

Perspective

October 2011 *By Davis Riemer*



DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

The conversations in our conference room of late have had elements of sadness and anxiety, as people talk about how they have been affected by the continuing economic turmoil. When we slide backward, the mere passage of time creates more problems. The “path” or “journey” to financial security can come to seem like the Yellow Brick Road to the Emerald City – entirely a work of fiction, or fantasy even, replete with dark visions. However, these negative thoughts come from wellsprings of emotion. Rationally, no one knows the future and we should prepare for several outcomes. From where we are, we should determine where we want to go and then develop a strategy. Will that rational approach assure the desired outcome? No – “Nothing is certain but death and taxes.” (Mark Twain.) But, we side with Yogi Berra: “If you don’t know where you are going, you’ll wind up someplace else.” The journey to financial security typically requires a long time to traverse and passing time brings both bad and good influences. We will encounter previously unforeseen problems, some of which might threaten our plans. However, time also allows dreams to materialize, plans to be made, savings and investments to grow.

Many journeys share common elements. Recently, I imagined myself headed for the Pacific, for California, in 1851. I had concluded that the California Gold Rush was real and that government treaties with major tribes had reduced the risks of encountering angry Indians on the way. Having worked my way through the known territory east of the Mississippi to Independence, MO, I faced the unknown West. So, I joined a group and we hired a guide, a scout. Although an immediate start confronted us with our fears of the unknown, the scout said that, if we delayed our start any longer, then both we and winter would arrive at the mountains at the same time, and mountain winters kill. He could say little definitively to allay our anxiety about what lay ahead. Weather, hostile Indians, sickness, landslides, death of pack animals, broken equipment – many things can happen on a journey. Having been on that trail before, he could only say “We’ll see. It depends.” One knows only two things – staying put means that one does not arrive at one’s destination, does not reach the dream; but, the journey means facing risks and troubles, which themselves might end the matter entirely.

Some Things to Think About Along the Way:

As though it were a “hot table” serving a buffet of dishes, this *Perspective* serves portions on several “hot topics” - volatility, Greece, budget issues in our own country, possible tax changes for us as individuals, the “Buffet Tax,” and then a bit of less visible but more encouraging good news. We drew the material from a variety of sources, all mentioned below.

Volatility:

So then, like the early settlers, in order to reach our destination, we must overcome challenges. There were dangers of physical challenge. On our financial journey, the dangers come out of other challenges, one being price volatility. But, as with many other regrettable things in life, volatility is largely to be endured in exchange for the reward sought.

Why “endured?” Because few ways to counter volatility can survive serious theoretical and statistical inquiry and speculative strategies increase risk. On the other hand, one can put money in guaranteed instruments. A bank in our neighborhood advertises a four-year CD paying 0.95% per year (before taxes), but when inflation is running over 2% per year, is that investment risk-free? However, “endured” does not mean “simply endured.” For intelligent investors, endurance comes in the form of patience, a quality acquired from discipline and also from the appropriate perspective of accumulated experience. Always, always, always, see the long view. One need not act solely in accordance with that view, but acting in ignorance of the teachings of time can cost far more than the troubles one thinks one will avoid.

When touting the ways in which their ideas will succeed where others have failed, some investment promoters remind me of Glendower (King Henry IV, W.S.):

Glendower: *“I can call spirits from the vasty deep.”*

Hotspur: *“Why, so can I, or so can any man; But will they come when you do call for them?”*

Glendower: *“Why, I can teach you, cousin, to command the devil.”*

Hotspur: *“And I can teach thee, coz, to shame the devil – By telling the truth. Tell truth and shame the devil.”*

Greece and Europe

Why might volatility decline? In the economic issues that both America and the Europeans face, a common factor has a profound effect – uncertainty with respect to government policy. The governmental bodies with the responsibility, power and authority to promulgate and drive policy or law are deadlocked. Uncertainty is extreme and the consequences of outcomes are serious. The markets and entire economies need government policy on both U.S. debt issues and European debt issues. The lack of government policy constitutes a major source of uncertainty

Many news stories about Greece and the European debt crisis bring volatile swings in the prices of stocks. We wanted to offer clients a simplified and shortened statement on the Greek financial crisis. To do this, we paraphrased the following paragraphs, but kept the intent and meaning true to the intent of the author, Martin Feldstein. Feldstein is a professor of economics at Harvard, who served as chairman of Ronald Reagan’s Council of Economic Advisers and is a former president of the National Bureau for Economic Research.

Feldstein states:

The Greek government is in an impossible situation. It has an unmanageable level of debt, a collapsing economy, a chronic balance-of-payments deficit, and insolvent banks. One way out is for Greece to default on its sovereign debt and write down the principal value of that debt by at least fifty per cent. Such a strategy of “default and devalue” has been used before by countries in similar situations. Being a member of the European Union has prevented Greece from using this option; however, if Greece were to leave the E.U., it could devalue its new currency, which might stimulate demand. However, political leaders are trying to prevent or postpone this outcome.

Financial institutions in Germany and France have large exposures to Greek government debt. Postponing default allows them to build capital and reduce their exposure to Greek banks. There is also a risk that a Greek default would induce runs on other banking systems and therefore sovereign defaults in other countries, particularly in Spain and Italy. A default by either of them would have disastrous implications for financial institutions in France and Germany.

The European Financial Stability Fund can cover Greece but not Italy and Spain, if they lose access to private markets. If a Greek default occurred soon, financial markets would regard defaults by Spain and Italy as much more likely, causing their interest rates and national debt to rise rapidly, thus making them effectively insolvent. By working to delay Greece’s default, Europe’s politicians hope to give Spain and Italy time to prove that they are financially viable.

The increased strength prior to default might mean less fear of dangerous contagion. Portugal might follow Greece, but the larger countries should be able to fund themselves at reasonable interest rates and the current euro-zone system could continue. However, the current interest rates on Greece’s bonds show that markets believe Greece will default soon and, even before that default occurs, interest rates on Spanish or Italian debt could rise sharply, putting these countries on a financially difficult path.

Although Feldstein did not mention it, it might be added that the Greek public does not yet seem to fully acknowledge its role in the problem. A meaningful portion of the population, including professionals, business owners, managers and the like – some of the upper echelons of the public – has ignored their responsibility to pay taxes. When the “upper half” refuses to join the system, the system as a whole will have trouble.

Policy on The Home Front

Our nation needs clear, reliable tax policy. Our economic difficulties have brought to the fore an awareness of the divide over solving budget and debt problems. We are currently dead-locked over the country’s future direction, so Congress created the Congressional Joint Select Committee to give us a plan to resolve this before Thanksgiving Day of this year. Of course, the Committee might fail to agree and throw it back to the Congress, so that they, too, can “kick the can down the road” (to the next election), allow the automatic cuts to take effect, and then return to the matter in November 2012 or January 2013, determined by which party wins the election.

The sheer size of the deficit indicates that, in order to make meaningful progress over the long run, we must use some combination of the following options: 1) Reduce transfer payments to or on behalf of individuals; 2) Reduce transfers to local governments, or; 3) Raise tax revenue. Tax revenue is realized in a variety of ways, the effects of which differ in the way they benefit or hurt various parts of the population. The “progressivity” of the tax code represents a line dividing public opinion about the underlying social contract. Much is being made of the disparity in incomes and wealth now, as more populist opinions are gaining traction following the collapse in 2008. The substantive and political challenges confronting both the Committee and the Congress are simply enormous. They – and we – must all adapt our approaches.

The Select Committee has been charged with deciding how much and where to cut expenses as well as how much and how to raise revenue. As they work, the Committee members will likely review the study “Addressing the Long-Budget Deficit: A Comparison of Approaches.” done by the Congressional Research Service, based on FY 2007, the last “normal” year prior to the recession. It analyzes both the structure of the debt challenge and also various options for debt reduction and tax changes.

These quite Brief Observations below were drawn from the report.

Expenses:

The big ticket items are transfers and interest payments. Seventy percent of the federal budget consists of transfers and interest payments. Transfers include payments to persons (e.g. Social Security and Medicare, almost half of federal spending) and to local governments.

Cutting domestic federal government services will not cut spending substantially. Defense spending constitutes about 20% of federal spending, but national security limits the savings that might be found there. Other Federal government services (e.g., air traffic controllers, border security, courts and corrections, etc.) constitute only 10% of federal spending and 2% of GDP.

Cuts to Local Governments will transfer but not solve the problem. Because the federal government provides about one-fifth of the revenue for state and local governments, cutbacks in transfers to these governments will shift part of the cost of services from the national to state and local governments, rather than altering the overall size of government services. Ultimately, state and local governments – whose finances might be in no better shape than the Federal Government’s – would have to determine what, and how, to maintain those services.

Revenue:

Revenue Raising Options Include: Increase income and capital gain tax rates, increase other taxes, introduce new taxes and reduce tax expenditures. (The term “Tax Expenditures” refers to offsets used by tax payers to reduce their tax liability, thus they amount to “losses” of government tax revenue. These offsets include special exclusions from income, exemptions, deductions, credits, preferential rates of tax, or deferral of tax liabilities, the most common example of which is the deduction for interest paid on a home mortgage.)

Effects of Different Taxation: Income taxes tend to fall more heavily on higher income individuals, so an increase in tax rates would likely hurt them more and contribute to the progressivity of the system. However, many tax expenditures would tend to benefit these same higher income individuals. Raising the cap on Social Security payroll taxes would increase the cost to higher income workers. Flat rate consumption taxes, including value-added taxes, carbon taxes and specific excise taxes (such as those on gasoline, alcohol and sugared beverages) would tend to be regressive.

Increasing Tax Rates: This includes: Higher income tax rates for higher income earners, including corporations, as well as higher capital gain tax rates for (presumably) wealthier tax payers. It could also include higher tax rates across the board.

Increasing Other Taxes. This group includes: Raising or eliminating the cap on earnings for payroll taxes, expanding the base to include employee fringe benefits, taxing Social Security benefits, increasing gasoline taxes and increasing alcohol taxes and perhaps others with smaller effect.

New Taxes. New tax sources include: Value added taxes, carbon taxes (including auction of carbon rights through a cap and trade system) and taxes on sugar-sweetened beverages. The Congressional study concludes that both value-added taxes and carbon taxes could raise significant amounts of additional revenues, and that these revenue sources differ in the incentives they create and also in their progressivity.

Reducing Revenue Losses in the form of Tax Expenditures. In 2007, the amount of revenue lost to tax expenditures exceeded 7% of GDP and 35% of total government direct spending. Without these losses to revenue, individual income tax receipts would have been 77% larger, corporate receipts 25% larger and overall income tax receipts 39% larger. However, some tax expenditures are technically difficult to eliminate (especially employer fringe benefits), some are valued as part of the social safety net (such as the earned income credit) and some are so politically popular (e.g., the home mortgage interest deduction) that eliminating them or scaling them back could be difficult.

For individuals, changes might include:

- Set lower dollar caps on mortgage interest deductions and disallow such deductions for vacation homes and home equity loans
- Ceilings on employer tax deductions for employee health insurance/care plans
- A “percentage-of-income” cap on state and local tax deductions
- Disallowance of personal property and sales tax deductions
- Taxation of dividends at ordinary rates and of capital gains at higher rates
- Treat “carried interest” as ordinary income (Dreaded by hedge fund managers)
- Include capital gains preferences in the alternative minimum tax (AMT)
- Disallow like-kind exchanges
- Repeal cafeteria plans
- Institute a percentage-of-income floor for charitable contribution deductions
- Reducing charitable deductions for gifts of appreciated property to the cost basis
- Tax Social Security benefits as pensions
- Tax inside buildup on life insurance plans

“Tax the Rich” and “The Buffet Tax”

Related to the foregoing, the flap over the “Buffet Tax” has been fascinating. Occasionally overlooked is the fact that Warren Buffet realizes the majority of his income from capital gain, the rates for which are lower than most of the rates for income tax. Regardless, Buffet made a point about

the social contract that attracted a lot of attention – that, at least in these circumstances, the wealthy have a higher duty to the whole than our current tax structure imposes upon them. In a recent issue, the capitalist and free-market leaning publication *The Economist* joined that view, offering their own “Three good reasons why the wealthy should pay more tax,” to wit:

- The experience of other nations which have had similar difficulties as the U.S. indicates that they have successfully dealt with the problem using a ratio of spending cuts to tax hikes of around 3:1 or 4:1. For the U.S., adopting a similar approach implies tax increases.
- Spending cuts fall disproportionately on the less well-off and, even before 2008, median incomes were stagnating and disparity in wealth was increasing. Furthermore, globalization has rewarded the well-off disproportionately.
- An increase in taxes paid by the rich does not require an increase in tax rates. It can be accomplished with increased simplicity, efficiency and clarity in the tax code.

Also according to the *Economist*, the U.S. relies more than other countries on income taxes, yet because of our system of tax credits, deductions, offsets and loopholes, the tax burden falls on a much narrower base than is perceived to be the case. These losses to revenue might amount to \$1 trillion per year and, were they all to be eliminated, the wealthier folk would pay most of the increase in tax.

However, the above-mentioned report to the Select Committee actually studies the obstacles to change in the tax expenditure category; it is not so simple. Our nation has extremely complicated financial dealings and structures. The extraction of any particular tax expenditure from the system will cause ripple effects and might have significant unintended consequences. For example, if the home mortgage interest deduction were eliminated, then the monthly payment buyers could afford would decline almost across the board, which would probably cause a decline in the prices that sellers would be able to obtain. You can imagine the response such a proposal might receive in today’s housing market.

It's Not All Bad

Many of our client meetings include a review of the issues and problems we face. After that cheerless task, we are occasionally asked: "So, what's out there that looks like good news?" Where are the stories that can give us hope? It is hard sometimes to remain convinced that there are good things happening. Well, we should read deeper into the paper, perhaps, keeping an eye out for other headlines, too. Here are seven that you might not have seen, gathered from third quarter global news by Jim Parker, Vice President, Dimensional Fund Advisors:

Robust Growth in Germany Pushes Prices – Analysts see a strong chance that German inflation will head up toward 3% by the end of the year, as a consequence of robust growth in Europe's biggest economy (Reuters, July, 27, 2011)

Brazil's Domestic Demand Still Strong – The Economist Intelligence Unit says economic growth in Brazil surprisingly picked up speed in the first quarter, challenging the government's efforts to cool the expansion. (EIU, July 6, 2011)

Japan's Retail Sales Top Estimates – Japan's retail sales rose 1.1 per cent in June, exceeding all economists' forecasts and adding to signs the economy is bouncing back from an initial post-disaster plunge. (Bloomberg, July 28, 2011)

No Fear in China – Traders betting on gains in China's biggest companies are pushing options prices to the most bullish level in two years. The Chinese economy is projected to grow by 9.4 per cent in 2011. (Bloomberg, July 28, 2011)

Southeast Asia Booms – Southeast Asian markets are the world's top performers in 2011 thanks to strong economic and corporate fundamentals. Thailand's index hit a 15-year high in July and Indonesia's index also reached a record high. (Reuters, July 22, 2011)

Australian Boom Keeps Rate Rise on the Agenda – The Australian dollar hit its highest level in 30 years in late July as traders looked to the prospect of another rise in interest rates on the back of a resource investment boom. (WSJ, July 27, 2011)

NZ Bounces Back – The New Zealand economy has grown more strongly than expected after the Christchurch earthquake, helped by improving terms of trade. The Reserve Bank signals it may raise interest rates soon. (Bloomberg, July 28, 2011)

Whether these have equal force with the bad news, we cannot now say. However, good news can spread as well as bad news, so the fact that these events are happening tells us at least two things:

- **Not all the news is bad, even though we might think it is.**
- **The press tends to exhibit a herding instinct, clustering around and oft repeating news about negative events. Frequent repetition of a news story can create an unwarranted perception of accuracy.**

The global economy is moving away from its historic heavy reliance on the U.S., while moving toward multi-polarity of economic energy. This increases the potential benefits from broad diversification and possibly also, for equity investors, it increases the opportunities for wealth building as well.

Let us, as did our pioneer forefathers who gathered in Independence, go forward believing that in the New Year we will have good reasons to celebrate.

DHR Investment Counsel, Ltd.
A Registered Investment Advisor