QUARTERLY NEWSLETTER

April 11, 2012

Market Commentary:
Equity markets around the globe experienced a strong rally during the 1st quarter of 2012. Below are the cumulative returns of major market indices for the three months ended March 30, 2012:

Benchmark	Year-to-date
S&P 500 Index[1]	12.54%
MSCI US Small Cap Value Index[2]	12.15%
MSCI EAFE Index[3]	10.86%
FTSE Developed Small Cap ex-North America[4]	14.44%
MSCI US REIT Index[5]	10.73%
MSCI Emerging Markets Index[6]	14.08%
Barclays Capital US 3-7 Year Treasury Bond Index[4]	-0.48%
Barclays Capital US TIPS Index[4]	0.86%
Barclays Capital U.S. MBS Index[4]	0.57%
Barclays Capital U.S. 5-10 Year Corporate Index[1]	3.05%
Barclays Capital U.S. Aggregate Bond Index[4]	0.30%

These strong returns were a result of improving economic outlook, but caution is advised since short term rallies mean that future return expectations are now lower. As of March 30, 2012, on a fundamental basis U.S. Equities were at the upper end of average valuations, while equities in developed markets outside the U.S. were slightly under. Given current valuations, dividend yields, and relatively low earnings growth, equity returns going forward would be anticipated to be well under the annualized 9.9% return experienced in the U.S. Stock market during 1926-2010, with the best valuations currently appearing to be outside the U.S.. Of course "excess" returns cannot be had without assuming additional risk as well.

1 Source: Vanguard

2 S&P SmallCap 600/Barra Value Index through May 16, 2003; MSCI US Small Cap Value Index thereafter. Source: Vanguard

3 Tracks more than 1,000 stocks from more than 20 developed markets in Europe and the Pacific Rim. MSCI EAFE Index returns are adjusted for withholding taxes applicable to Luxembourg holding companies. Source: Vanguard

4 Source: BlackRock

5 MSCI US REIT Index adjusted to include a 2% cash position (Lipper Money Market Average) through April 30, 2009; MSCI US REIT Index thereafter. Source: Vanguard

6 Select Emerging Markets Index, administered exclusively for Vanguard by MSCI, through August 23, 2006; MSCI Emerging Markets Index thereafter. Index returns are adjusted for withholding taxes applicable to Luxembourg holding companies. Source: Vanguard

Now for something completely different…..

After-tax returns

Taxpayers often seek to minimize their current taxes. At first glance this seems like a good strategy, but is it? After all, the net amount that eventually lands in an investor's wallet *after-tax* is what matters. This means that the investor's after-tax return is what matters most, *but this does not necessarily mean the best strategy is to reduce taxes paid in any one year*. Let's turn to an example:

Investor A & Investor B:
15% current marginal tax rate
25% future marginal tax rate
8% annual return
20 years until retirement

Investor A contributes $5,882.35 annually to his 401k plan, while Investor B contributes $5k annually (the after-tax equivalent of Investor A's 401k contribution) to his Roth IRA. Both investors contribute at the beginning of each year.

At the end of 20 years, the investors have the following account balances:

Investor A's 401k: $301,399.62
Investor B's Roth IRA: $256,189.80

By not paying taxes each year it would appear that Investor A has "won", but not so fast. Investor A has yet to pay taxes, while Investor B will not be taxed upon withdrawing his Roth IRA balance. Assuming a future marginal rate of 25%, the *after-tax* amounts that hit each taxpayer's wallet are:

Investor A's 401k: $226,049.72
Investor B's Roth IRA: $256,189.80

In this example, Investor B ended up with 13.33% more money in his wallet! The strategy of minimizing current taxes actually caused Investor A's after-tax returns to be *lower* than if had he simply paid tax each year.

This example assumes that future tax rates will be higher than current tax rates. If, however, future rates are the same as current rates then both returns would be exactly the same (if you don't believe this, then simply multiply Investor A's $301,399.62 ending 401k balance by 85%).

Placement of Investment Vehicles
Some investment vehicles (namely Equities) are anticipated to be "tax efficient". This means that their anticipated returns will be largely due to appreciation in value. This is in contrast to investment vehicles (namely Taxable Bonds) which are anticipated to be "tax inefficient". Over longer periods of time the main source of return of the latter type would be anticipated to be from interest yield (assuming interest rate risk is appropriately managed).

In order to show why the placement of different vehicle types is important, let's assume the following:

Equity return = 7% (capital appreciation, no dividends or other taxable events)
Taxable Bond return = 4% (no capital appreciation/depreciation)
Ordinary income tax rate = 25%
Capital gain tax rate = 15%

Investor A & Investor B each have $500k of investments. Each have a beginning allocation of 50% Equities, 50% Bonds. Investor A holds his equities in a taxable account and his Bonds in a tax-deferred account; while Investor B does the exact opposite. After 20 years, the Investors' pre-tax balances would be as follows:

Investor A:
 Bonds (held in tax deferred account) = $555,645.52
 Equities (held in taxable account) = $1,009,684.71
 Total pre-tax value: $1,565,330
Investor B:
 Bonds (held in taxable account) = $455,188.75 (note: 25% tax rate effectively reduces annual rate of return to approx. 3%)
 Equities (held in tax deferred account) = $1,009,684.71
 Total pre-tax value: $1,464,873
Pre-tax difference: $100,457

Now the investors each withdraw their assets and pay the "final" taxes:
A's net after-tax amount: $1,312,466 ($416,734 bonds+$893,732 equities)
B's net after-tax amount: $1,212,453 ($455,189 bonds+$757,264 equities)
After-tax difference: $100,013

Both investors had the exact same beginning balances, allocations, and pre-tax returns. However, the placement of Investor A's investment vehicle types cause his ending *after-tax* balance to be *$100 thousand greater* than that of Investor B!!

Strategic placement of investment vehicle types is critical for optimizing after-tax returns.

Odds and Ends

Placement of investment vehicle types is not the only strategy for optimizing after-tax returns, however. Chief among the other strategies for improving after-tax results are:

- Tax-loss harvesting while remaining fully invested
- Efficient portfolio rebalancing
- Strategic placement and selection of investment vehicles according to anticipated internal portfolio turnover
- Estate planning
- Keeping internal fund fees and transaction costs low
- Diversifying concentrated positions while taking account the potential impact of the Alternative Minimum Tax

Increasing a portfolio's anticipated after-tax result is neither easy nor intuitive, but it's certainly worth pursuing. Additionally, Congress does not make future tax rates known, so a few assumptions must be made. When making these assumptions a few things are fairly clear:

- In the U.S., long-term capital gains have nearly always been taxed at a lower rate than ordinary income
- Tax rates are currently quite low on a historic basis
- The U.S.'s balance sheet suggests that future tax rates will likely increase
- Future tax rates on ordinary income will likely be graduated as they have been in the past
- Future estate tax laws will likely result in a tax basis step-up as has been the case in the past

Summary

- After-tax results is what matters most, and not necessarily reducing the tax in any one year
- Placement of investment vehicles is critical for optimizing after-tax results
- In addition to placement of different vehicles, several other strategies exist for further optimizing anticipated after-tax results
- Certain assumptions *must* be about future tax rates, but history serves as a guide
- Increasing a portfolio's anticipated tax-efficiency is neither easy nor intuitive, but it's certainly worth pursuing

In Closing

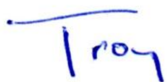
It's important to stay focused on long term results. Though global equity markets experienced a strong rally during the 1st quarter of 2012, such rallies cause future anticipated returns to be lower. Intelligent and disciplined investors recognize that higher volatility (i.e., risk) explains why stocks have outperformed bonds over long periods of time, and periodic rebalancing seeks to take advantage of relative strength and weakness in the marketplace as well as maintain the anticipated risk/return profile of an investor's portfolio consistent with their risk tolerance and time horizon. Though this strategy is sound, it is not easily followed. That is, it will cause investors to sell well-performing assets in order to purchase those not performing as well. In fact, most investors do just the opposite.

To measure how investors actually behave and perform, for the past 18 years Dalbar, Inc. has released their annual study: *Quantitative Analysis of Investor Behavior* (QAIB), a "free look" of which can be found here. For the 20 years ended December 31, 2011, the study found the average equity investor underperformed the S&P 500 Index by an annualized rate of 4.32%; while the average fixed income investor underperformed the Barclays Aggregate Bond Index by an annualized rate of 5.56%! This underperformance is VERY significant and is driven largely by investor fear and "performance chasing".

Like drivers, most investors think of themselves as above average. Unlike the children of Lake Wobegone, not everyone can be above average; therefore it's critical that every investor measure their portfolio's actual performance against a proper benchmark so they can properly assess how they are *actually* doing. Even seemingly very intelligent investors misjudge their actual performance. A fairly good summary on this subject can be found here.

Remember: *Diversify according to a well thought out and documented investment policy, and then remained disciplined. Doing so will greatly increase the probability you will actually meet your financial goals.*

If you need assistance developing an investment program and identifying appropriate investment vehicles, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience.



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