

INVESTMENT OUTLOOK & COMMENTARY

Third Quarter, 2007

Summary: The liquidity-fueled equity rally continues, and we've maintained a healthy allocation to equities despite our rising apprehension. While market valuations remain very reasonable, market risks are mounting in the form of higher U.S. tax rates and protectionist legislation. Both, in conjunction with an already-precarious U.S. housing and mortgage situation, have curbed our longer-term optimism for equity markets. Reducing equity exposure appears to be a question of "when" rather than "if".

Despite rising market volatility and rising nervousness on our part (more about this shortly), we're still well invested in equities. We could point to enduring earnings growth—companies should exceed eight percent earnings growth in 2007—or at the market's attractive 15 times price/earnings multiples for justification; but the main reason for our relative bullishness in equities is liquidity.

Thanks to low global interest rates and high economic growth, money is everywhere and being thrown at just about everything at a time when equity supplies are shrinking through company stock-buybacks, mergers and acquisitions, and private equity firms taking publicly-traded companies private through leveraged buyouts. Some \$2.7 trillion worth of acquisitions have been announced worldwide so far this year, representing a 62 percent increase versus this time last year. This higher-demand, lower-supply dynamic has caused a nice "melt-up" in stock prices.

Liquidity-led rallies are, however, temporary as the cost of capital (interest rates) and the return on capital eventually converge. Surely, as interest rates rise worldwide, acquisition activity will drop; however, that's not the cause of our concern. Along with the shaky housing market we illustrated last quarter are serious risks stemming from a political movement that, if enacted, would likely mean a grim environment for investors.

The Last Hurrah

There's a saying that goes: Economic expansion and equity bull markets usually don't die of old age—they are assassinated. Believers in this maxim generally agree the assassin is always a governmental policy *faux pas*. Examples of these abound: The Tariff of Abominations in 1828 protecting Northern industrial interests at the expense of Southern cotton growers and perhaps being the greatest factor in causing the Civil War; The Smoot-Hawley Tariff Act in 1930 making a recession a Great Depression; Nixon's price controls of 1973 causing inflation and an oil and gas shortage; loose monetary policy by then-Federal Reserve Chairman G. William Miller in 1978 causing stagflation; Alan Greenspan's post-Y2K

interest rate hikes exacerbating a market correction and causing a recession. These monumental policy mistakes, and more frequent smaller ones, were followed by significant losses in the stock market.

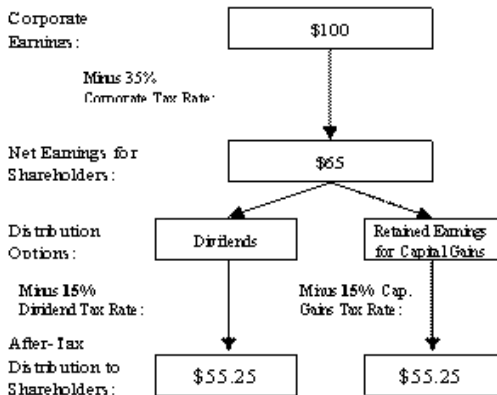
Unless things change significantly, Washington is yet again headed for policies of higher taxation and protectionism that will damage equity markets and our zero income-saving, asset-based economy as a whole.

We've long lamented the end of 2010 expiration of the 2003 Bush tax cuts where a myriad of tax rates move upward including earned income, capital gains and dividend income. At that time, federal tax rates for capital gains are scheduled to move from 15 percent to 20 percent; dividend income will rise from 15 percent to nearly 40 percent. The easy prognostication is widespread selling pressure leading up to the expiration as investors book their investment gains at lower tax rates.

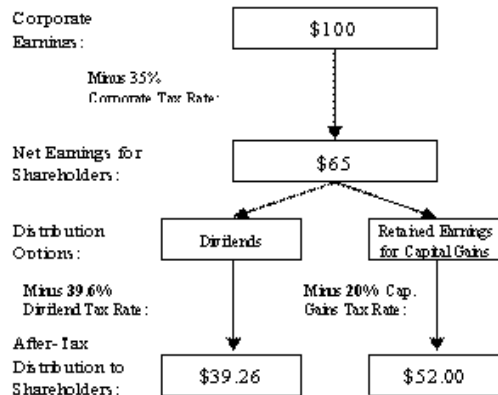
The effective tax increases may actually come sooner. With Democrats firmly in control of Congress and favored to win the presidency in 2008, one of Washington's first acts would be to expedite the tax increases, presumably starting 2009. Worse yet, current proposals to "fix" the growing problem of the Alternative Minimum Tax could raise taxes immediately. A Bush veto is not a given as he may concede higher tax rates in a horse-trade for continued funding for the Iraq war.

Our view that higher tax rates on investing will result in lower markets is rooted in the mother's milk of stock prices: after-tax earnings. The diagram below illustrates the proposed tax increases' effect on after-tax earnings:

Current After-Tax Returns for Shareholders



Proposed After-Tax Returns for Shareholders



Decline in after-tax return via dividends: -28.9%

Decline in after-tax returns via retained earnings/capital gains: -5.9%

Suppose that a company has \$100 of pretax earnings. After the 35 percent corporate tax rate, \$65 is available to shareholders. Here, management has the option of paying the \$65 as a dividend, where the shareholder will then receive \$55.25 after paying the 15 percent federal dividend tax rate (to simplify, let us ignore state and local taxes), or retaining the \$65 profit, where the value of the company theoretically increases by the same amount and represents a capital gain for shareholders. With capital gains taxed at 15 percent, the after-tax gain to shareholders via the earnings-retention option is, as with the dividend option, \$55.25.

Although its timing remains somewhat uncertain, capital gains tax rates at some time look to rise to 20 percent and dividend tax rates will rise to income tax rates, of which its highest rate is 39.6 percent. The diagram on the right shows that while shareholders receive less due to the tax increases, distributing earnings as dividends becomes far less appealing to investors than by capital gains. After-tax distribution to shareholders through dividends decreases 29 percent under the tax hike; through capital gains, the decrease is 6 percent.

Since dividends and capital gains are why investors purchase equities, the tax hikes inherently make equities less attractive. All things being equal, we would expect the market to revalue itself downward starting sometime before the tax hikes are enacted. Capital gains' relatively higher after-tax distribution will favor “growth” companies who retain earnings over “value” companies that typically pay out a larger proportion of earnings. Tax policy is obviously a partisan issue, and staunch resistance within Congress and from the White House to increasing taxes could, we hope, delay the tax hikes to their original 2010 expiration.

Meanwhile, there is strange bi-partisan support for protectionist measures and what amounts to China-bashing. Washington seems convinced that America's savings ills should be blamed on China and its fixed exchange rate to the U.S. dollar. Concerns over the trade deficit, exportation of certain jobs, and trade's impact on America's independence suggest protectionist measures, such as a tariff on Chinese goods, have a good chance of materializing, perhaps as soon as this year.

A trade war would likely result in retaliatory tariffs, higher inflation, lower economic growth, and an end to the worldwide equity bull market.

Watching and Waiting

Besides higher taxes and more protectionism, the U.S. housing market and the trillions of mortgage-related securities continue to worry us. Bear Stearns's recent announcement of significant losses in its mortgage-backed securities may be the first of many from Wall Street banks, insurance companies, and hedge funds that hold substantial amounts of mortgage-backed debt and the derivatives based on them. That mortgage-related securities amount in the tens of trillions of dollars creates the possibility of the next financial crisis. In addition, the price of homes are still being monitored as lower prices will likely place further strain on consumer spending—the heart of the U.S. economy.

For now, risks and volatility continue their ascent. While we remain in equities and are participating in the markets' "last hurrah", we're monitoring the markets as closely as ever. Should the liquidity-effect give way, we'll quickly reduce equity exposure in favor of Treasury bonds that should out perform in a deflating economy.

Neil Rose, CFA
Chief Investment Officer