

Recently, Mathew Doyle, Director of Family Office services sat down with select group of CapTrust's individual clients to discuss the upcoming election and CapTrust's view of its impact

Client: *Let's start with the obvious question, who wins in November?*

Thank you for not asking who I wanted to win and forcing me to break the cardinal rule of never discussing religion and politics. Your question of who will win, and the subsequent implications for taxes and the market, is likely to be a moot point, as taxes are likely headed up regardless of who is elected. Take for example McCain: although he supports making the Bush tax cuts permanent, he is likely to be pitted against a Democratic majority in both the House and Senate. Regardless of what McCain wants, the Democrats can sit back and simply let the Bush tax cuts sunset in 2010, thereby raising taxes by default. In all likelihood, he would need to sit down prior to such an event, probably in 2009, and broker a tax increase that both sides could live with, perhaps giving a little on the estate front to maintain the status quo on certain marginal tax brackets or capital gains and dividends.

Client: *What about Obama's tax proposal?*

After months of populist message of change, Obama's plan is finally starting to take more shape. He has offered a few ideas with regard to relief for low income workers, seniors and homeowners but conversely would increase capital gains and dividends from 15% to 25%. Corporations are at the top of the hit list as well as lifting the cap on Social Security withholding currently set at \$97,000 per year. Again, regardless of the candidate, the answer on taxes is either high or higher.

Client: *How does this affect me?*

Given that each of you has different circumstances with regard to income, withdrawal rates, even different mixes of taxable versus non-taxable accounts, changes in tax policy will affect each of you differently. For example, someone taking distributions from an IRA will watch the marginal tax brackets more closely while someone living off taxable investments will be more affected by capital gain and dividend changes.

Remember that taxes are only one of the two largest influences on your investments, with inflation being the largest influence. Let me explain using an example. Many of you are familiar with CapTrust's planning process where we test (under varying market conditions) the likelihood of achieving your goals. You are also aware that we look for a likelihood of success between 75% and 90%. So using a test case of John and Jane Doe with \$4,000,000, spending X, earning Y and having Z left over ... lets just say that produced a confidence level of 83 (well within our comfort range).

1. Raising capital gain and dividend rates from 15% to 25% and changing the marginal tax bracket from 28% to 30% reduced the probability of success from 83% to 81%. Not insignificant but not detrimental either.
2. Alternatively, we raised inflation from 3% to 3.5%. This reduced the base case from 83% to 77% success.
3. Taken together they reduced the base case from 83% success to 75% success. So a set of goals we previously had high confidence in is now somewhat in question.

As you can see, although taxes play a role, the larger issue is inflation. A change from 3% to 3.5% represents three times as much risk to achieving your goals than taxes. Putting oil aside for the moment, several countries have moved from being producers of goods to consumers as well. As infant economies continue to develop and thereby accelerate the desire to gather more "stuff", the world will put more and more upward pressure on inflation.

Thus, the combination of taxes and inflation will warrant changes to the overall structure of your portfolio and our recommendations.

Client: What changes would that be?

It's different depending on the candidate, but let's assume Obama for the moment.

1. First, if individual tax brackets increase, municipals may begin to look more attractive, especially given that the yield spread between treasuries and municipals remains historically high. Absent municipals, perhaps TIPS or other inflation hedging strategies may need to be considered.
2. Second, we will want to watch the balance between growth and value stocks. The Bush tax cuts that reduced dividends to 15% produced a steady stream of flows into dividend paying stocks – traditionally value stocks (utilities, financials, etc.). With the exception of last year, value has outperformed growth each year since that legislation was enacted. Granted there were other forces at play, but it certainly was a factor. If corporations are discouraged to pay dividends due to higher tax rates, you could see stock buybacks become popular once again.
3. Third, international markets have led the way for several years. If windfall profit taxes and the closing of corporate loopholes come to pass, international companies may gain a competitive advantage versus their US based counterparts. This would cause us to favor a higher proportion of international investing. The trick will be navigating these waters in an environment where the dollar stabilizes and currency gains are likely to eat into international returns. The answer may be managers and funds with discretion to allocate assets on a global basis and that have the flexibility to hedge currency.
4. Lastly, we need to be more aware of investing intelligently for after tax returns.

Client: How do you do that?

Depending on your individual circumstances you have to evaluate two critical factors for producing superior after tax returns:

1. First is asset location. If your tax bracket exceeds the capital gain and dividend tax rates, REITS and other items that produce a significant amount of ordinary income may better be placed in a tax deferred account. For that matter, if you're looking for additional yield, you may opt to use taxable fixed income inside an IRA in lieu of municipals. Ultimately these decisions would depend heavily on whether or not you had a taxable estate and what your tax bracket is likely to be.
2. Second is evaluating your managers. CGM Focus is a fund with an extraordinary track record that is right for very few people. With 300% turnover, virtually all the gain is taxed at ordinary income tax levels. Hedge funds are another example and typical to the wealthy families that Obama is targeting. They are extremely tax inefficient due to the frequent trading many of them employ, and with many projected to earn 8% after fees, the net after tax return could be in the 4.5% - 5.5% range. Such a low return makes you question whether the lack of transparency and illiquidity is worth it.

So we will continue to look for opportunities, which asset classes to own and the best place to own them.

Client: Is there anything else we can be doing now?

It is difficult to plan when the rules are constantly changing; however, there are some "low hanging fruit" opportunities that some or all of our clients may take advantage of.

1. First, anything where tax is paid now in exchange for no tax later has a distinct advantage. This includes 529 plans for educational funding and Roth IRA contributions and conversions (if appropriate).
2. Second, we are big believers in diversification and there is no time like the present to diversify low basis positions and concentrated stock.
3. Third, consult with your CPA and ask if you would be better off deferring deductible items like property taxes or charitable contributions to next year when tax brackets may be higher.
4. Lastly, I'd make best friends with my estate planning attorney and be ready to, once and for all, finish the postponed estate planning once we get more concrete guidance on the direction of the death tax.