STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS SUMMER, 2010

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,222 * Dow Jones Industrials 10,024 * 30 year U.S. Treasury Bond 4.24%

GREECE, DEMOCRACY, DEBT, AND DECLINE

"The earliest democracy in the world began in Athens, in 510 BC . . . . Democracy means the rule of the people (in Greek). That is where each individual person has a vote about what to do. Whatever the most people vote for wins."
— www.History For Kids.org

What the most Greeks voted for was a steady increase in government benefits and government jobs, with a good part of the expense pushed onto their under-aged, non-voting children. In 2009 government spending (federal, state, and local) was half—***50.4%***—of the entire Greek economy. And a third of the spending was financed with borrowed money.

It's the Achilles Heel of democracy. Once voters discover that they can vote money into their own pockets, they will. Politicians will be happy to help, buying their way into office with cash harvested from future generations (who can't vote) and from taxpayers (who are in the minority).

Growing debt means rising interest costs. And when investors noticed that Greece was deeply in debt they became nervous, and began to demand an 11% rate of interest to compensate them for the risk. If we (the United States) have to pay 11% when our public debt reaches $10 trillion 18 months from now, we'll find ourselves paying $1.1 trillion in interest every year, or *more than half* of the $2.1 trillion that the federal government collected in tax revenue in 2009.

Investors have been running around in a panic, and are only just now arriving at a realization that there are really two separate problems. There are nations, like Greece, that risk spiraling interest costs on debt owed to foreigners; and there are nations, like Greece, whose economies have been crushed by the weight of government spending that sucked the vitality out of all other sectors of the economy.

Japan is a case in point. It has the largest debt in the developed world, but 95% of the bonds are owned by the Japanese themselves. In 2010 the land of the Rising Sun won't *borrow* money from foreigners, but rather *lend* to them. That's what it means to run a trade surplus each year; Japan is saving and gaining wealth as we go deeper into debt. Forget what the pundits have been saying; **trade deficits matter**.

Japan's economy has nevertheless been moribund for most of the last 20 years, following a period of growth that seemed unstoppable. Japan was the "it" country in the 1980s, with a 2% unemployment rate, a strong social safety net, omniscient and omnipotent government planning, and active government intervention in industries and individual businesses. Many Americans argued that we should put our own economy in the hands of wise government technocrats who would manage every industry like puppet masters.

Then Japan's real-estate and stock-market bubbles burst, and the economy soured. The nation undertook spending programs (railroads, bridges, "social infrastructure", bank bailouts) in 1992, 1993, 1994, and 1995. Like Franklin Roosevelt in 1937, the Japanese then tried

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DEBT, AND DECLINE... *continued from page 1*

to reduce the huge deficits by increasing taxes, but found that their economy had been weakened by government programs that sucked up skilled workers, entrepreneurs, and investment capital. It plunged back into recession, the deficits and malaise continued, and by 2006 the nation's debt had grown to 180% of GDP, up from 63% in 1991.

Big Government has also slowed the growth of most of the economies of Europe. The nickname, after all, is Eurosclerosis; the loss of health and vitality that results when too few workers labor to feed and clothe and house too many bureaucrats. Slower growth means less tax revenue, which leads to higher tax rates that further stifle economic growth.

Yet Europe is sharply divided, between those who *borrow* from foreigners (the nations running trade deficits) and those who *lend*. Greece, Spain, Italy, Portugal, Ireland, and Britain have been borrowers, while Germany, Sweden, and the Netherlands add to their wealth each year by exporting more than they import. The countries with the big foreign debts are the ones that have to worry that their debt will spiral upward as a result of sharply rising interest rates.

As the crisis unfolded in Greece, investors around the globe moved their money into US dollars, with little thought to the fact that Uncle Sam faces both problems. Our government has grown, and it has reached this new heft with the help of money loaned by foreigners. Japan, China, and other exporting nations helped us finance the bailouts of Chrysler, General Motors, AIG, Citigroup, FNMA, and Freddie Mac, and we'll need further financing to pay for the expanding entitlements of the next 10 years.

We're optimistic that the nation will solve both problems in a single stroke with a move toward fiscal responsibility. We'll do it because we *have* to. The result will be very slow growth, but fear will be removed from the market. And investors will be able to look forward to low inflation and low interest rates. Dividends, anyone? ■

20 YEARS IN BUSINESS, AT THE SAME LOCATION

We're still getting the Madoff question from prospective investors. "How do we know that you're not a Ponzi scheme?"

The simple answer is that we don't have custody of your assets, and we don't create your monthly statements. Our clients' assets are held by US Bank (one of the two or three strongest banks in the nation); not as assets of the bank but as stocks and bonds that belong to our clients.

Custody costs us a pretty penny—it's our largest expense, after salaries—but it has other benefits. When bond prices were at ludicrous lows in the fall of 2008, we weren't stuck—like many of our competitors—with the bond offerings of a single brokerage firm. We were able to get competitive offerings, and buy "round lot" million-dollar blocks of bonds issued by AT&T, Norfolk Southern, Alcoa, and other blue chip companies—at prices so low that the bonds yielded more than 10%.

What *we* want to know is why investors signed up with Madoff—or any one of a thousand honest but under-performing firms—ten years ago when our benchmark account was valued at $206,583. At the time the air was slowly coming out of the tech stock bubble, and value stocks were about to begin a long run of outperformance after reaching absurd lows.

Today that account—which is managed without favoritism, and has always paid a 1% fee—stands at **$551,341.24**. For more information please visit our web site, www.Lumbard.com, and click on Performance. Or give us a call at (800) Lumbard, which works out to (800) 586-2273. Our US Bank relationship manager is Terry Schwartz, at (513) 632-4992. ■

LET'S MAKE A DEAL

There's a good chance for a budget deal in December that will bring our nation's budget deficits back to a "reasonable" level. If we're right the government's debt will continue growing, but it won't grow fast enough to scare foreign investors until large numbers of Baby Boomers begin to collect Medicare.

Still, it would be a shame to go through a giant deficit-reduction exercise without creating some new rules for our wayward Congress. We need to cap their spending, because we're trading big chunks of our children's America to spend more today.

From 1997 through 2005 there wasn't a single year in which federal spending exceeded 20% of GDP, and it's worth noting that we have almost never managed to collect more than 20% of GDP in taxes (the exceptions are 1944, 1945, and 2000, when investors were cashing in their winnings).

That time span includes the 1950s, a time when the top tax rate was 91%, and a long stretch in the 60s and 70s when the top rate was 70%. Apparently it's nearly impossible to squeeze more out of the taxpayers without sending people with high incomes into an early retirement. We should set 20% as a constitutional limit, and also establish a balanced-budget amendment for good measure.

Please visit
www.WeElectedYou.org

GOOD NEWS!

Corporations—and especially CEOs—have been the target of a lot of sticks and stones in the last year. Some of that was well-deserved, but you have to be impressed by the job that most of them did during the financial crisis.

We're not talking about the banks, or the companies nationalized by the federal government, but rather the thousands of companies that keep your lights on, heat your house, prepare your food, and otherwise keep you alive and healthy. They didn't just survive, but also took good care of their customers, refinanced their debt when interest rates declined, paid their dividends, and invested for the future.

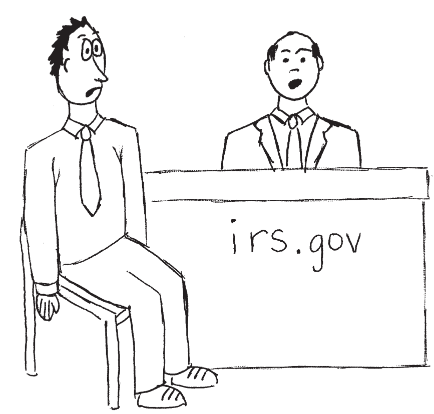
After all that, many of the biggest and best companies are selling at 10 or 12 times earnings. We're talking about Microsoft, AT&T, Kimberly-Clark, Comcast, and Raytheon. Pfizer and Sanofi-Aventis sell for less than 7 times earnings! At ten times earnings a corporation can afford to pay a 10% dividend; these companies *already* pay good dividends, and they can sharply increase them if they so choose. Would you rather earn big fat dividends, or a big fat zero in the money-market fund? ■

Thirty years ago the Dow was at 800, and thirty years before that it stood at 177. During the next three decades it will multiply fourfold, or tenfold, or somewhere in between.

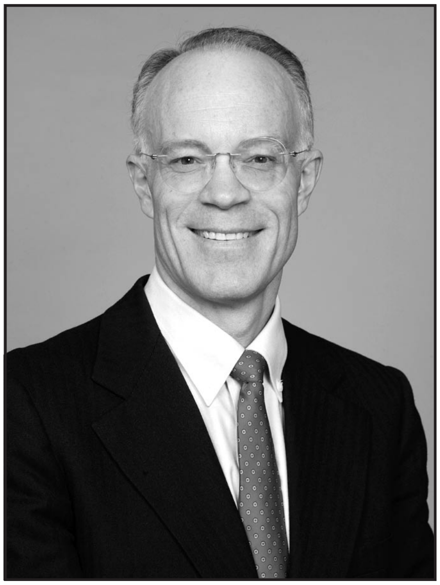
"OK Mr. Brown, I've calculated your federal tax, and you owe another $8,500. Please make out a check, payable to "Internal Revenue Service" for $1,000."

© Laura Lumbard

"As for the other $7,500, we'd like you to participate in our new "Eliminate The Middleman" efficiency program. Mr. Stephen O'Connor of Federal Hill Road



has just purchased a new Chevy Volt. He's due a tax credit for that amount, and you're going to give it to him."



John Lumbard, CFA

EVIL MONGERS!

Health insurance companies are still evil. Oil companies are evil again, after being out of the spotlight for many years. In public forums bankers and investment bankers are evil, especially Gold-in-Sacks, although privately the government continues to shower them with billions at the urging of trusted adviser Gold-in-Sacks.

Industries under suspicion include mortgage brokerage, natural gas production, telephone utilities, cable TV- Internet, beverages - soft drinks, fast-food companies, miners, water utilities, pharmaceuticals, medical instruments, tobacco companies, the auto companies that have not been nationalized, insurance companies that *have* been nationalized, most packaged-food companies, numerous media companies, and electric utilities—especially the coal-burning ones. Unless, of course, they're located in coal-producing states. ■

INTEGRITY

For some time now the news about climate change has bubbled with the carnival atmosphere of the tech stock and real estate manias. We believed the early claims that sea level could rise as much as 30 feet, knowing that oil consumption alone was putting 25 million tons of CO_2 into the air each year. The 30 foot estimate dwindled to a foot and a half (without any commentary whatsoever) as the projected temperature increase shrank, and somebody remembered that the oceans are really big.

There was a whispered admission that the Gulf Stream won't, after all, stop—and thus plunge Europe into an Ice Age. Hollywood did a movie about wolves and Arctic winds in New York, never really explaining how a warming greenhouse effect could cause temperatures of 50 degrees below zero at the 42nd Street library. Then Al Gore got the Nobel peace prize for having the biggest carbon footprint on the entire planet, and we knew that this had become a very unfortunate mix of science and religion.

Our own carbon footprint shrank, again, when we leased a couple of Priuses for the firm. Yes, we really are getting 53 miles to the gallon, even if we have to put our feet down on the pavement like Fred Flintstone when we want to come to a full stop.

We need to reduce our consumption of fossil fuels for environmental, national defense, and economic reasons. Coal emissions alone kill 24,000 Americans every year. And hardly anybody would argue that the simple and honest way to reduce gasoline and coal consumption—while raising revenue to reduce the government's massive deficits—is to tax gasoline and coal. Cap and Trade is a deliberate attempt to fool the voters into thinking that they won't feel the cost.

Complex solutions, obfuscation, heavy regulation, and political cowardice will push unemployment higher and sink the nation under a great weight of deceit. If Congress doesn't have the courage or honesty to propose a simple tax on fossil fuels, how can we trust them to deal with the complex and difficult issues that arise every day? ■

"A great big tax to create a great big slush fund to provide politicized handouts, run by a giant bureaucracy."

– Tony Abbott of the Australian Parliament, describing a proposed cap-and-trade bill in his country.

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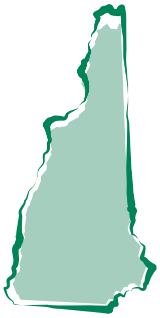
100 years ago the life expectancy of the average American male was just 50 years. The average work week exceeded 55 hours. Less than 10% of homes had telephones, and a mere 14% had bathtubs.

If you haven't re-financed your mortgage, do it now. These might be the lowest rates you'll see in the next 30 years.

INTEGRITY



New Hampshire has again been ranked as one of the least corrupt states (this time by the Daily Beast, which ranked us as *the* least corrupt state), and it's worth stopping for a moment to speculate why this might be true. The first and biggest reason is that we starve our state government via low taxes and "inadequate" revenue; every state agency has to fight for every scrap of funding, so every dollar is accounted for. New Hampshire somehow manages to keep the lights on year after year . . .

The second reason is that those legislators are paid just $400 a year. They're all part-timers who approach the job as a charitable act of public service. It's a mistake to allow legislators to see public service as a way to make a living, because in no time at all they'll come up with reasons why they deserve more money, more power, and lifetime tenure. ■

UP FROM THE GROUND COME A BUBBLIN' CRUDE

Imagine that the price of a commodity is $4 a pound, and suddenly the price drops to $2. It's not hard to imagine that some mines would close, while those with the richest deposits, the best technology, and the best mining equipment would survive.

That's not hard to imagine at all. So why is it so hard to imagine that a *doubling* of the price of the same commodity—or any other commodity—would cause mines to open and production to expand? The same goes for oil wells, alternatives to oil, and just about everything else that is produced in this world. If demand goes up, yes, the price will go up; but there won't be a "shortage". If the price goes up a lot, demand will shrivel while production explodes. It might be years before producers truly believe that high prices are here to stay, and more years before they actually open the mines or drill the wells, but the laws of supply and demand will not be denied.

Oil is gushing out of the floor of the Gulf of Mexico as if the world were a balloon full of the stuff. OPEC is struggling to keep its members from producing more than their quotas. And Iraq, long misrepresented and scorned, is beginning to follow through on plans to *triple* its 2.4 million-barrel-per-day output.

Drew D. Kellner

In 1962, when John Kennedy was President, tax revenue was 17.6% of GDP, spending was 18.8%, and Defense was 54% of the federal budget.

There's still a lot of misunderstanding about Islam (a large and peaceful religion whose name means "submission to God") and Islamism (a relatively new and militant perversion of Islam which draws inspiration from Salafism and Wahabbism). There is also a lot of misunderstanding about the war on terrorism. It seeks to discredit a strategy of achieving political goals via indiscriminate killing. Thanks to our troops, terrorism failed in Iraq—for Saddam's Baathists, for the Sunni tribal leaders, for the Mahdi army, for other Shia militias, and for foreign terrorists.

IT'S NOT JUST GREECE

In April a thousand Carlsberg brewery workers went on strike to protest a new rule that restricted beer drinking to lunch hour.

HUMAN NATURE

"For many of the working poor, the implicit marginal tax rate is greater than 100 percent." – Clifford Thies, Von Mises Institute

In plain English, Thies is saying that anybody receiving government benefits would be a fool to take a job (or admit that he has one). Thies starts by calculating that the total value of the benefits (food stamps, housing subsidies, health care subsidies, a free cell phone, and cash) available to an unemployed Virginia family of 3 is about $38,000 a year.

If the head of that household takes a job at $10 an hour (about $20,000 a year), she'll pay FICA tax, lose some benefits, and wind up with salary and benefits of about $40,000—a gain of just $2,000 for a full year of hard work. If she works even harder, taking two jobs that pay a total of $30,000 a year, the family's income will not budge. It will still be $40,000.

Most depressing is the fact that an increase to $40,000 a year would actually cause her family's take-home pay to slip back to $38,000. And she'll suffer even greater penalties if she starts her own business. In that case her FICA payments will be 15.3% of her income instead of 7.65%, because she won't have an employer to pay the "employer's share". And she'll have to pay that employer's share—7.65% of all wages—for any employees she hires, while she dives into a new world of business taxes, worker's comp, unemployment insurance, and state and federal regulation—even if it's just a janitorial business. It's a wonder that anybody ever gets hired at all.

When the family's income reaches $60,000 they'll finally start seeing some progress, because their take-home pay will jump to $50,000. At $80,000 they'll be allowed to keep $60,000, *provided that they don't plan to send any children to college.* Colleges charge tuition according to family income, in a way that acts as a second layer of graduated tax. The cost ranges from $0 to $55,000, per student, per year.

This is real money, and it hits most of the middle-class families you know. In a two-income family with college-age children, the second income adds almost nothing to the family's finances. It might even cause them to *lose* money.

Bit by bit we've created a system that destroys the incentive to work. As time passes there will be more and more people who choose to stay home, and more and more people who are willing to apply for public assistance. And, as in Europe, the media and the public will embrace reasons (family time, quality of life, reduced pollution) why a bad economy is a good thing.

The difference is that the United States has a special role in the world economy. Scores of developing nations have their economies built around the notion that American consumers will buy their exports, with dollars that have a known value to every citizen on the planet. America set an example of free markets, and then opened her own markets to the world to spark a surge in global prosperity—literally from rags to riche—that has never before been seen in human history.

– John Lumbard, CFA

From the Dean of the Faculty of Medicine at Harvard:

"We favor finding ways to give patients more control over their health-care expenditures. This would improve both cost discipline and health outcomes.

One way to do that would be to encourage the purchase of high-deductible insurance, coupled with putting money aside in health savings accounts—including a shift to HSAs of some of the funds now paid to insurance premiums. This would give patients a powerful incentive to focus on the cost of their care . . . . . We need to reach a consensus that Medicare, Medicaid, and private insurance are the main offenders, and must be reformed."

– Jeffrey Flier, MD, and David Goldhill

Performance Results:
The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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