ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Makes Changes to International Index Funds

This week, Vanguard announced that it was getting rid of one fund's loads, while also changing the distribution schedule for nine of its international index funds.

Emerging Markets Index Drops Loads

Investors in Emerging Markets Index will no longer have to contend with the 0.25% front- and back-end loads charged for trades into and out of the fund. At the same time, Vanguard initiated a 2% short-term trading fee on shares of the fund sold within two months of purchase, a standard feature for most of its international funds.

Going forward, as long as shares are held for more than two months, investors will only be paying 0.33% a year in fees for investor shares. The fund's Admiral shares, which require a $10,000 minimum initial investment, charge 0.20% a year, as does the ETF share class. However, the ETF will not be subject to the short-term trading fee, something for more active traders to consider.

Nine International Indexes Switch to Quarterly Distributions

In a move that Vanguard says will cut costs and reduce market impact, it has switched all share classes (Investor, Admiral, ETF, Signal, Institutional and/or Institutional Plus) of the following nine funds from an annual distribution schedule to a quarterly one:

- Emerging Markets Index
- European Index
- Global ex-U.S. Real Estate Index
- Pacific Index
- Tax-Managed International
- Total International Index
- Total World Index
- World ex-U.S. Index
- World ex-U.S. SmallCap Index

Investors in these funds should expect to see their first quarterly distribution in September 2012.

Tax Double Jeopardy

By now, you should have received your tax documents from your employer and investment custodians in advance of one of the most feared days on the U.S. calendar--tax day. While we get a couple of extra days this year to prepare our taxes (April 17, 2012 is the deadline for filing your 2011 returns), the Alternative Minimum Tax (AMT), a recurring nightmare for millions, just won't go away.

Congress created the AMT in 1969 after discovering that 155 taxpayers making over $200,000 (a princely income in those days) had avoided paying any federal income tax. Unfortunately, the AMT was not indexed to inflation and, over the years, it has begun to affect more and more people. Thanks to a last minute patch approved by Congress in late December 2010 as part of the Tax Relief Act, about 4.3 million taxpayers will have to pay up under AMT rules for tax year 2011 (had there been no patch, that number would have jumped up to an estimated 31.0 million), and they could owe thousands of dollars more on their returns as a result.

Essentially, the AMT functions in a parallel universe to the normal income tax, with different rates and methods of calculating income and deductions. If you fall into a certain income range, you have to calculate both your normal income taxes and the AMT and then pay whichever is higher. Many more than the aforementioned 4.3 million people who will be subject to paying the AMT will have to take hours filling out the necessary worksheet and form to figure out whether they owe it or just the normal income tax.

Possibly the most frustrating aspect is that many people who go to the trouble of filling out the AMT form will find that, in the end, they don't owe the tax. But since the number of people subject to the AMT has begun to rise, the IRS has been keeping a sharper eye out for AMT-related mistakes, so it's in your best interests to fill out the AMT worksheet, or to hire a professional to help you out if you're unsure about your return (any good do-it-yourself tax software should include an AMT questionnaire and calculate it for you as you fill out your return as well).

You can expect to be subject to the AMT (or at least to filling out the form) for tax year 2011 if your taxable income exceeds the exemption, which is currently $74,450 for married couples and $48,450 for singles and heads of households. As the law now stands, these amounts will drop considerably for tax year 2012, which would cause the number of taxpayers hit by the AMT to jump to an estimated 31.2 million households (or nearly

35% of all taxpayers) if no further patches are applied.

The people who should be most concerned about the AMT are those with children, especially two or more. According to the Urban-Brookings Tax Policy Center of Washington, D.C., for tax year 2012, when the most recent AMT patch expires, 40% of married couples with two children and 44% of married couples with three or more children will have to pay the AMT. And for those with higher levels of income, 95% of households with income between $200,000 and $500,000 and 82% of households with $100,000 to $200,000 in income will have to pay for tax year 2012.

In the past, part of the reason that Congress and the President have been unwilling or unable to eliminate the AMT is the amount of revenue it generates. If the Bush tax cuts, already extended two years, are kept in place beyond 2012, the AMT will generate an estimated $1.0 trillion in tax revenue over the next decade (this assumes annual patches to index the AMT to inflation; without patches the number would be substantially higher). We'll have to wait until later this year to see if any kind of consensus can be reached on how to change or eliminate the AMT. A bipartisan presidential commission recommended abolishing the AMT in a November 2010 plan, but President Obama's proposed 2013 budget includes no permanent solution, just the suggestion that the AMT be abolished and replaced with a vaguely defined "Buffett Tax" that would have those earning over $1 million a year paying at least 30% in income taxes (which would need considerable engineering--not to mention improbable bipartisan support--to be an effective replacement for the AMT).

The ISO Wrinkle
For those who exercised incentive stock options (ISOs) and qualified for the AMT as a result, there is a little-known provision that could potentially net a refund. Regular taxes do not factor in the "bargain element" of exercising an ISO; AMT taxes do, meaning that you're taxed on the difference between the fair market value of the ISO shares and the exercise price on the date you exercise the option. This can add up to a substantially larger tax bill. This is where the "AMT credit" comes into play--taxpayers subject to the AMT who exercise ISOs are generally granted a credit that can be carried forward indefinitely and applied to future tax returns to cover amounts in excess of what you'd pay under the AMT (this typically comes into play when your normal income taxes are marginally higher than the AMT, giving you a small break). If you earn an AMT credit one year and are subject to the AMT the next year, the credit cannot be used. However, there is a very beneficial exception if you have AMT credits that are more than three years old--these old credits become refundable, which means they

can be used to reduce taxes and give you the opportunity to collect any leftover amounts in cash. So if you have been hit with big AMT tax bills in the past and think you may have credits, we strongly urge you to look into this provision (or bring it to the attention of a trusted tax professional)--it might just put some money back in your pocket.

Funds to Fight the AMT
Fidelity, along with several other mutual fund companies, has taken some steps towards helping investors stave off paying the AMT. The firm currently offers six AMT-sensitive municipal money market funds (AMT Tax-Free Money Market, Tax-Free Money Market, California AMT Tax-Free Money Market, Massachusetts AMT Tax-Free Money Market, New Jersey AMT Tax-Free Money Market and New York AMT Tax-Free Money Market), and two AMT -sensitive bond funds (California Short-Intermediate Tax-Free Bond and Tax-Free Bond), which seek to invest only in securities whose interest is exempt from the AMT (and normal income taxes as well). While these funds can provide AMT protection when used in a wide-reaching tax strategy, don't expect them to protect you from having to calculate the AMT just because you hold them.

Vanguard does not provide any AMT-free funds as of yet, instead limiting a number of its tax-exempt, fixed-income funds' holdings to a max of 20% of assets in bonds with interest subject to the AMT. The reason, according to Vanguard's Fixed Income Group, is that eliminating AMT-taxable bonds would reduce diversification and lower the yields of certain funds.

Dealing with the AMT
This alternate tax reality is a problem for taxpayers--one which will keep growing each year--and unless the government takes decisive action, there won't be a lasting solution. Mutual fund families may be able to help out to a small extent by offering more AMT-free funds, but these are not the kinds of funds most investors will flock to, at least for a majority of their assets. Our best suggestion is to consult with a tax specialist if it seems as though you'll have to pay the AMT or if you've paid it in the past and think you might qualify for the credit. While the AMT is an additional burden, at least you'll have the peace of mind knowing that your returns were correctly calculated and that the IRS won't be coming after you for interest and penalties on unpaid taxes.

About Adviser Investments
Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. With 2,400 clients and over $2 billion under management, Adviser Investments is one of the nation's

largest mutual fund research and money management firms. Our investment professionals focus on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

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