Blackhaw Wealth Management Quarterly Letter

Uncertainty & Taxes, Consequences & Implications, Market Commentary

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October 2010

Uncertainty & Taxes

Investing is an inherently uncertain process. Investors face uncertainty with respect to interest rates, inflation, market volatility, corporate malfeasance, commodity prices, currency fluctuation, economic growth, monetary policy, fiscal policy, and external shocks such as terrorism, just to name a few. At the moment, the tension between cyclical factors, structural imbalances, monetary policies and fiscal policies has created one of the most uncertain economic environments in modern history. It can seem difficult to select investments and formulate an intelligent portfolio strategy to effectively address the risks to one's capital, yet that is precisely what all investors, professional and retail alike, must do.

Think back to March 2000; what were you doing at that time? That month the Nasdaq stock market peaked, following years of explosive growth in the technology industry. Optimism was high. We were living in the "new economy" and were enamored by all of its promise. Even the Federal Reserve Bank believed that it had reached a point at which economic cycles could be controlled, and that true recessions might be a thing of the past. Fast forward precisely 9 years, to March of 2009. The economy was contracting dramatically and the financial market was collapsing. By March of 2009 the stock market had lost almost 60% of its value, the economy had shed 7 million jobs, the federal government was taking control of 3 of the 30 companies within the Dow Jones Industrial Average and offering unprecedented financial support to hundreds of other companies in an effort to avert another economic depression. Gold prices were soaring, as were sales of guns and safes. I doubt there was a single mentally competent person alive back in March of 2000 that would have predicted such horrible events just 9 years in the future, but it is what it is. What will the next 9 years bring us? Continual deflation, or hyperinflation as some suggest? Gold prices of $5,000 per ounce, or more? The insolvency of the Medicare Trust Fund? All are possibilities.

Let's hold those thoughts for a moment and discuss something that is a little more certain: taxes. Despite all of the uncertainty and risk that we face today, tax policy will soon change in a known and unfavorable manner. As most readers are aware, the current statutory tax rate for qualified dividends and long-term capital gains is 15%. The tax rate for qualified dividends will automatically rise to become equal to an investor's ordinary income tax rate. The tax rate on long-term capital gains will increase to 20%. Additionally, most ordinary income tax brackets will increase, with the highest bracket moving from 35% to 39.6%. Although it is still possible for these specific rate increases to change (Congress *could* pass new legislation before year-end), it is more-or-less a foregone conclusion that most tax rates will trend higher from 2011 and beyond, and it is wise to invest accordingly.

From an investment perspective there are two principle reasons why investors care about tax rates. The first reason is because tax policies have a direct, lasting impact on economic growth. The second reason is that investors naturally seek to maximize the *after-tax* rate of return on their investments. We'll discuss the investment implications shortly, but let's frame the analysis first by exploring the economic consequences of tax policies. In doing so, let's look to Washington DC and to one of President Obama's former economic advisors for some insight.

Economic Consequences

Far from public view, there is a small group of esteemed economists known as the President's Council of Economic Advisors ("CEA"). The CEA's core function is to provide the President with objective analysis and advice on a broad range of economic matters. The CEA essentially functions as the foundation of the Administration's economic policies, making its members among the most influential economists in the country.

Until very recently, Christina Romer was the Chair of the CEA, having been appointed in early 2009. Regretably, Ms. Romer resigned from the Council on September 3rd, 2010 and has returned to private life. Somewhat ironically, Ms. Romer recently completed a research paper titled "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." The paper was published in the American Economic Review in June, 2010, and I quote from the publication here:

> *"This paper investigates the causes and consequences of changes in the level of taxation in the postwar United States. Our results indicate that tax changes have very large effects on [economic] output. Our baseline specification implies that an exogenous tax increase of one percent of GDP lowers real GDP by almost three percent… and that [capital] investment falls sharply in response to exogenous tax increases."*

In other words, for every $1 of increased taxes that the US government collects, there is approximately $3 of future lost economic output for the U.S. economy, relative to what would have happened in the absence of a tax increase. The primary conclusion to draw from Ms. Romer's research is simply this: <u>tax increases draw capital away from private enterprises and individuals, leading to large reductions in subsequent investment and economic growth</u>.[1]

Separately, recent research by Goldman Sachs projects that if Congress fails to act and allows the existing tax rates to rise as stipulated in current law, it will result in a reduction of 2011 economic

[1] The full paper is available at Ms. Romer's website: http://www.econ.berkeley.edu/~cromer/index.shtml

growth of approximately 2%. Given that most economists only forecast 2.0% to 2.5% growth in the next year to begin with, the implication is that the scheduled tax increases could cost the economy almost $300 billion in total output and likely lead to another recession (you will be forgiven if you were not aware that the current recession officially ended in June of 2009).

To be sure, even if the tax cuts are extended, if only for the middle class, the outlook still isn't terribly encouraging. The Chief U.S. Economist at Goldman Sachs said the following in a note to the clients on October 6th, 2010:

> *"We see two main scenarios for the economy over the next 6-9 months—a fairly bad one in which the economy grows at a 1.5% - 2.0% rate through the middle of next year and the unemployment rate rises moderately to 10%, and a very bad one in which the economy returns to an outright recession. There is not much probability of a significantly better outcome."*

So, the coming quarters will likely produce economic conditions that lay somewhere between "fairly bad" and "very bad." Any tax increase will tilt the odds squarely in favor of the latter scenario.

Investment Implications

As said previously, there are two principle reasons why investors care about tax rates. As we have just discussed, the first reason is because future tax increases will reduce economic growth (consequently reducing potential investment returns). The second reason is because our diminished investment returns will be further reduced by their necessary tax payments. Given the "one-two punch" effect that tax increases have on savings and investment returns it is useful to consider both portfolio management strategies as well as individual investments that may be able to provide acceptable investment returns and do so in a tax efficient manner.

Fortunately, there are attractive investments that are suited to a low-growth economic environment, and also convey tax efficiency either through special treatment within the tax code or through deferral of the tax liabilities. These investments include municipal bonds, master limited partnerships, high quality dividend paying stocks, and timberland REITs, to name a few. All taxable accounts at Blackhaw Wealth Management have significant investments in both tax-advantaged and tax-deferred securities. Furthermore, our investment strategy naturally favors longer-term investments, so our clients' investment returns are not heavily comprised of short-term capital gains. Our clients should understand this point: while taxation is never the key driver of the investment process at Blackhaw Wealth Management, it is a significant factor nonetheless and our clients' accounts are managed with the intent of maximizing *after*-tax returns.

It is worth pointing-out one noteworthy asset class missing from this discussion: conventional fixed income. Conventional bonds – including investment grade corporate bonds, CDs, treasuries, agencies, and others, are actually quite *inefficient* from a tax perspective. All of the income earned from these securities is taxed at an investor's highest marginal income tax rate. As if that wasn't bad enough, these securities happen to be trading at prices that offer very low yields. At the time of this writing, a 10-year U.S. Treasury Note is priced to yield 2.4%. To an investor in the highest tax bracket (likely to be 39.6% in 2011), the after-tax return would be reduced to approximately 1.4% per year- a truly pitiful rate of return to be earned on one's savings over an entire decade.

Market Commentary

The recent 3rd quarter saw very positive gains for the major equity market indices with the S&P 500 returning +11.3%. Such good returns might be perceived as a sign of an improving outlook for the US economy, so you might be surprised to hear that general economic conditions have actually worsened over the past few months. In fact, the economy has weakened so much that the Federal Open Market Committee (aka, the Fed) released a statement on September 21st and said the following (emphasis added by me):

> *"The Committee will continue to monitor the economic outlook and financial developments and is prepared* ***to provide additional accommodation*** *if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."*

On the surface this might appear to be a fairly benign sentence, but for investors it is quite important. You see, with interest rates at zero already, the primary lever that that the Fed has at its disposal to "provide additional accommodation" is a practice known as *quantitative easing*, and it involves purchases of large quantities of Treasury and Agency securities in an effort to further reduce long-term interest rates and mortgage rates. The Federal Reserve is acknowledging that the economic recovery is so weak and fragile that it may once again intervene in financial markets in an attempt to maintain some modicum of economic growth. This comes merely 8 months after the completion of the Federal Reserve's first quantitative easing program, during which time the Fed purchased more than $1.5 trillion in mortgage-backed securities in an effort to drive mortgage rates in hopes of boosting housing prices.

But wait, you might ask, if the economy is doing so poorly, why did the stock market appreciate so much in the last quarter? It appears that the stock market went up for the same reasons that <u>all markets</u> appreciated during the quarter: because the dollar went *down*. You see, the process of quantitative easing is actually more commonly known as "printing money." When the Fed buys treasuries and mortgage-backed securities it simply creates the money to do so. Any central bank that creates larger and larger amounts of currency out of thin air naturally causes the value of the underlying currency to decline. Most people think of stocks as going up in value, along with other assets such as such as gold, oil, foreign currencies, or commodities, but it may be more appropriate to think of the dollar as going *down* in value. If the dollar is worth *less*, then it naturally follows that you would need more dollars to buy the same ounce of gold, the same barrel of oil, or the same share of IBM. Since these assets are all priced in terms of dollars, any decline in the value of the dollar must be reflected as a price increase in a dollar-denominated asset. This is a form of inflation, although not the kind of inflation that readily shows up in the government's Consumer Price Index data.

Investors are faced with a paradox here. Conventional thinking suggests that if you fear another economic downturn, you would want to reduce your stock holdings and perhaps invest in bonds, but this is not a conventional situation. The cyclical factors that portend economic weakness may eventually be overwhelmed by the structural forces of currency debasement by the Federal Reserve. The economy may be reaching an inflection point; what used to seem scarcely *possible* is gradually moving in the direction of *probable*. The continued monetary expansion by the Federal Reserve and deficit spending by the federal government may do so much damage to our currency over the long-term that investors should do precisely the opposite of that which is conventional: sell fixed income securities and shift capital to assets of enduring value, such as stocks and real estate. For the time being it's still a question of "if", but someday soon it may become a question of "when".

Concluding Thoughts

This of course brings us back to the opening statement: Investing is an inherently uncertain process. The tension between cyclical factors, structural problems, monetary policy, and fiscal policy, has created one of the most uncertain environments in modern times. The combination of deflation and tax increases is a lethal combination and it suggests a weaker economy and lower investment returns. But the forces of monetary debasement and deficit spending are powerful as well, and these forces continue to stoke asset price inflation, as we see today. It can be difficult to evaluate individual investments and implement suitable portfolio management strategies with so much uncertainty and with the range of potential future economic conditions being so wide.

I believe this is one of the reasons why so many investors are holding high levels of cash at the present time - they are content to earn a certain 1% rather than exposure their savings to the uncertainty that surrounds them. As discussed in our previous newsletter, the Federal Reserve is penalizing savers who choose this course of action, as their investments will earn a return that is almost guaranteed to be overwhelmed by the dollar devaluation that will unfold over the next decade. By holding so much cash and corporate bonds, many investors are engaging in the financial equivalent of football's "prevent defense" – a tactic that is designed to protect against large losses but is prone to repeated small losses. Unfortunately, the prevent defense is a *tactic* to be use selectively; it is not a *strategy* to employed for a prolonged period of time.

Clients of Blackhaw Wealth Management should know that their capital continues to be actively managed with all of these considerations in mind. As our friends and clients know, we have been conservatively positioned throughout this year, with most accounts having no more than 60% in equities at any point in time. Although the year-end client letter (to be published in January 2011) will have a more detailed discussion of our investment results, I will say that our average client account has returned substantially more than the stock market averages through the first 9 month of this year, while having considerably less risk. We are playing well on both offense and defense, and we continue to look for ways to score points in an uncertain economic environment.

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