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The Bush Investor Relief Plan -

Good for Value Investors

By Daniel R. Sharp, Ph.D

In early 2003 the Bush administration proposed a massive tax cut, with some cuts aimed squarely at investors. Following within weeks was a proposed massive overhaul of the U.S. retirement system that would create new tax-deferred savings accounts and eliminate others. These two proposals are geared to promote long-term investing in dividend-paying stocks, which are two important tenants of value investing. First we will take a look at the investor tax cut proposal, and then follow up with an overview of the proposed changes to retirement plans.

The President made the proposal to end what he called the **"double taxation" of dividends**. Currently, dividends are taxed twice: Companies pay dividends out of earnings that have already been taxed, then shareholders pay ordinary income tax rates on dividends received. The common perception is that, by the time this bill passes Congress, it may be whittled down to a 50% exclusion of dividends. Even this will cause a double benefit for current holders of dividend-paying securities. Investors that hold dividend-paying securities in taxable accounts will get the tax break, but more importantly, all investors holding dividend-paying securities, whether in a taxable, tax-deferred, or tax-free account, will benefit from increased stock prices. Investors should find dividend-paying securities more attractive because of the tax break. No one cared about dividends four years ago when stocks were returning 20% a year, but right now a 5% dividend looks nice while your stock is treading water in a poor market.

An additional little known component to the dividend tax reduction policy is a provision for "deemed dividend reinvestment plans," or **DDRIPs.** The name is a

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Market Update March 2003

This quarter went exactly as expected until the last two weeks of the quarter in January. The market showed rebounding strength through Thanksgiving, gave a little back in early December due to tax loss selling, and then started January with several strong weeks. Then the spotlight on the seemingly impending war with Iraq clipped 10% off the market in two weeks

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little confusing — the provision would not create a new kind of shareholder account or stock purchase plan. Rather, a DDRIP would be a notional "account" — an accounting category on the books of a public company — to record the value of retained earnings that have been subject to corporate income taxes. When a shareholder sells stock, any per-share growth in the company's DDRIP account would be deemed dividend — and dividends would now be tax-free — thus reducing the amount of capital gains subject to taxation.

Suppose you buy a stock at $100. Over the next year, the company makes $2 per share in earnings, after paying corporate taxes. At the end of the year, you sell the stock at $110. Instead of paying capital-gains taxes on your whole $10 gain, you get to exclude the $2 in earnings — just as though it had been paid out in the form of a dividend. You only pay capital-gains taxes on $8 instead of $10 — effectively, it's a 20% reduction in capital-gains taxes. In theory, for long-term investors, it may be possible to completely eliminate capital gains taxes on a taxable position by simply holding it long enough and letting the retained earnings of the company track the stock price in the long-run and when harvest time finally does come – you have a tax free transaction. Now that's America!

Part II of the Bush investor relief plan is responding to concerns that **most Americans are not socking away enough money to live comfortably in retirement.** The White House wants to lift income restrictions and expand contribution limits to make it more attractive for investors to put money into tax-deferred accounts. All existing retirement plans would effectively be replaced by an LSA (Lifetime Savings Account), RSA (retirement savings account) and an ERSA (Employer Retirement Savings Account).

The **LSA** is the most flexible and the first account investors should fund. There are no age or income restrictions, penalties or taxes (ever). There is a proposed starting annual maximum contribution of $7500 and proceeds that can be withdrawn for any reason.

A family of four, for example, can have four LSA's in which they can save $30,000 a year, and grandparents can fund children's LSAs.

If you haven't tapped out your savings after fully funding your LSA, the next step is funding the **RSA**, which replaces today's IRA and Roth accounts. Investors will be encouraged to convert current IRA's to RSA's, but it is like a Roth conversion in that the amount converted is fully taxed as ordinary income. The first year the RSA is available, just like the Roth conversion, the IRS will allow you to declare the conversion "phantom" income over four years. Conversion will not be mandatory, and IRA's can still be maintained, but no new contributions to IRA's will be allowed after 2003, although rollovers from 401k's, etc. are still allowed. The RSA will have the same basic restrictions as today's Roth but with a higher annual contribution limit – starting at $7500 per year. No mandatory withdrawals at age 70, no taxes on proceeds, but penalties apply to withdrawals prior to age 58.

Both the LSA and RSA are individual savings accounts; the **ERSA** is an employer savings account meant to consolidate the 401k, 403b, and 457, SEP & SIMPLE employer retirement plans. Unlike the LSA and RSA, the ERSA is funded with *pre-tax* contributions, lowering your current income taxes, but is a *tax-deferred* account, not tax-free like the LSA and RSA. This means that investors will pay taxes for distributions, and it is likely that mandatory distributions at a certain age will apply.

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Yet there are benefits over current employer retirement plans such as lower administrative costs resulting from the differences between various types of current plans, and less onerous reporting rules by the IRS.

All of this is at the beginning proposal stage - but if these proposals do become law, we could be looking at the most exciting pro-growth tax policy since the Reagan years. And after three miserable years of the worst bear market in a generation, and after 15 years of wandering in the tax-policy wilderness, it may just be morning in America again. **$**

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time. As I've pointed out many times, geopolitical events have always affected markets negatively for a month or two, but in every case over the last one hundred years the market moves higher within three months of the event. I really believe we are faced with the rule and not the exception this time as well. Investors hate uncertainty, and if history holds, if and when war breaks out with Iraq, don't be surprised to see the market react positively, odd as it seems. This is exactly what happened at the outbreak of the Gulf War a dozen years ago, war broke out and the market had a huge rally that lasted several years. This time for "Son of Gulf War", we have the same stage set but even more reason for a rally – there was no three-year bear market preceding the original Gulf War, just a minor recession as we have now, and so valuations and interest rates were not as low as they are today.

While the geopolitical uncertainties have a vice grip on the market right now, they are overshadowing signs of improvement in the economy, which is far more important to a sustainable rally over the next couple of years. Many major factors have all improved over the past few months both economically and in terms of market valuation. Short-term interest rates are at their lowest levels in thirty years. Short-term fixed-income investments are always the alternative investments to stocks, and now pay a 35% lower interest rate than the Dow dividend. Usually investors have to accept a lower dividend yield from stocks to participate in the market. The bond market is now where the stock market was three years ago, at multi-generational highs. Ultra-blue chip stocks with Triple-A ratings generally trade at a significant premium to bonds, around 25%. Currently these bluest-of-the-blue chips are trading at a 25% *discount* to bonds. The last time this happened was 1993, which was a great point to have started investing in stocks. So both savings and fixed income investments do not look very attractive to investors for the foreseeable future. While absolute PE ratios still remain high by historical levels, the 40-year low in interest rates would normally result in much higher PE ratios, and when adjusted for this, the PE of the market is at its lowest point since 1955. The balance sheets of major

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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companies have improved dramatically over the past three years. Companies have cut fat, cleaned up, reduced debt, and are set for a good run of profits based on increased productivity, low inflation, and low interest rates. Finally, economic policy has become stimulative again after several years of being increasingly de-stimulative. The Federal Reserve spent much of the late 90's putting the brakes on the economy, now we've got the gas pedal floored. Low interest rates, liquidity, and stimulative fiscal policy in the form of proposed tax cuts and revamping of the retirement system is a triple combination that should allow the nation's economy to return to solid growth. In summary, low valuations, unattractive alternatives, improving corporate results, and a stimulative economy all stack up in favor of stocks.

While I was really hoping that this quarter would be the death of the bear market, the conflict in the Gulf region has likely delayed the recovery, but only by one quarter, possibly two at the most.

This latest buying opportunity may be the last for some time, and although we've had plenty of "buying opportunities" over the past nine months we can't see much else depressing this market once the war situation gets resolved. The odds are strong that anything done in Iraq would be quick and clean, which would certainly have the potential to ignite the markets. It would be unprecedented for the markets to experience a fourth straight year of declines, and so we think that a sustainable rally will start in 2003**. $**