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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

All eight women swimmers who advanced to the 100 meter freestyle finals in Beijing would have contended for a gold medal in the ***men's*** event in the 1968 Olympics

American companies have bought back $209 billion in shares thus far in 2008 .That figure is 45% less than last year.

Capital Gains Taxes

Both major presidential candidates have articulated their differences on income tax policy. Their views on capital gains taxes contrast a great deal. Barack Obama would prefer to see the capital gains tax increased while John McCain wants to keep the rate where it is. This article will examine the capital gains tax and the role in plays in investment portfolios

Survey of Capital Gains Taxation

Taxes on capital gains applied as soon as the Federal Income Tax was enacted in 1913. For much of the 20th century, taxpayers were allowed to exclude some fraction of their capital gains from taxation. When the income tax law was simplified in 1986, capital gains were taxed at the same levels as ordinary income. In 1997, capital gains once again attained preferred tax status if the underlying assets were held a certain minimum period. The maximum rates were 20% or 18% depending of the holding period.

The current tax regime for capital gains was put in place In 2003. Congress lowered the capital gains tax for most investors on those capital assets held one year or more. Couples filing jointly with an income of about $65,000 and above are subject to a 15% capital gains tax rate. That rate is currently scheduled to expire after 2010 and revert to the old rate of 20%.

Since 1990, capital gains realizations have ranged from 2% to 6% of GDP. While not a significant overall source of revenue, capital gains recognition is highly variable and is often cited as key driver in the overall tax revenue growth or decline. For example, capital gains recognition ballooned to more than 6% of GDP in 2000 and was a big factor in the temporary surpluses the federal government enjoyed at the time.

In recent weeks, Both the McCain and Obama campaigns have revealed more details of their plans for America's income tax system. McCain wants to maintain the comparatively favorable capital gains regime implemented in 2003 while Obama would like to increase the rate on both capital gains and dividends to 25%*. That is a pretty substantial change in the tax regime for investors with accumulated wealth.

The wealthy pay the lion's share of the capital gains tax. About ¾ of the tax is paid by the top 3% of the population. In fact, low income individuals enjoy a capital gains tax holiday through 2010.

Tax sheltered investments like IRAs and 401ks are unaffected by capital gains taxes as distributions from these accounts are taxed at higher ordinary income tax rates. Generally, a well managed portfolio will concentrate fixed income investments in these tax shelters. Most of the returns on bonds come in the form of interest payments - taxed as ordinary income. Equity holdings are typically concentrated in taxable accounts and thus the capital gains tax is the critical measure of taxation for a stock.

Significance of the Capital Gains Tax

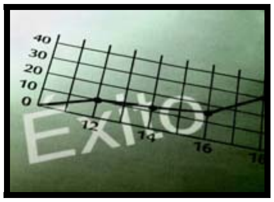
Most informed investors buy and hold their assets in the context of a passive or indexed investment strategy. We do that here at Haven Financial Advisors. Mutual funds and Exchange-Traded Funds (ETFs) generate taxable events through dividends and capital gains. If the funds are managed passively , there should be comparatively little short term gain. Most of the underlying assets are held for more than one year. In fact, the S&P 500 Depository Receipt (SPY) ETF has only had one capital gain distribution of any kind in the last twelve years. The 1099 forms for passive investments are comprised of rather small dividend distributions.

The largest taxable events occur only when the funds themselves are sold off. When these asset sales do occur, they tend to be long term capital gains. Under the currently tax regime, that kind of passive investment approach is rewarded with favorable tax rates.

The long term capital gains tax rate is really the means by which the government extracts wealth from an indexed equity portfolio. The prospect of an increase in that tax necessitates a review of unrealized capital gains. It may make sense to harvest some gains now at the lower rate of 15%.

The best way to illustrate is with an example. Consider an investor with an individual taxable account worth $400,000. The cost basis of the stock is $250,000. Let us assume that the investor has a five year time horizon and that the

*Depending on source, Obama has called for rates to increase to 20% and 28% as well



pretax return on the equity assets is 8%. Does it makes sense to harvest existing capital gains now at the lower 15% rate of defer them all another five years and pay the higher rate of 25%?

There is not an obvious solution as many variables can change in the real world. Will the increase in the capital gains tax really stand at 25%. Is the investment horizon really five years? Clearly we can't be sure of all the parameters.

What are the tradeoffs here? If we take capital gains now, we are taking advantage of a low tax rate that will be increased next year if Obama is elected. On the other hand, harvesting gains accelerates tax payment and takes investment capital off the table. A reasonable intuition is that the taxpayer benefits more from a tax deferral strategy as the actual investment horizon lengthens. Just how long, then, must that horizon be?

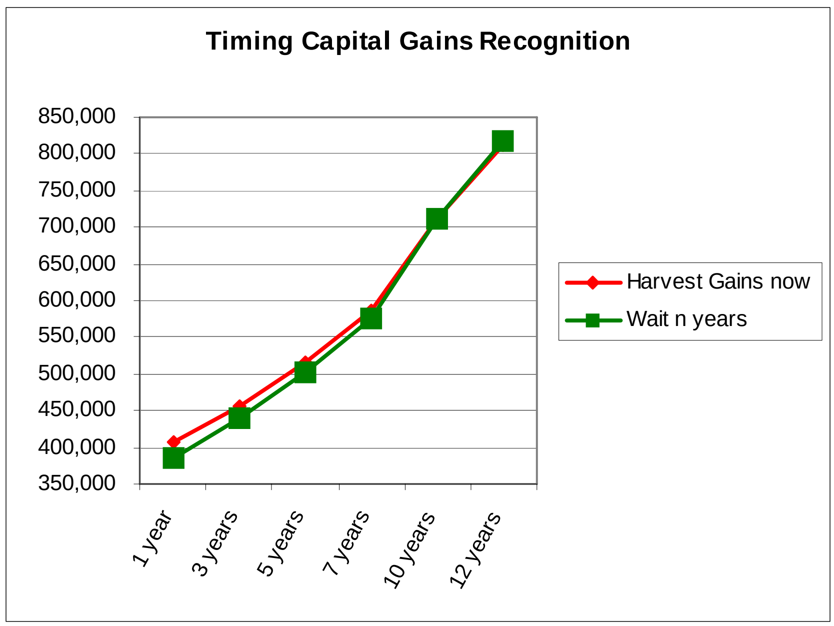
"For a five year investment horizon, the math reveals a substantial edge to the portfolio that takes its capital gains today. "

For a five year investment horizon, the math reveals a substantial edge to the portfolio that takes its capital gains today. The investor pays a 15% tax of $22,500 on $150,000 in today's capital gains. The remaining portfolio is $377,500. Over the next five years, the assets increase to $554,671. Then, a 25% tax of $38,668 is paid on the appreciation in excess of the new $400,000 cost basis. The investor has $516,003 left.

If the investor waits to pay the entire capital gain in five years at 25%, the after tax portfolio will be only $503,998. That is 2.4% less – a meaningful difference.

The chart below compares the results of each strategy over different investment horizons. The red line, representing the early harvest strategy, lies noticeably above the green line for the shorter investment horizons. At an 11 year investment horizon, the two strategies produce virtually the same result. Thereafter, the deferral strategy performs better

What is the takeaway from this analysis? First – there is no need to do anything now. The election results should be clear with almost two months remaining in 2008. Any capital gains increase would apply next year. A McCain victory would jumble the capital gains issue to an extent that no action is warranted. An Obama victory would necessitate a review of one's investment horizon. How soon are portfolio distributions anticipated? If it is likely that substantial distributions must be taken within the next ten years, a capital gain harvesting strategy may be warranted.



"The preliminary figure for July employment reveals that non-farm jobs are down 450,000 from their December 2007 apex. That is much less than half the retrenchment we experienced in the last two recession."

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What about that Recession?

Since May's newsletter, the prospect of recession has continued to occupy a prominent place in the political and economic news cycle. There have been a number of relevant developments. The preliminary 2nd Quarter GDP number indicated an annualized growth rate of +1.9%. Moreover, recently released trade data for the month of June indicated that US exports jumped by 4%. This will almost certainly lead to an upward revision in 2nd quarter GDP growth.

The jobs figures are not typical of a recession. The preliminary number for July employment reveals that non-farm jobs are down 450,000 from their December 2007 apex. That is much less than half the retrenchment we experienced in the last two recessions.

The prediction market Intrade now prices the likelihood of a recession in 2008 at only 22%. In the first quarter of this year, that likelihood was as high as 75%. Despite the problems in the nation's financial and homebuilding sector, this economy qualifies as "slowdown" rather than "recession".

With updated data, here are the annualized growth rates for GDP for the last 4 quarters.

Quarter	*Annualized Growth*
3Q07	+4.8%
4Q07	-0.2%
1Q08	+0.9%
2Q08	+1.9%
Trailing 12 months	+1.8%