LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,679 * Dow Jones Industrials 12,076 * 30 year U.S. Treasury Bond 4.23%

GETTING THE ECONOMY BACK ON TRACK

We have the most ridiculous tax system in the history of the world. Last year Clorox paid taxes at a 39% rate—nearly twice what they'd pay if they moved to Canada—while GE paid *nothing*. The wealthiest 10% of our citizens pay 70% of all the nation's taxes, but the wealthiest 400 pay at a 17% rate (and hedge fund managers like George Soros see most of their income taxed at 15%). Many tax questions are so thorny that *nobody* can tell you for certain how the IRS would deal with them.

All this craziness has spawned a huge industry. We've got far more than a million accountants and tax preparers crunching the numbers, not to mention tax lawyers who scheme and lobbyists who lobby . . . . That hardly sounds productive, but any Washington wonk will tell you that paper-shuffling employs huge numbers of people at a time when we need jobs. Yes, maybe we should fix the tax system, but *this is not the time to do it*.

These *are* tough times, and they'll stay tough for a while because we're paying for the excesses of the last decade—when we constantly pumped up growth by borrowing to buy houses and SUVs. We pumped it up some more with government borrowing and spending that was meant to give the economy a temporary lift, and now our economy has a bad hangover. Should we keep the patient in bed, or give him a few shots of Red Bull and coffee to get him back on his feet?

We'll go for rest and recovery—and a thorough physical. The patient's arteries are badly clogged. It just *can't* be true that it's a good idea to employ millions of highly-educated accountants and tax lawyers to do the equivalent of *"I lift things up and put them down"*. Simplifying our nutty tax system would be a good thing for our economy, *even* if we did it right now and caused an increase in unemployment among well-educated and hard-working people. They would find jobs; and millions of additional jobs would be created by America's businesses, soaring higher and farther without the heavy burden of complex taxation on their backs.

There might be just as much inefficiency and intrusion in our health care system. We're felling forests and filling millions of disk drives to collect *Privacy Notices* from you every time you turn around, and that's just the tip of the iceberg . . . .

Congress has also created a trade war with Brazil, which now applies gigantic tariffs to 100 American products ranging from appliances and boats to cars and cosmetics, in response to the harm that we inflicted on Brazilian industry with illegal cotton subsidies, sugar quotas, and ethanol tariffs. If you want to import Brazilian ethanol you'll have to pay a tariff of 54 cents a gallon!

State and local governments play a role as well. They've piled a mountain of burdens onto the backs of businessmen

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"At 5%, Washington's unemployment rate is easily the lowest among America's metropolitan areas. Employment in the metro area has risen by about 84,000 over the past year—roughly 6% of America's job growth, in a region with just 2% of its population."

– The Economist

GETTING THE ECONOMY BACK ON TRACK

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in the last couple of decades, to the point where you wonder why anybody would want to hire a new employee at all. Recently we spoke with a client, retired from an engineering practice, who told us he felt he had retired just in time. New regulations were killing worthwhile projects and crippling the ones that survived. The flood of new regs had created legal liabilities that no one could adequately estimate; businessmen were becoming risk averse; and jobs were being lost.

Many politicians believe that Depression-era programs such as the CCC and the WPA are the way to boost employment, but there's a reason why those programs are associated with the Depression. They helped to prolong it, and they did nothing to increase the availability food, clothing, housing, radios, kitchen utensils, or medical care. These lessons were re-learned in 20 years of on-and-off recession in Japan (the "Lost Decades"), and in the collapse of the Soviet Union—which offered ***a job to every citizen and poverty for all***.

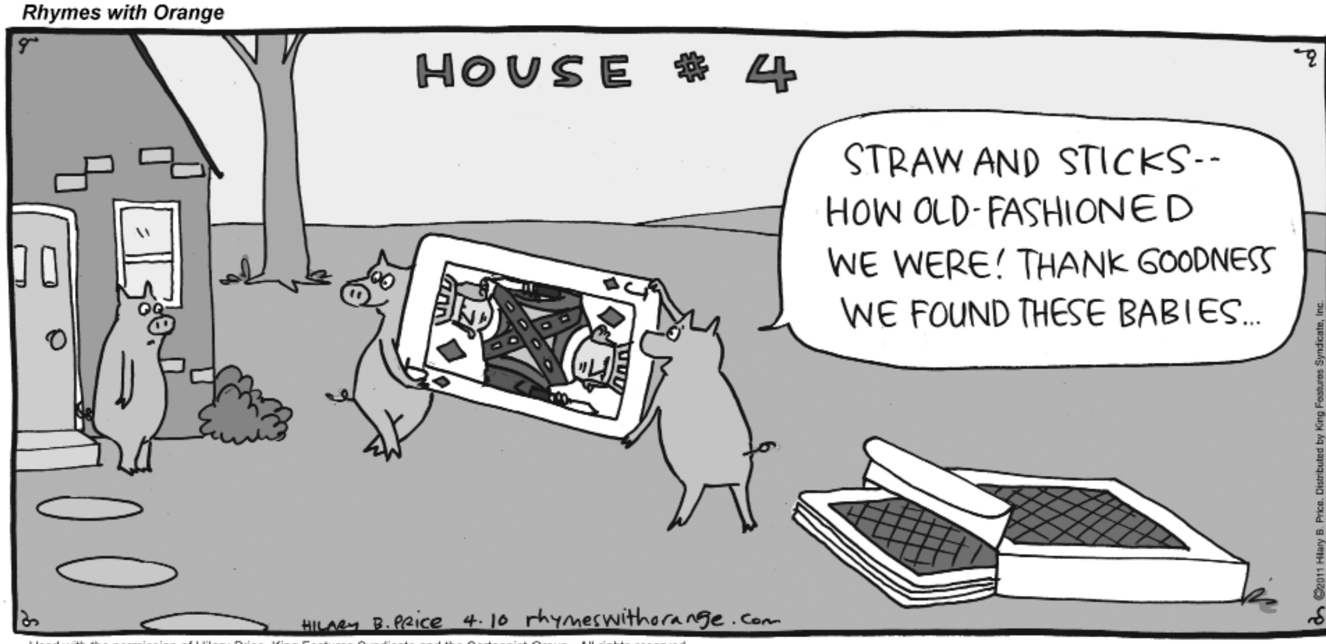
Policies that focus on raising employment instead of growth are doomed to failure. We can emulate Canada, which had huge debt problems (bigger than ours!) in the 1990s and vanquished them by embracing efficiency and growth; or we can re-live the experience of Japan, and suffer another two decades of lethargy by focusing on employment and the tired programs of the past.

Yes, we are mired in a long period of debt reduction. But we have before us a wonderful opportunity to boost growth by unclogging the economy's arteries. The *good* news is that they're full of plaque and fatty deposits! Rebirth and renewal lie ahead! ■

We can't lift the fortunes of the poor without embracing a policy of growth. It was the advancing productivity of workers that brought us—all of us—fresh fruit in the wintertime, indoor plumbing, electricity, and thermostats; as well as longer life expectancies, telephone service, and truly inexpensive family meals at McDonald's.

In 1800, 75% of our population was needed to feed our population and produce crops for export. Today the USDA says that just 2% of Americans are able to handle the same tasks. Imagine how costly food would be—and how little else we would have—if 75% of the nation were still employed in agriculture.

Rhymes with Orange



WHY BUY STOCKS?

From 1947 through 2009 corporate profits grew 7.9% a year. That's almost exactly the 8% growth rate of GDP in those years, in nominal (not adjusted for inflation) terms. We think that real GDP might only grow at a 2% rate in the next couple of years, and that inflation might run another 2%, but that would bring a nice 4% rate of growth in revenues and earnings. Companies that sell products in the faster-growing regions of the world might grow more quickly.

Stock prices rise with earnings growth, and they rise faster if they started at a low level. Right now it's possible to find dozens of big blue-chip companies that sell at 10 times next year's expected earnings. A company selling at 10 times earnings has the option (if it doesn't pay dividends) of buying 10% of itself each year. There would be little impact on the company's profits, but earnings *per share* would grow more than 10% (actually 11%) each year.

Most of these companies are spending part of their earnings to buy back shares, and another part to pay dividends of 2% or more. Sometimes much more. Not bad at a time when money market funds pay almost nothing.

Dividends grow along with earnings. Since 1995 the dividend paid by IBM has grown from a dollar to a split-adjusted twelve dollars a share. In 1995 the yield was 2%, so today's yield on a 1995 purchase would be a handsome **24%**. ■

Drew D. Kellner, CFA

S*XTUPLED!

On June 13 our benchmark account was valued at **$674,307**; up from $231,542 on 12/31/2000, and $100,000 in October of 1990. For more information please visit our web site, www.Lumbard.com, or call (800) Lumbard / 800-586-2273.

"Three Mile Island is an excellent example of the United States making a terrible mistake. We took what actually was a very minor incident and used that as justification to build tons of coal plants, which we now know was a terrible error." [The EPA estimates that coal plants cause 24,000 American deaths a year] "... activism from environmental groups wound up hurting the environment. Those groups allowed the panic of that moment, as well as preexisting concerns and superstitions about nuclear, to turn them away, and they wound up causing material damage to the environment."

– Nathan Myhrvold, chief technology officer of Microsoft until 1999, and the leader of an effort to build a nuclear reactor with no moving parts that runs on nuclear waste.

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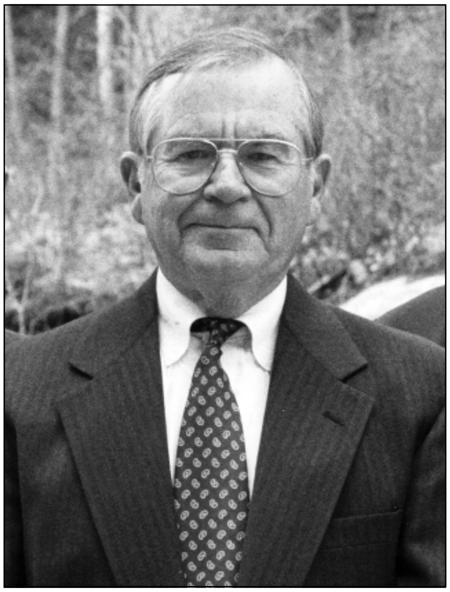
China, undeterred by the Japanese nuclear accident (in which *no one died*—and an 8.9 earthquake was unable to damage any of the reactors), will go ahead with the construction of 30 nuclear plants. We don't shut down air travel when an airliner goes down, and Japan hasn't banned the construction of houses and roads along her vulnerable coastline, where thousands died in the tsunami. One nuclear plant is equal to dozens of square miles of solar panels or wind towers, so the environmental footprint is far smaller. Unlike wind and solar, nuclear plants make little use of fossil-fuel backup plants that fire up when the sun don't shine and the wind don't blow.

We live downwind from China, so we should be thrilled that the dragon isn't building 30 giant coal plants . . . And there's a wonderful synergy between nuclear plants and electric cars that the nation of France (79% nuclear, for decades) is about to explore. ■



John Convery Jr., CFA

"The cure for low prices is low prices."

– Economist John Mauldin, arguing that the government's efforts to prevent home prices from declining were always doomed to fail.

"The essence of investment management is the management of RISKS, not the management of RETURNS."

– Benjamin Graham, *The Intelligent Investor*

"It's said that there are around 64 million empty apartments in China . . . . It's a property bubble like which I don't think we've ever seen."

– Gillem Tullech, a property analyst with Forensic Asia. Market-research firm Dragonomics believes that Chinese real estate prices have declined 5% in the last year.

SUPPLY RISING

Six years ago natural gas prices hit \$14. Experts declared that we were facing a shortage, and you would have been hard pressed to find anyone willing to say that today's prices would be at \$4. Exploration companies are "capping" their gas wells in hopes that prices will rise next year.

Now U.S. oil production is rising. It's up 10% in two years, and it's riding the same wave of technological change that caused a revolution in the gas market. Not long ago it was believed that we wouldn't be able to get oil out of shale without mining and heating it, but last year North Dakota produced 113 million barrels of oil from shale. The industry is in its infancy. Eric Konigsberg writes in The New Yorker:

"Since 2008, further estimates by the U.S.G.S. and other agencies have suggested potential reserves in the Bakken of as much as three hundred billion barrels. The new techniques employed there have led to seven or eight new oil plays, in Texas, Colorado, and elsewhere, said geologist Pete Stark. Taken together, the new reservoirs are expected to raise domestic production by as much as two million barrels a day."

Two million barrels a day is the amount of oil that Iraq used to produce, before it brought in outside experts who are expected to double production to 4.2 mbd by 2016.

A similar revolution in deep-water drilling is under way world wide. Exxon just made a big new find in the deep waters of the Gulf of Mexico, and Brazil is completing the infrastructure needed to produce oil from its massive deep water reserves. All these new technologies are the result of high prices for oil and gas, which financed the investment that made them possible.

High prices have also had a predictable impact on demand. Gasoline demand in the United States has been so soft that we've become an exporter, after 20 years as a net importer. We're even exporting gasoline to Saudi Arabia, although that has more to do with 45-cent-a-gallon subsidy for blending it with ethanol than anything to do with economics. But after the last big spike in oil prices, in the late 1970s, the nation's gasoline consumption declined 4 years in a row.

The laws of supply and demand should never be ignored. ■

Early this year hedge fund managers John Paulson and John Burbank were buying huge quantities of gold as a hedge against ***in***flation. Hedge fund managers George Soros and Alan Fournier were buying huge quantities of gold as a hedge against ***de***flation. The main thing to know about investing in gold is that investors can run it up or down whenever they feel like it; for good reasons, bad reasons, or no reason at all.

THE MARKET OUTLOOK

Early in the year we loaded up on stocks, and in April we cut back again. Our strategy was to embrace any ancient Wall Street saying that came to mind. "Sell in May and go away", "You can't go broke taking profits", " Bulls get rich and bears get rich, but pigs don't". We also thought that the commodity bubble would burst—taking stocks down with it—and that investors would begin to look forward to the weak economy in 2012.

The dominant theme of the next few years will be debt reduction and declining government stimulus at the state, local, and federal levels. The trouble with stimulus programs is that they depress the economy when they come to an end . . . .

Now that investors are back in their blue funk, it's time to remind everyone that corporations were spectacularly successful in coping with the economic crisis of 2008-2009. And while it might be true that many small-company and foreign stocks are still pricey, you can't say that about big blue chip multinationals. Microsoft sells at 9 times *this* year's earnings, and this fiscal year ends in a couple of weeks. If they used all those earnings to buy their own shares they'd gobble up the company in no time. The last few shares would control annual earnings of $19 billion . . . . .

We're not going to rush to spend the cash we raised in the Spring, but investors who are still sitting on great piles of the stuff should keep in mind that the markets can take off in a hurry when the idle days of summer draw to a close. Don't get taken to school. ■

John Lumbard, CFA

Last month's Mason-Dixon poll revealed that 65% of voters now support a balanced-budget amendment to the Constitution, with only 27% opposed. We're just one small panic away from the situation that Greece got into, in which nobody wanted to lend them money at interest rates below 11%. At even 10% our interest payments on our debt will be a trillion dollars, and our government's spending will rise to $4.4 trillion a year. We collect $2.2 trillion a year in taxes.

Still, this is best seen as a moral issue. Back in the good old days parents tried to leave an inheritance to their children. Are we really planning on sticking them with a gigantic debt to the Chinese? Really?

"When school children start paying union dues, that's when I'll start representing the interests of school children."

– Albert Shanker, while president of the American Federation of Teachers

WHAT THE DOCTOR PRESCRIBES

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Let's close with a positive example of government action. In 1978 Congress deregulated the airlines, shrugging off the fears of those who thought that airplanes would collide and poor maintenance standards would cause them to fall from the sky.

None of these things happened. Air travel continued to be extremely safe, and airfares declined an inflation-adjusted 30% in the next 12 years. Competition seemed like a dangerous idea, but in fact it allowed tens of millions of working-class Americans to travel the world, knees pressed hard against the seat in front of them. The same will be true in medical care, when we finally get past the prejudices and fears that have made a royal mess of one of our most important industries. ■

– John Lumbard, CFA
June, 2011

WHAT THE DOCTOR PRESCRIBES

Since 1994 Jeffrey Flier, MD, now Dean of the Harvard Medical School, has been offering a plan for health care reform that would rein in the galloping cost increases that threaten to bankrupt our government and make health care unaffordable to the middle class.

His concept—universal health care *and* a competitive market—would start with a "high deductible" insurance policy for every citizen that would serve as an inexpensive way to ensure that no one is bankrupted by illness. Costs would be controlled by insisting that citizens shop for their care, paying for a portion of every surgical procedure with funds drawn from tax-free savings accounts similar to an IRA.

For the first time consumers would have some skin in the game. When you sign up for knee surgery you never ask the price, so you shouldn't be surprised to see that the cost has skyrocketed. But until recently LASIK eye surgery wasn't covered by insurance, so patients shopped for price as well as quality and success rates. Prices responded by dropping dramatically even as outcomes improved—and surgeons now cure a much broader range of eye conditions.

When you buy a camera, a computer, or cosmetic surgery you do your homework, read all the reviews, and then go shopping armed with information that allows you to demand quality and a low price. Why should a knee operation be any different?

Instead you pick a doctor, grant him a monopoly, and tell your health insurance company to pay the bills. We, all of us, *like* the illusion that health care is free. It isn't. The "single payer" nations keep costs down by rationing, micromanaging, and forcing you to wait 6 months to get an MRI; but our own politicians have proven that they can't control costs in this manner. It's just too easy to buy re-election by offering bigger and better benefits than before.

It makes more sense to emulate the countries that allow competition to flourish, and have begun to lure patients from those single-payer nations by offering excellent care at a terrific price. Want that MRI now instead of next January? Each year more than a million medical tourists visit Singapore and Thailand alone—for complex surgery as well as for MRIs—and the number is growing all the time.

Forcing consumers to shop for care means that we'd have to ban "why not it's free!" insurance plans that allow patients to buy whatever they want, with little out-of-pocket cost. That would be intrusive—even more intrusive than the new ban on incandescent light bulbs—but the Medicare trustees just announced that Medicare will be ***bankrupt*** in 13 years. We'll need to come up with $25 *trillion* to cover future expected shortfalls. And Medic***aid*** is busting state budgets all over the nation, despite the fact that the federal government kicks in $277 billion a year. Add in health care for federal, state, and local workers, and programs for children, and you find that government at all levels has been paying for 55% of all health care in the nation.

A good part of that money was borrowed from the Chinese, but in the future it's going to have to come from the taxpayers. Health care is bursting household budgets as well, but we're not going to be able to sustain anything like the current system without a huge tax increase on most workers. "Most workers" would surely include the median household, which earns a bit less than $50,000 a year.

If your first thought is that a household making just $50,000 is one that *needs help* paying for health care, then you've arrived at the nub of the problem. How can we possibly afford to subsidize the average household?

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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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