



NCM Client Alert

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The Tax Man Cometh....and he ain't happy!

For almost seven years now investors have been lulled into a sense of tax complacency as previously incurred capital losses from the dreadful markets of 2000-2002 shielded them from significant taxable gain. This despite the fact portfolios have appreciated considerably during that time. Rest assured, things are about to change.

Beginning with tax year 2007 liabilities associated with capital gain distributions and reallocations will soar (initially I ended this sentence with an exclamation point, but to me an exclamation point connotes excitement....and this statement is anything but exciting).

While fund capital gain distributions are uncontrollable, capital gains incurred as a consequence of rebalances are. In 2007 most portfolios underwent significant rebalances as our Investment Committee sought to harvest gains from previously hot sectors of the market. It was the consensus of the Committee that there were two good reasons to trigger the gains this year and next.

The first justification for reallocation was market created portfolio imbalances. On the heels of five years of significant out-performance by "value" oriented funds as compared to "growth" oriented funds, the Committee became concerned accounts lacked adequate diversification and growth fund representation. The timing of our decision to shift assets could not have been better as we have moved into a growth dominated market during the second half of the year. In fact, the Committee feels we may be transitioning into a growth dominated three to five year market run.

While harvesting gains can be tax painful, we remember all too vividly the reluctance of investors to sell following the historical bull run ending in 1999. Some clients did not allow us to rebalance their accounts due to pent up capital gains. Unfortunately the market remedied that problem as the NASDAQ plunged nearly 80% (Question: Would there have been a better way?). Without action history is bound to repeat itself.

The second justification for rebalancing now is the Committee's belief it is highly likely the favorable tax treatment long-term capital gains enjoy will be in jeopardy beginning as early as 2009. In fact, the standard top tax rate on long-term gains, which is presently 15%, is already scheduled to rise to 20% in 2011. It is our contention that any Democratic administration will raise rates even higher. It is important to remember that as recently as 1997 long-term gains were taxed at 28% and then at 20% until 2003.

While it is never pleasant to receive a big tax bill, the reality is it is reflective of successful investing. As always, we will continue to work to minimize the tax consequences of our actions while maximizing returns.

Investment Committee

Northern Capital Management, Inc.