VIEWPOINTS

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MARKET COMMENTARY

FREDRIC W. WILLIAMS

Send In The Clowns…

"Don't you love farce?
My fault, I fear.
I thought that you'd want what I want -
Sorry, my dear.
But where are the clowns?
There ought to be clowns.
Quick, send in the clowns…
Don't bother - they're here."
- *Stephen Sondheim, 1973*

With all due deference to Mr. Sondheim's contribution to Broadway's "A Little Night Music", we thought a touch of editorial license was in order given the reprise currently playing out in our nation's capital once again. Our duly elected officials are treating us to an encore performance of their theater of the absurd as we endure yet another in what appears to be a never ending series of their interpretation of "leadership" via political brinkmanship. Rather than work to negotiate a compromise on the middle ground, our legislative clowns appear to prefer to stake out positions on the extremities – possibly because that garners them better media coverage.

Chris Matthews points out in his recently released book, "Tip and the Gipper: When Politics Worked", that although President Reagan and Speaker O'Neill were ideological opposites, they found a way to be cordial and productive working together:

> *"Why don't our leaders work to accommodate each other, employing civility as they cooperate to accomplish goals in the country's best interests? Why must we continue to suffer their relentless gumming up of the works? What in our national character, in the ways we choose to deal with one another and respect different viewpoints, has changed since the days of Reagan and O'Neill? How can we win back the faith that our republic is working?*
>
> *"Today we have governance by tantrum. Rather than true debate, we get the daily threat of filibuster. Shutdowns are engineered as standard procedure. In place of hard-earned statecraft we witness new tricks of the trade. Presidents make "recess" appointments to end-run Senate consent. Tea Partyers in the House of Representatives act as if voting "Nay" constitutes twenty-first century governance. Democrats in the Senate, for a while, refused to approve the annual budget – withholding consent to skip the embarrassment of*

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admitting dire fiscal reality. Brinkmanship grabs today's headlines even as public faith dies a little with each disappointing eleventh-hour deal."

Regardless as to how quickly this most recent drama gets resolved, the unintended consequence of this period of policy uncertainty will be continued constraint of business and consumer confidence – something that our glacially growing economy doesn't need as a headwind to forward progress. Reagan's 1986 quote appears to be as prescient now as it was then:

"The nine most terrifying words in the English language are: I'm from the government, and I'm here to help."

This September brought with it another dubious anniversary – five years since the onset of the financial crisis and its irresponsible sibling, The Great Recession. The collapse of Lehman Brothers in 2008 exposed the linkage that leverage provided to bind our financial institutions and economy to those of the rest of the world. The complacency that evolved in the mid-2000's from productivity gains and the disinflation that global sourcing provided, masked the build-up in systemic leverage that became an insidious component of our then new-fangled financial engineering.

Remember when everyone was "taking the vapors" six or so years ago, and believed that US home prices would always go up (so how could you have a "bad" loan?) and the rating agencies were beyond reproach? Those pipe dreams were rudely dashed as the downside of real estate leverage exposed mortgages that were, in fact, subprime – detailed in this space in 2007 under the moniker "Sublime Subprime". This contagion then spread to supposed triple-A rated CDOs (collateralized debt obligations) which had been stuffed into the portfolios of banks and insurance companies, both at home and abroad, under the mistaken belief that triple-A was in fact triple-A…an assumption that became painfully clear as being incorrect.

The losses and write-downs across a plethora of financial institutions pounded their balance sheets, causing some institutions to fail or be bought out, and greatly diminished liquidity as banks went into bunker mode and pretty much stopped lending. As we remember, the economy and markets collapsed, highlighting the linkage that still existed in our global financial system. It took a coordinated and concerted effort by central bankers around the world to step in and ward off the financial Armageddon that we stared down in early 2009.

Since then we've seen a slow healing process as the global economy worked off the aforementioned asset-pricing excesses and began to re-employ workers. Growth has been haltingly slow and the regulatory changes have gradually been implemented – neither dynamic being supportive of improving the much needed business and consumer confidence mentioned above.

But the good news is that corporate profits and efficiencies have improved balance sheets, while an increased savings rate, as well as a recovering housing market, have done the same thing for consumers. Absent a geo-political shock, or a sustained continuation of the Bozo-charade in Washington, the trend is for continuing improvements in both the domestic and global economies.

A recent WSJ article highlighted an interesting comparison: Warren Buffet stayed true to his vision of investing when all around were scared, putting approximately $24 billion into companies in the midst of the financial crisis – and generated a 40% return thus far from his patient longer term vision. In contrast, the U.S government invested $420 billion through T.A.R.P. and has realized a 12% return to date, according to the U.S. Treasury…kind of suggests we might want the Oracle of Omaha as our next Fed Chair, don't you think?

As Jason points out below in his equity commentary, the risk-off trade has driven our domestic markets higher, presenting us with relative valuation opportunities in both Europe and the developing world. The bond market, as Jay discusses, recovered a bit in the quarter from a Fed-induced case of "taper-worm", but still faces the inevitable normalization of interest rates over the intermediate term. We will, however, continue to look for opportunities that might be brought on in all asset classes by temporary pricing volatility.

EQUITY MARKET OVERVIEW — JASON E. FOSTER

Tempering The Rate of Ascent…

The news surrounding much of the third quarter offered the "on the fence" investor plenty of excuses to exit equities and stash capital into anything resembling safety, namely one's mattress as the vehicle of choice! Communications by the Federal Reserve regarding their stance on aggressive bond purchases led the investing community to believe that tapering was imminent, sending stock and bond investors for the exits. On top of this, the U.S. was on the verge of entering another entanglement overseas, this time with Syria. By the end of August the modest correction in the equity markets erased the prior gains of the quarter. But like the weather in Maine, things changed rapidly. Quickly the Fed fine-tuned its message, which felt like coordinated PR campaign, making it clear that tapering was off the table in the short-term. The situation with Syria also cooled sending stock prices back onto their positive trajectory, ending the quarter higher than the last.

For the year, generally speaking, the U.S. stock market continued to lead the developed world posting a 19.8% return as measured by the S&P 500, approximately +148% above the lows of the financial crisis back on March 9th, 2009. With the market trading at 14.3 times next year's earnings, interest rates well below historical averages, both corporate and personal balance sheets now restored, an oversupply of housing that has burned off, and too many other factors to list we believe the market is reasonably priced. However, not all regions of the world have experienced the same bounce, raising the possibility of opportunities elsewhere. For example, while the developed world has continued to recover, Emerging Markets have struggled all year, finishing this quarter with a *negative* return of (-4.1%) versus the considerably strong showing from the developed world. The divergence has created significant disparities in valuations, with Emerging Markets now trading at roughly a 23%-25% discount to developed markets.

Europe has our attention as well, now that it appears to have averted economic calamity and systemic failure. Remember the constant barrage of news coverage surrounding the collapse of the Euro thanks to the bad behavior of Greece, Portugal, Italy and Spain? Significant economic issues are still abundant, but what a long way we've come. By the fourth quarter of this year it is expected the EU will pull out of the recession and post positive economic growth. Europe has gone from booting a country like Greece out to preserve the Euro, to adding Latvia to the Euro next year, with Lithuania potentially on-deck. We believe this restoration of confidence back into the European Union should serve as a foundation for economic recovery. Couple that with powerful demographic trend of the millions expected to join the “consuming class” in Asia, Europe has the geographic advantage of being positioned close by to provide the goods and services that will be demanded. At IMCG we continue to favor stocks over bonds, and now with an even greater emphasis on a *globally* balanced portfolio.

Table 1 - Index Returns			
Equities	*Percentage Change for the 3rd Quarter*	*Percentage Change Year-to-Date*	*Annualized 10-Year*
S&P 500	**5.20%**	19.80%	7.10%
DJ Commodity Index	**2.10%**	-8.60%	4.10%
MSCI EAFA	**11.60%**	16.60%	8.70%
MSCI EM	**5.90%**	(-4.1%)	16.90%
NAREIT Equity REIT Index	**3.00%**	(-2.6%)	11.80%
Fixed Income			
Barclays Aggregate	**0.60%**	(-1.9%)	5.20%
Barclays U.S. Treasuries	**0.10%**	(-2.0%)	4.70%

BOND MARKET OVERVIEW — JAY O. FLOWER

A Big Splash In The Draining Pool…

During a period of continued record-setting outflows from the fixed-income space we also saw sales of corporate bonds in the U.S. reach an all-time high last month. Verizon issued $49 Billion on September 11th which was by far the largest corporate bond deal ever. The previous largest bond deal was from Apple earlier this year in April at $17 Billion. For the month of September the total new bond offerings from all borrowers tallied $193.7 billion. The previous monthly record was set last September at $177.3 billion. This is an unprecedented amount of corporate debt hitting the market during a time when investors can’t seem to hit the sell button fast enough on their own fixed income holdings. While investors have grown discouraged over their low bond yields and at the same time weary of rising rates corporations are taking full advantage of this low interest rate environment before it is too late. So, if outflows continued in the fixed-income arena during the last three months then who was buying these Verizon bonds? About a quarter of the offering was purchased by the two largest bond fund managers Pimco and Blackrock at $8 billion and $5 billion respectively. The remaining orders were filled by pension funds, endowments, institutional buyers and other wealth managers looking for higher-yielding securities.

Borrowers flooded the market in anticipation of the September 18th statement by the Federal Reserve where most economists and analysts anticipated they would announce the initiation of the tapering of the $85 billion in monthly bond purchases. As we know now, the Fed decided to leave the program as is and rates on the 10-Year Treasury continued their slide down to 2.61 to close out the quarter as the chart below shows.

Although the FOMC decided not to taper at the meeting in mid-September, we are still of the belief that yield levels will have to normalize over time. As we try to anticipate when this rise in rates will occur it is important to be aware of the distinction between the Fed's Quantitative Easing programs and the federal funds rate mechanism. These are two very different tools that will not move in lockstep. Bernanke has made it very clear that there will be considerable time between the end of QE programs and the first hike in the policy rate. Any change in the policy rate will be based on cumulative data such as unemployment figures and not simply the passage of time. We will have to closely monitor these economic data points to help guide our efforts in anticipating changes in the federal funds rate.

With this in mind we anticipate continued volatility in all areas of the fixed income markets as we slowly and turbulently move from an extremely accommodative policy to a less accommodative policy. There will be periods where markets get dislocated for any number of reasons and these periods can create tremendous opportunities. Ultimately, these volatile periods are healthy for the markets as they try to normalize over time.

FIDUCIARY CORNER — STEPHEN L. EDDY

The Not-So Hidden Cost of Hidden Costs: A Participant Lawsuit…

Two more high profile lawsuits by retirement plan participants against their employers (the plan sponsors) have been in the news recently: one because of the very nature of the plan sponsor; one because of news of a near-record settlement in a six year-old case.

As the Wall Street Journal reported recently, "Workers in a variety of industries have filed claims against more than two-dozen workplace retirement-savings plans in recent years over allegedly high fees and unsuitable investments. The cases are starting to work their way through the courts, with workers scoring legal victories and forcing changes in the way some plans operate."

In the first case, former and current employees of mutual fund and retirement plan platform giant Fidelity Investments sued the firm because it had only allowed proprietary Fidelity Funds in the employee 401(k) Plan and accused them of “self-dealing” and a conflict of interest. The complaint alleged primarily that the funds had higher costs than other funds available in the marketplace and that participants should have been given a better choice. Fidelity’s response was that it had enough in the way of low cost Fidelity index funds as options to pacify even the most frugal investor, and offered the lowest cost share classes (institutional) of its own funds in its plan. What is interesting is that:

a. *Fidelity offers platform clients (but apparently not its own employees) a very low cost open architecture platform that allows plan sponsors to choose low cost funds from Fidelity, Vanguard, PIMCO, American, T. Rowe Price and many other fund companies.*

b. *It puts Fidelity in a VERY awkward position: if they put let’s say, the Vanguard Windsor II Fund in their own employee’s plan as a large cap value option, what message are they sending to the managers of their own large cap value funds, and to the investors they are trying to attract to the Fidelity funds? One often overlooked aspect many people use when selecting a fund manager is determining if they “put their money where their mouth is” and invest their personal money in the funds they manage.*

It’s a very fine line to walk and depending on how this case goes, it looks like we’re heading into a new era of accountability, and possibly specialization among fund platforms.

In the latter case, a $30 million settlement was reached against fiduciaries responsible for overseeing the International Paper 401(k) plan. The suit alleged, among other things (stop me if you have heard this before) excessive fees and unsuitable investments. Another, less publicized, part of this settlement: the company has agreed to put the recordkeeping for its plan out to bid and hire someone to monitor the investment options. The clear message is lowest (not just “reasonable”) expenses; institutional (not “revenue sharing offset” share classes); and pure open architecture (not “limited” or “proprietary”) are the way to go. Plan sponsors need to figure that out before they are on the wrong side of one of these lawsuits.

PLANNING CONCEPTS — TRACY ROGERS

Where to retire??...

Something that is often overlooked in retirement planning is where you plan on retiring and the monetary benefits it may bring. Recently, I was talking to someone who was going to retire in a few years. I asked where and he quickly responded with “Florida”. When I asked why he said he’d “heard it was good for taxes”. This seems to be a common theme when people are looking at retirement. We always worry about having enough money but do not always evaluate where the money may go further. This conversation made me look back to some long time clients I saw in the spring. We helped them move to South Carolina and showed them how they could afford it. In our meeting I remember their saying it was a “raise” for moving. Their property taxes are less than $500 a year for a nice patio home.

Their electric bill averages around $100 a month for heat or cooling and lights. Services are cheaper and golf is a whole lot less.

<u>Taxes</u> **-** no matter where you live, Uncle Sam will take his cut of your retirement income. But your state could take a chunk as well -- the percentage depending on your location. If you're thinking of moving, check how the states on your list will tax retirement income, such as social security and pensions, and whether the states offer any tax breaks to retirees.

In reviewing a state's tax breaks, look at the types of income that make up your retirement income stream. Retirees who will rely on a pension might fare better tax-wise in a state that exempts pension income, while such a break will not matter much to those who will rely on income from dividends and interest. Those who will rely on Social Security may want to consider a state that exempts those benefits.

Also, states can differ on the types of retirement income they exempt. Some states exempt only public and private pensions, while others offer broader breaks, such as exemptions for IRA and 401(k) distributions. Keep in mind that states that offer tax breaks in one area may raise revenue by imposing higher taxes on other activities. For instance, a state that has no income tax could impose a high sales tax. Finally, look at the impact of local taxes. Most counties and cities determine property-tax rates, but many also tack on their own sales tax.

<u>Pensions and Retirement Accounts</u> **-** nine states rise to the top when it comes to being tax-friendly for income. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no income tax. Tennessee and New Hampshire only tax dividends and interest.

Among the 41 states with an income tax, 35 states offer a tax break for at least some retirement income. State and local government pensions are fully exempt in Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Mississippi, New York and Pennsylvania (note, some of these states do tax out-of-state government pensions). Twelve other states, plus D.C., offer a partial exclusion for public pensions. Some states treat public pensions differently from private pensions. Illinois, Mississippi and Pennsylvania <u>exclude</u> all private retirement income, while Kansas and Massachusetts <u>tax</u> all private retirement income. Hawaii doesn't tax money from retirement plans funded by an employer, but it does partially tax money coming from retirement plans to which employees contribute, and on and on we go.

Retirement-income exclusions vary in size and often include age or income restrictions. For instance, New Jersey offers an exclusion of up to $15,000 of retirement income for single filers age 62 or older whose gross income for the year does not exceed $100,000. In Georgia, the retirement-income exclusion for those ages 62 to 64 is $35,000, but it is $65,000 for those 65 and older. Montana offers a pension and annuity income exemption of up to $3,760 per individual, subject to income limitations.

Six states, though, provide no safe haven for retirement income: California, Minnesota, Nebraska, North Dakota, Rhode Island and Vermont. Connecticut offers a 50% exclusion for military pensions but no other retirement-income tax breaks.

Social Security Benefits **-** states treat Social Security benefits more generously than they treat other retirement income. The federal government can tax up to 85% of Social Security benefits, but most states don't tax benefits at all. Besides the nine states that don't have a broad-based income tax, 27 states and the District of Columbia exclude Social Security benefits from state income taxes. They are Alabama, Arizona, Arkansas, California, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Virginia and Wisconsin.

The remaining 14 states tax Social Security benefits to some extent. Minnesota, Nebraska, North Dakota, Rhode Island, Vermont and West Virginia tax benefits like Uncle Sam does -- that is, up to 85% of benefits can be included in taxable income on the state tax return. Connecticut, Iowa, Kansas, Missouri and Montana tax benefits above certain income limits. In Colorado, Social Security is not exempt, but benefits can qualify for the state's retirement-income exclusion, which is worth up to $24,000. In New Mexico, Social Security benefits may qualify for the state's $8,000 exclusion. In Utah, benefits may qualify for a retirement-income tax credit of up to $450.

Retirement-income tax breaks are subject to change -- Iowa is phasing out its tax on Social Security by 2014, while Michigan will be phasing in its Social Security tax starting in 2020.

The Bottom Line

Having a plan for where as well as when to retire could greatly affect the amount of money that is needed to be saved. There are many more factors than just income taxes in making retirement decisions and everyone's situation is unique. As part of the planning process we should make sure we evaluate where you plan on retiring and the other factors that come along with it.

IMCG NEWS

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