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"Cliff" Avoidance Has Lots of Money on the Move

Sick of hearing about the "fiscal cliff"? That's why we covered its main parameters three months ago. Negotiations in D.C. have yet to produce some sunburst of political courage, but the looming precipice *is* providing a constructive tutorial in basic corporate finance.

You may be familiar with the populist *cris de coeur*, "Corporations Are Not People." But a corporation certainly does embody people making decisions on behalf of themselves and lots of others (shareholders, employees, etc.). And taxes do play a role. In recent weeks, facing the prospect of dramatically higher taxes on dividends and perhaps capital gains as well, many public companies have announced special dividends to be paid out before year-end. Some of those companies are floating debt to replace some or all of that cash on the balance sheet. Does this all make sense?

Well, suppose *you* are the chief financial officer for ABC Widgets, a public company. ABC is solidly profitable, but the 2008-09 recession and myriad uncertainties since then have prompted your management to pursue a cautious business strategy. With respect to borrowing money and/or paying dividends, risk avoidance has been the order of the day. One result is the accumulation of a comforting but low-yielding pile of cash on the balance sheet.

Of course your job is not to slavishly pursue the most conservative strategy, but rather to weigh relative risks and benefits of different approaches to financing ABC's ongoing operations and long-term growth. There are drawbacks to maintaining lots of cash and low debt levels, especially in an environment that features ultra-low interest rates and demanding equity markets.

Forget taxes for a moment. If the stock market is pricing your equity at 16 times earnings, but you can borrow five-to-ten-year money in the bond market at 3.0-3.5%, a higher debt-to-equity ratio may be the kind of savvy financing shift you were already considering. The coupon rate on those bonds may be a little higher than your current dividend rate, but that's where tax considerations come in.

We think of dividends as a product of corporate earnings, but it helps to remember that they are really distributions of equity capital. A dividend is not deductible on a corporation's tax return; it's paid from after-tax surplus. On the other hand, the interest a company pays on its debt *is* deductible for corporate tax purposes. Corporate bond interest and dividend distributions are both taxable to the recipient, assuming that it's not a tax-deferred retirement plan or some other non-

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How "Safe" Is That Withdrawal Rate?

With each passing month, more folks are heading into a potentially long-tailed retirement in a chronically low-yield environment. Establishing a workable, sustainable rate of withdrawal from one's nest egg is certainly not a perfect science; there are just too many variables. But it's worth reviewing and updating some of the history.

In recent years the conventional wisdom has coalesced around 4% as a reasonable, sustainable rate of withdrawal from a well diversified portfolio of mainstream stock and bond holdings. The accompanying table looks at several different blends of stocks and bonds across 25 distinct 25-year periods falling within the 50-year period, 1962-2011. The stock returns used in the study are for the Standard & Poor's 500 Index; for bonds the benchmark is the Citigroup Long Term High Grade Corporate Bond Index.

These numbers provide some useful guidance but absolutely no guarantee. A set-it-and-forget-it withdrawal strategy is probably not advisable. While the time periods covered by this basic study encompass myriad investment climates, none of those periods featured the rock-bottom fixed-income yields facing investors today. Those low rates along with bouts of severe volatility in equity markets constitute the central investing challenge for a large cohort of Americans already in or fast approaching retirement. Periodic monitoring of that withdrawal rate and perhaps a little adjustment now and then are essential. ■

Odds of Success In Sustaining Withdrawals
(25 rolling 25-yr. periods, 1962-2011; assuming different blends of Stocks & Bonds)

Annual Withdrawal	100% Stocks	60% / 40%	50% / 50%	40% / 60%	100% Bonds
@ 4%	100%	100%	100%	100%	100%
@ 5%	100%	100%	100%	100%	84%
@ 6%	88%	88%	84%	80%	76%

Source: Ibbotson; American Funds Distributors

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So, What If Interest Rates *Do* Rise?

Will interest rates ever make a meaningful move to higher ground? These are truly unusual times, but let's assume rates will rise at some point. Researcher Craig Israelsen, writing recently in *Financial Planning* magazine, looked at the performance of intermediate term bond mutual funds for periods of both rising and falling interest rates over the past 36 years (1976-2011). His basic analysis suggests that for this moderate-risk category of fixed-income holdings, rising rates needn't produce a bloodbath.

Over those 36 years the federal funds rate – the rate at which banks lend to one another overnight – rose in 17 years and declined in the other 19 years. The rate represents a kind of base for the overall hierarchy of rates. From 1976 to 1981 the prevailing trend was definitely up, with fed funds rising from about 4.5% to a stunning peak of 16.4%. The next 30 years saw a dramatic secular decline to a token fed funds rate of 0.1% by the end of 2011. But there were a number of years when rates backed up, denting market prices for fixed-income instruments.

For starters there's that initial surge in rates from the end of 1976 to the end of 1981. Even then the average intermediate bond fund posted annualized total return of 2.7% according to Morningstar. Fed funds rose from 6.7% at the end of 1987 to 9.2% by the end of 1989. Yet intermediate bond funds averaged annual total return of 10.1% for that two-year stretch.

In the two years leading up to the end of 1995 fed funds rose from 3.0% to 5.8%, and the four-year period 2004-2007 saw a rise from 1.1% to 5.0%. Average annual returns for intermediate bond funds were 6.3% and 3.6% respectively during those two periods.

Does that mean bond fund investors have little to fear from higher rates? That may be too sanguine a view. For one thing, intermediate-term rates don't always move in lockstep with the fed funds rate. For research purposes the historical fed funds rate is fairly easy to document. But for some of the examples noted above, intermediate and long rates did not rise by the same magnitude as fed funds.

Total returns for bond mutual funds are a combination of coupon payments and changes in market prices for a fund's holdings. For nearly all of the past 35 years, coupons were more generous – often much more generous – than those being earned by today's intermediate term fund, especially if it keeps a relatively high quality portfolio.

At today's yields, coupon payments won't offer much of a cushion for falling market prices. History suggests that a big jump in rates will not necessarily decimate conservative fixed-income holdings. But comparisons from one period to another are never perfect, and pain thresholds tend to be relative. ■

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Cliff Avoidance... Lots of Money on the Move

taxable entity.

For the past decade the low tax rate on qualified dividends has mitigated the inherent drawback to equity in ABC's financing mix. Now, as CFO, you face the very near-term prospect of a much higher tax rate on dividends. All eyes are on you to recommend the action that best serves the interrelated interests of ABC and its shareholders.

You recommend a special dividend to distribute a chunk of equity while shareholders can still receive it at a maximum tax of 15%. At the same time, you head for the bond market, which is hungry for both yield and credit quality. ABC borrows a comparable chunk of cash at the lowest interest rates in the company's history.

By the way, this deadline-driven exercise may help pad government tax collections in fiscal 2013. But to the extent it promotes a higher debt-to-equity ratio across corporate America, that little revenue swell may be followed by a comparative trough in fiscal 2014. One hopes for a more robust economy to help counter *that* effect. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru Dec. 7, 2012 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	14.4 %	9.3 %	0.4 %	5.8 %
Mid-cap Stocks (Core)	12.8	12.1	1.9	8.1
Small-cap Stocks (Core) †	11.6	13.0	2.6	8.7
Foreign Stocks (Multi-cap) †	10.8	3.2	– 4.7	6.9
Emerging Market Stocks †	8.1	3.4	– 3.3	14.5
Natural Resources	– 0.7	5.3	– 2.9	11.5
Real Estate Related	18.8	18.5	3.1	10.5
Flexible Portfolio	7.7	7.1	2.0	6.6
General Bond	9.8	7.6	6.9	7.4
Int'l Fixed Income †	7.8	4.2	5.8	6.8
High-Yield Taxable Bond †	15.5	11.0	7.7	8.8
General Municipal Debt	12.8	7.7	5.6	4.8

* Source: Lipper, as reported in the online *Wall Street Journal*, December 8, 2012.
Past performance is NOT indicative of future results.

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

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Bipartisanship *Can* Get a Little Spendy

The election's over, and the *clameur du jour* is for bipartisanship to address the nation's fiscal follies. One might be a bit wary. Social Security and Medicare; Fannie Mae and Freddie Mac; federal tuition grants and subsidized student loans; tax breaks for employer-provided health insurance: All of these started modestly with the best of *bipartisan* intentions. Each is now at the heart of some Gordian Knot of runaway costs and perverse incentives.

So what *might* we hope for from the battle over spending and taxes? It's useful to turn the clock back to just after the 2010 mid-term election. The players and their positions were much the same as now. After weeks of political brinkmanship they settled on a two-year extension of current income tax rates and a broad reduction in the *employee* portion of the payroll tax.

That compromise didn't work out too badly. Even in a tepid recovery, individual income tax receipts for fiscal 2012 were 26% higher than 2010, and corporate income taxes rose 27%. Payroll tax revenues only slipped about 2% despite a 15% cut in the rate.

Meanwhile, spending leveled off, albeit at a lofty level. Social Security benefits are rising as Boomers retire, but a lot of those folks now pay Medicare premiums while still pretty healthy. Their big drain on the program may be a few years off. Defense spending is idling near historic lows as a share of the budget and gross domestic product (GDP).

Compared to the factor of economic performance, the issue of tax rates on high-income households is thin gruel. The Congressional Budget Office estimates that President Obama's approach would only raise about $82 billion annually, and that's with "static scoring," the assumption that taxpayers and the economy do not react to such changes. Of course they do react; it's just a question of how much, so the revenue gain could well be even less. By comparison, expiration of the payroll tax cut should boost annual revenue by at least $100 billion.

With modest but sustained economic growth, another extension of current income tax rates, and restoration of the full payroll tax rate, federal revenues should rise by perhaps $225 billion. And with continued restraint on spending growth, the deficit could slip somewhere below 6% of GDP. Perhaps they'll come up with a grander bargain than that. Then again, they could do worse. ■

Federal Fiscal Year Revenue and Spending
(in billions of $)

	2007	2008	2009	2010	2011	2012
Receipts	2,568	2,524	2,105	2,163	2,302	2,449
Outlays	2,729	2,983	3,518	3,456	3,599	3,538
Deficit	– 161	– 459	–1,413	–1,293	–1,297	–1,089
% of GDP	– 1.2	– 3.2	– 10.1	– 9.0	– 8.7	– 7.0

Source: The Congressional Budget Office

At Least One Tax Hike Is Certain

Several tax issues are still up for grabs, but one certainty is the new 3.8% surtax on investment income for high earners. It's part of the Affordable Care Act passed in 2010 with implementation set for 2013. So who gets to pay this tax?

The new tax is **imposed on unearned net investment income** (e.g., capital gains from stock sales, dividend income, bonds, mutual funds, annuities, loans, and home sales) to the extent the taxpayer's **adjusted gross income (AGI) exceeds $200,000** (single) **or $250,000** (married filing jointly).

To simplify, consider two married couples, each with joint AGI of $300,000. Couple #1's AGI includes $225,000 of earned income and $75,000 of dividends and capital gains, while Couple #2 shows $275,000 of earned income and just $25,000 of dividends and gains. Couple #1 pays the 3.8% surtax on $50,000, the amount by which their AGI exceeds $250,000 but still only a portion of their net investment income. Couple #2 pays the surtax on all $25,000 of their net investment income, since their earned income alone exceeded the threshold.

Remember, this new tax sits atop whatever rate ends up applying to various categories of investment income. And an added dollar of *earned* income may trigger the surtax on more of one's *investment* income. Those moving parts create some complexity and unpredictability, obscuring the true marginal tax rates for households earning in the vicinity of the relevant threshold. Maybe that was the objective. ■

Indiana Reels In Return Expectations

A few years back we noted the possibility that public pension funds might reassess the investment returns they assume to gauge their ability to meet future obligations to retirees. This fall the State of Indiana's public pension fund became the first to drop its projected returns below the 7% threshold. At 6.75% it's the lowest assumed rate of return among 126 large public systems tracked by the National Association of State Retirement Administrators.

Many public pensions face projected shortfalls, disappointing investment results, ultra-low interest rates, misuse of public funds, and battles with employee unions. Some are changing their investment portfolios and benefits packages, as well as trimming public services.

Lowering the projected rate of return adds to the pain by raising the current employer contribution for a pension to be deemed adequately funded. Most state funds have held to long-term projections in the 7-9%

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Your e-Mail Could Be Fertile Ground for Fraudsters

Email is ever so convenient, but there are those who would exploit it for illicit gain. Brokerage firms have seen a rash of attempted fraud by perpetrators who gain access to client e-mail accounts. They search for information on where that client holds accounts. Then they generate emails to those financial institutions with special requests to wire money to alternative accounts.

With the ability to peruse someone's email messages, perpetrators can make a fraudulent request sound pretty convincing. One strategy is to take advantage of folks when they're on vacation and harder to reach by phone to verify the request. An urgent email seeking a special wire of funds may seem credible.

Banks and brokerage firms have tightened verification requirements for wire requests, especially wires to accounts that do not appear to be controlled by the client. Protective measures also may affect procedures for processing address changes, account re-registrations, deposits and withdrawals.

"Third-party" wires and other special requests can be a real service under any number of legitimate special situations. Precautionary verification may impose some inconvenience, but it is designed to address a clear and present danger.

Last summer we offered a few practical suggestions to make it more difficult for miscreants to hack your email and other online accounts. But as with most everything in the investment world, there are no iron-clad guaranteess. ■

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Indiana Reels In Return Expectations

range, although 45 states have lowered the assumption somewhat since the financial crisis.

Indiana had room to be conservative. A January 2011 report from Moody's Investor Service noted that the state's pension fund had the nation's second-lowest combined pension and long-term debt liability as a percent of its GDP. (Hawaii's is the lowest.) Indiana's integrated pension fund is one of the oldest *hybrid* systems, established in 1955 with both defined benefit and defined contribution components.

Strains on public pensions may continue to hog the headlines. Higher returns would surely help, but as Indiana officials might suggest, hope is not a strategy. Indiana law stipulates that if state budget reserves exceed 10%, the overage is split 50/50 between taxpayers and the public employee pension system. This provision kicked in $360 million this past year, bringing the system's funded status to 80% of future obligations. Looks like there's more to envy in the Hoosier state than just basketball. ■

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