STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS AUTUMN, 2012

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 3,172 * Dow Jones Industrials 13,540 * 30 year U.S. Treasury Bond 2.95%

SIMPLICITY RULES

The Republican Party's platform in the presidential campaign is built around tax and entitlement reform. The Democratic Party's platform is built around ensuring that Mitt Romney never again has a 13% tax rate. Big tax increases for everybody from janitors to journalists are less than 4 months away, but Romney's rate would still be in the teens . . . gimme a minute . . . We're going to go way out on a limb and predict major changes in the tax code before the cherry trees bloom in the nation's capital.

This is a wonderful thing, because our tax code is corrupt and dysfunctional. Incomprehensible law is little better than lawlessness, and it's worth remembering that the certainty and predictability that came with the Rule of Law was the key to the spectacular improvement in living standards of the last 200 years.

In 1800 it took 75% of our population—men, women, and children—to produce food for consumption and export. We'd still be as poor as church mice if not for bold and risky investment in inventions such as the steel plow (John Deere, 1837) and the steam tractor (1850 or so); for the first time businessmen and farmers believed that they would be allowed to earn a fair return, and that their property would not be confiscated by the King of England or anyone else.

Certainty and predictability are not adjectives that any knowledgeable observer would apply to our tax code. Our accountant tells us that no one, anywhere on this planet, can give you a firm answer to some common questions that relate to the taxation of partnerships.

According to The Economist, Americans spend 7.6 billion hours a year preparing tax returns. "By this measure", the magazine adds, "the tax-compliance industry is six times larger than car-making."

Just last week we spoke with a Peace Corps employee who had won a pyrrhic victory over the IRS—spending so much on legal fees that the effort resulted in a loss of both time and money. Time may not seem like the sort of thing that should worry the pretty little heads of congressmen, but an hour of Steve Jobs' time was worth a thousand jobs.

Sweep away all the crazy tax deductions and special deals, and we'd gain more than a sense of fairness. We'd all save time and aggravation, and a hundred thousand highly-trained accountants and tax lawyers would be free to create jobs and do good in the world—instead of working diligently at the equivalent of *"I lift things up and I put them down."*

Washington will soon change for the better, because it *has* to.

The stock market is already up 14% this year, and we're not backing away from our prediction of a 25% gain. Really we can say anything we want, because Mayan forecasters tell us that the world is going to end on December 21—a few days before the Fiscal Cliff kicks in and our next newsletter is due. Meanwhile stocks are still so deeply undervalued that their prices are simply *wrong*. Yes, Europe is in flames, but if you wait for the fire to die down the s'mores will all be gone.

STOCKS WE LIKE

In our last issue we laid out our principles for picking stocks, and we do like stocks—especially the ones below. Every single one of these companies could pay a dividend of more than 9% if they used all their earnings for that purpose.

Metlife (MET - $35). The only reason the stock is this cheap—six times earnings!—is that the Fed won't allow them to buy back shares. If they could, they could theoretically buy 16% of the company every year.

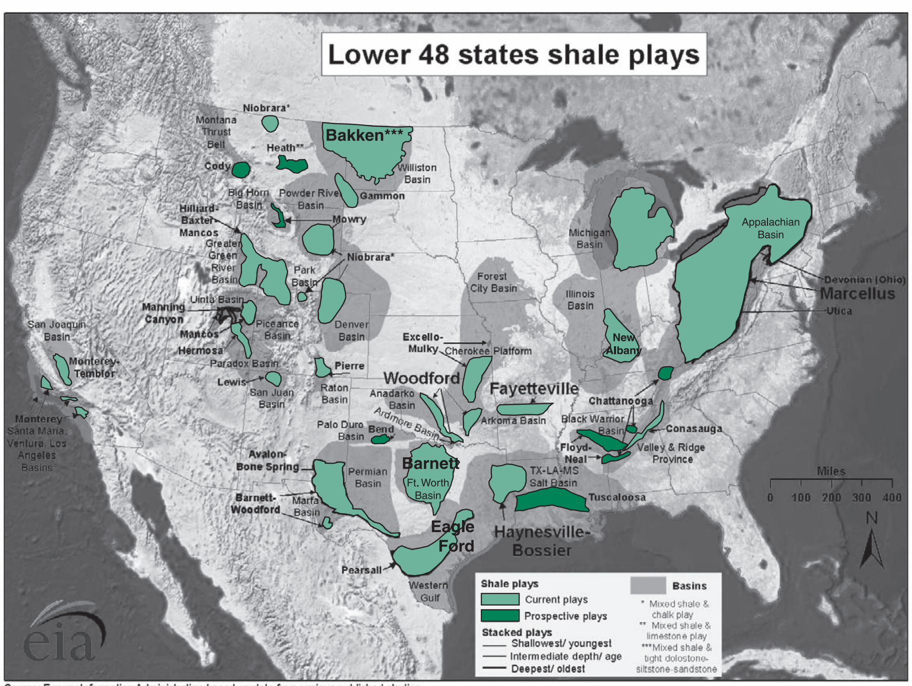
Microsoft (MSFT - $31): Mr. Softie has declined over the past 12 years, while earnings doubled—and then some. The yield is 2.6%, and they could pay 10% if they weren't buying back shares at bargain prices.

i-Shares Poland (EPOL - $26): Polish stocks are cheap, the economy is growing, the nation is hard-working and well-located, and it's not even part of the euro. The yield is nearly 5%.

Ford of Turkey (FOVSY - $49). We also like Ford of Detroit, but Ford Otomotiv Sanayi yields more than 8%—and makes the hot-selling Transit Connect van that you see popping up all over the place. Global auto sales continue to rise, up *five million* in 2012 alone.

Johnson Controls (JCI - $28). Johnson was the happy recipient of one of the Stimulus Program's dumb mistakes, a $300 million grant to build a lithium-battery plant that has contributed to a battery glut. It also makes the seats for the world's least-expensive car. Its energy-efficiency division retrofitted the Empire State Building to cut energy use by $2.4 million a year.

Seadrill (SDRL - $41). Seadrill is up almost 30% in the last year, but it still yields 7.9% and the dividend is still growing. That's because the company has the best and newest fleet of ultra-deep-water drilling rigs, and they're in such high demand that a brand-new rig (they have 18 under construction) was just leased for *$233 million a year.*



Source: Energy Information Administration based on data from various published studies.
Updated: May 9, 2011

This is the Energy Information Administration's new shale map. It's basically an err,umm,sorry admission that there's oil and gas all over the damn place, and that the alarms they sounded quite recently regarding shortages were somewhat misplaced.

SEP(AND A HALF) TUPLED

"Extensive and readily available data show that in a random 12-month period, about 60% of mutual fund managers underperform; lengthen the period to 10 years and the proportion of managers who underperform rises to about 70%."

–Charles Ellis, CFA,
Financial Analysts Journal

As we go to press in mid-September our Benchmark account—a real, fee-paying account that opened in 1990 at a value of $100,000—stands at **$749,267**, up 14.3% for the year and ***up 62%*** (from $461,826) in January of 2008.

THE ONLY GAME IN TOWN

Wall Street has been moaning that the economy is bad, the Fiscal Cliff is looming, Europe is imploding . . . and now they're saying that stocks have gone up too much. The angriest pundits are the ones who've had all their money in cash. But the key point isn't *theeconomystupid*, it's low interest rates. Interest rates would have to double to justify today's stock prices, and even then there'd be a good argument to put your stock in America, and your portfolio in stock.

We are, of course, assuming that Europe won't get much worse, and that the Fiscal Cliff won't plunge the economy into recession. We need to reduce our deficits by a couple hundred billion dollars each year, but we can't actually *balance* the budget in 2013 because that would cause an immediate recession—and everyone in Washington knows it. Like it or not we're addicted to deficits, and we'll have to reduce them slowly over a period of years.

In August the yield on 10-year bonds issued by 3M corp. was 2.06% while the expected dividend yield on shares of 3M was 2.56%. That didn't make any sense at all, so it's no wonder that stocks have been climbing steadily since then.

Even with an inflation rate of just 1.7%, an investment in CDs or money market funds will cause you to lose ground, and bonds aren't much better—in fact you run the risk of a sizable loss as interest rates rise over the next 5 years. The dividends paid by a sensible stock portfolio are twice as high as the yield you'd receive from a portfolio of US Treasury bonds of various maturities, and that's just the dividends—today's corporations pay out just a small part of their earnings as dividend. They use the rest to buy back stock or invest in growth. For the most part these companies are in fabulous shape, with lots of cash and little debt. ■

Paul K. Wright, CFA

INFRASTRUCTURE

Here in the 'States there's a lot of talk of infrastructure needs, but little discussion of the biggest infrastructure problem we have today. There's a tidal wave of new oil and gas being produced in the country, but much of it sells at artificially-low prices because we don't have enough pipelines, refineries, or LNG plants to deal with it. And instead of helping to finance or facilitate these infrastructure investments the federal government has been actively opposing them.

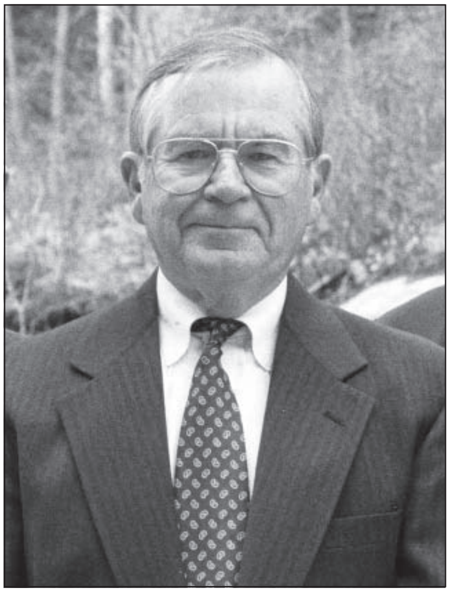
Delta Airlines is so worried about the outlook for jet fuel that it bought one of the refineries that was recently closed by regulatory burdens, and is planning to ship oil in from North Dakota by train. Seriously. A fleet of minivans—jobs for soccer moms!—might be the best way to get the crude to the train depot . . .

Opponents of pipelines and fracking hope to drive up the price of gasoline enough to discourage consumption. It's working—gasoline consumption has been falling for 6 years—but pouring sand into the gears of the economy is not at all the same thing as policy. Instead of creating unemployment, wouldn't it make sense to let free people and free markets bring prices down, and then use taxes to push prices back to current levels? *We sure could use the tax revenue*, and it's free money. Talk about low-hanging fruit . . . ■

Happiness is a Choice.
Choose Happy.

"I could end the deficit in 5 minutes. You just pass a law that says that anytime there is a deficit of more than 3% of GDP, all sitting members of Congress are ineligible for re-election."

—Warren Buffett, *on* CNBC



John Convery Jr., CFA

REAL ESTATE RISING

In April, May, and June, the S&P/Case Shiller home price index rose at an annualized rate of 11.3%. The underlying trend isn't quite that spectacular, but make no mistake—housing has bottomed and is slowly rebounding. Fifteen year mortgages are at 3%!

Since before the financial crisis we've been using the New England experience of the late 80's and early 90's as a rough guide to the coming housing crash. Home prices began to fall visibly at the end of 1988, and over the course of 4 years they declined roughly 30%. Four years later, in 1996, they were back to the level of 1988. This time around the recovery will take much longer, but the comparison has been useful.

How could anybody have been surprised to see the second bubble burst like the first?

We think stocks are a better investment than real estate, but anybody who has been planning to buy a house should make the purchase sooner rather than later.

"Either you were complicit, grossly negligent, or incompetent," John Mann, a Labour lawmaker, told Mr. Diamond [CEO of Barclay's Bank].

After a pause, Mr. Diamond asked, "Is there a question?"

– The Wall Street Journal

"The Social Security Administration put together a random sample of 125 Americans who were at least 90 years old and received old-age benefits but did not use their Medicare benefits. It confirmed that at least 23 of these Americans were dead, with three having passed away 29 years, 21 years, and 19 years ago respectively."

– The Wall Street Journal

Once we've finished looking for deceased beneficiaries over the age of 90, we're going to start in on the 89 year olds.

"We don't have the guts to tell seniors the truth. When Medicare was passed in 1965, the average life expectancy was 69. Today the average life expectancy is 85. Medicare was never meant to cover nearly 20 years of life. It's got to be changed...there has to be a reshaping of entitlements."

– Ed Rendell, former chair of the Democratic National Committee and governor of Pennsylvania

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" . . . the average American receives Medicare benefits that are three times the amount he pays in. A two-earner couple making $89,000 a year who retire this year have paid about $114,000 in Medicare payroll taxes during their careers, but will draw about $355,000 in medical services during retirement."

– The Brownsville Herald, quoting economists at the Urban Institute

The Consumer Financial Protection Bureau says that the nation's student loans now exceed $1,000,000,000,000. The money is owed by the same children who will inherit our $16 trillion-dollar debt.

How's about we come up with a solution that does not involve borrowing money from the Chinese that will have to be paid off by today's students?

LEADERS OF THE FUTURE

Dozens of Harvard students have been accused of cheating on a "Government 1310" take-home exam. It's hard to understand why this was unexpected, as the formal title of Government 1310 is <u>Introduction to Congress</u>.

OUR BIG FAT GREEK . . . CONGRESS

If Germany would just borrow and spend, preferably on Greek olive oil, the problems of Europe would melt away. That's what NY Times columnist Paul Krugman is saying, but he's deliberately overlooking the fact that Greece has far too much debt—and that it would not be in any trouble whatsoever if it had lived within its means.

Wage increases are justified when a worker becomes more productive (with the help of new equipment and techniques), and produces more in each hour of work. That's the source of all the world's improvement in living standards. There's nothing easy about retraining and employing the workers who are no longer needed, but Germany has been making the effort every year—while Greece "preserved jobs", raised the wages of unproductive workers, avoided investment in new technologies, fattened its government payrolls, and covered the inevitable shortfalls with borrowing.

Greece is in trouble because of debt, anti-competitive policies, heavy regulation, and excessive benefits given to politically-connected workers and voters who are only too happy to sell their votes to the highest-bidding politician. Sounds a bit like the U.S., doesn't it?

If the euro had never come into existence, Greece's currency would have declined every week; and Greeks would have experienced a steady decline in their standard of living as the cost of foreign goods went up and up. They wouldn't have borrowed from foreigners because no lender would have been willing to take the risk of being paid back in near-worthless drachmas.

With the euro the Greeks still had options. If they didn't want to embrace efficiency, productivity, and capitalism they could have held wages at low levels and lived within their stagnant means. Want 6 weeks of vacation, a government job for lazy cousin Stavros, and a cigarette break every hour? No problem; just take a small pay cut each time your productivity declines, and be more frugal than ever. If you don't borrow, you don't risk a financial crisis.

Over the course of the last 40 years the United States has built a Rube-Goldberg imitation of the European Welfare State. There's no need for all the complexity and confusion created by our state and federal governments, and there's certainly more to economics than simply spending to create jobs as Paul Krugman recommends.

In the last 200 years farming has become so efficient that less than 3% of our population can now produce all our food—and export to feed the world. That didn't happen without massive job losses and pain, but if it *hadn't* happened food would be fantastically expensive today. And those "excess" workers created personal computers, health care, iPhones, and supermarkets that would have dazzled the royalty of yesteryear.

Drew D. Kellner, CFA

Today we would respond to a wave of downsizing in the farm belt by refusing to allow layoffs to happen. It's not easy to accept that *preserving jobs is a sure path to future unemployment and poverty*, but it is—as are congressional mandates that the Air Force purchase cargo planes that it doesn't want.

We can reduce unemployment without increased deficits and additional debt; the lesson from Europe is that we need to balance our budgets as soon as possible, and embrace growth and change—and layoffs—as goals of good government. As the Germans do.

ALEXANDER HAMILTON'S TWO CENTS

According to the White House Budget Office, the US is currently collecting about $2.5 trillion in taxes, and spending about $3.8 trillion.

The nightmare scenario for the federal debt is that foreign investors will become skittish, and it's already happening; Japan and China continue to buy US Treasuries as a means of currency manipulation, but all other foreign buyers have cut back. The only good news is that interest rates have gone down rather than up, because the Fed has been buying *three-quarters* of all new treasury bonds since the beginning of this year (data, St. Louis Fed).

Actually, this is wonderful. We worried that interest rates would rise to 10%, and that the increased interest cost would add a trillion dollars every year to the budget, the deficit, and the debt. But if the Fed owns all the bonds, they'll hand the interest back to the Congress. *Who says there's no such thing as a free lunch?!!?*

Meanwhile, let's remember that we're collecting 16% of GDP in taxes and spending 24% of GDP on government programs. "Mandatory" programs such as Medicare/Medicaid are almost 16% of GDP by themselves. But we've never collected more than 20% of GDP in taxes, and we were *never* able to reach even *that* level when the top tax rate was greater than 40%.

Bill Clinton collected more tax than any other president, with a top personal rate of about 40%. In those years all Americans, at every income level, had higher tax rates than they have today.

Alexander Hamilton argued that one of our nation's greatest assets is its ability to borrow during a crisis. We no longer have that ability, because we've issued so much debt in ordinary times. Our debt is now larger than our GDP—just about where Greece's debt stood in 2006—and it's growing much faster. Next year our debt will be at the level of Greece 2008. Perhaps we should start thinking about selling off some of our islands . . .

– John A. Lumbard, CFA

John Lumbard, CFA

Beginning in January you'll pay new Medicare taxes if your income is greater than $200,000 (or $250,000 for married taxpayers filing jointly). There are actually two new taxes, with a 0.9% surtax on wages, and a 3.8% tax on interest, dividends, and capital gains.

Tax reform will raise those rates further—the wealthy could see a 23.8% rate on long-term capital gains, while the middle class pays 20%—so all taxpayers should think hard about their unrealized capital gains. Consider "taking" gains before the end of 2012.

License plate spotted on a car owned by a school for novice drivers:

MYBAD

CONTINENTS OF INCONTINENCE

"America has run a deficit for 40 of the last 44 years; Britain for 51 out of 60 and Spain for 45 out of 49. France has not balanced its budget since 1978; Italy since 1960."

– The Economist

"How did you go bankrupt?"
"Two ways. Gradually, then suddenly."

– Ernest Hemingway, *The Sun Also Rises*

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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