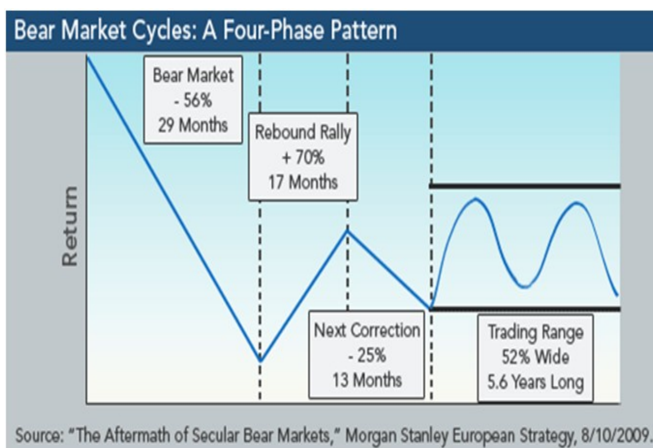
THOMPSON WEALTH MANAGEMENT, LTD.

Post-Election Concerns

As we have for the last several years, we continue to expect equity markets will be volatile within the context of a generally positive but moderate return trend. This is typical of the aftermath of financial crisis periods.



Source: "The Aftermath of Secular Bear Markets," Morgan Stanley European Strategy, 8/10/2009.

On the one hand countries, states, municipal governments and individuals are struggling to address the debt and spending problems that caused the crisis in the first place. This seems likely to continue to limit upside.

On the other hand, support continues to come from record (if slowing) corporate profits, accommodative monetary policy and attractive equity valuations and forward returns relative to bonds. This seems likely to continue to limit the downside.

Our essential message is this. When the market rallies smartly, as it has since summer, don't get caught up in the momentum. Expect the market to go two steps forward and then one backwards!

When the market corrects, as it appears to be doing since the election, don't make the mistake of extrapolating short-term concerns into long-term realities.

If you try to time the market and sell to avoid short term risks, you run the chance of missing out on returns also. Given the moderate return climate we expect, missing out on just a few days on the upswing can greatly reduce average annual returns. (See my recent article Can An Investor Successfully Time the Market.) Moreover, the associated taxes and costs can greatly eat into returns.

Recently, I met someone who inherited a trust from his grandmother filled with dividend paying blue chips bought and mostly held since 1961. He was considering liquidating the stocks because of concerns about higher capital gains taxes and the "fiscal cliff", which he fears may cause a slowdown in economic activity next year. Moreover, he fears that other investors trying to get out ahead of a fiscal cliff might trigger a big sell off.

First of all, it makes little sense to accelerate capital gains in order to save a few dollars in taxes unless the money is going to be needed in the next few years. Remember, those stocks can be held and taxes deferred for years…potentially forever (it worked that way for his grandmother).

Second, it rarely makes sense to follow other investors who may not have the same time horizon or risk tolerance, might not have built a prudent asset allocation and might not have taken pains you have to create a solid financial foundation for investing. Investing is all about balancing the risks of short term fluctuations in market prices against the longer term risks posed by inflation. Currently, alternative investments like bonds and cash stand very little chance of offsetting inflation.

Third, it is fair to say that his man would be significantly worse off if his grandmother had sold out her stocks every time there was a change in tax/fiscal policy, or every time risks appeared on the horizon. Let's remember she made those investments when the top tax bracket was above 60%!

Moreover, it's easy to lose sight of the fact that the companies in the portfolio prospered and the value quadrupled many times over despite the never ending risks that popped up through the fifty year period. Indeed, the grandson forgot that she made those investments right before the Cuban Missile Crisis when the country was staring at nuclear war.

Despite the downturns and the track record of governments, the companies in her portfolio prospered through 10 actual recessions (and about a million imagined recessions) and many changes in the tax code. They persevered through the Cold and Vietnam Wars and numerous other conflicts around the world, the Arab Oil Embargo and the malaise of the 1970s. Companies prospered in spite of the assassination of Kennedy, the impeachment of Nixon, the switch from the gold standard, wage and price freezes, the high unemployment and hyper-inflation of the early 1980s, the Japanese manufacturing miracle, the failure of money center banks, the collapse of Bear Stearns and the S&L system in the 1980s, not to mention Black Monday when the stock market lost 25% in one day. I could go on all day.

Post Election Concerns

The fiscal cliff is unlikely to happen, but if it does and it causes a recession, this too shall pass!

The U.S. has added $5 trillion of new debt since the financial crisis began, and there is a huge gap today between spending and tax revenue. (It's not nearly as high as the deficit faced after WWII, by the way). But one could make a case that if U.S. politicians take bold action and both increase tax revenue and cut spending over time (so as to avoid the "fiscal cliff"), this will put our country on a more sustainable fiscal path – which in turn might alleviate one of the market's key sources of anxiety. Viewed this way, higher taxes may not be such a universally bad thing for markets.

Tax Increases

Stocks are always unpredictable in the short run, but our research would suggest the stock market isn't destined for a bear market simply because tax rates could rise.

- History suggests no clear link between the direction of tax changes and equity markets.
- While tax policy and related sentiment certainly can impact equities, we continue to look at stocks more holistically.
- Well conceived balanced portfolios will likely benefit from rising equity markets, but have a substantial "cushion" through fixed income and more defensive, yield-focused investments should equities post a retreat.

Is history any guide to what markets might do into 2013, given the potential tax changes? To answer this question, we studied the seven most recent tax law changes going back to 1981 - and the performance of the stock market six months before the change, six months after, and cumulatively (Exhibit 1). For the three tax ***increases*** since 1981, the S&P 500 was up 5%, 14%, and 16% in the 12 months surrounding the change. But the data also shows that tax ***decreases*** have occasionally coincided with rallies. To make matters even fuzzier, the sample period did not include any major increases on just dividend taxes.

What about taxes on dividends?

Prior to 2003, dividends weren't treated separately and were lumped into ordinary income. The tax cuts in 2003 marked the first time dividends were treated as a separate category, and 2013 will mark the first time dividends are increased as their own separate category (assuming this moves forward). The conclusion from this exercise - acknowledging the small sample – is unmistakably blurry. There is no clear link between tax changes and U.S. equity performance.

Why? Not all investors are sensitive to taxes. Think of all of the IRAs, 40 1(k)s, and other retirement accounts where many Americans have a considerable portion of their equity exposure. To put this into perspective, Americans hold roughly $19 trillion in such retirement accounts, and nearly half of all stock and bond mutual funds are held in IRAs and defined contribution plans. Further, many U.S. stocks are held by non-U.S. taxpayers who are less concerned about the U.S. tax system, and many foundations and endowments enjoy tax exempt status. So even if tax rates go up as planned, many investors may not be significantly impacted.

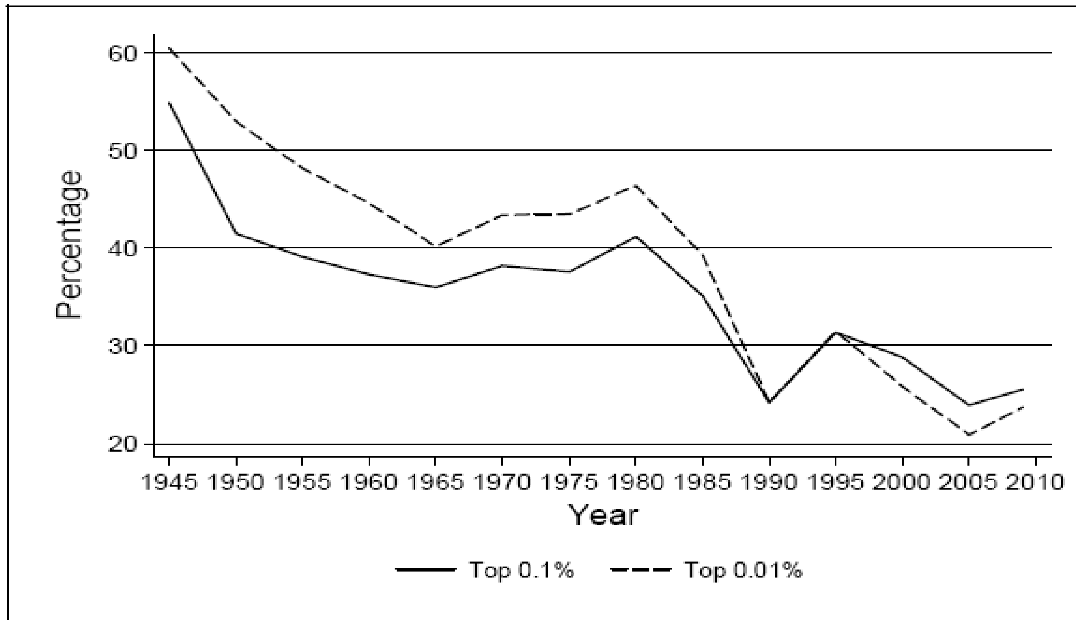
Exhibit 1: Tax Changes and the Stock Market: No Clear Link

President & Year of Passage	Tax Increase/Decrease	Impacts	S&P Performance 6 Months Prior	S&P Performance 6 Months Post	S&P Performance Cumulative
Bush/May '03	Decrease	Capital Gains & Dividends	+3%	+10%	+13%
Bush/May '01	Decrease	Income Tax	(5)%	(9)%	(14)%
Clinton/Aug '97	Decrease	Capital Gains	+22%	+5%	+27%
Clinton/Aug '93	Increase	Income Tax	+1%	+4%	+5%
Bush/Nov '90	Increase	Income Tax	(7)%	+21%	+14%
Reagan/Oct '86	Decrease Increase	Income Tax Capital Gains	(2)%	+18%	+16%
Reagan/Aug '81	Decrease	Income & Capital Gains	(4)%	(5)%	(9)%

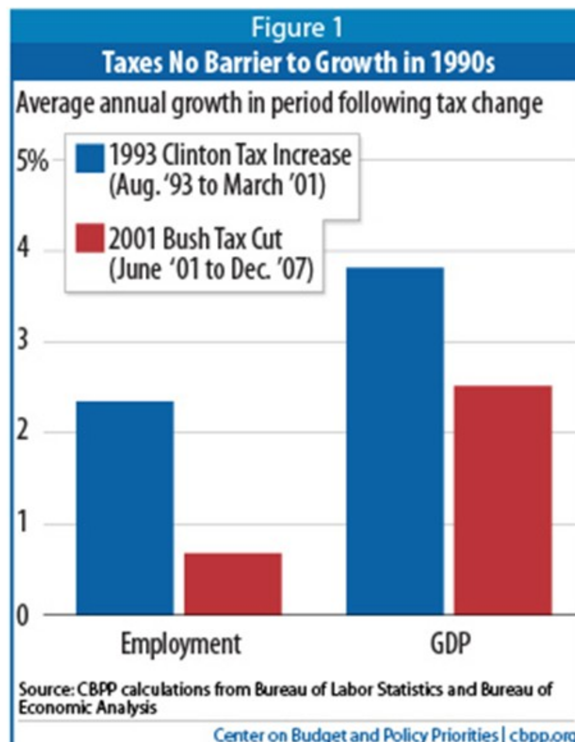
Source: FactSet, Tax Policy Center

Context for Today
That's not to say that tax rates are unimportant – they clearly matter. But taxes need to be considered among a host of other equity drivers such as sentiment, corporate revenues, earnings, the overall health of the global economy, and valuations. Even with higher taxes, a positive trend in a number of these other factors could predominate and lift equities.

Figure 1. Average Tax Rates for the Highest-Income Taxpayers, 1945-2009



Source: CRS calculations using Internal Revenue Service (IRS) Statistics of Income (SOI) information.



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