ELECTION YEAR

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Politics and Investment Performance

With President Obama's first term in office coming to a close, here's the result of an investigation into the relationship between the composition of the legislative and executive branches of the U.S. government and market performance. The "unified" situation refers to years when the Senate, the House of Representatives, and the White House were all controlled by the same party. The "partially divided" situation represents years when the House and Senate were controlled by the same party, but the White House was held by a different party. The "completely divided" situation uses data from years in which the two houses of Congress were divided. Both the S&P 500 and the diversified portfolio (60% stock/40% bond) averaged the highest returns during unified years, lower returns during partially divided years, and the lowest under completely divided years.

Average Annual Returns 1926–2011

	S&P 500	Diversified portfolio	Number of years
"Unified" years	14.8%	9.9%	45
"Partially divided" years	11.1%	9.5%	30
"Completely divided" years	1.1%	7.4%	11

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. The time period examined is 1926–2011, and the returns are average annual returns.

Stocks—represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds—20-year U.S. government bond.

ABCo.

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Advisor Corner

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Everyone's economic and life situation is unique, and I keep that in mind when providing financial security advice. I believe that personalized service is essential when matching clients with the right financial security products and services. As an ABCo. Advisor, I am dedicated to learning about your personal goals. Together we will use them to build a financial security plan focused on your specific needs.

I understand my clients are in different stages of life: you might be purchasing a first home, financing a child's post-secondary education or planning for retirement. I believe a financial security plan must reflect your personal or business situation, and so will work to highlight the financial security products that best fit your goals. Once your custom-tailored financial plan is in place, we will continue working together to review achievements against your stated aims, and ensure you are comfortable everything is moving forward according to plan.

The Fiscal Cliff

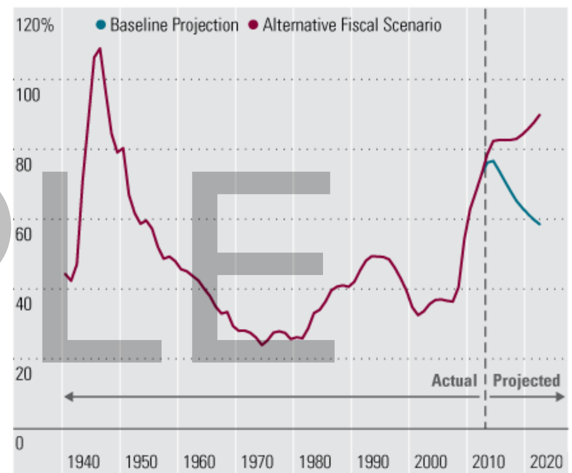
The term "fiscal cliff" has dominated headlines but besides adding another phrase to your political vocabulary, what does it really mean to you? The "fiscal cliff" is the U.S. fiscal situation that could dramatically change the economic landscape in this country, defined by a bundle of momentous tax hikes and spending cuts that are due to take effect at the end of 2012 and early 2013. The intended goal of these tax hikes and spending cuts is to reduce the national deficit. A reduction of national deficit appears to be a good thing on the surface but such dramatic belt-tightening so quick has raised concerns about the possibility of growth deceleration and a potential recession. Before digging deeper, it is important to distinguish between baseline and alternative fiscal scenarios. Under the baseline scenario, existing policies would expire, allowing for the implementation of tax hikes and spending cuts whereas the alternative scenario calls for an extension of existing tax provisions.

According to the Congressional Budget Office (CBO), the 2012 federal debt held by the public will reach 73% of GDP; the highest level since 1950. Under the current baseline scenario*, the federal budget deficit will shrink to an estimated $641 billion in 2013 from $1.1 trillion in 2012. Given the current fragile economic conditions, the CBO anticipates that the U.S. economy may fall into a recession if GDP declines and unemployment increases. To be precise, the CBO expects the 2013 (year-over year) fourth quarter real GDP to decline by 0.5% and the unemployment rate to rise to about 9% in the second half of 2013. Under the alternative scenario*, the 2013 federal budget deficit could total $1 trillion, with the 2013 (year-over-year) fourth quarter real GDP growing by 1.7% and unemployment staying in 8% range.

If Congress fails to extend tax breaks, here is what we can expect. The Bush tax cuts will expire and income taxes, estate taxes, capital gains taxes, and tax rates on dividend income will increase. The Social Security tax cut will expire, raising the rate from 4.2% to 6.2%. The alternative minimum tax (AMT) will affect significantly more Americans. High-income earners will be taxed as part of the Affordable Care Act (Obamacare). Spending cuts legislated by the Budget Control Act of 2011 will affect the national defense budget and other programs across the board. The emergency unemployment compensation will expire at the end of the year. The Medicare payment rate at which Medicare pays physicians will decrease by about 27%.

While inaction by Congress may have dire consequences, Morningstar economists expect Congress will take action after the 2012 election season to keep tax rates from rising too drastically and delay the spending cuts. Until then, revisit your retirement portfolio to ensure it is well positioned to weather a fiscal cliff worst-case scenario.

Federal Debt (as % of GDP) Held by the Public



*The baseline project assumes that current laws remain in place and are set to expire as planned. The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (started at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

The Tax Man Cometh … Or Does He?

You've probably heard a lot about how the election will affect both the economy and your wallet. What you're probably asking is, "What does this mean for the dividend portion of my portfolio?" To take a step back, the appeal of dividends is not now, and has never been, purely a function of tax policy. Dividends work because they deliver what capital gains can't: consistent cash returns that are always and only positive. Cash flow that you can use to meet your personal investment objectives even if stock prices are down. And, compared with bonds, dividend-paying stocks offer a measure of protection from inflation and a good shot at lasting capital appreciation. This is not to say that taxes are irrelevant, but most of what you're hearing needs to be taken with a grain of salt.

Since 2003, dividends (as well as long-term capital gains) have been taxed at a maximum federal rate of 15%. If the President and Congress do nothing, then the top tax rate on long-term capital gains will revert to 19.8% on New Year's Day 2013, but the top tax rate for dividends will skyrocket to 39.6%. (And this doesn't include the additional 3.8% Medicare tax on investment income for high earners next year) But before you dump all your dividend-paying stocks in fear of a tax hike, consider the following:

1. Will dividend taxes actually go up? That outcome can't be ruled out, but it's worth remembering that in 2003, 2008, and again in 2010, a span encompassing three different congresses and two presidents of differing political affiliations, the current taxation of dividends has been affirmed. A comprehensive tax reform package might involve a more modest tax increase on upper-bracket earners, but neither Republicans nor Democrats actually want the country to roll off the "fiscal cliff".

2. Let's assume the worst: that the pre-2003 tax rules snap back into effect. What's changed? That depends on you. Most investors aren't in the top tax bracket so their tax rates might rise from 15% to 25% or 28%, but the implication that everyone's dividends will be taxed at 39.6%, is simply not true.

3. Two key groups of high-yielding equities, master limited partnerships (MLPs) and real estate investment trusts (REITs), were never eligible for the 15% federal tax rate in the first place, so the treatment of these income streams isn't at risk.

4. Many investors hold the bulk of their stocks (and receive the bulk of their dividends) in tax-deferred accounts like IRAs, Roth accounts and 401(k) plans. What's the impact of a dividend tax hike here? The answer is nothing as the investor only pays tax when money is withdrawn from the account.

5. Even if taxes on dividends go up, what's the alternative? Except for municipal bonds, the interest paid on fixed-income securities is already taxed as ordinary income. Bolting for the bond market would only reduce your tax bill because you would earn much smaller returns!

Past performance is no guarantee of future results. Returns and principal invested in stocks or REITs are not guaranteed. Dividends are not guaranteed. A REIT must distribute at least 90% of its taxable income to shareholders annually. REITs involve special risks such as management quality, corporate structure, the ability to increase revenues from rents, and the balance of the supply of new buildings with demand for space. Investments in securities of MLPs involve risks that differ from an investment in common stock, including limited control, cash flow and dilution risks. Funds in a traditional IRA grow tax -deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Authored by Josh Peters, CFA; Chief Equity-Income Strategist; Editor, Morningstar DividendInvestor.

Economic Indicators in an Election Year

The 2012 presidential election is in full swing and, as we draw closer to the November 6, 2012 election date, many Americans are wondering which presidential candidate will be better for the economy. The U.S. economy has always been a focal point of elections, and although no crystal ball exists to determine election results (or stock performance, for that matter), economic indicators may show how an incumbent has performed. A strong or improving economy may add more credibility to the incumbent's leadership abilities, which may increase his odds of winning another term in office.

Since President Barack Obama took office in January 2009 in the midst of a recession, through his time in office till now, economic results have been mixed. The unemployment rate has fluctuated, but is now lower from the high of 10% back in October 2009. The S&P 500 has recovered nicely and GDP growth has also improved and held steady over the last 11 quarters.

However, home prices have continued to fall and gas prices to rise. A home is one of the biggest purchases for a family, with most of their wealth tied to their home. Falling home prices negatively impact the net worth of American households and may affect their propensity to spend. Higher gas prices mean people have to spend more money on gas, leaving less money for other discretionary purchases. Finally, interest rates remain at all-time lows as the Federal Reserve attempts to spur economic growth. This makes it difficult for investors to earn any return from saving accounts and other low-yielding investments, offering little reward to risk-averse investors or retirees.

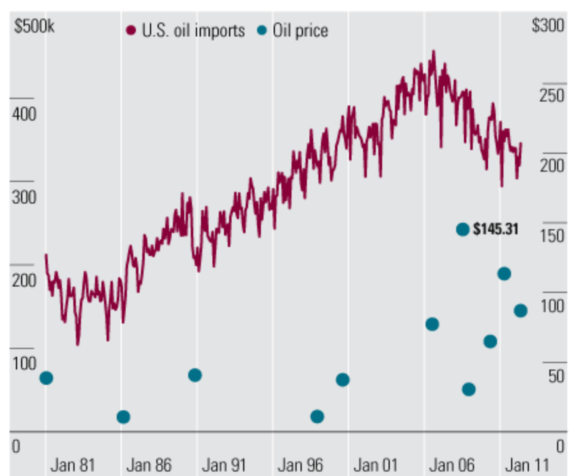
Regardless of the election outcome, the President will probably continue to make economic recovery one of his priorities and, in light of this assumption, investors should expect the low-interest rate environment to continue.

The Politics of Oil

With prices reaching $4 at the pump, the oil problem will probably be a major factor during the 2012 election season. In March 2012, the White House published a report showing how U.S. oil imports have dropped from 57% of total consumption in 2008 to 45% in 2011, a powerful argument for when president Obama needs to defend his energy policy.

In fact, oil imports (measured in thousands of barrels) have been dropping since 2006, but prices continued to climb, reaching a high of $145.31 per barrel in 2008. A more important question that comes to mind is whether the decline in imports is indeed due to more efficient domestic production or simply to decreasing demand caused by escalating prices.

U.S. Oil Price and Import Trends



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Oil prices: West Texas Intermediate Crude in U.S. dollars per barrel. U.S. oil import data from the U.S. Energy Information Administration.