CAPTRUST

Consulting Research Group

From the desk of Eric J. Freedman, Chief Investment Officer

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Yesterday's congressional "fiscal cliff bill" (H.R. 8, the American Taxpayer Relief Act of 2012), passed in the early hours of New Year's Day in the Senate and during the later hours in the House, marks a turning point in what has been a polarizing debate. Among other provisions, the bill extends tax rates for most Americans and postpones sequestration, or automatic spending cuts, for two months. So far, global capital markets—which have been volatile heading into the end of 2012 pending congressional action—are reacting positively as measured by riskier asset class performance. While we see the deal as a short-term positive for investor sentiment, negotiations have not fully addressed budget issues that will cause further debate in coming months. The bill contains some important considerations for CAPTRUST plan sponsors, especially regarding in-plan Roth conversions, which we outline on the next page. Despite rampant media attention surrounding this deal, we urge investors to look past the noise and focus instead on the link between their investment objectives and the path they are following to reach those objectives.

Like many other high schools, my alma mater's yearbook featured individual senior photos with a self-selected quote under each head shot. A friend of mine, prone to writing book reports the night before their due date, selected the quote, "If it wasn't for the last minute, a lot of things would not get done." Washington delivered on this just-in-time mentality, passing legislation a day after the fiscal cliff's technical start. Investors have been concerned about what higher tax rates and forced spending cuts could mean for an already fragile U.S. economy, and last night's legislation provided some salve to these concerns.

The fiscal cliff's root cause stems from the cumulative imbalance between government spending and tax receipts, and last night's bill passage is receiving mixed reviews with respect to its impact on the federal deficit. The Congressional Budget Office (CBO), whose mission is to be a nonpartisan, analytical resource for the U.S. Congress, estimated a fiscal year 2012 deficit of $1.1 trillion, the fourth straight year with a deficit that exceeded $1 trillion. The CBO estimates that yesterday's fiscal cliff bill will add to the deficit—a claim the White House refutes. Irrespective, the bill did put off the previously set automatic spending triggers and did not address the debt ceiling, for which Congress needs to authorize an increase during the first quarter. President Obama indicated last night that he did not want to engage in a debate about the debt ceiling, but congressional members concerned about spending trends may try to use it as a leverage point. The coincident timing of the debt ceiling discussion and automatic spending cuts bears watching.

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Bill Specifics

While the bill includes several line items, individual investors should be aware of the following key provisions:

- Tax rates permanently rise to 39.6% for families with income above $450,000 and individuals above $400,000.
- Capital gains and dividend tax rates are set at 20% for families and individuals with income above the $450,000 and $400,000 levels, respectively.
- The estate tax is reset to 40% for taxpayers at the $450,000/$400,000 income levels, with a $5 million exemption indexed to inflation.
- The bill introduces a new kind of voluntary Roth conversion for defined contribution participants, pending specific plan features.
- The Alternative Minimum Tax (AMT) will be inflation-indexed, providing a permanent "patch."
- The Social Security payroll tax cut will expire—moving from a 4.2% to 6.2% rate.
- Tax exemptions and deductions are limited for higher-incomes—the Personal Exemption Phase-out (PEP) and itemized deduction limits are set at $250,000 and $300,000, respectively.
- There is no change to tax-exempt status of municipal bond interest.

In an apparent effort to create additional sources of tax revenues to help finance the extension of the sequester, one of the last provisions added to the American Taxpayer Relief Act was an in-plan Roth conversion feature. An early interpretation indicates this is a permanent amendment to the tax code allowing qualified defined contribution plans with Roth features to offer participants the opportunity to transfer any amount to a Roth account. Participants can make this election regardless of income level. The value of tax-deferred savings converted to a Roth account will be considered taxable income, with taxes due in the tax year of the exchange.

In aggregate, these provisions are broadly in-line with what analysts thought, heading into negotiations, with the income thresholds within the expected range. However, the voluntary Roth conversion feature is somewhat of a new development.

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Investment Implications

The bill has already provided a relief rally in riskier asset classes, and we would expect that rally to continue based upon both sentiment and improving fundamentals. Global macroeconomic readings have been more constructive in recent weeks pending yesterday's outcome, with favorable developments in the U.S. housing market, Chinese growth, and some stability in Europe. Growth momentum could carry riskier asset classes higher and we see several areas of opportunity with a global perspective. We are mindful, however, that the structural issues surrounding the U.S., Europe, and Japanese fiscal situations are not easily fixed and political risks remain significant. Again, the first quarter could see another congressional showdown regarding the debt ceiling and the sequestration's start.

Conclusions

The fiscal cliff deal provides short-term relief to a chronic issue that will still need to be addressed over time. The U.S. economy, like many of its global peers, has been debt-dependent for a prolonged period, and rectifying the tax and spending woes is not an overnight event. However, like my friend who waited until the last minute to write book reports, policymakers cannot continually deliver solutions at the eleventh hour. Financial markets may not be as forgiving in the future, and addressing the cumulative debt through additional compromise would be a welcome development while the task is still manageable. CAPTRUST will continue to work on your behalf to match the global capital market opportunity set with your specific objectives, and we welcome your questions and thoughts.

Best wishes for a safe and healthy new year.