

# SHARPER ♦ GRANITE



*Optimal Portfolio Management*

**SUMMER**  
**2003**

## IN THIS ISSUE

- **Financial Markets Summary**
- **Significance of the New Tax Cut Package**
- **Studying The 1929 Crash**
- **SEC Investigates Conflicts of Interest at Major Wall Street Firms**
- **Second Quarter 2003 Economy Review**

**W**ith the primary efforts in Iraq subsiding, our outlook for the financial markets has brightened even further this quarter. First, as discussed in our Spring 2003 letter, throughout history U.S. markets have experienced significant growth in the periods following war victories. Second, the \$350 billion tax reduction passed by congress on May 21st will have a significant positive impact on the U.S. markets and economy. This quarter we provide a briefing on the tax code changes, and discuss its impact on individuals, portfolio management and the economy.

Other positive events in the quarter include better than expected quarterly corporate earnings across several different industries, as well as an indication that President Bush will reappoint Alan Greenspan to another term as Federal Reserve Chairman. Finally, we see the current environment as near-perfect for merger and acquisition opportunities, which can spark equity prices and improve bond quality.

This optimism has many speculating as to whether we are marking the end of a three year old bear market. We study the economy and history to gain perspective, then act prudently and with perspective that matches the time horizon of each of our clients. This quarter we share our analysis of the only other market drop this century that compares in magnitude to our recent decline, The 1929 Crash.

## Financial Markets Summary

In the second quarter of 2003 (April 3<sup>rd</sup> – July 2<sup>nd</sup>) the S&P 500 Index surged 13.2%, while the Lehman Aggregate Bond Index increased 1.6%. The average of all Sharper ♦ Granite client portfolios increased 13.1% and maintained a risk level 21% less than that of the S&P 500 Index.<sup>1</sup> At this risk level portfolios should be expected to gain 10.5% in an efficient market.<sup>2</sup> The average of all Sharper ♦ Granite portfolios outperformed the S&P 500 Index on a risk-adjusted basis each of the two quarters of 2003. Please refer to the personal letter from your advisor for a report on your portfolio performance this quarter.



The relatively quick and successful war effort along with the tax cut package sparked strong market performance this quarter. The bond bull market continued its incredible resiliency, aided now by Fed Chairman Alan Greenspan's comments that 1) he expects interest rates to remain low for quite a while, and 2) the Fed will buy back longer term Treasuries. This acts to lower yields of long term maturities. The Fed's lowering of the Discount and Fed Funds rates by ¼ point on June 25<sup>th</sup> directly lowered short term bond yields. This was the 13<sup>th</sup> rate reduction since January 2001.

Not only were stock market returns gaudy this quarter, but underlying market fundamentals were also strong. Up days came on heavy volume, and down days occurred on light volume. This is evidence of institutional money flowing into the market and broad participation in the rally. For the first two months of the quarter, more than 87% of stocks in the S&P 500 Index showed gains. This is impressive considering that in 1999, the last full year in which the S&P 500 Index posted a gain, the average month saw only 47% of the index's component stocks higher. ●

## Significance of the New Tax Cut Package

In May, President Bush signed into law a \$350 billion tax cut package. The law cuts taxes by \$330 billion through 2013 and provides \$20 billion to state and local governments to be paid over the next two years, half for Medicaid and half for other programs. We believe that the 2003 \$350 billion tax cut package will have a strong positive effect on the economy and long term investments in general.



### *What It Means to You*

**1. Corporate Dividends:** The top rate on dividends is lowered to 15%, and 5% if your marginal tax rate is in the 10% or 15% brackets. The new rates run through 2007; in 2008, the lower 5% rate drops to zero. The previous top rate was 38.6% for dividends. In 2009 rates revert back to current levels without new legislation.

Note: The drop from 38.6% to 15% is the most significant impact from this tax cut. This cut does not apply to bond or most REIT coupon payments, which are still taxed as ordinary income, thus making these competitive investments relatively less desirable.

**2. Long Term Capital Gains:** The top rate on long term capital gains is lowered to 15%, and 5% if your marginal tax rate is in the 10% or 15% brackets. The new rates run through 2007; in 2008, the lower rate drops to zero. The current top rate is 20% percent for long term capital gains. In 2009 rates revert back to current levels without new legislation.

Note: Since short term capital gains are still taxed at ordinary income rates, as high as 35%, there is an even stronger incentive to hold equity investments for more than one year in taxable accounts.

**3. Personal Income Primary Tax Brackets:** Several tax reductions that had been scheduled to occur later this decade are accelerated to the present. The income tax brackets are reduced from 38.6% to 35%, from 35% to 33%, from 30% to 28%, and from 27% to 25%. The 15% bracket does not change. The lowest 10% bracket is expanded to higher incomes for 2003 and 2004.

**4. Other Personal Income Taxes:** The child credit is increased to \$1,000 per child, instead of the current \$600, for 2003 and 2004. For married people filing joint returns, the 15% bracket is expanded, and the standard deduction increases in 2004 and 2005. The bill also prevents more taxpayers from paying alternative minimum tax (AMT) in 2003 and 2004.

**5. Small Businesses:** To encourage the initiation of new businesses and the expansion of existing businesses, the tax bill increases small businesses investment write-offs from \$25,000 to \$100,000 in 2003, and all businesses may depreciate 50% of newly purchased assets this year, 2003.

### *What It Means to the Economy*

The drop in the long term capital gains rate helps to encourage new investment and should help re-ignite the languid initial public offering (IPO) market. Only 1.9% of all stocks are new issues; this is the lowest annual number in the last twenty years.<sup>3</sup>

The relative change in the dividend tax rate was much more significant than the change in the capital gain tax rate. So the after tax value of dividend producing companies will increase relative to low or no-dividend firms. Furthermore, the dividend rate cut will encourage companies to initiate or raise dividends, freeing cash stockpiles out to shareholders.

Finally, the depreciation acceleration should act to spark capital expenditure, where we already see signs of pick up.

### *How It Affects Our Portfolio Management*

Adjustments to Sharper ♦ Granite portfolios will be subtle. Sharper ♦ Granite portfolios are kept tax efficient in several ways. One way is through the use of tax efficient Exchange Traded Funds (ETF's) and other index-based securities. Also, we allocate a client's long term securities within their taxable accounts vs. tax deferred (e.g. IRA) accounts.

For example, there is value to placing high dividend stock and bond funds within the tax deferred accounts while holding high growth equity positions within the taxable accounts. In this manner the most significant tax effects are delayed and long term capital gains are controlled, taken according to the client's tax strategy.

The drop in the dividend tax rate from ordinary income rates (as high as 38.6%) to 15% and the drop in the long term capital gains rate from 20% to 15% removes some of this need for sheltering high dividend equity investments within the tax deferred accounts and allows greater flexibility in asset placement. However, the benefit of *deferring* dividend taxes still exists within IRA accounts.

More importance is now placed on the value of funneling returns in the form of either long term capital gains or dividends and avoiding short-term capital gains, which are still taxed as ordinary income. ●

**"Summer Rally" – myth or reality?** Myth. Summer stock market performance, as measured by the Dow Jones Industrial Average peak to trough, actually trails that of every other season. While summers on average do show market improvement, it is less so than other seasons. Since 1965, winters average 13.6%, springs 10.9%, falls 10.6% and summers 9.4%.<sup>15</sup>

## Studying the 1929 Crash

Tulip bulbs of the 1600's, the roaring 20's and tech stocks in 2000. What fun they were for investors on the way up, and how painful they were on the way down. The recent three year bear market was unexpected by most and extremely rough on investors. Has anything like this ever happened before? History shows important similarities between the 1929 stock market crash and the recent stock plunge that began in April 2000.



### **The Plunge**

The Dow of the 20's actually resembled the Nasdaq of the 90's in composition. Both were filled with high-growth, new technology companies that had been speculatively bid up. The hot Nasdaq technologies of the 90's, software and the internet, are analogous to automobile and airplane innovation in the 20's.

During their final spectacular climaxes, the 1928 Dow increased 81% in 1 ½ years and the 1998 Nasdaq increased 203% in just over a year before falling off of their respective cliffs. Then, from 1929 – 1932 the Dow fell 89%, compared with the Nasdaq 78% plunge from 2000 – 2002. The chart on page 5 compares the roaring 20's run up of the Dow and subsequent collapse to the Nasdaq bubble and pop of the 90's (on a percentage basis).

During the Depression, Americans worried about more than the ailing Dow Jones Industrial Average. Banks plunged into insolvency in the economic morass following the crash of 1929. The unemployment rate rose above 30%. A crippling drought swept through the nation, ravaging vital crops.

The 1929 Crash left the wide spread impression that stocks could not be worthy long term investments. Stories of corporate scandal and greed from the 20's bubble years rained down, leaving investors no appetite for stocks. So much had been written about so many who had been decimated by the market that the notion of stocks beating other financial assets was regarded as ludicrous. The media of the day reflected the public's fatalistic mood:

*"Some of the selling represented the closing out of impaired collateral loans, but mostly the steady chipping of values was attributable to the almost universal lack of faith, brought about by depression and deflation, in the earning ability of equity stocks."*

- Barron's, July 8, 1932

### **The Recovery**

This ultimate pessimism marked the nadir of the market's path on that very day. The Dow spurted 10.5% in the next four days to begin a new rally. Post-crash studies show that those who had long term time horizons and held their equities through the crash, earned 9.0% per year from 1926 – 1960 after taxes and transaction costs. These returns were significantly higher than real estate or any other investment media available during this 35 year period.

The lower chart shows how \$5,000 invested in 1925 just before the crisis, and held through the collapse, still grew to \$8,300 by 1940, \$61,700 by 1955, and \$276,000 by 1965. The 1929 – 1932 crash was the worst in 200 years of recorded history in U.S. equities.

### **Lessons Learned**

1. You don't need to do the impossible – predict market tops and bottoms. All you need to do is asset allocate properly based on your time horizon and risk tolerance.

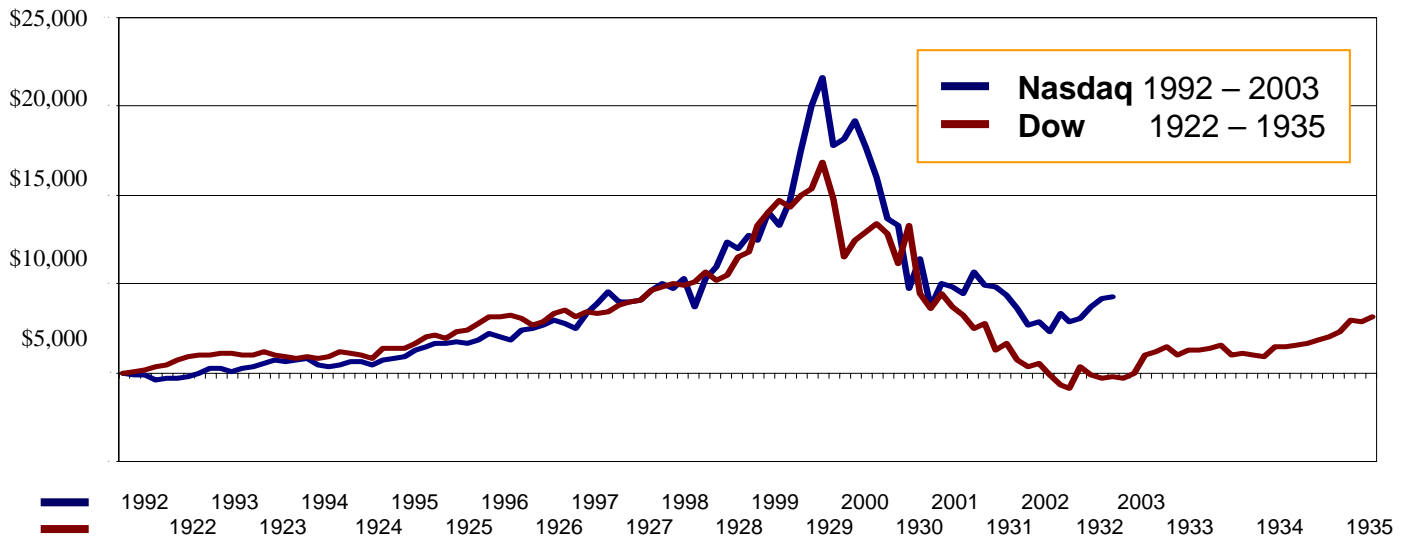
Of course, those who needed their investment money in the early 30's were crushed. But then, if the money was anticipated to be needed in the early 30's, then it should never have been heavily invested in equities to begin with in 1929. The correct answer on stock/bond/cash allocation truly depends on time horizon. This rule holds today just as it did in 1929.

Those needing to tap their nest egg within three years should never hold a portfolio heavily weighted by stocks – neither in 1929, 2000, nor today. However, those with a longer time horizon can benefit tremendously from the long term performance of equities, which are ultimately driven by the ever improving long term economic fundamentals (productivity, rate of new inventions and services, fluidity of global trade, information flow, market efficiencies, etc.).

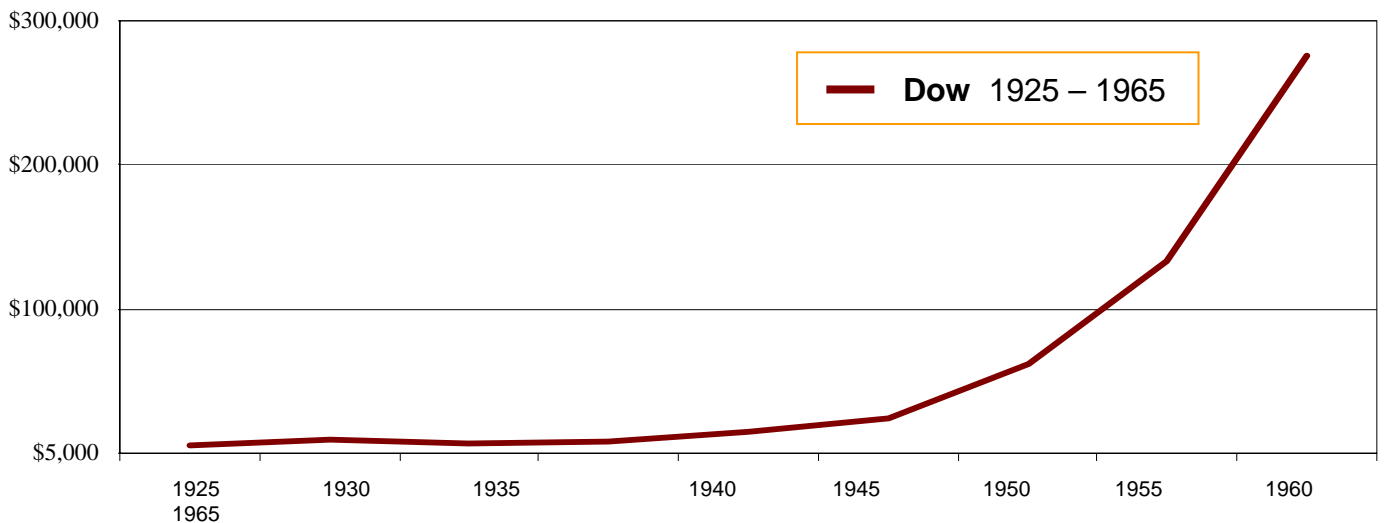
Our objective at Sharper ♦ Granite is not to predict market tops and bottoms, but rather to architect and manage optimal portfolios, customized for each client's time horizon, risk tolerance and other investments.

2. Incorrect asset allocation not only can crush you over the course of a few years, like 1929 – 1932, or 2000 – 2002, but it also can bite you hard on a day to day basis. Jumping in and out of the market is extremely dangerous.

## *Two Crashes for the Ages...*



## *...and a Long Term Perspective*



Those who finally got out of the market on the day of the *Barron's* article, July 8, 1932, missed a 10.5% run in the next four days. In fact sudden market bursts are common. From 1980 – 2002 your stock market investments averaged 13.8% per year, but if you somehow missed the thirty best days, your return was only 7.7% per year.<sup>4</sup> ●

## SEC Investigates Conflicts of Interest at Major Wall Street Firms

Investigations by the SEC and NASD intensified this quarter. The May 22 *Wall Street Journal* featured a series of stories on the conflicts of interest that advisors face at major Wall Street firms. The State of Massachusetts followed up with fresh charges against Morgan Stanley.

Light is being shed on the conflicts that exist when brokers and financial advisors are compensated by selling certain products. As many have questioned for some time -- how can brokers act in a client's best interest when they are paid for selling particular mutual funds, stocks or annuities? Furthermore, no law requires brokers to disclose many of these potential conflicts. As illuminated by these investigations, Sharper ♦ Granite strongly recommends using financial advisors and portfolio managers whose only compensation comes from clients.

The following chart illustrates recent probes into broker conflicts of interest that exist for brokers and analysts who may have incentive to sell particular mutual funds or tout certain stocks for personal or bank profit at the expense of clients. ●

### *Brokerage Conflicts of Interest under Investigation in 2003*

#### Mutual Fund Sales

- “An SEC probe will look at whether brokerage firms have pushed mutual fund products on customers because of compensation they receive, rather than based on customer needs.”  
— *Wall Street Journal*, “SEC Looks at Brokers and Mutual Fund Sales,” May 22, 2003
- “The National Association of Securities Dealers (NASD) is examining whether conflicts exist and is considering a rule that would require disclosure of payments (to brokers when mutual funds are sold) .”  
— *Wall Street Journal*, “SEC Looks at Brokers and Mutual Fund Sales,” May 22, 2003
- “Today an investor getting financial advice can never be assured the playing field is 100% level. To get more investors into Morgan Stanley's poorly performing stock funds, Morgan Stanley brokers selling the most in-house mutual funds are rewarded with goods and services selected from their Business Development Program Catalog, which provides \$13 million in sales rewards to brokers for 2003... Morgan Stanley's clients aren't informed of the practices that might influence which funds are being recommended.”  
— *Wall Street Journal*, “The Morgan Stanley Fund Machine,” May 22, 2003
- The State of Massachusetts filed charges against Morgan Stanley for misleading investors. “Following the *Wall Street Journal* articles, Morgan Stanley lied to us about the extent of their practice of rewarding brokers and brokerage branch managers for pushing certain mutual funds on clients without disclosure of their personal profits. After investigation, we found dramatic effects on their sales from a practice that puts profits ahead of client well-being.”  
— William Galvin, Massachusetts Secretary of State, *CNBC*, July 14, 2004

#### Investment Banking

- “In April 2003 the SEC, NASD, and other regulators fined 10 major securities firms a record \$1.4 billion for their tainted stock research in a bid to win investment banking business.”  
— *Investors Business Daily*, May, 2003
- “For analysts working for big brokerages with investment banking departments, optimism was more important to career advancement than forecasting accuracy” during the 1886 – 2000 time period studied.  
— Finance Professor Harrison Hong, Stanford University, Study Published in the *Journal of Finance*, February 2003

### Second Quarter 2003 Economy Review

The indicators we track have turned even more positive this quarter. While still at a relatively low point, the economy continues its slow expansion. With monetary stimulus in place, low inflation, and the recently passed tax cut, we expect the U.S. economy to continue its slow improvement as the year unfolds.

The U.S. unemployment rate continues to creep up; however, the unemployment rate is historically a poor *leading* indicator of the economy. Earnings announcements were broadly positive this quarter. Other key Leading economic indicators we track are reviewed below:



#### Leading Economic Indicator Summary

**↑ Market Cycle:** The S&P 500 has declined now for three consecutive calendar years, marking only the third time in the last century that that has happened. The only four year consecutive downturn was 1929 - 1932. Throughout the second quarter of 2003 the market showed positive signs in its day to day movement, rising on days of higher volume and falling on days of lower volume. This is the footprint of institutional money flowing into the market. The flow of institutional money is a good momentum indicator for two reasons:

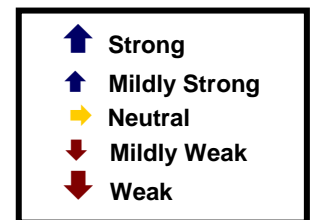
1. Money management institutions are so large that they are challenged to turn direction on a dime and shift quickly from net buying to net selling, thus they tend to generate momentum. There is simply no way for institutional investors to cover their tracks when they gush into or out of the market.
2. This momentum effect is augmented by the fact that institutional managers tend to copy each other, simply a result of managers and analysts keeping an eye on their competition.

Furthermore, as expected during market recoveries, corporate earnings reports are now significantly beating expectations across a variety of industries.

- ↑ Political Cycle:** This is the third year of President George W. Bush's term. Traditionally, the third year in the presidential cycle is the strongest as elected officials, both the President and Congress, typically try to boost the economy to improve their chances of re-election. A recent example of this is the tax cut just passed. Since 1948, the third year of the presidential cycle has seen the S&P 500 Index post an average gain of 23.3% (21.9% with Republican presidents), far in excess of the other years of the cycle.<sup>5</sup>
- ➔ GDP Growth:** Gross Domestic Product (GDP) is the official economic measure of the U.S. economy. In the 1st quarter of 2003 the economy grew at a revised 1.4% net of inflation.<sup>6</sup> It was the seventh consecutive quarter of expansion, or positive economic growth, since the official recession of 2001. Growth remains positive but slow.
- ↑ Purchasing and Manufacturing:** The key economic purchasing indicator is the Chicago Purchasing Managers Index (PMI).<sup>7</sup> This measure continued its slow expansion as it has over the past two years.

The Institute of Supply Management (ISM) Index, the key manufacturing indicator, indicated contraction through the entire second quarter, but maintained an improving trend.<sup>8</sup>

Durable goods manufacturing remains slow as there is limited pent-up demand for big-ticket consumer goods. Manufacturing represents one-sixth of the total U.S. economic output.



↑ **Inflation Control:** The most widely used measurement of inflation is the Consumer Price Index (CPI). The core CPI remained extremely low at +0.1% during the first month of the quarter,<sup>9</sup> implying a continued low inflation environment and justifying the Federal Reserve Board's lowering of interest rates yet again on June 25<sup>th</sup>.

↑ **Consumer Spending:** Consumer spending remained relatively flat during the quarter as consumers remained mindful of the sketchy jobs outlook.

Consumer confidence is an important *leading* indicator of economic behavior. Postwar optimism gave the Consumer Confidence Index a sharp turn for the better in the second quarter. The IBD/TIPP Economic Optimism Poll moved from long-term pessimistic low points back into the range of optimism.<sup>10</sup> The University of Michigan Consumer Confidence poll surged in April and May following the war, then fell in June, but remains at levels which demonstrate improvement.<sup>11</sup>

↑ **Capital Spending:** Capital spending continued its steady upward trend over the last nine quarters. Moreover, business investment should get a significant lift from the accelerated write-offs allowed under the new tax cut package.

↓ **Investor Sentiment:** Investor sentiment is an important contrarian indicator. Market conditions are actually more favorable when "expert" newsletters are more bearish. This is true for two reasons. First, studies show that "experts" seeking to time the market are consistently wrong more often than they are right. Second, short-term investors place their bets first, then tout their directional picks. For example, when investors are overly bullish, they have likely already employed their capital, leaving less money to be pushed into the market generating demand.

According to *Investors Intelligence* bullish readings sat at extreme levels going into the final week of June.<sup>12</sup> However, the Hulbert Stock Newsletter Sentiment Index (HSNSI),<sup>13</sup> which measures institutional optimism, and the American Association of Individual Investors (AAII),<sup>14</sup> which measures small individual investor sentiment, both swung from strong bullish readings on June 20<sup>th</sup> to strong bearish readings on July 1<sup>st</sup>. ●

Sharper ♦ Granite opens Los Angeles office. Sharper ♦ Granite is pleased to announce the opening of its Southern California office at Continental Plaza in El Segundo, located near Los Angeles International Airport. Call (310) 426-2909 or email to set up a visit if you are in the Southern California area.

Questions?  
Contact us at:  
questions@sharpergranite.com

#### Notes and Acknowledgements:

1. Arithmetic average used for return measurement. Asset weighted average beta used for risk-adjustment to market risk level. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 10% of total assets. All client portfolios weighted equally in calculation.
2. The "Efficient Market" line referred to is the Security Market Line (SML) for 2Q03, which is defined as the line on a risk-return chart connecting a point representing a risk-free investment (defined as the 3 month Treasury yield) and a point that represents the S&P 500 Index return at risk level  $\beta = 1$ .
3. *Investors Business Daily*, June 2003.
4. Ibbotson Associates.
5. Jeremy J. Siegel, Professor of Finance, Wharton School of Business at Penn University; and Sharper ♦ Granite Research.
6. U.S. Commerce Dept.
7. National Association of Purchasing Management (NAPM) – Chicago, June 30, 2003.
8. Institute of Supply Management (ISM), July 1, 2003.
9. U.S. Labor Dept.
10. IBD/TIPP Economic Optimism Poll.
11. University of Michigan as reported in the *Wall Street Journal*, June 13, 2003.
12. *Investors Intelligence*, June 30, 2003.
13. Hulbert Stock Newsletter Sentiment Index (HSNSI), July 1, 2003.
14. American Association of Individual Investors (AAII), July 1, 2003.
15. Stock Trader's Almanac.