TRUST
INVESTMENT PERSPECTIVES
A Publication of TRUST COMPANY OF OKLAHOMA October 2012

Avoiding A Fall Off The Fiscal Cliff.

By now, you've likely heard talk about the looming "fiscal cliff" the U.S. could be headed for in 2013. Financial commentators, politicians and the Congressional Budget Office (CBO) have weighed in with their predictions of what will happen if Congress doesn't act in time to avoid the automatic spending cuts and tax increases scheduled to take effect in 2013. The decisions of policy makers over the next few months will have a serious impact on the economy over both the short and long term.

It helps to understand exactly what the fiscal cliff is and how it was created. In August 2011, the country was nearing the debt ceiling, and our "do-nothing Congress" was living up to its name. Finally forced into taking action, the Budget Control Act of 2011 was passed in a deal between Congress and the President to raise the debt ceiling.

The legislation created a bipartisan "supercommittee" tasked with developing a plan to decrease the deficit by $1.2 trillion over 10 years. The law also stipulated that if the committee couldn't come up with a plan, spending cuts ("sequestration") of $110 billion a year for 10 years split between discretionary domestic and defense spending would begin in 2013. The idea was that these automatic cuts would be so broad and untargeted that both parties would find them repugnant and be motivated to reach an agreement. Unfortunately, the committee failed, setting the country up for another countdown to crisis.

Without any action, the spending cuts related to sequestration as well as a host of tax increases will occur in 2013. For a full breakdown of what some are calling "taxmeggedon," see the related article in this issue by Joanna Murphy.

Effect on economy

Of course, it is possible that Congress and the President could act to avoid some or all of the scheduled changes, most likely in the lame duck session after the November 6th elections. But given the contentious political environment, it's important to at least consider the possibility of inaction. Consider that in September, Republican Speaker of the House John Boehner said that he was "not confident at all" that the two sides could come to an agreement and avoid the fiscal cliff.

The CBO analyzed the numbers and found that if Congress does take action and avoids the scheduled spending cuts and tax increases, the growth of real GDP in calendar year 2013 would be around 4.4 percent. If Congress is unable to act, and the changes take effect as scheduled, the CBO projects that GDP would grow an anemic 0.5 percent for the year, including a contraction of 1.3 percent over the first half of the year, possibly throwing the economy into recession.

While 4.4 percent GDP growth is obviously superior to half a percent growth, the CBO correctly warns that extending 2012 policies without a plan for future deficit reduction would put the U.S. on an unsustainable fiscal path.

Zac Reynolds
Vice President

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VIEWPOINT

A Message from the Desk of Tom Wilkins

It gives me great pleasure to write about employee advancements and new hires at Trust Company of Oklahoma, as those topics indicate to me that efforts are being made to serve you, our client, even better. While this letter has an overall positive ring to it, I first have some sad news to share.

After 25 years of service on our board of directors, Murray Gullatt passed away, August 28, 2012. While it is easy to say that everyone here at TCO will miss him greatly, his impact on me both personally and professionally could never be conveyed in a single sentence. I owe much to his leadership, counsel and friendship and would like to say thank you, Murray.

Now on to something that would bring a broad smile to Murrays face, company growth. First, Zac Reynolds, our newest portfolio manager in the Oklahoma City office, has earned the designation of Chartered Financial Analyst (CFA). This designation has often been referred to as the "gold standard" in the investment profession due to its rigor. You can get to know Zac a bit better by reading his thoughts in this month's lead investment article. Zac, Congratulations!

In addition, our Oklahoma City office has shown additional growth by hiring Ben Byers. With over 35 years experience in the trust and investment profession, Ben exemplifies the professionalism we seek. Look up the word "fiduciary" and you will get a good understanding of Ben's character. We are very excited to have him as part of our team. Ben, welcome to the TCO family.

Thomas W. Wilkins *Chairman, President & Chief Executive Officer*

Indeed, there are fears that a lack of progress soon on the debt issue could lead to increased borrowing costs for the U.S. government. The accompanying chart on page 3 shows the lower annual deficit as a percentage of GDP if we go off the fiscal cliff (dark blue bars) relative to extending current policies (light blue, brown and green bars). As you can see, the deficit is projected to be much larger if the fiscal cliff is avoided, in no small part thanks to higher debt service payments.

However, as my colleague Corey Redington showed in his July Investment Perspectives article, the U.S. is not currently feeling much of a pinch from its payments on the national debt. In fact, thanks to historically low interest rates (and a lot of help from the Fed), the government's interest payments are currently consuming a smaller percentage of GDP than in 1992. That leads us to believe that Congress should take advantage of this window of opportunity to focus on economic growth in the short-term while putting into place a plan for deficit reduction in the long-term.

Monetary Action

While Congress and the President seem to be doing everything they can to make the environment difficult for businesses and investors, the Federal Reserve and its chairman Ben Bernanke seem to be doing the opposite. Indeed, it could be argued that Congress is doing too little and Bernanke is doing too much to compensate for the lack of fiscal action.

Bernanke's latest creation is QE3, a program announced on September 13 that will expand the Fed's holdings of long-term securities through purchases of mortgage debt at a rate of around $40 billion a month. This program comes on the heels of two previous rounds of quantitative easing that led to bond purchases totaling $2.3 trillion. The goal of QE3 is to keep interest rates low to support borrowing (particularly for home purchases and refinancing) in an attempt to stimulate growth and reduce unemployment. This round of quantitative easing is the first time the Fed has left the timing of the program open-ended, an unprecedented action even in the post-financial crisis era of extraordinary government intervention. The Fed also extended the date through which it "anticipates that exceptionally low levels for the federal funds rate are likely to be warranted" to at least mid-2015.

The stock market reacted positively to the announcement of the program, rallying to near multi-year highs. The sentiment wasn't universally positive however, as Richmond Fed President Jeffrey Lacker dissented, saying he opposed additional asset purchases. Others within the Fed argued that continued easy money policy could stoke inflation. Judging by the stock market's response to previous rounds of QE, the post-announcement rally can be like a sugar high, which inevitably ends when market participants realize that monetary policy will not be a cure-all. It will take long-term fiscal solutions before a strong, sustainable recovery can take hold.

Effect on companies and investors

One unfortunate side effect of the short-term solutions enacted by both Congress and the Fed over the past few years is the uncertainty that has been created. After all, it is difficult for businesses to plan if they do not have good visibility into future rules and regulations. Uncertainty leads to scaling back or delaying projects and hiring, which can reduce profits, keep unem-

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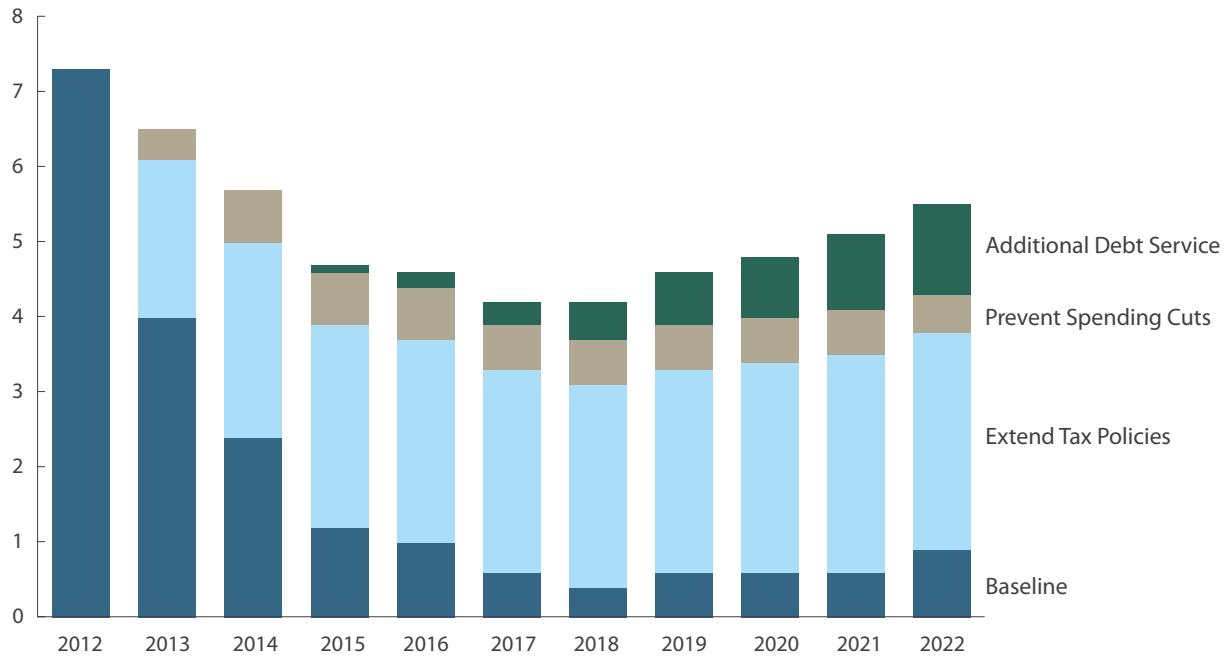
Deficits Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of GDP)

August 2012
http://go.usa.gov/7QY



Deficits under CBO's current-law baseline projection average about 1 percent of GDP over the 2013–2022 period. By comparison, under an alternative scenario, in which some changes specified in current law would not occur and many tax and spending policies that have been in effect in recent years would continue instead, deficits over that period would average about 5 percent of GDP.

Congressional Budget Office

ployment high, and depress stock prices. Consequently, the stock market could benefit from the increased certainty that would come from the election and subsequent action – or even inaction – from Congress. After all, by January 1, companies should know what the playing field will look like going forward and will be able to adapt their businesses as needed.

Perhaps even more than businesses, individual investors are facing a range of possible environments in 2013. For example, the dividend tax rate for higher-earning individuals could be as high as 43.4 percent if current rates are allowed to expire or as low as 18.8 percent if Congress acts to extend the existing rate. Capital gains, interest income, and the estate tax also could see increases ranging from moderate to severe. So what should investors consider as they move toward 2013?

Special Dividends: Just as individuals may attempt to accelerate income into 2012 to avoid higher taxes in 2013, companies are making similar considerations. Goldman Sachs predicts that a record number of companies may pay special dividends in the fourth quarter to return cash to shareholders at 2012's low dividend tax rate.

Tax-free Investments: As tax rates increase, investments that produce tax free income or returns become more valuable. Tax-free municipal bonds may see increased interest and demand as a result. Consider that the taxable-equivalent yield of a 3 percent municipal bond is 4.62 percent at the 35 percent tax rate, but jumps to 5.3 percent if the top interest-income tax rate goes to 43.4 percent as scheduled.

Retirement Accounts: Contributions to tax-deferred accounts such as IRAs and 401(k)s made in 2013 may help shield income from higher tax rates. Plus, investors won't have to worry about higher taxes on dividends or interest income for assets that are located within tax-advantaged accounts.

Benjamin Franklin once said that nothing in this world is certain except death and taxes. Unfortunately, Franklin didn't mention anything about what rate of taxes must be paid. If the fiscal cliff and its attendant tax code changes have left you feeling uncertain, consider this a perfect opportunity to meet with trusted tax, trust, and investment professionals to discuss your unique circumstances. With a well considered plan in place, you may look back on the fiscal cliff someday as just a bump in the road as you work toward your goals.

How Do You Spell Taxmeggedon?

In recent months, you may have heard the ominious and odd term "taxmeggedon." And, if you're like me, you may have asked yourself, how does one spell taxmegeddon? A quick Internet search provides no consensus. Taxmeggeddon is as varied a term as it is off the wall, but it is, unfortunately, very real.

No matter how you spell it, taxmegeddon is coming to a theatre near you.

There are two major reasons why almost all taxpayers will feel the wrath of taxmeggeddon. First, the Bush tax cuts are set to expire at the end of this year causing income tax rates to increase in 2013 for most individual taxpayers. Currently, rates for individual taxpayers are 10, 15, 25, 33 and peak at 35 percent. Long-term capital gains and most dividends are taxed at 15 percent. Without further legislation, if the Bush tax cuts expire, individual taxpayers will see income tax rates increase to 15, 28, 31, 36 and 39.6 percent, long-term capital gains rates increase to 20 percent and dividends will be taxed at the higher ordinary income tax rates.

Secondly, those taxpayers deemed "high income" will also begin to pay for the Affordable Care Act (Obamacare). High income is defined as modified adjusted gross income (MAGI) of $200,000 for individuals, $250,000 for joint filers and $125,000 for married filing separate taxpayers. These taxpayers will pay a 3.8 percent surtax on the lesser of net investment income or MAGI in excess of the applicable threshold. Investment income includes interest, dividends, annuities, royalties, rents and income from other passive activities. Investment income does not include distributions from retirement plans such as IRA's.

The following chart outlines the top tax rates with best and worst case scenarios for high income taxpayers in 2013:

	Current Top Tax Rate	2013-Current Rates Expire	2013-Current Rates Extended
Long-Term Capital Gains	15%	23.8%	18.8%
Dividends	15%	43.4%	18.8%
Interest Income	35%	43.4%	38.8%
Estate Taxes	35%	55%	35%
Estate/Gift/GST Exemption	$5.12 mil	$1 mil	$5.12 mil

Even with all the uncertainty, there are a few simple steps that everyone can consider to mitigate possible tax rate increases:

- Tally your assets. Along with retirement plan balances, home values, and brokerage accounts, be sure to include the value of life insurance that you own. You may be surprised to find that your estate is larger than you anticipated.

- Review your investment portfolios. Pay special attention to any capital gains and losses. With capital gains rates almost certain to go up, recognizing gains in 2012 may be preferable to waiting until next year. Conversely, consider deferring capital losses into 2013 when they may be more valuable. However, tread carefully before incurring substantial gains that you would not otherwise take just to take advantage of the 15 percent rate. Capital gains are treated as income for the Alternative Minimum Tax (AMT) and recognizing large gains can have unintended AMT consequences.

- If you are planning to convert a traditional IRA to a Roth, doing so this year may offer additional savings compared to next year when income tax rates may be higher.

For those higher earning individuals and those with substantial assets (above $5 mil), consider utilizing all or a portion of the currently available (and historically high) $5.12 mil gift tax exemption. Assets anticipated to appreciate in value may be particularly good candidates for gifting programs. Remember that gifting techniques can be as simple as forgiving an outstanding loan. The techniques increase in complexity depending on the goals of the donor and assets involved.

The best course of action may be to outline now those changes that would be appropriate if current tax cuts expire at year-end but wait for clarity before making substantive changes. Every individual's family and tax situation is unique so it is extremely important, to consult with qualified tax and legal advisors, especially if you are a high earner or have substantial assets.

We at TCO also stand ready to work with you and your advisors as you establish or modify your financial plan, whether it be investment planning or estate and/or gift planning.

Joanna Murphy
Vice President

So You Think You're Rational?

Recent headlines about the lottery have made me wonder why many people make the money decisions they do. So, for the first time in this publication, here is a pop quiz (don't worry – it won't be graded):

Choose between:
a.) A sure gain of $3,000,
b.) An 80 percent chance of winning $4,000 and a 20 percent chance of winning nothing.

Choose between:
a.) A sure loss of $3,000,
b.) An 80 percent chance of losing $4,000 and a 20 percent chance of losing nothing.

Choose between:
a.) A 2 percent chance of winning $5,000,
b.) A 1 percent chance of winning $10,000.

If you chose option (a) for the first question, a sure gain of $3,000, you are in popular company. Most people do. Even though option (b) has a higher expected payout of $3,200 ($4,000 x 80 percent), most people are risk-averse. This explains why many people are too conservative with their money.

If you chose option (b) for the second question, an 80 percent chance of losing $4,000, once again you are in popular company. People will do most anything to avoid a loss, even when the expected loss of $3,200 for option (b) is $200 more than the $3,000 guaranteed loss of option (a). While people are generally risk-averse when making money, they are usually loss-averse when things are going down. This explains why people often sell out when stocks are going down. In addition, gains and losses are not viewed equally by most. A dollar loss is usually harder to handle than a dollar gain is to be happy about.

If you chose (b) for the third question, you have a lot of friends. This question helps explain why lotteries work so well. Our mental calculators break down, and we tend to ignore small percentages (1 percent) while focusing on big numbers ($10,000). While the expected payouts from both are equal ($5,000 x 2 percent = $10,000 x 1 percent), you at least double your chances of winning something by picking option (a).

But then again, if we were all completely rational with our money, lotteries would not have the payouts they have. While pop quizzes may get graded on the curve, the real world does not. Controlling our emotions is important for our financial health.

Cameron Turner
Vice President

LET US KNOW

Each quarter Trust Company of Oklahoma publishes our newsletter "Investment Perspectives." Our Professionals write informative articles on topics we think would be of interest to you. But we want to know what you think. What are some topics that you would like to read about? Send your thoughts to Marketing@TrustOk.com and we will do our best to include your interests throughout the upcoming year.

The Children's Center

The Children's Center, located in Bethany, Oklahoma, is dedicated to helping children with complex medical and physical disabilities maximize their potential. In an atmosphere of faith, hope and love, this private, non-profit pediatric hospital provides general pediatrics, medical and respiratory care, rehabilitative therapies, and special education to youth and children, both inpatient and outpatient.

Current patients have disabilities as a result of birth defects or complications, traumatic accidents and illnesses. Highly qualified staff members provide 24-hour medical care and training and support to families. The average length of stay for patients in the Nursing and Rehabilitative Care Unit is 24 months, while the average length of stay for patients in the Pediatric Medical Rehabilitative Unit is two to four weeks.

The Children's Center Pediatric Physician Clinic provides a wide variety of services to more than 3,000 patients each year. Uniquely staffed by a team comprised of Oklahoma's finest doctors, children receive state-of-the-art treatment ranging from general pediatrics to specialized medicine for children. The Center's physicians use an interdisciplinary, family-centered approach for meeting a child's needs. In all cases, families are considered an integral part of the care-giving team.

The Children's Center staff believes that life is sacred, an inherent gift from a loving Creator; and that all children are of equal worth, without respect to physical beauty, intelligence, health or productivity. It is the goal of the Center to respond to the needs of patients and their families with hope for the future, and more importantly, a sense of loving care.

The Children's Center has state-of-the-art facilities and equipment, highly-trained nurses, therapists, teachers, and physicians with unique specialties; but without love, our work would mean little.

To learn more about the wonderful work being done daily at The Children's Center, visit **tccokc.org**, or become a fan on Facebook and Twitter.

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