

TAXING MATTERS.

BY DOUGLAS KREPS, CFA

As we enter the final quarter of 2011, we thought it would be important to look forward to 2012, and the new tax reporting requirements individuals will face. While capital gains tax rates are not changing, the reporting and documentation of capital gains and losses for 2011 will be different than 2010.

First, a bit of history: for the 2011 tax year, the IRS will be adopting a new tax format for the tracking and reporting of capital gains. Despite the seismic shift in operations for custodians, registered investment advisors, accountants, and taxpayers, the new rules come from, of all things, the Emergency Economic Stabilization Act of 2008, which required custodial brokers to report the cost basis of investments to the

IRS. In the past, this was the responsibility of the tax payer and/or the tax preparer. However, a 2005 IRS study indicated that the government was losing about \$11 billion a year due to taxpayers improperly reporting the correct tax basis for security sales. Not wanting to miss out on the chance to catch cheaters (and thwart potential cheaters) the government put in place a mechanism to reduce the



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likelihood that taxable gains would go unreported. Hence, the requirement that broker dealers track cost basis was born.

As is usually the case with new tax regulation, the final details have yet to be hashed out, but the broad requirements are clear. For all stocks purchased after January 1, 2011, mutual funds shares acquired after January 1, 2012, or other investments bought after January 1, 2013, the broker will be required to report the purchase cost of these “covered” securities that were sold on the annual 1099 report to both the taxpayer and the IRS.

So far, this does not sound so challenging. However, as we have been investigating the changes, we have found a number of potential issues which taxpayers will need to pay close attention to.

First, many broker dealers have been tracking the cost basis for shares purchased through their firms for some time. Unless the broker was closing out the same tax lots as the shareholder, there may be a mismatch between the broker’s records and those of the shareholder. These differences may be compounded when a taxpayer has

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multiple accounts, given that the new 1099 reporting is account specific, not tax payer specific. Second, there will be situations where the broker does not have the basis, especially for positions established over five years ago. And third, there will likely be differences where shares were inherited and subject to a step up in basis.

So where will taxpayers stand come April 15, 2012? We have identified a few steps that individuals can take now to reduce stress next year. First, it is important to remember that while brokers will be required to report the basis of sold shares acquired and subsequently sold after 2011, there is no requirement for brokers to report the basis of securities purchased before January 1, 2011 to the IRS. Instead, the brokers will be reporting this information to shareholders on year-end summaries. This is important, as it will provide the opportunity for shareholders to compare their records to those of the custodian for open positions. Where there is a mismatch, it will be important to synchronize the records. Our firm has been working with our clients and the custodians to ensure that all parties’ records match, and we anticipate this will be an ongoing process.

Second, there will be a new form for taxpayers who have

taxable capital gains: form 8949. Instead of entering taxable gains directly on Schedule D, filers will first have to complete the new 8949 form which will allow the taxpayer to provide information that may not be on the new 1099 form from their broker, or to update the basis where a tax filer’s information is different from the broker-provided 1099. Unfortunately, specific instructions on the revised Schedule D and form 8949 are still pending, but a good reference is www.irs.gov. As is common with new regulations, the requirements are still evolving, and we will continue to monitor guidance from tax experts and the IRS and share that information with you.

Please understand that Fort Pitt Capital Group does not provide tax filing advice, and this article is intended to inform our clients about pending changes in the tax code. It does not represent specific tax advice, and we encourage you to contact your tax advisor regarding your tax filings.



DOUGLAS KREPS, CFA

As Principal and Portfolio Manager at Fort Pitt Capital Group, Doug is responsible for asset allocation strategies and mutual fund selection. He also coordinates daily operations and client reporting.

WELCOME

Fort Pitt Capital Group is pleased to announce that Melissa Botta has joined our firm as a client service representative. A graduate of the University of Pittsburgh, Melissa has spent the last 7 years working for JP Morgan Chase in Columbus, Ohio. While there, she worked with institutional fixed income and equity accounts, managing communications between clients, brokers, and traders. We are excited to bring her institutional experience to our operations team, and welcome her back to Pittsburgh.

CAPITAL

YOUR FUTURE IS OUR FOCUS.
VOLUME 14, NUMBER 4, OCTOBER 2011



THE AXIS OF ARTIFICE

BY CHARLIE SMITH

Several thousand (mostly young) people are currently protesting in Zuccotti Park near Wall Street. One of their messages is that large financial institutions control too great a portion of the nation’s wealth, and should therefore be broken up. Interestingly, Wall Street itself attempted to deliver this same message three years ago in the form of a financial crisis and stock market crash. But instead of allowing market forces to swing the sledgehammer, our political leaders enacted a rescue package which rendered the too-big-to-fail banks *even bigger*. Sadly, such perverse outcomes have become the norm in the U.S. economy in recent years. This essay summarizes some of them, and in so doing lays out a few of the reasons the economy is moribund. Talk of renewed recession is in the



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air, and unless our political and financial leaders change course and stop subsidizing zombie banks, our economy is likely to continue to stagnate.

The answer to the question of why the economy can’t get off the dime goes as follows: You don’t encourage risk-taking and economic activity by driving down returns. Growth happens when investors take risks justified by high prospective returns. Prospective returns are high when asset prices are low. Unfortunately for our economy, nearly every policy enacted since the fall of 2008 has discouraged risk taking by *temporarily and artificially inflating asset prices*. The best example is the housing market. Fiscal and monetary policymakers have enacted one strategy after another to prop up home prices. Federal tax credits

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THE AXIS OF ARTIFICE (CONTINUED FROM COVER)

for first-time buyers, payment assistance for delinquent homeowners and large purchases of mortgage-backed securities by the Federal Reserve have all been tried, with little long-term effect. Home prices continue to bleed, and will do so until they reach an equilibrium determined by real supply and real demand, not the artificial demand created by politicians and the Fed. How much lower might they go? Our best guess is that a cumulative decline of as much as another 10% for the average U.S. home over the next three years would bring prices in line with incomes and available mortgage credit.

Another example of policy error is the artifice in mortgage rates themselves. Ninety-five percent of mortgages currently underwritten in the U.S. are backed by the Federal government in the guise of Fannie Mae, Freddie Mac or the Federal Housing Authority. Most banks will not write a new mortgage unless they can immediately sell it to the Feds. What do you think this means for mortgage rates? Where would rates be without a ready buyer for 95% of originations? Three percentage



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points higher? Four? The price of credit in today's housing market would undoubtedly be higher if taxpayers were not providing a backstop. Artificially low mortgage rates keep home prices artificially high, which in turn acts to dampen real demand because buyers aren't sure if prices are authentic. Buyers sit on their hands and try to decide if the subsidy is permanent. This sends prices lower over the long term. Perverse? Yes. Unfortunately, also the norm in today's federally “managed” housing market.

The most egregious illustration of a subsidy designed to inflate asset prices is the Federal Reserve's policy of keeping short-term interest rates at or near zero (ZIRP). Soon after the financial crisis in the fall of 2008, the Fed cut the rate at which it lends overnight money to banks to less than 0.25%. This change acted as a massive subsidy to the banking system, in that it gave the banks nearly unlimited amounts of money to buy longer-term securities and earn a “spread” on the difference between their (nearly free) money and the rate earned on the securities. This policy has the effect of driving retail rates

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for short term investments (bank CDs and money market funds) to near zero as well, crushing the incomes of many retirees and small savers. Policymakers are effectively picking the pockets of middle America to fund both weak bank balance sheets and government spending. Can you say “Tea Party”?

ZIRP keeps the banks flush, however. This is the true goal of *all* the policies mentioned above: Keep the prices of failed investments from the last cycle (mortgages, strip malls, housing developments and financial assets in general) high enough long enough so

that the banks don't have to admit they're insolvent. This gives them time to earn their way out of the problem by pocketing the spread on government bonds and other low-risk investments. Call it extend and pretend, pray and delay, whatever you want, the goal is the same. What the strategy does not do, however, is encourage risk taking. Zombie banks don't have to make loans when they can rake small savers and the taxpayer for their daily spread. So they don't, as of June 30, 2011, net loans and leases held by all FDIC-insured U.S. banking institutions were **9% below** the level of 3 years ago. Credit continues to shrink, the economy flounders.



“THE MOST EGREGIOUS ILLUSTRATION OF A SUBSIDY DESIGNED TO INFLATE ASSET PRICES IS THE FEDERAL RESERVE'S POLICY OF KEEPING SHORT-TERM INTEREST RATES AT OR NEAR ZERO (ZIRP).”



CHARLIE SMITH

Principal and Chief Investment Officer at Fort Pitt Capital Group, provides the economic overview for the firm, while also managing client portfolios of individual securities.

The Wall Street protesters are onto something. They've figured out that policymakers have colluded with bankers to form an Axis of Artifice. The Fed and the administration pump cheap money into the system to keep asset prices up; bankers funnel much of it right back into government spending and debt. Each takes its cut along the way. Meanwhile private credit stagnates, small business withers and unemployment soars. The winners are those closest to the great money flow between New York City and Washington, DC. The rest of us go down the tubes. There's a solution to this dilemma, however; one I believe would be quite amenable to the ragtag group in

Zuccotti Park. We need to break the axis by electing new leaders who will stop the artifice and let rich people fail.

QUARTERLY REVIEW BY DENNY BAISH

The third quarter of 2011 was not kind to most investors, as the major equity indices turned in their worst performance since the fourth quarter of 2008. Domestic small and mid-caps led the way down posting losses of 22% and 20%, respectively. The S&P 500 held up better, but still finished the quarter down double digits. International developed stocks, represented by the MSCI EAFE, suffered steep declines as well, losing 19%.

On August 5th, the ratings agency Standard & Poors downgraded the United States from AAA to AA+ after Congress failed to adequately address our long-term debt problems. The downgrade, along with continued concerns of Greek (and potentially Irish, Portuguese, Italian, and Spanish) defaults sent the markets on a downward spiral. Fundamental economic concerns also remained in the headlines during the quarter: fears of a double-dip recession spilled over from the second quarter as most economic data remained weak. The employment picture in the U.S. continued to paint a bleak picture as the unemployment rate remained at 9.1%, and long-term unemployed counts continued to rise. The Federal Reserve kept interest rates unchanged and in an unusually direct statement announced the intention to keep rates near zero until at least 2013.

As noted above, there was no place to hide in the stock markets, as all market capitalizations posted heavy losses.

Small-caps fell the most losing 22% during the quarter, while mid-caps followed close behind dropping almost 20%. Large-caps lost 14%, but held up better as investors sought out larger, more stable companies. Financial companies weighed heavily on value-oriented stocks during the quarter. The large and mid cap value sectors lagged their growth counterparts by 5% and 2%, respectively, and small-cap value and growth declined in lockstep.

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BENCHMARK INDEXES

INDEX	3 RD QUARTER RETURN
DJIA	-11.49%
S&P 500	-13.87%
S&P Mid Cap 400	-19.88%
Russell 2000	-21.87%
MSCI EAFE	-19.01%
BarCap Agg. Bond	3.82%

Facing the headwinds of a slowing economy and potential government defaults, developed international stocks posted substantial declines during the third quarter, wiping out gains from the first half. And despite higher GDP growth rates, emerging market stocks, represented by the S&P/IFCI Emerging Composite, turned in their worst quarterly performance since 2008, falling 23%.

On the plus side, most areas of the fixed income market posted gains as investors looked for safety from the volatile equity markets. U.S. Government bonds led the way with gains of 2.4% for long-term U.S. Treasur-

ies and 3% for intermediate-term U.S. Treasuries. Investment grade corporate bonds showed strength returning 2%, and despite currency turmoil, international bonds gained 1%. After leading the way in the first half of the year, high yield bonds fell 6%.