

## EARLY MUSINGS

November 17, 2008

Now that the voters have spoken, our economic future is coming into focus. While much of that future still remains blurred, we expect increasing clarity over the next six months. In the meantime, I have come up with several conclusions that will likely be used in developing our investment strategy for the next couple of years.

Americans have decided that government should play a bigger role in their financial security while at the same time deciding that government also needs to change. It is that new role, prompted by change, which will largely determine our economic outlook until Americans vote again in two years. The change, now being defined by congressional and senate leaders, is becoming quite clear, but the new White House views on it remain unclear. I find myself hanging on every word president-elect Obama utters in the hope that I can get a more convinced sense of direction. Admittedly, understanding Alan Greenspan was an easier task.

First, we must realize that all the individuals in charge are advocates of big government. Without exception, the power players in the Senate and the House of Representatives all advocate more government programs, more government control, and more government regulations. New programs for health care, alternative energy, college tuition, economic stimulus, tax rebates and financial bail-outs will cost money. Accordingly, we can expect to be looking at trillion-dollar annual deficits as a result of new government intervention and program costs. The prospect of such large deficits will surely drive the new Washington elite in search of new fees and taxes.

There are really only four key places where sufficient monies can be found to help pay for the new programs:

**Wealthy Individuals:** To date, the definition of wealth has been confined to income levels and capital gains. There have been no advocates for taxing the after-tax accumulation of wealth, so we expect the tax rates on income, social security wages, capital gains and dividends to increase for those Americans fitting the definition of “wealthy”. For most of us, this has been expected. Any attempt to “fix” the alternative minimum tax (AMT), however, should be watched carefully, as it will likely carry much higher effective tax rates for those few caught in the AMT trap. The AMT fix will likely be targeted at the upper 2-3% of taxpayers.

**Unrepatriated Earnings:** Currently, the tax code effectively allows American corporations to exclude foreign earnings from a U.S. tax if these earnings are kept over seas. Of course, the foreign country taxes are paid, but this rule is a tax haven to many of our best companies simply because the U.S. corporate tax rate is the second highest in the world. A new unrepatriated earnings tax would yield a “mother load” of new tax revenues, but it will be harmful to many of our best companies. We feel the likelihood of such a tax is fairly high. Herein lies the reason for selling many of our favorite companies in client portfolios. A tax on unrepatriated earnings will affect the free cash flow of these corporations which in turn will effect the valuation of the underlying shares.

**Private Retirement Accounts:** The tax-free accumulation of funds in private retirement accounts has been the foundation of financial security for many American families. The aggregation of these funds amounts to a sum well into the trillions. Under consideration in the Education and Labor Committee in Congress is a proposal to nationalize these funds (401K Plans) in return for a Treasury note, guaranteeing the proceeds upon retirement for each participant. At retirement, each participant will receive an annuity from the Federal Government. While this nationalization will yield enough cash to pay for the \$700 billion bail-out, it will deny the use of these savings for each individual. Obviously, if this proposal gains momentum, it will trigger much selling in the markets by those trying to escape with their savings. Paying the tax and “getting out of Dodge” may be an option chosen by many small business owners.

**Restricting the Existing Budget:** The fourth and perhaps the most obvious source of funds will be our existing budget. Simply put, the taking of money from one area and spending it in another will have different consequences for different companies. The sector in which a company operates in will be key. Committee chairs are already expecting a 25% cut in the defense budget. As a result, we can expect defense stocks to be vulnerable to these budget shifts.

Obviously, none of these conclusions are positive for the long-term economic outlook. Increased taxes, regulations and nationalization all work to erode the confidence of investors, and it is no surprise that the market has been selling off in anticipation of much of this.

The corporate beneficiaries of the new programs represent the silver lining in the outlook. An infrastructure repair program will help certain construction related firms. The “green” movement will likewise benefit certain companies. We are sifting through the data for the gems in this regard.

Additionally, we expect the dollar to ultimately weaken as these expected programs and policies are implemented. If our analysis is correct, the current strength of the dollar will give us a wonderful opportunity to invest in great foreign companies when the time is right. Presently, there are many cross-currents in the currency markets as the financial crisis frightens capital into safe havens and Americans dis-invest in foreign markets. Timing will be everything for this part of the strategy and we will likely be implementing it gradually.

The commodity markets, likewise, have been destroyed recently and most critical commodity prices are at bargain basement levels. You can expect us to bargain hunt for good commodity producers once our trade policies are defined and the economic bottom can be anticipated. Until then, cash is king and we have loads of it in portfolios.

At the end of the day, we expect a portfolio comprised of good global companies that are foreign-based, special situation U.S. companies that won't be negatively affected by foreign earnings taxes, yet positively affected by a weaker U.S. currency. Bonds will likely be inflation-protected. Lastly, the portfolio should be hedged against any potential currency shock.

This may sound like a tall order, but we plan to get there incrementally as the picture becomes clearer and as it confirms our thinking.

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