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ASSET MANAGEMENT

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Boston Security Analysts Talk:
"Investing for tax efficiency in a world of low absolute returns"

My talk today has two parts: general and specific. The general deals with my outlook for investing overall in today's most uncertain world. It will be, in my judgment, a world of low absolute returns, for a period of possibly a few years. The specific part of my talk refers to the desire for achieving tax efficiency in today's investment climate.

Let's start with the general. Why my emphasis on the prospect for low absolute returns, starting with the US markets?

First, let's refresh ourselves about what we have seen in the way of 50-60 year returns from financial assets. Remember that over such very long term time periods, US high quality bonds have generally risen about 1% better than inflation, with US equities typically providing a further return of another 2-3 points above inflation. At today's inflation rate of roughly 2 ½% this would imply a real return objective for Treasuries and other top quality bonds of 3 ½%, and for equities of about 5 ½% to 6 1/2%. After adding back in today's inflation rate, the nominal or absolute returns indicated by these assumptions would be 6% for quality bonds and 8-9% for stocks. Those figures would have made sense under many economic conditions. However, economic conditions and market valuations are subject to long cycles, in which growth may be above or below historic patterns and valuations above or below historic means. So, let's take a look at more recent history first, and then examine where we might be now.

Over the past 20 years, as you know, the rate of return from US quality bonds has actually been much better than 6%, as both inflation and interest rates declined steadily from the highs of the 1980s and early 1990s. However, today long-term Treasuries yield only between 2-3% depending on the maturity date, rates which we have not seen since the late 1940s. To believe in an assumption of a nominal rate of 6% from Treasuries or high quality corporates would indicate a further drop in interest rates close to Japanese levels of about 1%. While that outlook is not an impossibility, if we entered a decade of steady deflation, I think it quite unlikely. We have a better diversified and more productive economy than Japan, we are a technological leader, we start a lot of new companies, we have strong gains in productivity—all these reasons imply that our growth will be faster than Japan's has been. So in my judgment, to expect a long period of deflation in this country appears unrealistic. Certainly, political leaders could continue to mislead the country's voters into thinking that we can afford both relatively low taxes and relatively generous entitlement programs. And if they did so, then markets may well challenge them, as European markets challenged their leaders over the past year or two. The more likely outcome, in my judgment, is for a period of a year to as much as 2-3 years in which interest rates don't move a lot, as we await the eventual solution to both the European debt problem and our own budget problem. If at the end of that period, little or no progress has been made, and we are totally dependent on the generosity of central banks to keep us afloat, then I believe that markets will force yields higher, not lower, out of fear. So perhaps the best which we should expect from high quality bonds is a total return which approximates the current coupon, or 2-3%, and we could end up with a lower figure, if bond investors drive rates higher. Therefore, I think that the 20 year rally in the high quality bond market is in the process of topping out. If I am right, then total returns of perhaps 0-3% from Treasuries and top-ranked corporates is all that we should anticipate.

As for US equities, their total return reflects a dividend yield plus appreciation. A current yield of 2% on stocks is pretty good when measured against Treasuries, but it's not high when put up against a very long term historic yield of 3-4%, which over the past 50-60 years has been more typical. Therefore, to get a total absolute return of 8-9% would imply a profits growth rate of 6-7% or a steadily higher price-earnings ratio. However, for reasons that I will now discuss in greater depth, to forecast that high an earnings growth rate would seem optimistic. While valuations can always rise, in today's uncertain world, I would not want to count on that happening.

Our country is facing a challenge which no one not born after the 1920s has seen, an adjustment to enormous deficits and debt, which force tough decisions. As we have experienced this past year time and time again, every time a group of political leaders tries to deal with debt and deficit reduction problems, they blink. A politician wants to protect his or her own voters from the bulk of the adjustment process, because they are afraid of getting turned out of office unless they strike a deal which their constituents believe is favorable for them—that is, it places the burden of adjustment on other people. Republicans want to protect their constituent base from having to pay more taxes and therefore want the bulk of the adjustment to be paid by Social Security and Medicare recipients. Democrats want to protect the elderly and infirm, and want to maintain past promises to those groups even if realistic projections show that those promises cannot be honored. Gridlock ensues, as we saw both in the failure of the so-called super committee to agree on a relatively small package of budget adjustments and also when the debate over raising the debt ceiling last summer turned into farce.

No matter who wins next November's election, the biggest single challenge for a new President will be to deal successfully with the immense long-term problem of our rising debt and our far too large deficits.

It was only just over a year ago that a very responsible and sensible plan was placed on the table to deal with these problems. Called Simpson-Bowles, it was a plan sponsored by a bi-partisan group of seriously minded citizens. However, despite the balanced nature of the plan and the detailed series of steps listed, which would have brought our debt under control and our budget into balance in the next 5-6 years, the plan fell with a dull thud. No one in position of real authority backed it. Why? Because it demands sacrifices from every citizen, and politicians are still trying to lay the bulk of burden of adjustment on groups which they do not represent, instead of thinking of what's good for the country as a whole.

Eventually, of course, the markets will force politicians to deal with problems seriously instead of postponing them, as is happening in Europe right now. Eventually, we in the US will deal with our challenges, and I predict that Simpson-Bowles or a very close variant of that plan will win out, just because it calls for everyone to sacrifice a little, which seems much fairer than trying to protect one or another group from having to sacrifice anything at all. It will take real leadership for the country to understand that argument, leadership which today is lacking. It may well take a number of years to get to the point where this outcome finally becomes inevitable. It may well also take bond market pressure to force people to address this problem.

But until we pass a realistic budget adjustment plan, we seem doomed to several years of somewhat below average growth, because of relatively high unemployment and a consumer who wants to lower his or her debt level rather than continuing to take on more obligations. It's not a bad outlook, unless you are in the ranks of the unemployed, but it is an outlook which is far from inspiring.

What about equities in a period of slow growth and record current corporate profit margins? It's very hard to project any further improvement of those profit margins, unless productivity turns out to be more rapid than projected. A more likely outcome is flattish to slightly higher earnings, as revenues rise slowly while margins drift a bit lower or stay about the same. Again, not exactly a bad outcome but one that's far from exciting. Nominal returns from US stocks, under these conditions, might range from 5-7%, not the 8-9% historical range, with the entire gain coming from modest earnings growth coupled with a very slow rise in price-earnings multiples back towards the historical mean.

If bonds are going to have a total return of 0-3% and stocks one of 5-7%, then this implies nominal rates of return under the past 50-60 year averages. If I am right, then what does an investor do, who wants to try for a higher average rate of return, as well as for the best tax efficiency from an invested portfolio?

Diversification is one answer to the challenge of trying to improve long-term returns. While diversification into other geographies and assets classes did not work in 2011, in our judgment, that year may well prove the exception to the rule. Other parts of the world, such as Asia, should grow much more rapidly than the US over the next 3-5 years; specialized asset classes, such as distressed debt or very small cap stocks, should be able to add value over the traditional classes of high quality stocks and bonds. Therefore, assuming that investors will take some risk, more than in 2011, in favor of a higher return, we advocate investing a portion of one's funds outside the US and in specialized asset classes, not typically correlated with top quality US bonds and stocks. Here at Aureus Asset Management, we do this diversification through carefully selected external managers, all of whom are specialists in either a single geography, a single industry, or a single asset class.

As to tax efficiency, one obvious choice is to use high quality tax-exempt bonds instead of Treasuries for your fixed-income asset allocation, since municipals today yield as much or a little more than Government bonds, even before deducting taxation from the Treasury return. Of course, we are aware of the challenges facing states and localities. Too many have promised too much to retirees, both in pensions and health benefits; there will be years of conflict over these promises, many of which will have to be reduced, to be affordable. Yet our neighbors in Rhode Island have just managed to reduce their unfunded pension liabilities by well over one-third, by a process which combined public education with an openness to having all citizens involved in the debate. Other states are beginning to take similar actions. So, states are making some long-term progress towards cutting back on expenses. However, revenues are the other side of the coin, and here growth will be very slow. Revenues for municipalities principally come from income, sales and real estate taxes. Sales and real estate taxes should rise very slowly, given our projections, and income tax revenues only just a little faster. Every state and municipality is going to have to make do with less. To avoid deficits, each community is going to have to project less growth in revenues and consequently considerably less growth in expenditures. Because the penalties for bankruptcy, if you're a municipality, are so burdensome, I believe that these wrenching changes will be made and that most municipalities are actually pretty decent credits. Certainly, you will want to examine the worth of individual municipal bonds, but as a group, an investment in tax-exempts should be quite sound.

A complicating factor going forward obviously will be the uncertainty over changes in tax policy. The Simpson-Bowles report recommends drastic tax simplification, with many deductions either repealed or limited. I am very much in favor of tax simplification. I see no need to continue to support the careers of hundreds of thousands of tax lawyers or accountants, just because Congress has listened to the siren calls of many lobbyists over the years. Tax simplification could mean, among other things, strict limits on the deductibility of mortgage interest or employer funded health insurance costs; it could also mean elimination of many favored tax loopholes, some of which distort the investment landscape. What is certain is that there will be much increased scrutiny of so-called tax avoidance schemes, and clients should not be exposed to anything which has the slightest doubt as to its tax justification. However, the Supreme Court has ruled in the past that interest on municipal bonds is not subject to Federal taxation. The only way that exclusion could be modified, in my judgment, is if Congress passes tax simplification which places limits on what any investor can claim in overall tax reductions. But since tax simplification is only a dream at the moment, I would argue that for a number of years municipal bonds should remain far preferable to Treasuries, for those investors concerned with lowering their taxes.

In the next few years, I also expect favorable tax treatment for dividends which means that high dividend paying stocks should be in favor. A dividend tilt makes sense to me, both for tax efficiency and for reasons of emphasizing income as a larger percentage of overall total return. While a number of investment pundits have adopted this theme recently, I believe that the theme may well continue until our national budget debate is over. Special equities such as MLPs and REITs continue to have attraction, both because of their current yields and in the case of MLPs, a favorable tax treatment of that income stream. Another thought: because of the current fear factor in the markets, the spread between top quality and lower ranked bonds has widened out a lot. Take advantage of this by looking carefully at high yield funds run by reputable companies with analysts who take the time to analyze every individual credit, and you should do fine. These high yield funds, however, are not generally tax advantaged, so an investor should make them only in search of pre-tax income. In addition, we think there are excellent opportunities in asset backed securities, such as pools of mortgages, or student loans or credit card receivables. These assets demand intensive scrutiny, to determine which ones have satisfactory underlying credits. Here is where we see the need for a specialist again, a firm that just concentrates in and knows as much as possible about this particular security. Finally, for as long as capital gains are provided favorable tax treatment, this suggests a policy of favoring investment in stocks with at least a one-year time horizon. Dividends and long-term capital gains are clearly preferable to ordinary income.

Tax loss harvesting will still be an important part of everyone's annual tax planning. And if tax rates are eventually adjusted so that either dividends or capital gains are taxed as ordinary income, then the pressure for tax loss harvesting will be greater, and the need to plan for it ahead of time will be all the greater. Even now, stocks with especially severe losses in a particular year seem to feel the effect of tax loss harvesting earlier every year. If tax rates are equalized, it's probable that tax loss harvesting will start even earlier than now.

None of these suggestions are particularly revolutionary or new. This is a time not to take chances, as uncertainties are especially high. However, it's probable that an eventual solution to our budget and debt problems will come in the form of several bills passed by Congress rather than one huge overhaul all at once, just because it's easier to get major changes accomplished in that body on a piecemeal basis rather than in one grand gesture. If that's so, then I hope that all of us will have plenty of time to see what's coming, and adjust to it by taking appropriate action.

Stay tuned. Just remember to adjust your expectations as to future returns to today's circumstances, and to plan your investments based on today's tax laws, keeping a flexible mind as to what changes may eventually appear. It's going to be a really interesting ride over the next few years.