



**Artemis**

FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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### *Executive Summary*

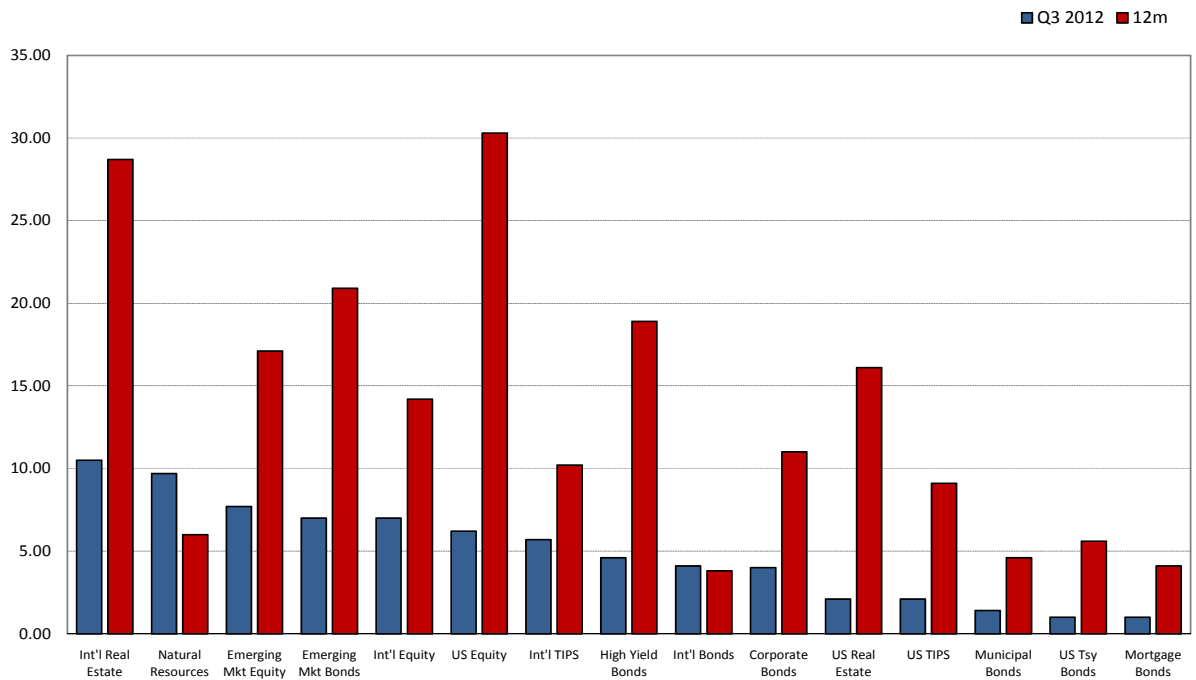
- **Global equity markets rose in tandem in Q3**, benefiting from new policy intervention in Europe, the U.S. and in several emerging markets. All segments of the bond market also had positive returns, led by credit-sensitive segments such as emerging-market bonds and high-yield debt.
- **On a 12-month basis, the U.S. equity market is still the clear winner**, but for the first time in a while, both emerging market and international developed equity outperformed U.S. equity during the quarter. Both international and U.S. real estate also posted positive returns during the quarter and have done very well over the last 12 months.
- **We expect the global economy to continue to slowly improve next year** on the back of stronger U.S. growth and continued global monetary support, and we believe that Congress will devise a tax and budgetary compromise to keep the economy moving forward. Our “tail risk” insurance could prove helpful if Congress fails to act.
- **We have no plans to reduce risk in client portfolios**, although we are reducing our commodity position because we no longer believe that holding a basket of commodities adds sufficient value. We continue to favor U.S. high-yield debt, emerging-market debt and real estate. These asset classes offer attractive yields and the prospect of modest price appreciation.
- In this report, **we summarize what’s at stake in terms of prospective tax reform** in the U.S. and outline both Obama’s and Romney’s current proposals. **We also provide our best ideas on how investors may be able to blunt some of the effects of future tax increases.** We will be closely monitoring developments after the elections and will be in touch with those clients who might benefit from one or more of our ideas.



**Markets in Review**

Global equity markets rose in tandem in Q3, benefiting from new policy intervention in Europe, the U.S. and in several emerging markets. For the first quarter in a long time, emerging and international developed equity markets outperformed the U.S., although on a 12-month basis, they are still well behind (Figure 1). All segments of the bond market also had positive returns, led by credit-sensitive segments such as emerging-market bonds and high-yield. Finally, both international and U.S. real estate also posted positive returns and have done very well on a 12-month basis.<sup>1</sup>

Figure 1: Asset Class Performance in Q3 2012 (percentage points)



Returns in the U.S. were bolstered by increased consumer confidence – retail sales surprised to the upside, as did new and broad-based momentum in the housing market.

<sup>1</sup> Our U.S. real estate index is a blended index of equity REITS and commercial mortgage debt instruments reflecting our investment stance in this sector. On a 12-month basis, U.S. REITS alone outperformed international REITS.



Credit access improved for both corporations and consumers as banks eased their standards for new loans during the quarter. Overall GDP growth was, however, sub-par. We believe this sub-par growth largely reflects a response to the ongoing macro uncertainties, particularly the looming “fiscal cliff,” and not a new cyclical downswing.

In Europe, we witnessed the announcement of a new bond-buying program, which sparked a significant improvement in Eurozone financial conditions. China also embarked on new policy measures to stimulate growth, as did Brazil, Japan and several other countries.

### ***Artemis Portfolio Strategy***

While U.S. investors face heightened political uncertainty due to potential budgetary and tax gridlock at the end of 2012, we expect the global economy to continue to slowly improve next year on the back of stronger U.S. growth and continued global monetary support. (We also believe that Congress will punt on the “fiscal cliff” and devise a compromise to keep the economy moving forward.) The U.S. housing market recovery, although in its very early stages, appears to be bolstering consumer confidence. Consumers are benefiting from low mortgage rates and low energy prices (namely, natural gas). Employment growth is also picking up, in part due to the energy boom and nascent revival of the U.S. manufacturing sector. Most importantly, the Federal Reserve has clearly signaled continued policy support — if we have learned anything over the last couple of years, it’s “don’t fight the Fed.”

As such, we have no plans to scale back our risk exposure, particularly in light of the “tail risk” insurance we have in place in client portfolios. While this hedge has not been needed thus far due to the decisive central bank action the U.S. and Europe took in September, it could prove helpful if the U.S. Congress really does fail to act responsibly after the elections.

We have, however, decided to close out our small commodities positions in client portfolios. This reflects a change from where we thought we were heading during the summer, but on further research and testing, we came to the following conclusions:

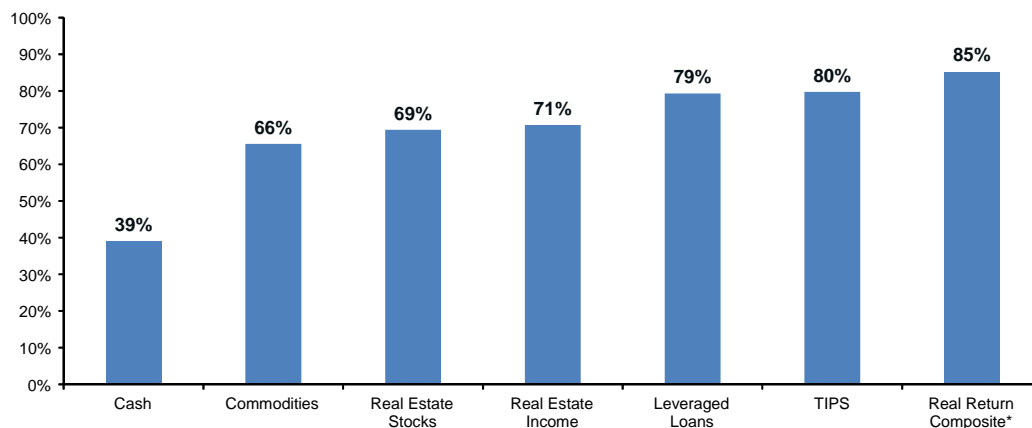
1. **The bull market in industrial commodities of the last decade is likely over** – There is no question that economic and financial conditions for commodity prices were almost perfect in the last decade: A falling dollar, strong demand and limited supply response all worked to push prices higher. We do not believe these conditions will hold to the same extent over the next decade. While we don’t think the dollar is going to appreciate greatly, we do believe the dollar will be supported for some time by relative weakness in Europe and Japan. More importantly, we are now starting to



witness supply-side expansion; e.g., shale gas and oil production in the U.S. as a case in point. Many emerging-market economies are also interested in importing fracking technology to exploit their resources. Finally, while we will continue to see robust industrial commodity demand from countries such as India and China, OECD demand continues to decline. All these factors together suggest we are unlikely to see the sustained price increases of the last decade.

- 2. Commodities' role as a portfolio diversifier is overstated** – We have made this observation before, as oil and other industrial commodity consumption growth have become more tied to the growing appetite of emerging-market economies in recent years. By 2013, for example, the International Energy Agency expects China, the former Soviet Union and the Middle East to account for fully 77% of the net increase in global oil demand, whereas in the 1970s, OECD countries accounted for the vast majority of the increase. In brief, emerging markets have become the buyers of last resort -- making oil demand and therefore prices, more pro-cyclical and highly correlated with emerging-market performance.
- 3. Commodities provide only modest inflation protection** – One of the often-mentioned benefits of holding a diversified basket of commodities is inflation protection. Commodities do indeed provide some inflation protection but not as much as many other choices available – see Figure 2.

Figure 2: Frequency of Exceeding Inflation, 1973-2012



\*Frequency of Exceeding Inflation shows the percent of trailing 12-month periods each asset class outperformed the trailing 12-month change in the CPI. The composite represents a blend of all real asset categories. Data through 8/31/12. Source: Fidelity



4. **Commodities are highly volatile** – Commodities have traditionally been one of the most volatile asset classes, but as long as they provided sustained price appreciation, diversification and inflation protection, the risk/reward of investing in the asset class had a logic. This is no longer true in our view (and the last thing clients need in their portfolios these days is a volatile asset class that does not add sufficient value).

Due in part to our decision to reduce our commodity exposure, and increased evidence that we may well be approaching a trigger point where emerging-market equities start to rebound, we have removed our underweight position in emerging-market equities in client portfolios. In brief, we think emerging-market equity exposure is a better way than commodity exposure to benefit from emerging-market growth.

On the fixed-income front, we continue to favor U.S. high-yield bonds, U.S. dollar-denominated emerging-market debt and commercial mortgage-backed securities. For high-tax-bracket clients, we also favor high-quality municipal debt, which we believe will continue to provide decent risk-adjusted returns in the near-term, and may even benefit by increased demand as high-income earners learn they have few tax-advantaged options left from which to choose. (See our latest Brief, *The Case for Investing in Municipal Bonds*, on our website for more detail.)

Finally, we made a decision earlier this year to increase our exposure to domestic and international commercial real estate, in anticipation of the global recovery of this sector, and we have been well rewarded for doing so. While we are unlikely to see as much appreciation in the future, yields in this asset class remain relatively attractive, and some continued price appreciation is likely.

### ***Tax Reform: What Should Investors Do?***

As most everyone knows, the political debate is soon to move beyond talk about taxes and deficits to action on both. The Bush tax cuts are scheduled to expire at the end of the year, and the deal reached last year to increase the national debt ceiling mandates automatic cuts in discretionary government spending of \$2.1 trillion over 10 years, with the bulk of these cuts slated to begin in 2013. In this section, we summarize what's at stake and provide our best ideas on how investors may be able to blunt some of the effects of future tax increases.



The tax increases on the table fall into five main categories:

1. **Expiration of the Bush tax cuts** – The lower income and capital gains tax rates in effect for the past decade are scheduled to expire at the end of 2012.
2. **Expiration of the payroll tax cut** – You may have forgotten, but beginning January 2011, the employee’s share of the Social Security tax was reduced from 6.2% to 4.2%, saving those who earn the maximum income subject to Social Security taxes \$2,202 in 2012, and close to that amount in 2011. The higher rates are scheduled to return in 2013 and beyond.
3. **New healthcare reform taxes** – The biggest new tax is the 3.8% Medicare surtax on investment income beginning in 2013. Unlike the tax increases cited above—where political leaders have said they would like to make adjustments—the Medicare surtax seems almost certain to be imposed as scheduled. The tax only comes into effect to the extent a family’s overall income is above \$250,000 (\$200,000 for individuals). The tax is calculated on any *net investment* income over the \$250,000/\$200,000 threshold. Absent guidance from the IRS, experts believe the tax applies to just about all forms of investments (including trusts) except:
  - Municipal bond interest and other non-taxable income such as Roth IRA income,
  - Qualified retirement plans, Social Security income and IRAs,
  - Schedule C business income, and
  - Income from a business on which you are paying self-employment tax.

Embedded in the same healthcare reform law are several other new tax changes. One is an additional Medicare payroll tax of 0.9% on employees earning more than \$200,000 (\$250,000 for couples). Also starting in 2013, a taxpayer will only be allowed to deduct the medical expenses that exceed 10% of AGI, a significant change from the current level of 7.5%. This last change is waived for 2013-2016 for those 65 and older.

4. **Estate tax increases** – The estate and gift tax rate of 35% is scheduled to expire in 2012; without action, it will revert to 55%. In addition, the estate and gift tax exemption amounts will decline from \$5.12 million to \$1.0 million.
5. **Other tax-related changes** – There are many other smaller tax increases on tap for 2013, such as a return of the marriage tax penalty, elimination of the 10% income tax bracket and the 0% dividend and long-term capital gain tax (for those in the lowest

two income tax brackets). In addition, the deductibility for student loan interest is scheduled to end, along with the American Opportunity Education Tax Credit.

The principal changes discussed above are summarized in Figure 3.<sup>2</sup>

Figure 3. Scheduled Tax Increases in 2013		
Tax Item	2012	2013
Ordinary Income	35%	43.4%
Dividends	15%	43.4%
Capital Gains	15%	23.8%
Payroll Tax	4.2%	7.1%
Estate and Gift Taxes	35%	55%
Estate and Gift Tax Exemption Amounts	\$ 5.12m	\$1.0m

Despite current tax rates being very low relative to historical norms (Figure 4 on next page), few believe that all of these tax increases — especially when coupled with large spending cutbacks — will take effect in 2013, due to their negative effect on the economy. Estimates vary, but many economists expect that if the full brunt of spending cuts and tax increases proceed, the slowdown could cause as much as a 3.5 percentage point reduction in GDP in the first half of 2013. This would clearly put the economy back in recession.

### **President Obama's Tax Plan**

How tax policy takes shape in 2013 depends in part on who wins the coming election. The current bet is that if the Democrats keep control of the White House and Senate, the Bush tax cuts will be extended for all but upper-incomers. President Obama favors rate increases for single filers with incomes over \$200,000 and couples with incomes above \$250,000, but this reportedly does not sit well with some moderate Senate Democrats. As a result, there's a chance that any tax rate increase will hit only taxpayers with taxable income over \$1 million. Likewise, while Obama has proposed taxing dividends as ordinary income, Senate

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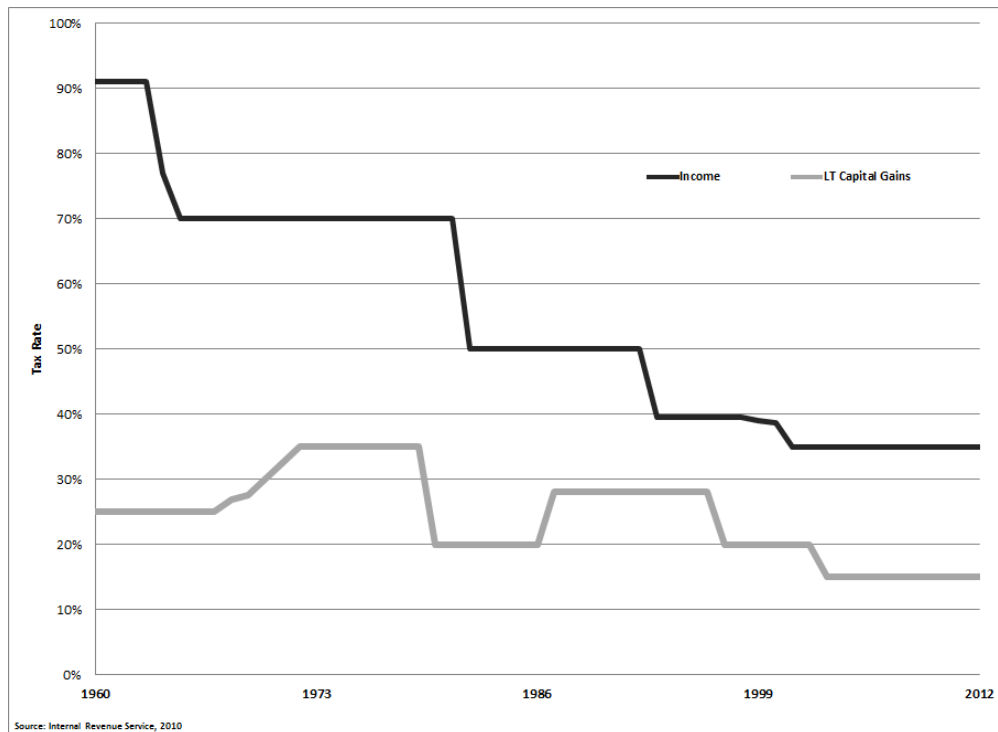
<sup>2</sup> Tax rates reflect highest marginal rate and incorporate additional taxes related to the healthcare reform law. Healthcare-related taxes include a surtax of 3.8% on net investment income and an additional 0.9% payroll tax affecting single filers with income in excess of \$200,000, and joint filers with income greater than \$250,000.





Democrats rejected that idea earlier this year. More likely, if capital gains and dividends increase, they will both only increase to 20%.

Figure 4: Historical Maximum U.S. Federal Tax Rates, 1960-2012



Less well publicized is the fact that Obama favors curbing some itemized deductions. First, he would reinstate a 3% cutback in itemized deductions that lapsed in 2009, but at higher income levels than before. Deductions other than medical expenses, investment interest paid or casualty losses would be trimmed by 3% of the amount by which income exceeds \$250,000 for couples, and \$200,000 for singles.

Obama would also reduce the value of itemized deductions for high-income earners—write-offs that remain after applying the 3% reduction—by capping the tax value of itemizations at 28% beginning in 2013. When coupled with his proposal to reinstate the 36% and 39.6% tax brackets, taxpayers in brackets above 28% would be paying an extra tax of up to 11.6% on their write-offs. The same taxpayers would also pay up to 11.6% tax on interest on municipal bonds, employer health coverage, self-employees' health insurance, IRA contributions and 401(k) contributions.



### **The Romney-Ryan Tax Plan**

If Romney wins the election, we are told he currently favors reducing everyone's income tax rates by 20%, eliminating capital gains and dividend taxes for those making less than \$200,000, and maintaining revenue neutrality by putting a cap on tax deductions and broadening the tax base. Recently, he has mentioned that filers could be limited to \$17,000 of itemized deductions, although he's also said the ceiling could end up at \$25,000 or even \$50,000. It's not clear whether the ceiling would be the same for singles and couples. Romney also stated that he'd keep write-offs such as mortgage interest and donations to charities. But whatever the final number, if a taxpayer's total Schedule A deductions exceeded the cap, they would get no tax benefit for excess itemizations, even if they consisted of mortgage interest or donations.

Romney has said that his tax plan won't reduce the total share of taxes paid by the wealthy. Therefore, the higher the cap on deductions, the more pressure there will be to reduce the size of the tax cuts for high-income earners. So upper-income earners with very large itemized deductions may wind up net losers. But even more recently, Romney said that his plan would still allow for preferences for the middle class for things like charitable deductions, home purchases and healthcare.

The problem is that the math of Romney's plan doesn't seem to add up – there literally aren't enough deductions and "loopholes" enjoyed by the wealthy to make up for the estimated tax savings they would achieve annually from the 20% rate reduction – \$251 billion per year (in 2015) among households with income above \$200,000 according to the Tax Policy Center.

In brief, we don't know which candidate's plan and in what form will actually get passed – and this makes planning very difficult. But what we do know is that the Bush tax cuts automatically expire at the end of 2012 with Obama still in office, and Obama has repeatedly said he will veto any legislation that leaves the Bush rates in place for the wealthy. We also know that the 3.8% Medicare and other healthcare taxes are very likely here to stay.

If your income is high, you may be able to blunt some of the effects of future tax increases by taking action this year. Here are some ideas:

1. **Accelerate income into 2012** – Consider asking for your bonus early if you are typically paid in January or later and/or exercise non-qualified stock options before



the end of the year. This will lock in the 35% maximum rate on that income because there is no talk of increasing tax rates this year retroactively.

2. **Consider selling highly appreciated assets** – While one should not sell for tax reasons exclusively, the 30- day wash rule only applies to tax loss harvesting (i.e., if you sell a security at a loss, you must wait 30 days before you can buy back the same security). This means that you could sell the security, realize the gain, and buy back the same security the very next day. Remember, even if capital gains taxes remain at 15%, the 3.8% Medicare surtax will kick in for some people on January 1. A recent study determined that if the capital gains tax rate does increase to 23.8% and the value of an asset grows by 4% per year, an investor would have to hold the asset for an additional 15 years to be better off than he would be had she sold the asset initially and paid tax at the lower rate.<sup>3</sup>
3. **Consider increasing your (high quality) municipal bond exposure** – Municipal bonds are free of federal tax and free of state tax if the issuer is the state in which the purchaser resides. Thus, for high-net-worth investors, the tax-adjusted returns for municipals are typically superior to those on alternative fixed-income instruments like Treasuries.

As mentioned earlier, President Obama’s 2013 budget proposal includes a 28% cap of the exemption for municipal bond income for families with income of more than \$250,000. This means that investors in the maximum 35% tax bracket would end up paying an effective rate of 7% on municipal interest income (or 11.6% if the Bush tax cuts expire). In our view, this only marginally reduces the attractiveness in municipal bonds, especially in light of the fact that municipal bond income is exempt from the new 3.8% Medicare tax.

4. **Convert an IRA to a Roth** – The attractiveness of this option depends on many variables, but if the option makes sense for you currently, it will pay to get the job done in 2012. The reason is that waiting until 2013 might trigger the 3.8% Medicare surtax because converted income is counted in AGI and thus can subject more of your investment income to the tax.

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<sup>3</sup> *Prepare for Higher Tax Rates – Pay Now or Later?* Parametric Portfolio Associates, LLC, March 2012.



5. **Implement more tax-efficient investment strategies** – There are a variety of ways to do this, including utilizing more tax-efficient investment vehicles such as index-based mutual funds and ETFs, investing in stocks that pay qualifying dividends, and harvesting tax losses. In addition, one should remember that some investments such as bonds are inherently less tax-efficient and should be placed in tax-deferred accounts, if possible.
  
6. **Accelerate discretionary deductible payments** – The whole area of deductions is a bit tricky because they are either worth more in 2012 if deductions are capped in 2013 and income tax rates go down (Romney’s proposal) but worth more in 2013 if they are not but income tax rates increase. Given that both Obama and Romney favor some form of capping deductions, if you are planning a large charitable contribution, it might make sense to do it before the end of the year.

We will be closely monitoring developments after the elections and will be in touch with those clients who might benefit from one or more of these strategies.