightly beat inflation before tax, but this small return advantage can easily disappear on an after-tax basis.1 Nonetheless, the table clearly demonstrates that equities have delivered returns exceeding both bills and inflation by a wide margin, even when accounting for taxes.[2]

Table 1: Annualized Nominal Returns (1900–2010)

Country	Inflation	Bills	Equities
Australia	3.9%	4.6%	11.6%
Canada	3.0%	4.7%	9.1%
US	3.0%	3.9%	9.4%

UK	3.9%	5.0%	9.5%

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

However, the tradeoff for pursuing higher expected returns of equities is accepting the risk of substantial declines compared to the relative stability of bills. Table 2 shows that equity values in the four markets have dropped from 50–69% over a two- to six-year period, whereas bills have always been flat or better (if you consider minus 2 basis points a rounding error).

Table 2: Worst Performing Periods for Equities and Bills, Nominal Returns (1900–2010)

	Equities		Bills	
Country	**Period**	**Total Return**	**Period**	**Total Return**
Australia	1970–1974	–50%	1950	0.75%
Canada	1929–1934	–64%	1945	0.37%
US	1929–1932	–69%	1938	–0.02%
UK	1973–1974	–61%	1935	0.50%

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

The risk and return relationship from a preservation of capital perspective is apparent in these nominal returns, but the picture is a bit different after considering the impact of inflation. In terms of preserving purchasing power, now the "riskless" asset looks far from risk free.

Table 3 contains the biggest peak-to-trough declines, in real terms, for equities in these four countries over the same time period. It likely comes as no surprise that the magnitude of the real declines is substantial, with stock prices dropping anywhere from 55–71% after inflation. However, the duration of the declines is still relatively short, ranging from two to five years, and it took equity investors in these countries anywhere from three to eleven years to break even.

Table 3: Worst Performing Periods for Equities, Real Returns (1900–2010)

	Peak to Trough Decline			Subsequent Recovery
Country	**Period**	**Total Return**	**Years**	**Years**
Australia	1970–1974	–66%	5	11
Canada	1929–1932	–55%	4	3
US	1929–1931	–60%	4	4
UK	1973–1974	–71%	2	9

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

In contrast, the data in Table 4 for bills, or the "riskless" asset, in these four countries is revealing. The biggest peak-to-trough declines after inflation now remarkably range from 44–61%, a similar order of magnitude to equities. Furthermore, the duration of the declines extends to a range of seven to forty-one years with investors in bills waiting an astounding seven to forty-eight years to recover!

Table 4: Worst Performing Periods for Bills, Real Returns (1900–2010)

	Peak to Trough Decline			Subsequent Recovery
Country	Period	Total Return	Years	Years
Australia	1937–1977	–61%	41	21
Canada	1934–1951	–44%	18	34
US	1933–1951	–47%	19	48
UK	1914–1920	–50%	7	7

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

More than ever, comparisons like these are needed when discussing the tradeoff of preserving capital versus preserving purchasing power. Investors feel the risk of equities in real time. Volatility is immediate and apparent as their portfolio value shows up in the mail every month or on their computer screen every day. Conversely, the risk of investing in bills and other low-volatility assets is less discernible and may take time to detect as it shows up when investors open their wallet at the grocery store or gas station many years later.

Investors may still want to revisit the tradeoffs they made and alter course if appropriate. However, changes to a long-term plan should reflect an informed decision rather than an emotional one. Fear and greed are powerful forces, but we should resist letting them dictate the tradeoffs we make in our lives or in our portfolios.

As the Most Interesting Man in the World would say, "stay invested, my friends!"

1. Returns in this table are pre-tax, but actual consumption, as represented by inflation, requires after-tax dollars; therefore, if the marginal tax rate on interest income exceeds [1 – (Inflation/Bill Return)], the real return is negative. (e.g., Canada: [1 – (3.0/4.7)] = 36% but the highest marginal tax rate on income is roughly 45%.)

2. The difference in the real return of equities versus bills would increase after taxes in countries where the tax rate on income exceeds the tax rate on dividends and capital gains.

For more information on these topics and more contact Azimuth Financial Planning at (603) 373-8793.