Tarheel Advisors Newsletter

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My Rate Has Fallen and Can't Get Up!

It was 1989 when Mrs. Fletcher had her infamous fall to only be saved by Life Call. Unfortunately Japan wasn't so lucky in 1989, because this was when they began their downward interest rate spiral, and to this date they have yet to get back up.

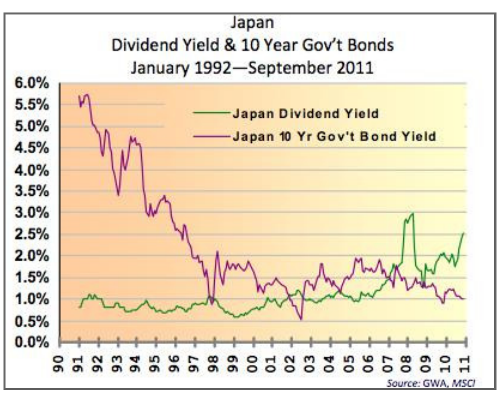
Since Japan has been in this position for so long many market pundits are quick to say that Japan doesn't matter. To an extent they might be correct. The world has experienced solid economic growth over the past two decades while Japan suffered a general economic malaise.

I say Japan matters for a very different reason, and that's precedence. Low interest rates and loose monetary policy have been proven to be great tools for smoothing out your plain vanilla economic recession. However, the case in Japan shows that cheap money is completely ineffective against curing a depression. The Japanese 10 year treasury bond hit 1% in 1998. When we fast forward to 2012, the rate is still virtually unchanged.

Unfortunately, the hard lessons in Japan have been mostly ignored and are being repeated in every corner of the world. In 2009, the US Federal Reserve lowered their target overnight rate to 0%-0.25% where it still stands. This rate change was initially intended to be a short term fix, but just this month the Fed committed to maintaining this rate through 2014.

Now is the time for investors to consider the effect of what an extended low interest rate environment will have on their portfolios. Being that Japan is 14 years into their deflationary interest rate spiral, there is a very real possibility that the U.S. could follow suit for the next decade or more.

The effect on bond portfolios is already painfully obvious. For the highest rated investment-grade bonds it's extremely difficult to realize yields greater than 2-3%. When one factors in an inflation expectation of around 3%, it leaves one with little choice but to purchase hi-yield or international paper in order to realize a positive real rate of return in the bond market.



The effect of low interest rates on one's equity portfolio isn't as easy to decipher. Analysts on TV are quick to say that equities are a no-brain decision when the dividend yield on the S&P 500 is greater than the yield of the 10-year Treasury bond. However, when we look at the historical data in Japan, this decision isn't so clear cut. The first time the yield on equities in Japan was greater than bonds was in 1998. Since that initial inflection point, the Nikkei index is down over 50%. Today the dividend yield on the Nikkei is nearly 3 times that of the yield on their 10-year treasury bond.

Has the U.S. fallen into the same interest rate trap that's plagued Japan? Will Life Call come to our rescue?!? Fed Chairman, Ben Bernanke, keeps hitting that button, but no one seems to be coming. So, while equities shouldn't be completely shunned, a healthy pessimism about future market returns should be expected. The annualized 8% rate of return that many investors are accustomed to with an all equity portfolio should probably be trimmed down closer to 6%.

Keep in mind that having lower market expectations for an all equity portfolio will by no means lower volatility. While yield in Japan has been scarce for over a decade, volatility in their markets hasn't been nearly as hard to find. Up and down moves of 25% or more have been the norm in Japan for two decades (sound familiar?).

So, is there any prayer for the investor needing 8% in this environment? While one may be swimming against the current, there is still some hope. With the average yield on the S&P 500 at around 2%, there are still an abundance of stocks with dividend yields of 3-5%. A well built portfolio of these equities, diversified with high yield bonds (and a little bit of market help) still has a chance of getting you to the 8% you're accustomed to.

-Ryan Glover, CFP®

2012 Market Update

S&P 500	**+8.31%**
DOW	**+5.42%**
NASDAQ	**+12.66%**
MSCI World	**-1.08%**
BONDS	**+2.6%**
GOLD	**+2.4%**

Mortgage Rates

15-Year	**3.01%**
30-Year	**3.63%**
5/1 ARM	**2.69%**

Did You Know?

*The US was debt free for its first and only time under Andrew Jackson.

*If you invested $1,000 in WalMart's IPO back in 1970, your investment would now be worth approximately $1.8 Million.

*The NC General Assembly passed a tax break beginning in 2012 where taxpayers may deduct the first $50,000 of net business income for the taxable year on their N.C. income tax returns. Presumably, "business income" will include income from partnerships, LLCs, S-Corps and Sole-Proprietorships (but not C-Corps).

HealthCare Revisited

In April of 2010, we took our first stab at analyzing the Health Care and Education Reconciliation Act (H.R. 4872), or perhaps better known as the "Patient Protection and Affordable Care Act (ACA)" or "Obamacare". Given its 2000 page size and lengthy amount of time before implementation, we tried to stay relevant and discuss how the bill and its provisions would impact your portfolio and personal finances. Now that we are two years down the road and one Supreme Court decision behind us, I felt that revisiting the topic might prove useful to those of us who have put the financial impact on the back burner.

So, whether you think the law is a "mandate" or a "tax", good or bad, let's dive into some of the provisions and see how they will affect your individual situation.

Starting on January 1, 2013, an new 3.8% surtax will be added to "unearned income" for single and joint filers with total net incomer greater than $200,000 and $250,000, respectively. "Unearned income" or net investment income includes dividends, interest, and income derived from many other passive activities, but it notably does not include distributions from IRAs or tax-free interest from municipal bonds.

Also beginning in 2013, an additional 0.9% Medicare Hospital Insurance tax will apply to wages of an employee or earnings of self-employed individuals that exceed specified thresholds. For single filers the tax applies to wages earned in excess of $200,000 in that year, and for joint filers the threshold is $250,000. Self-employed individuals cannot deduct any portion of the tax.

How will these new taxes affect your portfolio? Well, as usual, it depends on your situation. For high income earners, the potential consequences of these two additional taxes plus the likely expiration of the Bush-era tax cuts could mean that the dividend income tax moves from the current 15% all the way up to 43.4% in 2013 and beyond. This significant change makes dividend paying stocks less attractive and growth stocks more enticing. Along those lines, if an investor wanted to capitalize on this shift in sentiment but still generate income from their portfolio, we would suggest deploying a covered call overlay on your portfolio. This strategy tends to work well when incorporated with growth stocks which typically provide more option premium to call writers. Since dividends and short-term capital gains look destined to be treated equally taxable by year end, this strategy should provide investors with continued exposure to the equity markets and income without worrying about the effects of any tax rebalancing act.

Another possible area to focus on is municipal bonds. As previously mentioned, tax-free interest payments from these securities will avoid the 3.8% surtax and will continue to be attractive versus taxable bonds, especially if the expected ordinary income bracket shift occurs at year end. If you want to profit from the impact of the ACA, we would suggest overweighting municipal bonds; more specifically, those backed by the revenue of hospitals. While state and local governments have been publicly struggling with record deficits and have made general obligation bonds less attractive from a credit rating standpoint, we believe that hospital bonds stand to benefit from almost a perfect storm of newly insured patients, higher income tax rates, and yield hungry investors. With a tax equivalent yield that is already attractive relative to similarly rated corporate bonds, municipal hospital bonds could see an uptick in credit rating associated with better loss-recovery rates and higher volume that is likely to kick in as soon as 2014. The one caveat to beware of is that hospital bonds in different states should not be treated equally. Since the Supreme Court ruled that States can opt-out of the Medicaid expansion, and the government cannot withhold matching funds, it is highly like that some States will choose to go it alone. Hospitals in these states may be affected when it comes to re-imbursement from patients covered under Medicaid.

Obviously, the outcomes of the November presidential and congressional elections could strongly influence the final outcome of these tax provisions. But, I think it is safe to assume that it is extremely unlikely that any meaningful changes to the current path will be made prior to the law's implementation.

In this environment, more effective tax planning will be best accomplished by staying closely attuned to the developing congressional debate surrounding future individual income tax rates and communicating regularly with your tax adviser.

-Walter Hinson, CFP®

Provision	Current law through 2012	Beginning 2013
Top rate on ordinary income	35%	39.6%
Top rate on dividends	15%	39.6%
Top rate on long-term capital gains	15%	20%
Health care reform increases	None	0.9% tax on earned income; 3.8% tax on investment income
PEP & Pease limitations on itemized deductions	None	Restored
Marriage penalty relief	Expanded bracket and standard deduction	Expires
Estate and gift tax parameters	35% top rate; $5 million exemption	Returns to pre-2001 levels: 55% top rate; $1 million exemption

The tax rate table and research for the article above was obtained through the publication: *Still Standing: Planning for the high-wealth tax increases ahead* prepared by the Tax Policy Group of Deloitte Tax LLP. The full report is available via the link below:

http://www.deloitte.com/view/en_US/us/Services/tax/6706b343f8e28310VgnVCM2000001b56f00aRCRD.htm

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