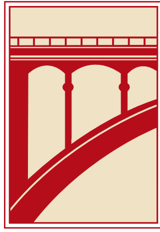

CLIFFORD ASSOCIATES

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SECOND QUARTER 2006

LOWER TAXES, HIGHER GROUND

by Ralph Weil

The degree to which an individual's taxes affect equity prices is central to any valuation discussion. Historically, the dividend tax has attracted more scholarly attention than the capital gains tax. The appropriate tax on capital gains has long been hotly contested in policy circles (tax-setting bodies), but has received little attention from scholars. This is surprising because most companies do not pay dividends, and those that do typically distribute a small percentage of their profits. Thus, it would seem that capital gains tax should be more important to investors than the tax rate on dividends. We would suggest that perhaps the lack of scholarly attention on the subject of capital gains taxes rests on a few important factors.

The first of these might be the short-term nature of the research. Most research in equity valuation concerns itself with the immediate impact of any change. On the other hand, the impact of capital gains taxes on the value of a stock is often played out over a longer-term horizon as the company invests and reinvests its capital. A second factor is that for scholarly research to be valid, in most scholars' minds, all other things must be held the same

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INFLATION TIPS: EXPECTATIONS ARE KEY

by Randy Zaharia

Oil breaks through $75 per barrel. Gold exceeds $700 per ounce before dropping back below $600. Copper and commodity prices hit record highs, and gasoline is parked permanently above $3.00 per gallon. Have the 1970s returned? Has inflation once again run rampant? Well, the answer is no; inflation is not a runaway train, spiraling towards 10% or higher, especially given the recent increases in interest rates and the slowdown in the growth of money. However, there is no question that many more people have heightened concerns, and some have, once again, queried us about inflation-protected securities. Of all these securities, the most common are the U.S. Treasury Inflation Protected Securities, so let's take a look at their particular characteristics.

U.S. Treasury Inflation Protected Securities (TIPS) are direct obligations of the U.S. government, just like U.S. Treasury Bills and U.S. Treasury Notes.

TODAY, THERE ARE OVER $350 BILLION IN OUTSTANDING TIPS, ACCOUNTING FOR NEARLY 4% OF ALL OUTSTANDING PUBLIC U.S. DEBT.

Given the first issuance of TIPS in February 1997, the U.S. TIPS market has been around and active for nearly ten years. Today, there are over $350 billion in outstanding TIPS, accounting for nearly 4% of all outstanding public U.S. debt. Maturities are in 5, 10, 20, and 30 year terms, with the 10-year TIPS being the one security receiving the most attention from the fixed income market place. Both TIPS and U.S. Treasury Notes have fixed rates or coupons (e.g., 2.0% or 4.0%); however, TIPS have an additional wrinkle in that the principal, not the coupon, will fluctuate up or down depending on the movement of the Consumer Price Index (CPI), the stated index of inflation. As a result, the principal at maturity typically exceeds 100% of the face value, and the value will never drop below that 100% face value. In this way, the investor has some protection against inflation.

The returns to both the Treasury Notes and TIPS are comprised of two components: 1) an inflation expecta-

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Lower Taxes, Higher Ground

so that the impact of that one change can be measured. While real-world dynamics make this impossible, they should not discount the insight gained by isolating the role of capital gains taxes in our analysis of a company's fundamentals. As you know, at Clifford Associates we have not followed the conventional path in our research and securities valuation. Before we discuss an example of how we incorporate capital gains taxes in our valuation work, let's first consider some additional background.

When an individual sells a share of stock, the government taxes the realized gain, which is the difference between the sales price and its tax basis (usually the purchase price). With the exception of the period between 1988 and 1990, individual taxpayers pay a lower tax rate on the sale of capital assets held beyond a minimum period of time, which has historically ranged from six to 18 months. Currently, the appreciation on investments held for more than one year (long-term capital gains) is taxed at a maximum rate of 15 percent, while the appreciation on investments held for shorter periods (short-term capital gains) is taxed at the ordinary tax rate, currently capped at 35 percent.

This past quarter, Congress passed, and the President signed into law, a new tax bill. There were two provisions that directly affected investors in the equity market: capital gains tax rates and the tax rate on dividends. The new law extended the current rates (discussed above) for two additional years beyond the 2008 expiration date. Before the passage of this bill, the percentages were to revert back to the old rates of 20% for long-term capital gains and ordinary income tax rates on dividends. The outcome of this legislation is that by maintaining the lower rates for a longer period of time, individual taxpayers will be able to keep more of the long term capital gains and dividends they receive. Let's now look at how that outcome ultimately affects the valuation of the stocks we own.

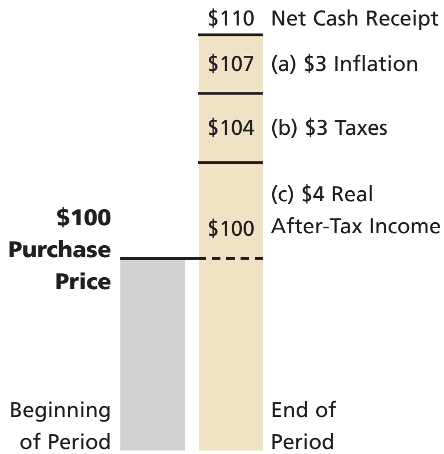
In the analysis given below we assume a few points. The first is that the marginal investor is a tax-paying individual. What do we mean by marginal investor? In economic terms, it is the last buyer or "the buyer on the margin" of an item who sets the ultimate price in a free market, that is, the price that clears all of the goods from the market place. In the case of the equity market, it is the price that is set by the latest or most recent buyer and seller acting with what they believe to be all the knowledge that is available to them at the time. The next trade may be at a different price because the next buyer and seller believe they have different information at a later time. The reason for making the marginal buyer a taxable investor is he is looking at his return on an after-tax basis. The second point we assume is that all other things affecting the stock price are held static.

We all know that investing in equities involves some risk, particularly compared to buying and holding Treasury Bills, which are the accepted risk-free investment. Therefore, to buy a common stock, the marginal investor would need a return that is above the T-Bill rate. Because the investor lives in the real world, he should also factor in taxes and inflation into the expected return. In other words, he should be concerned with a real, inflation-adjusted, after-tax rate of return. The real after-tax reward that one person needs to invest in equities is most likely different than the rate someone else would demand. In the equity market, we have a meeting of the marginal buyer and marginal seller who set a price (value) that is agreeable to both of them and will clear the market at that point in time.

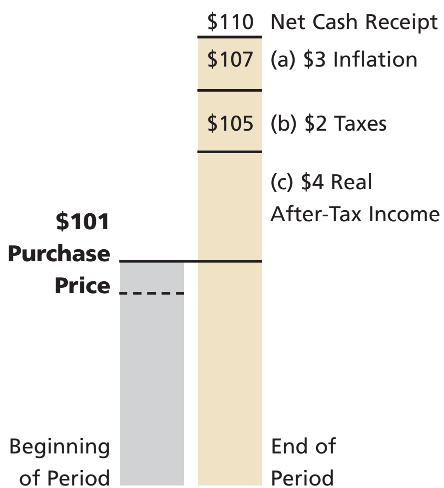
As an example of how this works in the market, and how taxes impact the decision, let's assume an investment has a $10.00 return for one year and at the end of that year the investor would receive his investment back plus the $10.00 gain. Inflation for the period is 3% (a) and taxes are 3% (b). The after-tax and after-inflation return that the marginal investor requires is $4.00 (c). In this example, the investor is willing to pay $100.00 for $10.00 plus a return of his investment at the end of the period. The graph at the top of the following depicts this situation.

THE OUTCOME OF THIS LEGISLATION IS THAT BY MAINTAINING THE LOWER RATES FOR A LONGER PERIOD OF TIME, INDIVIDUAL TAXPAYERS WILL BE ABLE TO KEEP MORE OF THE LONG-TERM CAPITAL GAINS AND DIVIDENDS THEY RECEIVE.

CURRENTLY, THE APPRECIATION ON INVESTMENTS HELD FOR MORE THAN ONE YEAR IS TAXED AT A MAXIMUM RATE OF 15 PERCENT, WHILE THE APPRECIATION ON INVESTMENTS HELD FOR SHORTER PERIODS IS TAXED AT THE ORDINARY TAX RATE, CURRENTLY CAPPED AT 35 PERCENT.



Now let's see what happens when we reduce the tax rate that the taxable investor has to pay on the gain. In this example we will cut the tax by a third to 2% (b). We now see that he is willing to pay a higher price ($101) for that same $110 cash return at the end of the period.



The same conclusion would be reached if we examined the lowering of the tax on dividends. That is, for any period when taxes are lower than they were before, the marginal investor is willing to pay a higher price for that same return. The examples cited here are approximations for a number of reasons, the biggest being that all other things that affect stock prices are held constant which in the real world could not happen.

The take-away from this analysis is that tax cuts tend to create an environment where buyers are willing to pay more for their return on investment.

From a company's standpoint, this phenomenon comes into play when management determines what is their cost of capital (the price they pay for equity funds and borrowed money). Extrapolated in a very general sense, one could argue that lower capital gains taxes contribute to lower cost of capital (the lender/investor pays more for the same dollar return) which helps drive increased rate of return for the company. As fundamental analysts, it's that higher rate of return we find more attractive and meaningful than price/earnings ratios. To come full circle, from a valuation standpoint, as investors we are willing to pay more for a company that exhibits a sustainable positive rate of return. At the end of the day, we look for a permanent extension of the current capital gains tax rates to be in the best interests of a robust market. §

ORGANIZING PERSONAL FINANCIAL FILES

For many people, getting their financial house in order is a well-intended but elusive goal. We are often asked which files should you keep, and why do you need to keep them? How long should you keep them and in what format? David Andrew has written a brief guide to organizing your personal paperwork, covering such topics as:

- Income Taxes
- Estate Planning
- Insurance
- Employee Benefits
- Home Inventory
- Warranties and Owner's Manuals
- Proof of Transactions
- Investments
- Bills
- Vehicles
- Property
- Personal Papers

If you would like an unabridged copy of this guide, please visit our website at www.clifford1915.com or contact us to provide one by mail. §

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Inflation TIPS: Expectations are Key

tion or index, and 2) a real return or payment for holding a long-term bond. Unfortunately, for a straight 10-year U.S. Treasury Note, it is not apparent what these two components are. Alternatively, the TIPS allow an investor to purchase a bond at a specific real return, while adding on an inflation component. For example, by purchasing the 10-year TIPS due 1/15/2016, a security with a 2% fixed coupon and at a market price of about 95.5% of face value, the resulting real return would be approximately 2.55%. In other words, the TIPS will return 2.55% over the CPI index until the 2016 maturity. As a further analysis, an investor can determine the market-implied inflation rate by taking the current 10-year U.S. Treasury yield (5.13%, 7/10/06) and subtracting the real return of the TIPS (5.13% - 2.55% = 2.58%; see chart). In other words, the market, overall, appears to be pricing in an expected 10-year inflation rate of 2.58%. The question for the investor then becomes, "Is this implied inflation rate too high, too low, or about right compared to my expectations?"

Taking all of this into account, it is clear that TIPS will fluctuate with respect to interest rate expectations, inflation expectations, and real bond

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THE QUESTION FOR THE INVESTOR THEN BECOMES, "IS THIS IMPLIED INFLATION RATE TOO HIGH, TOO LOW, OR ABOUT RIGHT COMPARED TO MY EXPECTATIONS?"

PRINCIPALS

Maye Albanez, CFA
S. David Andrew
Peter J. Boyle, CFA
James R. Brown
Kenneth H. Dike, Esq., CPA
James B. Fox, III
Kathleen Gilmore, CFP®
Terrell H. Price
Ralph E. Weil, CFA
Bruce C. White
Randall L. Zaharia, CFA

OFFICES

Pasadena
200 S. Los Robles Avenue
Suite 320
Pasadena
California 91101
P 626-792-2228
F 626-792-2670

Huntington Beach
16902 Bolsa Chica Street
Suite 204
Huntington Beach
California 92649
P 714-846-2851
F 714-840-5212

Evergreen
P.O. Box 2945
Evergreen
Colorado 80437
P 720-746-1244
F 720-294-9896

www.clifford1915.com

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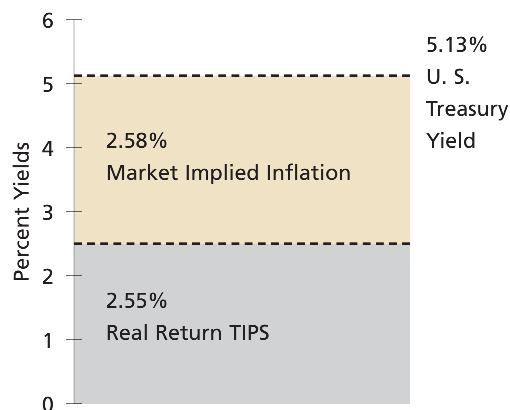
Inflation TIPS: Expectations are Key

yields. In the early 2000s, when interest rates were in the 6 to 8% range, real bond returns, as measured by TIPS, were at times over 3.5%. When yields were at their lowest points in 2003 and 2004, TIPS returns narrowed to less than 2.0% and were approaching 1.5%. With current TIPS returns in the 2.5% to 2.6% range, the real returns are slightly above the averages for these securities over the last five to ten years. On that basis, the TIPS are more attractive now than they were two or three years ago, and slightly more attractive overall, sitting just above their averages.

Even if an investor decided to purchase TIPS, he would need to take a number of issues into account. First, there is only a modest institutional market for these securities, limiting the liquidity available for buying and selling these bonds. These bonds are primarily targeted for the retail investor, not the endowment or pension portfolio, with the spread between bid and ask prices fluctuating between 1/8 to 1/4. Second, TIPS are influenced by a number of technical factors such as seasonality and sudden movements in and out of TIPS. Third, the accounting treatment of these bonds can be a CPA's nightmare, given the appreciation and/or depreciation of the principal value. In addition, the investor, in a taxable account, would be taxed annually on the appreciation, much as he would be if he owned a zero coupon bond. Fourth, most of the TIPS are bought up by TIPS fixed income mutual funds which provide a cleaner vehicle in which to invest in TIPS by eliminating many of the accounting hassles and tax issues. For these reasons, the best place to own these funds is in an IRA or 401k account (in fact, whether a fund or a bond, it is probably best held in a tax-exempt account).

While there are a number of key factors to consider regarding the investment in inflation-protected securities, we have identified at least a few critical ones. First, is the investor's inflation expectation higher than the market's? As the analysis showed above, the market is expecting about a 2.6% inflation rate, and the key, then, focuses on what the investor's expectations are relative to that 2.6% long-term inflation rate. At Clifford Associates, we expect inflation to fluctuate between 2% and 4%, so the 2.6% seems reasonable over the next 10 years. Second, are the real returns high? As noted above, the real returns are higher than a few years ago, but only slightly above their averages. Whether the real returns will approach 3% is a difficult question. Finally, are both the economy and inflation expected to continue rising? At Clifford Associates, we are anticipating an economic slowdown over the next 12 to 18 months due to rising energy costs, rising interest rates, a slowing housing market, and slower money supply growth. However, other economists and investors have differing views and expectations. In the final analysis, there are a number of factors that may influence a decision to purchase an inflation-protected security, including economic factors, timing, and comfort level. TIPS and other inflation-protected securities may be appropriate for some, although the case for owning them at this time is not necessarily compelling. §

TIPS Yields & Expectations
an example of a 10-year U.S. TIPS



SOURCE: BLOOMBERG AS OF 7/10/06

WITH CURRENT TIPS RETURNS IN THE 2.5% TO 2.6% RANGE, THE REAL RETURNS ARE SLIGHTLY ABOVE THE AVERAGES FOR THESE SECURITIES OVER THE LAST FIVE TO TEN YEARS.