MV Capital Management Midweek Market Commentary

Elections, Taxes and Investment Strategy

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With less than one month to go until Election Day the political narratives are in full swing. Dead-center in the crosshairs of the economic debate is the subject of taxes: what will happen to the Bush-era rates on income and capital gains, what about the payroll tax, Medicare contribution taxes and all the rest that no doubt have the CPAs and tax attorneys of the world busily at work helping their clients make sense of what might happen. The questions that tend to come our way, as investment advisors, is how changes in tax policy may impact investment portfolios and what action, if any, one should take.

Wagging the Dog

When it comes to decisions around taxes the fundamental tenet of our beliefs is this: taxes are the tail, investment policy is the dog. In other words, your investment policy should drive tax decisions; tax decisions, or reactions to changes in tax policies, should not drive investment policy. The tail should not wag the dog. If you have a taxable, non-qualified portfolio then when evaluating two alternative approaches, all else being equal it makes sense to opt for the one that is more tax-efficient. But first make sure that all else is equal. As in: ***if*** *both alternatives are equally prudent in view of my long-term return objectives, risk tolerance and other relevant considerations,* ***and*** *alternative A is more tax-efficient than alternative B,* ***then*** *alternative A is the right choice*. That's how to make investment decisions around taxes. Pay attention to those operands "if, and, then" – because they matter.

Uncertainties and Probabilities

Here's how not to make investment decisions around taxes: make decisions today, irrespective of whether they are in line with your investment policy, because of tax policy changes that *might* happen tomorrow. Right now there is a great amount of uncertainty. We don't know who is going to win the presidential election, who will be in control of the Senate or the House of Representatives, or what margin of control the majority parties have to work with, or any number of other variables that will influence how tax policies are fashioned. We don't know what dynamics will be at play as opposing sides try (or not) to reconcile their differences to avoid the "fiscal cliff". The possible outcome generating much of the debate among investors about what to do is the long term capital gains tax, which could go back up to 20% from the 15% level that was established as part of the Bush cuts in 2003.

In our opinion there is a logical way to address this question, which is simply this: If your investment policy doesn't contemplate any necessary asset sales that would trigger a long term capital gains tax event, don't create asset sale mandates just to "lock in" a 15% rate. However **if**, in the context of your overall asset planning and income generating plans over the next twelve months or so, you identify asset sales that are likely to take place, **and** you are relatively indifferent as to the timing now or one year from now, **then** perhaps it makes sense to think about selling when you are certain about what the capital gains rate is rather than when you don't know what it will be. That's prudent, and that is wholly in line with investment policy dictating tax actions – the dog wagging the tail, as it should be.

Election season brings out the snake-oil salesmen and Chicken Littles of the world, running around with hyperventilating headlines about how the sky is falling and you have to act now. Nonsense. Successful investors are the ones who ignore the breathless hype and stay disciplined and patient.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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