MITCHELL MCLEOD PUGH & WILLIAMS
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The Art of Asset Location

Asset location is a part of the investing strategy that involves deciding which investments to hold in which accounts, and taxes play an important role in this decision. Here are a few basic guidelines.

Hold in Your Tax-Sheltered Accounts: Assets With High Tax Costs. In general, government or corporate bonds and bond funds may be a better fit for tax-sheltered accounts (like IRAs and 401(k)s) than for taxable accounts because their payouts are taxed at an investor's ordinary income tax rate. If you need to hold bonds in your taxable accounts, a municipal bond or municipal bond fund might offer you a better after-tax yield than a taxable bond investment, because income from munis is exempt of federal income taxes.

Hold in Your Taxable Accounts: Assets With Low Tax Costs. By contrast, stocks and stock funds may generally be a better bet for taxable accounts. Long-term capital gains, which is what you have when you sell a stock that you've held for at least a year, are taxed at a much lower rate than bond income (however, these favorable tax rates are set to expire at the end of 2012).

Stocks are not guaranteed and have been more volatile than the other asset classes. Dividends are not guaranteed. Bonds are subject to credit/default risk and interest-rate risk. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes apply to any capital gains distributions. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

Mitchell McLeod Pugh & Williams, Inc. - Adviser Corner

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Today we are less than a month away from the 2012 presidential election and less than three months from year end. At no time in recent memory has our country had so many important issues to be addressed before December 31st. The election outcome is currently too close to call, and the ultimate resolution to the so called "fiscal cliff" is unknown. For investment managers, the prudent course of action is to remain cautious of making any drastic tactical moves in the face of such uncertainty. The direction of capital markets based on upcoming events cannot be known. History does tell us, however, that individuals, corporations, and markets do not like uncertainty. Even if the ultimate resolution of these issues is viewed as a negative, the simple removal of the uncertainty could prove to be a significant and positive offsetting factor. Until then, we will move ahead with our normal year-end activities such as account reviews, gifting of appreciated securities to fund charitable contributions, and verification of RMDs for IRAs.

Monthly Market Commentary

Although several bellwether stocks, such as Intel, Texas Instruments, FedEx, Norfolk Southern, and Caterpillar announced earnings warnings, investors mostly shrugged-off weaker fundamentals and placed their hopes on growth through coordinated easing. Investors were not disappointed, as additional quantitative easing (QE3) was announced on September 13th. Riots in Spain caused markets to react negatively, durable goods orders took a dive because of airline orders, and income and consumption numbers were hit hard by a quick spike in inflation rates. However, year-over-year data for almost every report continued to look a lot better than the volatile month-to-month statistics.

GDP: Second quarter real GDP growth was unexpectedly revised downward in September to 1.3%, after initially being revised upward to 1.7% from 1.5% in August. Adjustments were across the board, which included a slowdown in personal consumption, inventory growth, and negative net exports.

Employment: The recent jobs report revealed a surprise drop in the unemployment rate to 7.8%, down from 8.1% in August. In September, 114,000 jobs were added, but more importantly, the job numbers were revised substantially higher for July (+40,000 jobs) and August (+46,000 jobs). These revisions are likely to produce meaningful increases in both personal income and consumption growth.

Housing: Housing data was mixed as house prices rose but pending home sales seemed lighter than expected. The Case-Shiller 20 City Index rose 1.2% sequentially and is now 7% to 8% above lows reached this spring. The relatively consistent improvement in prices over the past few months should help the appraisal process that has kept many pending homes that went under contract from actually closing. Consistent price increases, along with near-record low mortgage rates and skyrocketing rents, could push potential buyers off the fence.

Manufacturing: New orders for durable goods were down a whopping 13%. A major air industry show in July often causes a huge boom for airline orders in that month, followed by a collapse in August. If volatile categories such as airliner orders and other transportation equipment are ignored, new orders were down a modest 1.6% in August. Morningstar economists believe that while the export news looked particularly bleak, a combination of ramp-up in jetliner productions from Boeing and continued improvements in the auto industry (auto sales hit a new recovery high in September) should prevent a rout of the manufacturing industry in the U.S.

Quarter-end insights: The initial fears at the end of the second quarter that the U.S. would be pulled back into a recession because of slowdowns in Europe and China, has not come to pass. Markets were surprisingly strong in the third quarter, mainly from actions by central banks around the world that drove markets higher. Although the housing recovery has been improving for most of 2012, it has yet to have any significant impact on overall economic activity since residential housing only represents 2% to 3% of GDP. This excludes spending that typically follows home purchases, such as new furniture and landscaping. Morningstar sector analysts' quarter-end outlook highlighted lackluster fundamentals that showed no definitive signs of either a collapse or a boom. During the third quarter, cyclical and more economically sensitive stocks generally did well while more staid industries, such as utilities, generally underperformed the market. There is also concern of a stronger dollar undercutting sales growth with a general fear that the higher dollar may likely depress margins in the months ahead. High margins and conservative capital spending have resulted in higher levels of cash at major corporations, which is finding its way into the mergers and acquisitions space. Much of the merger and acquisition activity as well as general corporate growth stories continue to be built around emerging-markets growth, despite near-term pressures in some of those markets.

The Tax Man Cometh … Or Does He?

You've probably heard a lot about how the election will affect both the economy and your wallet. What you're probably asking is, "What does this mean for the dividend portion of my portfolio?" To take a step back, the appeal of dividends is not now, and has never been, purely a function of tax policy. Dividends work because they deliver what capital gains can't: consistent cash returns that are always and only positive. Cash flow that you can use to meet your personal investment objectives even if stock prices are down. And, compared with bonds, dividend-paying stocks offer a measure of protection from inflation and a good shot at lasting capital appreciation. This is not to say that taxes are irrelevant, but most of what you're hearing needs to be taken with a grain of salt.

Since 2003, dividends (as well as long-term capital gains) have been taxed at a maximum federal rate of 15%. If the President and Congress do nothing, then the top tax rate on long-term capital gains will revert to 19.8% on New Year's Day 2013, but the top tax rate for dividends will skyrocket to 39.6%. (And this doesn't include the additional 3.8% Medicare tax on investment income for high earners next year) But before you dump all your dividend-paying stocks in fear of a tax hike, consider the following:

1. Will dividend taxes actually go up? That outcome can't be ruled out, but it's worth remembering that in 2003, 2008, and again in 2010, a span encompassing three different congresses and two presidents of differing political affiliations, the current taxation of dividends has been affirmed. A comprehensive tax reform package might involve a more modest tax increase on upper-bracket earners, but neither Republicans nor Democrats actually want the country to roll off the "fiscal cliff".

2. Let's assume the worst: that the pre-2003 tax rules snap back into effect. What's changed? That depends on you. Most investors aren't in the top tax bracket so their tax rates might rise from 15% to 25% or 28%, but the implication that everyone's dividends will be taxed at 39.6%, is simply not true.

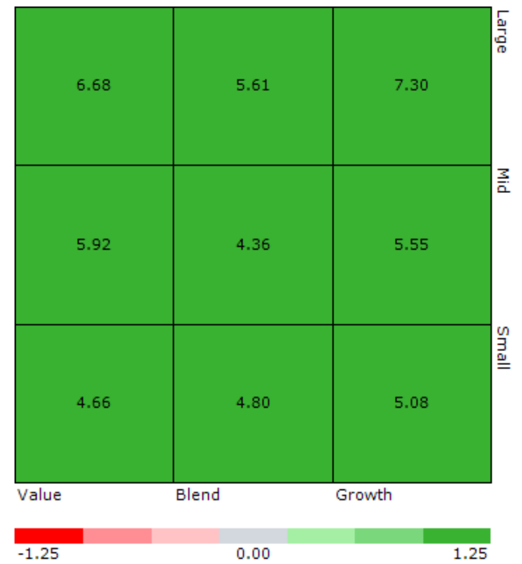
3. Two key groups of high-yielding equities, master limited partnerships (MLPs) and real estate investment trusts (REITs), were never eligible for the 15% federal tax rate in the first place, so the treatment of these income streams isn't at risk.

4. Many investors hold the bulk of their stocks (and receive the bulk of their dividends) in tax-deferred accounts like IRAs, Roth accounts and 401(k) plans. What's the impact of a dividend tax hike here? The answer is nothing as the investor only pays tax when money is withdrawn from the account.

5. Even if taxes on dividends go up, what's the alternative? Except for municipal bonds, the interest paid on fixed-income securities is already taxed as ordinary income. Bolting for the bond market would only reduce your tax bill because you would earn much smaller returns!

Past performance is no guarantee of future results. Returns and principal invested in stocks or REITs are not guaranteed. Dividends are not guaranteed. A REIT must distribute at least 90% of its taxable income to shareholders annually. REITs involve special risks such as management quality, corporate structure, the ability to increase revenues from rents, and the balance of the supply of new buildings with demand for space. Investments in securities of MLPs involve risks that differ from an investment in common stock, including limited control, cash flow and dilution risks. Funds in a traditional IRA grow tax -deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Authored by Josh Peters, CFA; Chief Equity-Income Strategist; Editor, Morningstar DividendInvestor.

Quarterly Market Barometer



3 Month, ending September 30, 2012. The U.S. Market returned 6.19% (YTD 16.12%).

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are "value" and "growth" while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.

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