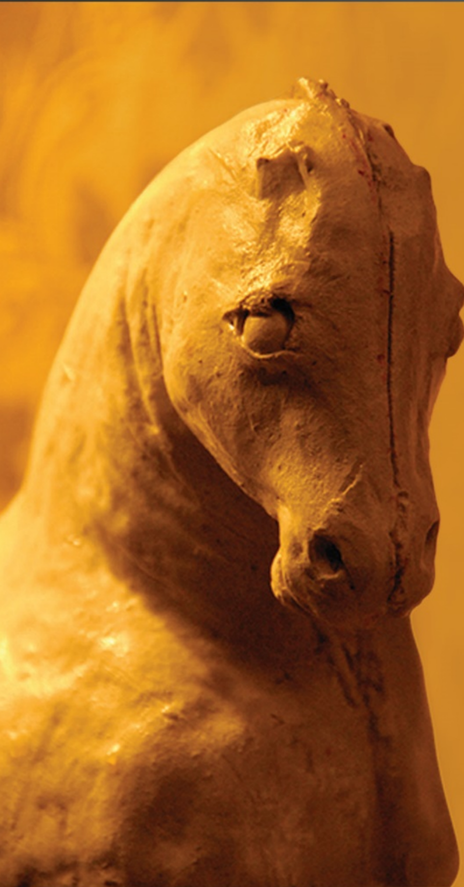

The Equus Report

—BY BARNABY LEVIN

BOSTON TEA PARTY

January 8, 2003

Boston Tea Party

Life is not black and white like it is in the "Lord of the Rings." There, everyone knows who the bad guy is and that his goal is nothing less than to crush spirits and enslave the world. And, despite the risks, they also know that the only choice they truly have is to join hands, "take arms against a sea of troubles and, by opposing, end them."[1] Failing that, they only prolong the inevitable.

No. We live in a world of far greater ambiguity. We can recognize many of the pressure points, starting with the price of oil at $32 per barrel and of gold at $350 an ounce. With regard to oil, it seems pretty clear that the currently high price can be attributed to Iraq and to the strike in Venezuela. Resolve these and prices will fall, perhaps substantially, benefiting everyone but those in the oil sector itself.

Not nearly so obvious is the case of gold. Up more than 10% in December alone, the market seems to be saying that inflationary pressure is on the rise. So why are six- and twelve-month CDs still hovering between 1- and 1.25%?[2] Which is it: inflation or deflation? If deflation, we should be buying bonds and selling stock. If inflation, sell bonds and buy stock.

Instead, after more than two years, we're still stuck in the middle of this transitional period when both sides have a point. Some indicators, like commodity prices,[3] predict the day when supply will get tighter; others, like capital spending and our country's political agenda, see the uncertainties of the moment and recognizing a current need to stimulate. So, for the moment, we – like the market – must play both sides of the field. We must preserve cash while investing for the future. Offense and defense. But that doesn't offer much in the way of guidance, does it?

Perhaps we should turn to Byron Wien, Morgan Stanley's Chief Strategist. Even though he may be wrong as often as he's right,[4] his annual "Surprises" bear attention. Each year he makes ten

[1] "Hamlet," William Shakespeare

[2] "Bank Money Accounts," *The New York Times*, January 2. 2003

[3] "John Bollinger's "Capital Growth Letter," December 20, 2002. "Commodity speculators should be having a field day, as there is strong price action evident across the commodity markets. Wheat broke out to new multi-year highs. The same is true for corn. Cocoa has already had a nice run and coffee is just trying to emerge from a massive base. And all this is confirmed by a strong CRB Index that is pounding out a new five-year high. Yes, I know that we are not supposed to be worrying about inflation just yet, but prices are rising."

somewhat tongue-in-cheek predictions, assigning a one-in-three probability that each will come to pass. This year, for example, he predicts that, after falling last year,[5] "yields on 10-year Treasuries will move toward 5.5% as the federal deficit threatens to reach $200 billion."[6] As my clients know, I agree, believing interest rates are more likely to be higher than lower a year from now. This is why I have been keeping bond maturities short in our fixed-income portfolios.

He also predicts that "Government legislative relief on the double-taxation of dividends will encourage some technology companies to start making quarterly payouts" because, at the moment it seems, both our state and federal governments are taxing companies, first, on the profits they make – and then the individual on whatever portion of those profits companies pay out in the form of dividends. In the face of this, "Dubya" has been making it very clear that he considers taxing revenue streams or profit once is more than enough and his proposed reduction in taxes on dividends, he believes, will encourage capital flows and investment in the market. This is what we want, because investment leads to job creation.[7]

So what will happen if he succeeds? In my opinion, this one change could have a far greater, longer-term, positive impact than simply stimulating the economy. First of all, it would mean that any income from most stocks would be tax-preferred to the investor, effectively raising stock's yield relative to bonds or other fixed-income instruments. Second, there is evidence that over the course of the twentieth century, dividends have accounted for more than 50% of the S&P 500's total return.[8] Any acceleration in the rate at which corporations raise their dividends could enhance or, at least, help to maintain the long-term rate of return the markets have enjoyed for the past forty years. Finally, there is evidence that corporations do respond to changes in tax policy with regard to what they do with their free cash flow. As tax rates on long-term capital gains have fallen from a high of 45.5% in 1954 to their current 20%, companies have become increasingly focused on plowing their profits back into the business in an effort to

[4] "The 10 surprises of 2002," Byron R. Wien, Morgan Stanley January 4, 2002. **Right:** Strength in the U.S. economy early in the year is a result of inventory rebuilding and proves to be short-lived. **Wrong:** The economy does a double-dip and slips back into recession. **Right:** The S&P closes lower in 2002 for the third straight year. **Wrong:** Alan Greenspan resigns as Federal Reserve Chairman. **Right:** The yield on the 10-year U.S. Treasury drops below 4% and bonds outperform stocks. **Wrong:** As terrorism recedes as a threat, everyone starts traveling again. **Right:** Pension fund solvency becomes a major investment issue as more companies reveal that their defined-benefit plans are underfunded. **Wrong:** A post Enron populism sweeps the U.S. regulatory landscape. And **Wrong:** the Democrats take decisive control of both houses of Congress.

[5] "Investing Outlook: Assessing the Moving Parts," William H. Helman, Smith Barney *Capital Markets Commentary*, December 6, 2002. "The shock of 10-year Treasury yields of 4%, given the history of the past 30 years, was met with strong skepticism. The yield was 5.4% as recently as March 2002, and it averaged 6.25% for the nine years from 1992-2000 when the year-over-year CPI change averaged 2.6%."

[6] "The 10 surprises of 2003," Bryon R. Wien, Morgan Stanley, January 6, 2003

[7] Alex Keto, Dow Jones Newswires, January 6, 2003

[8] "Dissecting the Total Return," William Helman, Salomon Smith Barney *Capital Markets Commentary*, October 15, 2002.

fund even greater growth because that was what the capital markets were rewarding.[9]
But now, given:

a) A slower-growth economy that is characterized by weaker demand and overcapacity

b) A spotty record of companies' ability to identify "investment opportunities" which have led, instead, to record write-offs over the past decade;

c) A lessening of the incentive for companies to raise money through debt- versus equity issuance which, in turn, would reduce leverage; and

d) Investor's increased willingness to pay more for "the reality of dividends today than the dream of growth tomorrow,"[10]

I believe that companies might shift to paying – then raising – dividends, and at a faster rate than in years past. Now, if we make those dividends tax-free to the investor and compare stock dividends of 2, 3 and 4% to the current coupons on corporate and municipal bonds -- coupons that are fixed until maturity -- why would anyone want to buy a bond? Let's put aside for the moment how this might impact the bond market (perhaps leading to an accelerated shift toward inflation indexing). As Baby Boomers continue to age and approach retirement, the importance of replacing earned- with unearned-income becomes increasingly important and I expect that companies will be pressured to raise their dividends, possibly in line with the growth of earnings versus the rate of inflation, which has been low for quite some time.

My point is that, while nothing much has changed with regard to the markets and investor psychology, I've often spoken of things that take us by surprise or that we haven't fully thought of that truly have the greatest impact on us and our economy. It seems to me that the problem today is not so much things like the war with Iraq. If Bush's proposal doesn't get bogged down by political wrangling over who benefits most, it is this seemingly inconsequential (yet eminently reasonable) idea of eliminating double-taxation that could actually end up being one of the biggest movers and shakers on our domestic economic landscape for many years to come. Even if he is only partly successful, we should benefit because many of the holdings in our equity portfolios not only pay a dividend – they are also easily capable of making substantial increases in the years ahead because their growth rates and balance sheets support doing so.

[9] "Tax Policy, corporate Tax Structure and Economic Behavior," Victor A. Canto, *La Jolla Economics*, December 20, 2002.
[10] "The Return of the Dividend," John Manley, Smith Barney *Investment Themes*, December 20, 2002

As always, when it comes to equity selection, each company must focus first on building its business, profitability and positioning itself for increased market share going forward. If they do, stock prices will track earnings over time as they have since 1871.[11] But, enhancing the dividend payout or its tax treatment will offer shareholders the potential for a higher total rate of return.

On a totally different topic – for those of us who live in California – I only wish they would run California like a publicly traded company. Income Statement and Balance Sheet: It's pretty straightforward. As long as we keep spending more than we earn, our state will remain Cash Flow negative and will need to keep tapping its Balance Sheet which, of course, is currently under attack. California's unemployment rate of 6.4% is now one of the highest in the nation[12] and we already have the nation's highest tax rates on income and consumption at 9.3% and 8.25%, respectively. This alone equals 17.55% of every dollar we make. Add property tax of 1.3% on the median home value of $328,310[13] and -- on a $100,000 annual income -- this adds another 4.27%, bringing the state total to 21.82%. Adding Federal taxes of 28%-35%; Social Security (up to a maximum $5,394 in 2003) at 6.20%; and Medicare at 1.45% brings the average tax to 52.2% and a high of nearly 65% – which means **that most of us already work the first half of every year for the government!** Am I missing anything? Please tell me how it is that the very segment of the population that already foots most of the bill seems to have so little say in the state's affairs?[14] Or how we can start the process of moving this discussion out of the realm of Party Politics?

Here's a novel idea: how about introducing our new "Full/Fair Disclosure" rules to the Government? We should require the state and the Fed to publish every line item of their respective budgets on an annual basis, just as we now demand of publicly traded companies. Allow everyone to see – in black and white – exactly where our already substantial taxes are going before asking us to pay any more. After all, we are the "shareholders" of this state and this country and we are the ones who are paying the "rent." As creditors, shouldn't we have

[11] Source: Cowles Commission 1871 to 1925; A&P 500 1926 to present.
[12] U.S. Department of Labor, Bureau of Labor Statistics
[13] California Association of Realtors, December 20, 2002. "The median price of an existing, single-family detached home in California during November 2002 was $328,310 – a 21.5% increase over the $270,210 median for November 2001."
[14] "State Budget Rises, Falls with Taxes Paid by the Rich," Daniel Weintraub, The *Sacramento Bee*, January 15, 2002. "On page 103 of the governor's Budget Summary is a graph that shows how much of the state's personal income tax revenue comes from people reporting various amounts of income. The chart shows that, while people reporting adjusted income of up to $50,000 for 1999 accounted for about 70% of all tax returns, they paid less that 8% of all income tax. Middle income folks making between $50,000 and $100,000 accounted for another 20% of taxpayers and paid about 18% of the tax. But the top 10% -- taxpayers reporting an income more than $100,000 – paid 75%, or $24.6 billion, of the state's personal income tax. The message here is not that we should feel sorry for the wealthiest Californians. It's that we should hope that they stay wealthy **and** Californians. Because, economically speaking, if they get sick or move, all the services they pay for – from public schools, to health and welfare programs for the poor, to environmental protection-will suffer along with them."

the right to cut through the political rhetoric – especially when, with things as they stand in California alone, the world's 5th largest economy is already having problems paying its bills?[15] Perhaps voters, if they were given a direct say in the matter, could offer a suggestion or two. And then, perhaps, when asked to vote for a given bond or change in tax policy going forward, we would be better equipped to make informed decisions.

Failing that? Maybe the thing we really need is a 21st Century, Boston Tea Party![16]

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[15] U.S. Department of Commerce, Bureau of Economic Analysis

[16] "Boston Tea Party," Cassandra Jansen, *From Revolution to Reconstruction* – an .HTML project, November 11, 2002. "In 1773, Britain's East India Company was sitting on large stocks of tea that it could not sell in England. It was on the verge of bankruptcy. In
an effort to save it, the government passed the Tea Act of 1773, which gave the company the right to export its merchandise directly to the colonies without paying any of the regular taxes that were imposed on the colonial merchants, who had traditionally served as middlemen in such transactions. With these privileges, the company could undersell American merchants and monopolize the colonial tea trade. The act proved inflammatory for several reasons. First, it angered influential colonial merchants, who feared
being replaced and bankrupted by a powerful monopoly. More important, however, the Tea Act received American passions about the issue of **taxation without representation** and the colonists responded by boycotting tea. Unlike earlier protests, this boycott mobilized large segments of the population and helped to link the colonies together in a common experience of mass popular protest. On the evening of December 16, 1773, three companies of fifty men each, masquerading as Mohawk Indians and led by Samuel Adams, went aboard the three ships anchored in Boston Harbor, broke open the tea chests, and heaved them overboard."