

LUMBAR D  
INVESTMENT  
COUNSELING

INSIGHT

Nasdaq Composite 1,400.33 \* Dow Jones Industrial 8627.40 \* 30 year U.S. Treasury bond 5.01%

## GOOD ECONOMY, BAD MARKET

The U.S. economy is growing. It's not firing on all cylinders, but it's growing a lot faster than anybody realizes. In fact, during most of 2002 it grew at approximately the 3% pace that has been the long-term average for our economy.

At the moment we're seeing a bit of a slowdown that's largely related to softness in the automobile sector. But the Federal Reserve is printing money as fast as it can, and housing continues to get a boost from low interest rates. Those low mortgage rates are boosting *all* consumer purchases, because homeowners are slashing their mortgage costs by refinancing their homes; and most of them seem to be taking out additional cash with larger mortgages. Then they spend the proceeds on motorboats and motorcycles and other gas-guzzling toys.

The talking heads on CNBC keep asking when corporations are going to resume buying computers the way they did in 1999. The most useful answer to that question is "never", because 1999 was an aberration that had a lot to do with crowd psychology,

bubbles, and Y2K fears. Our economy will continue growing, but high-tech revenues will grow moderately; along with those of plumbing supplies and asphalt and kitchen appliances and legal services. Well, maybe not as fast as legal services.

A good economy does not guarantee a good stock market. Stocks are still overpriced, particularly in the best-beloved sectors of the stock market. And we're still in an environment in which an investor considering a stock has to spend many hours to come up with a guesstimate of "true" earnings. The markets float on a sea of confidence, and it's hard to feel confident about buying zero-dividend stocks if you don't feel confident about their earnings.

It's not normal that millions of people watch CNBC each day, and it's not normal to have the business press and investors obsess about tech stocks to the exclusion of everything else. It's certainly not normal to have investors castigate the markets as "rigged" even as they make monthly 401K investments in mutual funds. Mutual funds that bought Tyco and Enron and

Worldcom and Global Crossing.

Still, we're approaching the end of this bear market. We've almost arrived at the day when we can focus on individual stocks without worrying what "the market" is going to do, and we can already buy without worrying about what the economy is going to do. You can safely buy the stocks of banks and retailers and basic-industry companies, because there's no longer any need to shy away from investments that require economic growth to succeed.

Better still, it's now safe to buy "high yield" bonds. Yes, these bonds are often called "junk" bonds, but they are certainly safer than the stocks of the same companies. A "B" rated company might be a modest-sized firm with good growth and very solid finances,

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"A lie gets halfway around the world before the truth has a chance to get its pants on."

— Sir Winston Churchill

*Good Economy (continued from page 1)*

or it might be a larger company that has hit a rough patch or taken on too much debt. In recent months we've been able to find safe bonds that yield 12% or more, and we're expecting to reap significant appreciation from them as well. Perhaps more appreciation than anybody will get from stocks.

What about war and terrorism? We have to admit that the decline in air traffic after 9/11 was surprisingly large, but such "one-time" events rarely have a significant effect on economic growth or corporate profits. A war with Iraq would cause no more than a hiccup in the growth of our huge economy, and the markets would hardly react at all.

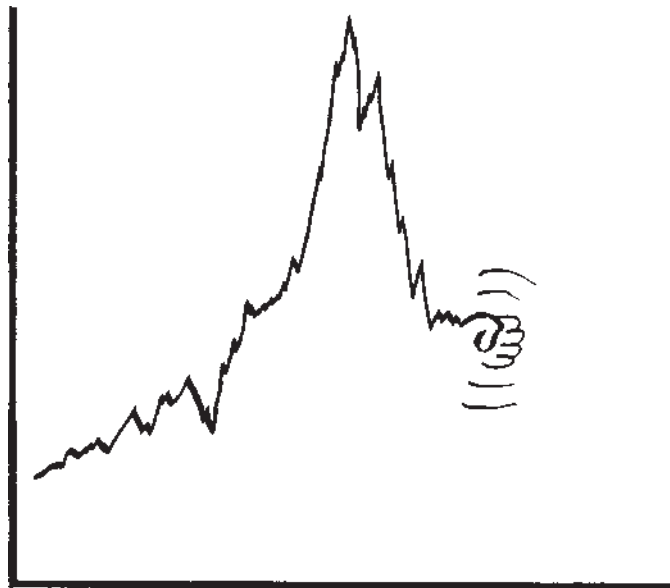
Our client accounts are now in positive territory for the year. That's partly due to purchases of BellSouth, Bristol-Myers, Schering Plough, Sprint, and other stocks when they were at their recent lows; and it's partly due to a sale of all of our "short" funds in September. But it's also very much due to the rapid appreciation of our foreign-bond and high-yield bond portfolios. Foreign government bond portfolios are rising because the dollar is falling; high-yield bonds are rising because it seems that our economy will be OK, after all.

The most likely scenario is modest growth. Sluggish growth, that causes little joy in Mudville; but mighty Casey will not strike out.

"Enough gloom. Here's a thought to cheer people up. The dividend yield on the Dow is 2.48%. The 10-year U.S. Treasury is yielding 3.66%. From here, if the Dow goes up a mere 1.2% a year on average during the next 10 years, it will have been a more-attractive investment than today's 10-year Treasury.

Now does that seem so hard?"

- Jesse Eisinger, The Wall Street Journal



"We've been made out to be freewheeling jet-setters, playboys reliving our adolescent years . . . For me, and for most CEOs, the irresponsible image really rankles."

- Dennis Kozlowski, CEO of Tyco, writing in Directors & Boards magazine in 1995.

"It's not just some stupid dog umbrella stand"

- Wendy Valliere, interior decorator for Dennis Kozlowski, explaining why it was reasonable that Tyco International paid \$6,000 so that he could have an umbrella stand shaped like a dog.



## DIVIDENDS RULE

Companies that refuse to pay dividends—and then reinvest the money they save to generate growth—actually grow more slowly than those which pay the cash out to shareholders. That's the assertion of Clifford Asness and Robert Arnott, capital-market researchers who have been publishing frequently in the CFA Digest and the Financial Analysts Journal.

This is a radical concept. Finance professors—and the study materials for the CFA designation—have always taught that companies give up a big part of their growth potential when they give a chunk of each year's earnings to shareholders as dividend. That money could be used to build new factories and buy other companies and invest in research and development. So it's no surprise that this assertion has sparked a lot of disagreement, and Arnott and Asness have been forced to produce more studies over longer time periods. Most of which seem to support their claims.

If they are right, it's because most CEOs are doing a very bad job of reinvesting the cash that normally would have gone to shareholder dividends. The CEOs say that they are buying back shares and thus making the stock go up, but what's *really* happening is that their modest purchases do little more than soak up the shares created in the stock-options program. The options program that has been enriching

the CEO and other members of management.

The rest of the cash goes to higher executive salaries and foolish acquisitions. It's a long-established fact that 70% of all corporate acquisitions are a bad idea. Recent experience looks to be even worse.

As for the CEO's complaint that dividends are taxed twice, we think it's mostly an excuse. A company like Tyco hardly pays any taxes at all, but that never encouraged Dennis Kozlowski to pay a dividend. And it's likely that the excuse will soon disappear; there's a very good chance that the government will soon give you a reduced tax rate on dividends that will put them on an even footing with capital gains. The result should be a backlash of common sense in corporate offices around the country.

Paul Wright of our investment advisory board thinks that the stocks of dividend-paying companies will surge in anticipation of the tax-law change. Investors have been getting tired of dividend-free investing anyway, after three down years. They are beginning to notice that stocks with dividends have a natural defense against declining markets; every time they go down, their dividend yields rise.

In the end, investors don't have to decide whether companies with dividends grow fastest. If the honest companies grow at the same pace as the zero-dividend companies, their stocks



*John Lumbard, CFA*

Photo by Rick Balboni

will rise as quickly. And their shareholders will also receive dividend checks in the mail.

Let's take an example of a stock with a 4% dividend yield, and a ho-hum 5% rate of earnings growth that allows a 5% rate of dividend growth, and the same rate of appreciation in the price of the stock. It will be 14.4 years before the dividend doubles to 8%, and it will take the same amount of time to see a doubling of the stock price.

How very dull. But listen to this: If you were to start with an investment of \$10,000, and reinvest all the dividends in the example above (getting an 8% rate of return on the reinvestment), after 15 years you would have a total of \$40,712.72

Now *that's* real investing!



## OVERSEAS PROFITS

For a long time we've been asserting that the U.S. dollar was overvalued, and that it would decline. We didn't feel comfortable saying that it would decline against the yen or the currencies of Latin America or Southeast Asia, so we focused on buying bonds issued by the governments of Europe. Of course, the pundits argued long and loudly that the euro was flawed, that the European Common Market was flawed, that the governmental policies of the European nations were all flawed, and that nobody in his right mind, in any nation in the world, would invest anywhere except the good ol' US of A.

America's trade deficit continued to grow. We borrowed more money from China, and we sold American companies and real estate to Europeans to fill the gap. Foreigners now hold huge stakes in U.S. treasury bonds, corporate bonds, common stocks, and real estate.

Imbalances can persist for years, but not forever. Today the euro is worth more than a dollar. In fact, it stands at \$1.03, up from a low of 83 cents. And it's about to feel the warm winds that pushed the dollar to such a ridiculous height, because a rising currency creates its own updraft.

The big impact is on inflation. A rising euro will mean that the

## NUTS AND BOLTS

*Fees, Custody, and Minimums at Lombard Investment Counseling.*

We can't claim to have escaped *all* the accounting scandals and stock-market declines unscathed, but in 2000 our average account saw a return of 7.9%. In 2001 our average return was 9.59%, and for 2002 we're looking at a modest but *positive* return—in a black year when few investment advisers can claim to be in the black. Even fewer can claim positive results for each of the last three years.

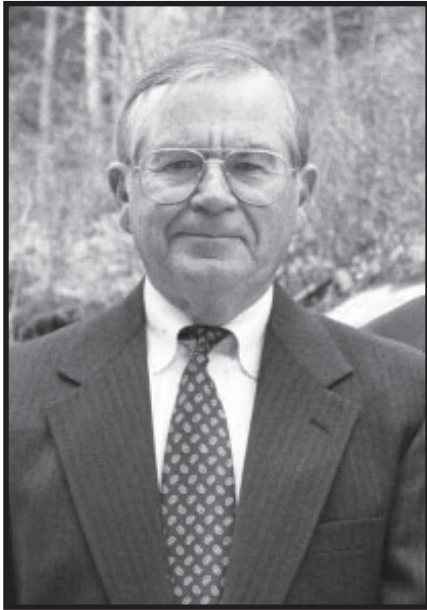
We now have a track record of solid returns that spans 12 years. The keys to this record have been diversification, value, and a "bird in hand" philosophy that emphasizes dividends and interest. Our client accounts are held in custody at the U.S. Bank, State Street, and other major institutions. Each client has a custodial account at the bank in his or her own name, and Lombard Investment Counseling covers the cost. The result is the ability to use multiple stockbrokers, and "block trade" in a way that brings great flexibility and extremely low commissions on trades.

Our annual fee is 1.1% of the first \$500,000 in assets, 0.85% of the next \$500,000, 0.7% of the second million dollars, and one-half of 1% of any assets above \$2 million. Our minimum is \$350,000. If you would like further details, please call (800) LUMBARD, and ask Jan for an information kit.

prices of imported goods—oil and wheat and clothing and high-tech goods—will not rise in Europe. That means that the European Central Bank can stop worrying about inflation, and push interest rates down to lower levels . . . as they just did. Lower interest rates mean stronger growth, and stronger growth attracts investment from other nations, causing a stronger currency; and lower inflation, lower interest rates, and stronger growth.

As the euro rises to \$1.05 and \$1.10 we'll be paring back our investment in European government bonds, which has grown to unreasonable size. But we won't sell them all until America's trade deficit gets down to a reasonable level. It eventually will, and the result will be a rebirth of American manufacturing. So we'll slowly shift from foreign bonds to American manufacturing stocks. What could be better than that?

Give us a call at 1(800) Lombard. **Not (800) Lombard!** (800) Lombard.  
That's (800) 586-2273.



John Convery, CFA

## LONG-TERM INVESTING

From the earliest days of the stock market, through boom and bust and war and depression, common stocks were always bought for their dividends. Investors started to toy with the idea of buying stocks for “appreciation only” during the first technology-stock bubble in the late 60s, but the last decade stands alone as the *only* time when dividends were shunned by the majority of investors and the majority of corporations. Today only 21% of corporations pay dividends to their shareholders, down from 67% in 1978.

Think about that. If you owned half of a hardware store, you would expect to get half the profits each year. If your partner wanted to invest all those profits in expansion, you might be willing to go along for two or even three

years, but you’d be looking forward, eagerly, to the day when your dividends started to flow again.

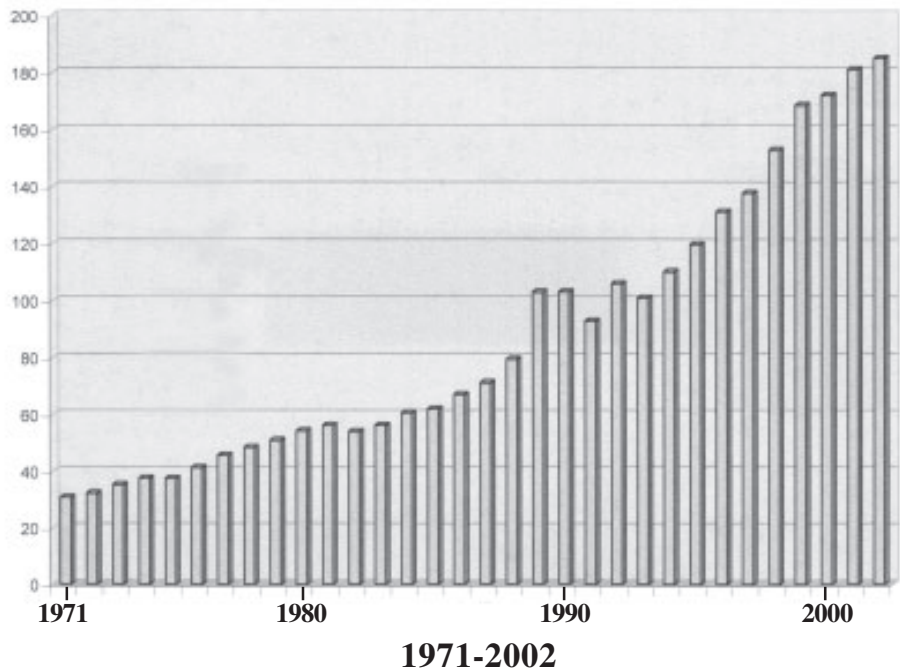
Similarly, it has always been accepted that young, rapidly-growing companies would be unable to pay dividends during their years of heavy reinvestment for growth. But all companies reach maturity, and growth always slows as size increases. The notion that large, mature, slow-growing companies such as Cisco and Microsoft would refuse to share their profits with shareholders would have seemed incredible to the investors of the 1920s—or the 40s or the 60s or the 80s.

Bear markets have a way of bringing investors back to earth, and back to sound practices and

rational thinking. In this process we turn over rocks to see what’s underneath, and in the last two years investors have discovered a number of unsavory truths about Worldcom and Enron and a host of other companies. Difficult markets also change the mental set of market participants, and in this case it’s likely that they will continue to move away from the technology stocks and the other high fliers. Investors are beginning to seek out real companies with real earnings that are able to pay a cash dividend.

Sound investing isn’t about buying stocks that double overnight. It’s about steady appreciation that’s built on steadily growing dividends, over long time periods. Start investing today, and avoid the rush.

Dividends For The Dow Jones Industrial Average



*A Point Of Patriotic Pride:*  
**THE WORLD'S BIGGEST TAX LAWS**

It's easy to make the tax code more complex; lock a dozen congressmen in a room, and out will come more special-interest deals and homeowner exemptions and pork-laden amendments than your accountant can lift, let alone read.

Tax simplification, on the other hand, is hard. Every little change hurts *somebody*, so simplification can only take place when there's a big incentive such as a tax cut that eases the pain of all those who are hurt by the loss of loopholes and favored rates. In fact, we're nearing the point at which almost everybody has a special, treasured deduction; for oil drilling or stock options or interest on the home mortgage. The result is a Third World tax system that strangles productivity and growth, mis-allocates the nation's resources, and causes near-universal discontent.

One of the great frustrations of the last Congress was its failure to undertake tax reform at a time when taxes were being cut. Now they're talking about tinkering with the tax laws again, and they should keep one principle uppermost in their minds. Simpler is better. Fewer deductions and tax breaks and loopholes would bring higher productivity to the entire nation, and they would also bring lower tax rates to everybody.

**This Used to Be the Most Beautiful  
Country in the World**

From 1992 to 1997 more than 3 million rural acres were lost to development in the northeastern U.S. alone.

**Whip-Sawed**

In our last issue ("Say Goodnight To The Day Traders") we projected that massive "short" positions would cause massive short-covering rallies. Hello Nasdaq 1500. The day traders aren't done yet, so keep your seatbelts fastened.

Another key point is that taxes discourage, while tax reductions encourage. When you raise taxes on cigarettes, sales of cigarettes go down a little. Raise taxes on gasoline—something we should have done long ago—and gasoline sales go down. You wouldn't see everybody rush out and buy a Toyota Prius, but you *would* see consumers asking about the gas mileage of new cars and trucks and boats. A businessman going on a trip would take the Volvo instead of the truck, and skiers would notice for the first time that it really does cost more to drive to Sugarloaf than to the White Mountains. It always has.

Our current tax system encourages consumption and borrowing, and discourages income. We have some incentives for savings, but we discourage dividends by applying double taxation. The alternative minimum tax is snaring more taxpayers every year, and driving them to drink—or retirement.

Even after the 2001 tax cuts, American taxes are near their highest level ever when expressed as a percentage of our total economy (GDP). Those cuts reversed years of "bracket creep" tax increases, and gave a tax cut to nearly every worker in the nation by changing the 15% tax bracket to a 10% bracket and eliminating the "marriage penalty". The bad news is that the new law added complexity. One important reason is that the changes have been spread out over the course of ten years, in the hope that our economy would eventually generate enough growth to offset the soaring cost of Medicare and Social Security.

Ain't gonna happen. The current plan is to abandon all the changes in 2011. The nation will be without an estate tax in 2010, and only in 2010. Expect to see a lot of wealthy, elderly people take up skydiving in that year, because on January 1, 2011 the entire tax code goes back to the way it used to be. Unless the Congress decides to extend the changes. Or change the changes. Or extend selected parts, and change others.

John Lumbard, CFA

**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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