Quarter Notes

Second Quarter 2012

What is “asset allocation”?

The performance of an investment portfolio is affected by many factors, among them:

- *security selection*, the choice of a stock or bond that fits well in the investor’s overall strategy;
- *timing,* the purchase and sale of portfolio assets at the best point in the market cycle (buying low, selling high); and
- *asset allocation,* the choice of relative weight for various asset classes held in the portfolio.

According to academic studies, the third element makes the greatest contribution to portfolio performance. Deciding upon the composition of the portfolio, choosing among various asset classes, and rebalancing the portfolio from time to time helps smooth portfolio volatility for a given targeted return.

From the desk of:

DeAnn Y. Peter
Investment Executive
573.499.7317
E-mail: deann.peter@primevest.com

Jackie Shupe
Investment Executive
573.499.7308
E-mail: jackie.shupe@primevest.com

Joseph Eckelkamp
Investment Executive
573.499.7341
E-mail:
joseph.eckelkamp@primevest.com

Landmark Investments

Located at:

Landmark Bank
801 E. Broadway
PO Box 1867
Columbia, MO 65205
Office: 573.449.0811
Fax: 573.443.5344

Begin with the classes

The various investments in a portfolio may be divided into asset classes. The historical record of each class may be evaluated to determine expected risk and reward characteristics for the class as a whole. Such asset classes may include:

- Large-capitalization growth stocks;
- Large-capitalization value stocks;
- Mid-cap growth stocks;
- Mid-cap value stocks;
- Small-cap growth stocks;
- Small-cap value stocks;
- Commodities;
- Real estate investment trusts;
- International stocks;
- Emerging markets stocks;
- U.S. investment-grade bonds;
- High-yield bonds;
- Foreign bonds;
- Cash.

The different asset classes are subject to different kinds of market risks, so they do not respond to market developments in the same way. To simplify, some years when stocks are up, bonds are down. Some years it’s the reverse. On the other hand, there are times when stocks and bonds do seem to be moving together, up or down. The degree to which each asset class moves together with the other classes can be mathematically determined and is called *correlation*.

A mixture of asset classes may be created to match the investment objectives of a given investor. (See “Portfolio profiles” below for examples of objectives.) For example, an investor who is concerned about capital preservation and maximum current income might invest 60% in bonds, 40% in stocks. An investor with a long time horizon, who is willing to accept higher risk in search of maximum capital growth, might choose 100% stocks, including riskier small-cap issues and emerging market equities. There are countless portfolio variations, each with determinable risk and reward characteristics.

Fine-tuning

The historical returns of asset classes are not simply accepted at face value; they must be put into context. The long-term trend for each asset class is identified and compared to the recent trends. If an asset class appears undervalued with this analysis, its weight in the portfolio may be increased; if it is overvalued, decreased.

Once the model for the portfolio is established, specific securities will be selected that conform to it. The portfolio will need to be monitored on an ongoing basis for unexpected deviations from the historical norms.

By understanding and using such data, through the process of portfolio optimization the riskiness of a given portfolio may be reduced without sacrificing the potential for reward. Alternatively, one may increase the potential expected return, without increasing risk, through appropriate adjustments among the asset classes.

Getting help

How many individuals are able to manage their investment portfolios with such a level of sophistication? Probably not many. But these are the tools used by institutional investors and professional portfolio managers.

We help people with their investment and financial management tasks throughout their financial life cycle. The steps needed to achieve financial independence are not always easy to take, but they become easier when you have professional assistance in implementing your plans.

Please give us a call when you need a hand in managing your investment portfolio.

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

Portfolio profiles

Where do you fit in along the risk/reward continuum? Here are some sample portfolio types that may be used in discussing asset allocation models.

Profile	Objectives	Comment
Conservative income	Current income, capital preservation is a secondary objective.	Relatively lower risk
Balanced	Capital preservation and capital growth	Moderate risk
Moderate Growth	Long-term capital gains	Moderate risk
Growth	Long-term capital gains	Riskier assets
Aggressive Growth	High returns	Highest risk

Source: M.A. Co.

Is it too early for year-end planning?

One key requirement for successful management of an investment portfolio is tax management. Taxes are not the most important thing, but by paying close attention to them one can measurably improve portfolio returns.

The basic rule is that long- and short-term capital gains may be netted against each other to reduce one's taxable income. If one has realized capital gains, one might "harvest" capital losses to reduce taxes. Also, up to $3,000 of net capital losses may be written off against ordinary income each year. In general, one wants to defer taxation as long as possible.

However, tax uncertainties may change the calculus in 2012.

Changing rates

This year, the top tax rate on long-term capital gains is 15%, and the top rate on short-term gains is 35%. Next year could be a very different story. Under current law, all of the "Bush tax cuts" expire at the end of this year. That would push the top rate on long-term gains to 20%. In addition, the phase-out of deductions for higher-income taxpayers would return, adding 1.2% to the bill. What's more, under the Affordable Care Act, an additional 3.8% tax will apply to the investment income of higher-income taxpayers, bringing the final tax rate on long-term gains to 25%. That's an already scheduled tax rate increase of 66.6%. Short-term gains would be taxed at 44.6%.

These are the taxes already on the books. In addition to these, President Obama has proposed the "Buffett rule" tax, which would apply a 30% tax rate to long-term gains of millionaires.

Top tax rates on capital gains

	2012	2013	Plus deduction phase-out	Plus Affordable Care Act tax	Total 2013 tax on capital gains
Long-term gains	15%	20%	1.2%	3.8%	25%
Short-term gains	35%	39.6%	1.2%	3.8%	44.6%

Source: M.A.Co.; Internal Revenue Code

When the Bush tax cuts were on the brink of expiration in 2010, the Congress extended them for two years, with a December tax bill. That could happen again. But the reason given for that extension, that the economy was not growing strongly enough to handle a tax increase, was more clearly true then than it is today. The economy is somewhat stronger, and the national debt much larger, than in 2010. The fate of the tax rates could turn on the outcome of the November elections.

Conventional wisdom may not apply

The prudent course is to not hope for or plan for tax law changes, but to base decisions upon the rules that are on the books today.

That suggests that some taxpayers should consider realizing gains this year, to lock in the lower tax rates, and hold off on selling losers until 2013.

Taxpayers who have several lots of the same stock may identify to the broker which lot should be sold. If shares have been purchased over a period of years, each of these lots could have a different tax basis. The usual rule of thumb is to sell the shares with the highest basis to minimize the taxable gain on the sale. In 2012, the better course may be to sell the low-basis shares first, to maximize the lock-in of the lower tax rates.

Hypothetical example. Alice bought 100 shares of XYZ four times over a period of ten years. Her purchase prices were $20, $70, $75 and $100 per share. The shares are trading today for $100 each. Thus, Alice's $40,000 in XYZ stock has a tax basis of $26,500, indicating a gain of $13,500. If Alice is in the top tax bracket, she'd owe $2,025 on a sale in 2012, or $3,375 if she waits until 2013.

If Alice sells the 100 shares purchased most recently, she'll have no gain at all. If she sells the 100 shares purchased for $20 each, her gain will be $8,000. A sale in 2012 yields a federal tax on $1,200, while a sale in 2013 would be taxed at $2,000 (assuming no further changes in price or tax laws).

Against these tax factors, Alice will need to weigh the outlook for XYZ stock. If the price goes up enough in the next year, that fact could be more important than the higher tax rates.

To learn more about how taxes may affect your portfolio planning, see your tax advisors. *Neither PrimeVest nor any of its representatives may give tax or legal advice.*

Just ask us

What is meant by “large-cap” and “small-cap” stocks? Are large caps better than small caps? Which is better for me?

The market capitalization of a company is the total value of stock in the shareholders’ hands. It is the product of the share price times the shares outstanding. Although the definitions are somewhat fluid, generally a market capitalization of $10 billion is considered large, and a capitalization of $2 billion or less is small. The range from $2 billion to $10 billion is the mid-cap area. “Mega-cap” stocks are those with capitalization over $200 billion.

Each category has advantages and disadvantages. Large companies, with more resources, tend to weather financial storms and economic downturns better. However, all the large companies are followed very closely by Wall Street analysts, so finding an “overlooked gem” is less likely. Smaller companies may have greater potential for explosive growth, and over the very long run, the return from small stocks has been higher than from large stocks.

There’s no simple answer to which stocks are right for you. You’ll need to consult with your investment advisors to explore that question.