



Wealth Advisors,  
Investment Managers

## First Quarter 2015

You have likely noticed that our quarterly letters have expanded over the past eighteen to twenty-four months. Our goal is to share Albion's views across our core service areas to clients. We also appreciate that your time is valuable and each person has different areas of interest. To balance these opposing goals, we share a short summary below and have attached a package with the deeper discussions. We hope you like the new format.

In the Tax Musings section we discuss taxation in general and the IRS in particular. We speculate about the diverging economic trajectories of tax compliant cultures relative to non-compliant cultures and offer specific data relating to the United States tax enforcement system.

In The Market and Economy section we review the current economic information and draw parallels to the economic and market situation we confronted this time last year. Our overall conclusion is that while there is always the potential for a black swan event we expect the year to reward us with low single digit economic growth, a continuation of low interest rates, and positive equity market returns.

The Client Corner highlights what keeps many of us excited to come to work each day; the chance to make a difference in someone's life. We outline one client's story and highlight how over the twenty years we've known them they have remained positive and resilient through ups and downs. During our most recent meeting we walked through their transition to the next phase of life - retirement - and helped them achieve clarity on their parents' financial situation which if not handled properly could delay their retirement plans. It is an honor to be part of these conversations and to contribute at some level to successful outcomes.

Finally in Albion News we report on a gathering of clients and staff in Alta where John Bird, our co-founder, shared the early history of Albion and described the importance of the founding culture to what Albion has become today. As we have grown from a staff of two to twenty-two we remain true to a culture of caring and our client centric philosophy.

We hope this note finds each of you in good health and enjoying the company of friends and family as springtime unfolds.

Warm Regards,

**Albion Financial Group**



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## Tax Musings

*"The nation should have a tax system that looks like someone designed it on purpose" ~ William Simon*

I write this as we wrap up the annual ritual of income tax filing. Each year we fulfill a range of last minute requests in an effort to help our clients prepare their returns and each year we are reminded of the complexity of our tax code that now extends to over 3.7 million words. While our individual tax preparation efforts are challenging the aggregate numbers are daunting. The National Taxpayers Union estimates that in 2009 individual taxpayers spent 3.8 billion hours complying with federal tax laws. That's a lot of time and does not include the hours spent by paid preparers working on our behalf!

Consider it from the perspective of the IRS – the agency charged with implementing the tax laws passed by Congress. In 2012 the IRS processed 237.3 million tax returns, collected \$2.52 trillion in taxes and issued refunds of \$373.4 billion. The largest source of IRS tax receipts was from individual estate and trust income tax returns which totaled \$1.387 trillion, or 55% of all taxes paid.

*"Taxation is the price which civilized communities pay for the opportunity of remaining civilized." ~ Albert Bushnell Hart Actual Government 1903*

*"Taxation **with** representation ain't so hot either" ~Gerald Barzan*

Every society has mixed feelings about taxation; we are no different. Yet a culture of tax compliance tends to be associated with more successful economies. Europe is a great example. Northern Europe tends to have a culture of compliance and by and large the northern European economies are stable. Southern Europe has a culture of tax avoidance. They are struggling. The United States has a strong culture of tax compliance which goes a long way toward keeping corruption at bay: While most of us don't like paying taxes we do because we know that everyone else does too.

In addition to fair and consistent application of the tax law tax compliance is also stronger when filers fear getting caught misstating income. In our system this means an IRS audit and as of 2013 audit rates were as follows:

- The IRS audited less than 1% (.96%) of total returns
- For incomes under \$200,000 the audit rate was 0.88%



- Incomes between \$200,000 and \$1,000,000 had an audit rate of 2.7%
- Incomes over \$1,000,000 had an audit rate of 10.85%
- Incomes between \$5,000,000 and \$10,000,000 had an audit rate of 16%
- Incomes over \$10,000,000 had an audit rate of 24%

These rates have been dropping in recent years as the IRS has been impacted by two powerful forces: The cost of IRS compliance with new tax laws passed by Congress, and IRS budget cuts which have reduced manpower available to audit for tax law compliance. The IRS budget will be reduced again this year by approximately 3%. They estimate that the cuts will cause at least 46,000 audits to not get closed and that the government will miss out on collecting at least \$2 billion in revenue it is owed. That works out to about \$6 lost for every \$1 of budget cuts.

We have a complex economy so it makes sense that there is complexity in our tax code. However we have reached a point of absurdity where even those who do their best to provide accurate returns find themselves in an audit situation – occasionally with an IRS auditor who does not fully comprehend the 3.7 million words of the code he is charged with enforcing. But here's to making it through another tax season without, we hope, too much pain. If the pain is too great perhaps you can follow the lead of Snoopy.

*"Dear IRS – I am writing you to cancel my subscription. Please remove my name from your mailing list." Snoopy (Charles Schulz)*



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## **The Economy and Markets**

Entering 2014 many professional prognosticators opined that while the American economy was accelerating interest rates were too low to be sustained and U.S. stocks were expensive. Further they worried that even though inflation was anemic the Fed was inching towards raising rates. Meanwhile parts of Europe were in depression; Japan a liquidity trap; and China aloof to its own fundamental economic and social challenges.

Sound familiar? It should.

Entering 2015 the tenor of consensus hummed a comparable tune. And like 2014, we believe that this year's reality will ultimately stray from the preliminary common view. In the first quarter the U.S. economy took several blows from what appear to be transitory factors. Exceedingly snowy weather snarled supply chains and kept people at home. An appreciating U.S. dollar dented exports. Low energy prices negatively impacted aggregate capital investment. And strife in labor negotiations hobbled west coast ports vital to the smooth flow of commerce.

Despite these problems the American economy remains buttressed by steady job growth, recovering confidence (both business & consumer), improved private sector balance sheets, and upward household consumption - especially once higher savings and lower gas prices take hold. The variables are many, but all told we reason that we're on a low- to mid-2% GDP growth path.

Overseas, Europe is showing signs of healing. A cocktail of Fed-style quantitative easing from the ECB, a weaker euro, perkier moods, and mending financial conditions have been favorable. If sustainable this would be a clear positive for the global economy. In Japan policymakers continue to use stimulative monetary, fiscal, and regulatory measures to jumpstart a soggy economy. In China the regime has taken steps to support a slowing economy, while keeping long-run reforms a priority. Tension in the Middle East remains elevated as various insurgencies and military campaigns create turmoil. Indeed, there are many global risks but for now we don't anticipate that any will corrode the fundamental reasons we own stocks.



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Well functioning financial markets consider (i.e. price in) all relevant information. The result in the January through March period was that broad-based U.S. stock indices were essentially flat. It seems there were just too many crosscurrents for a trend, either up or down, to take hold. In the bond market, yields have generally fallen since the year began. These movements are near parallels to the same period last year.

The valuations of U.S. stocks were little changed during the quarter. The market as a whole is neither expensive nor cheap at just over 16.5 times earnings expected over the next twelve months. This is a bit above the long-run mean, but in an environment of low interest rates and inflation it's reasonable. This concept however hasn't discouraged some observers from expressing concern about overvaluation and bubbles as this bull market enters its seventh year. However neither the economy nor the stock market is at or approaching levels of reckless exuberance. Moreover, studies of longer duration bull markets - those running five years or more - suggest that stocks don't just suddenly decline due to perceptions of overvaluation. In most cases it is economic recession that ends these entrenched bull market advances. And armed with reams of current economic data, we do not see a recession on the horizon.

Against this backdrop we believe it is appropriate to maintain equity allocations and remain diligent in our efforts to discover and own great companies at reasonable prices. While we are mindful and alert to the world's risks, the four pillars underpinning a healthy stock market - earnings and the economy, interest rates, inflation, and valuation - endure.



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## **Client Corner**

In many of our relationships we address not only the financial well-being of our clients but also the financial situation of their parents and/or children as the need to provide financial assistance to family members can have a dramatic impact on a personal financial plan.

During a recent financial review with a client couple this really hit home. The couple is getting close to retirement and we were looking for issues that had the potential to improve their financial situation in coming years as well as issues that could negatively impact, postpone, or derail their plans. With both children through college, established in their own careers, and financially independent, we turned our attention to the husband's aging parents.

The parents recently sold their home, moved into an apartment, and have the proceeds from their home sale as well as an annuity purchased many years earlier as their asset base. We discussed the importance of meeting the dual objectives of creating a current cash flow stream for the parents while ensuring that the investment approach had a high likelihood of meeting their long-term needs.

With the desired outcome in mind we gathered information on the annuity contracts and combed through the details to be sure we understood the terms of the contracts and what they could and could not provide. Armed with this knowledge we then met with our clients and outlined a strategy for providing his parents with a comfortable current cash flow and an appropriate amount of growth potential to stay ahead of potential inflation in the coming years. It was extremely helpful to our clients to finally understand how the annuities worked and to know that their parents had a plan to keep them financially independent. Knowing that their parents are taken care of has given them peace of mind as they look forward to enjoying their next stage in life.



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## **Albion News**

Alta Ski Resort and Alta Lodge recently provided a backdrop for Albion clients and team members to return to Albion's roots and revisit the company's formative years. John Bird walked us down memory lane as he recalled stories of Albion Financial Group's beginning in the basement of the Alta Lodge and spanning the rich thirty-two year company history.

In the early eighties John's youthful follies while briefly working for the Forest Service left him seeking an engaging diversion to supplement skiing and rock climbing in Little Cottonwood Canyon. Breaking from the singular discussion of skiing, John gravitated to a young Toby Levitt who had idealistic aspirations of changing the financial services industry from the end of a box canyon. A friendship, business partnership and common goal of respecting and caring for clients developed between Toby and John with a strength that would last decades.

Bill Levitt, Toby's father and the long-time mayor of the Town of Alta, was an influential mentor to Toby and John as they established Albion Financial as a pioneer in the fee-only investment services industry. Industry peers with businesses based upon commissions from selling investment products warned Toby and John that a fee-only compensation structure would at best provide a skinny, meager existence. Both Toby and John decided they were okay being thin, stuck with their principles, and took a chance, launching an independent firm based upon being impartial and un-biased when investing client assets.

We were lucky enough to share lunch at the Alta Lodge with several of Albion's earliest clients who have had personal and financial relationships with John and Toby for three decades. Although Albion has grown in many ways since those early days in Alta, the culture of mentorship, caring, respect and independence remains steadfast.