What's the Impact of Tax Changes on Equities?

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- The coming U.S. election has put tax rates on center stage for investors
- History suggests no clear link between the direction of tax changes and equity markets
- While tax policy and related sentiment certainly can impact equities, we continue to look at stocks more holistically
- Our portfolio will likely benefit from rising equity markets, but has a substantial "cushion" through fixed income and more defensive, yield-focused investments should equities post a modest retreat

The looming November 6 U.S. election and recent party conventions have an increasing number of investors looking at tax policy: What changes will likely emerge after the vote? What might those changes mean for markets?

Given the current political climate, it's impossible to know exactly which scenario will emerge, or when. That said, some key U.S. tax rates are *scheduled* to rise significantly. As outlined in Bessemer's July 27 **Tax Update**, for high earners, the long-term capital gains rate is expected to increase next year from 15% to 23.8%, and the dividend rate from 15% to 43.4%.

Higher tax rates reduce the after-tax return of stocks held in taxable accounts. If the dividend rate goes from 15% to a much higher ordinary income rate, an investor's after-tax return goes down for stocks that pay dividends. The math is similar for a change in capital gains rates, which impact an investor's after-tax proceeds when a successful investment is sold.

A Historical Perspective

Is history any guide to what markets might do into 2013, given the potential tax changes? To answer this question, we studied the seven most recent tax law changes going back to 1981 — and the performance of the stock market six months before the change, six months after, and cumulatively (Exhibit 1).

For the three tax *increases* since 1981, the S&P 500 was up 5%, 14%, and 16% in the 12 months surrounding the change. But the data also shows that tax *decreases* have occasionally coincided with rallies. To make matters even fuzzier, the sample period did not include any major increases on just

Exhibit 1: Tax Changes and the Stock Market: No Clear Link

			S&P Performance		
President & Year of Passage	Tax Increase/Decrease	Impacts	6 Months Prior	6 Months Post	Cumulative
Bush/May '03	Decrease	Capital Gains & Dividends	+3%	+10%	+13%
Bush/May '01	Decrease	Income Tax	(5)%	(9)%	(14)%
Clinton/Aug '97	Decrease	Capital Gains	+22%	+5%	+27%
Clinton/Aug '93	Increase	Income Tax	+1%	+4%	+5%
Bush/Nov '90	Increase	Income Tax	(7)%	+21%	+14%
Reagan/Oct '86	Decrease Increase	Income Tax Capital Gains	(2)%	+18%	+16%
Reagan/Aug '81	Decrease	Income & Capital Gains	(4)%	(5)%	(9)%

Source: FactSet, Tax Policy Center

dividend taxes. Prior to 2003, dividends weren't treated separately and were lumped into ordinary income. The tax cuts in 2003 marked the first time dividends were treated as a separate category, and 2013 will mark the first time dividends are increased as their own separate category (assuming this moves forward). The conclusion from this exercise — acknowledging the small sample — is unmistakably blurry. There is no clear link between tax changes and U.S. equity performance. Why?

Not all investors are sensitive to taxes. Think of all of the IRAs, 401(k)s, and other retirement accounts where many Americans have a considerable portion of their equity exposure. To put this into perspective, Americans hold roughly $19 trillion in such retirement accounts, and nearly half of all stock and bond mutual funds are held in IRAs and defined contribution plans. Higher rates on ordinary income taxes hurt investors as they withdraw money from these accounts over time, but most investors get to enjoy many years of tax-deferred growth. Further, many U.S. stocks are held by non-U.S. taxpayers who are less concerned about the U.S. tax system, and many foundations and endowments enjoy tax-exempt status. So even if tax rates go up as planned, many investors may not be significantly impacted.

Context for Today

That's not to say that tax rates are unimportant — they clearly matter. But taxes need to be considered among a host of other equity drivers such as sentiment, corporate revenues, earnings, the overall health of the global economy, and valuations. Even with higher taxes, a positive trend in a number of these other factors could predominate and lift equities.

Let's consider the tax-equity issues via a macro lens. The current S&P 500 price-to-earnings (P/E) multiple is about 12.5x forward earnings and 15-16x last year's earnings (as of August 30). This is low relative to history (the median P/E since 1980 is 18x trailing earnings), especially against the backdrop of very low interest rates. One reason for today's low multiple is that investors are nervous about many big-picture macro issues, including the U.S. fiscal imbalance. The U.S. has added $5 trillion of new debt since the financial crisis began, and there is a huge gap today between spending and tax revenue. One could make a case that if U.S. politicians take bold action and both increase tax revenue and cut spending over time (so as to avoid the "fiscal cliff"), this will put our country on a more sustainable fiscal path — which in turn might alleviate one of the market's key sources of anxiety. Viewed this way, higher taxes may not be such a universally bad thing for markets.

Summary

We continue to expect equity markets will remain volatile within a range. Questions over growth and political developments seem likely to limit upside, while support continues to come from relatively attractive valuations and accommodative monetary policy. Stocks are always unpredictable in the very short run, but our research would suggest the stock market isn't destined for a bear market simply because tax rates could rise.