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High Pointe

DATE: April 20, 2016
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Taxiing through Taxing Times

Ask affluent people what their marginal tax bracket is and most will say 39.6%. A few might elaborate and say that they pay only 20% because they make sure that most of their income comes from dividends and long-term capital gains, and not from interest income or short-term capital gains.

Both answers underestimate their effective marginal tax rate. Take into account the following additional tax-related costs.

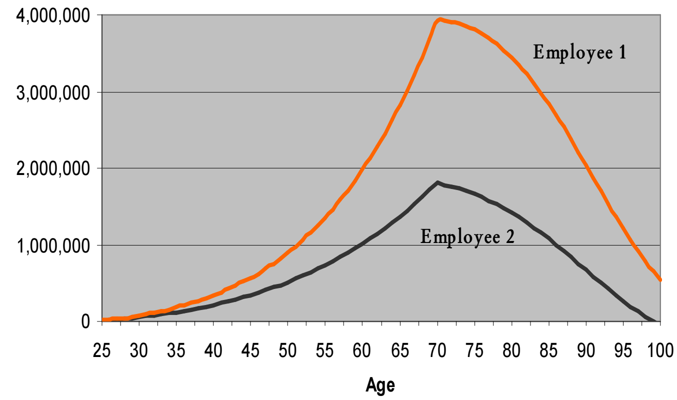
- Net Investment Income Tax (imposed as part of Obamacare)
- State Income Tax
- Alternative Minimum Tax Exemption Phase Out
- Itemized Deduction Phase Out

The exercise will make you realize that the effective marginal tax rate on interest income and short-term capital gains for affluent investors can range from 39.6% to 57.9%. And, marginal tax rate on dividends and long-term capital gains can range from 20% to 45.3%.

Given that effective tax rates are higher than perceived by affluent clients, they deserve our full attention in designing and implementing an investment strategy for their assets. In our client letter last quarter, we listed several steps that should be taken to design a tax-efficient investment strategy. In addition, high tax rates can, and should, influence how clients save and withdraw money for retirement. This quarter we focus on the optimal strategy for saving. Next quarter, we will write about the optimal strategy for withdrawing assets in retirement.

One of the key strategies for saving assets for retirement is to put them in tax-deferred accounts such as 401k and IRA accounts. There is little argument about the merits of this idea for those who are early in their careers as shown on the next page.

The chart to the right shows accumulation of assets for two employees.[1] They save identical amounts. Employee 1 invests in a retirement account and Employee 2 invests in a taxable account. Both employees invest identically and spend identically in retirement. It is clear that Employee 1 is well covered past age 100 whereas Employee 2 runs out of money at age 99.



It is easy to reach the conclusion that a 25-year old is well served by maximizing his contribution to the tax-deferred investment vehicle. But, what about someone who is older and richer? Should he continue to contribute to a tax-deferred retirement account? Up to what age?

Some advisers recommend that clients stop contributing to retirement accounts as they get older and as their retirement account balances get large. Below, we examine some of the reasons given to support this recommendation. It is our opinion that that some of the arguments have merits but others do not. Therefore, a "one size fits all" recommendation to stop contributing to retirement accounts does not make sense. Instead, each client situation needs to be examined individually in order to make the right decision. Here are the most cited objections to the idea of maximizing contributions to tax-deferred retirement accounts.

- *Withdrawals from tax-deferred accounts are mandatory but not so from taxable accounts*
  Yes, but the mandatory withdrawal requirements are typically small relative to the spending needs of most affluent clients. In the example above, the client would have to withdraw $81,000, after taxes, in the first year. It is safe to assume that this client's expenses exceed that amount by a considerable margin. Of course, one needs to ensure that the Required Minimum Distribution is not going to trigger incremental taxes (e.g., Net Investment Income Tax). This requires anticipation and correction during the course of the year rather than waiting until the end of the year.

- *Taxable accounts get a "step up" in basis at death but that benefit does not accrue in retirement accounts such as IRAs*
  It is true that at the time of an individual's death, his beneficiaries inherit the assets at current market value and do not need to pay capital gains tax on the appreciation that those assets have experienced. In other words, the cost basis of the inherited assets is "stepped up" to be equal to the current market value. However, the benefit of the step up in basis is offset by the lower past growth of the assets because of the lack of tax deferral.

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[1] *Assumptions: Initial Salary: $75,000 growing at 4% per year. Contribution Rate = 13% of salary until age 70, then withdrawal at the IRS mandated Required Minimum Withdrawal Rate for Employee 1. Equity Return 7.5% per year, Fixed Income Return 3.5% per year. Assets invested using the formula Equity Allocation Percentage = 110 – Age. Equity Return Components: Dividend 2%, Long Term Capital Gains = 80% of Total Capital Gains. Tax Rate of 23.8% on long term gains and dividends and 43.6% on interest income and short term gains.*

- ***Excess accumulation in retirement accounts increases the probability of an estate exceeding $10.9 million (for a couple) thus incurring estate tax***
  This point is superfluous. Additional estate tax would be levied only on the "extra" assets resulting from the tax deferral thus generating incremental wealth, net of additional taxes.

- ***Withdrawals from an IRA are taxed at the ordinary income tax rate whereas those from taxable accounts might be eligible for a more favorable capital gains tax rate***
  This point certainly has some merit. However, clients should realize that in order to experience capital gains, one has to invest in equity-oriented assets. Practically speaking, many clients decrease their equity exposure as they get older and often hold some bonds in their taxable portfolios. This asset allocation decision, although logical, can get in the way of using taxable accounts in an optimal manner.

- ***Taxes in the future are likely to rise and therefore it is better to pay taxes now rather than pay them in the future***
  Even though this point is speculative, it does have some merit. In light of large government deficits, it is hard to imagine a scenario where our taxes in the future will not be higher. It is possible to calculate how much taxes would have to rise for the tax deferral advantage to be negated but we leave that exercise for another time.

So, some of the objections to holding large retirement accounts are valid but others are not. Clients should note that blind faith in these objections might make them miss out on a valuable opportunity – the opportunity to convert a regular IRA to Roth IRA. In Roth IRAs one pays taxes up front and then enjoys the opportunity to see them grow forever without paying any taxes on the income and capital gains, and with no required minimum withdrawals.

Integrating taxes into your investment, saving, and withdrawal strategies is complex because it requires customized analysis. We would encourage clients to figure out their effective tax rates and then have a discussion with their investment adviser. Such a discussion will likely reveal that a majority of clients should hold assets in all three types of accounts – taxable, tax-deferred, and Roth. The proportions will vary depending upon each client's specific situation. Until such a discussion takes place, it is critical that tax-inefficient assets such as taxable bonds be held in tax-deferred accounts. Also, investors should generate much of their return from long-term capital gains and dividend income.

At High Pointe, we follow this advice for our own clients. We hold tax-inefficient assets in tax-deferred accounts. And, we strive to achieve at least 80 percent of our equity returns through tax efficient means, i.e., through dividends and long-term capital gains. The data below for our funds (limited partnerships) shows the extent to which we have met our goal.

Percent of Return from Long Term Capital Gains and Dividends

	2013	2014	2015
High Pointe Funds	86%	94%	97%

Note: Each client situation is different. The ideas presented here should not be construed as investment or tax advice for any specific client. They are meant to highlight issues that High Pointe believes merit discussion. High Pointe is not a tax adviser.

Investment Returns

The returns of our main products are summarized below and a discussion of our investment strategy follows in the next section.

Investment Performance (Net of Fees)[1]

For Periods Ending March31, 2016

	One Quarter	One Year	Three Years	Since Inception[2]
Large Cap Value	-0.5%	-3.7%	11.0%	9.3%
Russell 1000 Value Index	1.6%	-1.5%	9.4%	6.6%
Large Cap Growth	-0.4%	-6.9%	9.7%	8.2%
Russell 1000 Growth Index	0.7%	2.5%	13.6%	3.7%
Small Cap Equity	-2.9%	-17.2%	0.7%	7.9%
Russell 2000 Index	-1.5%	-9.8%	6.9%	6.7%
International Equity	-2.2%	-13.6%	0.8%	1.3%
MSCI AC World ex US Index[3]	-0.4%	-9.2%	0.3%	0.7%
Global Opportunity	-3.4%	-11.5%	n/a	0.8%
MSCI AC World Index	0.2%	-4.3%	n/a	3.7%

[1]*Performance for the latest quarter is preliminary and subject to change.*
[2]*Inception Dates: Large Cap Value – January 1, 1998; Large Cap Growth – August 1, 1999; Small Cap - January 1, 1998; International Equity – December 31, 2006; Global Opportunity: October 1, 2013.*
[3]*Gross total return index from December 31, 2006 – December 31, 2009; Net total return index from January 1, 2010.*

High Pointe Capital Management, LLC (the "Firm" or "High Pointe") is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Advisers Acts of 1940 and its amendments. High Pointe is an independent investment management firm that is not affiliated with any parent organization.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Performance results are shown in U.S. dollars, net of management fee, and are based on composites of all fee-paying, fully-discretionary accounts. Returns for the periods presented are time-weighted. Results shown include all accrued dividends and interest, realized and unrealized gains and losses. Gross dividends were used to calculate the performance prior to January 1, 2010. As of January 1, 2010, accrued dividends used are net of non-reclaimable withholding taxes. Leverage has not been used in any portfolio in the composite. High Pointe's fee schedules are disclosed in Part 2A of the firm's Form ADV. All fully discretionary, fee-paying accounts are included in at least one composite. The composite results portrayed during the period are compared to the performance of their respective indices because the securities purchased for each of the composites are most closely aligned with the securities comprising these indices.

*The **Large Cap Value** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization in excess of $2 billion that offer good "value" relative to other companies in a similar business, their growth potential, or their historical valuation levels. The **Large Cap Growth** composite is comprised of portfolios invested primarily in growth stocks of companies with market capitalization in excess of $1.5 billion that exhibit high expected earnings growth to maximize capital appreciation. The **Small Cap Equity** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization of less than $4 billion. The **International Equity** composite invests in stocks that are primarily domiciled in a country other than the U.S., including emerging markets, without any constraints regarding capitalization or style. The **Global Opportunity** composite invests opportunistically in foreign and domestic companies without any constraints regarding capitalization or style.*

A complete list of firm composites and performance results is available upon request. Returns represent past performance and are not indicative of future results. Investment may result in the loss of principal.

*The unmanaged **Russell 1000 Value Index** measures the performance of those securities in the Russell 1000 Index having lower price-to-book ratios and lower forecasted growth values. The unmanaged **Russell 1000 Growth Index** measures the performance of those securities in the Russell 1000 Index having higher price-to-book ratios and higher forecasted growth values. The unmanaged Russell 1000 Index is comprised of 1,000 of the largest capitalized companies that are traded in the United States. The unmanaged **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index is comprised of the 3,000 largest U.S. companies based on total market capitalization. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. The **MSCI All Country World ex-U.S. Index** measures the equity market performance of world's developed and emerging markets. Currently the index consisted of 45 countries (22 developed and 23 emerging countries). The **MSCI All Country World Index** measures the equity market performance of world's developed and emerging markets including the U.S. Currently the index consisted of 46 countries (23 developed and 23 emerging countries). A net total return index reinvests dividends after the deduction of withholding taxes, using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treats. These indices do not reflect fees and expenses associated with the active management of separate account portfolios.*

Investment Strategy

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of -0.5% for the quarter, trailing its benchmark, the Russell 1000 Value Index by 2.1%.

Underweighting the Consumer Staples and Utilities sectors incurred a 0.4% cost for the portfolio. Our view is that both of these sectors are too expensive and we expect to maintain our underweight. Our investment in the Biotechnology industry suffered as the high prices of drugs remained a key focus of regulators and investors. As a result of this focus, Biotechnology industry is revealing interesting investment opportunities. On the positive side, our investment in the Technology Hardware industry benefitted from strong results in a weak environment.

During the quarter, we decreased our investments in the Energy and Materials sectors and increased our investments in the Industrials and Technology sectors. In the Energy sector, we sold positions in the Exploration and Production industry that had struggled with weak oil prices. We also reduced our investment in the Fertilizer industry as the agricultural industry suffered from exposure to Brazil. We repositioned our investments into the Consumer Finance and Industrial Machinery industries. In addition, in the Healthcare sector, we sold an investment in the Managed Healthcare industry that had agreed to be acquired at a premium in favor of the Healthcare Facilities industry.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of -0.4%, lagging its benchmark, the Russell 1000 Growth Index by 1.1%. An underweight to Telecommunications and an overweight to Energy held back performance. Stock selection was weak in the Healthcare sector, but was offset by strong selection in the Consumer Discretionary and Technology sectors.

In the Healthcare sector, our investments in the Pharmaceuticals and Biotechnology industry investments suffered as regulators and investors focused on high drug prices. In addition, our investment in the Healthcare Service industry faced a contentious contract renegotiation. On the positive side, our investment in the Technology Hardware industry executed well in a weak economic environment. In the Consumer Discretionary sector, our investment in the Casino industry performed well on turnaround prospects.

During the quarter we increased our investments in the Consumer Discretionary and Financials sectors and decreased our investments in the Technology and Energy sectors. In the Technology sector, we sold a Data Processing industry investment that had executed well in a challenging economic environment. In the Energy sector, we reduced our Equipment and Service industry investments that had struggled with weak oil prices. We reinvested the proceeds into the Automotive Retail, Cable, Brokerage and Managed Healthcare industries.

Small Cap Equity

High Pointe's Small Cap Equity strategy produced a return of -2.9% during the quarter, trailing its benchmark, the Russell 2000 Index by 1.4%. Stock selection was weak during the quarter in the Financials and Technology sectors, but was partially offset by strong stock selection in the Healthcare and Industrials sectors.

In the Financial sector, our investments in the Asset Management industry struggled as equity markets weakened. On the positive side, our investment in the Auto Parts industry benefitted from strong execution. During the quarter we increased our investments in the Consumer Discretionary and Industrials sectors and reduced our investments in the Technology and Financials sectors. In the Technology sector, we took profits as one of our investments in Software industry agreed to be acquired at a significant premium.

International Equity
High Pointe's International Equity strategy produced a return of -2.2%, lagging its benchmark, the MSCI All Country World ex-US Index, by 1.8%. Stock selection was weak in the Healthcare and Technology sectors but was partially offset by strong security selection in the Consumer Discretionary sector.

In the Technology sector, our holding in the emerging market Internet Service was penalized as sales shifted towards lower profitable segments. Our investments in Diversified Banks suffered as investors shunned banks *en masse* regardless of their quality. On the positive side, our emerging market Construction Materials investment benefitted as management executed well.

During the quarter, we increased our holdings in the Materials and Energy sectors and decreased our investments in the Consumer Discretionary and Technology sectors. We also modestly repositioned our investments out of emerging markets and into North America. In the Consumer Discretionary sector, we sold a European apparel company that had performed well. We reinvested the proceeds in North American Oil and Gas Services and Fertilizers and emerging market Construction Materials.

Global Opportunity
High Pointe's Global Opportunity strategy produced a return of -3.4%, trailing its benchmark, the MSCI All Country World Index by 3.6%. In the Healthcare sector, our investment in the US Healthcare Service industry faced a contentious contract. In the Financials sector, our investments in Diversified Banks struggled with an aversion of bank stocks regardless of their quality. On the positive side, our US Technology Hardware investment benefitted from strong results in a weak environment. In addition, our investment in emerging market Construction Materials profited as management executed well.

During the quarter, we increased our investment in the Materials and Consumer Staples sectors and decreased our investments in the Consumer Discretionary and Telecommunications sectors. We also reduced our investments in Continental Europe and increased our investments in the UK and emerging markets.

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As the first quarter came to a close, evidence was building that momentum stocks are breaking and value stocks are emerging from their nuclear winter that has now lasted several years. This development has heartened investors like us who have avoided expensive momentum stocks since our firm's inception and instead invested in value stocks in a disciplined manner. In our next letter, we will update you on further developments on this important front.