THE RUDD COMMENTARY

{ AUGUST 2010 }

We are excited to publish this edition of *The Rudd Commentary*, which is a monthly publication designed to bring you a professional opinion on the current investment environment and some developing trends. Since we are in the business of managing investments for our clients, we will focus on information and events that we feel are material to that end. We will not comment on opportunities or challenges relating to specific securities as this would undermine the value we provide for our private clients. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

The second quarter of 2010 was definitely a trying one for individual investors and one of the most volatile quarters I have seen in my career. The S&P 500 index was down 11.4% for the 3 months ended June 30th which scared many investors out of stocks and into bonds pushing treasury yields to historically low levels despite the weakening U.S. balance sheet. To point out the significance of this, consider that stock funds on average have not seen positive annual inflows since 2006, in comparison with bond funds which have received over $647 Bn over the same period according to the Investment Company Institute. This continued push into bonds is happening despite record low interest rates, a sovereign debt crisis in Europe, while on the heels of a world-wide corporate and consumer credit crisis. Most individual investors and their brokers are simply unwilling to take ownership of U.S. and foreign companies (even with high dividend yields) and are instead choosing to loan money to these same companies and the U.S. government at very low interest rates. Why? In order to answer this question, it is necessary to take a look at some history.

The twenty years from 1987-2006 was a wonderful time to live in America and be an investor. According to Ibbotson, large company stocks as measured by the S&P 500 index provided an average total return of 11.8% per year. Long-term corporate bonds also did relatively well averaging 8.6% per year over the same period. Credit availability was expanding as well, providing millions of American's access to housing and transportation that was not previously available for high risk borrowers. With interest rates low, employment opportunities numerous, and inflation in check, this was clearly fertile ground to plant investment seeds and watch them grow. This "Great Moderation," as labeled by many economists, shifted our investment paradigm from annual real returns in the low single digits to one where consistent 10+% equity returns were expected and 20+% in any one year was a tail wind. It is no wonder why investors are frustrated with their more recent investment returns considering that most families approaching retirement have made financial projections spanning 30 or more years based on this exceptional two decade period. This is undoubtedly causing angst among the baby boomers or those retirees who were a little heavy in stocks over the last decade and probably the root cause of the 10 to 1 bond to stock mutual fund in-flows pointed out above. Many investors are searching for current income in this low rate environment to fund their most recent standard of living that was driven by the consistent robust returns during The Great Moderation.

THE GREAT CONFISCATION »

I am sure (I hope) that when cars were becoming common place on the roads of America, the goal of a speed limit was to make the roads safer for the community due to the number of pedestrians and varying modes of transportation present. Over time, as the number of cars grew, citations followed, and as income was recognized, politicians began to find use of these funds to support other needs of the community. After years of increasing citation revenue, municipalities probably became dependant on the income and decided to take steps to enhance revenues from other sorts of traffic violations through the use of new innovative deterrents such as the infamous red light camera. What began as a deterrent to improve safety gradually became something else, a tax to generate revenue.

The evolving investment environment is similar in many respects to my speculation of the progression in citation revenue. As government actions are expanded in an unpredictable manner, whether in the securities industry or not (i.e. healthcare reform), after-tax returns for investors will be lower as these taxes (directly or in the form of fines, fees, or pork) increase to pay for more services. Public companies will then divert more of their resources to manage these increasing policy risks and trust among consumers and businesses will dwindle, increasing the cost of all business transactions. The result will be an environment with higher taxes, inflation, unemployment, and price/return volatility, which of course will give reason for more government policy. The next twenty years could be quite different from the last.

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IN DIVIDENDS WE TRUST »

A common debate among financial professionals deals with the payment of dividends and whether or not it is better for companies to reinvest earnings in new projects or pay them out to shareholders. At first glance, it seems very simple that income from a stock is better than no income. However, when taxes, reinvestment opportunities, and corporate governance are considered the issue becomes a little more complicated. The most obvious disadvantage for investors who receive dividends is taxes. It's not so much the taxes paid (currently taxed at 15% for most companies) by the investor that create this disadvantage, but the fact that these same dollars were already taxed at the corporate level. In other words, as the owner of the company you are paying taxes twice on the same earnings. This is called the double taxation of dividends and it is a hot topic. Another material disadvantage that could exist is a possible lack of opportunities for the reinvestment of dividends received. With interest rates at historic lows, companies may have better opportunities than the average investor such as developing a new smart phone or blockbuster drug that can be exploited with retained earnings.

Despite these disadvantages, this new environment of higher taxes and lower real investment returns could create a higher demand for dividend paying stocks because dividends do a few very powerful things. First, receiving income now rather than the promise of growth in the future gives the investor control of how the earnings are reinvested or spent. It can also reduce the short-term volatility of an investor's portfolio as dividends are recognized now and opportunities for retained earnings may take much longer to produce commensurate stock appreciation. Finally (and my personal favorite), dividends have a sobering effect every quarter on company management by promptly reminding them who owns the company. Once a company has a long history of paying dividends, management seems to become very interested in continuing and increasing these payments to portray a strong and stable company. Dividend payments might also become a valuable compensation tool and a way for management to neutralize some of the recent scrutiny over excessive executive compensation. This could have the effect of encouraging upper management to take larger equity stakes in the companies they manage in order to capture rising dividends as profitability improves. While dividends may have a disadvantage in theory, investors who are hesitant to trust politicians and company executives may find them more appealing now than ever before.

THE COST CENTER »

The recent credit crisis has prompted legislation aimed at creating "a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end too big to fail, and prevent another financial crisis." While we definitely need laws to combat fraud, theft, and blatant usury, if "We the People" wish to remain a capitalist economy, our civil servants need to be reminded of a few things. First, governments are cost centers, not profit centers (something that is elementary to those of us with experience working for or running a successful business) and do not add to the bottom line. Second, this recent financial reform bill will create 10 new federal agencies with the power to write new rules that will govern banks, investment firms, and consumer finance companies. We can expect more government employees, more government benefits, more paperwork and more attorneys to bill us for answering the many questions that will arise. This seems like a very inefficient way to "rein in Wall Street".

THE BOTTOM LINE »

While the recent credit crisis may indeed be an uncommon event, as investors we must accept that markets have human participants and are ruled in the short-term by fear, greed and bad government policy (Fannie & Freddie). The boom and bust cycle of our economy and the public markets is not something to be afraid of and it cannot be "prevented" in a capitalist system. To pass policy that attempts to do so does not make the system "safer", it makes it a different system. A free market requires financial casualties from time to time and Americans cannot claim economic victory on a battlefield that cannot be lost.

Invest long and prosper,

Josh Rudd

The Rudd Company, LLC is an independent investment management & consulting company. We provide objective investment advice and customized asset management services for individuals, family offices, and institutions. We specialize in serving clients with unique tax needs, liquidity concerns, and a desire to make a positive social impact with their investment choices.

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