In another effort to jumpstart the economy, the Federal Reserve has once again initiated an economic stimulus program (QE3). While the immediate reaction seemed to be positive, the longer term effects are subject to debate, and, we believe, subject to the Law of Diminishing Returns. In other words, the benefits from each subsequent quantitative easing measure have become less apparent and potentially will create perverse long-term outcomes.

QE1 certainly helped calm the markets and inject some needed liquidity into the markets at a time of unparalleled uncertainty. Yet the pure economic benefits of that effort and QE2, which followed it, clearly have been limited.

Consider: core capital goods orders continue to contract. Unemployment remains stuck at stubbornly high levels and the labor participation rate is at its lowest in several decades. Household income, when adjusted for minimal inflation, is down and consensus GDP growth rates continue to be revised lower. Obviously the Fed felt it had to do something more.

The reality is the Fed’s massive easing programs are having minimal impact on the broad economy.

And while interest rates will remain very low for at least another three years, assuming we take the Fed at its word, these low rates have not necessarily encouraged consumers to borrow or spend more, nor have they led corporations to invest more in capital equipment or hire at a rate sufficient to mitigate current unemployment levels. In fact, the massive liquidity the Fed is injecting into the financial system is not going into the hands of end consumers where it would be used many times over, increasing the velocity of money in the economy, which is the very essence of economic activity. Money changing hands helps economies grow, drives demand, and ultimately creates jobs. Instead the money is left sitting inside banks in the form of excess reserves, or used as a tool for speculation in the capital markets, which inherently pushes asset prices beyond their intrinsic value.

Indeed, while the Fed’s stimulus has been a boost to market valuations, the same cannot be said for economic profits, notwithstanding the fact corporations are very healthy. Similarly, bond prices have continued to rise (and yields have fallen), prompting investors to take more risk in search of interest income.

It’s not surprising that some observers have expressed concern that the Fed’s ultra easy monetary policy may serve as a breeding ground for a market bubble. Moreover, one noted economist cited other unintended consequences of this Fed policy in an article published by the Federal Reserve of Dallas. Key among them is the misallocation of investments, which ultimately threatens the health of financial institutions and the functioning of financial markets, constrains the independent pursuit of price stability by central banks, encourages governments to refrain from confronting sovereign debt problems, and redistributes wealth in a highly regressive fashion.

All that said, it appears the Fed believes it has no choice but to stay on this course, particularly with the proverbial “fiscal cliff” looming at the end of the year. Accordingly there is already speculation the Fed may launch QE4 before next year given the central bank’s concern about the possibility of a recession.

~ continued
**continued ...“The Law of Diminishing Returns”**

should Congress not reach a deal to avert the cliff, which by most accounts will drain between 4-5 percent out of the economy in 2013. The fiscal cliff, as we all know, is a term referring to approximately $600 billion in tax increases and mandatory spending cuts that will be triggered January 1, 2013 should Congress fail to act. While we hope both Republicans and Democrats can find a way to reach a compromise, we are not willing to speculate with clients’ money that this will occur.

Throw in the debt ceiling, which will be reached sometime early next year, and we have a recipe for fiscal chaos. We believe these conditions have been largely ignored given the recent upward market move and corresponding decline in implied volatility. While we are not ignoring the old adage, “Don’t fight the Fed,” we are nonetheless concerned about all the above, as well as the ongoing troubles in Europe and the marginally significant slowdown in the emerging economies.

Therefore we have maintained our defensive posture in portfolios, including holding a healthy level of cash or cash equivalents, which we can quickly deploy should market values decline.

Finally, everyone at Windsor appreciates your continued confidence and trust. We will continue to work hard on your behalf.

~ David O. Koch, CFA, CFP®
President & Chief Investment Strategist

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**What to do with all that cash?**

As discussed by David Koch above, persistent macro economic uncertainty resulting from the upcoming election, the much-anticipated “fiscal cliff” in the U.S., continued weakness in Europe, and the potential for a hard landing in China have caused corporate executives to be very cautious with their capital investment and hiring plans. This is adversely affecting the pace of the economic recovery. As a result, corporate America as a whole is generating significant free cash flow, which can be used by management teams in five different ways. To wit:

- **To buy growth through mergers or acquisitions**, which can be effective if the purchase price is reasonable and the strategic fit appropriate. However, history shows that most transactions do not add value in the long-term.

- **Companies can pay down debt**, but most large corporations have already significantly improved their balance sheets since the financial crisis.

- **Companies can accumulate cash**, but that is suboptimal considering the current level of short-term interest rates.

- They can repurchase shares of the company’s stock, which we advocate only if the stock is attractively priced. This can result in an increase in intrinsic value per share.

- **Companies can pay dividends to shareholders**, which we prefer. Specifically, we favor companies with above market dividend yields and a history of growing them at a faster pace than the market.

Share repurchase plans became popular in the 1990s as a way for companies to offset dilution from the issuance of stock options and maintain earnings per share. In many cases the price paid for the shares was too high, which resulted in a poor return on investment. The only share repurchase plans that make economic sense are those that increase the intrinsic value per share for shareholders who hold onto their stock, resulting in a higher stock price, though the timing of that is uncertain. Currently, we have invested in several companies that are taking advantage of their low stock price and rapidly repurchasing shares.

Dividend investing as a strategy has become popular once again as a result of aging demographics and historically low interest rates. We welcome its return because, as we have stressed over the past several years, dividends play a significant role in generating total return for common stocks, particularly in a slow growth environment. Also, companies that pay dividends are often higher-quality, with strong balance sheets and more predictable free cash flow. Since dividends tend to be reoccurring, and cutting or eliminating them can negatively affect the company’s stock price, management usually remains focused on having funds available to make the distribution, as opposed to investing in poor return projects or engaging in empire building through ill-advised M&A transactions.

By comparison, the entire S&P 500 produced a total return of just 6.9% and a standard deviation of 18.1%. In short, according to this research, dividend growers and initiators have produced higher returns with lower volatility than other stocks over the long-term. We believe the outperformance among dividend-paying stocks can continue and have positioned our equity portfolio accordingly.

We think that dividend-paying stocks will continue their streak; however, there is a chance for short-term volatility due to the potential of higher tax rates on dividends. We will likely use any short-term volatility to add exposure to high-quality companies with a history of dividend growth. The current tax rate on qualified dividends is 15%, but it is scheduled to revert to ordinary income tax rates in 2013. Also, some investors will be subject to an additional 3.8% tax from healthcare reform.

In summary, while the current macro economic outlook remains uncertain, we continue to find select opportunities in high-quality companies that on average have higher dividend yields or are growing their dividends faster than the market, many of which are also actively repurchasing their own shares. Oftentimes these companies can be considered unexciting or dull, and will almost certainly underperform in raging bull markets; however, history shows that slow and steady wins the race.

Clients often ask, “Which is more important, dividend yield or dividend growth?” Interestingly enough, according to a recent analysis by Ned Davis Research, history favors dividend growth. Examining S&P 500 data since 1972, Ned Davis found that dividend growers and initiators provided an annualized return of 9.5% with a standard deviation of 16.3% versus a return from all dividend paying stocks of 8.7% and a standard deviation of 17.1%.

~ Josh Hill, CFA
Sr. Portfolio Manager & Co-Director of Equities
As we begin the fourth quarter of 2012, we encourage you to take action on your end-of-year planning. It’s especially important to pay attention to this admittedly vexing task earlier rather than later, because this year provides us with a unique window of opportunity that may be closing and some tax strategies take analysis, time and coordination among planning professionals to put in place. Your typical planning may include gifts to charity, taking mandatory distributions from retirement plans, or making gifts to family members.

**Why is this year different?**

As discussed in our spring 2012 newsletter, assuming Congress does not take action before year-end, a large number of tax increases will be triggered on January 1, 2013.

Most notably, the Bush-era income tax cuts will expire, which will result in an increase in federal income tax rates across all income brackets, an increase in long-term capital gains rates from 15% to 20%, and the taxation of dividends as ordinary income. In addition, we will also see the arrival of new taxes for those with Modified Adjusted Gross Income in excess of $200,000 for single taxpayers and $250,000 for married taxpayers filing jointly. Specifically, these taxpayers will begin paying an additional 0.9% in Medicare tax over the wage amounts listed above and see a 3.8% Medicare surtax on certain unearned income over the same thresholds. Estate and gift tax exemptions are also scheduled to retrace from $5.12 million back to $1 million in 2013.

Apart from increased rhetoric from both sides of the Congressional aisle, little has changed since we wrote on this topic in the spring. Speculation is rising regarding whether Congress will extend some (or potentially all) of these provisions, or whether they will be allowed to expire as the law currently reads. At this stage, we can do little more than guess what will happen.

These potential tax increases prompt the discussion of accelerating income, deferring deductions, and possibly making significant gifts before the end of the year.

**How does it affect me?**

The potential arrival of the tax increases previously discussed could prompt you to consider looking at the benefits of implementing tax planning strategies before the clock strikes 12 on December 31. For example, you may wish to accelerate income into 2012, defer deductions into 2013 (or later), or look at gifting to implement certain planning objectives. There are a number of tools and strategies that may be used to capitalize on the current tax environment, such as a conversion of retirement funds to a Roth IRA (see below), harvesting long-term capital gains, or perhaps changing the timing of business income distributions. Each client’s situation and objectives must be analyzed to determine what is right for them.

Time is short to complete this work, however. Professionals in the legal, tax, and planning communities have already voiced concern that many people will wait until the last minute to look into these questions, making it impossible for all clients to get their work completed before December 31. The implementation of certain strategies can take weeks, sometimes months. If you are considering some action, don’t wait until after the November election to initiate a conversation. We don’t want miss an opportunity for you simply because time ran out to look into these questions.

**Example of a Planning Strategy: Roth Conversion**

We have had several discussions with clients regarding Roth IRA conversions. At first blush, the concept is relatively simple in that it involves taking money from your retirement plan (such as an IRA), paying ordinary income tax on that amount, and transferring those funds to a Roth IRA. Recently, the income limitation was removed allowing anyone to do a conversion, and you can convert all or a portion of a tax-deferred retirement account to a Roth.

Not surprising, though, this “simple” concept can become rather complicated. For example, to answer “how much” to convert, we often seek counsel from a client’s tax preparer. In our coordinated efforts, we look at tax rates today, and what we anticipate rates to be in the future. For retirees that are enrolled in Medicare Part B, we review any increases that may take place in premiums by increasing income taken into 2012. As a result of the conversion, the amount of Social Security income subject to taxation can see an increase, which further clouds the analysis. By reviewing tax projections and weighing pros and cons we are able to arrive at a potential conversion number.

**What do I need to do?**

Begin your planning discussions as soon as possible. If you are contemplating strategies that need to be implemented in the 2012 tax year, we can help add perspective on many concepts. Your Windsor team wants to ensure you are able to take advantage of these strategies while you can.

IRS Circular 230 Disclosure: Pursuant to U.S. Treasury Regulations contained in Circular 230, any tax advice contained in this communication is not intended to be used and therefore may not be used (i) for the purposes of avoiding any tax-related penalties that may be assessed under the Internal Revenue Code or (ii) in promoting, marketing, or recommending to any party any tax-related matter addressed herein.

~ Jennifer McCool, CFP®
Co-Director of Wealth Planning

~ Jamie Fritschel, CFP®, CPA
Co-Director of Wealth Planning