Market Commentary - October 2015

Stocks just finished their worst quarter since 2011 with the S&P 500 finishing down 6.9% and the Dow falling 7.6%. The current correction, which began in May, seems especially nasty this time as almost 40% of S&P 1500 stocks (a larger, more representative index comprising large and mid-cap stocks) are down at least 25% from their 52-week highs. This degree of share price damage is usually reserved for true bear markets. The biggest surprise was that health care stocks, normally a more defensive area and a good place to ride out corrections, were not spared, falling 11.1%.

The correction began on concerns the Chinese economy was slowing at a faster pace than reported which then led to growing anxiety about U.S manufacturing exports in general. The Fed was widely expected to raise interest rates in September (from its current baseline of zero) and when they chose to wait, investors were caught off guard and wondered … Is the U.S. economy slowing? Is recession now a greater possibility? The most recent bear narrative hinges on expectations of disappointing Q3 earnings (down 4.6%, or up 1% ex-energy). A government shutdown would have added insult to injury though the funding battle will return in December. Clearly, bearish sentiment has grown more pervasive over the past five months.

Of course no one really knows if we are simply experiencing a typical correction or the beginning of something more dramatic. Are things really that bad? Do the bears have it right? We don't think so. The economy is growing, interest rates should remain low, and valuations are no longer stretched as they were last spring. Earnings are expected to grow 10% in 2016 although we suspect that number will be revised somewhat lower in the coming months. Many higher quality stocks are now near bargain basement prices. So, for now we remain optimistic but not Pollyannaish. We will continue to move equity portfolios toward a more conservative, more cautious stance in acknowledgement of the cycle's current fatigue.

Tax Aware Investing

Why are Separately Managed Accounts the right choice for High-Net-Worth investors?

At Clearview we make extensive use of Separately Managed Accounts (SMAs). While more complex to work with, they offer far greater customization potential and flexibility. *Through the use of SMAs, each security can be treated independently and therefore in the most tax-aware manner. Further, they can be tailored to each client's unique and changing circumstances.*

Why is tax-aware management so important today?

Taxes are an unpleasant but inevitable fact of life. However, the amount of tax paid can be reduced through careful planning. **We define tax-aware management as the maximizing of client specific after-tax returns.** Few asset managers focus on their client's after-tax returns and most investment advisors do not engage in tax-aware best practices either. The lack of emphasis on reducing taxes and thus improving after-tax returns means most investors pay more than they should which may act as a limiter to lifestyle in retirement. Federal taxes alone could cost from a quarter to a third of net realized gains. *Therefore, we believe that thoughtful planning and execution is an important element to the asset management/investment advisory process.*

How sensitive are you to taxes (realized gains) in your portfolio? Are there many opportunities to tax-loss harvest this year?

We are always sensitive to the tax consequences of our actions. After all, investors should focus on after-tax returns. Tax-aware management does not drive investment decisions but is an important part of the process. Our long term time horizon combined with lower portfolio turnover help to improve after-tax returns.

The opportunities for tax-loss harvesting this year depend on when the portfolio was funded. For those who have been invested in the entire bull market cycle, there is less opportunity to tax-loss harvest because of large unrealized gains across the portfolio. More

recent purchases, however, may offer the opportunity to realize small capital losses. *For those investors who funded in the last few years, there is likely to be more harvesting opportunities. Continued volatility should create even more opportunities to realize short term losses with the goal of reducing net realized capital gains.*

Why is the deferral of portfolio gains important?

The primary goal of active tax-aware investment managers should be to maximize after-tax returns. Short term gains (taxable positions held less than one year) are taxed at ordinary income rates which can escalate to nearly 40% as income rises! The tax on long term gains, while only about half that of short term, is still a substantial impediment to portfolio growth potential and therefore should be postponed for as long as possible. *Unless taxes are expected to rise dramatically, deferring gains when and where possible is an essential part of maximizing each client's after-tax returns. Knowledgeable estate planners, tax professionals and investment advisors agree that the deferral of gains is advantageous to portfolio growth in nearly all situations.*

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