DICKINSON Investment Advisors

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Is The Barely-Believed Bull Market Sustainable?

The old adage tells us stocks historically climb a wall of worry. And, with the Standard & Poor's 500 Index racking up a 16% total return in the first 9½ months of the year, the cliché would seem to apply.

To be sure, there is no shortage of bad news. We've experienced the slowest economic recovery of the post-World War II era. With unpleasant memories of 2008 to 2010 — the worst recession since The Great Depression — still fresh in mind, unemployment remains stubbornly high. Fears about Europe's recession worsening and the Eurozone crumbling persist. The prospect of another Mideast war looms large amid increased political instability in the region.

Yet, through all of it, stock prices have risen. Who could have predicted it? Chalk up another one for long-term strategic asset allocation. Modern Portfolio Theory has worked. However, amid the strong stock gains, it's wise to remember that nothing goes straight up. Nonetheless, the barely believed bull market continues to be accompanied by generally encouraging economic releases.

Earnings. The consensus forecasts for earnings on the S&P 500 have remained strong. In September 2012, Wall Street analysts expected stocks in the S&P 500 index to earn $103 a share for 2012, and stocks traded at a 13.9 price-to-earnings (p/e) multiple, meaning investors were paying $13.90 for every $1 of earnings. In mid-September, however, speculation grew that corporate profits might falter. An earnings slowdown could dampen enthusiasm for stocks quickly. If companies deliver profits in line with expectations, however, it would make sense for stock prices to continue along the same rising trajectory as earnings.

Valuations. At 14, the p/e multiple on stocks in mid-September was, by no means, high by historical standards. When the bull market became grossly overvalued in 2000, stock prices traded at a p/e of 30.

World Growth. While Europe is expected to end the year showing negative growth, it recently was expected to grow modestly in 2013. The U.S., the world's largest economy, is expected to grow 2% in 2012 and slightly more in 2013. Meanwhile, China, the planet's second-largest economy, has slowed but still expected to grow at nearly an 8% pace for 2012 and slightly more in 2013.

Pleasant Surprises. The Citigroup U.S. Economic Surprise Index turned positive in early September 2012. The

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Standard & Poor's 500 Index Has Climbed A Wall Of Worry

Source: Standard & Poor's. Data through September 7, 2012.

The People We Help

People from all walks of life engage Dickinson Advisors for help with managing their investments, but many of them share some common traits. Perhaps the most common reason for hiring our firm: fear of running out of money in your senior years. Individuals look to us for an investment plan that is diversified, conservative, and inflation-protected.

Beyond seeking to make their investment income last a lifetime, many of our clients are:

- Former employees of large corporations— in particular, Union Pacific. I have specialized knowledge and family connections with U.P.
- Widows seeking an advisor they can trust.
- Referred by attorneys after receiving legal settlements or inheritances.
- Farm owners and business owners transitioning into retirement.
- People who need to coordinate investing, financial planning and tax strategies. As a CPA and a CFP® professional, I provide this integration of services.
- Individuals seeking a faith-based advisor.

We realize that your nest egg at retirement is irreplaceable and that you are entrusting your full confidence in our abilities. We take this responsibility very seriously, and I want to thank you for your trust and confidence.

Ron Dickinson

Start Harvesting Gains In 2012

If you're in the same tax boat as most other investors, you should start thinking about harvesting capital gains from securities sales in 2012.

That's right—harvesting gains, not losses. The normal advice is to look for valuable tax losses, especially at the end of the year, that you can use to offset capital gains as well as up to $3,000 of ordinary income. (You can carry over excess losses to the following year.)

But this year is different. The current maximum tax rate of 15% on long-term capital gains—realized on the sale of securities you've held longer than a year—is scheduled to increase to 20% in 2013. Furthermore, the tax rate for short-term gains (from the sale of assets held one year or less) will also rise, especially for high-income investors. Short-term gains are taxed at ordinary income rates that currently reach no higher than 35%. Beginning in 2013, however, the top rate for ordinary income is set to rise to 39.6%. Next year you may also be subject to a 3.8% Medicare surtax that will apply to net investment income if you exceed a specified threshold.

Congress could still act to preserve some or all of the lower tax rates, but even if that happens, it probably won't be until after the November elections. Therefore, the optimal approach, at least for now, is to focus on the current tax benefits of selling stocks that have appreciated significantly during the time you've owned them. If you believe those shares are likely to continue to increase in value, it probably makes sense to hold on to them and not to worry about future tax consequences. But if the outlook for future gains is uncertain, you might want to take advantage of today's favorable tax treatment of long-term capital gains.

Let's suppose, hypothetically, that you're holding a stock position you bought 10 years ago for $10,000 that is now worth $25,000. If you sell the stock in 2012 and have no other capital gains or losses during the year, you'll pay tax of $2,250 (15% of your $15,000 profit). But if you wait until next year to sell at the same $25,000 price, you'll owe tax of $3,000 (20% of the $15,000 profit). That's an extra $750 in tax you could avoid.

Tax planning that involves investing decisions can quickly become complicated, and it's always important not to let the "tax tail wag the investment dog"—that is, to put tax considerations before sound investment strategies. That's why this year, in particular, it's wise to start considering the possibilities long before year-end deadlines and to consult with your tax and investment advisors. We can help you stay on top of possible changes to the tax laws and work with you to make choices that are right for your situation. ●

Don't Forget The 'Other' Surtax

In the wake of the Supreme Court ruling upholding the constitutionality of the 2010 health-care law, much of the focus has shifted to the 3.8% Medicare surtax that will apply to some high-income investors beginning in 2013. And this is with good reason. Those who are in the top 39.6% tax bracket then may pay an effective federal rate of as much as 43.4% on a portion of their investment income. Add in state taxes, and the new levy could be truly painful.

Yet there's another new Medicare surtax that hasn't received much attention. Beginning in 2013, you will have to pay an extra 0.9% tax on "earned income" which exceeds an annual threshold—$200,000 for single filers and $250,000 for joint filers. It's a relatively straightforward calculation—unlike the larger new surtax, which depends on how much income you receive from your investments as well as your overall earnings.

And while this additional new tax may seem small, it comes on top of the 3.8% Medicare surtax, plus your regular federal and state income tax liability. What's more, if your income is high enough, you might owe this tax year in and year out. It really can add up.

Take the example of a single filer who earns $500,000 a year. Starting in 2013, this person will have to pay an extra 0.9% surtax on the $300,000 that exceeds the $200,000 threshold, or $2,700 (0.9% of $300,000). Now assume that the figures stay the same for the next 10 years. As a result, this taxpayer will have to fork over a total of $27,000 (10 years x $2,700).

For the purpose of calculating the surtax, you can rely on the usual IRS definition of "earned income," which includes the following:

- Wages, salaries, tips, and other taxable employee earnings,

Stock Valuations By Historical Standards

The stock market is fickle and unpredictable, but it's not overvalued.

In fact, if the companies in the Standard & Poor's 500 Index deliver 2012 earnings at or near the consensus level expected by Wall Street analysts, stocks would be poised for gains. In addition, if earnings falter, stock prices may drop, but the low valuation level as measured by historical standards, would seem to be working in favor of investors.

What's A Stock Worth? Earnings are the ultimate determinant of stock prices, and the price/earnings (p/e) ratio on stocks is the key metric. The p/e ratio on U.S. companies in the Standard & Poor's 500 Index in mid-September, after a strong summer rally, was 14; investors were willing to pay $14 for every dollar earned by U.S. companies in the S&P 500 over the previous 12 months. The S&P 500 is a broad barometer of the value of large U.S. companies,

* Estimated 2012 and 2013 bottom-up S&P 500 earnings per share (left axis), as of August 31, 2012, for 2012 is $103.32 and for 2013 is $115.40.

Sources: Yardeni Research, Inc. and Thomson Financial survey of consensus estimates; Standard & Poor's for index price data through September 6, 2012; and actual earnings data through June 30, 2012.

Historical Comparison. At 14, the p/e ratio was less than half its level at the top of the technology stock bubble of 2000. In that speculative period, according to analysis by Fritz Meyer Economic Research, an independent consultant to institutional investors, the S&P 500 traded at a p/e multiple as high as 30 — and the usually-tight correlation between stock prices and earnings broke down. The accompanying graphic shows a significant gap opening up and separating the price of S&P 500 stocks from the underlying earnings.

Global Slowdown. Stocks, during the first eight-and-a-half months of 2012, turned in an impressive 16% total return, but a slowdown of economic growth globally could end the rally. As companies were poised to report third-quarter earnings, fears of disappointing profits grew. A global economic slowdown could quickly cause a big drop in stock prices. What's the chance of that? While you can't expect past performance to repeat itself, using history as a guide is helpful when trying to see into the future. So let's look at the last few market pullbacks.

Nothing Goes Straight Up. From its Global-Financial-Crisis low of 683 in early March 2009, the S&P 500 Index climbed to 1464 in mid-September 2012 — more than doubling in value over 30 months. But stock prices did not go straight up in this period. After hitting 1217, in April 2010, the index plunged 16% over 10 weeks to 1022, only to recover over the next year to 1363, before pausing to drop 10% early this summer and then shooting to the 1460s. Keep in mind, the strong ascendance in stock prices still has not surpassed October 2007 pre-Crisis all-time high on the S&P 500 of 1561.

Inflation Supportive. The amount that investors are willing to pay for a dollar of corporate profits —stock valuations — depends on a range of factors, and one key factor is inflation. According to Meyer, in periods of unusually high inflation, such as in 1980 when the inflation rate soared to a 14% annual rate, the p/e ratio on stocks shrunk and stocks were valued at just eight times their trailing 12-month earnings. However, in times of moderate inflation, investors historically have valued stocks at between 15 and 20 times earnings. "Considering that inflation is currently running at a low rate of 2% annually," says Meyer, "a p/e multiple of 14 was below the historical range and that's very encouraging."

Analyst Revisionism. According to Meyer, it's not uncommon for analysts to ratchet down earnings toward the end of the year. "It's a very typical pattern for Wall Street analysts to start out the year overly exuberant and then shave their earnings estimates toward the end of the year," says Meyer. "What's significant is that 2012 and 2013 earnings estimates by Wall Street analysts have been holding up remarkably well."

Multiple Expansion. While the potential risks of investing in stocks are real, so, too, are the possible rewards. Earlier this year, the consensus earnings forecast of Wall Street analysts called for the companies in the S&P 500 Index to earn $103.32 per share for 2012. "If 2012 earnings are indeed delivered at a level close to where they were forecast to come in at," Meyer says, "then stock valuations would be very reasonable, and multiple expansion could boost stock prices." ●

- Union strike benefits,
- Long-term disability benefits received prior to minimum retirement age,
- Net earnings from self-employment if you own or operate a business or if you're a minister or member of a religious order,
- Gross income received as a statutory employee.
- On the other hand, the IRS says the following items are not included under its definition of earned income:
- Pay received for work while an inmate in a penal institution,
- Interest and dividends,
- Retirement income,
- Social Security benefits,
- Unemployment benefits,
- Alimony,
- Child support.

Finally, business owners don't have to fret about doubling up on the surtax. The 0.9% levy applies only to employees who exceed the income threshold, not to the business entity that provides their salaries. At least that's a small consolation if you're stuck with this extra tax liability. ●

Getting In On The "Ground Floor"

Suppose you want to diversify your holdings by investing in real estate. Or maybe you believe that the real estate market, in the doldrums for years, is ready to bounce back. Even with depressed prices throughout most of the country, you'll still have to pay a pretty penny to acquire a building or a parcel of land in a prime location.

But you don't necessarily have to go whole hog. Instead of buying a property outright, you might acquire shares in a real estate investment trust (REIT). It's akin to buying shares of a mutual fund, so this type of investment hedge doesn't have to cost you a small fortune.

Although past performance is no guarantee of future results, REITs did outperform a couple of notable benchmarks last year. According to the National Association of Real Estate Investment Trusts (NAREIT), the yield on the average REIT in 2011 was 4.34%, compared to an average dividend yield of 2.1% for the Standard & Poor 500 stock index and an average yield of 1.87% for 10-year Treasury notes.

A REIT is a corporate entity that invests in real estate properties in much the way a mutual fund invests in stocks. Professional managers handle the portfolio, and if the REIT meets certain requirements, it gets favorable tax treatment. Due to income and tax reporting rules for REITs, such investments are often held in retirement accounts.

There are three basic types of REITs:

1. Equity REITs. These are by far the most common type. An equity REIT holds physical real estate properties—typically, shopping malls, hotels, hospitals, offices, or timberland—that generate rental income. Some equity REITs focus on properties in a particular geographic area. A REIT's properties usually are purchased to be part of a portfolio of investments instead of being developed for resale.

2. Mortgage REITs. A mortgage REIT originates and buys or sells mortgages for property owners. The loans are secured by real estate, mortgage-backed securities, or existing mortgages. Essentially, this type of REIT is a finance company. The main revenue source is interest from the mortgages.

3. Hybrid REITs. These combine elements of equity and mortgage REITS, including direct property ownership and mortgage lending. They earn both rental and interest income, and can provide diversification within a single investment.

A REIT doesn't have to pay corporate income tax if it distributes at least 95% of its net annual earnings as dividends. And though REIT income generally doesn't qualify for the favorable 15% maximum tax rate that applies to "qualified" dividends in 2012, beginning in 2013 all dividends (including REIT dividends) are scheduled to be taxed as ordinary income. Barring a last-minute legislative change, REITs then will be on a level playing field with stocks that pay dividends.

Are REITS the right investment for you? We can analyze your situation. Give us a call. ●

Barely-Believed Bull Market

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index quantifies the volume of economic surprises. Before every major economic data release, Bloomberg, a news service, polls economists' expectations. The index compares consensus forecasts gathered by Bloomberg to actual releases on unemployment, gross domestic product, and other economic data. The positive turn of this index was itself a pleasant surprise.

Service Sector. While the media often pays attention to manufacturing growth, manufacturing activity accounts for just 29% of the output of the U.S. economy. In contrast, services account for 64% of U.S. economic output. Most recent figures from the Industry for Supply Chain Management showed surprising strength in non-manufacturing services. According to Fritz Meyer Economic Research, an independent consultant, two forward-looking sub-indexes in the services sector — new orders and employment — both showed encouraging growth.

Conclusion. The direction of the economy will become clearer after the presidential election, but the many positives could continue to surprise investors. Asset allocation, broad diversification, and avoiding big bets on a market or specific security have worked. But the strong returns of recent months may make it more likely that an investor's ability to control emotional reactions to volatility could be tested in the months ahead. Some parting observations:

- The U.S. remains the world's most stable and liquid economy.
- It's unlikely that the recovery from The Great Recession of 2008 to 2010 will strengthen soon.
- Bonds offer the lowest yields in decades.
- Federal Reserve Board Chairman Ben Bernanke has indicated he will keep interest rates low until the jobs picture improves.
- The Fed now regards the threat of inflation secondarily to job-creation.
- Positive surprises in U.S. economic data are a reassuring reminder of the resilience of the U.S. economy.

In a period when the Iranian nuclear threat, U.S. presidential election, and unity of the Euro alliance are on the cusp, investors are on edge. But the first nine months of 2012 was an opportunity to capitalize on progress in an era of pessimism. ●

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