# Trusted Advisor

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## New Tax Law Spells It Out:

**"T-H-I-N-K *V-A-L-U-E*"**

Readers of this newsletter know we seek value not thrills. But it was thrilling to learn on May 26, that Congress had passed a new tax bill with tremendous incentives for intelligent investing included. Frightening deficits will result if Federal spending is not reduced to match lost revenues, however this bill did something very right: it encourages people to be smart investors.

**Dividends:** Dividends will now be taxed at a maximum rate of 15%. For couples in high tax states like California, with taxable incomes over $172,000, this compares very favorably with interest income, such as that received from taxable bonds or savings accounts, taxed at about the 40% marginal bracket. Even tax free bonds may no longer make tax sense for many investors.[1]

The market for financially sound companies that can generate cash flow and pay it out is about to expand dramatically. We are glad to own many such companies for our clients and expect to be rewarded in the months ahead.

Once, investors absolutely insisted on receiving substantial dividends from their stock holdings. Prior to the early 1960's it was normal for the dividend yield on stocks to exceed the interest paid on corporate bonds. Since stocks are a riskier investment, this only makes sense. Over time, both Corporate America and the Wall Street investment bankers managed to convince the analysts, institutional investors and the little guy that it would be better to let management hang on to corporate profits rather than paying them out as taxable dividends. Sometimes this is a good thing. If there are outstanding reinvestment opportunities for a company, such as improvement of a drug to expand it's healthcare applications, then the money is better employed for "plow back" than for dividends. But corporate management has, as often as not, shown itself to be woefully lacking in talent when it comes to investing shareholder's money. With encouragement from Wall Street some companies, like ITT Industries (ITT) became "conglomerates", buying up many disparate businesses under one roof. It is a rare management team that can successfully understand and compete in everything from hotels to defense electronics to copiers.[2]

In many cases, it is better to pay out a high percentage of profits to the owners. Example: Microsoft is sitting on some $43BB of short term cash, with no apparent good use for it. What are they planning to do with all this money? Invest it in more high tech losers? Gates, Ballmer and Co. definitively proved their incompetence during the tech bubble of the late 1990's by investing in a slew of internet start ups and, like everyone else, Microsoft lost a lot of money.[3] With earnings now growing at only 10% per year, this mature company is, like the old Ma Bell, a monopoly, a mature company that should pay fat dividends to shareholders.

**Capital Gains:** With the exception of Real Estate Investment Trusts (REIT), long term capital gains on most property will now be taxed at a maximum rate of 15%. For families in high tax states like California, with taxable incomes over $172,000, this compares with short term gains that are taxed at about the 40% marginal bracket. Clearly, jumping in and out of stocks sacrifices a sizeable tax benefit.

Certified Financial Planner™

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## How to Invest for Optimum Profit

The new tax law is intentionally skewed to encourage thoughtful, long term investing, the precise approach we preach and practice for our clients every day. No wonder I was beaming when the law's new provisions were announced! Not surprisingly, most of our holdings have been on the rise since the new law was published. Dividend paying companies stabilize a portfolio. According to Standard and Poors, during the disastrous market year 2002, when non-dividend members of the S+P 500 index declined 30% in value, dividend payers fell only 18%.[4] So far this year the high dividend paying Dow Jones Utilities are up 14.45%, as compared with the Dow Jones Industrial Average, up 8.65%.

The new tax law is great, and makes investing a more profitable occupation, but as a Certified Financial Planner™ practitioner, I try to add a structural advantage by avoiding taxes altogether. How do you spell tax free? R-O-T-H. A surprising number of people qualify for a Roth IRA, which can be funded each year in the amount of $3,000-$3,500 (people over age 50). If you are not covered by a qualified retirement plan at work, you can fund a Roth with no restrictions. Even if you are covered at work, unless the Adjusted Gross Income of you and your spouse exceeds $150,000, you too can have a Roth. Conversions from regular IRA to Roth IRA sometimes make sense too. We help people determine the best course to take, because zero tax is always better than non-zero tax!

## Is It Better to Stay in Cash or to Re-Enter the Stock Market?

My conversations with a wide variety of people suggest that there is a lot of money sitting on the sidelines, squirreled away in money market accounts. In most cases, this produces a negative return. If you are earning 2% on a Certificate of Deposit, and in a 25% average tax bracket, you net 1.5% on your money. Then, as the cost of living rises about 2.5%, you lose 1% per year in buying power. Most folks were just fine with this math while watching the stock market crater. After all, minus 1% was better than minus 22% in 2002. But my sense is that as the stock market has been climbing and home values soaring, there is discontent the MoneyMarket Land. What to do?

First, put *some* money back into stocks! Equities have made many folks wealthy when they invest in great businesses for the long haul. Common stocks have recently undergone the worst beating in a generation. While I suspect we will not see a booming market ala the 1990's again, well chosen companies can produce respectable positive returns after taxes and inflation, starting right now.

Stocks are, however, only one alternative to money market funds. For my clients, stocks are the back bone of the portfolio (perhaps 40%) but they are by no means the only portfolio holding. In the past five months, real estate investment trusts (REITS) holding warehouses, shopping centers and multifamily dwellings in a diversified mix, have produced returns of over 10%, and an average annual rate of return of about 6.5% for the past five years (compare that to the S+P 500, down about 1% annually).[5] Clients are doing well in a diversified fund of foreign bonds, where we've enjoyed a mouth watering 28% growth in value.[6] Neither of these investments derives momentum from the stock market.

If you are stuck in the money market rut, it may be time to get up and out and back on track to build your net worth for the future!

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**1.** We've been pleased to place clients in a natural gas utility with dividends north of 6%, an after tax yield of 5.1%.

**2**. ITT divested many of it's far flung operations during the 1990's and now operates in four major segments which all benefit from competancies in engineering.

**3.** In 2001and 2002 the company recognized $9.1billion in investment losses, primarily in the cable and telecommunications industries.

**4.** Wall Street Journal, January 7 2003

**5.** Source: Morningstar online, reporting the results for Franklin Real Estate Securities Fund

**6.** Source actual portfolio performance for clients of Gary E. Miller, late June 2002 to May 30 2003