



[the *compass*]

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## What do Whitewash and Mutual Fund Selection Have in Common?

by Mike Palmer, CFP®

I've got a natural interest in social experiments (perhaps in my next life I'll come back as a research scientist), especially ones that reveal how people make decisions about money. After all, in the wealth management business we manage emotion every bit as much as we manage money. Understanding habits, foibles, blind spots and the like are invaluable in helping clients achieve a successful investment experience.

I have to admit that early in my career I too was captive to what I call the "Wet Paint" theory. How many times have you seen a bench (or similar object) with a "wet paint" sign adorning it, but still felt the need to touch the bench to see if it really is still wet? That's the social condition apparently at work with many people (and some advisors) selecting mutual funds. Despite the warning disclaimer that *past performance is not an indication of future results* people invariably use that as a key factor (if not **the** key factor) in selecting money managers. So even when we're explicitly warned not to, and despite the fact that there is no empirical evidence to support it, we assume that funds that did well in the past will do so in the future. Why?

Research into this area of social psychology indicates some interesting findings. We are a pattern seeking species; if we weren't, we would have become extinct long ago. We try to form accurate impressions of the world knowing that we don't have complete information. This often results in seeing patterns where none actually exist. A simple example of this is the following question: A bat and a ball together cost \$1.10. The bat costs a dollar more than the ball. How much does the ball cost?

In our Winter *Compass* we will reveal the answer and discuss some alternate methods of making choices and selections that may lead to better outcomes.



### NOTABLE QUOTE

**"Nowadays people know the price of everything and the value of nothing."** – Oscar Wilde

# Why Do I Want to Hear About Taxes Again?

by John Slayton, CFP®

In prior *Compass* issues we have discussed the impending year-end perfect storm of tax increases, across the full spectrum of estate, gift and income taxes. We do not wish to rehash prior articles, or to obsess over tax increases, but time is short and potential impact is severe, so here are some time critical action items before year-end. Congress could act before January, but it has matters such as an election and the approaching “fiscal cliff” to distract any efforts on taxes.

## Summary of Scheduled Year-End Changes

### Income Tax Rates Spike:

- Net long term capital gains rates increase from 15% to 20%.
  - > Top ordinary income tax rates increase from 33% and 35% to 36% and 39.6%.
  - > A special 3.8% Medicare surtax will apply to the lesser of net investment income for the year or the amount by which modified adjusted gross income exceeds \$250,000 for a couple (\$200,000 for an individual). Wages above these thresholds will also incur an additional .9% Medicare tax (1.45% to 2.35%).

### Estate/Gift Tax Rates Return to 2001 Levels:

- Unified lifetime estate/gift credit decreases from \$5.12 million to \$1 million.
- Maximum gift/estate tax rates will increase from 35% to 55%.

## Immediate Planning Opportunities

### Income Tax

- Reconsider tax loss harvesting
  - > Use short-term capital losses to offset realized short-term capital gains, which are taxed at ordinary income tax rates, but not long-term capital gains, which are taxed at 15% in 2012.
  - > Save excess capital losses for 2013, when ordinary income and long-term capital gains rates will both be higher.

- If consistent with your investment goals, realize long term capital gains
  - > Any long-term gains will be taxed at a rate of 15%, rather than potentially 23.8%.
  - > Particularly significant for sale of a business or large investment property.
  - > Successful long-term investment planning should always trump tax planning, however.
- Consider a Roth IRA conversion
  - > Because the amount converted is fully taxable in the current year, conversion in 2012 could involve less tax than 2013.
  - > Be careful if you converted to a Roth in 2010 and opted to pay half the taxes on each of your 2011 and 2012 returns. You still owe half the taxes and you may not want to add another tax obligation.

### Accelerate income and defer deductions

- Reverse traditional planning and accelerate any income possible into 2012.
- Deductions will be more valuable at 2013 higher income tax rates, so bunch and defer them if possible.

### Estate/Gift Tax

- Consider gifting large sums (if practical)
  - > The gift tax exemption is currently \$5.12 million, and is slotted to return to \$1 million next year.
  - > Making large gifts to heirs now decreases one's taxable estate.
  - > If you made intra-family loans previously to take advantage of the historically low interest rates, consider forgiving them now in order to utilize the current gift tax exemption.
- It is uncertain as to whether a “clawback” of such gifts might occur in the future. This should not stop the gift, however, because you should be no worse off than you are today, prior to the gift.
- Consider leveraged gifting/estate freeze vehicles
  - > Grantor Retained Annuity Trusts (“GRATs”) have been the focus of earlier articles, but GRATs are particularly desirable in times of low interest rates. The use of GRATs

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# Password Paradox

by Jay Eich, CFP®

**A**s I stared at my computer screen one night while in college, I thought, “why can’t I remember my password?”. In the past few years I can remember more than one conversation with my wife that focused on the answer to a security question tied to our bank account. “Did you capitalize that?”, “Was there a # sign after the nickname of your first car?” or “What was the name of your first dog?” Why can I remember the phone number of a childhood friend I have not spoken to in years but not a simple password? It became obvious to me that we had too many usernames, passwords, and security questions to remember. From financial (banking, investment, retirement, and social security sites) to social (email, Facebook, LinkedIn, Pinterest), to professional (trade groups, etc.) to others (airlines, retailers, magazines), we have over fifty different on-line accounts, all with different rules regarding the length of the username, and how the password is to be comprised (letters, numbers, special characters, and upper/lower case). Our priority is the safety of our account information, but of obvious concern is the ability to remember how to log into these sites. We began to focus on more effective user names,

passwords, and security questions and worked on a system to better manage the location of this information.

When creating a username many of us use some version of our own names or the names of our family members. Instead of using real names, come up with an alias. Your favorite movie, novel, or cartoon characters are all suitable choices. If a number is required, use your favorite number or year. If capital letters are required, alternate between a capital and lower case letter.

Passwords can be more complicated. Several years ago letters were the only requirement. Now it’s not uncommon for a password to require a capital letter, two or more numbers, as well as multiple special characters such as a # or @ sign. Finally, the password is often required to be changed every month or so. While there are many ways to devise a password, the most important factors are to avoid using actual words and to use different passwords (have at least four) for different types of sites. One solution is to use a favorite phrase as the base of your password. Favorite lyrics and quotes are examples. If needed, you can add numbers, capital letters, and special characters. For example, Neil

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- could be limited under future legislation.
- > Charitable vehicles, such as Charitable Lead Trusts and Gifts of Remainder Interests in Residences (after retaining a lifetime occupancy right), are appealing in today’s low interest rate environment.
  - > Remember that lower interest rates lower the deduction for Charitable Gift Annuities, but the portion of the annuity payments that are tax-free increases to as high as 60%.

It is not clear what Congress will pass before the election or in the brief lame duck session. Congress could wait until next year, and then make changes retroactive to January 1, or not make them retroactive at all. These issues can be complex and confusing, but prudent planning before year-end will prove profitable.

## Interested in learning more about behavioral finance?



Noon  
 Tuesday, October 9  
 Granary in Farrington Village

Join Trust Company principal Mike Palmer for a lunch presentation exploring how behavioral biases harm investors and techniques you can use to avoid them. Seating is limited, so please call Lisa Shirley (919) 781-8287 or email her at lshirley@tcts.com to reserve your space.



## Behind the Scenes at Trust Company of the South

- >> David Paul, son of Amy and Mitchell Paul, achieved the rank of Eagle Scout in his Boy Scout Troop 451 in Durham. His Eagle Scout project was landscaping and improvements to the grounds of Reality Ministries, which serves underprivileged youth in Durham. Congratulations David!
- >> Mike Palmer recently attended the DFA Advanced Conference in Austin, TX and was among a handful of advisors featured in a new DFA video series entitled "The Value of Advice."

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Armstrong's quote "That's one small step for man, one giant leap for mankind" would translate to "tossfmoglfm." If capital letters are required, one alternative is to alternate between upper and lower case letters. If using numbers, select your two favorite numbers and then count up when required to change. Special characters can be added at the beginning and the end. If the password needs to be shortened, cut it off at the applicable length. Using capital letters, special characters, numbers and upper and lower case letters the above password example would translate to "\$ToSsFmOgLfM1123\$".

Many times you are required to choose predetermined security questions. These questions typically have very common answers. So as not to make the answer obvious, add a favorite acronym to the end of each answer. For example, if your street name is Tobey Hill, write "tobeyhillcfp".

Once you have created this information you will need a place to store it. While there are a few excellent online password manager sites (LastPass and RoboForm are a couple of the better known applications), many will want to store passwords using either pen and paper or an Excel file. If you choose the written or Excel method, be sure not to write down your phrase or question. Use a hint instead. Referring to the example above, use Alden (Neil Armstrong's middle name). Be sure to use the special character \* as a placeholder for certain parts of the password. Using our example above, "\$ToSsFmOgLfM1123\$" would be written "\$alden\*\*\*\*\$".

In a world of constant complexity and one increasingly reliant on technology, finding a *method* to navigate the most basic elements of everyday life can deliver peace of mind.



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