

After two years of political back and forth we now know who will be running the show for the next four years and have some expectations as to how President-elect Barack Obama will impact the future of wealth management (or at least the next four years!). In the very near term, we can expect a balancing act between nursing the faltering economy and implementing some of the policies espoused in his campaign. There are few doubts that for those considered wealthy, as measured by annual income above \$200,000 for individuals and \$250,000 for married couples, taxes will become more burdensome. In this briefing we aim to answer the question, **“how can I modify my portfolio in order to minimize the impact of higher taxes without taking on more risk?”** We will also preview some of the spending programs and regulatory changes we expect may have an impact on investment opportunities going forward.

What are the expected tax implications of President-elect Obama's administration?

As many of you know, the tax cuts of 2001 and 2003 are set to expire on December 31, 2010. Without any action by the President or Congress, we should expect the following to happen:

- The top two tax brackets for **ordinary income** will revert to 36% and 39.6% from their current levels of 33% and 35%;
- The **long-term capital gains** rate will return to 20% from 15%;
- The maximum **short-term capital gains** rate will jump from 35% to 39.6%; and
- The **qualified dividend** rule which currently taxes qualified dividends at 15% would be eliminated, therefore pushing dividend tax rates to the same as ordinary income, 39.6%.
 - However, President-elect Obama has indicated that he would seek to keep the qualified dividend rule, but apply a 20% rate for higher earners while maintaining the current 15%/0% structure for lower income individuals and families.

How does this impact our approach to portfolio management?

For investors in higher tax brackets, the tax regime as proposed stands to make all asset classes, with the exception of tax-exempt fixed income, less attractive in absolute terms. **We believe the impact to expected after-tax returns for various asset classes and investment styles will range from 0.0% to -0.6% (annualized) based on our current ten-year investment forecasts.**

Asset Class Modeling Inputs: Projected Returns/Risk over Ten-Year Investment Horizon (2008-2017)							
Asset Class	Pre-Tax Gross Return	Standard Deviation	Current After-Tax Net Return	Expiration After-Tax Net Return	Difference	% Difference	
Equity							
Domestic Equity	U.S. Large Cap Equity	10.25%	15.00%	9.64%	9.12%	-0.51%	-5.31%
	U.S. Small/Mid Cap Equity	10.75%	20.00%	9.09%	8.81%	-0.28%	-3.11%
International Equity	Developed Non-U.S. Equity	14.00%	16.00%	11.77%	11.21%	-0.56%	-4.78%
	Emerging Market Equity	16.00%	24.00%	13.35%	12.81%	-0.55%	-4.10%
Alternative Equity	Private Equity	12.50%	25.00%	12.12%	12.04%	-0.08%	-0.68%
	Directional Hedge Funds	13.50%	12.00%	9.53%	8.89%	-0.64%	-6.68%
Real Assets							
Real Assets	Real Estate	11.75%	14.00%	8.30%	7.96%	-0.34%	-4.06%
	Commodities	9.25%	12.00%	6.61%	6.35%	-0.26%	-3.89%
Non-Directional/Fixed Income							
Non-Directional	Non-Directional Hedge Funds	8.25%	6.00%	5.68%	5.29%	-0.39%	-6.80%
Fixed Income	Tax-Exempt U.S. Bonds	4.00%	5.00%	3.60%	3.60%	0.00%	0.00%
	Taxable Govt/Corp Bonds	5.25%	4.50%	3.15%	2.93%	-0.22%	-7.08%
	High Yield Bonds	8.75%	8.00%	5.20%	4.83%	-0.37%	-7.08%
Cash Equivalents	Cash and Equivalents	3.75%	1.00%	2.31%	2.14%	-0.16%	-7.08%

Within asset classes, there is a wide range of potential outcomes and investors will need to focus on manager specific detail in order to gain a better understanding of the potential impact to returns. In other words, there will be a greater potential value-add from manager selection if one selects managers with a greater tax awareness and an investment approach focused on the needs of the taxable investor. Managers that are cognizant of managing gains until they reach long-term status by minimizing turnover, and actively harvesting losses, will become more valuable in a higher tax environment. This is not something that is particularly new to us, as we have always focused on this approach. **The value of tax-exempt bonds and tax-aware investment strategies will increase.** This includes actively tax-managed portfolios, passive tax-beneficial structures such as ETF's and ETN's, and active portfolio strategies that tend to be more efficient simply because of their strategy and approach to investing (e.g. buy and hold strategies vs. frequent trading).

The following list details some of the more significant considerations by asset class given the expected change of tax regime:

- **Cash Investments:** Tax-Exempt money market funds will become increasingly more attractive relative to Government and Prime money market funds. Risk aside, one would benefit by investing in Tax-Exempt money markets on an after-tax basis if the yield were at least 61.4% ($1 - [\text{tax rate}]$) of the equivalent taxable money market fund.
- **Fixed Income:** For high quality fixed income, where little capital appreciation is expected and returns are driven almost exclusively by income, the same rule as for cash investments would apply. For fixed income investments where there may be some expectation of capital gains contributing to returns, such as high yield bonds, the tax bite as a percentage will be less, and may make them suitable for diversification and after-tax return contribution for taxable investors.
- **Non-Directional Hedge Strategies:** Funds employing arbitrage trades where a significant portion of returns are either short-term capital gains or income, will be among the most heavily impacted by higher taxes. There are funds however that we consider non-directional which may not be as inefficient, such as those employing distressed debt strategies or event-driven strategies, where a more significant portion of their return may be long-term capital gains.
- **Equity:** Managers that manage their portfolios with a high level of tax awareness, making efforts to hold investments until they reach long-term status, holding dividend paying companies long enough to ensure their "qualified" status and regularly harvesting losses (particularly short-term) will add value to a portfolio. Tax-managed index strategies, such as those employed by firms including Parametric, will become even more attractive on an after-tax basis. This begs the consideration of whether active management should be utilized at all in asset classes where a manager's ability to outperform an index is challenged and the magnitude of outperformance on a pre-tax basis for the most successful of managers is minimal. Exchange traded funds (ETF), because of their structure, have historically been able to minimize distributions and therefore are considered very tax-efficient.
- **Directional Hedge Strategies:** Many long-short equity hedge managers are not cognizant of the tax implications of their strategies. Generally, the managers that run a significant portion of their own taxable assets are more cognizant and tend to run more tax-efficient portfolios. This is an asset class where each manager needs to be evaluated individually as they will vary dramatically.
- **Private Equity:** Private Equity has long been one of the more tax-efficient asset classes as income is kept to a minimum and holding periods tend to be long, therefore creating an asset that tends to produce mostly long-term capital gains. Private Equity will become more attractive relative to other strategies that have exposure to short-term gains and income generation.
- **Real Estate:** Real Estate comes in many different structures, public vs. private, REIT vs. REOC, and each has its own unique tax treatment. Starting in the public realm, REITs which pay out significantly all of their income generated are taxed at regular income tax rates as these are not considered qualified dividends. Conversely, REOCs (Real Estate Operating Companies) are not required to distribute their income and therefore are more tax-efficient to investors. The tax efficiency of Private Real Estate partnerships varies, depending on their approach and structure, but are generally also more tax efficient than REITs.

- **Commodities:** Investing in commodities via equities is a relatively efficient way to access the asset class. Investing in a fund that uses commodities futures (treated as 60% long-term, 40% short-term gains for tax purposes) typically is less tax efficient, depending on the underlying collateral held for the futures contract. Most hold either Treasuries or Treasury Inflation Protected securities, which are taxed at standard income tax rates. Some utilize municipal bonds which are more tax favorable, but the decision hinges on whether the tax-equivalent yield is higher than Treasuries. Finally, a unique vehicle, the Exchange Traded Note (ETN) can be used where it is considered (currently) as a prepaid forward contract and therefore is taxed based on maturity or time of sale. ETN's do not typically make distributions generated from underlying Treasury holdings and that income generated is not taxed along the way. In fact, if the ETN is held more than a year, the net gain once sold is taxed at the long-term capital gains rate.

In addition to the implications noted above there are some considerations that should be evaluated given the current environment.

- Significant losses in 2008 may provide the opportunity for investors to harvest losses in their portfolio.
- This year's down market may also afford investors the opportunity to transition or upgrade managers, where previously the tax implications may have inhibited such a move.
- As we approach a time where taxes are likely to change, it may make sense to harvest some gains and reset cost basis with the thought that an investor can harvest the gains at lower long-term rates (15% vs. 20%) and also create the opportunity to harvest short-term losses in the future which could be used to offset short-term gains at the 39.6% rate.
- As we near year-end, we are entering distribution season for mutual funds. It is prudent to be aware of the pending distributions and consider taking action (potentially selling in advance of) or deferring action (don't buy until after the distribution is paid) as the case may be.
- Another benefit that has resulted from recent market declines is that a number of mutual funds now have embedded (unrealized) losses, which for current purchasers of the funds provides a bit of a tax benefit.
- One thing to consider with regard to hedge fund of funds is the high water marks which most funds employ. Managers only charge incentive fees on gains made above previous high water marks. In the case of a fund of funds, a new investor into the fund may benefit from the fund's existing high water mark with its underlying managers (similar to the point above regarding embedded losses in mutual funds, except that it is a return benefit rather than a tax benefit, both of which add to an investor's bottom line).

Convergent Wealth Advisors has a powerful analytical tool in PORTAX, a proprietary software package that considers a mean variance optimization, after-tax returns, volatility and correlation among asset classes to evaluate the efficiency of all possible portfolios in a risk and return framework. Our analysis of the current tax regime versus the expected tax regime under President Obama shows that there is a marginal difference in allocation due to the changing tax landscape, but that the more dominant factor remains diversification benefits across asset classes. **Generally speaking, the analysis suggests a shift towards more efficient asset classes such as equities (with longer holding periods) and away from taxable fixed income, non-directional hedge funds and real assets.** It is important to note that, as discussed above, the difference in manager selection and investment vehicles can have a significant impact on this outcome.

What about Changes to the Estate Tax Regime?

Though not the main focus of this paper, we felt it prudent to at the very least highlight the likely changes to the estate tax. The current **estate tax** regime is slated to sunset on December 31, 2010, such that after 2010, a year in which no estate tax would exist, 2011 would see a return to a \$1 million per person exemption and a 45% maximum tax on larger estates. Obama's plan as it relates to the estate tax is to allow for a \$3.5 million per person estate tax exemption and apply a maximum rate of 45% for assets in excess of

that level. As prudent estate planning can add significant value to future generations and should not be overlooked, we will provide our thoughts regarding these opportunities in a separate offering.

What are President-elect Obama's prescribed spending and regulatory plans?

Often government-related spending and programs can shift the investment environment, creating new opportunities or quelling others. As we evaluate the investment landscape ahead of us, we will take special note of the issues President-elect Obama has discussed as areas to increase the amount of dedicated resources:

- Education
- Military
- Green Technology & Alternative Energy
- Infrastructure
- Health Insurance
- Tax breaks/incentives for small businesses and businesses that bring more jobs to the U.S.

The funding for the above priorities will likely come from:

- Higher taxes for wealthy individuals
- Proposed closing of tax loopholes that are currently exploited by corporations
- Legislation that would levy income tax on incentive fees earned by hedge funds and private equity funds
- A cap and trade or similar system for controlling greenhouse gases
- Eliminating tax breaks for gas and oil companies
- Reduction in spending on Iraq
- More efficient spending on programs such as Medicare/Medicaid

Indirect impacts to the financial system may arise from policies related to:

- An increase in the minimum wage
- Tighter regulation and greater transparency on the financial industry
- A different approach to global diplomacy
- Imposing tighter budgetary controls on government spending
- A more union-friendly environment
- Efforts to create regulation around equal pay for equal work in order to insure that women or minorities are not disadvantaged

In Conclusion:

"The best laid plans of mice and men often go awry" is a quote taken from Robert Burns' poem *To a Mouse* and which was the inspiration for the aptly titled John Steinbeck novel, *Of Mice and Men*, a story about two displaced migrant ranch workers in the Great Depression. Given the challenges presented to our economy today, much like the challenges faced nearly 80 years ago; President-elect Obama faces some tall hurdles and must be prepared to adjust as the best laid plans often go awry. Investors need to be prepared and nimble enough to anticipate coming changes and to maximize the potential of their portfolio. Convergent is closely monitoring the developments in Washington to determine how changes in our government will affect portfolios and we will develop recommendations for changes to portfolios as appropriate.

Disclosure:

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Convergent uses a forecasting methodology to calculate these forward looking forecasts. The three key inputs into the optimization framework include expected returns for the asset classes to be modeled, expected risks (volatility) and pair-wise correlation coefficients among those asset classes (asset classes with low correlation provide portfolio diversification). We generate forward-looking return forecasts for the modeled asset classes that are linked to projections of economic growth, interest rates and consensus earnings forecasts, taking into consideration current market valuations as well as our longer-term global views. Risk and correlation projections are based largely on historical observations and relationships. For this analysis, we have modeled a ten-year period, commencing in 2008 and ending in 2017 (we feel that a ten-year horizon is an appropriate time-frame for evaluating existing and potential portfolios as it is long enough for a policy portfolio to be reasonably implemented and held but is short enough for projected dollar amounts and inputs to still be meaningful). At the end of this period, we assumed the portfolio continues to be managed and is not liquidated, nor are any accumulated, applicable unrealized capital gains taxes paid at the end of the period. In order to better evaluate the risk of the potential portfolios, we utilize a Monte Carlo simulator to provide probability estimates. These probability distributions allow us to evaluate risk of a particular asset mix in a number of different manners that a client may be more familiar with, beyond just projecting their standard deviation. A detailed description of the methodology of deriving these forecasts, which are updated on a quarterly basis, is available upon request.