// The Patient and Disciplined Investor…

Ruminations on long-term wealth building

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"In faith there is enough light for those who want to believe and enough shadows to blind those who don't." – Blaise Pascal

Which Political Party Has Been Best for Stocks?

The answer might surprise you…it surprised me. This chart came from an e-mail to me from Oppenheimer as part of a larger article. Interestingly, stocks have performed poorly under a Republican president with a Republican Congress. Political stalemates appear to have worked best for stocks when a Democrat was in charge of the White House with Republicans in charge of Congress. I wouldn't read too much into this chart, but I also wouldn't automatically assume one political party is best for markets.

S&P 500 Index Annualized Returns
1928 through July 31, 2012[1]

President	Congress	Return
Republican	Republican	2.1%
Republican	Democrat	8.6%
Republican	Split	13.4%
Democrat	Split	13.9%
Democrat	Democrat	14.1%
Democrat	Republican	18.2%

[1] Bank of American Merrill Lynch, "Election 2012" August 16, 2012. Standard & Poor's 500 Composite Index is a market-capitalization-weighted index that tracks the stocks of 500 primarily large-cap U.S. companies chosen for market liquidity and industry group to represent U.S. equity performance. Indexes are unmanaged. Their results include reinvested dividends and/or distributions but do not reflect the effect of any sales charges, commissions, or expenses. Past performance is not an express or implied guarantee of future results. Individuals may not invest directly in any index.

When Bill Gross Talks, People…Listen?

Remember the ad for E.F. Hutton? "When E.F. Hutton talks, people listen." Well, when Bill Gross of Pimco speaks, knowledgeable investors recently listened…then raised their eyebrows. For those of you who don't know Mr. Gross, he is considered the preeminent bond fund manager of our time. He is probably covered as much as anyone in the financial media talking about investments. So when Mr. Gross says something, it tends to get a little press, especially if it's controversial.

Mr. Gross wrote in his investment outlook column on July 31st that "The cult of equity is dying."[2] He said returns on stocks operate much like a "Ponzi scheme" and a "chain letter". He makes the populist – uhh, Marxist – argument that capitalists have been "skimming" resources from labor. He even started off with an analogy of our beautiful Colorado aspen trees saying, "Like a once-bright-green aspen turning to subtle shades of yellow then red in the Colorado fall, investors' impression of 'stocks for the long run' or any run have mellowed as well." Okay, then – but he forgot to mention that the trees blossom again in the spring, but I digress.

This isn't new for Mr. Gross. He's been known to make these kinds of inflammatory statements. But it's this sort of pessimism and misinformation masquerading as wisdom that is difficult for the average investor to understand. Unfortunately, people read this bunk and actually base their investments decisions on it. Not only is it hyperbole, but Mr. Gross' missive is just plain wrong. His main substantive point – and I'm stretching the word

[2] http://www.pimco.com/EN/Insights/Pages/Cult-Figures.aspx

"substantive" - is that the real return on stocks, meaning after inflation, of 6.6% is "an historical freak" and impossible if the real economy, again after inflation, is growing at 3.5%...both of which, as Mr. Gross concedes, have happened over the last 100 years. That might have been a mouthful for you, so let's say it another way. Mr. Gross is saying that the return on stocks has exceeded the gross domestic product in the United States over the last 100 years – nearly double - and that this cannot possibly continue.

First, I'm not a statistician, and I don't play one on TV, but this should strike you on its face as a questionable supposition considering that it's persisted for 100 years – a statistically significant amount of time. It's hard to imagine a relatively, if not relentlessly, efficient market getting it wrong for onnnnne-hunnnndred years. Second, where Mr. Gross is flat wrong is that the return an investor receives is manifestly different than the growth rate in an economy. For an excellent discussion on this topic, see a GMO white paper by Ben Inker.[3] Among other things, citizens consume goods and services in an economy whereas investors delay their gratification by reinvesting dividends and capital gains. By definition, the metrics must be different.

Unfortunately this nonsense sells, the world listens, and the business of pessimism grinds on. Meanwhile, fear is strengthened, more "investors" and their "advisors" give up on taking ownership positions in the greatest wealth-producing companies the world has ever seen, and – like a frog in a boiling pot of water - they continue to die a slow, quiet death of financial strangulation…the autopsy will reveal extremely high levels of fear brought on by the financial media – finished off by rising prices while trying to live on a fixed income. The end.

I agreed with Mr. Gross, however, on one point: "Unfair though it may be, an investor should continue to expect an attempted inflationary solution in almost all developed economies over the next few years and even decades." I agree. That's where bondholders could get crushed, and Mr. Gross is on firmer ground as a bond fund manager when he says, "[I]t is even more of a stretch to assume that long-term bonds – and the bond market – will replicate the performance of decades past."[4]

Bottom Line: Sometimes smart people say dumb things.

Really, a Lost Decade?

Okay income investors, listen up. Here is an interesting statistic that you won't pull out of the mainstream press. Dividends per share in the S&P 500 have not only kept pace with inflation the last 10 years, but dividends actually beat inflation by a staggering **32.6%**. Even the high inflation of the 1970s saw dividends mostly keep pace. Here is the "real" dividend – meaning after inflation – in May 2012 dollars since 1972.[5]

January 1, 1972	$17.17
January 1, 1982	$16.23
January 1, 1992	$20.37
January 1, 2002	$20.43
January 1, 2012	$27.11

Today, yield-starved income investors must mull over an ever decreasing pile of fixed income investments, and the choices aren't pretty…1.60% on a 10-year government bond…0.64% average 1-year CD rate in Denver[6]. Or maybe you're feeling frisky and will let it all hang out with a fixed annuity that might yield 2%. The current U.S. inflation rate is running somewhere north 2.5%, so purchasing power is under pressure. And if you don't hold one of these miserly vehicles in an IRA, then you can cheerfully remit about 1/3 of your pittance to the state and federal governments in taxes.

Bottom Line: Dividends have been an outstanding inflation-fighter for decades and especially good the last 10 years.

The Fed Did It Again

The Federal Reserve announced on September 13th that they would extend the ultra-low interest rates into 2015 and buy additional mortgage-backed securities. Markets celebrated and moved up sharply. But I wouldn't cheer just yet.

[3] See GMO White Paper by Ben Inker, August 2012 at www.gmo.com/America/GMOInsights/
[4] See the The Denver Post, Wall Street Journal Sunday, on September 16, 2012: "According to the London Business School research, most of the real, inflation-adjusted returns from U.S. bonds over the last 100 years came in just two eras: the 1920s and 1930s, and since 1981."
[5] http://www.multpl.com/s-p-500-dividend/table
[6] http://www.denverbankingrates.com/cd-rates/average-august-cd-rates-for-denver-co/

The main two drivers of the economy are monetary policy, which is managed by the Federal Reserve, and fiscal policy, which is managed by the federal government. When both of these tools are working together, the economy tends to do well. Essentially, the Federal Reserve's job is to provide the correct amount of money the economy needs to properly function….with "correct" being the operative term. Currently, there is plenty of money in the system - and, as savers are painfully aware, the Fed has delivered rock-bottom interest rates. In other words, the Fed has done its job – though many would say they've provided too much money that is distorting markets and causing gold, commodities, and bonds to soar while hurting the dollar.[7]

The fiscal side, however, remains uncertain. The health care legislation, upcoming elections, federal debt, the "fiscal cliff" (higher taxes and spending cuts), etc. are all contributing to uncertainty on the fiscal side. Europe clearly hasn't helped things, either. But as the election comes and goes in November, a good deal of uncertainty could be eliminated from the fiscal side. If that happens, then we might get both fiscal and monetary approaches working together that could be good for markets. Of course, political gridlock could also continue that gives us more of the same over the next couple of years.

Markets cheered the Fed move on September 13th, but I'm concerned this could ultimately lead to further inflationary pressures. For the moment, however, too much slack remains in the economy that is keeping inflation subdued. But this will eventually change, and it could change quickly. The Fed really is in unchartered and unprecedented territory, and it remains to be seen how they will handle withdrawing money from the banking system as the economy strengthens further.

<u>Bottom Line</u>: The near future is clear as mud.

New Medicare Tax of 3.8%

The new health care legislation was upheld in June by the U.S. Supreme Court in a 5-4 decision as a legitimate power of the federal government to levy a "tax" on its citizens.[8] And the new health care laws do indeed contain a little-noticed tax provision – as I understand the meaning of "tax" - that will cause you to owe the federal government 3.8% of your "net investment income" if your adjusted gross income exceeds a certain "threshold amount." For married couples filing joint, the Medicare Tax will apply on net investment income if their adjusted gross income exceeds $250,000, or $200,000 for single filers.[9]

Now, that might seem like a large income, and it is for most people. But the law is not indexed for inflation. In similar fashion, Social Security benefits were tax-free until 1983, but then Congress started taxing "high income" seniors. Another tax bracket was added in 1993 – again not indexed to inflation. It was little noticed at the time because few taxpayers – uh-um, I mean voters - were affected. Fast forward to today, however, and many if not most seniors are now paying tax on their Social Security benefits. Tax laws have a way of creeping like a bad fungus.

I won't pretend that my crystal ball is any clearer than anyone else's, but it would not surprise me to see the Medicare tax grow higher than 3.8% in the future as Congress wrestles with the penurious Medicare program. It wouldn't surprise me either if the law was amended to apply to lower-income taxpayers. Medicare, on its current trajectory, is a train-wreck, and something significant has to give.

What might be the solutions for you? In general, the most effective strategies against future income taxes and the new Medicare tax are investments that generate tax-free income. Not tax-<u>deferred</u> vehicles like a 401(k) or traditional IRA, but tax-<u>free</u> vehicles. That would include Roth IRAs, aggressively-funded life insurance, and municipal bonds. Of the three, I like the life insurance option for many investors, but to understand this strategy, you must throw out everything you think you know about life insurance. It's certainly not a good strategy for everyone, but properly structured and adequately funded life insurance contracts can generate significant retirement income…tax-free, including being free of the Medicare tax. Roth IRAs work under the tax law today, but I sense that Congress will eventually use Roth IRA distributions – while allowing the distributions to remain tax-free - to determine things

[7] A good argument can be made that better Fed policies would cause investors to direct capital toward more productive uses, such as businesses – especially small businesses - that have good ideas on how to produce new products and services…and create jobs! Hoarding gold doesn't create jobs.

[8] National Federation of Independent Business v. Sebelius, <u>567 U.S. ____</u> (2012).

[9] http://health.burgess.house.gov/uploadedfiles/one_page_on_unearned_medicare_tax.pdf

like…the Medicare tax, taxation of your Social Security benefits, and the tax you pay on capital gains and dividends. That's speculation on my part, but it's not a stretch to see that coming.

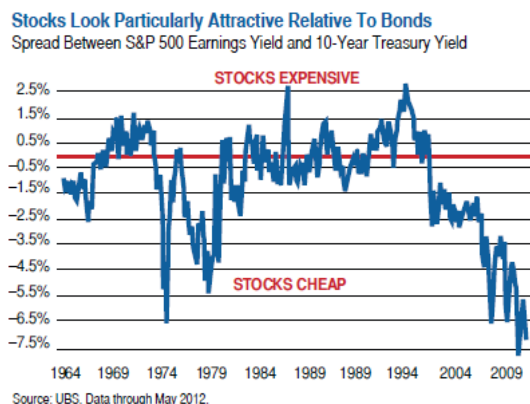
What could also happen is that the Republicans win in November and the entire health care law is repealed…thus, no Medicare tax. But that will not relieve the enormous pressure on Congress to do something about Medicare. We've always had a progressive tax system in which higher-income earners are taxed at increasing rates – nothing new. But we've seen a relatively new trend that is using income levels to determine the Medicare tax, Social Security taxes (and now Medicare part B premiums!), exemption phase outs, "stimulus" payments, tax rates on capital gains and dividends, etc. Regardless of how we got here, smart investors know that it's more important than ever to manage investments around inflation and taxes.

Bottom Line: Please call the office and schedule some time with me to review your options. It's important to know your options and how to limit the impact of taxes on your investments.

Conclusion

An often-cited metric to determine the "fair value" of stocks is to divide corporate profits by the current 10-year Treasury yield and then compare this index to historical data. This method right now suggests Dow 63,000. That's not a misprint. Considering that the Dow is around 13,500, this seems absurd. I'm not suggesting anything remotely close to that will happen in the short-term or that stocks are even undervalued – maybe they are, maybe they aren't. But I am suggesting that corporate profits are strong, interest rates are low, and stocks look like a bargain compared to bonds today.

Stay invested, my friends.



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Todd's Background

Todd has been serving clients since 1992. Prior to that time, he attended Boston University School of Law and obtained his law degree in 1989. He practiced law from 1989 to 1992 in Dallas, TX with a large international law firm in the areas of taxation, securities, and corporations. He graduated from Kansas State University in 1986.