A Potpourri of Topics

The curious word “potpourri” is not pronounced phonetically in English perhaps because of its convoluted journey into the language. It originated as the Spanish phrase olla podrida, literally “rotten pot” which referred to a spicy stew of meat and vegetables from the town of Burgos. It also had the connotation of a mixture or medley. When Napoleon’s troops invaded Spain during the Napoleonic Wars, they translated the name of the tasty stew directly as olla pot (pot) and podrida /pourri (rotten). The phrase soon entered the English language (thanks to Wellington’s men?) as a single word with the second connotation, a miscellaneous collection or anthology. It also came to mean a mixture of dried flowers and spices used to freshen the air. The word retained its French pronunciation making it a terror in spelling bees.

We thought our readers might enjoy a refreshing potpourri of short topics rather than our usual lengthy article on one subject. So we offer three savory items for consideration.

Aspiring to 1%

The Occupy Wall Street movement, many members of the political class, and some political commentators have pointed to the “unfair” distribution of income in the United States as a problem demanding a solution. Some cite the groundbreaking research of the French economists Thomas Piketty and Emmanuel Saez, “Income Inequality in the United States, 1913-1998” (NBER Working Paper 8467), as the justification for sharply higher marginal income tax rates. Those economists claimed that the top 1% of U.S. taxpayers more than doubled their share of total U.S. personal income from around 10% in the 1970’s to over 20% today.

A paper they released in November 2011 argued that the optimal rate on high earners could range between 57% and 83% (depending on certain assumptions) without adversely impacting those earners’ incentive to work. Perhaps their research inspired Francois Hollande, France’s newly elected Socialist president, to propose a 75% tax rate on French citizens with incomes over 1 million euros ($1.3 million). Their work certainly reinforced the opinion among some political leaders that higher tax rates on “the rich” would not negatively impact economic growth. Others would strenuously disagree.

We will sidestep that debate trusting that our longtime readers can guess which side we would support. Instead we show the updated Piketty-Saez data through 2010 so curious readers can determine where they stand in the income distribution. The professors used IRS pre-tax data for total income (which includes capital gains). They broke the data into percentiles showing the threshold income required to get into each.

<table>
<thead>
<tr>
<th>Percentile</th>
<th>2010 Threshold Total Income</th>
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</thead>
<tbody>
<tr>
<td>Top 10%</td>
<td>$108,024</td>
</tr>
<tr>
<td>Top 5%</td>
<td>150,400</td>
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<tr>
<td>Top 1%</td>
<td>352,055</td>
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<tr>
<td>Top ½%</td>
<td>521,246</td>
</tr>
<tr>
<td>Top 1/10%</td>
<td>1,492,175</td>
</tr>
<tr>
<td>Top 1/100%</td>
<td>7,890,307</td>
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The threshold to be among the reviled “one percenters” was a total income of $352,055.

A and Not A

Chief Justice John Roberts stunned many political pundits by siding with the liberal faction of the Supreme Court on the question of Obamacare’s constitutionality. The crux of the issue was the individual mandate requiring the purchase of health insurance or the payment of a penalty. The Chief Justice wrote the 59 page majority opinion and rejected the government’s primary argument for the constitutionality of the individual mandate - that it was permitted under the Commerce Clause. He then proceeded to find the mandate valid according to the government’s secondary argument - that it was permitted under the Congress’s enumerated power of taxation.

That finding perplexed many observers because nowhere in the Patient Protection and Affordable
The Ever Conflicted Market

Whenever fraud, theft, or Ponzi schemes occur on Wall Street, investors rightfully question the ethics of the entire industry. After all, Bernie Madoff and Allen Sanford weren’t just blatant lawbreakers. They succumbed to the temptation that professional money managers face every day -- the temptation to act in their own self-interest instead of their clients’ best interests. The recent financial scandals remind us of this inherently unresolved conflict that lurks beneath the surface with even the most trustworthy of advisors.

Unlike a car salesman with a tangible product, a salesman in the financial services industry is the product. Even if he’s not directly making investment decisions, he’s either giving advice or endorsing a manager. And when counsel is sold, the salesman becomes part of the product. Therein resides the dilemma.

If we’re not careful, professional investors might succumb to the business pressure of getting and retaining clients by telling people what they want to hear rather than what they need to hear. This natural tendency to act like politicians, whose paramount objective is to stay in office, was clearly illustrated in a 1999 poll. Of the analysts and portfolio managers surveyed at major investment houses, most believed that a “major bear market” was likely even as they were advising their clients to stay fully invested.

How can this be? In 1936, John Maynard Keynes aptly described the reason in his magnum opus, *The General Theory of Employment, Interest and Money* when he wrote, “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” The sad reality is that professional investors are more likely to keep their jobs if they act like everyone else, employing strategies that won’t deviate too greatly from the market averages. When markets rise, everyone’s happy. When markets fall, managers can often convince their clients to hold on since the market will inevitably rebound. After all, it’s the long-term that counts.

This last assertion is certainly true. Prudent managers, however, recognize that major market downturns have caused long-term losses. They don’t ignore this risk by saying, “I can’t protect clients from another major collapse. If that happens, all bets are off.” This bias emanates from the short-term, job-threatening risk of missing a bull market. Professional investors must do their job of making unbiased judgments in order to see the risks and to protect their clients’ capital.

At Patton Albertson & Miller, protecting our clients’ capital is a key objective. We go to great lengths to resist the short-term bias of the investment advisory business and instead stay focused on our clients’ best long-term interests. Like all responsible wealth managers, we interview our clients to help them maintain an appropriate investment policy. If it’s a policy geared primarily for growth, then we look to invest a majority of the portfolio, say 70%, in stocks. Yet, unlike most wealth managers, we don’t blindly put 70% in stocks without considering the market environment. Our competition often ignores the question of relative risk between stocks and other asset classes. Many would put 100% of a growth-oriented investor’s account into stocks and leave it there. Again, they’re merely following the crowd.

We don’t. Our allocation to stocks is currently much lower than normal, even for our most growth-oriented clients. We’re not perma-bears. It’s just that, in our best professional judgment, we don’t think the financial crisis of 2008 has been resolved. As we have communicated many times, stock market rallies since the crisis have been fueled primarily by government fiscal and monetary interventions. The proverbial “can” has been kicked down the road multiple times. Yet the can has gotten heavier with each successive kick and the probability of a shock to the system that cannot be contained has progressively risen. Accordingly, it remains challenging for us to find undervalued stocks because market prices generally do not reflect this systemic risk.

Again, how can this be? It stems from the conflict of interest inherent to the industry of professional investing.

John Healy, CFA

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Care Act was the word “tax” ever applied to the “shared responsibility payment”, the teeth of the mandate. During the Congressional deliberations preceding passage of the law, lawmakers had been very careful to claim the payment was a penalty, not a tax. Chief Justice Roberts reasoned that for some purposes it was a penalty, not a tax, but for constitutional purposes it was a tax, not a penalty. A and Not A.

We read both the majority opinion and the 65 page dissenting opinion of justices Scalia, Kennedy, Thomas, and Alito. Both advanced clever, often subtle, arguments for their opinions and cited an array of constitutional law cases to support their respective positions. In the end, the logic of the dissenters, “The provision challenged under the Constitution is either a penalty or else a tax.” (567 U.S., 17) did not sway the majority of the Court. Obamacare survived constitutionally although not without substantial revision. The Court invalidated the law’s provision which severely penalizes states if they refuse to adopt vastly expanded Medicaid coverage. Several states including Georgia might decide to opt out of the expanded Medicaid program for fiscal reasons.

Nothing will really be settled until after the November elections. The Republicans have sworn to repeal Obamacare. President Obama must win to preserve it. Until then healthcare stocks remain under a cloud of uncertainty.

Hair of the Dog

The European debt crisis is now in its third year. The
The “Fiscal Cliff”
Will Municipal Bonds Fall Off?

“Fiscal cliff” is the moniker for a combination of fiscal policies that are scheduled to go into effect or to lapse in 2013. These include the expiration of the Bush tax cuts, the expiration of the 2% payroll tax holiday and emergency unemployment compensation, and the automatic budget cuts (sequestrations) written into last year’s Budget Control Act that resolved the debt ceiling standoff. Analysts estimate the combination of the tax hikes and spending cuts in total to be over $500 billion which is approximately 4% of GDP. A large number of economists think this enormous amount of fiscal drag could push the economy back into recession.

Laws, however, can be changed. Many in Congress agree that the massive Defense Department budget cuts, labeled “catastrophic” by Defense Secretary Leon Panetta, must be stopped. But getting there will require a bipartisan agreement, something that has been elusive in Washington. Further complicating matters are the upcoming elections and the need to raise the debt ceiling again in early 2013. The online political site “Politico” sees four scenarios:

1) Congress acts before November. They think this is the most unlikely outcome.

2) The Budget Ax falls. The doomsday scenario that no one wants.

3) A Lame-Duck Breakthrough. Freed from election pressures, lawmakers could be in a better mood to negotiate. Steve Bell of the Bipartisan Policy Center thinks, however, there would be just too much to sort out in the final 45 days of the year.

4) Partial Fix or a Delay. Congress comes up with a short term partial fix to stop some of the sequestration cuts and lets the new Congress in early 2013 come up with a longer term solution to taxes, spending, and deficit reduction.

The tax exemption of interest earned on municipal bonds could be at risk once Congress and the Administration get down to serious negotiations on tax reform and deficit reduction. The threat to tax-exemption is higher than any time since 1986 (the last major tax reform) and comes from both sides of the aisle according to George Friedlander, a long time municipal strategist at Citibank.

When first introduced in 1913, the federal income tax code excluded the interest earned by holders of debt obligations issued by states and their political subdivisions. Most legal scholars believed that any Federal taxation of this interest income would be unconstitutional because of the Tenth Amendment and the doctrine of intergovernmental tax immunity. Alas, the Supreme Court rejected this claim in 1988 in South Carolina v. Baker. While the ruling was a narrow one about the registration of new issue bonds and not broadly about tax exemption directly, the Court went on to warn “… owners of state and local bonds have no constitutional entitlement not to pay taxes on income from the bonds…the States must find their protection from congressional regulation through the national political process.”

Municipal bonds are a tempting target for some members of Congress given their urgent need for higher Federal revenues. Although many in Congress acknowledge the appropriateness of states, cities, and counties needing to borrow for schools, water and sewer facilities, roads, and other infrastructure purposes, they question the appropriateness of “fat cats” and “one percenters” not paying taxes on the interest from such borrowings.

The Congressional Research Service reports there are three types of proposals under consideration:

1) The most onerous is the Simpson-Bowles plan which would completely eliminate the tax preference.

2) Another, along the lines of the President’s 2013 budget proposal, would cap the preference at the 28% marginal tax rate. If the taxpayers were in a higher bracket, for instance 35%, they would effectively pay a Federal tax rate of 7% on municipal interest income.

3) The last broad proposal would substitute a direct issuer subsidy (similar to the recent Build America Bonds Program) for the tax preference, and all municipal borrowing would be taxable.

We think the direction of broader tax reform will likely dictate which modifications, if any, are made to the tax treatment of state and local bonds. Of course, some changes might be positive. For example, if regular income and dividend tax rates were increased while municipal bonds remain tax exempt, this would make them relatively more attractive. We will have a much better perspective on probable changes after we see the November election returns. Stay tuned!

Charlie McAnally
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crisis began with Greece admitting it had fudged its fiscal books and has now spread to Spain and Italy. European leaders met in Brussels late in June for another round of negotiations largely pitting Germany against Spain, Italy, and increasingly France. Germany wanted serious financial austerity from the troubled countries before committing more aid. The Latin countries wanted more “growth incentives” because the political cost of just more austerity was too high.

On cue, the European Central Bank cut its benchmark lending rate to an all-time low of 0.75% in an effort to stimulate the European economy. The ECB is following the same monetary path as the U.S. Federal Reserve - providing abundant liquidity and encouraging businesses and individuals to borrow and spend. The plight of savers and risk adverse investors elicits no sympathy.

Unlike those under the influence of conventional Keynesian orthodoxy, we reason simply that the solution to a debt and solvency crisis cannot be more debt just as more liquor cannot be the cure for a hangover. Hair of the dog.

We fully expect the ECB’s money printing to fail in Europe just as the Fed’s efforts have failed in the United States. The underlying problem is un-repayable debt. Severe financial losses are unavoidable; the only question is who bears the losses. Europe would be better off requiring their banks to write down losses are unavoidable; the only question is who bears the losses. Europe would be better off requiring their banks to write down losses. 

The key point is that shareholders and bondholders of financial institutions should bear the losses, not the taxpayers. The European political classes, with their close ties to the financial sector, hope that money printing can somehow give the banks time to work out of their credit problems. It didn’t work in Japan, it hasn’t worked in the U.S., and we doubt it will be any different in Europe. The distortions arising from monetary interventionism complicate investment decisions for both stocks and bonds. Sometimes there are no good and easy solutions - the European debt crisis is a case in point.

Bill Miller, CFA