The ACM Journal

Travels & Tribulations

Hiking is one of my favorite activities. In fact, one of the few places where I truly relax is in the woods, on a mountain. So, I was very excited about our family trip to the Adirondacks. We were going to hike Blue Mountain, which has a fire tower at the top with a spectacular 360 degree view of the Adirondacks.

We got a late start the day of the hike and the weather forecast was not encouraging. There was still some sun shining though as we left the hotel, so I was hopeful. As I raced the rapidly changing weather, my sons fought and my 2-year old daughter, Nyla cried the entire time. The only thing that would soothe her was my wife reading Curious George Goes to a Chocolate Factory, which she reread at least a dozen times. I know it is a cliché, but the boys asked almost incessantly "are we there yet?" which further made the vein in my forehead bulge.

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Capital Markets Review

The third quarter started on a volatile note in the capital markets as investors tried to gauge the direction of the economy and stock market. July was a rollercoaster ride for stocks, but August and September were mostly constructive after a stock market rally began late in July. Oddly enough, the catalyst for the rebound was continuing economic weakness.

Economic Weakness Spurs Stocks

Preliminary second quarter GDP statistics were released on July 27th with 1.5% growth. Because this rate of growth was so weak, traders believed the Fed would have to step in with a new stimulus program, and the stock market rallied on those hopes. Additionally, further weakness in Europe, mostly in Spain and Italy, drove European Central Bank president Mario Draghi to announce that the central bank would do "whatever it takes" to avert a collapse of the Euro. The Dow rose over 200 points that day. Government intervention and bailouts are not the ingredients of strong, healthy economies, but they are effective at propping up capital markets in the short run.

Of course, all the speculation in July regarding a further government stimulus package proved prescient. Not only did the Fed announce an open-ended mortgage bond purchase program in September, but Europe and Japan also enacted new stimulus measures late in the quarter. The result was a lift in global asset prices, with depressed international stocks leading the way.

The quarter ended with more volatility in the aftermath of the stimulus news. On the one hand, there was bullish economic news. Home prices were up 6.9% and consumer spending rose 3.3% year-to-date. Both statistics grew at rates not seen in at least six years. However, on the bearish side was continuing strife in Europe. Greece and Spain both saw demonstrations, in some cases violent, over austerity measures put in place to remedy their ailing economies. Stocks see-sawed in reaction to these divergent events.

Stocks Show Solid Gains

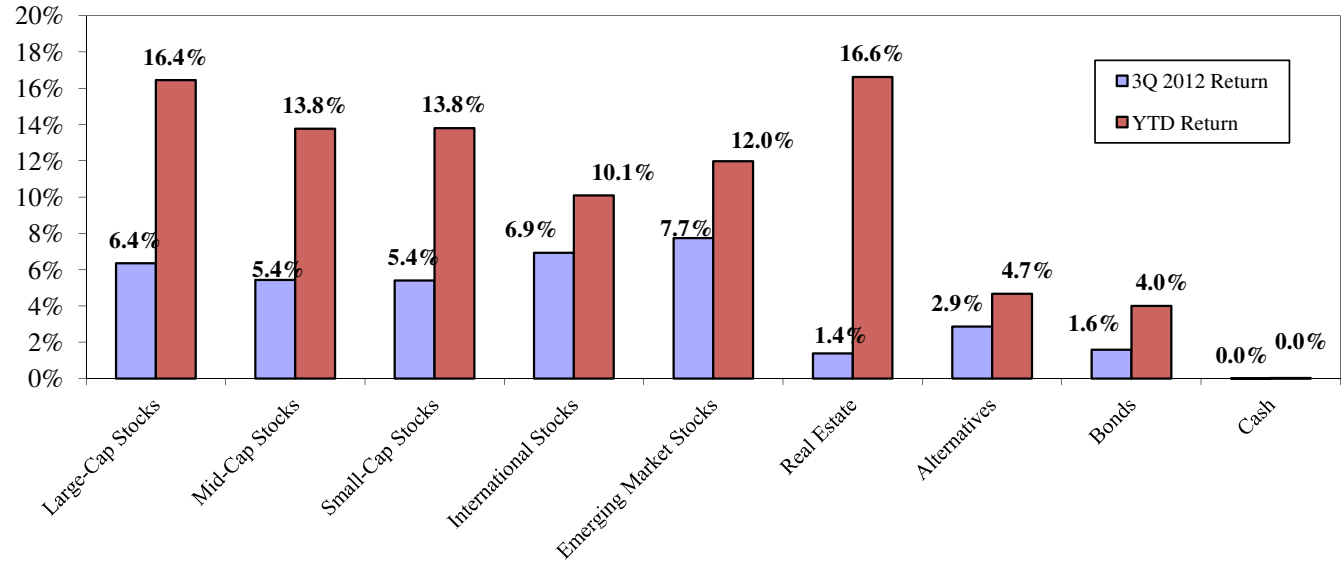
In the end, the quarter was a solid one with stocks up over 6.0% both at home and overseas (see nearby graph). Smaller-cap stocks in the U.S. lagged somewhat as investors continue to seek out safer, more liquid stocks with higher dividend yields. Interestingly, real estate was also a laggard in the quarter, reversing its recent strength. Nevertheless, real estate remains the best performing asset class year-to-date with a gain of 16.6%. While valuations may be getting stretched for real estate investments, we believe they are an important part of a long-term investment program because of the diversification benefits they offer.

In an interesting turn of events, international stocks were the best performers in the third quarter. Developed market stocks rose 6.9% and emerging market stocks gained 7.7%. Both had been significantly lagging domestic stocks so far this year. Unfortunately, the strength probably is not indicative of recovering economies. We fear there is more turmoil to come in Europe. Rather, international stock market gains likely reflect the fact that attractive valuations, after a long stretch of poor performance, have enticed some investors. This is particularly true after the European Central Bank's pledge of further government support for failing economies.

Bonds Post Moderate Returns

Bonds posted more moderate returns, earning 1.6% in the third quarter. Mortgage bonds were among the strongest performers thanks to government buying in that sector. Treasury bond prices remain at very high levels, offering paltry yields. Accordingly, we've recently moved assets out of Treasury bonds and into somewhat higher yielding mortgage and corporate bonds. Because we are still using high quality bonds, many with government guarantees, the risk profile from our allocation shift should not change much. In fact, we think we will be able to get an extra 1.0% or so in yield while reducing downside risk in the event of an interest rate spike.

New research from The Leuthold Group shows that while presidential elections historically



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

have not been meaningful for the direction of stocks, they have been indicative of the direction of interest rates. On average since 1925, interest rates tend to rise if Republicans are elected president and fall if Democrats are elected. We aren't making changes to our bond strategy to account for this, but it is something to watch.

Alternative Investments Rise

Our alternative investments, which include things like commodities, currencies, and higher yielding fixed income strategies, have performed quite well so far this year. The idea with these investments is to get moderate returns while reducing risk in the overall portfolio. In the past couple years we have seen a reduction in risk, but we haven't seen much return. This year the trend is easing and we're finally seeing respectable returns that are more in-line with historic norms.

Despite dire headlines and prognostications, especially those declaring the "cult of equity is dead", the second quarter shaped up quite nicely for all segments of the global capital markets. There are still challenges ahead, not the least of which include the election, the looming "fiscal cliff", and earnings announcements that are likely to be somewhat disappointing. How these events unfold, and their impact the capital markets, remains to be seen. However, stocks have shaken off worse concerns in the past and we expect patient, long-term investors to continue to reap the rewards the capital markets offer. Cycles and trends come and go, but diversified, long-term investing has always stood the test of time.

Let's Get Fiscal

One of the biggest issues causing discomfort in the U.S. economy is the looming "fiscal cliff" at the end of 2012. Current tax rates, originally set under George W. Bush's presidency and extended under Barack Obama, are set to rise to pre-2003 rates. This means at least a three percentage point income tax increase for all but the lowest tax brackets, and, most pertinent to our profession, it means a significant increase in capital gains, dividend income, and estate tax rates. Specifically, long-term capital gains rates would increase from 0% to 10% for lower tax brackets and from15% to 20% for higher brackets. Estate tax rates would move from 35% to 55% and the exemption would fall from over $5 million to $1 million. Short-term capital gains and dividends would be taxed as ordinary income. On top of these changes, a 3.8% tax on investment income will be in effect to support the Affordable Care Act, colloquially known as Obamacare, and will be charged on capital gains and dividends for the highest tax brackets.

It is still in question whether the fiscal cliff will occur. The two presidential candidates each have plans that would either modify or eliminate the fiscal cliff, but the ability of either candidate to implement his plan will depend on both the outcome of the election and the political and economic pressures that follow. For purposes of this article, let's assume the fiscal cliff will occur. What will be the impact on the economy? More importantly, what will be the impact on investors?

Most pundits believe the fiscal cliff will be disastrous for the U.S. economy. Recent *Wall Street Journal* and *Financial Times* reports label the fiscal cliff as the biggest threat to economic recovery and GDP growth. The cliff has also created caution among chief executives, who report their lowest confidence level in over three years. This lack of confidence and fear of fiscal tightening is reflected in the finances of corporations, which are hoarding cash and still reluctant to engage capital. Yet the correlation between low capital gains rates and economic growth is questionable.

During the last ten years of low tax rates, we have seen a short boom, spectacular bust, and a slow, prolonged recovery. However, during the late 80s and early 90s, capital gains tax rates were very high, ranging from 28% to 33% over the period, and the U.S. economy grew at an unprecedented clip. Capital gains rates were lower at 20% during the boom years of the late 90s, but these rates were still higher than what we have seen for the past ten years. This data shows, as usual, that pundit predictions of doom and gloom are far from guaranteed.

For investors, the impact will also be a bit murky. If you earn under $250,000 per year, the effect will be minimal. For our clients, we will, as usual, try to keep realized capital gains to a minimum, and we will realize capital losses where possible to offset gains. However, if you earn over $250,000 per year, you will be subject to substantially higher income, dividends, and capital gains tax rates, and you will also be subject to the 3.8% surcharge mentioned above. Thus, higher earning investors will be much more sensitive to portfolio rebalancing and realized gains if and when the cliff hits. We will continue to take tax impact into consideration in our portfolio management work.

The question remains: does one realize capital gains now, or hold on for the long haul? While it may be tempting to realize gains now to avoid higher tax rates later, this move reduces the level of assets that can continue to compound in the future. It therefore probably makes sense to remain a long-term investor and hold your positions. Even if rates on gains are higher in the future, the money earned through compounding could very likely outweigh the extra money you give to the government in taxes.

If you are concerned about your assets beyond your own lifetime, we advise that you have a conversation with your estate planner, as both tax rates and exemptions, may be subject to change in the next few years.

Regardless of who gets elected or what Congress decides, we feel the best strategy is to stay invested, realize losses whenever possible to offset current or future gains, and organize investment and estate plans that give as little money to the government as possible. Every investor has different circumstances, so please feel free to contact us if you would like to discuss possible ramifications from coming tax law changes in greater detail.

Presidents, nuns and tractors

The election season is upon us and there has been much debate over not just the outcome of the election, but the impact as well. The nation seems more polarized than ever and the two political parties appear to be doing little to unify us.

Politicians have been describing this as the most important election of our generation. Both sides believe much is at stake and that irreversible harm may be done to the country and our way of living if “those guys” win. The reality is probably more moderate.

As indicated elsewhere in this newsletter, who sits in the Oval Office has historically not mattered much for the stock market. I believe it likely won’t matter that much for other parts of our lives either.

We may pay more or less in taxes. Economic activity may be plus or minus a percentage point, but our day-to-day lives will probably look pretty much the same regardless of who wins the White House. It is our work ethic and resiliency that I believe matters the most. Perhaps those are eroding in our culture, but they are far from gone.

One of our clients, a monastery in Elmira, was recently hit with the

tornado that ripped through their city in late July. Their home was spared, but there was a lot of damage to the property. This is a group of cloistered nuns, which means they don't get out much, if at all. Most of them are also quite elderly. However, they didn't sit around and wait for anyone to bail them out. They went outside with chainsaws, rakes, and tractors to clean up the mess.

Even more interesting, their neighbors came over to help. Many of these volunteers likely were not Catholic or the least bit interested in the monastic life. They were there because they saw someone in need and it was the right thing to do. They worked in the rain and without any expectation of pay (except possibly an eternal reward).

In the end, the nuns regarded this event not from the perspective of victims. Rather, they were grateful, first that they were still safe after the storm, but later that there was such an outpouring of positive community spirit as a result of a terrible event.

So, during this election season, I like to think of the example of my nun friends and their neighbors. I don't believe it will matter that much whether we end up with a Democratic or Republican victory. Americans still have the tenacity and work ethic to move the country in a positive direction. We have a 200-year foundation to build upon and I don't think that can be undone with one presidential election. It also wouldn't hurt if we learned to work together a little more.

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We arrived at the mountain just in time for the rain to start in earnest. Any prospect of hiking now firmly in our past, we turned around and headed to the Adirondack Museum a few miles away. The museum was actually terrific, but small compensation for my lost hike.

That night, in the hotel we were awakened in the middle of the night by the alarm clock, which the kids must have been monkeying with. Nipa turned it off, but it soon went off again, at which point she unplugged it. However, that too was in vain, as the battery backup allowed the alarm to sound a third time, just after we had again drifted off to sleep. At that point Nipa took the clock into the bathroom. I'm not sure what she did with it, but I had visions of her putting it in a pillowcase, smashing it against the walls, and flushing it down the commode.

Already a bit irritable from my disappointment the day before and a lack of sleep, we had another surprise in the morning. There was a knock at our door and we opened it to find a police officer. Apparently Nipa had inadvertently hit the emergency button on the phone when cleaning up one of the many spills from the weekend. I was looking forward to getting home to the relative quiet of mowing the lawn.

So, we had quite an adventure of poor weather, mediocre accommodations, bad food, endless whining, law enforcement, and lots of Curious George. I tell you this so that you know you'll be able to find me in the office for the foreseeable future; I have no plans for additional vacations.

WHAT IS ARMBRUSTER CAPITAL MANAGEMENT?

Armbruster Capital Management is an investment advisor to individuals, families, and smaller institutions. Because we don't sell any investment products, we remain unbiased in our selection of funds. We use index funds to drive down costs, manage the tax bite, and gain broad exposure to the various segments of the global capital markets. Ongoing communication is the cornerstone of our service offering. You can reach us on our cell phones anytime.

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