

SHARPER ♦ GRANITE



Optimal Portfolio Management

Two years ago in our *Winter 2008* letter we wrote encouragingly in our research article, “Positive Returns Will Spring from Fear Factors.” At that time we expressed a bullish outlook for all asset classes except Treasuries.

Since that article the S&P 500 Index has returned 46%, and the S&P 600 Index (small stocks) is within 10% of its all-time high. Those who did not panic during the downturn and who bet against the “Armageddon Scenario” were rewarded. We are now nearly through the economic recovery stage and entering the expansion phase.

Given the challenges of depressed residential real estate, European debt, and global budget deficits, can the U.S. stock market move higher still? We believe so, at least for a while. Record corporate earnings, stimulative Fed policy, and low inflation are a recipe for stock market gains.

We mentioned last quarter that a resolution of U.S. tax rules and rates could provide a market catalyst. In fact, the Tax Relief Act of 2010 resolved the uncertainty with lower overall taxes than expected. With tax rules finally in place for 2011 and 2012, corporations and households may now move forward. Companies may complete their 2-year projections, finalize IT budgets and start hiring. Families now know what their 2011 take-home pay will be and can confirm a vacation or home remodel. Managers of trusts and endowments now have rules under which to optimize their investment plans.

This quarter we summarize the new tax rates, reviewing key strategies that affect many of our clients. With the rules finally set, now is a great time to review tax strategy with your tax professional and financial advisor.

WINTER
2010

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Financial Markets Summary

The S&P 500 Index (with dividends added) ended the fourth quarter up 10.8%, and completed the year up 15.1%.¹ Leading sectors for 2010 were real estate, U.S. small-cap stocks, and China, all of which returned over 23%.¹ The Dow (with dividends) increased 11.1% for the year.¹

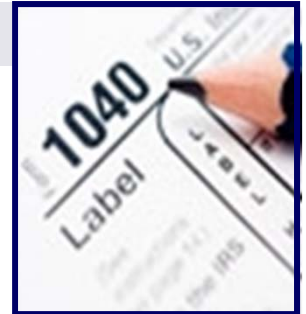


The Dow hit its 2010 peak on December 29th, right at year-end, similar to the way it did in 2009. Strange coincidence? Not at all. Sharper ♦ Granite research notes an incredible “Year-end Effect.” It is far more substantial than the frequently-mentioned “Santa Claus Rally.” Since 1928 the Dow has hit its high for the year between December 27 – 31 an astonishing 22% of the time.²

Bonds also performed well in 2010 though their incredible streak of six consecutive quarterly gains finally came to an end in 4Q10. The Barclays Capital U.S. Aggregate Bond Index, which Sharper ♦ Granite uses as a high-quality bond benchmark, returned -1.3% for the quarter, but gained 6.5% for the year.¹ In recent months, belief in a stronger economy

and higher future inflation sent long-term bond rates higher and bond values lower. Municipal bonds were hit especially hard as the benefit of their tax-free status was diminished with the surprise income tax-cut extension through 2012 and the uncertain state of the Build America Bonds program.

Tax Uncertainty Resolved: New Rates and Appropriate Strategies



A recent Vanguard study showed that of all the expenses investors pay, taxes take the biggest bite out of returns.³ In December, the Tax Relief Act of 2010 extended the Bush tax cuts through 2012 and included some new cuts. The tax cut bill passed Congress relatively easily. Overwhelming votes in favor of the bill in both the House and Senate took place in the “Old Congress,” which was the most Democratic in decades. The new Congress, which takes office in January, is even more in favor of lower taxes and will want to extend them beyond 2012.

Looking out to 2013, if the current most-likely scenario plays out, the House would remain Republican in the 2012 election, with a likelihood of the Senate becoming Republican as well. According to Intrade, a 70% probability currently exists that both the Senate and House will be Republican in 2013.⁴ The Democrats and Obama are currently favored to win the 2012 presidential election. Thus, 2013 could produce the same divided government as in the Clinton years, which was good for both the economy and stock market.⁵

Before the November elections and the Tax Relief Act of 2010, most tax strategies sought to take advantage of the relatively low rates before the assumed increased in 2011. Now we have those favorable rates extended for two more years, giving clarity in the near-term, but also setting up the same debate two years from now, during the next presidential election. Given this situation, we would like to share our portfolio tax strategies for the next two years.

While principles of asset allocation and diversification endure, asset *location* becomes even more important due to the tax rate differences across asset classes.

We encourage clients to maintain IRA accounts for retirement strategies and 529 plans for college strategies in addition to their taxable accounts. With this flexibility in account type, your advisor can locate the heavily-taxed assets in the tax-protected IRAs and 529 plans while placing the tax-advantaged assets in the taxable accounts.

2011 & 2012 Tax Rates - Tax Relief Act of 2010 *

Taxable Income Thresholds		Income & Short-term Cap Gains Tax Rate	Long-term Cap Gains Tax Rate	Dividend Tax Rate
Single	Married			
<\$8,500	<\$17,000	10%	0%	0%
<\$34,500	<\$69,000	15%	0%	0%
<\$83,600	<\$139,350	25%	15%	15%
<\$174,400	<\$212,300	28%	15%	15%
<\$379,150	<\$379,150	33%	15%	15%
>\$379,150	>\$379,150	35%	15%	15%
Estate Value		Estate Tax Rate		
Single	Married			
<\$5,000,000	<\$10,000,000	0%		
>\$5,000,000	>\$10,000,000	35%		

* Taxable Income threshold values are for 2011 and will be updated for 2012 by the Internal Revenue Service

Income Tax

Current U.S. income tax structure is quite low by historical standards. While the political shifting gives income tax rates a chance of remaining low beyond 2012, investors should assume that they will be similar or higher, but not any lower.

Roth Conversions will continue to be attractive over the next two years, especially for those experiencing lower-than-normal income years. The uncertainty of future income tax rates makes a strategy of “tax rate diversification” worth considering. Specifically, some investors are converting part of their IRAs to a Roth IRAs across 2010 - 2012 in order to pay some of their IRA taxes in the near term while income tax rates are low.

Capital Gains Tax

The 46% climb in the stock market over the last two years has generated significant capital gains in many accounts, making cap-gains tax management critical. The tax advantage of long-term gains over short-term gains remains substantial for now, especially for those in the higher tax brackets.

When executing rebalancing trades, Sharper ♦ Granite minimizes short-term gains in client accounts using proprietary RiskPoint rebalancing software which favors long-term over short-term gains. We also encourage clients to consider the high tax penalty of short-term gains when making withdrawals within one year of investment.

Dividends Tax

The huge advantage of receiving income from qualified dividends rather than from interest remains for now. Cash flow from most stock dividends is taxed at no more than 15%, whereas interest from savings, money markets, and most bonds can be taxed as high as 35% federal and 9.55% CA state.

Therefore, we continue to favor dividend-paying stocks and preferreds over bonds to generate much of the total return in Sharper ♦ Granite portfolios, especially for those in the higher tax brackets. The dual prospect of rising interest rates and high taxation of bond income makes bonds, especially bond *funds*, unattractive over the next two years. This perspective could change in late 2012 as the dividends tax rate could be the most vulnerable to an increase in 2013.

Estate Tax

While the dividends tax rate could be the most vulnerable, the estate tax exclusion is probably the safest. Set at \$5,000,000 per person and \$10,000,000 for couples in 2011 and 2012, the estate tax exclusion has generally been increasing over past years with little political momentum toward lowering it.

Estate planning, however, is still complex. Tax attorneys are currently parsing the details of the recent estate tax changes to determine optimal strategies and discover possible traps.

A-B trusts are no longer necessary since the exclusion is now “portable” so that if one spouse dies and does not use the entire \$5 million exclusion, the surviving spouse can combine the remainder with their own \$5 million exclusion without the need for an A-B trust. However, those already holding A-B trusts with one spouse deceased may be trapped into unnecessary capital gains taxes if action is not taken.⁶ We encourage all clients to work with their Sharper ♦ Granite advisor, estate tax attorney, and tax accountant to keep estate plans optimized based on the recent estate law changes.

Gift Tax

The gift tax will “reunify” with the estate tax for 2011 and 2012. That is, the lifetime gift exclusion climbs from \$1 million to \$5 million (\$10 million for couples), and a maximum tax rate of 35% for assets above that exclusion. \$13,000 per year per person may still be gifted without diminishing this lifetime gift exclusion.

Fourth Quarter 2010 Economy Review

History shows that the best stock market returns come during periods of slow economic growth, low inflation, and declining interest rates. The Leading Economic Indicator Summary below indicates we have these three conditions, a so-called “Goldilocks” scenario, along with several other positive indicators. The Fed’s Beige Book confirmed the economic momentum, indicating that ten of the twelve Federal Reserve districts improved their economic activity last quarter.⁷



Leading Economic Indicator Summary

↑	Very Positive
↑	Positive
→	Neutral
↓	Negative
↓	Very Negative

↑ **Calendar Cycle:** The first quarter of each year tends to be strong, powered by January which has been the third strongest month for the S&P 500 since WWII.⁸

January is an especially good month for small caps and international stocks. Small caps have averaged a phenomenal 4.8% return in the month of January since 1925. In foreign countries January returns account for an astonishing 30% of the total annual return on average.⁸

↑ **Interest Rate Stimulus:** Interest rate direction is the most significant short-term influence on stock prices.⁸ Both long and short-term interest rates continue to sit at extremely low levels by historical standards. Low inflation will likely keep the Fed’s short-term rate target near zero for another six months. Low treasury yields are helpful to stocks in that they represent an unattractive alternative investment.

While the current U.S. budget deficit is hurtful to GDP (see our *Spring, 2010* article, “The Strength of the Recovery and Danger of High U.S. Debt”), zero correlation exists between a nation’s budget deficit as a percentage of GDP and the 10-year treasury rate.⁹ A study covering 1909 – 2009 found inflation expectations to be the strongest driver of long-term interest rates.⁹ Inflation expectations are currently tame (see page 5).

↑ **Political Cycle:** We are now in the third year of President Obama’s term, traditionally the strongest. Since 1948, the third year of the presidential cycle has seen the S&P 500 Index post an average gain of 23.4% (24.4% with Democrat presidents), far in excess of the other years of the cycle.⁸ Since 1960, every third year of a president’s term has been positive, and all but one year has had double-digit gains. Most of this gain comes in the first nine months of the year,¹⁰ and since WWII there has not been a negative six-month period following a mid-term election.¹¹

↑ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy, tallying all goods and services produced in the United States. 3Q10 GDP rose 2.6%, increasing for the 19th straight month.¹² This is solid GDP growth, near the “sweet spot” for stock market performance. Stocks perform best when GDP growth is in the modest 1% to 2% range.¹³ Higher growth rates coincide with lower stock market performance due to the high interest rates that accompany periods of hot growth. In those times high bond yields compete for investor money.

- ↑ **Employment Momentum:** Leading employment indicators continue to improve this quarter. Average hourly workweek increased at nearly the highest rate ever;¹⁴ non-farm payrolls increased more than expected, adding 103,000 new jobs in December;¹⁵ and jobless claims decreased.¹⁶

Charles Schwab's analysis of the last ten recessions since 1950 indicates that perhaps companies cut too many jobs during the last recession due to fears of a depression. Recessionary declines in non-farm payroll are closely correlated with GDP decline. Based on the GDP decline of our last recession, Schwab estimates that a normal payroll decline should have been 4.5%, when, in fact, we saw a 6.1% decline. That equates to 30% more job cuts than this particular recession warranted and implies that a hiring boom could come.¹⁷

- ↓ **Home Price Trends:** The S&P/Case-Shiller Index shows nearly flat prices in most metropolitan markets as the housing price rebound has stalled a bit. San Francisco continues to lead the recovery with eleven straight months of price gains (over the previous year) and a 6% price increase in September from a year earlier. The Los Angeles metropolitan area is also showing positive year-over-year price changes, with a 4% gain in September from a year earlier.¹⁸

- ↑ **Stock Market:** Of all economic forward-looking indicators, the stock market is one of the best. The S&P 500 Index has now gained 86% since its March 9, 2009 low point.¹⁹ The S&P 600 Index (small caps) is back to within 10% of its all-time high.¹

The stock market may benefit from a reversion to the mean vis-à-vis bonds. Since 1926 we have had 65 rolling 20-year periods. In only three of those 65 periods have bonds outperformed stocks. In the first two, stocks went on to trounce bonds over the next five years.²⁰ The third period recently occurred in the 20-year period ending 2009.

- ↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing metric, trended upward again this quarter, indicating economic expansion for the 16th consecutive month through November.²¹

- ↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The CPI and almost all future inflation indicators remain tame. As of December, the CPI was running at only 1.1% year-over-year. The more-important Core CPI, which excludes the volatile food and energy components, sat barely positive at 0.8%, well below the Fed's target level of 1% to 2%.²²

Looking out a decade, the best predictor of average inflation over the next ten years is the 10-year TIP-Treasury spread, the difference in yield between the 10-year Treasury and the 10-year Inflation-protected Treasury (TIP). This spread has recently risen to 2.4%, indicating that the market is assuming average annual inflation of 2.4% over the next ten years.^{23, 24}

- ➔ **Oil Price Control:** Oil prices gained 12% this quarter reflecting prospects for a hotter global economy. Oil prices ended the year nearly flat.¹ Flat to lower oil prices combined with a higher stock market is an indicator of controlled economic strengthening. We continue to watch the price of oil carefully and consider it one the most significant threats to the recovery.

- ↑ **Consumer Spending:** The October and November retail sales reports, led by auto sales, were the strongest of all 4Q10 economic data.^{5, 25} Holiday shopping analysis from MasterCard indicated that 2010 saw the strongest retail shopping season ever, exceeding even the most optimistic forecasts.²⁶ Meanwhile, the Conference Board's Consumer Confidence Index surged in October and followed that breakout with more gains in November.²⁷

- **Business Capital Spending:** Manufacturing sector expansion improved through December, suggesting future growth after stalling badly a quarter ago.²⁸ However, the Aruoba-Diebold-Scotti (ADS) Business Conditions Index, designed to track real business conditions at high frequency, contracted for the second straight quarter.²⁹
- ⬆ **Corporate Earnings:** U.S. corporate profits launched to an all-time high of over \$1.6 trillion in 2Q10. Profit margins, which tend to have more influence over earnings per share than changes in revenue growth, jumped from 6.3% in 2009 to 8.6% in 2010 and are projected to hit an all-time high of 9.4% in 2011.³⁰
- ⬇ **Investor Sentiment:** Investor confidence soared in 4Q10 according to both Investors Intelligence and the American Association of Individual Investors.^{31, 32} This is a bearish sign for stocks as it indicates that much of investors' cash has already been pushed into the market.
- ⬇ **Insider Trading:** Insider buying lost momentum and leveled off this quarter. The 30-day moving average remained near the key \$10 million/day level but was unimpressive.³³ This indicates that corporate executives were not overly bullish about their companies' prospects.
- ⬆ **Merger and Acquisition Activity:** M&A dollar volume dropped dramatically following the financial crisis but then rebounded in 2010. M&A volume totaled over \$700 billion in 3Q10, the busiest quarter in two years.³⁴

Notes and Acknowledgements:

1. 2010 Indexes used: S&P 500 Index, Dow Jones Industrial Average, S&P 600 Small Cap Index, Vanguard's REIT Index ETF (VNQ), BlackRock's Morgan Stanley's Hong Kong Index ETF (EWH), BlackRock's Goldman Sachs Oil Index ETF (OIL), iBoxx Liquid Investment Grade Bond Index.
2. Sharper ♦ Granite research and Dow Jones data
3. "Don't Let the Tax Sunset Leave your Portfolio in the Dark," The Vanguard Group, August, 2010
4. Intrade.com, December 20, 2010
5. Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University, December 20, 2010
6. "Personal Planning Strategies," Proskaur Rose, LLP, December 2010
7. Federal Reserve and TD Economics, December 1, 2010
8. *Stocks for the Long Run*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University
9. Sharper ♦ Granite Research. Data sourced from U.S. Bureau of Labor Statistics, January 1, 1946 to December 1, 2010
10. Ned Davis Research, data from December 31, 1929 to December 31, 2009
11. "Get It Right", Ken Fisher, *Investment Advisor*, June, 2010
12. U.S. Commerce Department, December 22, 2010
13. From 1946 - 2010, ten calendar years have occurred with inflation between 1% and 3% and GDP between 2% and 3%. Average S&P 500 total return in those ten years was 13.3%. Bloomberg, Bureau of Economic Analysis, Charles Schwab, and The Leuthold Group.
14. Schwab Center for Financial Research, FactSet, and the Department of Labor, October 10, 2010
15. U.S. Department of Labor, November 5, 2010 and January 7, 2010
16. U.S. Department of Labor, the 4-week first-time unemployment claims moving average declined to 422,750 as of December 25, 2010
17. Schwab Center for Financial Research interpreting regression analysis of data from 1950 – 2010 from the Bureau of Economic Analysis, FactSet, and the Department of Labor, December, 2010
18. Standard & Poor's/Case-Shiller Index of Home Prices through September, 2010
19. S&P 500 Index closed at 676.53 on March 9, 2009, and 1257.64 on December 31, 2010, a 86% change
20. The Leuthold Group and Charles Schwab, December, 2010
21. Institute of Supply Management, November 10, 2010
22. U.S. Department of Labor, December 15, 2010
23. Bloomberg, December 22, 2010. Difference between 10-Yr Treasury = 3.36% and 10-Yr TIP = 0.99% is 2.37% implied average 10-Yr inflation rate
24. RiverFront trend chart shows implied inflation expectation rising in 4Q10, December 13, 2010
25. U.S. Commerce Department, *AdvisorOne*, November 15, 2010
26. MasterCard Advisors SpendingPulse and the *New York Times*, December 27, 2010
27. The Conference Board Consumer Confidence Index, November 30, 2010
28. Business Outlook Survey, Federal Reserve Bank of Philadelphia, August, 2010
29. The Aruoba-Diebold-Scotti Business Conditions Index, Federal Reserve Bank of Philadelphia, December 11, 2010
30. Federal Reserve Bank of St. Louis, reported in "Getting Winded in the Race for Profit Gains", *Wall Street Journal*, December 1, 2010
31. Investors Intelligence, December 22, 2010
32. American Association of Individual Investors, November 10, 2010
33. Insidercow, December 30, 2010
34. Dealogic, *Fortune*, November 1, 2010