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# Skeptics – Not So Fast

The equity market price action in the First Quarter of 2013 felt like a one way trade. Volatility continued to lessen and market corrections were few and far between. In fact, the largest correction from high to low was just 3 percent. As the index climbed to new recovery highs, the overwhelming sentiment being expressed to us was, "is this for real?" Here are a handful of fundamentals providing the underpinnings of the market's current price levels.

- Accommodative Central Bank Monetary Policy
- Less Bad News Coming out of Washington D.C. on the Fiscal Cliff
- Strong Corporate Balance Sheets and Resilient Corporate Earnings
- Increasing Dividends and Share Re-Purchase Activity
- Foreign Flow of Funds into U.S. Equities
- Valuations below Long-Term Historical Averages
- Ongoing Skepticism by the Investing Public
- Greater Wealth Effect through Rebounding Home Prices

| | % Cumulative Return 12.31.07 - 03.31.09 | % Cumulative Return 03.31.09 - 3.31.13 | % Annualized Return 12.31.07 - 03.31.13 |
|---|---|---|---|
| Domestic Equity | | | |
| S&P 500 TR | -43.94% | 114.24% | 3.55% |
| Russell 1000 Value TR USD | -47.44% | 120.06% | 2.81% |
| Russell 1000 Growth TR USD | -40.97% | 116.45% | 4.78% |
| Russell 2000 TR USD | -43.69% | 137.69% | 5.71% |
| International Equity | | | |
| MSCI EAFE Developed Market USD | -50.94% | 82.20% | -2.12% |
| MSCI Emerging Market USD | -52.70% | 101.82% | -0.88% |
| Domestic Fixed Income | | | |
| Barclays US Agg Bond TR USD | 5.36% | 26.54% | 5.63% |
| Citi Treasury Bill 6 Mon USD | 2.62% | 0.73% | 0.63% |
| Alternatives | | | |
| London Fix Gold AM PR USD | 9.80% | 74.47% | 13.18% |
| FTSE NAREIT All REITs TR | -56.00% | 225.64% | 7.09% |

Source: Morningstar, Inc.

Looking back on market history over the past twenty years, intra-year equity market corrections have averaged around 15 percent. Even under the scenario that you throw out the big Bear Market years of 2002 & 2008, the average correction is nearly 13 percent. There are some strategists that suggest the train has already left the station for 2013. We are inclined to be patient, disciplined and opportunistic. We are always cognizant of valuation and certainly some sectors have gotten off to a better start this year than others. The advantage of using individual stocks allows us to discriminate and spares us the burden of having to attempt to market time based upon macroeconomic factors.

**Asset Class Performance – Post 2007**

In the back of my mind, I am always keeping track of various asset class returns since the prior market peak in 2007. As investment flows in many instances are unfortunately driven by rear view mirror rather than future expectations, it is often helpful to gauge the performance of these various major market indices as we wind our way back to levels that pre-date the crisis. On a positive note, all of the major investment asset classes, save that of the International Equity Indices, are back into positive territory, despite steep drops going into March of 2009. Frequently, as evidenced by the results presented, how much capital that is preserved on the way down, is a considerable factor in your full market cycle return experience.

| Continued on Page 4

1 Skeptics – Not So Fast

2 The Impact of Higher Tax Rates on the Equity Market

3 Common Questions: The American Taxpayer Relief Act of 2012 and 2013 Contribution Limits

Route To:

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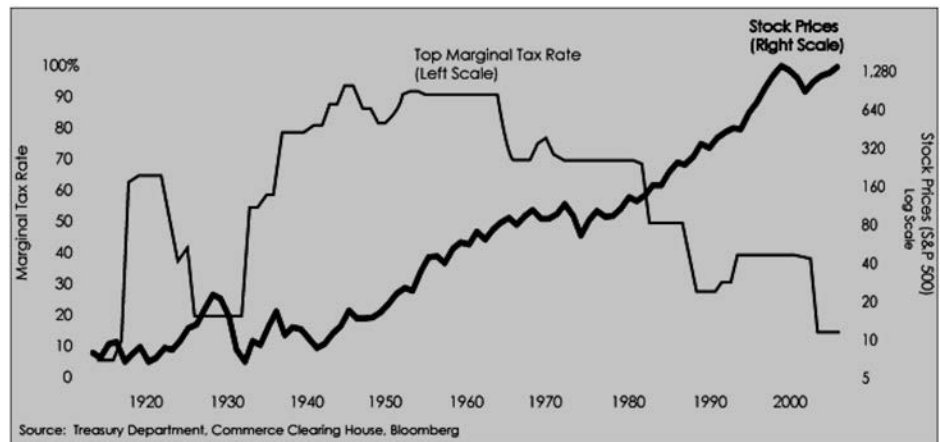
# The Impact of Higher Tax Rates on the Equity Market

Brian Christensen, CFA
*Senior Vice President*

By now, I'm sure you are all aware of The American Taxpayer Relief Act of 2012 (the Act) which was passed on January 1, 2013. I still haven't determined if it is called a "relief act" because we were relieved the country didn't go over the fiscal cliff or because the Act is relieving many citizens of their hard earned cash. In any event, much has been discussed about potential investment implications as a result of the Act.

Analyzing historical changes in tax policy suggest there has been very little correlation between tax rates and stock prices. The chart shown at right tracks data from the early 1900's until 2012.




The market research firm Strategas Partners identified that increases in capital gains tax rates in December 1969 and October 1976 were followed by stock market sell-offs as measured by the S&P 500 Index of 20.6% and 5.6%, respectively. In October 1986, President Reagan's Tax Reform Act of 1986 cut income and corporate tax rates while also increasing capital gains tax rates. The stock market declined initially but within six months had increased by more than 20%. These are two examples where the capital gains tax was increased, yet different outcomes resulted in the stock market.

From 1980 to 2012 there have been seven changes to tax rates. The table below identifies those changes and the resulting performance in the S&P 500 Index.

There are several explanations for why measuring the impact of tax changes on stock market results is challenging. First, a significant portion of the investments made in U.S. markets are for tax-exempt, tax-deferred or foreign non-taxable investors. Standard & Poor's estimates that as much as two-thirds of dividends from S&P 500 companies are paid to tax-preferenced investors. IRS tax data supports this assertion as only about 30% of all dividends paid are reflected on U.S. tax returns. Secondly, while qualified dividends and capital gains continue to be taxed at the same rate, there is no intrinsic tax benefit in favoring one style of equity investment versus another.

While tax rates are certainly relevant they should not be the foundation for one's long-term financial plan. We continue to be firm believers that investment fundamentals are most important. Our focus remains steadfast on corporate earnings and revenue growth, balance sheets, dividend growth, interest rates, and economic strength among others. Short-term tax considerations should not side track long-term financial goals. Success in achieving your goals is dependent upon maintaining discipline within your investment strategy not seeking ways to maximize tax savings.

| | | | S&P 500 Performance | | |
|---|---|---|---|---|---|
| **President & Date** | **Increase/Decrease** | **Impact** | **6 Months Prior** | **6 Months Post** | **Cumulative** |
| Bush - May 2003 | Decrease | Capital Gains & Dividends | 3% | 10% | 13% |
| Bush - May 2001 | Decrease | Income Tax | -5% | -9% | -14% |
| Clinton - August 1997 | Decrease | Capital Gains | 22% | 5% | 27% |
| Clinton - August 1993 | Increase | Income Tax | 1% | 4% | 5% |
| Bush - November 1990 | Increase | Income Tax | -7% | 21% | 14% |
| Reagan - October 1986 | Decrease | Income Tax | -2% | 18% | 16% |
| | Increase | Capital Gains | | | |
| Reagan - August 1981 | Decrease | Income & Capital Gains | -4% | -5% | -9% |

Source: FactSet, Tax Policy Center, Bessemer Trust

# Common Questions: The American Taxpayer Relief Act of 2012 and 2013 Contribution Limits

Stephanie A. Ricketts, CFP®
*Relationship Manager*

How quickly three months have passed since the 11th hour passing of the American Taxpayer Relief Act of 2012. Prior to the passing of the Act, we were facing fairly sizable tax hikes for 2013; dividends were again to be taxed at ordinary income tax rates, long term capital gains were to increase to 20% and estates greater than $1 million would be taxable at a 55% rate. In the end, however, the changes that passed through Congress were much more reticent. Now that the dust has settled, we are frequently getting several questions in our client meetings about the Act and its impact on their portfolios, taxes and estate and financial plans.

The following is a summary of some of the most common questions and more significant tax changes effected by the act.

**How will my dividends be taxed?**
As in the past, investors in the 10% and 15% tax brackets will continue to pay nothing on dividends and those in the 25%, 28%, 33% and 35% tax brackets will pay a 15% rate on their qualified dividend income. The Act does raise the top rate to 20% to those taxpayers whose incomes exceed the thresholds set for the 39.6% rate ($400,000 for single filers and $450,000 for joint filers).

**What tax will I pay on Long Term Capital Gains?**
Much is staying the same with long term capital gains rates as well. Those in the 10% and 15% tax brackets will not owe any capital gains on securities held for more than one year, and those in the 24% - 35% tax brackets will continue to enjoy long term capital gains taxed at 15%. The increased 20% capital gains rate again kicks in for the same taxpayers who are also seeing the dividend tax hike.

**Am I subject to the 3.8% Medicare Surtax?**
The Medicare Surtax is an outgrowth of the Affordable Health Care Act and is a 3.8% tax imposed on the lesser of an individual's net investment income (NII) for the year or adjusted gross income (AGI) in excess of $200,000 for single filers and $250,000 for married taxpayers filing jointly. Note that investment income is included in adjusted gross income and consists of (among other items) stock dividends and interest from cash and bonds; short and long term gains; and the taxable portion of annuity income, royalties and rents. Net investment income does not include municipal bond income, distributions from IRA's or qualified retirement plans, or pension and Social Security Income.

Putting number examples to this surtax may help in determining if you will be subject to this tax.

*Example 1:* A couple with $275,000 in AGI and $15,000 in NII would owe the 3.8% tax on the $15,000 net investment income. They owe on the $15,000 as that amount is less than the $25,000 by which their AGI exceeds the $250,000 threshold.

*Example 2:* A couple with $220,000 in AGI and $15,000 in NII owes no surtax because their AGI does not exceed $250,000. That amount ($0) is smaller than their investment income.

*Example 3:* A couple with $300,000 in AGI and $150,000 of NII would owe the 3.8% surtax on $50,000, which is the amount of which their AGI exceeds the $250,000 threshold, yet is lower than their net investment income

**Will I be subject to Estate Tax?**
Certainty has been restored to estate and gift tax policy after a decade of ambiguity. The Act permanently provides for a maximum federal estate tax rate of 40% (increased from 35%) with an annually inflation adjusted $5 million exclusion for estates after December 31, 2012. Because this figure is indexed for inflation, the 2013 exemption is $5,250,000. The agreement also continues to unify the estate and gift taxes and makes permanent the portability of the deceased spouse's lifetime exemption.

Sophisticated estate and business succession strategies that have been historically available to the high net-worth tax payer are also maintained. A key democratic proposal to extend the minimum term of grantor retained annuity trusts to 10 years and eliminate the income and gift tax benefits related to sales or gifts to intentionally defective grantor trusts was *not* included in the final agreement.

**Can I make a Qualified Charitable Distribution (QCD) from my IRA this year?**
Amongst the various extenders in the Act was the reinstatement of rules allowing for an individual to make a QCD from an IRA to a charity, assuming the individual has reached the minimum age 70 ½ years, stays within the $100,000 limit, and meets other requirements regarding the distribution and the receiving charity. In addition to the age requirement and $100,000 dollar limit, funds must be transferred directly from the IRA to the charity, applied only to IRA distributions (not 401(k)s or other qualified plans), and the distribution must be to a public charity. There is no charitable deduction for the donation, but rather the QCD is excluded from income entirely. This is extended through December 31, 2013.

And lastly, while not part of the American Taxpayer Relief Act, it is worth noting the following contribution limits and gift tax exclusion amount for 2013 as these are common questions as well.

**IRA Contribution Limits:** Investors under age 50 can contribute $5,500 to their IRA's in 2013, with the catch up for those over age 50 staying at $1,000 (for total 2013 contribution of $6,500).

**ROTH IRA Income Limits:** These limits have increased in 2013 so that individuals making less than $127,000 will be able to make at least a partial ROTH IRA contribution and married couples filing joint can make at least a partial contribution if they earn less than $188,000. These limits, however, continue to be more of a formality because of the "backdoor" IRA maneuver, whereby a person funds a traditional nondeductible IRA and converts it to a Roth shortly thereafter. This strategy continues to be good for investors looking to move assets to the "tax free withdrawal" bucket, providing they don't have large pools of traditional IRA assets.

**401(k) Contribution Limits:** The maximum 401(k) contribution limit has increased slightly in 2013 to $17,500 for those under age 50 and $23,000 for those over age 50. If you turn 50 this year, you do not need to wait until your birthday and can contribute the extra catch up amount at the beginning of the year.

**Gift Tax:** The annual gift tax exclusion amount jumps to $14,000 for 2013, an increase of $1,000 over last year and savers in 529 college savings plans can gift $70,000 to a single individual in a single year without triggering a gift tax (assuming they make no further contributions to the same individual's college plan in the subsequent four years).

# *Skeptics – Not So Fast*

*Continued from Page 1*

**Dividend Yielding Stocks – A Crowded Trade?**
We are beginning to catch wind of a growing sentiment by some market analysts that the recent outperformance by higher yielding dividend paying stocks is being framed as one more irrational market exuberance. In this instance, the emphasis is on conservatism and safety. These analysts have equated this recent phenomenon to prior manias such as the Energy Sector swoon in the early 1980s, the Technology Sector bubble in the late 1990s and the dominance of the Financial sector prior to the Great Recession in 2008. As a consequence of a growing market capitalization weighting of the top 20% of dividend paying stocks within the S&P 500 Index, the theory is that investors are so focused on the attractive dividend yields from these stocks that they have lost sight of the relative valuation measures that go along with that benefit. Alliance Bernstein research has suggested that valuations for these top dividend payers is about 50% above their long-term average.

It is hard to argue that investors are seeking out investment alternatives to traditional conservative fixed income vehicles and FDIC insured products in light of the fact that in most instances these investment vehicles are providing today a negative pre-tax real rate of return. As a consequence, money has flowed into more risky, but yield rich asset classes such as Real Estate Investment Trusts (REITs), High Yield Taxable Bonds (also known as Junk Bonds), lower quality Tax Exempt Bonds, Master Limited Partnerships (MLPs) and higher yielding common stocks. With U.S. Treasury 10 year notes still yielding less than the average stock held in the S&P 500 Index, and those dividend payments still receiving preferential tax treatment, albeit, potentially not as preferential as was the case in 2012, it is reasonable and rational to believe that investors have taken a keen interest in conservative dividend paying stocks.

In addition, it warrants some consideration that as baby boomers retire or begin the glide path towards retirement, that of the two components of total rate of return, income and capital appreciation, there is an increasing emphasis and preference placed upon income. As investors look around for companies that can deliver attractive income, they are generally willing to pay a higher multiple of earnings for those companies that have a long history of dividend payment, who have been able to maintain a consistent dividend policy due to steady and reliable cashflows, and are likely to increase that dividend each and every year well into the future. Recent statistics would support the notion that corporations are beginning to take note. In the S&P 1500 Index (a broad stock market index) approximately 940 companies paid dividends—the highest total since 1999. We are also seeing significant dividend increases by these companies as they look for ways to increase their return of capital to shareholders. Long-term research points to the fact that the subset of companies that maintain a dividend and can successfully grow that dividend over time exhibit the best return and risk attributes among their large cap index constituents.

**Energy Independence by 2020**
If you are looking for a glimmer of positive news out there, look no further than the recent prediction by the International Energy Agency, (IEA) which recently forecasted that the United States would exceed Saudi Arabia as the world's leading oil producer by 2020. Further shocking is the recent statement by Exxon Mobil that the U.S. will be a net exporter of energy by the year 2025 and furthermore the IEA states that the North American Continent (U.S., Mexico and Canada ) will be a net exporter of crude oil by 2030. Citigroup released a research report in February of this year that commented on the fact that in 2012 crude oil production in the United States increased by 1.16 million barrels per day, the most in recorded history, while natural gas liquids production increased 170 barrels per day. In fact, including production by our neighbors to the north and south, we now produce more natural gas than any other continent in the world. According to research by Barron's magazine, due to surging domestic production, imports of petroleum and natural gas over the past 6 years have declined from 14 million oil equivalent barrels a day to below eight million barrels—a rate that we have not seen since the late 1980s.

Shale drilling and the use of hydraulic fracturing has unleashed oil reserves in areas such as the Bakken formation in Montana and North Dakota, the Marcellus Formation primarily in New York and Pennsylvania, the Utica Shale formation in Ohio and The Permian Basin in Texas.

What does this mean for the United States Economy?

- Jobs should be created not only from the exploration and production of energy, but the build out of energy related infrastructure projects such as natural gas pipelines and liquification plants.
- Cheap and stable supplies of energy should stimulate interest in locating manufacturing facilities in the United States.
- According to Glenmede Research, roughly 20 percent of current U.S. oil imports come from the Middle East. Eliminating the need for supply from this unstable part of the world should likely result in a significant reduction of resources deployed to maintain geopolitical stability.

Will Williams
President

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