

The Financial Navigator – February Newsletter

This month we update you on the tax changes for 2013 that were finalized last month, and review some of the best performing stocks of 2012; home builders. Who would have thought with the nation still dealing with upside down mortgages, an over-supply of housing stock, and the high number of foreclosures, that homebuilders would lead the stock markets higher? Especially with the stark headlines that dominated the financial news; but don't feel too bad, most of the pros missed the homebuilders stock race to the top too, read on for more information.

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,

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Betting against the House

Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.

For those seeking to outperform the market through stock selection, underweighting the market's biggest winners can be just as painful as overweighting the biggest losers.

It's New Year's Day 2012. In addition to overdosing on televised college football, you're spending part of the holiday working on the family finances. Armed with a laptop and various online financial tools, you're on the hunt for appealing stock market opportunities. To prune the list of candidates to a manageable size, you decide to focus on firms that are leaders in their respective industries and exhibit above-average scores on various measures of financial strength. As you work your way through the alphabet, you come to the "P" stocks, and another candidate appears. It's a prominent player in a major industry (good), but operates in a notoriously cyclical industry (not so good), is currently losing money (definitely not good), pays no dividend, and has a junk-bond credit rating of BB-minus. Next! You push the "delete" key and move on.

Congratulations. You just passed up the best-performing stock in the entire S&P 500 Index for 2012. Shares of PulteGroup Inc., a Michigan-based homebuilder with a 60-year history, jumped 187.8% last year amid strong performance for the entire industry. For the year ending December 31, 2012, all 13 homebuilding firms listed on the New York Stock Exchange outperformed the S&P 500 Index by a wide margin, with total returns ranging from 34.1% for NVR, Inc. to 382.8% for Hovnanian Enterprises, Inc. The Standard & Poor's SuperComposite Homebuilding Sub-Index rose 84.1% in 2012 compared to 13.4% for the S&P 500 Index.

The point? For those seeking to outperform the market through stock selection, underweighting the market's biggest winners can be just as painful as overweighting the biggest losers. Investors are often caught flat-footed by stocks that do much better or much worse than the broad market, and the problem is not limited to individuals. Not one of the 10 seasoned professionals participating in Barron's annual Roundtable stock-picking panel in early January 2012 mentioned homebuilding stocks or any housing-related firms.

The recent surge in housing shares also serves as a reminder that stock prices are forward-looking and tend to rise or fall well in advance of clear changes in company fundamentals.

Investors who insist on waiting for evidence of healthy profits before investing are often frustrated to find that a firm's stock price has appreciated dramatically by the time the firm begins to report cheery financial results. Shares of Hovnanian Enterprises, for example, rose 580% between October 7, 2011, and December 31, 2012, even though it continued to report losses. Similarly, it is not unusual for a firm's stock price to decline long before signs of trouble become obvious.

The behavior of the S&P Homebuilding Sub-Index in recent years illustrates the challenge of relying on industry characteristics to provide a reliable guide to the direction of stock prices. Notice that as the headlines, and expert analysis of the housing industry, become more alarming the index continues to march higher. (Note: Index inception was December 31, 1994, at 100.)

<u>DATE</u>	<u>S&P HOMEBUILDING INDEX</u>
JULY 28, 2005	1063.19
<i>Index sets a record high, up more than tenfold from its year-end 1994 level of 100.0.</i>	
OCTOBER 9, 2007	368.13
<i>Index closes 65% below its peak on the same day the S&P 500 sets a record high.</i>	
MARCH 6, 2009	150.21
<i>Index slumps to its low for 2009, and the S&P 500 Index follows suit on March 9.</i>	
JULY 27, 2010	239.18
<i>"Sales of new homes are near 47-year lows. ... Homebuilders, which began buying up land late last year in anticipation of an economic and housing rebound, are stuck with thousands of acres that are prone to lose value as the market struggles." - Robbie Whelan, "Supply of Homes Set to Grow," Wall Street Journal, July 27, 2010.</i>	
JULY 11, 2011	250.23
<i>"The housing decline will be a long, multiyear process, and the multiplier effect across the economy will be enormous." Quotation attributed to Doug Ramsay, Leuthold Group. Roben Farzad, "The Housing Horror Show Is Worse Than You Think," Bloomberg Businessweek, July 11, 2011.</i>	

DECEMBER 23, 2011

236.80

“Simply put, Hovnanian [Enterprises] may soon become hard-pressed to make payments on its groaning load of debt—\$1.6 billion, all in the form of bonds ... and it has no bank credit lines to fall back on.” Robin Goldwyn Blumenthal, “Hammered and Nailed,” Barron’s, December 24, 2011.

MAY 14, 2012

326.18

“Excess inventories “are the mortal enemy of prices, and we’ve calculated an excess of 2 million units, over and above normal working levels of inventories of new and existing homes.” - A. Gary Shilling, “Is Now the Time to Buy Your First House? No: The Fall Isn’t Over,” Wall Street Journal, May 14, 2012.

JANUARY 21, 2013

484.52

“House prices are vulnerable to a new wave of foreclosures now that mortgage modifications have been tried and largely failed.” - A. Gary Shilling, “Prepare for a Stock Market Plunge,” Forbes, January 21, 2013.

JANUARY 30, 2013

503.65

“Sharp home price increases—particularly in once-decimated cities such as Phoenix and Las Vegas—are raising concerns among some economists that speculation could return to certain markets if such double-digit gains continue.” - Alejandro Lazo, “Prices Rise, and So Do Fears of a Bubble,” Los Angeles Times, January 30, 2013.

BOTTOM LINE

Many observers in recent years predicted that a recovery in the housing industry would be agonizingly slow, and they were right. Many investors in recent years have avoided housing stocks as a consequence, and they’ve been wrong: Housing stocks have outperformed the broad US stock market by a healthy margin from the market low in March 2009 to the present day.

Bottom Line: Markets have a 101 ways to remind us of Nobel laureate Merton Miller’s observation: Diversification is the investor’s best friend.

2013 Fiscal Cliff Tax Outcome

On January 1, just in the nick of time, Congress finally got around to dealing with the tax part of the fiscal cliff drama by passing what is hilariously named the *American Taxpayer Relief Act of 2012*. Thanks to the demise of the so-called payroll tax holiday, all workers will pay higher taxes this year, but the new law cancels federal income tax increases that would have resulted in added misery for just about everyone. Here’s a summary of the most-important changes for individual taxpayers.

Individual Income Tax Rates

- All the individual marginal tax rates are retained (10%, 15%, 25%, 28%, 33%, and 35%). A new top rate of 39.6% is imposed on taxable income over \$400,000 for single filers and \$450,000 for married taxpayers filing jointly.
- There will continue to be favored treatment for capital gains and qualified dividends. A 20% rate applies to capital gains and dividends for individuals above the top income tax bracket threshold (\$400,000 / \$450,000). The 15% rate is retained for taxpayers in the middle brackets. The zero rate is retained for taxpayers in the 10% and 15% brackets.
- As previously mentioned, the payroll tax that finances Social Security will increase from 4.2% to 6.2%, what it was a couple of years ago.

Other Income Tax Changes

- The personal exemptions and itemized deductions phase-out is reinstated at a higher threshold of \$250,000 for single taxpayers and \$300,000 for married taxpayers filing jointly.
- The exemption amount for the Alternative Minimum Tax (AMT) on individuals is permanently indexed for inflation.
- Beginning January 1, 2013, net investment income (which includes capital gains, interest and dividends) is subject to the new 3.8 percent Medicare tax if adjusted gross income exceeds \$250,000 for joint filers and \$200,000 for single individuals.
- The IRA charitable rollover is restored for 2012 and 2013 for individuals over 70½.

Estate Tax Changes

- The estate, gift and generation skipping transfer tax exemption amount is retained at \$5 million/person indexed for inflation (\$5.25 million in 2013).
- The top estate tax rate increased from 35% to 40% effective Jan. 1, 2013.
- The estate tax “portability” election, under which, if an election is made, the surviving spouse’s exemption amount is increased by the deceased spouse’s unused exemption amount, will continue.

REFERENCES

Lauren R. Rublin, “Barron’s Roundtable, Part One—Listen

Up Class, Here’s How to Profit,” Barron’s, January 16, 2012.

Yahoo Finance, finance.yahoo.com, accessed February 5, 2013.

CRSP data provided by the Center for Research in Security

Prices, University of Chicago.

S&P data provided by Standard & Poor’s Index Services Group.

