Your Portfolio and Your Tax Bill

We know that taxes are inevitably on your mind this time of year. In October, we wrote comprehensively about the tax law changes that would affect many of you; however, the rules keep changing and we thought a refresher was warranted.

In tax year 2013 income tax and capital gains taxes will increase for many of you. Single U.S. taxpayers who make more than $400,000 and married couples who earn more than $450,000 will find themselves in a higher tax bracket.

Previously, individuals with annual taxable income over these thresholds were subject to a 35% federal income tax, but in 2013 that new rate is 39.6%. The tax rate on capital gains and dividends has increased to 20% for U.S. taxpayers in the highest tax bracket. Taxpayers in any of the lower brackets will not be affected.

Additionally, in 2013 the 3.8% Affordable Care Act surcharge on unearned income from rent, royalties, interest, dividends, and some capital gains will apply to those of you who make more than $200,000 per year and to married couples filing jointly who make more than $250,000.

One of the impacts from the fiscal cliff legislation that has not received much attention (but should!) is the reintroduction of the Pease limitation, which reduces the amount of itemized deductions that certain taxpayers are allowed.

The infamous Pease limitation was first introduced in 1990 and it is named after former Congressman Donald Pease. The purpose of the Pease limitation was to raise revenue by limiting the most common itemized deductions among high-income earners. Pease limitations apply to the itemized deductions that are nearest and dearest to our hearts:

- Charitable contributions
- Mortgage interest
- State, local, and property taxes
- Miscellaneous itemized deductions

The limitation for 2013 will take effect on AGI levels that exceed $300,000 for joint filers and $250,000 for individuals, indexed for inflation. While other complicating factors persist, the quick math is that

For every $100,000 you earn over the aforementioned thresholds, you will lose $3,000 of itemized deductions.

In the presence of these new income tax headwinds, we thought it might make you feel better to consider the multiple layers of tax management that we employ in your portfolio.

In general, maximizing after-tax returns dictates that we hold broad-market equity portfolios, tax-managed equity funds, and municipal bond instruments in taxable accounts. Higher dividend-paying asset classes, taxable bond funds, and real estate investment trusts are largely held in tax-deferred accounts.

Asset location refers to which type of account (either taxable or tax-deferred) in which a client should hold each of their investments. After determining the appropriate asset allocation, we then focus on an optimized asset location, knowing that a rational investor seeks to maximize after-tax return.

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Beyond intelligent asset location we employ additional tax management strategies as part of our stewardship of your assets. In the equity portion of the portfolio we implement low-cost, tax-efficient, market-wide institutional funds with extremely low

turnover (less than 5% in 2012). The result is that taxable dividends are almost entirely qualified due to the longer holding periods of the underlying stocks. By "qualified," we are referring to the IRS jargon that describes how some dividends qualify for favorable tax treatment—while others, called ordinary dividends, are taxed as ordinary income at your highest marginal bracket.

The need to sell an investment in a taxable account also presents an opportunity for planning. When only a portion of a position is sold, the tax information that the custodian reports to the IRS may depend on which underlying "tax lots" are actually sold. For example, you may accumulate a position in a particular security over time, buying smaller quantities at different prices. A tax lot is a record of the amount, price, and date of each of these purchases. If you were to sell some of that position, the tax implications would depend on which of those lots are reported sold. The good news is that since the investor can elect to specify which lots are sold, Rockwood has another opportunity to incorporate prudent portfolio management with your overall tax picture.

Specifically, we have the capability to use "short-term tax sensitive" tax lot cost basis accounting in your portfolio. While it will mostly be transparent to everyone except your accountant, to efficiently manage taxes we have established the portfolio accounting structure to ensure that shares will be redeemed in an order that seeks to first tax-loss harvest and then avoid short-term capital gains when securities are sold at a gain.

Furthermore, we often utilize mutual funds that use tax lot accounting inside the funds themselves. The result is that tax implications are considered during the internal mutual fund rebalancing that is necessary to maintain our specific tilts toward small-cap and value stocks.

An investor's chance of outliving his or her money is reduced when we implement strategies designed to maximize total return potential rather than income-oriented strategies. In addition to creating wealth more prudently, providing regular cash flows from your investment portfolio is best sourced from a combination of dividend and interest income and the harvesting of capital growth in the portfolio (especially within the current low interest rate environment).

Tax management is an oft-ignored yet tremendously important element of expert portfolio management. It requires that an advisor have an intimate knowledge of his or her client's tax picture and take the time to carefully and thoughtfully plan each transaction with respect to trade-offs between tax implication, risk, and the optimal investment strategy.

Take the World View Please

Which is more valuable: All the shares of ExxonMobil stock or the entire worth of the 270 companies traded on the Italian stock market?

If you guessed ExxonMobil, you have perhaps already intuited that investing in a handful of large U.S. companies or in purely market-cap-weighted strategies does not produce a robustly diverse portfolio. In fact, the ten largest U.S. companies in aggregate are larger than the entire stock market of any other country in the world. Academically diversified portfolios capture the universe of available equity investments with specific tilts toward dimensions of the market that are expected to produce higher long-term returns.

World Market Capitalization

If it's been awhile since you have seen this cartogram, you will note that it depicts the world not according to land mass, but by the size of each country's stock market relative to the world's total market value.

Population, gross domestic product, exports, and other economic measures may influence where the news is made. But the map offers a different way to view the universe of equity investment opportunities. Markets are efficient, and global capital will migrate to destinations that offer the most attractive risk-adjusted expected returns. Therefore, the relative size and growth of equity markets may help in assessing the political, economic, and financial forces at work in these countries—not the other way around.

By focusing on investment metrics rather than on economic reports, the chart further reinforces the need for a disciplined, strategic approach to global asset allocation. Of course, the investment world is forever in motion, and these proportions will change over time as capital flows to markets that offer the most attractive returns. New in 2012, Israel has moved from being an emerging market to being a developed one, and Colombia, Egypt, and Peru have been added to the emerging markets available for investment.

The cartogram brings into sharp relief the investable opportunity of each country relative to the world. It avoids distortions that may be created or implied by news media attention to economic or fundamental statistics, such as population, consumption, trade balances, or GDP. **Not to worry—you can squint, but you won't find Cyprus.**

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