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INVESTMENT PERSPECTIVES

Taxes Are Not Just A Year End Event

This quarter's Investment Perspectives will focus on how we work with our clients throughout the year in helping to achieve the best after-tax results consistent with appropriate investment decisions. Since almost all of our clients are families that usually have some of their assets in Living Trusts or other taxable accounts, after-tax results are very important. In our opinion, it really is not what our clients make or earn before taxes, it is what they keep after taxes!

Following are the tax issues that we address with our clients throughout the year:

- Capital Gains – We continuously strive to generate only long-term capital gains in our clients' taxable accounts. This is a very important tax-related benefit we provide for all of our clients. If an appreciated asset is sold in the first year it is owned, it is subject to ordinary income taxes. Depending on a client's tax bracket, ordinary income tax rates may be as high as 35% for federal taxes and 9.3% for state taxes for residents of California. However, if the appreciated asset is sold after one year, the capital gains tax rate is only 15% for federal taxes while the California state tax remains at 9.3%. Note that some states have their own capital gains tax rates, but California does not.

  For example, assume that you started with $1 million invested in common stocks on January 1, 2006 and these assets grew by 8% in 2006. If you sold all of the stocks before the year elapsed, you would pay taxes at ordinary income tax rates. You would have earned $80,000 gross but would have paid combined federal and state taxes of about $32,800, for a net gain of $47,200. On the other hand, if you held the stock for at least one year, you would still have earned $80,000 gross but would pay combined federal and state taxes of only $16,800, for a net gain of $63,200, or 34% more than the net gain of $47,200 if you sold before one year. Due to compounding, the benefits of holding your assets for at least one year versus selling before one year elapses becomes even more advantageous.

- Tax Harvesting – We continuously monitor our clients' portfolios to see if there are any stocks with losses that can be sold to offset capital gains. We do not believe in

aggressively selling assets in a portfolio to achieve this tax break, but we do believe in selling if the advantage is significant. The IRS has approved two ways of taking the loss: 1) either selling the original position and then buying it back after 30 days, or 2) doubling the position and then selling the original position after 30 days. We typically use the second method when we can since it is not uncommon for a stock to realize most of its performance within a 30-day period each year, and we are not smart enough to know when that period will be!

- Other Gains and Losses – We regularly ask our clients and their tax advisors to inform us of any realized gains or losses in assets that we do not manage. These could be large casualty losses, real estate gains or losses, etc. We take these gains and losses into consideration when we are buying or selling stocks that we manage for our clients.

- Portfolio Turnover – It's important to recognize the impact that portfolio turnover has on after-tax returns. (The definition of turnover, by the way, is the greater of purchases or sales during any one year divided by the average weighted portfolio during the year.)

  A recent Stanford study compared median pre-tax and after-tax performance for 62 actively managed stock mutual funds over a 30-year period from 1963 to 1992. A high tax-bracket investor received 45% of the pre-tax performance, while a medium tax-bracket investor received 59% of the pre-tax performance. Further, assuming they liquidated their investments at the end of the year and paid additional capital gains taxes, these figures dropped to 42% and 55% respectively. The conclusion is that high portfolio turnover significantly reduces your after-tax returns.

  Unfortunately, turnover rates for assets held in mutual funds are increasing dramatically. Twenty-five years ago, mutual fund portfolio turnover averaged 30 percent - today it averages over 100 percent! At HCM, our 2004 turnover rate was 18% – that is why our after-tax returns are quite attractive for any taxable portfolio.

- Value vs. Momentum Growth – Turnover for a momentum growth portfolio can be up to five times higher than turnover for a value portfolio. With turnover rates this high, many of the gains in momentum growth portfolios are short-term in nature and taxed at ordinary income tax rates. We will typically own a company for 3 to 6 years before selling whereas a momentum investor may own a company for 3 to 6 months, or less! Patience and discipline in the investment process are very important – selling after a short time does not produce the best after-tax results.

- Bonds – We use a tax-sensitive approach for purchasing bonds in our clients' taxable accounts. We have a model that determines the most appropriate type of bond to buy at any point in time based on current bond yields and our clients' individual tax brackets. For many of our clients in higher tax brackets, double tax-free municipal bonds are most appropriate. For example, a municipal bond due in eight years would now yield approximately 3.6%. It would take a corporate bond yielding 6.1% (which

is subject to both federal and state taxes) to match the municipal bond yield. However, eight year corporate bonds are yielding only 5.0% now, so our model would automatically select the municipal bond for the client in the highest tax brackets.

Before continuing, we would like to **strongly emphasize** that final decisions regarding taxes should always be reviewed with a qualified CPA or enrolled agent, and that legal issues should always be reviewed with a qualified attorney. Our role is to point our clients in the right direction and identify ways that they can meet their goals – we are not the experts in taxation and estate planning.

In addition to the ongoing tax planning discussed above, in client meetings we are often asked questions regarding various financial planning strategies. Some of the more common strategies are discussed below:

- Gifting to Individuals – In 2006, any individual may gift up to $12,000 (this is an increase from $11,000 in 2005) to any other individual without the gift counting against his or her $1 million gift tax exclusion. We also suggest to our clients that they consider gifting appreciated stock (rather than cash) to their children if the child's capital gains tax bracket is lower than the parent's tax bracket. (Note that different tax rules may apply based on whether the child is over or under age 14 and how much earned income the child had). This is a good way for grandparents, for example, to pass on some of their wealth outside of their estate.

  In addition to the $12,000 gift, you may gift tuition paid directly to an educational institution and medical expenses paid directly to the provider. These two gifts do not count against the $1 million gift tax exclusion.

- Gifting to Charities – If a client is planning to gift to a charity, it is usually much better to gift appreciated stock rather than cash to a qualified non-profit organization. A client can take a tax deduction for the market value of the stock on the date of the gift and avoid paying any capital gains taxes.

- Charitable Remainder Trusts – In a Charitable Remainder Trust (CRT) a client irrevocably gifts assets to a charity in exchange for the following benefits:
  - A high, steady rate of income for the remainder of the donor(s) life or of designated beneficiaries lives
  - Elimination of capital gains taxes
  - A current income tax deduction
  - A probable reduction in estate taxes

  Because the charity does not pay capital gains taxes, it makes sense for CRTs to be funded with highly appreciated assets (such as real estate) or low cost-basis stock. Note that real estate must be held free of debt to qualify for the Charitable Remainder Trust.

- Step-Up in Basis – As our clients get older or their health begins to deteriorate significantly, we have advised them to delay selling appreciated assets. In the estate of a person who has died, the appreciated asset usually receives a step-up in basis to the current market value – this means that the appreciated asset has a new starting point for tax purposes. This new "basis" is the value of the stock on the date that the owner died, rather than on the date that the owner bought the stock. This strategy usually results in a significant reduction in capital gains taxes paid by heirs when they sell the asset.

- Legal Title – We encourage our clients to always consult their attorney regarding the most appropriate type of legal ownership (Living Trust, Crummey Trust, etc.) for their assets.

- College Funding – One of the best ways now for a parent or grandparent to help with college education for their children or grandchildren are the so-called 529 Plans (named after Section 529 of the Internal Revenue Code). In a 529 Plan, earnings grow tax-free and are typically not taxed if used for qualified higher education expenses. The owner of the Plan (typically a grandparent) may establish it for the beneficiary (typically a grandchild). The owner may gift up to $12,000 per year, and two owners (i.e. two grandparents) could gift $12,000 each. As a special incentive, an owner may contribute up to 5 consecutive years all at one time (a total of $60,000 for one owner or $120,000 for two owners) without it impacting his or her lifetime gift tax exemption. The owner(s) would have to file gift tax returns for the next five years.

- Business Retirement Plans – If a client has not established a retirement plan for his or her business, we point out the tax benefits of such a plan. Typically, pre-tax funds can be contributed to the Plan and can grow tax-free within the Plan before being taxed upon withdrawal.

- Zero Premium Collars – This can be a useful tool for large concentrated low-cost equity positions in a thinly traded or illiquid stock. A zero premium collar uses derivative transactions designed to protect an investor against a significant drop in the price of a stock. In exchange for downside protection below a certain "floor" price (by purchasing a put option), an investor gives up some upside above a certain price (by selling a call option). If the money you receive from selling the call option is equal to what you pay for buying a put option, the cost to you is zero – this is known as a Zero Premium Collar.

Our goal in making clients aware of tax and estate planning issues is to ensure that they can use this information in planning their financial lives. While all investment decisions should be based on sound research and intelligent analysis of each individual stock, there are tax-related decisions that everyone should consider in managing their assets.

While we make every attempt to have our clients' assets grow consistently and safely, it is important that tax and estate planning issues are included in the wealth management

picture. We will continue to ensure that we manage our clients' assets wisely while providing them with appropriate advice regarding their entire financial picture.

HCM’s investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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