Capital
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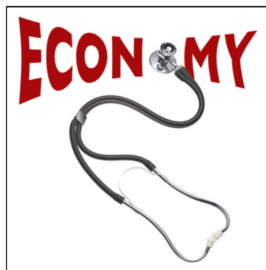
How Important Is The Debt Level To Future U.S. Economic Health?

During this year's first quarter, U.S. investors were heartened by improving economic indicators at home and by Europe's efforts to contain its sovereign debt crisis. Yet that good news, which helped fuel the recent stock market rally, may overlook a larger, more persistent weakness—a ballooning federal deficit that independent economist Fritz Meyer describes as a "debt bomb." Whether Congress finally deals with the issue could go far in determining the nation's long-term economic health.



Meyer points to the possibility that U.S. debt levels could leapfrog current projections—of a rise to $4 trillion during the next decade—and surge to as high as $11 trillion. A critical measure of economic viability is the level of debt relative to gross domestic product (GDP), and the higher the percentage of debt to GDP, the more the United States may begin to resemble Greece, Spain, Portugal, and other nations at the center of the European sovereign debt crisis. And although the current percentage of U.S. debt relative to GDP is better than in some other countries, that level could be on a trajectory to a danger point, depending on which of two possible projected scenarios actually occurs.

The two possibilities are contained in a Congressional Budget Office (CBO) report produced each January that describes what may happen during the following decade based on current tax laws. This year, there were two sets of projections because there are two starkly different scenarios for taxes and federal spending beyond the end of 2012.

One projection is based on what will happen under laws now on the books. This "baseline" scenario assumes that several tax cuts enacted during the past 11 years will expire on schedule at the end of the year. Those laws, which reduced tax rates across the board—for income, capital gains, dividends, estates and gifts—and have limited the number of people subject to the alternative minimum tax (AMT), were supposed to "sunset" in 2010 but got a last-minute, two-year extension.

The CBO's baseline scenario assumes that this time all of those taxpayer-friendly provisions indeed will expire, resulting in a rush of new tax revenue beginning in 2013. If that happens, the CBO projects that federal revenue could increase by as much as $800 billion during the next two years, rising to 16.3% of GDP in 2013 and 20% of GDP the following year. This surge in tax collection would be helped not only by higher tax rates but also by a sharp increase in the percentage of taxpayers subject to the AMT. The level of US debt would be impacted by a scheduled 30% reduction in fees that Medicare uses to reimburse physicians for their services.

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It's Never Boring!

While the six-month stock market rally, which seemed to run out of steam at the end of March, provided some welcome relief in the face of continuing economic challenges around the world, we keep in mind that the market can move down just as quickly as it can move up.

Some investors believe they must shift to a more aggressive allocation in an effort to capture the highest return possible during a sharp rally. This reminds us of those who made such a move in the late 1990's, and during the housing boom.

Our general approach is to maintain a balance between growth and defensive securities. While this approach may not always maintain pace with a torrid market rally, it has proven to hold up very well during periods of market volatility, without necessarily sacrificing long-term results.

We are just as interested in wealth preservation as we are in the growth of our clients' wealth. Please call us if you would like to review your accounts with us.

We appreciate those who continue to refer new business our direction. If you happen to know someone looking for a financial partner, we would be pleased to arrange a meeting in an effort to determine whether we're the right fit for his or her needs.

Thank you!

Judy

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Start Harvesting Gains In 2012

If you're in the same tax boat as most other investors, you should start thinking about harvesting capital gains from securities sales in 2012.

That's right—harvesting gains, not losses. The normal advice is to look for valuable tax losses, especially at the end of the year, that you can use to offset capital gains as well as up to $3,000 of ordinary income. (You can carry over excess losses to the following year.)

But this year is different. The current maximum tax rate of 15% on long-term capital gains—realized on the sale of securities you've held longer than a year—is scheduled to increase to 20% in 2013. Furthermore, the tax rate for short-term gains (from the sale of assets held one year or less) will also rise, especially for high-income investors. Short-term gains are taxed at ordinary income rates that currently reach no higher than 35%. Beginning in 2013, however, the top rate for ordinary income is set to rise to 39.6%. Next year you may also be subject to a 3.8% Medicare surtax that will apply to net investment income if you exceed a specified threshold.

Congress could still act to preserve some or all of the lower tax rates, but even if that happens, it probably won't be until after the November elections. Therefore, the optimal approach, at least for now, is to focus on the current tax benefits of selling stocks that have appreciated significantly during the time you've owned them. If you believe those shares are likely to continue to increase in value, it probably makes sense to hold on to them and not to worry about future tax consequences. But if the outlook for future gains is uncertain, you might want to take advantage of today's favorable tax treatment of long-term capital gains.

Let's suppose, hypothetically, that you're holding a stock position you bought 10 years ago for $10,000 that is now worth $25,000. If you sell the stock in 2012 and have no other capital gains or losses during the year, you'll pay tax of $2,250 (15% of your $15,000 profit). But if you wait until next year to sell at the same $25,000 price, you'll owe tax of $3,000 (20% of the $15,000 profit). That's an extra $750 in tax you could avoid.

Tax planning that involves investing decisions can quickly become complicated, and it's always important not to let the "tax tail wag the investment dog"—that is, to put tax considerations before sound investment strategies. That's why this year, in particular, it's wise to start considering the possibilities long before year-end deadlines and to consult with your tax and investment advisors. We can help you stay on top of possible changes to the tax laws and work with you to make choices that are right for your situation. ●

A Common Error In Powers Of Attorney

Even if you do things the right way in estate planning, things may still turn out wrong if small details are overlooked. For instance, while you may recognize that it's important to establish a power of attorney for an elderly relative, if the document fails to address certain contingencies, you may be powerless to act when your help is needed most.

A power of attorney, governed by state law, is a legal document allowing one person to act on another's behalf. It must be created by someone—the principal—who has the mental capacity to understand all of its ramifications. The person appointed to act for the principal is known as the attorney-in-fact or the agent. Once the principal has signed the document, the attorney-in-fact can make decisions for him or her.

Powers under a power of attorney may be broad or limited. For example, a broad power of attorney often grants control over all of the principal's assets. On the other hand, a limited power might restrict an agent's activities to selling a home or other real estate.

The most common type of power of attorney, the durable power of attorney, remains in effect should the principal become incapacitated, whereas a non-durable power of attorney is typically used for a specific purpose, such as temporarily managing a person's financial affairs while that person is incapacitated.

While all of this may seem straightforward enough, if the power of attorney isn't carefully drafted to accommodate changing conditions, a family's intentions could be defeated. A common error is a document that fails to name one or more contingent attorneys-in-fact who can step in if the person named in the document is unable to fulfill the responsibilities of this position. That might happen if the original agent has died or is

Modern Portfolio Theory: Does It Still Work?

Modern portfolio theory (MPT), introduced more than half a century ago by Nobel-laureate Harry Markowitz, is all about diversification. It's based on the notion that over the long term, a properly balanced group of investments will perform better than any single holding would do on its own. MPT looks at the historical returns and volatility of stocks, bonds, and other assets to create a portfolio mix that can maximize expected returns based on how much risk an investor is willing to take. The riskier a portfolio is, the higher its potential return may be.

For decades, MPT has been a bedrock principle for creating investment portfolios. Asset managers have used it for the mutual funds they run, and financial advisors have put it to work in choosing investments for their clients. But in recent years, particularly since the economic crisis and market meltdown that began in 2008, MPT has come under fire. Many people contend that it no longer works. They point to the fact that in 2008 and 2009, almost every kind of investment lost value, and that even perfectly diversified portfolios let investors down.

Yet the idea that MPT has outlived its usefulness—and that it failed during the recent financial crisis—ignores the reality that an analysis of market history confirms, says independent economist Fritz Meyer. Modern portfolio theory remains "the best mousetrap yet devised" for managing investments, Meyer says, and he analyzes 40 years of market performance data, from 1970 to 2010, to prove his point.

Meyer looked at what would have happened to a portfolio, created in 1970, that was divided evenly among seven kinds of assets: cash; large-cap U.S. stocks; small-cap U.S. stocks; non U.S. stocks; U.S. bonds; real estate; and commodities. Maintaining an equal exposure to those asset classes would have yielded an average annual return of more than 10% during the subsequent 40 years, compared with just under 10% a year for the Standard & Poor's 500. Yet the diversified portfolio would have had half the volatility of the S&P, according to Meyer.

So why are so many people convinced that MPT doesn't work in today's markets? Meyer suggests that in many cases, it may be because investors succumbed to the natural human tendency to stop the pain during a bear market and sold their holdings at what turned out to be the worst possible time. "Our generation has learned a very important investment truth the hard way," says Meyer. And many of those who got out of the market in 2008 or 2009 remain on the sidelines, he says, waiting until they regain their confidence. In the meantime, of course, they have missed out on several years of strong market gains.

Another problem, Meyer says, is the tendency to confuse modern portfolio theory with "buy and hold"—the idea that simply staying the course with investment choices will produce the best results over the long haul. MPT may indeed resemble a buy-and-hold strategy, Meyer notes, because an investor who subscribes to MPT will remain fully invested. But that doesn't mean that a portfolio will sit there unmanaged no matter what occurs in financial markets.

Even an investment portfolio run according to the principles of MPT will need periodic changes, Meyer says. Rebalancing holdings to keep them in line with their original portfolio percentages is especially important, and ought to be done either quarterly or annually, according to Meyer. Without such adjustments, assets that were performing well would soon make up an outsized proportion of overall holdings, and the portfolio's returns could suffer when stocks, for example, then lose ground during an investment cycle. Beyond rebalancing, other kinds of shifts may also be made to MPT portfolios based on an analysis of economic or industry factors.

Meyer is skeptical of the alternatives to MPT that many advisors and investors have turned to recently. Absolute return strategies, tactical asset allocation, and attempting to time the market simply don't work, he says, and though fleeing stocks and other comparatively risky assets during market swings may seem like a good idea, it can put investors in a hole that it will be difficult to dig themselves out of. Meyer notes that some who sold out during the worst of the recent bear market may have had to postpone retirement or permanently reduce their standard of living.

With a disciplined MPT approach, on the other hand, you're taking advantage of a powerful tool that has long proven its ability to maximize returns and minimize risks, Meyer concludes. ●

incapacitated or otherwise unwilling or unable to act.

To see what can go wrong, consider this hypothetical situation. John Greenbow, age 80, names his spouse Nina, age 75, as his attorney-in-fact, and their two children, Lester and Michelle, as contingent attorneys-in-fact. John creates a separate document naming himself as attorney-in-fact for Nina. Five years later, Nina shows signs of Alzheimer's disease, so John assumes her financial affairs. But he suffers a stroke soon after and is incapacitated. While Lester and Michelle have been designated as attorneys-in-fact for John, they aren't authorized to act on behalf of Nina.

This problem could have been easily avoided if John had incorporated language into Nina's power of attorney that would have enabled the children to act on her behalf as well. And that's the point—it's crucial to think ahead and plan for the worst imaginable scenario. If you've anticipated all possible scenarios, you can rest easy knowing help will be there when it's needed. ●

Future U.S. Economic Health

(Continued from page 1)

The baseline scenario also factors in the impact of another current law, the Budget Control Act of 2011. Passed last August to allow the U.S. debt limit to rise, the legislation calls for broad, automatic spending cuts if Congress fails to achieve major deficit reduction.

The baseline scenario shows the federal deficit for fiscal year 2012 dropping to $1.1 trillion, or 7% of GDP, and projects that the shortfall will continue to decline steadily to less than $200 billion and will average just 1.5% from 2013 through 2022.

Because neither spending cuts nor tax increases are ever popular, the CBO report also includes an alternative fiscal scenario based on the notion that Congress once again will give taxpayers a reprieve. If the current tax breaks continue rather than expire, payments to doctors remain at current levels, and the Budget Control Act spending cuts are somehow averted, the level of U.S. debt could skyrocket.

Under the CBO's alternative fiscal scenario, the annual U.S. budget deficit would remain high, averaging 5.4% of GDP during the next 10 years rather than the 1.5% average projected under the baseline scenario. Meanwhile, total public debt would approach 94%, the highest level since just after World War II.

Meyer considers the CBO's alternative fiscal scenario to be the more realistic of the two projections, and he believes the long-term impact of failing to reduce U.S. debt would be a weaker economy. Though further postponing tax increases and spending cuts would spur economic growth in the short run, leading to higher rates of GDP expansion and reduced unemployment, unchecked deficits ultimately would reduce private investment and cause GDP growth to fall below levels predicted under the baseline scenario. ●

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