Wars, Acts of God and Taxes

> Market values are fixed only in part by balance sheets and income statements; much more by the hopes and fears of humanity; by greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion and numberless other causes impossible to be listed without omission.
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> *The Battle for Investment Survival*, Gerald M. Loeb, 1935

It has been hard to make much money in 2004. The stock market has been extremely frustrating for most investors, especially in light of the strong performance of the economy and the excellent year-over-year growth of corporate earnings. For the four quarters which ended June 30, 2004, real GDP increased 4.7% – a robust economic performance by any standard. Unemployment, at 5.4%, is now lower than the average rate of unemployment during the entire decade of the 1990's. In addition, corporate profits are up more than 20% compared with similar periods in 2003. Yet the stock market has ignored this good news. The S&P 500 Index (total return) was up only 1.51% for the first three quarters of this year. The NASDAQ fared worse, dropping 5.32% for this period. The Dow Jones was down as well, falling 2.12% through September 30, 2004. So, why is the stock market turning its back on this good news?

Legendary investor and market strategist Gerald Loeb had it right in the above quote. While corporate earnings and balance sheets are what matter in the long run, what matters in the short run are things like election hopes and fears, energy prices, interest rates and terrorism. At this moment, investors' most important concern is November's Presidential election and which party will control the Senate. Investors are also worried about the price of oil. Recent acts of God – four hurricanes in the Southeast and the Gulf of Mexico – as well as other events disrupting oil supplies around the globe, have pushed oil prices to an all-time high of $54 per barrel. Additionally, the Federal Reserve has been methodically raising short term interest rates in 1/4 percent increments. The Fed Funds rate has been increased three times this year from 1% to 1.75%, with more rate hikes on the way. These factors cause stock market investors to worry that the U.S. economy will slow, raising again the specter of a global deflationary spiral. On the other hand, bond investors are cheered by a slower economy and possible deflation but worry that higher energy prices and commodity prices will ultimately cause an inflationary cycle.

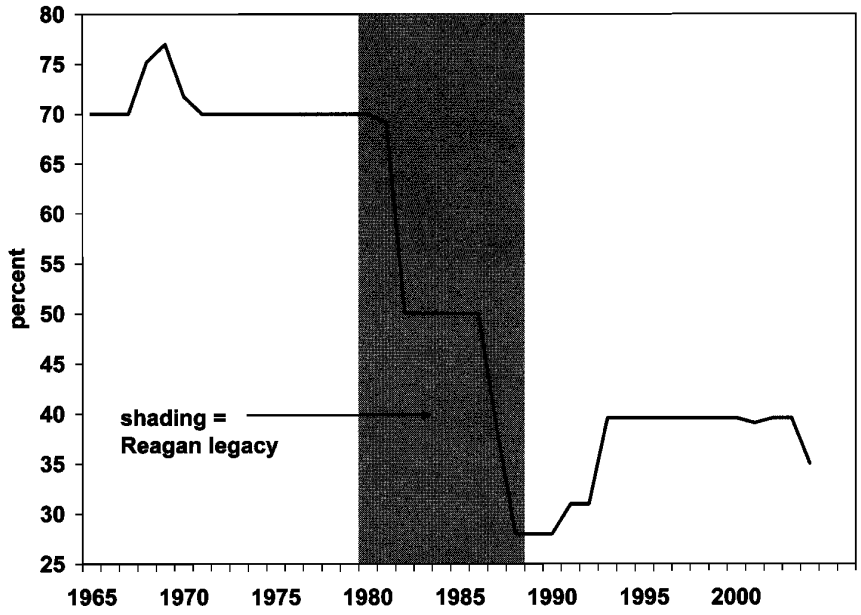
In the race for President, the most critical issue for voters is probably the War in Iraq and the question of how best to defeat the global terrorism of radical Muslims. But not far behind is the economy, and President Bush and his challenger, Senator Kerry, have very different ideas about taxes. As taxes and fiscal policy are such an important component of this year's Presidential election, we would like to clear away the rhetoric and address some important facts about four kinds of taxes – federal income taxes, taxes on dividends, taxes on capital gains, and estate taxes.

U.S. Income Taxes

President Bush has been criticized by his political opponents for his tax cuts for "the rich," but in fact, the fiscal policy of cutting the top marginal income tax rates has a long history in America.

Income tax rates were raised significantly by Woodrow Wilson to help finance World War I. When President Coolidge took office, his Secretary of the Treasury, Andrew Mellon, proposed dramatic cuts in the income tax rates to get the economy moving, and Coolidge was able to get this legislation passed, helping to launch the roaring 20's. Forty years later, President Kennedy proposed cutting the top marginal income tax rates as well. The story is told that an unhappy citizen approached Kennedy about his tax proposal and said, "Mr. President, isn't it true that your tax cuts favor the rich?" "I hope so," replied the President. But the President in the last century who really changed the playing field on income taxes was President Reagan. The chart below shows President Reagan's legacy in transforming the way that the U.S., and now most of the industrial world, thinks about the top marginal tax rate:

Top Marginal Tax Rate in U.S.
1965 – 2004



Source: Internal Revenue Service
Bear Stearns & Co, Inc.

In 1980, when Ronald Reagan was elected President, the top marginal tax rate was 70% (down from 90% under Roosevelt's New Deal). The top marginal tax rate kicked in at an income level of $215,400 (around $500,000 in today's prices). As can be seen above, the top marginal tax rate was 28% when President Reagan left office. The enormous growth of the U.S. economy in the 1980's was caused, in part, by the lower taxes which increased incentives to work, save and invest. Furthermore, dramatically lower tax rates resulted in tax revenues almost doubling between 1981 and 1989. Actual IRS revenues went from $550 billion to $991 billion in this period. As this powerful fiscal tool began to be understood in other industrial countries, first one nation, then another, began to reduce the top marginal tax rates to jump-start their economies. Even Russia recently reduced income taxes to a flat rate of approximately 15% and has watched tax revenues climb. In the U.S., the top tax rate climbed back to 39.6% between 1990-1994, but under President George W. Bush, the top marginal rate was cut to 35%. Has this cut in the top marginal income tax rate caused a greater tax burden on the poor? The table below tells the story:

Percentage of Total U.S. Income Taxes Paid by Income Group

Households	Adjusted Gross Income	% of Total Income Tax Paid
Top 1%	Over $285,000	33.7%
Top 5%		53.8%
Top 10%		65.7%
Top 50%		96.5%
Bottom 50%		3.5%

Source: Internal Revenue Service, 2002 data

It is clear from the above table that the households that benefit from President Bush's tax cuts are those which actually pay taxes. It is important to note that households in the bottom 20% not only pay no income taxes but also receive an "earned income tax credit" which is, in fact, a refund of part of the social security payroll tax. A family of four making $40,000 pays no income tax under current tax legislation. The Bush tax legislation also exempted an additional 3 million workers from any federal tax obligation, increased the child tax credit to $1,000, and eliminated the marriage penalty. Thus the charge that the recent tax cuts were only for the "rich" seems to be mere campaign demagoguery. It is perhaps useful to ask the question about the wisdom of fiscal public policy where roughly half the households pay little or no income tax. Would it not be "fairer" to have an income tax where most of the working population pays some level of income tax rather than the current system which pits those who pay taxes against those who don't?

Taxes on Dividends and Capital Gains

In the period 1926-2000, the average annual return of the S&P 500 Index was 10.7%. According to work done by Ibbotson Associates, dividends provided 4.6% (43%) of the total return and capital appreciation the remaining 6.1%. While the dividend yield on stocks in the decades before the 1980's was generally above 4%, the dividend yield on the S&P 500 Index fell in the late 1990's to around 1.2%. The low value that was placed on dividends over the past two decades resulted largely from U.S. fiscal policies. The inability to deduct dividends from corporate taxes encouraged management to use debt financing, as interest was deductible. Moreover, investors greatly preferred the long term capital gains (taxed at 20%) instead of dividends (taxed up to 39.6%). Accordingly, many companies routinely repurchased stock with their cash rather than increasing the payout of dividends.

The Bush administration put taxes on dividends and long term capital gains on an equal footing. The tax rate on long term capital gains dropped from 20% to 15%; the tax rate on qualifying dividends dropped to 15% also. For investors in the upper brackets, this meant a drop in taxes on dividends from 35% to 15%. This has encouraged a wide variety of companies to increase significantly their payout of dividends. This major change in fiscal policy is of real benefit to the stock market, we believe. It provides investors with an incentive to hold dividend paying stocks rather than bonds (as interest income is taxed at higher rates). It can also provide over time a support level for stock prices in down markets. We say over time, because the dividend yield on

the S&P 500 Index is approximately 1.75%, and it is likely to take some years before it climbs to the 3%+ level (unless stocks drop precipitously again). If President Bush is defeated in his bid for re-election, it is likely that efforts will be made to raise the tax rate on dividends and capital gains to former levels.

Estate Taxes

A major tax reform in the Bush administration was the lowering of estate taxes (or death taxes, as some call them). Before 2000, federal estate tax (which starts at rates of 50%+ for the non-exempt portion) was levied on estates which were larger than $600,000. The new legislation established the following schedule:

Federal Estate Tax Exemption (Per person)	Year Becomes Effective
$1 million	2002-2003
$1.5 million	2004-2005
$2 million	2006
$3.5 million	2009
Unlimited exemption	2010
Reverts to $1 million	2011

It is likely that a Kerry administration would seek to make changes – perhaps lowering the Federal Estate Tax Exemption for the years 2006 and beyond.

Conclusion

This investment commentary will be mailed so that our clients and friends receive it after the election on November 2. It is not meant to be a political piece to influence how the reader votes. It is, however, intended to make clear that taxes can have a dramatic effect on stock prices. Tax policies and incentives change human behavior decisively, and after the election, we will be analyzing what the winner says and what it means for the capital markets. Currently, the valuation of many large capitalization stocks is attractive. The Dow Jones at 9,900 has a P/E ratio of 14.5 on 2005 operating earnings. It has been a decade since we have seen that level of valuation. The presidential race is close, and investors fear that a Kerry administration will raise taxes broadly. It is altogether possible that a Kerry win is already discounted in the market, and that it will not have the effect of depressing the market further. But even if it is not, it is important to reiterate our initial premise: what matters in the performance of a stock over the long term is the growth in earnings and sound balance sheets. High quality stocks with growing earnings, strong balance sheets, competitive positions, and capable management will turn in good long term performance once the market's consolidation has been completed.