



# INVESTMENT STRATEGY UPDATE

July 1, 2008

## **THE IMMINENT TAX HIKE**

The U.S. presidential race is now well underway. But no matter what the political rhetoric or who eventually wins, we believe dramatic changes are coming in the way investors will be taxed. Although there is not much in the tax code currently slated to change in 2009, we know that without any action on the part of our politicians, there will be significant increases in income, estate, and capital gains taxes in 2011. Probably more influential to future taxes than the race for president is the strong likelihood of a significant pickup of House and Senate seats by the Democratic Party. Coupling this increase with large budget deficits and problems with the current tax code makes us believe there will be some sort of compromise tax legislation that raises rates, possibly as early as next year. Given that assessment, we believe now is the time for investors to consider any large unrealized capital gains in their portfolios, as well as their exposure to low-growth dividend-paying stocks.

### **A Quick Primer on Our Tax System**

The overall tax system in the United States is extremely complicated, with both regressive and progressive elements. In other words, some taxes disproportionately affect the less-well-off, while others clearly target the wealthy. For example, gasoline taxes represent a much larger portion of a typical factory worker's income than that of a highly compensated CEO, almost regardless of how much each drives. Similarly, 100% of the worker's income is subject to Social Security tax, while most of the CEO's is not. On the other hand, the CEO pays at a much higher income tax rate than does the worker.

Because the system is so complicated, most people probably don't have a good idea of how much they actually pay in total taxes. In fact, despite the overwhelming focus on the various tax laws passed during President Bush's two terms, the reality is that those laws affected only 45% of the average American's tax burden. They had no impact on payroll taxes (26% of the tax burden), property taxes (10.8%), or sales taxes (10.5%). Nonetheless, because that 45% represents personal income, capital gains, corporate income, and estate taxes, it is the most relevant to investors.

In this regard, the current tax structure in the U.S. is based on the Economic Growth and Tax Relief Reconciliation Act of 2001. The 2001 Act was then modified by what we will refer to simply as "the 2003 Act" and "the 2005 Act." Collectively, they constitute the "Bush tax cuts." The thrust of the 2001 Act was to lower ordinary income tax rates (creating a new 10% bracket), lower the estate tax rate and raise the exemption amount, and raise the deductible contribution limits for retirement accounts. The 2003 Act was an adjustment to the 2001 Act that accelerated

the reduction in ordinary income tax rates, provided the first Alternative Minimum Tax “fix” by increasing the exemption amount, and, most importantly to investors, lowered the long-term capital gains tax rate for the highest-bracket taxpayers from 20% to 15% and lowered taxes on qualified dividends to the same 15% rate. The 2005 Act extended the lower capital gains and dividend tax rates by two years.

In addition to all of those changes, the Bush tax cuts contained a major twist: All of the provisions enacted will “sunset” or disappear as of the 2011 tax year, when rates will revert to those of 2001. If not changed, this sunset would obviously result in higher tax rates across the board, with the impact being felt most keenly, in percentage terms, on estate taxes.

## **What the Candidates Say**

### *Capital Gains*

The status of the laws’ capital gains provisions is of great import to investors. Originally, the very attractive 15% long-term capital gains tax rate was slated to expire this year, however the 2005 Act extended this provision through 2010. In theory, this extension could mean that we have three years in which to sell any appreciated stock positions that might be too large or that only have modest long-term investment potential. This theory, however, does not consider the impact of politics. The two presidential candidates have stated vastly different views on what our tax code should look like, and the result of the November elections will determine the likelihood of an earlier change in the law. Although not originally in favor of them, John McCain now supports the Bush tax cuts and wishes to make them permanent. On the other side of the aisle, Barack Obama would like to see capital gains tax rates rise to 28% for people with annual incomes greater than \$250,000.

### *Estate Taxes*

The most ludicrous aspect of the sunset provision in the Bush tax cuts is that, effective January 1, 2011, it reinstates a 55% tax rate on estates larger than \$1 million, while there is no estate tax at all in the year 2010. Naturally, each candidate has a preferred alternative to the current scenario, with Obama wishing to keep the 2009 estate tax rate of 45% and an exemption of \$3.5 million indefinitely, while McCain is aiming for a 15% tax rate on estates worth more than \$10 million. Our expectation is that the urge to fix the estate tax problem, coupled with the desire to reduce the budget deficit, will lead to some sort of 2009 compromise bill that is likely to include capital gains and, perhaps, other tax rates as well.

### *Dividend Income*

Dividend income could very well be a part of such compromise tax legislation. Under the current laws, qualified dividend income is taxed at 15% (the same as long-term capital gains) and is slated to be taxed at that rate through 2010. McCain’s blanket policy statement of making the Bush tax cuts permanent would, of course, leave that tax rate in place. He would also seek to lower corporate tax rates, from the current 35% to 25%, to ameliorate the effect of double taxation of dividends. Obama has not indicated a desire to lower taxes for large dividend-paying corporations and has observed that dividend income should be taxed at the same rate as ordinary income, as it was before 2003.

## **The Political Calculus**

While not pretending to be political experts, we do at least try to be attentive to political trends. We are certainly not alone in assigning a very high probability to a strong Democratic majority in both the Senate and the House in 2009. McCain may win the presidency, but we can be fairly certain that 2009 will not see a new law that makes the Bush tax cuts permanent. While the chances of a Democratic White House and Congress certainly appear good, we also assign a fairly low probability to a filibuster-proof majority in the Senate. We believe that no matter who wins in 2008, there is a reasonably high likelihood of a tax law being passed in 2009, perhaps even retroactive to January 1. The terms and timing will, of course, be a function of who holds the most power, but it behooves investors to consider taking action this year. If we assume that such a tax law would seek to fix certain glaring problems, such as the estate tax issue, and balance the desires of both political parties, then we need to expect that tax rates will increase across the board.

## **Taking Action**

Subject to the caveat that we never like to see the “tax tail wag the investment dog,” we nonetheless believe that determining a desired level of exposure to large, low-cost-basis stock positions and selling at least part of the way toward that level in 2008 would make sense. After all, even if capital gains tax rates only increase from 15% to 22% in 2009, that could still overwhelm the performance of a mature, low-growth stock, or one whose investment theme may have run its course. The degree to which we trim positions will be a function of our perception of the remaining investment opportunity, the relative power each party appears to hold in Washington after the election, and, of course, individual client preferences.

The same calculus would go into our assessment of low-growth holdings that generate meaningful dividend income. In other words, we don't plan to worry about stocks that we own for potential capital appreciation that also happen to pay dividends, but if a stock is held primarily because of the dividend income it generates, it could be subject to future weakness due to investors' reduced preference for dividend income.

## **What the Market Says**

There appears to be a very clear correlation between changes in capital gains tax rates and stock market returns. During the ninety-one years from 1917 through 2007, there have been ten years during which capital gains taxes were reduced, and during those years the stock market returned, on average, 14.7%. Unfortunately, we do not foresee any scenario in which capital gains tax rates drop after 2008. History also tells us that when capital gains rates remained unchanged, the market still appreciated, averaging a 6.8% return for the seventy years with no change. Not surprisingly, for the eleven years during which capital gains tax rates were increased, stock market returns were a smaller 4.8%, on average.

## **Market Commentary**

The U.S. stock markets have been stuck in a volatile trading range for most of this year. The S&P 500 was down as much as 14.4% for the year on “Bear Stearns Monday,” when the Federal Reserve Board forced the merger of Bear Stearns into JPMorgan. It then rallied strongly through mid-May, and now, once again has retreated to new yearly lows.

Interestingly, the situation is much worse in Asia, where the Hong Kong market is down 20%, India’s BSE is down 34%, and the more speculative Shanghai market is down 48%, so far this year.

Portfolio performance in the U.S. stock market during this period has primarily been a function of exposure to just a few key sectors. With little stabilization in the housing market, the financial de-leveraging process goes on, as banks, brokerage houses, and insurance companies have continued to record huge mortgage-related losses. Having been forced to sell assets and raise additional capital, financial stocks have performed quite poorly. On the other side of the coin are the energy and natural resource stocks. Oil prices have jumped to levels beyond what most people consider sustainable, yet there is no clear indication of where they will eventually peak. China now accounts for 70% of new oil demand, and there is little sign of a slowdown. Economic growth in China continues to be strong and sales of SUVs are growing three times faster than are sales of smaller cars. Of course, we like to say that the best cure for high oil prices is high oil prices. Over time, people will adjust their habits and investment capital will find its way into new technologies that change the status quo and ultimately even improve the way we live.

In the meantime, however, rising energy prices keep the stress on global consumers, forcing them to cut back on discretionary spending, and increase cost pressures for nearly all businesses. Another concern we have is the recent dramatic shift in rhetoric by the Fed, which is now emphasizing the risk of rising inflation, leading us to believe that there is a strong likelihood of future interest-rate increases. This shift has already caused interest rates to back up, with the yield on 10-year Treasury notes rising from approximately 3.4% to 4.0% in the past three months.

However, as we noted last quarter, with crisis comes opportunity. We are convinced that the Fed will do all it needs to in order to keep the financial system viable. If long-term interest rates rise further, we would take that as the first signal in more than a year to buy bonds more aggressively. Regarding our equities exposure, we are closely monitoring the path of oil prices, inflationary pressures, and the general state of the U.S. and global economies. For now, we maintain a relatively defensive stance, keeping buying power intact. Yet we also believe that a buying opportunity will soon be upon us. Ultimately, U.S. corporations are in excellent shape and stock market valuations are quite reasonable. Furthermore, there remains a huge amount of cash on the sidelines. Investing is a long-term endeavor and U.S. equities are quite attractive overall, in our opinion.

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