Mentor Monthly Missive

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Wealth by Numbers

America has long been known as the land of opportunity and the promise of a better life to people from all over the world. Recently, however, many Americans feel robbed of opportunities and better lives by the top 1% of their own. This growing income inequality has led to problems and civil unrest, as demonstrated by the “Occupy Wall Street” movement.

The table presents household income distribution data from the U.S. Census Bureau. Given that the poverty threshold for a two-member household is around $14,000, it appears that approximately 13.7% of Americans are poor. At the other end of the income spectrum, 3.9% are rich, with household incomes higher than $200,000.

Household Income Distribution in 2010

Under $5,000	3.5%
$5,000 to $9,999	4.3%
$10,000 to $14,999	5.9%
$15,000 to $19,999	6.1%
$20,000 to $29,999	11.5%
$30,000 to $39,999	10.2%
$40,000 to $49,999	8.9%
$50,000 to $74,999	17.7%
$75,000 to $99,999	11.4%
$100,000 to $149,999	12.1%
$150,000 to $199,999	4.5%
$200,000 and over	3.9%

Source: U.S. Census Bureau, Current Population Survey, 2011 Annual Social and Economic Supplement. Poverty threshold also from the U.S. Census Bureau.

MENTOR CAPITAL

Meet our Wealth Managers

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Mentor Capital Management Inc. was founded in response to the belief that a consumer’s best interests are served when his or her financial planner is Fee Only. Advisors of Mentor Capital strive to provide objective, prudent and thoughtful advice to clients based on their personal goals and objectives.

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Dividends and Taxes: Dos and Don'ts

Dividend-paying stocks have enjoyed a renaissance during the past several years. Despite the high-profile blowups of many financial stocks, dividend payers generally outperformed non-dividend payers during the financial crisis. Further burnishing dividend payers' appeal is the currently benign tax treatment of dividends: Those in the 25% tax bracket and above pay taxes at a 15% rate on qualified dividends, while those in the 10% and 15% tax brackets pay no taxes at all on such dividends. That's a big attraction, but investors need to do their research before embracing dividend payers for their taxable accounts. Here are some dos and don'ts.

Do Understand the Difference between Qualified and Nonqualified Dividends: You often hear that the dividend tax rate is either 15% or 0%, depending on your tax bracket. But if it's not the right kind of dividend, you could actually owe ordinary income tax on your dividends (as much as 35%, depending on your tax bracket). That's because the Internal Revenue Service separates dividends into qualified and nonqualified categories. One big type of nonqualified dividends are those that REITs kick off; while their yields might be lush relative to the income you receive from other stocks, you'll owe ordinary income tax on that income. Owing to that tax treatment, investors in the typical real estate fund have paid a tax-cost ratio of 1.9% per year during the past decade, far higher than any other equity category. (Foreign-stock dividends may not necessarily qualify for the low tax treatment, either.)

Do Watch Out for Income-Focused Funds: If you buy and hold individual stocks, you can do your homework and downplay nonqualified dividend payers. But if you own stock mutual funds focused on dividend payers, such as those with "Equity Income" or "Dividend" in their names, you won't have the same opportunity to pick and choose. Unless a dividend-focused fund is explicitly tax managed, the manager's only goal is to maximize income and total return. That means it's highly possible that the fund will hold companies that kick off nonqualified dividends, and such a fund may even own some bonds, to boot. So before you park an equity-income fund in your taxable account, first spend some time looking under the hood.

Don't Assume It Will Stay This Way: We've gotten spoiled with the low tax rate on dividends. But the current policy has only been around since 2003, and it's set to revert to pre-2003 levels in 2013. That means that dividend income will again be taxed at investors' ordinary income tax rates. If that happens, you might decide you want to get those dividend payers into a tax-sheltered wrapper like an IRA or 401(k) post-haste. After all, it's better to let those dividends compound rather than letting the IRS take a big cut right off the top.

Don't Hold Very High Dividend Payers in Taxable Accounts: Even if a company's or fund's dividends are qualified all the way, companies and funds that kick off very high levels of income are still usually best left in your tax-sheltered accounts. That's because you're going to receive that high income stream whether you need the money or not, and in turn, you'll owe taxes on that dividend for the year in which you received it. By holding non-dividend payers in your taxable accounts, by contrast, you won't be on the hook for taxes unless you take action and sell shares. Of course, you might decide that dividend payers' fundamental attractions supersede the tax considerations, but all else equal, dividend payers are less tax-efficient than non-dividend payers, even in the current low-tax environment.

Monthly Market Commentary

April employment numbers were low, but auto sales were near record levels, housing data continued to improve, and retail sales are moving ahead at a slow but steady pace.

GDP: First-quarter real GDP growth slowed down to 2.2% from 3.0% in the fourth quarter last year. The number would have been much higher if government-defense and business-construction spending hadn't fallen significantly. In perspective, the drop in GDP growth is not such bad news given all the offsetting factors, and Morningstar economists estimate that we seem to be on track for 2.0%–2.5% growth in 2012 and 2013.

Employment: April's employment report was definitely bad news, with only 115,000 jobs added, a disappointingly low number when compared with the recovery high of 275,000 we saw back in January. If interpreted as a trend instead of as a number, this could mean more bad months ahead. However, weather, the auto industry, and seasonal factors can affect month-to-month employment data, making the bad news seem worse than it actually is. Examining the data year-over-year can strip out seasonality and eliminate month-to-month anomalies such as strikes or weather-related fluctuations. Year-over-year job growth has been steadily trending upward, from 0.8% in May 2011 to 1.6% in February 2012, then slightly down to 1.4% in April 2012.

Morningstar economists believe that, even though we shouldn't expect high numbers like in January anymore, employment growth will continue and will vary greatly by sector. So far, the manufacturing sector has been performing above average, while government has been experiencing a sharp decline. When comparing current job growth numbers with the ones observed during past recoveries, it becomes apparent that things are a little worse this time around (1.4% employment growth on an annualized basis versus a 1.9% average for the recoveries from the 1982, 1990, and 2001 recessions). Government is the sector with the worst shortfall.

Auto sales: In April, the auto industry experienced its second-best month of the recovery. Sales were not quite as strong as in February, but they were better than in any other month of the recovery since 2009. Strength in the auto sector was a main driver in the recovery, contributing 1.1% of the 2.2% increase in GDP during the first quarter of 2012.

Consumer spending: Inflation-adjusted consumer spending only increased by 0.1% in March, following 0.3% and 0.5% increases in January and February, respectively. However, warm weather and the reduced use of utilities may have played a role in keeping the March number low. On the other hand, year-over-year employment data suggests wage income is up only modestly (maybe 0.5% to 1.0% after inflation), while consumption is growing faster (about 2% after inflation).

Housing: Improvement in this sector has been steady and dramatic, as demonstrated by the Case Shiller 20 City Index, the Federal Housing Finance Administration Report, and pending home sales numbers. With mortgage rates back down, affordability back at record levels, and inventories in several markets near historic lows, the prognosis for further improvement is excellent.

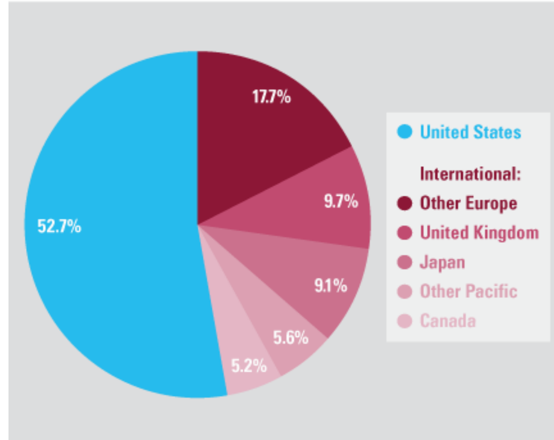
When economies diverge: Can the U.S. economy keep improving if the rest of the world slows down? The Eurozone economy declined by 0.3% in the fourth quarter of 2011 and now appears poised to fall even faster in the first quarter. Inflation in Europe also seems to be on the rise, driven primarily by oil prices. As Europe is China's largest trade partner, a European slowdown may not bode well for China's economy. The U.S. derives less of its GDP from exports and a weakening in this area has so far been offset by a powerful auto industry, but the consensus is for the trade deficit to increase in the months ahead.

A World of Opportunity

As trade barriers continue to break down, the world economy has become a small neighborhood. Should investors seek to participate in this wave of globalization, or are they getting all they need here at home?

Historically, foreign investments have acted in a significantly different way from domestic investments. When the U.S. market slumped, various opportunities abroad have prospered. An American investor who put some money into foreign markets may have reduced risk while still attaining attractive returns. With the spread of globalization, this benefit decreases as companies across the globe are acting more like each other. However, as the image illustrates, an investor who doesn't take advantage of options outside of the United States is missing out on roughly half of the investable developed stock market opportunities in the world.

World Stock Market Capitalization
Year-End 2011



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Source: World Market Capitalization by Country is from the Morgan Stanley Capital International Blue Book℠. The data is expressed in U.S. dollars.

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