HAMILTON POINT
Investment Advisors, LLC
CHAPEL HILL, NC

ANDREW C. BURNS
President/Chief Investment Officer

RICHARD S. WOODS, CFA
Chief Operating Officer

February 2015

Miles and Miles of Taxes

The country swing band "Asleep at the Wheel" will soon visit NC and we will be there hoping to hear their classic, "Miles and Miles of Texas." We encourage you to YouTube this catchy tune while reading this newsletter about our government's desire to close an ongoing budget deficit, potentially by raising taxes. This thirst for new revenue reminds us of two things: 1) the importance of tax-aware investment strategies (such as Hamilton Point's Global Core Equity Strategy) and 2) the need to anticipate how a changing tax code could affect even non-taxed investors like retirement accounts and non-profit endowments.

The Federal budget deficit in 2015 is supposed to total around $500 billion, down from a peak of over $1,400 billion post crisis, but currently projected to return to in excess of $1,000 billion annually by 2025(1). Stating the obvious (even if politicians don't grasp it), the primary ways to resolve a permanently imbalanced budget are to raise tax revenue and/or cut spending. Since politically-charged entitlement reform or further discretionary spending cuts seem unlikely at present (there is already talk of rolling back "sequestration cuts"), identifying alternative revenue streams for the government becomes increasingly relevant.

Washington Hates When You Hold Winners

When it comes to taxing investments, the federal government has thus far only figured out how to tax *transactions* by forcing individual investors to pay taxes on interest, dividends and capital gains —and only if those events occur. If someone buys $1 million worth of Google's stock and holds it while it doubles in value over ten years, no tax is paid by the investor since Google does not pay a dividend, and in this case, we assume the investor does not sell the shares to recognize a capital gain.

Frustratingly, from the government's standpoint, many investors like our hypothetical Google investor (and those advised by Hamilton Point, generally), tend to hold good investments for the long term—while harvesting losses which reduce tax liabilities—and therefore greatly minimize capital gains taxes. We believe this approach of "keeping winners" and selectively trimming losses is a great way to invest for the long-term, and it happens to be tax efficient too.

As a bonus, the IRS allows the original cost basis to be "stepped up" to a date-of-death value for those inheriting the investments, thus eliminating any embedded unrealized capital gain. As long as estate "death" taxes are avoided, an individual stock could theoretically be held for decades and passed on to the next generation without ever incurring a dime of federal tax liability.

Texas-Sized Taxes

Conversely, taxable investors holding a collection of funds (mutual funds, index funds, ETFs and hedge funds alike) are likely to be considered relative "friends" of the IRS. First, a fund is generally required to "distribute" capital gains to their investors annually based on trades made in the fund's portfolio during the year. Many funds are expressly *not* tax sensitive, so a meaningful percentage of gains these funds experience are subject to tax each year, without the investor having any control or ability to defer them as with

1) "The Budget and Economic Outlook: 2015 to 2025." Congressional Budget Office. January 2015

CONTINUED ON REVERSE >

holding a portfolio of individual stocks. In addition, selectively recognizing losses as a tax-aware strategy of reducing tax liability is difficult, as a fund investor cannot sell just a component of the fund. We note that hedge fund investors, in particular, may be the IRS's "best friends" since many of these cabals trade constantly and generate high ordinary income taxes, meaning that over 40% of investor "returns" can end up being paid to the government.

Potentially relevant to both taxable and heretofore non-taxed investors (e.g. endowments and retirement accounts), is our inkling that the government may need to start taxing investments based on "value" rather than "transactions." In retrospect, Congress probably wishes the federal government had long ago taken the approach of local government predecessors who developed formulas for taxing real estate annually, even in the absence of a transaction. Real estate has long been an easy target for local governments since it is taxed based upon its mere existence, and the federal government may wish to emulate that approach.

One sign of this is a recent proposal by the Administration to impose a tax on undistributed, overseas corporate profits, that were previously untaxed until funds were repatriated to the U.S. (i.e. a transaction occurred). This is illustrative of our point for two reasons: 1) the proposed tax gets imposed on the *amount* of overseas cash rather than waiting for a transaction and 2) both taxable and non-taxable investors would ultimately "pay" this tax in the form of a hit to corporate cash that could negatively impact widely-held stocks. Admittedly, this tax, as proposed, is unlikely to pass in the near-term, but we think it is indicative of the likely path for the federal government to raise revenue on something other than transactions.

You Can Run but Cannot Hide

Another potential revenue stream, for example, would be a seemingly small percentage, value-based, ad valorem tax on trillions of investment assets in our country held by individuals AND institutions above a certain level (regardless of their tax status for transaction purposes). Since most every politician running for reelection wants to avoid increasing taxes on the "middle class" (regardless of how that term is defined), it would be foolish, in our opinion, to assume these huge pools of previously non-taxed assets, including large endowments, would not be on the table for taxation in future reform efforts aimed at reducing the deficit.

Until serious proposals are made, we remain agnostic politically about the best course for closing our federal budget deficit; however, as with the "Medicare surcharge" instituted on some investment income in 2013 and other proposals trickling out of Washington, one way or another, we see "miles and miles of taxes" ahead. We just hope a different country-western classic, Lefty Frizzell's "If You've Got the Money, I've Got the Time," doesn't become the official anthem of the IRS. Regardless, we think investors of *all* types should at least contemplate how the tax code might evolve in the coming years.

Meanwhile, we believe our emphasis on in-house research to identify high quality, individually-purchased investments for the majority of a portfolio will remain the best way to grow and preserve capital—whether in a taxable or non-taxed account. Particularly for taxable investors though, this approach has the added advantage of efficient tax management. After all, we are aligned with our clients in this regard, since the less of our clients' money that goes to the government – the more we have to manage and the more clients have to compound for their future benefit.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA
RWoods@HamiltonPoint.com

Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

The commentary is for informational purposes only and the opinions expressed herein are those solely of Hamilton Point. Hamilton Point reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. There is no assurance that any securities or strategies discussed herein will be included in or excluded from a client portfolio. It should not be assumed that any of the securities, strategies or internal studies discussed were or will prove to be profitable or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. For a free list of all recommendations made by Hamilton Point during the last year, please contact us using the contact information provided below. An investment in our strategies is subject to investment risk, including but not limited to, the loss of principal and may not be suitable for all investors. This is not a recommendation to buy or sell any particular security and should not be considered financial advice. Past performance is not indicative of future results. A full description of Hamilton Point and its investment strategies and advisory fees can be found in Hamilton Point's Form ADV Part 2 which is available upon request or at the Investment Adviser Public Disclosure website. Hamilton Point is an investment adviser registered with the U.S. Securities and Exchange Commission, though such registration does not imply a certain level of skill or training. Hamilton Point's principal place of business is in the State of North Carolina. HP-15-11