FIDUCIARYVEST
Investment Strategies for Fiduciaries

White Paper January 2012

Useful, or useless calendar year returns
Every year, as the expiring calendar comes off the wall to make way for its replacement, the world of people and institutions who care about investments (whom does that leave out?) performs a ritual that has the apparent purpose of appraising and evaluating their year's returns. The standard 12-month performance look-back typically creates either a proud glow, or a sheepish confession, despite the fact that most of what happened was delivered by the marketplace, rather than by the sweat of yours or anyone else's brain. Investments, after all, do not care whether you, or we, have keen interest in an investment-related calendar-year bonus or tax calculation.

Even though calendar year periods are meaningless for investment markets, they do have patterns; if they did not, their returns would be completely random and every market day would have no relationship to the past or future. That said, there is no sign that market patterns can be boxed and ribboned by the calendar, as if their cycles were close kin to a retail clothing store. Instead, markets are ultimately a multi-year proposition, and we never know how many years will form the next cycle, or finish up the one we're in. The most useful sort of forward information we can discern is whether markets are currently low or high on the totem pole of a cycle. At FiduciaryVest, we have spent portions of the past five years studying what we know about the cyclical behavior of markets and exhaustively testing how to use it for high-probability, near-term forecasting.

2011 – so what?
2011 is done. And what did it deliver? T-bills: zero; US Stocks: nearly zero; non-US stocks: double-digit-bad; bonds, in the aggregate: not bad… nearly 8%. There were a few investing niches that offered a worthwhile return: REITs: 8.5%, long-maturity US Treasuries: 30%!, Gold shares (GLD) 9.5%, after ringing up 32% through August, and for five years ended December 2011: 149%.

2012 – now what?
Despite the frailty of forecasting, we can be rather certain that Treasury bond yields will not go below 0%. US equities are off to a sprint-start in 2012 which, we believe, is prodded by the market makers' win-win prospects for: (1) an awakening economy… a housing bottom in many metro markets, plus business borrowing demand and credit availability from the banks…or, (2) if needed, a new Fed QE liquidity program to be announced in February. Despite these two roses in the path of US economic recovery, we are sticking to our previously expressed psychological conclusion that US businesses will not create significant new full-time jobs until they are drowning in sales growth.

Where did the ECB get all those Euros they swapped with the Fed?

Continued disorderly conduct in Europe
Dark horizon: All of the optimistic good stuff in the US rests in the fragile arms of final fiddling by a nervous, reluctant Germany and its menagerie of Euroland partners who face major debt payments before the end of this quarter. If the Euro comes a-cropper, all rosy US stock market bets are off. The potential Euroland daisy chain of events would flow about like this: (1) Greece finally does not arrive at a workable solution to its debt, causing (2) very frail Portugal to default, causing (3) Italy to face the strong probability of a "negotiated default" of some sort, all of which brings (4) Europe's major banks to their knees.

Copyright ©2012, FiduciaryVest, LLC; all rights reserved.
This publication is NOT intended, or suitable as a basis for investment decisions. Before taking any significant action, readers should seek professional investment advice that will incorporate their specific investment needs and circumstances.

There is little reason to expect that this scenario will not run head-on into the US Fed, before it gains the full momentum that will plunge it into Step (4). In fact, the Fed has already stepped into Europe, via something called a “dollar swap” program. It goes like this: The European Central Bank (ECB) sends Euros to the US Fed which sends that amount of value in dollars to the ECB which then lends them to capital-starved Euroland banks. If you think you missed something in this description, you did. The key to unwrapping the swap is to ask: Where did the ECB get all those Euros they swapped with the Fed? [The answer appears to be that the ECB simply printed them, in which case the Fed has, in effect printed those dollars and, also in effect, the Fed has printed dollars to shore up European banks. Suppose the Euro fails... a real possibility; do we think the Fed will then get its dollars back?]

The 99% movement in the US

Despite early indications that the Occupy Movement was a Tower of Babel, it now seems to have found its core purpose, conveniently in time to lend a hand in the 2012 election contests.

> Theme: the top 1% of US taxpayers must begin to pay a “Fair Share” of the nation’s tax collections.

After further consideration, instead of focusing on the 1%, they decided to align with the President’s long standing definition: any married couple earning more than $250,000 is “rich”. More recently, we have learned that what’s fair is a rich-tax rate that is at least equal to the aggregate rate being paid by “working people” (a persistent, but undefined class) and by others constituting the undefined “middle class”.

The most interesting question in this emerging war of tax returns is whether it is Mitt Romney’s super-richness ($21 million of annual income) that bothers a large number of voters, or his tax rate (just below 15%)? For those who respond that Romney’s wealth is problematic for them, pollsters could further enlighten us by asking those who indicate their income is below $66,000 (i.e., the bottom 75%, according to latest IRS figures): Are you comfortable with voting for President Obama, even though his income was more than 62 times yours ($4.1 million, just before he became President), or Newt Gingrich, despite the fact that he makes more than 47 times your income ($3.1 million)?

The Supreme Court vs the Public Opinion Court

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes…..there is nothing sinister in so arranging affairs as to keep taxes as low as possible… for nobody owes any public duty to pay more than the law demands."---Judge Learned Hand, US Court of Appeals ruling in favor of a taxpayer who sued the IRS, later affirmed by the US Supreme Court

[Note: Even Warren Buffett, a part-time fund-raiser for President Obama’s re-election campaign, agrees that Gov. Mitt Romney shouldn’t pay higher income taxes under current law.]

Fair Share and the eye of the beholder

Democrats tend to view the nation’s growing, chronic budget deficits as sure evidence that Uncle Sam is not raising enough revenue; Republicans say they uniformly believe the deficits are clear evidence that Sam is over-spending his means.

Whether the goal is to reduce the federal budget deficit, provide health insurance for those without, or even for no specific reason, there is a history of support in public opinion polls for higher income taxes on the most affluent Americans. A 1985 CBS News/New York Times poll found 69 percent felt that "people who have more money than you" were paying too little in taxes, while they themselves were “paying their fair share” (51 percent) or even “too much” (45 percent). Three years later, 63 percent said they thought federal income tax rates should be increased for people whose income was $100,000 or more. More recently, in 2008, 62 percent said they supported tax increases for those making $250,000 a year in order to provide health insurance to those without it. In early 2008, before the economy tanked, 58 percent said taxes for the wealthy should be raised in order to pay for "new government programs and tax cuts for those making less money." In 2011, majorities in various polls said that taxes on households earning $250,000 or more should be

raised to lower the nation's budget deficit. A 2011, Gallup poll showed that 66 percent favor raising taxes on that same above-$250,000 level to pay for the president's jobs plan. Finally, a whopping 70% favored eliminating some tax deductions for corporations (jet airplanes?), thus raising their taxes.

Close the gap: The "Buffett Rule" is a tax plan proposed by President Obama to stem growth in the income-gap between the highest 1% of US taxpayers and the remaining 99%. This tax formula would set a tax-rate floor (apparently about 25%) that would apply to some of the 450,000 taxpayers earning more than $1 million per year and would replace the Tax Code's existing 40-year-old Alternative Minimum Tax that was originally designed to accomplish about the same thing as Obama's plan. The philosophical goal given by the President for the proposed tax floor is to make sure that the wealthy ($250,000+) pay at a rate that is at least as much as "working Americans."

Tax Facts (inconvenient truths for some cable TV heads): Opinion polls on taxing the rich bring forth a consistent voter-pulse (see above), but the facts below might surprise most of those being polled.

Conclusion: Both Mitt Romney and Warren Buffett will pay significantly more income taxes under whatever minimum rate is proposed under the so-called "Buffett Rule". But, if that proposed Rich Tax is enacted strictly on a "fairness" basis (according to Buffett's principle, which the President supports), then the new law will ***not*** apply to the average taxpayer who has income above Mr. Obama's targeted $1 million (actually won't even apply to very many with income north of $1.5 million), because those folks already pay an overall average tax rate of 24% , while the Top twenty-five percent of incomes (those above $66,000…middle class?) only pay an average of 15% tax.

Latest IRS-released data (for 2009 Federal income tax returns)

Income Bracket	Income Level in Bracket	Bracket's Share of Total Income	Bracket's Share of Total Taxes Paid	Bracket's Average Tax Rate
All taxpayers		100%	100%	**11%**
Bottom 99%	Below $344,000	**83%**	**63%**	**Less than 11%+**[1]
Top 1%	**Above $344,000**	**17%**	**37%**	**24%**
Top 0.1%	**Above $1.4 million**	**8%**	**17%**	**24%**
Other brackets:				
Bottom 50%	Below $32,400	14%	2%	2%+7.65%[1]
Top 25% to 50%	$32,400 to $66,200	21%	11%	6%+7.65%[1]
Top 10% to 25%[2]	**$66,200 to $112,000**	**23%**	**17%**	**8%+7.65%**[1]
Top 5%[3]	Above $155,000	32%	59%	20%[3]

[1] Rates shown are income tax rate + "payroll tax" rate: 7.65% [6.2% Social Security tax (up to $106,000), plus 1.45% Medicare tax]; these tax amounts are matched by employers. Self employment income, up to $106,000 total, is taxed at 15.3% for Social Security and Medicare (because there is no employer match).
[2] This bracket approximately represents "middle-income America".
[3] Includes Top 1% and Top 0.1%.