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HAWK Talon

Monthly Hawk100 Insights — January 2013

Plop, plop. Fizz, fizz. Oh, what a relief it is!

Congress enacts The Taxpayer Relief Act of 2012.

American taxpayers suffering a new year's hangover got a dose of relief from their fiscal cliff aches and pains. On January 1, Congress passed The Taxpayer Relief Act of 2012 to substantially reduce tax-related risks associated with the fiscal cliff. Still, the Act does raise rates on some taxpayers and potentially on your portfolio.

Tax rate changes.

You surely have heard that the Bush tax cuts expired December 31. The table below shows 2013 rates enacted through The Taxpayer Relief Act — together with Affordable Care Act — and rate changes from last year. For brevity, we focus exclusively on rates applied to ordinary income and investment activity.

For lower brackets, taxes will be assessed at the same rates as in 2012. Obamacare slaps 3.8% on "unearned" income (capital gains and dividends) for married couples earning over $250,000. Ordinary income rates rise on married couples earning over $450,000.

The Taxpayer Relief Act averted the worst of the fiscal cliff. If taxes had tripled on dividends and been allowed to rise on all incomes, severe economic harm likely would have resulted. Instead, financial markets celebrated the relief with a robust 5% rise in the S&P 500 during January. Was that rise was rational?

Bracket (000)	Ordinary Income		Capital Gains		Dividends	
	Rate	Change	Rate	Change	Rate	Change
0 – 18	10.0	---	0.0	---	0.0	---
18 – 72	15.0	---	0.0	---	0.0	---
72 – 146	25.0	---	15.0	---	15.0	---
146 – 223	28.0	---	15.0	---	15.0	---
223 – * 250	33.0	---	15.0	---	15.0	---
250 * – 398			**18.8**	**3.8**	**18.8**	**3.8**
398 – 450	35.0	---	**18.8**	**3.8**	**18.8**	**3.8**
450 –above	**39.6**	**4.6**	**23.8**	**8.8**	**23.8**	**8.8**

*** Bracket table separated to facilitate comparison across various taxes assessed. The foregoing bracket reflects those for married taxpayers who file jointly.**

We can use fundamental valuation models and assume efficient markets to investigate. During the fourth quarter, many companies paid special distributions to ease shareholder exposure to potentially high taxes. With that aberration, we look to a more normal time in the market such as September 30 when Morningstar data showed the S&P 500 dividends yielding 1.98% and growing 10.34%. At 2012 tax rates, an efficient market would require 10.47% after-tax return.

After-tax return = dividend yield×(1-ordinary rate) + dividend growth×(1-capital rate)

$$10.47\% = 1.98\% \times (1 - 15\%) + 10.34\% \times (1 - 15\%)$$

If stocks pay dividends as in September, after tax return would fall to 9.39% in 2013. However, we assume investors would still require 10.47% after tax. Thus necessarily, dividend yield would rise to 3.40%, growth would rise to 11.76%, or some combination thereof.

$$10.47\% = \mathbf{3.40\%} \times (1 - 23.8\%) + 10.34\% \times (1 - 23.8\%)$$

$$10.47\% = 1.98\% \times (1 - 23.8\%) + \mathbf{11.76\%} \times (1 - 23.8\%)$$

Bear in mind, raising dividends shrinks future growth. Companies balance the trade-off between whether to distribute or to reinvest ideally with an eye to maximum shareholder value. Now, companies payout 30% of profits and retain 70%. With dividends and capital gains taxed equally, payout ratios do not affect tax efficiency.

We make three big assumptions: companies payout 30% of earnings, profit growth keeps pace at 10.4%, and investors require after tax return of 10.47%. We could rationally expect the S&P 500 to fall 36% to 911 by the end of 2013 from 1426 as of December 31.

Why did stocks rise 5% during January?

Hawk100 attributes the January return primarily to changed investor demand after Congress enacted "permanent" tax rates below those that were expected. In our third quarter letter, we showed how fiscal cliff tax risks could have erased 57% of stock values. Most investors reasonably believed Congress was unlikely to act after the November election results. The Taxpayer Relief Act eliminated that worst case scenario and reduced tax risks to beat investor expectations. As we saw, stocks jumped despite the tax hike. Who needs Alka Seltzer?

By Richard Clemens, CFA CPA, *President*