Please remember to contact Beacon Financial Advisors, Ltd. if there are any changes in your financial situation or investment objectives, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A free copy of our FIRM BROCHURE (Form ADV, Part 2) is always available upon request.

An important note: Where reference is made in VIEW to Beacon’s relative performance, or individual mutual fund performance, it applies to fully invested portfolios for the period. Actual results vary among clients, as risk tolerance levels and the timing of asset purchases & sales are unique to each of our clients. Each client’s unique results are revealed in the performance reports inside their Investment Review. Clients are urged to compare the custodians (Schwab Institutional et al) account statements with Beacon’s reports.

“Al Qaeda disbands; Says Job of Destroying US Economy Now in Congress’ Hands.”
Comedian Andy Borowitz on the “Fiscal Cliff”

3rd hour theatrics were required for Congress to pull us all away from the “fiscal cliff”. After the Senate voted 89 to 8 to approve the—drumroll please—American Taxpayer Relief Act, the House of Representatives rubber-stamped the bill by a vote of 257-167. We emphasize “relief” because normally one cannot get the Senate and House to agree on what time it is! But “relief” for whom? Certainly not for industrious, hardworking families with taxable income above $450,000. Those families in exactly the same income situation as 2012 will see a substantial tax increase. We think this is a case of “the devil is in the details” because there will be many taxpayers surprised to find out their taxes are going up even though their tax rates are unchanged. And that is because of Congress’s favorite way to raise tax revenues—thru the “back-door” approach—what Beacon characterizes as “stealth taxation” (see definition below). Keep these phrases in mind: PEP and Pease.

At first blush, the law appears simple. Only the highest tax rate in 2012 at 35% will increase to 39.6% for single filers with $400,000 or more in taxable income, and joint filers at $450,000 and higher. All other tax brackets will remain as they were. But, the two backdoor tax increases—PEP and Pease—will apply to taxpayers earning meaningfully less (thresholds are $250,000 for single filers, and $300,000 for joint filers). PEP stands for Personal Exemption Phase-out. The personal exemption is a deduction before arriving at taxable income and in 2013 is $3,900 per person. A family with four children could deduct $23,400. But the PEP stealth tax means the personal exemption is “phased out” above $300,000 and is vanished completely at $422,000. The Pease stealth tax (named for former Ohio D-Rep Donald Pease) is a cap or limitation on all itemized deductions (Schedule A on a Form 1040). For taxpayers above the aforementioned thresholds, up to 80% of itemized deductions can be eliminated. Of all the articles we’ve sifted through about the new tax law, we think this quote by a New York CPA says it all: “The new law replaces uncertainty with confusion. Only tax wizards can understand the entirety, specially for those earning between $200K and $450K.”

Definition of stealth tax (n)
bing.com - Bing Dictionary
Stealth tax—unnoticed additional tax; a new tax or a tax increase that is introduced largely unnoticed, or an additional charge that is effectively a tax though not officially classed as one.
The US economy exited recession around July 2009 (the stock market bottomed in March 2009), and since then has resembled what economist Brian Wesbury has termed the "Plow Horse Economy" (not the record-setting thoroughbred in the mid-1980s or 1990s, but it’s not going to keel over and die-by-recession either). In 2011 real* GDP (*nominal economic growth less inflation) grew 2%. While official reports on 2012 GDP will be released in late January, 2012 will resemble 2011’s 2%. The median of the range of estimates for 2013 is 2.5%. That’s slightly faster growth than 2011-2012, mostly due to projections of manufacturers inventory replenishment, and rebuilding from Super-Storm Sandy. This is not a recession outlook.

Oft-cited signs the underlying trend for economic growth has improved are accommodative monetary policy (loose), and an emerging self-sustaining recovery in residential housing. Housing is apparently bottomed and new-home starts are up over 20% from a year ago. Even with annual new home starts nearing 775,000+, it is widely reported that is only about half the level that will be needed to support demand over the next several years.

The consumer spending outlook is constructive since for many US middle-income taxpayers the American Taxpayer Relief Act (see p. 1) means most will not see an increase in their federal income taxes. The 2011-2012 2% cut in the employee’s share of the payroll tax was not renewed for 2013, but that is not viewed as a major economic negative.

Inflation declined in 2012 to about 1.8% versus 3% in 2011 (Social Security check increases will be smaller as a result). A consensus view is inflation will reaccelerate back to 2.5% or more attributable to increases in housing costs, health care, and education (does education EVER cost less?).

As for interest rates, the FED has already signaled it will keep short-term rates near 0%, but recently noted it will begin to raise rates when US unemployment declines to 6.5% (now in the high 7%’s). So 2013 looks predictable, but 2014 could see FED interest rate hikes. The longer end of the yield curve (controlled by the “market”) is a harder call, but the consensus view is the 10-year Treasury yield now at about 1.9% will increase by 100 basis points or so by the end of 2013. This year market-rates may rise as investors (e.g. the “market”) “activate” on the FED’s benchmark on unemployment push longer-rates higher as the economy improves. Notably, mortgage interest rates will rise along with the 10-year Treasury but not enough to derail the housing recovery.

Now about politics—there are no badges of courage expected to be handed out in 2013. It is widely expected the (global) political class will not deviate to much from the recent past. In Washington D.C. the unemployment rate is very low, and the housing market is red hot, but major structural fiscal reforms for “flyover-country” are very cold. The near-term headlines will be about the debt ceiling, automatic spending cuts (e.g. sequestration), entitlement structural reforms, and tax simplification. Our two-party combatants likely will not be able to forge “grand bargains” but only incremental, piecemeal approaches.

In summary, this economic outlook is a decent (yet unspectacular) backdrop for corporate earnings and thus, for stocks. Prices for stocks (i.e. P/E multiple) using historical and forward earnings estimates remain relatively attractive in the US and even more so in some developed and emerging economies. However, the US interest rate cycle suggests US bond total returns will be much lower than 2012. Hence, we began shifting some bond allocations to international markets in 2012. Overall, this “plow horse economy” economic outlook will factor in as Beacon assesses our 2013 investment strategy.
STOCKS  All of Beacon's stock fund partners produced double-digit returns in 2012, as did our international funds led by Dodge & Cox and Third Avenue Value at 22% each. Dodge & Cox (San Francisco) has long been a holding in our clients portfolios across three major asset classes of US stocks, international stocks, and US bonds. A 2012 quantitative ranking by Morningstar of the 30 largest mutual fund companies found Dodge & Cox at the very top (see below; note $1MM is average manager investment in own fund!). Recently Morningstar featured Dodge & Cox in their 11/13/12 WHAT MAKES A GRADE A FUND COMPANY: Two Exemplary stewards of shareholder capital.

We’ve inserted the link (below) to the full article, and here are a few of the major observations Morningstar made about Dodge & Cox:

⇒ ...Is not a household name, and has never tried to be, but is one of the finest fund companies there is.
⇒ ...Shines in our stewardship ratings...it has the rare distinction of earning not only an overall A, but an A for the individual components that go into the rating (Corporate Culture, Manager Incentives, Fees, and Board Quality).
⇒ ...Features management teams with long tenures...take a long-term perspective...(has) a clearly articulated strategy.

To read hyperlinks, hold CTRL + click (mouse)
• http://news.morningstar.com/articlenet/article.aspx?id=573153
• http://www.morningstar.com/advisor/t/66373036/what-makes-a-grade-a-fund-company.htm?q=what+makes+a+grade+a+fund+company

BONDS  Bond sector returns were a mixed-bag in 2012 as the bell-weather Barclays Aggregate Bond Index returned 4.23%. We say “mixed-bag” because this widely-followed index is heavily weighted to US Treasury and Agency bonds (i.e. “risk-free”), with smaller weightings to corporate and mortgage-related bonds. As retail investors continued their post-2008 stampede away from stocks and into bonds (i.e. sell low, buy high), and yields were already abnormally low, safe-bonds underperformed.

Contrary to the index, Beacon's bond partners had an exceptional! We say exceptional because it’s a real milestone when a taxable bond manager outperforms it’s benchmark by 700 basis points like MetWest Total Return (MWTIX) did with it’s 11.5% return. Morningstar nominated the MetWest team as one of three finalists for US fixed income manager of the year. Beacon’s other taxable bond manager, Dodge & Cox Income (DODIX), also had a notably good comparative year with a return of nearly 8%. On the tax-exempt (municipal) bond side, total returns were even more impressive as AllianceBernstein’s two funds returned about 17% and 9% respectively (ABTYX, ALTVX).

Overall 2012 was rewarding for our balanced, global portfolios. Conservative clients’ total returns exceeded 10%, and moderate/aggressive clients had returns in the 12% to 15% range. Because bond returns rivaled those of stocks, in 2012 we did not perform any major portfolio rebalancing. As we noted on p. 2, the economic outlook and valuations favor stocks versus bonds, so major rebalancing is not imminent.