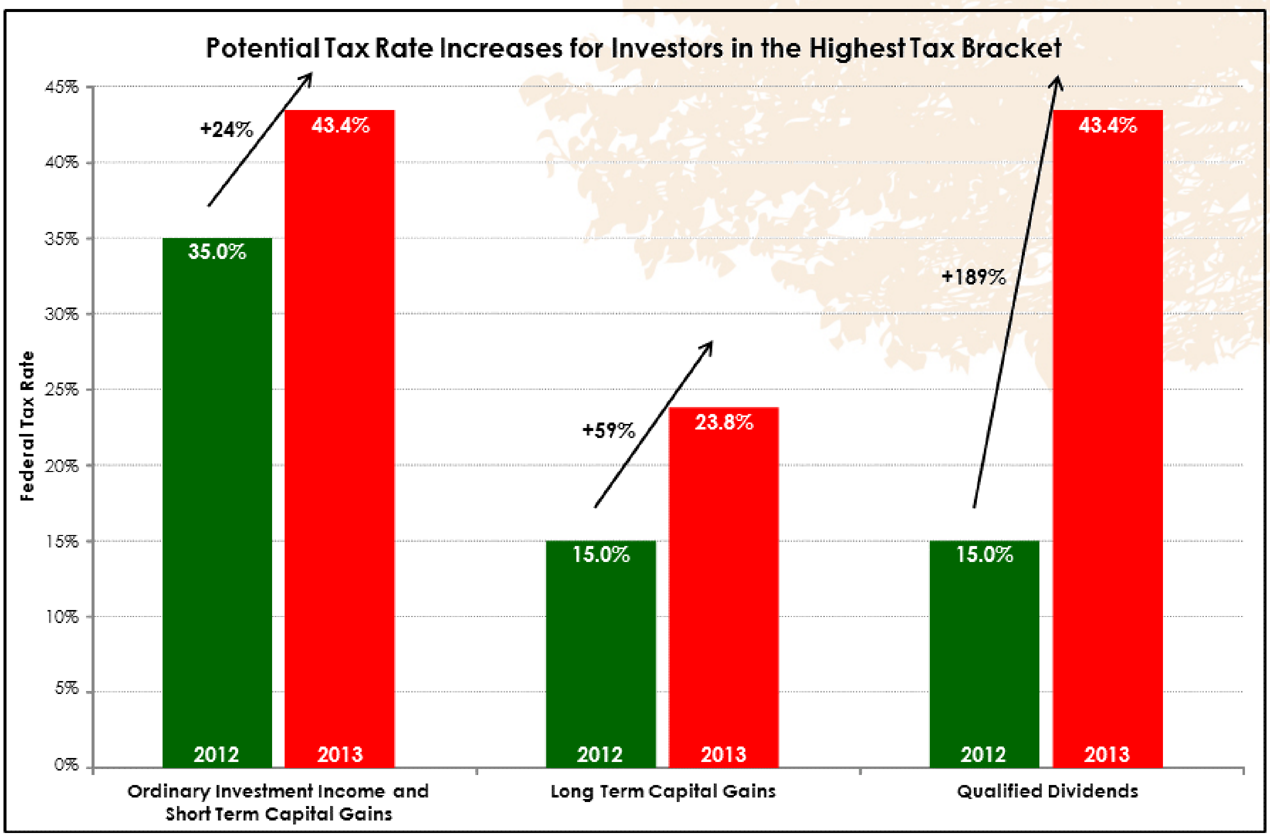
Quarterly Newsletter

OCTOBER 2012

CAPITAL MARKETS UPDATE | Major central banks remain active in markets and recently announced additional measures to support economic growth. Equity markets delivered handsome gains for the quarter with foreign stocks (Emerging Markets +7.7% and International +6.9%) outperforming domestic stocks (Large Cap +6.4% and Small Cap +5.3%). Domestic fixed income posted a solid return (+1.6%), though modest in comparison. The European Central Bank's bold actions may mark a key turning point in the region's debt crisis provided European policy makers continue to make progress with structural reforms that preserve the Euro, increase competitiveness and restore fiscal responsibility.

TAX UNCERTAINTY | We are in the midst of a closely contested presidential and congressional election cycle. Within one month (no hanging chads please), we will know the victors. Unfortunately, we still won't know the structure of our tax code beyond December 31st. In fact, lower tax rates on all Americans that have been in place for over a decade are scheduled to expire at the end of 2012. The lame duck session of Congress after the election promises to be action-packed. It is possible that Congress will renew the legislation for a short term and defer action to the new Congress in 2013. However, President Obama has said he will veto any further extension of the tax cuts for upper income families. Needless to say, great uncertainty remains.

The chart below depicts what we do know—tax rates on ordinary investment income, capital gains and dividends will vault higher if Congress does not act this year. Part of the increase reflects the expiration of tax cuts that will affect everyone. Recent health care reform also imposes a new tax on investment income for affluent families. Beginning in 2013, families with adjusted gross income over $250,000 ($200,000 for individual taxpayers) will pay an additional 3.8% tax on taxable investment income. The tax applies to dividends, interest, capital gains, rents, royalties and distributions from annuity contracts. The tax does not apply to tax-exempt municipal bond interest, life insurance death proceeds or to amounts withdrawn from qualified pension plans and IRAs. As you can see, the change is dramatic in each category. The most severe is a near tripling of the tax rate on qualified dividends.



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TAX-EFFICIENT INVESTING | In any tax environment, attention to the details matters. If tax rates materially increase, it will be especially important to have tax-efficient portfolios. Here are several ways to reduce tax drag on investment returns.

- **Asset Location**—Simply said, what should we hold where? Big picture, it is best to mute the tax inefficiency of some assets by holding them in tax-qualified accounts (IRA, 401(k), Keogh plan, etc.). Good examples are taxable bonds that pay ordinary income and mutual funds that are prone to capital gain distributions. Assets like stocks and index funds are generally best held in non-qualified accounts (Personal, Joint, Trust, etc.) to take advantage of long term capital gains rates and lower turnover. All other things equal, it is a good discipline to tilt non-qualified accounts toward equities and qualified accounts toward taxable bonds. That said, if the tax rate on dividends is increased to equal that on ordinary income, it may be best to hold stocks with a high dividend yield in qualified accounts.
- **Strategic Rebalancing**—The old adage "begin with the end in mind" is at the heart of this discipline. As part of the asset location decision, we still prefer to hold some growth assets like stocks in qualified accounts for future rebalancing flexibility. Often, the location of rebalancing trades will depend on the tax implications. Given the choice, we prefer to realize capital gains in a tax-deferred (IRA) or tax-free (Roth IRA) account.
- **Loss Harvesting**—It is prudent to harvest interim losses when available. This is normally accomplished by selling and reinvesting in a similar fund. Realized losses may then offset realized gains plus up to $3,000 in ordinary income in a given year. Any remaining realized losses are carried forward for use in future years. As an aside, the tax value of realized losses will increase in line with capital gain tax rates.
- **Exchange Traded Funds (ETFs)**—We have long been proponents of ETFs when investing in indexed assets like equities. ETFs generally have much lower expenses, lower trading costs and in almost all situations, lower capital gain distributions than their mutual fund counterparts. Capital gain distributions from ETFs in client portfolios have been essentially zero since inception.
- **Municipal Bonds**—Tax exempt interest income may be more valuable in the years ahead. The key is to maximize your tax-equivalent yield (your "take home pay") after factoring in applicable federal and state income taxes.
- **Gifting Appreciated Stock**—When satisfying charitable pledges, it is generally more efficient to gift an appreciated security (e.g., a stock or ETF) than to write a check. You may receive the same itemized deduction and avoid future capital gains tax on that holding. If you would like to replenish the portfolio, you may repurchase that same security. The end result: you have raised the basis in the security to the current market price. Generally, stock gifts are efficient in minimum amounts of $500. Please consult your tax advisor to evaluate the prudence of accelerating vs. deferring charitable gifts.
- **Charitable Gifting from an IRA**—In recent years, investors over 70½ in age have been able to make charitable contributions from their IRA. The income from this distribution is not taxed. Even better, the gift may be used to satisfy part of the Required Minimum Distribution. It remains to be seen if this option will be available in 2012 and beyond.
- **Roth IRA Conversions**—Roth IRAs are more valuable in an environment of rising taxes. Your investments may grow tax free, there are no required distributions during your lifetime and distributions are not taxed (for you or for your heirs). All investors are eligible to convert a Traditional IRA to a Roth IRA. The trade-off to evaluate here is paying taxes now vs. paying taxes later.

Each client's situation is unique. Discipline in our investment process is a key part of optimizing the tax efficiency of your investment portfolio. We are happy to participate in discussions with your tax advisor. Please let us know if you have questions or if your income or tax circumstances change.

GLOBAL TACTICAL ASSET ALLOCATION | In your Investment Report, please note that we have renamed the All Asset category Global Tactical Asset Allocation (GTAA). Specific funds included in GTAA are the PIMCO All Asset Fund, PIMCO All Asset All Authority Fund and the PIMCO Global Multi-Asset Fund. Within GTAA, the fund manager opportunistically adjusts the asset class mix based on the opportunities and risks in the global investment environment.