PATRIOT
INVESTMENT
MANAGEMENT

Dear Clients & Friends of Patriot Investment Management

Despite the election, the "fiscal cliff", the debt, the deficit, the Fed and the deteriorating Eurozone, stocks had a great year in 2012 and continued to rise strongly through January. The S&P 500 index of large U.S. stocks added a monthly gain of 5.1% on top of a 16% gain in 2012. It was the largest January gain since 1997. S&P 500 gains of over five percent in January have happened only twelve other times since 1950, and the market finished the year positive all twelve times, with an average additional gain of 15% over the remaining eleven months.

Since 2007, equity mutual funds have seen increasing net redemptions every year. In contrast, bond funds have had rising net inflows, which eclipsed equity fund inflows in 2008. This fund flow divergence has widened every year for the last five years. However, this trend reversed course in January, as investors allocated cash to equity funds of all kinds, often at a rate not seen in years. As of January 30th, equity investors invested a net total of $34.2 billion into both equity mutual funds and equity ETF's for the month – the highest equity fund inflows recorded since January 1996 according to data recently released by Lipper.

In January, the S&P 500 recorded its first close above the 1,500 mark since 2007, and investors have been responding to these broad stock market gains. Markets in turn are responding to signs of improvement in the global economy, and in particular to improvement in purchasing managers' indices in China, the United States and Europe.

With the Dow Jones Industrial Average just a few percentage points from topping its all-time high and bond investors facing shrinking yields, higher inflation risks and higher taxation, some believe we may be on the cusp of a flow reversal from bonds back into stocks. Stock valuation metrics (price to earnings, price to book, dividends vs. Treasury yields) continue to suggest that the market is still undervalued compared to recent historical averages. Will 2013 be a good year for the stock market? We don't predict; but we do see some encouraging signs.

It's Tax Season Again!

It's that time of year again, and tax season is in full swing. Here's what you need to know:

- 1099s are available for most accounts. You should be receiving your 1099 statement by mail, and for clients who participate in Schwab's paperless statement program, eDelivery, Schwab also keeps an electronic copy available online via the Schwab Alliance Website. Once you login, go to the Accounts Summary page and click on the link "Download your 2012 tax documents now" to download your statements. If you are not enrolled in eDelivery and would like to be, please contact us to get started.

- As a courtesy to our clients and their tax advisors, we can provide realized gain/loss reports, 1099 statements, and other documents as needed directly to your tax advisor. This is a complementary service that we offer that saves your tax advisor time – and you, money! If you would like to take advantage of this service, please provide us with your tax advisor's contact information.

- The IRS is cracking down on identity theft and scams targeting taxpayers. The IRS does not initiate contact with taxpayers by email to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels. If you get an unsolicited email that appears to be from the IRS, please report it by sending it to phishing@irs.gov. If you find a suspicious website that claims to be the IRS, please send the site's URL by email to phishing@irs.gov, using the subject line: suspicious website.

Taxpayer Relief Act Creates Tax Changes - A Primer for What's New in 2013

In the final hours of January 1, 2013, Congress narrowly avoided going over the "fiscal cliff" and passed the American Taxpayer Relief Act of 2012. The new Act raises taxes on upper-income Americans, stops other tax increases and postpones cuts in federal spending. This agreement creates a number of Federal tax implications for individuals and businesses.

Here is a brief synopsis of how the provisions line up in a few key areas:

- **Income tax rates**: The top bracket rises from 35% to 39.6% for individuals making more than $400,000 and joint filers above $450,000. All other rates on taxable income under $400,000/$450,000 remain the same.
- **Capital gains & dividend taxes**: Top rate goes from 15% to 20% for individuals making above $400,000 and joint filers above $450,000. People making less than those benchmarks will not see an increase.

- **Employee-paid payroll taxes for Social Security**: On earnings up to $113,700, the rate jumps to 6.2% from 4.2%. This affects all workers.
- **Munis**: Municipal bonds remain exempt from federal taxes.
- **Estate tax rates**: Top rate rises from 35% to 40%. Estates under $5 million (adjusted for inflation) remain exempt. Spousal estate and gift tax provisions were permanently extended.
- **Alternative Minimum Tax**: The AMT has been adjusted to increase with inflation; 2012 exemption amounts are $50,000 for individuals and $78,750 for married filing jointly.
- **Qualified Charitable Distributions from IRAs**: The Relief Act of 2012 calls for the extension of this provision retroactive to 2012 through the end of 2013. Taxpayers age 70½ and older are allowed to donate up to $100,000 of individual retirement account (IRA) assets directly to a charity and count the contribution as part of their required distribution from the account. This is a tax-free distribution from the IRA.
- **Sales Tax**: Also reinstated and extended through 2013 is the option to deduct state and local sales tax - this is especially important for Tennessee residents.

  Remember, tax laws are constantly changing, so if you have any questions regarding your particular situation, please discuss these important changes with your tax advisor.

Exotic & Alternative Investments: Tread Carefully

The headline read: "Wall Street Loves Alternative Investments? Should You?" Alternative investments….exotic products…a hot new asset class….please exercise caution whatever their name. . Although they sound interesting and tempting, their performance may not always be so great. It's been said that the plain-vanilla buy-and-hold investing of the last fifty years has turned sour. In response, several financial services firms are offering new products and strategies – so-called "alternatives" to volatile equities and low-yielding fixed income.

We see this in commodity and gold funds, real estate, managed futures, and hedge funds. They are hyped as a way for investors to diversify their portfolios with investments that are not correlated to the movement of stocks and bonds. "They (alternative investments) may have been a bit over-hyped," said Cheryl Costa, a principal and financial planner with Forteris Wealth Management. "People have enough trouble understanding regular mutual funds and some of these alternatives are not very well understood."

Performance has been sporadic with many of these products, especially hedge funds. The HFRX, a widely used measure of industry hedge fund returns, was up by just 3% last year, compared with a 16% rise in the S&P 500. Furthermore, as a group, hedge fund managers (the supposed sorcerers of the financial world) have returned less than inflation over the last ten years.

With hedge funds, there are, of course, market-beating superstars. The top decile of managers has served up returns of over 30% in the past year, according to Hedge Fund

Research, a data provider. But a third have lost money, including some of the stars of yesteryear: John Paulson, celebrated as an investment wizard in 2007 for having foreseen America's housing bubble, reportedly saw his flagship fund lose 17% in the first ten months of 2012, after a 51% fall in 2011.

Even though many of these alternative products are not closely correlated with the stock or bond market, the ability of these investments to generate inflation-beating returns over long periods remains questionable. We continue to believe that traditional investments of stocks and bonds should remain the core holdings for most individuals.

New 401(k) Fee Disclosures Could Equal Bigger Nest Eggs for Earlier Retirement Options

In 2012, the Department of Labor implemented new rules requiring that all 401(k) plans disclose all of their associated fees. Participants will now get detailed information listing the fees and expenses with each quarterly statement. This is great news for participants, as you now have an opportunity to reduce the costs of your retirement investments. Here are a few recommendations:

- **Switch to lower-cost investments.** You should aim for expense ratios of 0.5% or less per year. Use this new information to select lower-cost investments that will still meet your needs for growth. Look for index funds in the plan, as these usually have the lowest fees and often provide superior long term returns to their more expensive counterparts.

- **Make sure you are getting the services that are promised.** Pay attention to the part of your monthly statement that provides information about the services provided and the fee for each.

- **Ask for better options.** If the investment options charge high fees, consider asking your employer to add some more affordable investment choices. Suggest similar funds with lower expense ratios or that the 401(k) plan offers at least one index or passively managed fund.

- **Retire sooner.** Switching to investments with lower expense ratios may allow you to retire sooner and with a larger nest egg. Studies show that higher fees can lead to a significant drag on returns. One analysis concluded that some target-date fund owners lose 30% or more of their retirement income to fees. This equates to between 5 and 15 years worth of retirement income deducted from a 401(k) account over a worker's lifetime.

- **Explore plan options**: Many plans allow workers above a certain age (typically 55) to move their 401(k) investments into a separately managed rollover IRA. Other plans allow for existing 401(k)'s to be separately managed in a segregated account. If your plan is full of expensive fees and poor investment choices, be proactive in making changes.

Economic Outlook - More Optimism in 2013?

While we can likely expect more political wrangling from Congress this year, and episodes of short-term volatility as a result, overall we at Patriot are optimistic for the year ahead, the direction our economy is slowly going, and how that affects your investment strategies. There are three sectors of the economy that are responsible for our optimism – housing, energy and deleveraging.

First, housing: Home sales rose 9.2% in 2012, the biggest annual increase since 2004. The inventory of unsold homes dropped by 21.6% year over year while housing prices rose 6.3%. This rising demand, coupled with higher prices and lower inventories of unsold homes is fueling a recovery in the housing market.

Next, energy: We are seeing a reduction in U.S. energy dependence on foreign countries. Because of horizontal drilling and hydraulic fracturing, our net petroleum imports to the U.S. have gone from 13 million barrels a day in 2007 to 8 million barrels today. In four years, we have gone from the world's largest importer of natural gas to self-sufficiency. For the first time in 60 years, the U.S. is a net *exporter* of refined products. The International Energy Agency predicts that by 2020, the U.S. will be the world's largest oil producer.

Finally, deleveraging: Household debt payments are at the lowest level since 1993, and as a percentage of assets, household debt has fallen to 20%, approaching the long-term 18% average. Our banking system is awash in cash -- $9.17 trillion as of early December against loans of $7.17 trillion.

These important sectors of the economy are showing healthy signs of recovery, and economic indicators point to continued strengthening throughout 2013.

And In Closing...

We appreciate your confidence and the opportunity we have to work together with you.

If you have friends or colleagues who could benefit from our low-cost, tax-efficient portfolio management system or our financial planning, please have them contact us. We'd be happy to speak with them.