[the*compass*] winter 2013

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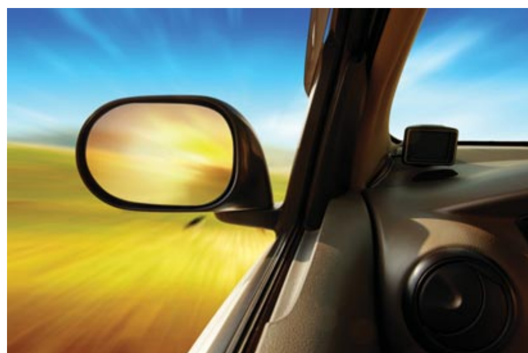

Driving Forward While Looking in the Rear View Mirror

by Mike Palmer, CFP®

In our Fall issue we discussed some of the pitfalls that can waylay investors who fail to heed the warning that past performance is not an indication of future results. We posed a question that illustrates how our desire to seek patterns often leads us astray: A bat and a ball together cost $1.10. The bat costs a dollar more than the ball. How much does the ball cost?

Most people answer reflexively that the ball costs ten cents - an answer that fits neatly into our conventional pattern seeking paradigm. Only when we allow our reflective thinking to overtake our reflexive mind are we able to deduce the correct answer. The total of the two items is $1.10, but the bat costs a dollar more than the ball, so the ball must cost five cents.

There are a variety of reasons our brains aren't particularly adept at making wise choices, especially when it comes to matters of finance. Overconfidence is a significant hurdle. If we constantly doubt our actions it can lead to unhappiness, and in most facets of life confidence is deemed a virtue. To combat overconfidence, a better framing technique might be placing a probability on our prediction on the front end. By telling ourselves that there is a 65% chance we'll be correct, we give ourselves "an out" when our prediction turns out to be incorrect. We are more accepting of our fallibility because we stated at the outset a possibility of error. Without this device we tend to engage in

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NOTABLE QUOTE

"Life takes you a lot of places. Every day you adjust your compass."

– Brad Kelley

Trust Company of the South...because wealth management is more than managing money

2012 | the year in review

by Mike Palmer, CFP®

As we sweep up the confetti and put a wrap on 2012, it might be insightful to look back at the investment landscape to prepare us for the year ahead. 2012 was a year like most others, full of ups and downs and abundant opportunity for investors to become "prisoners of the moment," to be overtaken by media pessimism and retreat to the siren of "this time is different." Below is a look back at some of the highs and lows of the stock market's 2012 journey.

February: Facebook files for an initial public offering. The stock starts trading May 18 amongst great fanfare. But the hype soon wanes and by September the stock is down more than 50% from its initial price. It ends the year down 25%.

April: JP Morgan Chase is roiled over losses incurred by a trader in their London office. The loss initially believed to be $1.5 billion (and referred to by CEO Jamie Dimon during an April 12 call as a "tempest in a teapot") was subsequently revised to be closer to $6 billion. The stock falls nearly 30% in less than a month, but ends the year up 35%.

May: Financier Leon Black pays $120 million for Edvard Munch's "The Scream" – the highest price ever paid for a work of art.

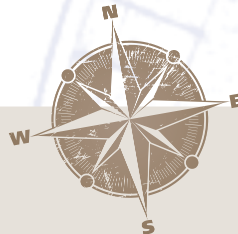
June: Riots and protests sweep Greece, forcing the creation of a new government. There is wide speculation about the future of the Euro. International markets crater with the MSCI EAFE index dropping 16% in 8 weeks. The MSCI EAFE index ends up 17% for the year.

August: Apple becomes the largest US company ever as measured by market cap. In August the stock is up over 60% for the year, but it falls to close the year up 24%.

November: President Obama is re-elected. The market promptly falls 5% over the next week, before reversing course and ending the year higher than on election day.

December: Amid the Mayan doomsday prophecy and hand wringing over the fiscal cliff the market goes up 4% for the month.

As this litany of woe and recovery illustrates, the journey to a successful investment experience requires as much intestinal fortitude as intellect. Reaping the rewards offered by the world's capital markets requires a combination of discipline and emotional detachment that eludes many investors. As for 2013, we'd expect more of the same – lots of seemingly dire and ominous news, but resilient markets that reward long-term investors.



[POINTS OF THE COMPASS]

>> Over the holidays I watched an hour long interview with David Feherty and Ken Venturi on The Golf Channel. It was a fascinating discussion, but one blurb I picked up that made great sense was Venturi's habit of marking his ball heads up on the green. However, if he'd had to move his mark out of the line of a competitor he marked it tails up, a habit that allowed him to avoid an unnecessary penalty. I recommend Charles Duhigg's book *The Power of Habit* for more insight into why we do what we do.

>> Despite being surrounded by two of the world's most tumultuous countries (Greece and Syria), Turkey managed the world's best performing stock market last year, up 55%. A common misconception is that a country's economic strength is correlated to the performance of its stock market. Historical evidence actually shows a negative correlation between economic growth rates and stock returns. I guess Mark Twain was right, it ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

>> The most interesting book I read last year was Nate Silver's *The Signal and the Noise*. Silver correctly predicted the exact results of the Presidential Electoral College a week before the election. In a world increasingly driven by data, Silver offers some valuable insight into how to effectively use data and also how to identify the right data to make better decisions. There's a great video of an interview with Nate Silver at Google headquarters, well worth watching, easy to find on the internet.

Medicare Funding Rescues

by John Slayton, CFP®

With the holiday season behind us and the fiscal cliff averted (for now), we can examine one component of the new tax rules effective January 1. CNBC's fiscal cliff countdown clock (with tenths of seconds no less!) was only slightly less entertaining than the never-ending comparisons to the ending of the 1991 movie, *Thelma and Louise*. With all the hoopla, little mention was made of the new Medicare surcharges that were adopted as part of the Patient Protection and Affordable Care Act of 2010 and effective January 1. ***In lieu of amorphous and incalculable tax hikes and spending cuts, the new Medicare surcharges are specific and significant, and took effect without any action by Congress.***

> These taxes affect taxpayers with a **modified adjusted gross income (referred to as "MAGI")** of $200,000 for an individual or $250,000 for a couple filing jointly (collectively, "**High Wage Earners**"). MAGI includes AGI, plus wages from work, **net investment income**, qualified retirement plan distributions and any foreign earned income exclusions you have had.

> These amounts are not indexed for inflation, similar to our perennial favorite, the Alternative Minimum Tax.

The Medicare payroll tax on earned income had been 2.9%, 1.45% from both the employer and employee. High Wage Earners will automatically now be subject to an **additional 0.9% payroll tax on earned income** over the above limits, withdrawn from pay checks.

More complex and troubling is a new Medicare tax on **net investment income**, which has always been exempt from Medicare tax.

> High Wage Earners will owe an **additional 3.8% surtax** on the amounts by which their net investment income exceeds the above income thresholds, and if their wages are already above the limits, they will owe the surtax on their entire **net investment income**.

> The key is the definition of **net investment income**, which includes interest, dividends, capital gains, royalties, income from passive activities (such as partnership income reported on a K-1), the taxable portion of nonqualified annuity payments and rental income (which is taxable even if you are actively managing the rental properties, due to their inherently passive nature).

> **Net investment income** does not include tax-exempt interest from municipal bonds, withdrawals from a traditional retirement plan or retirement annuity, life insurance, social security, veterans' benefits or income from businesses in which you actively participate.

> Withdrawals from traditional IRAs (not Roth IRAs) do count towards MAGI, even though they are not counted as net investment income, so they can cause you to be over the above income thresholds, subjecting your **net investment income** to the 3.8% surcharge.

For almost the last ten years, **Qualified Dividends** have been taxed at the federal rate of 15%. Effective January 1, for High Wage Earners, this will rise to a maximum rate of 20%, plus the 3.8% surtax. Hopefully this will not have an undue impact on the desirability of investment in income-producing, blue chip stocks.

What Can I Do to Temper the Impact of These New Taxes?

> Hold assets that pay taxable interest or dividends in tax-deferred accounts such as IRAs or other tax-deferred vehicles, rather than currently taxable accounts.

> Depending on your individual situation (each of us has our own tax concerns/priorities in any given year):

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revisionist history; we look at all the unknowns that subsequently became known and tell ourselves had we only known these things our prediction would have been different.

It's also a good idea to write down predictions and state the reasons for one's forecast. Too often we confuse correlation with causation. We can be "right," but for all the wrong reasons. This leads to another behavioral finance dilemma, confusing luck with skill. Luck plays a much greater role in our lives than we want to believe. We tend to associate our good outcomes with skill or talent and dismiss our failings or shortcomings to bad luck.

For those interested in learning more on this subject, we recommend Daniel Kahneman's book, *Thinking, Fast and Slow.* Becoming aware of these and other foibles is a good start to better decision-making.

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- Consider harvesting capital losses, in order to have them available to offset capital gains in future years, to decrease net investment income.

Tax treatment should not control the investment decision, but always should be a consideration.

> Shift some of your investments with taxable earnings into instruments whose earnings are not included in MAGI or net investment income, such as municipal bonds or permanent whole life insurance policies (whose cash value is not treated as net investment income when withdrawn). Always be sensitive, however, to the after-tax effective yield of municipal bonds versus treasuries or corporate bonds and the relative cost-effectiveness of life insurance as an investment vehicle.

One final note. The marriage penalty inherent to the married filing jointly threshold of $250,000 versus a single threshold of $200,000, when coupled with the other marriage penalty provisions that return in 2013, could cause certain married couples (such as dual income couples) to reconsider filing separate tax returns in order to minimize taxes. The rationale of the marriage penalty is a worthwhile subject for discussion on a different occasion.

Planning will help ease the pain. Call us if you have any questions!

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