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Dear Hawk100 Member.

I am pleased to present you with your Hawk100 Wealth Alignment Report for the 2012 third quarter. For this edition of our quarterly letter, I've decided to take an academic approach to explain the situation facing financial markets in advance of the end of 2012.

Stark challenges face Washington, DC, locales, and nations abroad. Spendthrift fiscal and monetary policies have amassed huge encumbrances upon citizens. Those encumbrances introduce present, short-term, and long-term ramifications. Together, let's peer over the edge of the "fiscal cliff" and take in the view of the potential impact on your portfolio.

"Fiscal cliff" is the term coined by Federal Reserve Chairman Ben Bernanke to describe the coming cascade of fiscal and monetary policy changes scheduled to take effect January 1, 2013. Unless Congress and President Obama take action, the fiscal cliff includes recklessly devised spending cuts called "sequestration" which were set in motion during the debt ceiling debate of the summer of 2011. Moreover, many simultaneous tax increases could hammer taxpayers on several heads as follows:

- Ordinary income tax rates and rules revert to pre-Bush-era levels
- Taxes on investments will be assessed at ordinary income rates rather than aligned with capital gains rates. Plus, Obamacare assesses old age, survivors, and disability insurance (OASDI) tax on "unearned" income (interest, dividends, capital gains, etc.).
- Estate tax rates and rules revert to pre-Bush-era levels with lower exclusion amounts and higher tax rates.
- The temporary payroll tax holiday expires and Obamacare hospital insurance (HI) tax further raises the cost of employment.
- The Alternative Minimum Tax (AMT) "patch" expires and forces millions to pay AMT.

Ordinary income taxes.

The Bush-era tax cuts are scheduled to expire December 31, 2012. Recall that rates were originally scheduled to rise after 2010, but Congress and President Obama extended Bush's low rates through 2012. Otherwise throughout his presidency, Obama has promised to increase tax rates for those with higher incomes (he often says those are married couples who file jointly and earn $250,000 although the highest bracket began at $288,350 in 2000). The following table presents rates without Congressional action.

2012 Bracket	2012 Rate	2013 Bracket	2013 Rate	Rate Change
0 – 17	10.0	0 – 17	15.0	5.0
17 – 71	15.0	17 – 44	15.0	
71 – 143	25.0	44 – 106	28.0	3.0
143 – 217	28.0	106 – 161	31.0	3.0
217 – 388	33.0	161 – 288	36.0	3.0
388 – above	35.0	288 – above	39.6	4.6

The foregoing brackets reflect those for married taxpayers who file jointly.

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Investment taxes.

Taxes on net investment income will be assessed at ordinary income rates rather than aligned with capital gains rates. Plus, Obamacare assesses 3.8% OASDI taxes on “unearned” income. As applied, unearned income includes the sum of:

- gross income from interest, dividends, annuities, royalties, and rents (other than income derived from a trade or business to which the tax does not apply),
- other gross income derived from any business to which the tax applies, and
- net gains attributable to the disposition of property (other than property held in a trade or business to which the tax does not apply).

Description	2012 Max Rate	2013 Max Rate	Obama-care	2013 Total	Rate Change
Interest income and non-qualified dividends	35.0	39.6	3.8	43.4	8.4
Qualified dividends	15.0	39.6	3.8	43.4	28.4
Net capital gains	15.0	20.0	3.8	23.8	8.8
Qualified dividends are those received from stock held for more than 60 days of the 121-day period beginning 60 days before the ex-dividend date.					

Estate and gift taxes.

Estate and gift tax rules and rates that were enacted under Bush then unified and extended through 2012 are scheduled to change next year. The amount which deceased taxpayers are allowed to exclude from their taxable estates would fall by 80% from $5,120,000 to $1,000,000. Furthermore, the effective tax rate would rise from 35% to 55% applied to the taxable estate value in excess of the exclusion amount. One positive note, on October 18, the IRS approved an increase to the annual exclusion for gifts from $13,000 to $14,000 per year, per donee, per donor. In other words, each person making a gift may give up to $14,000 in 2013 to each person receiving the gift with no tax consequences.

Description	2012	2013	Change
Lifetime exclusion amount	$5,120,000	$1,000,000	($4,120,000)
Estate tax rate	35.0	55.0	20.0
Annual exclusion amount	$13,000	$14,000	$1,000

Payroll taxes.

The temporary tax holiday that had reduced payroll taxes will expire. 6.2% will be assessed for the employee portion of OASDI taxes. Those taxes, used to fund social security, had seen temporary 2% relief in effort to boost employment. While unemployment remains stubbornly high, Hawk100 expects Congress to view the relief as unsuccessful to let this temporary relief expire without a fight. Also beginning in 2013, Obamacare hospital insurance (HI) tax will assess 0.9% on employee wages to further raise employment costs.

Description	2012 Rate	2013 Rate	Change
Employee OASDI	4.20	6.20	2.00
Employer OASDI	6.20	6.20	
Employee HI	1.45	2.35	0.90
Employer HI	1.45	1.45	
Total	**13.30**	**16.20**	**2.90**

Alternative Minimum Tax.

The AMT concept was enacted in 1969 to capture tax revenues from taxpayers who report high incomes offset by high deductions. AMT is essentially a separate federal income tax system with its own rates and rules. If your income exceeds exemption limits, you may be subject to AMT, and you must calculate taxes under the AMT system. If your AMT exceeds your regular tax liability, you must report and pay the difference when you file your return. For years, Congress has temporarily relieved AMT with a "patch" that increases the AMT exemption amount and forestalls a dramatic rise in the count of AMT-affected taxpayers. That patch could expire before taxpayers file returns for 2012.

In 2009—the latest year for which data is available from the IRS—US taxpayers paid $22.6 billion AMT. If the AMT patch is allowed to expire, millions of taxpayers may find themselves with an additional AMT tax liability when they file in April 2013.

2011 median US household income fell to $50,054 according to the US Census Bureau report issued in September: Income, Poverty and Health Insurance Coverage in the US. According to the same report, median earnings of men and women fell to $48,202 and $37,118, respectively. With AMT exemption amounts below median incomes, over half the population could incur compliance cost of complex AMT rules if not incurring an additional AMT liability.

Description	2011 Exemption	2012 Exemption	Change
Married filing jointly	$74,450	$45,000	$29,450
Married filing separately	$37,225	$22,500	$14,725
Single or Head of Household	$48,450	$33,750	$14,700

Sensible observers recognize the pending tax changes are politically untenable. Hawk100 expects Congress to take some action to forge some legislation however ugly it may be. A present challenge for investors is to forecast what legislation could be tangled together by a Congress and President that have failed repeatedly to effectively compromise. 2012 election results seemed only to reinforce widely divergent stances among powerful factions within Democrat and Republican circles. It also seems that the Republican stance is relatively weak against a Democratic Senate and President and any likely resolution includes tax increases that would adversely affect financial markets.

Expected tax effect on asset values.

How do we expect these tax changes to affect investors? Please excuse my academic and mathematical exercise. It's the best way I know to answer this complex question. Assume for discussion purposes that stocks and bonds were efficiently priced as of September 30. If so, the efficient market hypothesis tells us the values of securities reflect all relevant investment risks. Thereby, we could expect returns to equal our required returns. Further assume that investors examine returns after taxes and that their risk preferences remain static. Thus, if tax rates rise, investors' pre-tax required returns must rise commensurate with the new taxes.

Provide purpose.

For securities aligned with your provide purpose (i.e., bonds), prevailing yield is a fair estimate of expected return. As of September 30, the Barclays Aggregate Bond Index yields 1.56% and the highest marginal tax rate is 35%. After paying taxes at current rates, that yield becomes 1.01%. In other words, every $156 of income taxed at 35% nets $101. Efficient investors require 1.01% after tax return on their investments in bonds.

$$\text{After-tax yield} = \text{Pre-tax yield} \times (1 - \text{marginal tax rate})$$

$$1.01\% = 1.56\% \times (1 - 35\%)$$

If ordinary income tax rates rise as discussed, the highest marginal rate would become 43.4%. If the index continued to yield 1.56% pre-tax, then after-tax yield would drop to 0.88%. We stipulated that investors statically require after-tax returns of 1.01% so pre-tax yield would necessarily rise to 1.79%.

$$\text{After-tax yield} = 1.01\% = 1.79\% \times (1 - 43.4\%)$$

So we conclude that if taxes rise, as discussed, we could expect yields to rise from 1.56% to 1.79%. How might this affect bond prices?

Bond prices and yields are inversely related. When yields rise, bond prices fall. When yields fall, bond prices rise. Duration is an approximate measure of bond price sensitivity to a 100 basis-point (1.00%) change in yield. As of September 30, the Barclays Aggregate Bond Index duration is 4.36. If yields were to rise by 1%, we could expect the price of the index to fall approximately 4.36%. If yield rises from 1.56% to 1.79%, bond values could fall by 1.00%.

$$\text{Approximate \% change in bond value} = -\text{Duration} \times \text{Change in Yield}$$

$$-1.00\% = -4.36 \times (1.79\% - 1.56\%)$$

Therefore, if investor risks and required after-tax returns remain unchanged but tax rates rise as scheduled, it is reasonable to expect values to fall to such an extent that offsets virtually all after-tax income earned on bond holdings. This condition compounds when one considers the risk that investors increase their return requirements in the face of rising economic and political risks in advance of the fiscal cliff.

Hawk100 is removing its favorable opinion on securities aligned with your provide purpose.

Promote purpose.

Undertaking a similar exercise for securities aligned with your promote purpose (i.e., stocks) we need to be mindful that dividends and capital gains would become subject to different tax rates. Dividends, now taxed at 15%, would be subject to 43.4% taxes. Capital gains, now taxed at 15%, would be subject to 23.8% taxes.

We could derive a fair estimate of required return from a broadly accepted valuation model, the dividend discount model. Under reasonable assumptions in an efficient, mature market, the dividend discount model holds that the intrinsic value of a stock should equal the next expected dividend divided by the difference between the investor's required return less a constant rate at which dividends are expected to grow.

$$\text{Intrinsic Value} = \frac{\text{Next Dividend}}{(\text{Required Return} - \text{Dividend Growth Rate})}$$

An efficient market would be valued at its intrinsic value, so we can adjust that formula to solve for the required return. The resulting formula clearly identifies two components of required return—dividend yield and dividend growth—taxed at different rates. As of September 30, the Standard and Poors 500 Index trailing dividend yield was 1.98% and the long-term growth rate was estimated at 10.34%, according to Morningstar. In an efficient market, the pre-tax required return would be approximately 12.32%.

$$\text{Required Return} = \text{Dividend Yield (ordinary)} + \text{Dividend Growth (capital)}$$

$$12.32\% = 1.98\% + 10.34\%$$

Current tax rates imply that investors' required return becomes 10.47% after taxes.

$$\text{After-tax return} = \text{yield} \times (1\text{-ordinary rate}) + \text{growth} \times (1\text{-capital rate})$$

$$\text{After-tax return} = 10.47\% = 1.98\% \times (1 - 15\%) + 10.34\% \times (1 - 15\%)$$

If tax rates rise in 2013, and stock dividends continue at current levels, the after tax return would fall to 9.00%. However, we stipulated static risk preferences, and investors would continue to require 10.47% after tax. To preserve that return, either dividend yield would immediately rise to 4.58% or growth would need to rise appreciably to 12.27%.

$$\text{After-tax return} = 10.47\% = 4.58\% \times (1 - 43.4\%) + 10.34\% \times (1 - 23.8\%)$$

or

$$\text{After-tax return} = 10.47\% = 1.98\% \times (1 - 43.4\%) + 12.27\% \times (1 - 23.8\%)$$

Understand that raising dividends actually shrinks future growth. As companies earn finite profits, they can either distribute those profits as dividends to shareholders or retain the profits to invest in projects that grow future business earnings. Companies rationally balance the trade-off between whether to distribute

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earnings or to reinvest earnings much like people must decide whether to spend their wages or to save and invest wages.

Companies currently distribute about 29% of earnings and retain about 71%. To increase dividend yield from 1.98% to 4.58%, companies would need to distribute 68% of earnings. That would reduce growth to levels that fall short of the required return. Instead, higher dividend tax rates behoove companies to reduce dividend payouts in favor of riskier internal growth objectives. At current earnings levels, companies would optimally pay out less than 10% of earnings for a dividend yield of just 0.62% while seeking growth in excess of 13.28%.

$$\text{After-tax return} = 10.47\% = 0.62\% \times (1 - 43.4\%) + 13.28\% \times (1 - 23.8\%)$$

Such a high growth objective puts more onus on management to allocate capital budgets into fewer, riskier projects and concentrates investor portfolios into fewer, less diverse stocks. These conditions raise risks to maintain a static return and make investments less attractive on a risk-adjusted basis.

The market provides another way to achieve the required after-tax return without affecting either dividend policies or growth rates. Market prices could fall to such a level that results in a 4.58% dividend yield. How much would prices fall? Investors would have to bleed 57%.

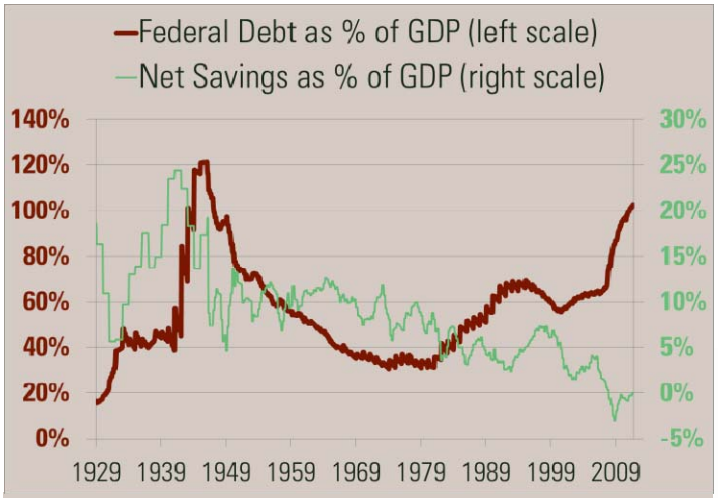
Therefore, if investor risks and required after-tax returns remain unchanged but tax rates rise as scheduled, it is reasonable to expect values to fall or investment risks to rise significantly.

Accordingly, Hawk100 is pragmatically avoiding securities aligned with your promote purpose.

In God We Trust.

Federal debt measures $16.1 trillion as of September 30 and exceeds Gross Domestic Product (GDP) for the first time since the end of WWII.

Some representatives of Congress and officials of Treasury blithely cite that previously high level of debt as precedent for decades of peaceful economic expansion. We rather think the Post War expansion was secured liberty through the sacrifice of veterans we recently celebrated. That expansion also coincided with an era of American thrift.



SOURCE: US Department of Commerce, Bureau of Economic Analysis, Treasury Direct

The accompanying chart shows US federal debts and the net rate of savings relative to GDP. It is easy to see that when federal debt last exceeded 100% of GDP, Americans had been saving more than 15%. Now, net savings are negative. Importantly, savings have been negative since the end of 2008, exactly when federal debt began to explode under Bush's and throughout Obama's administrations.

Congress has little choice but to face the fiscal cliff headlong. The Congressional Budget Office (CBO) told Congress in a November 8 report that falling over the cliff would increase the likelihood of a US recession in 2013 and would reduce GDP by 0.5%. Other analysts, most notably at Goldman Sachs, have forecast more bearish outlooks of recessions as deep as 5%. Congress must act, but only with prudence and pragmatism, not politics. Alas, there is little hope…but hope we must.

Federal Reserve Notes (i.e., US dollars), say "In God We Trust." They have to…no one else seems to have enough to finance today's omnipresent public debt.

Focus on the positive. As you celebrate Thanksgiving, I hope you have the opportunity to share the holiday with your family and to reflect on all that gives you grace. While doing so, please remember that Hawk100 truly appreciates your membership.

Warmest regards,

Hawk100
Richard Clemens, CFA
President