

FOCUS

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Your fair share

We realize that tax season is behind us, but some information came our way (courtesy of TrendMacrolytics) that we think brings into focus one of the central problems with our tax code, namely the extent to which the trend towards greater progressivity forces the tax burden on fewer and fewer people. Here is TrendMacro's synopsis of this report:

A new report from the Congressional Budget Office shows that over the last 17 years, effective tax rates have become much more progressive. The total federal tax rate on the lowest quintile of households has fallen from 10.2 percent in 1984 to 5.4 percent in 2001. Indeed, the Bush tax cuts dropped the rate from 6.4 percent in 2000.

Meanwhile, the effective rate on the top quintile has risen from 24.3 percent in 1984 to 26.8 percent in 2001. The ultra rich saw even bigger increases. The top 5 percent of households saw an increase from 26.1 percent to 30.1 percent over the same period, and the top 1 percent saw an increase from 28.2 percent to 33 percent.

Not surprisingly, the share of total federal tax liabilities borne by different quintiles also shows a sharp increase in progressivity. The bottom quintile's share fell from 2.4 percent in 1984 to 1.1 percent in 2001. The top quintile's share rose from 55.6 percent to 65.3 percent. The top 5 percent of households increased their share from 28.2 percent to 38.5 percent and the top 1 percent increased from 14.7 percent to 22.7 percent.

In short, between 1984, well after the Reagan tax cut was fully effective, and 2001, effective tax rates and the share of total federal taxes paid fell for 80 percent of the

population—everyone except those in the top quintile. And this was over a period in which the top federal income tax rate fell from 50 percent to 39.1 percent.

You can view the full report on the web at: <http://www.cbo.gov/showdoc.cfm?index=5324&sequence=0>

As we've pointed out before, the narrowing of the tax base was one of the major factors that contributed to California's ongoing budget woes. A continuation of this trend at the national level could lead to major funding problems for the Federal government in the event of a serious recession.

Scandals we didn't hear about

A recent article in *Business Week* described yet another way in which the investment banking industry stretched the rules to serve its own interests. When AOL was about to merge with Time Warner, Goldman Sachs purchased 1% of AOL Europe, reducing AOL's stake below 50%, thereby allowing AOL to keep \$200 million of losses from showing up on its financial statements during the months before the merger. Goldman even admitted that this was the purpose of the transaction. After the merger, AOL bought the shares back in a pre-arranged transaction. This is yet another clear example of financial engineering for the benefit of the engineers. Their motto: Anything for a fee.

(Extracted from Bob Veres' *Media Reviews*)

The core of the problem

The preceding article motivated us to revisit another article, this one by Bob Arnott, founder of Research Affiliates and editor of the *Financial Analysts Journal*, on the topic of ethics and business (published on the First Quadrant website). Although the bulk of the article deals with the recent accounting scandals, he cites some studies that examined societal ethics by asking the general question, "How pervasive is corruption in society at large?" As he says in the article, the answers are troubling.

- A KPMG study reported that 76% of employees surveyed stated that they had observed a high level of illegal or unethical conduct at work in the preceding 12 months, 45% admitted that they had lied to their supervisors during the same period, and 36% said that they had lied on or falsified a written report. Only 1%, however, believed that their own ethical standards were lower than those of their peers.
- A Rutgers University study reported that 70% of university students surveyed admitted that they had cheated on an exam in the past year, and 87% admitted to cheating on written assignments. It also showed that among graduate students, more than 60% admitted to cheating to improve their chances of getting into graduate school. For MBA students, the figure was 75%!
- Many business schools no longer require the teaching of ethics in their programs. One even introduced the concept of “situational ethics.”

A lack of faith in the ethics of managers causes investors to demand a higher return on their investments—in other words, a “credibility” premium to compensate for the higher risks of investing in an environment in which accounting data and statements by management cannot be trusted. However, Arnott goes on to address the more general problem:

“Our society is probably overly tolerant of dishonesty and corrupt behavior. It is too easy to get away with unethical behavior. It is too easy to resume one’s career even after getting caught in the act.

“If we reach a point where an individual is shunned by his or her peers for taking a pencil or stamp from the office, we can safely assume that the ethical standards of senior managers will cease to be an issue. Unfortunately, this will not likely happen during the careers of today’s

newly minted graduate students. In other words, we should brace for the possibility that ethical scandals will continue to be commonplace for the balance of our careers. In the meantime, we should start teaching our own kids that a promise is a promise, a lie is a lie, and honesty is not a matter of subjective interpretation.”

We couldn't agree more.

***Bubble, bubble,
toil & tumble?***

Could the recent rise in interest rates spell the beginning of the end for the housing market? Certainly, the property market this year has been far more resilient than anyone could have hoped to imagine. The question is how much further can it go? Because crystal balls are a rare if nonexistent commodity, all we can do is look at what is happening and try and put it in a historical context.

Jim Jurak, a columnist for MSN Money, recently laid out his “three rules of bubbles.”

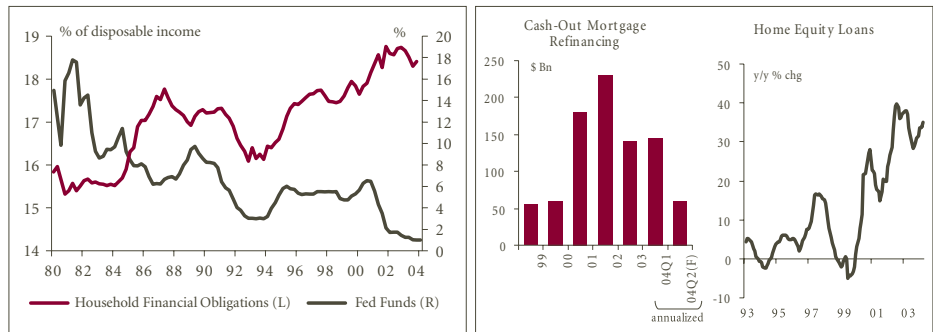
1. *A bubble expands far longer than anyone expects.*

Part of the widespread discounting of the notion of a housing bubble is that people have been saying that there has been a housing bubble for years, so why is it any more true now? If one argues long enough that a market is overpriced, eventually it will be true. However, history is littered with failed predictions of market crashes called too early. What good is it if you called the crash last year and 300% ago?

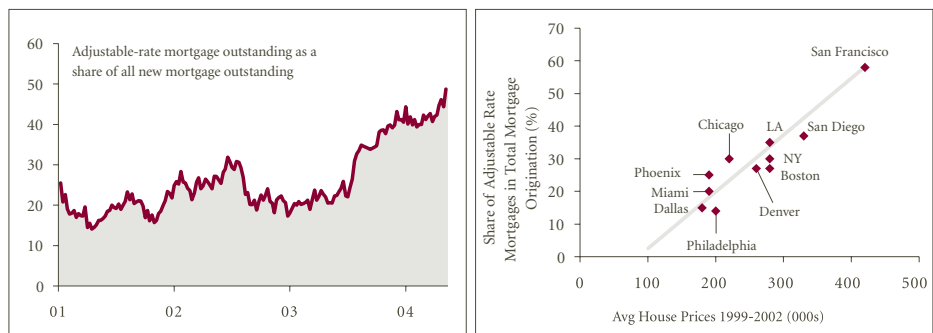
2. *A bubble expands faster as the cycle nears its end.*

Does speculative frenzy accompanied by cheap credit sound familiar? Double digit increases in home prices and people rushing to “lock in” cheap interest rates seem to be the rule of the day. So what makes this different than any other interest rate cycle in the past? Rates have risen before, and the housing market didn't implode. Inflation is in check, so why would a couple of hundred basis points make a difference now?

Recently, CIBC World Markets published a research note titled “Higher US Rates: Why a Little Means a Lot.” In it, the authors outline why this expansion of credit is unlike any other we have ever seen. Americans are leveraged to the hilt and have never in the past used so much leverage to fund the kind of consumption growth we have seen over the last four years. Short term credit represents a record \$0.26 of each dollar spent, and mortgage credit has expanded 25% since early 2002.



Moreover, use of adjustable rate mortgages (ARMs) is at a record high because as the housing market has taken off, first-time buyers have had to stretch to make the payments fit within their budgets. ARMs as a % of all new mortgages have more than doubled since 2003 to over 50%, all in order to make the payment “more affordable.” It is particularly telling to look at the use of ARMs in higher priced markets. For instance, in San Francisco, over 60% of mortgage originations were ARMs.



There has also been a surge in the use of interest-only loans, which grew 25% last year and now represent 13% of all new mortgages. Why? Again, buyers are stretched, and they generally figure, “Why do I need to spend my money to build equity when the market can do it for me?” The last time interest-only financing was as popular? 1929.

As the well of borrowers has begun to dry up, banks and finance companies have increasingly begun to lend to borrowers that just a couple of years ago they wouldn't have touched. The sub-prime (read: high risk) sector of the market now accounts for over 10% of all mortgage originations, more than double the rate of just ten years ago.

All of this leads us to Jurak's Rule Number Three.

3. *It's tough to admit the cycle is over.* Our impulse is to do whatever it takes to continue to inflate. It makes us feel good, and it's certainly good for the finance companies' bottom lines. The financial markets have certainly done everything they can to continue to keep the borrowing gravy train running, pushing ARMs, interest-only loans, and home equity lines, as well as lowering borrowing standards, all of which are hallmarks of a credit bubble. It may take some time for the results to start to filter through. As revolving debt rates begin to climb and ARMs reset to market rates, we should begin to see an increase in the number of consumer bankruptcies. Overstretched and bankrupt consumers are generally not going to be buying a home. They are far more likely to try and sell it and cash out. Right now, the risk in the property market just doesn't justify the reward.

Our conclusion: consider the recent rate hike a last call at the property saloon.

(Charts and data courtesy CIBC World Markets)

***Military
intelligence***

Aim towards the enemy.

—*Instruction printed on
U.S. rocket launcher*

When the pin is pulled, Mr. Grenade is not
our friend. — *U.S. Army*

If the enemy is in range, so are you. — *Infantry Journal*

A slipping gear could let your M203 grenade launcher fire
when you least expect it. That would make you quite
unpopular in what's left of your unit. — *Army's magazine
of preventive maintenance*

It is generally inadvisable to eject directly over the area
you just bombed. — *U.S. Air Force Manual*

Try to look unimportant; they may be low
on ammo. — *Infantry Journal*

If your attack is going too well, you're probably
walking into an ambush. — *Infantry Journal*

If you see a bomb technician running,
try to keep up with him. — *U.S.A.F. Ammo Troop*


Inside Woodside

First, the promised overhaul of our website has been delayed a bit. We hope to have the new version up and running by the end of this quarter. We'll keep you posted.

Although we are very happy for her, we are also sad to report that Nancy Daly, a colleague of fifteen years, has left the firm to take a breather and decide what she wants to pursue next in her life. She has moved to Reno to be able to spend more time with her family and, as Ernie Arbuckle of the Stanford Business School used to say, re-pot. Fortunately, Nancy has agreed to continue doing financial planning for our clients on an outsourced basis, so we will continue to be in close touch with her. We wish her all the best in whatever she decides to do. We also want to thank her for her years of loyal service to our clients and for her significant contributions to Woodside's success.

As a reminder, our offices will be closed on Monday, September 6, in observance of the Labor Day holiday. ☒

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