Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Third Quarter of 2013

Leigh Bivings, Ph.D., CFP®

Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420

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Executive Summary

- **Global equity markets remained volatile during the quarter but managed to end on a very strong note.** The U.S. market was up +6.4%, and international developed markets were up a very impressive +11.3%. Even emerging markets, which rebounded late in the quarter, delivered +5.8%. The Fed's decision in September to delay tapering its bond-buying program help fuel a late-quarter rally.

- **Most fixed-income returns reversed into positive territory this quarter, also helped by the Fed's decision to delay tapering.** International bonds did particularly well, as did U.S. high-yield and floating-rate bonds. The quarter closed with the 10-year Treasury trading at 2.61%, down from 3.0% earlier in the month.

- **The only substantive move we made to our portfolios during the last quarter was to more fully implement our decision to reduce our exposure to emerging-market equity and rotate the proceeds into international equity,** with a strong tilt toward Europe (Germany more specifically). More generally, we are remaining overweight risk.

- **We did not make any changes to our fixed-income strategy,** as we have already prepared portfolios for an increase in interest rates. While bonds rallied in the second half of the quarter, we don't see that the bond rally will go much further, as the Fed has merely delayed its tapering action

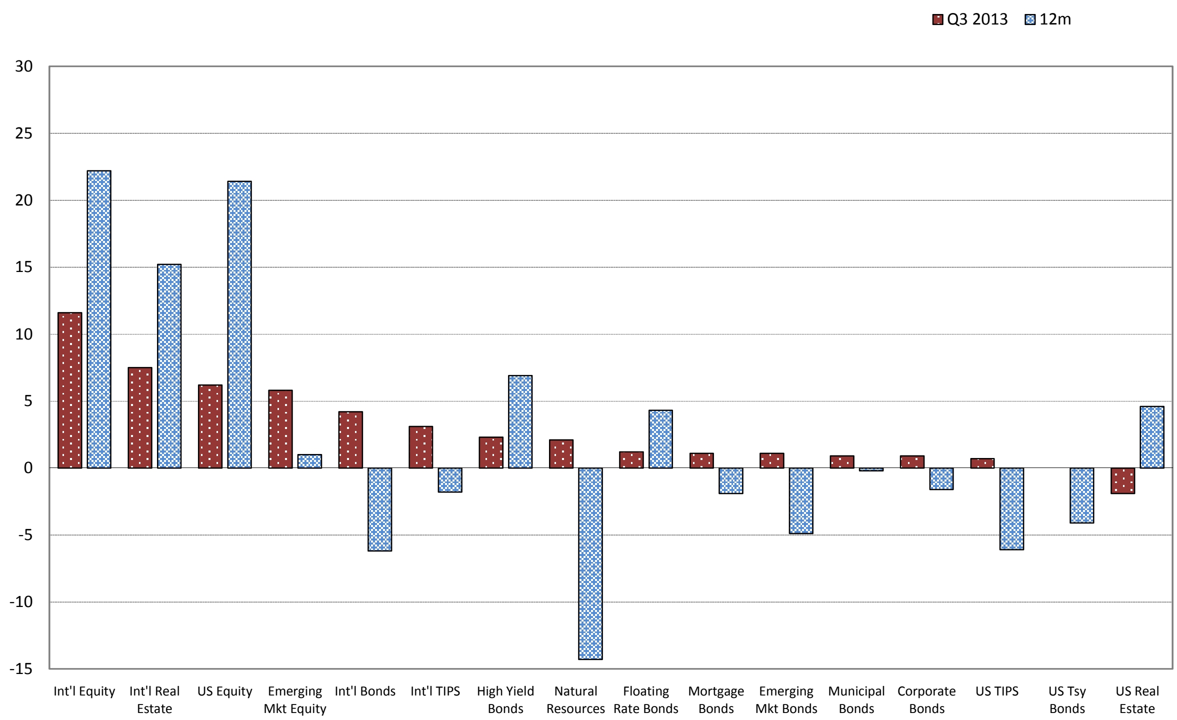
- **In this issue, we focus on the tax planning opportunities available to investors due to the implementation of the American Taxpayer Relief Act of 2012.** Our firm recently increased our capabilities to undertake more in-depth tax planning to help our clients take full advantage of all available opportunities to minimize taxes.

- **As in prior years, we will reach out to all clients with tax-planning opportunities that might apply to them.** We are also encouraging clients to get in touch if they anticipate a large change in their income from this year to next year.

Markets in Review

Despite continued volatility, global equity markets ended the quarter on a very strong note, with the U.S. market up +6.4% and international developed markets up a very impressive +11.3%. Even emerging markets, which rebounded late in the quarter, delivered +5.8%.Fixed-income returns were also positive across most segments, with high-yield leading the way at +2.3%. Only U.S. REITS posted a negative return. See Figure 1.

Figure 1: Asset Class Performance in Q3 2013 (percentage points)



The quarter got off to a good start, with the Fed striking a more dovish tone than in its communication in late May; this eased fears about reduced monetary stimulus in the short term. Data showing that the U.S. manufacturing sector expanded in July to the highest level in two years also reassured investors. However, the U.S. equity market retreated in August amid uncertainty by investors about whether the Fed would begin scaling back its quantitative easing program at its next policy meeting. U.S. equities came under further pressure due to mounting worries about the possibility of a western military strike on Syria.

In September, the economic and geopolitical news from just about everywhere improved. Japan reported that its GDP growth rate was rising much more than anticipated, and deflation was ending. The recovery in the euro zone continued. Recent data also confirmed that the Chinese economy had entered a broad-based rebound, with industrial production picking up briskly and credit growth reaccelerating.

Thus, many people were very surprised by the Fed's decision on September 18 to delay tapering its $85 billion-a-month asset purchase program. The decision indicated that the Fed is still concerned about the slow pace of job growth and potentially worried about a stalled housing recovery due to higher long-term interest rates. Many (including yours truly) also believe that the Fed was nervous about potential gridlock in Congress and its impact on the economy.

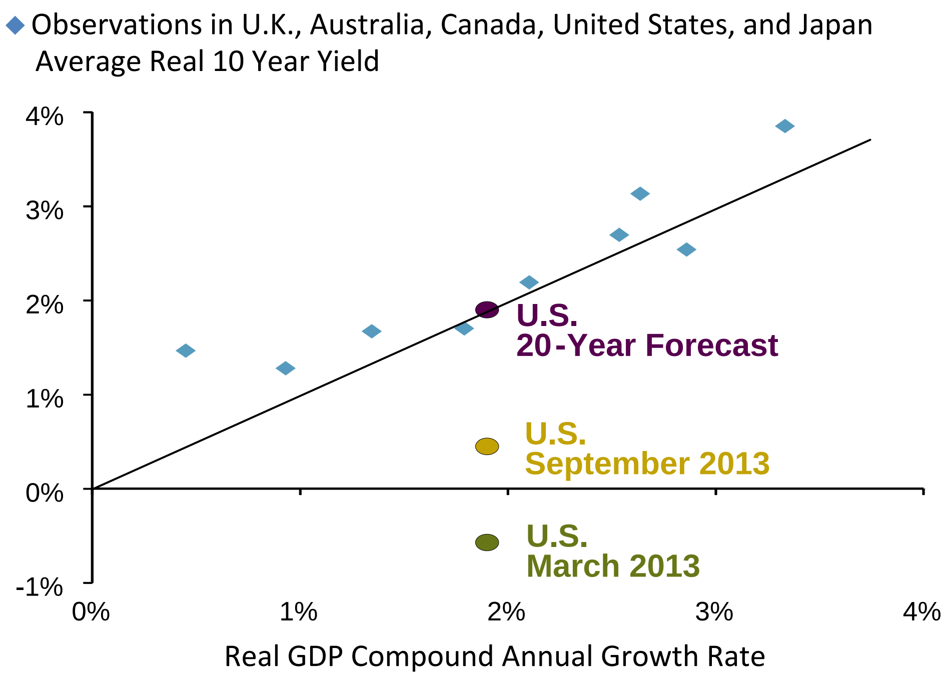
As mentioned, international developed markets — particularly Europe — had a terrific quarter, boosted by some better-than-expected macroeconomic data and a period of relative calm on the political front. GDP figures showed that the single-currency bloc emerged from recession during the second quarter with a growth rate of 0.3%, the first positive reading in almost two years. In contrast, emerging markets had a slower quarter, with the prospect of benign global liquidity following the Fed's decision to postpone tapering providing the main boost to returns.

As for fixed income, the prospect of the Fed tapering its asset purchases continued to weigh negatively. The segments that will most keenly feel the effects of a reduction of the current easing – U.S. Treasuries and Treasury Inflation-Protected Securities (TIPS) – were among the worst performers.

However, bond markets stabilized after the Fed surprised markets on September 18 by announcing that it would not taper in the immediate future. The market reacted by taking 10-year bond yields from a two-year high of 3.0% to a close of 2.61%. Most other bond categories also reversed into positive territory late in the quarter.

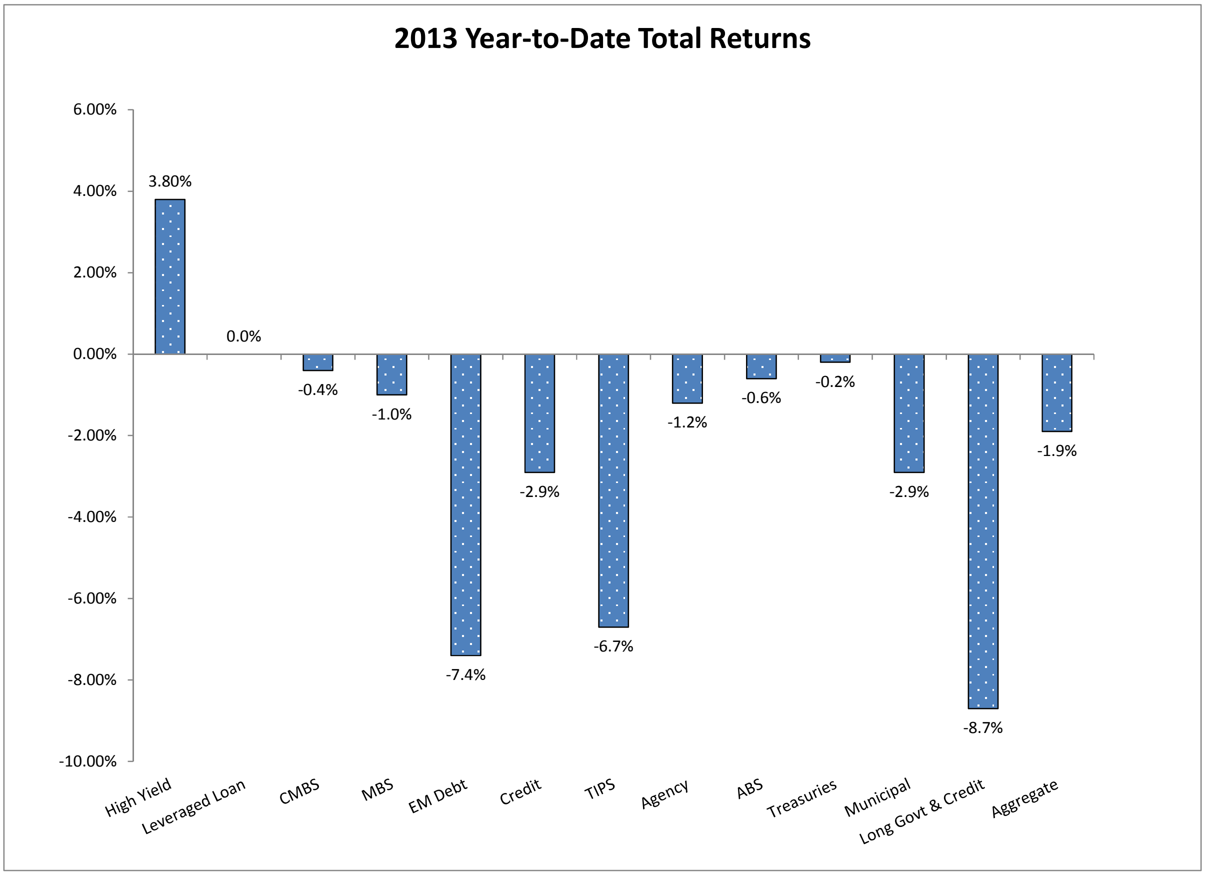
Of note is that with 10-year Treasuries trading at 2.6%, we may be almost halfway through the interest rate resetting process. Figure 2 plots the average real yield on 10-year government bonds in several developed economies over the 1985-2013 period, versus each country's average real GDP over the same period, and indicates that over the long run 10-year real yields tend to converge with the pace of real GDP growth. I think most analysts would agree that despite large year-to-date losses in some key segments of the bond market, the first half of the resetting process has not been as dire for those investors who have been steering clear of long-duration government bonds. (Figure 3).

Figure 2. Real Yields and Real GDP Growth for Selected Economies, 1985-2013



Source: Fidelity

Figure 3. Fixed Income Returns – Year-to-Date 2013



Source: Fidelity

Artemis Strategy

The only substantive move we made during the last quarter was to fully implement our decision across all portfolios to reduce our exposure to emerging-market equity and to rotate the proceeds into international equity, with a strong tilt toward Europe (Germany more specifically). As we wrote last quarter, the indicators out of Europe suggest that Europe will resume growing soon. We especially like Germany because it is a lower-risk way to gain exposure to Europe, and Germany is poised to grow rapidly as the global economy picks up. Returns for Germany (and Europe in general) were indeed robust for Q3, far outpacing the U.S. and emerging markets.

Are we throwing in the towel on emerging markets? No. We, like most, still believe in the long-term growth story of emerging markets. They have more favorable demographics and exhibit lower deficit and debt imbalances than the advanced economies. But corporate earnings in many emerging-market countries have lagged significantly, especially compared with the U.S., and previously overlooked structural problems have been exposed in the recent growth slowdown. In particular, emerging-market countries with current account deficits witnessed capital flight and currency depreciation after Fed Chair Ben Bernanke began to signal the near-end of bond purchases in the U.S. -- hence emerging-market bonds were among the worst hit.

Many will argue that emerging markets are cheap and that now is the time to buy, not sell. In our view, while valuations may appear attractive, it is large due to two cheap sectors – commodities and banks – that drag down the average. Furthermore, those sectors are cheap for a reason: they are risky. The overall universe is not cheap when those sectors are excluded.

However, we stand poised to increase our exposure to emerging markets as conditions improve. In particular, we are going to be watching for a sustained improvement in domestic demand conditions in developed economies – enough to sustain export growth momentum from manufacturing-oriented emerging market economies. We are also going to be looking for a cessation of the interest rate hikes some emerging markets are implementing to defend rapid currency depreciation in recent months. We would take that as a positive signal, as higher interest rates tend to reduce growth. Finally, we are going to be watching corporate earnings momentum in the region.

We are also watching developments back at home. U.S. equity is no longer cheap, and the pace of earnings growth has slowed considerably and is not expected to exceed 5% on a per-share basis for the first nine months of this year. This is a very low number for a market up more than 20% during that time frame. However, we believe liquidity settings by the Fed and other central banks will remain supportive, and profits will likely reaccelerate to double-digit growth again next year, benefiting from what increasingly appears to be a synchronized global recovery. Hence, we are staying overweight risk.

At the moment, we are very comfortable with our fixed-income strategy, which is focused on the more credit-sensitive (versus interest-rate) segments of the market. We have no immediate plans to adjust our clients' holdings. A strengthening world market will likely prevent a meaningful rally in bond prices, so we do not plan to reduce our underweight stance. While bonds rallied in August and September, we don't see that the bond rally will go much further, as the Fed has merely delayed its tapering action. Hence, the bond market will face the same concerns sometime in the fourth quarter when clear signs of growth reacceleration emerge, both within and outside the U.S. economy.

Generating Tax Alpha

As our clients have heard before, what matters most in investing is the after-tax return received on your investments, not the before-tax return. While the former is more difficult to measure, this shouldn't stop investors and their advisors from pursuing the goal of maximizing after-tax returns. This goal just became that much more important this year with the implementation of several provisions of the American Taxpayer Relief Act of 2012 (ATRA), which created new taxes, higher tax brackets on the wealthy, and returned the phase-out of deductions and other items. In short, the U.S. income tax regime has become more progressive and more complicated – both of which make tax planning that much more important.

As a result of these changes, we at Artemis have recently begun increasing our capabilities (via training and adopting new tax planning software) to undertake more in-depth tax planning, and to integrate this activity with our investment management and financial planning. We intend to help our clients take advantage of all available opportunities to improve their after-tax returns.

In this section, we briefly review the new tax regime and what it means for most of our clients, lay out some of the planning opportunities we see, and conclude with a reminder to all of our clients to get in touch with us if they are expecting their income this year to be substantively different than next year. As in prior years, we will reach out to all clients with opportunities we see that are applicable to them.

New Tax Regime for 2013

The most notable provisions of the new tax code include the following:

- **New Top Tax Bracket** – The new bracket is 39.6% for *taxable* income (i.e., income after all deductions) in excess of $400k for individuals, and $450k for married couples.

- **Phase Out of Itemized Deductions ("Pease Limitation")** –Total itemized deductions are reduced by 3% of excess income over a threshold. The threshold amounts are *adjusted gross income* (i.e., income before deductions) of $300k for married couples, and $250k for individuals.

- **Phase Out of Personal Exemptions** – This provision reduces personal exemptions by 2% of the total exemptions for each $2,500 of excess income over a threshold. The threshold for this phaseout is the same as the threshold for the Pease Limitation.

The net impact of the above phaseouts is that each rule increases an individual's marginal tax rate by about 1% (with a greater impact on larger families that phase out more exemptions at once).

- **New Long-term Capital Gains and Dividend Rate** – Top tax rate on long-term capital gains and dividends increases to 20% for those in the top tax bracket. On the other hand, ATRA makes qualified dividends, which are taxed at the more favorable long-term capital gains rate, permanent.

In addition, ATRA extends a number of other rules through 2013 that were due to lapse at the end of 2012. The most notable of these include:

- **IRA Charitable Exclusion** — Distributions from an IRA made to a qualified charity, up to a maximum of $100k, are excluded from income.
- **Various Business Provisions** — This includes the Work Opportunity Tax Credit, the increased Section 179 expense deductions for small businesses, and the 50% bonus depreciation for larger businesses.
- **AMT Relief** – Higher AMT exemptions for 2013 and, importantly, the AMT exemption amounts will be indexed for inflation in the future.

Finally, the new law offers an entirely new rule under the legislation:

- **New Roth Conversion Flexibility** – Individuals can now convert their existing 401(k) plan to a Roth 401(k) plan if their employer offers designated Roth accounts under the plan, regardless of whether the individual is allowed to take a distribution of the plan.

In addition to all of the above, 2013 is also the first year the new 3.8% Medicare surtax takes effect, which is levied on the lesser of net investment income or the excess of modified adjusted gross income (MAGI) above $200k for individuals, and $250k for marrieds filing jointly. There is also a second new Medicare surtax of 0.9%, which is owed on earned income exceeding $250k if filing jointly and $200k for individuals. Finally, the temporary cut in the payroll tax to 4.2% ended this year, with the rate moving back up to 6.2%.

The net impact of all of these tax changes for a married couple, filing jointly with two kids and various levels of income, is shown in Figure 4.

Figure 4. Impact of ATRA on Tax Owed by Families Filing Jointly with Two Children

	$250,000		$500,000		$750,000		$1,000,000	
	2012	2013	2012	2013	2012	2013	2012	2013
Income								
Salary	250,000	250,000	500,000	500,000	750,000	750,000	1,000,000	1,000,000
Interest / Cap Gains	35,000	35,000	35,000	35,000	35,000	35,000	35,000	35,000
Adjusted Gross Income	**285,000**	**285,000**	**535,000**	**535,000**	**785,000**	**785,000**	**1,035,000**	**1,035,000**
Itemized Deductions	90,200	90,200	105,875	105,875	122,695	122,695	139,445	139,445
Phase-out (Pease)				(7,050)		(14,550)		(22,050)
Allowable Itemized Deductions	**90,200**	**90,200**	**105,875**	**98,825**	**122,695**	**108,145**	**139,445**	**117,395**
Personal Exemption	15,200	15,600	15,200	15,600	15,200	15,600	15,200	15,600
Limitations				(15,600)		(15,600)		(15,600)
Allowable Personal Exemptions	**15,200**	**15,600**	**15,200**	**-**	**15,200**	**-**	**15,200**	**-**
Taxable Income	**179,600**	**179,200**	**413,925**	**436,175**	**647,105**	**676,855**	**880,355**	**917,605**
Federal Income Tax								
Ordinary Income	33,867	33,442	108,763	115,757	190,376	209,741	272,014	305,078
Dividend and Cap Gain	2,250	2,250	2,250	2,250	2,250	3,000	2,250	3,000
AMT	10,008	9,647	20,737	13,653	9,124			
0.9% Medicare surtax				2,250		4,500		6,750
3.8% Medicare surtax		1,259		1,258		1,259		1,260
Total Federal Income Tax	**46,125**	**46,598**	**131,750**	**135,168**	**201,750**	**218,500**	**274,264**	**316,088**
Total Social Security Wage Tax	4,624	7,049	4,624	7,049	4,624	7,049	4,624	7,049
Difference in Total Tax		**$ 2,898**		**$ 5,843**		**$ 19,175**		**$ 44,249**

Source: Artemis Financial Advisors

One thing to note from the table is that the phaseout of itemized deductions is based on income, not on the amount of deductions. Thus, the presence of itemized deductions does not make it less valuable to engage in strategies like charitable giving. Using the $500,000-income couple in Figure 4 with $105,875 in itemized deductions, the phaseout is $7,050, and the net deductions are $98,825. If charitable contributions or any other deduction are added, the tax benefit of that charitable deduction is unaffected by the already-phased out $7,050 of deductions. The charitable contribution still produces tax savings at the marginal tax rate. Thus, the phaseout of itemized deductions should be viewed as an increase in the marginal tax rate that applies to additional income, not as a reason to avoid or reduce deductions.

Another thing to note is that the AMT fix ends up being one of the most significant tax planning changes under ATRA (and overlooked by me when I did some early calculations for clients just following the change in the law). For example, if we look again at the $500,000-

income couple, we see that their 2013 AMT tax due has actually declined by $7,084 versus 2012, offsetting more than 50% of the combined impact of the other tax increases.

Tax Planning Opportunities – Reducing Taxable Income

What are the tax planning implications? The primary impact of the new rules in the aggregate is that our income tax system is now more progressive, which at the margin makes tax-deferral strategies more appealing as income rises. One option is to explore the use of tax-deferred annuities, of which there are now several low-cost options available on the market. This strategy is especially useful for workers who have already maxed-out on the deferral possibilities offered by their employers but who have additional savings to invest. Similarly, it also makes sense now to look anew at any deferred compensation plans offered by one's employer.

Another approach to reducing taxable income involves the increased use of municipal bonds in lieu of investments with taxable earnings. Notably, the tax-free nature of municipals was left unchanged in the new law, and so municipal bond earnings remain excluded from any income calculation, including the calculation of net investment income (important for the new 3.8% Medicare tax). Net investment income also does not include withdrawals from a retirement plan, such as a traditional IRA, Roth IRA or 401(k), or payouts from traditional defined pension plans or annuities that are part of retirement plans.

Tax-Location Strategies

The new tax law also makes so-called "tax location" strategies more valuable. These strategies exploit the different tax treatment investments receive in the various types of tax-preferenced accounts. (To review, in 401(k)s and IRAs, all tax is deferred until withdrawal and then taxed at ordinary income rates, but in Roth accounts the income tax is paid at the time the money is deposited and all future earnings are tax free.) Recent research has shown effective asset location decisions can add 0.2-0.5% to annual returns without changing the underlying investments.[1]

But it's important to remember that good asset location decisions actually should be influenced by both the tax efficiency of investments and also their expected returns. Thus, the first best candidate for placing into a tax-preferenced account is an investment that has

[1] Blanchett, David and Paul Kaplan. "Alpha, Beta, and Now…Gamma." Morningstar White Paper, August 28, 2013

high expected returns that are taxed at ordinary rates (e.g., real estate investment trusts come to mind) or a high-turnover equity fund (e.g., many hedge funds). Another candidate is international equity funds because dividend-paying foreign stocks are not eligible for qualified dividend treatment. What does not come to mind are most core bond holdings – in today's environment with yields so low, tax-deferring something that doesn't earn much to begin with is not really worth much.

Tax Gains and Tax Loss Harvesting

ATRA made permanent the 0% capital gains tax rate for taxpayers in the 10%-15% income tax brackets. So the cutoff for having to pay any capital gains begins at the 25% income bracket, which for 2013 starts at $72,501 for married couples filing jointly and at $36,251 for singles. As usual, we plan to harvest gains for all those clients who qualify.

Similarly, as in prior years, we will also be on the lookout for tax-loss harvesting opportunities as they arise. This year and going forward, taking losses to offset gains can also reduce the tax bite of the 3.8% Medicare surtax.

Business Tax Planning

There are several strategies for businesses owners. In some cases, acting soon is important because the tax breaks expire at the end of the year. One is the 50% bonus depreciation – firms using this break can write off one-half of the cost of new assets with useful lives of 20 years or less. Leasehold improvements made to the interiors of commercial realty are eligible, too. With the gridlock in Congress, this break may not be revived for 2014, so put assets in use by December 31.

The bonus depreciation comes on top of the right to expense up to $500,000 of equipment put in use during the year. The $500,000 limitation phases out dollar-for-dollar once more than $2.0 million of assets are placed in service during the tax year. Unless Congress acts, the limit for next year will decrease to around $145,000, and the phaseout will start around $580,000.

Finally, C-corp owners can consider taking dividends in lieu of salary. This can be beneficial if the corporation is in a low tax bracket and the owner is in a higher bracket. The owner's tax savings due to the special tax rates on dividends, plus the payroll tax savings on the dividend, can exceed the extra tax the corporation pays because the dividend isn't deductible. Note that this strategy won't work for S Corporations or for personal service firms.

Roth Opportunities

Don't forget the intra-plan Roth conversion opportunity. This new provision likely makes sense for those who think their tax rate is anticipated to be higher in the future than it is now (young professionals come to mind).

One of my favorite Roth strategies is relevant for those who are retiring prior to age 70 ½, when distributions from IRAs become obligatory, and who do not need to start taking Social Security until age 70 (which in and of itself is often the most generous option). During these pre-Social Security years, reportable income and, therefore, one's tax bracket may actually be very low if already-taxed savings, such as Roth withdrawals, are used to finance current spending. Engineering a very low tax bracket in the future is a great reason to convert some IRA savings to a Roth today.

Other Ideas

This may be the last year clients age 70 1/2 or older can make tax-free qualified charitable distribution. This provision allows taxpayers to give up to $100,000 directly to charity from their individual retirement account without having to count the distribution as income.

Let's Talk Taxes

In summary, folks who think they may be near one of the income thresholds mentioned above this year, or who know their income is going to be a lot less or more next year have the most to gain from sound tax planning. We will be reaching out to all clients in the next month or so as we see opportunities applicable to their circumstances.