Woodside Asset Management

Focus

Volume 16, Number 1 / January 2, 2003

Dividends do matter

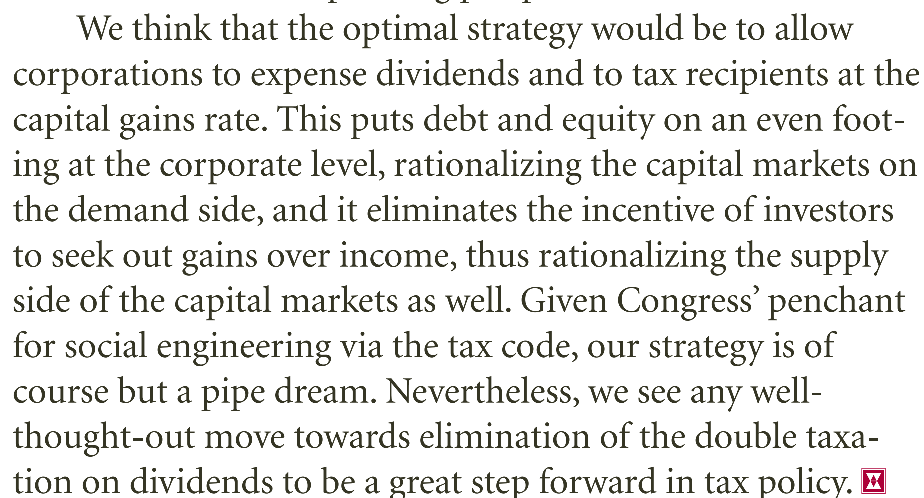
There has been a huge buzz lately about one of the Administration's tax reform/cut proposals: a change in the way dividends are taxed. One version would be to eliminate taxation at the individual (recipient) level, putting dividend-paying stocks on a level playing field with municipal bonds, at least in terms of tax treatment. Another would make them deductible to the corporation just like interest payments. Yet a third would tax them at capital gain rates, thus eliminating any incentive on the part of the recipient to favor capital gains over dividends. While each version has its pros and cons (and proponents and detractors), the general concept is important because it has major implications for the capital markets.

Under the current system, corporations have an incentive to favor debt (i.e., issuing bonds) over equity (issuing stock) when raising capital: the interest on bonds is deductible, while issuing stock may dilute earnings and place a drag on stock performance. Furthermore, they also have an incentive to use earnings to buy back shares in the open market (which is anti-dilutive) instead of paying dividends. Dividends have to be paid with after-tax dollars, and they are then taxed again at the shareholder level. Under a buy-back strategy, shareholders have the option of selling shares and paying a capital gains tax instead of receiving dividends and paying tax on them at the higher ordinary income tax rate.

This incentive to favor debt has led to an explosion of corporate debt relative to equity. It could also be argued that it has contributed, at least in part, to some of the recent financial and accounting scandals: with their compensation tied to share price via options, managements sought to

bolster share price through numerous mechanisms besides simple corporate operating performance. With increasing debt came increasing risk, and eventually the risks manifested themselves, to the great detriment of both shareholders and bondholders.

One of the great advantages of dividends is that they provide a clear and objective measure of corporate performance. You can fudge earnings with accounting gimmickry, but you can't fudge a cash payment. Furthermore, once a dividend payout level is set, management is loath to decrease it because doing so generally has a very negative impact on share price. Of course, if a company has investment opportunities available to it that will serve to maintain or accelerate its growth, it should probably choose to make those investments rather than pay out the cash in the form of dividends. Assuming that the accounting can be trusted, the market will recognize and reward such decisions if the investments prove to be viable. Thus, true "growth" companies are not put at a disadvantage if the taxation of dividends changes, and with no incentive to favor debt over equity, managements will (hopefully) choose the level of indebtedness that makes the most sense from an operating perspective.



We think that the optimal strategy would be to allow corporations to expense dividends and to tax recipients at the capital gains rate. This puts debt and equity on an even footing at the corporate level, rationalizing the capital markets on the demand side, and it eliminates the incentive of investors to seek out gains over income, thus rationalizing the supply side of the capital markets as well. Given Congress' penchant for social engineering via the tax code, our strategy is of course but a pipe dream. Nevertheless, we see any well-thought-out move towards elimination of the double taxation on dividends to be a great step forward in tax policy.

A pound and a half of flesh?

It is well known that taxpayers in the highest income brackets pay the largest share of personal income taxes. In 2000 (the most recent year for which data is available), those in the top 1% of income paid 37.4% of all personal income taxes, up from 36.2% in 1999 and only 25% in 1991. However, these same taxpayers only received 20.8% of all adjusted gross income in 2000, also up slightly from 20.8% in 1999 and only 13% in 1991. To qualify for this elite group, you had to report adjusted gross income of just over $313,000 in 2000. As in years past, the top 5% of incomes (above $128,000) paid 56% of all taxes. The top 50% of incomes paid 96%.

Understanding these figures is key to understanding why the Administration has floated the idea of reducing payroll (i.e., Social Security) taxes instead of reducing income taxes as part of its stimulus package: it is impossible to cut income taxes without benefiting those in the highest brackets, i.e., the nefarious “rich.” Every worker, rich or poor, pays payroll taxes. It wouldn’t surprise us that in order to get his package approved by Congress, the terms of any payroll tax cut would benefit only those in lower income brackets. After all, the “rich” don’t need any such cut.

We read recently that when JFK proposed his income tax cuts, a reporter asked him if the cuts would benefit the rich. “I certainly hope so!” replied Kennedy. Let us hope that President Bush can exhibit the same kind of leadership and courage when it comes time to debate whatever stimulus plan is put forward.

Will the Streak End?

Will 2003 be the fourth consecutive year of negative stock market performance? Victor Canto and Charles Parker of La Jolla Economics (LJE) recently published an article, “Will the Streak End?” LJE addresses this question with an interesting twist. A famous if tongue-in-cheek forecasting “technique” has been to compare the winner of the Super Bowl with the direction of the stock market. If the AFC wins,

then the stock market will be down (which has been the case for the last three years). LJE argues that since the Super Bowl is less than forty years old, this indicator does not include the Depression years. Therefore, LJE decided to go with the longest-lived sports championship, baseball's World Series.

The table below shows stock market returns, Gross Domestic Product (GDP) and the World Series winner. The years selected are the only four episodes during which the stock market declined three years in a row.

MARKET RETURNS, GDP AND WORLD SERIES RESULTS

YEAR	LARGE-CAP STOCKS	GDP	WORLD SERIES WINNER
1929	(8.4)		AL
1930	(24.9)	(8.6)	AL
1931	(43.3)	(6.4)	NL
1932	(8.2)	(13.1)	AL
1933	54.0	(1.4)	NL
1939	(0.4)	8.1	AL
1940	(9.8)	8.5	NL
1941	(11.6)	17.1	AL
1942	20.3	18.4	AL
2000	(9.1)	3.8	AL
2001	(13.1)	0.3	NL
2002	(23.8)	2.5	AL
2003	?	?	?

La Jolla Economics identifies the following correlations (their data contained more periods than those shown):

- Two consecutive American League victories followed by a National League victory signal a down market in the fourth year.

- An American League victory followed by alternating victories signals an up market in the fourth year.

While the winner of the World Series for 2003 remains an open question, the recent pattern suggests an up stock market in 2003.

Whimsical forecasting aside, there are some insights to be gained by considering the economic environment during those periods when the stock market foundered for extended periods. In the beginning of the Depression years, the economy was growing at a negative rate, and then income taxes were increased from a 25% maximum marginal rate to a whopping 63% rate. That change alone would have been sufficient to send the economy into a tailspin. (Gov. Davis: Please take note.) In 1939-42, we were on the brink of war, as perhaps we are now. LJE suggests that the current defense build-up should serve as a strong fiscal stimulus in pulling the economy out of the doldrums. A tax rate cut would also help. As long as the Fed continues to play ball, we should have a good season. Rooting for the NFC to win the Super Bowl may not hurt either.

From our Financial Planning Department

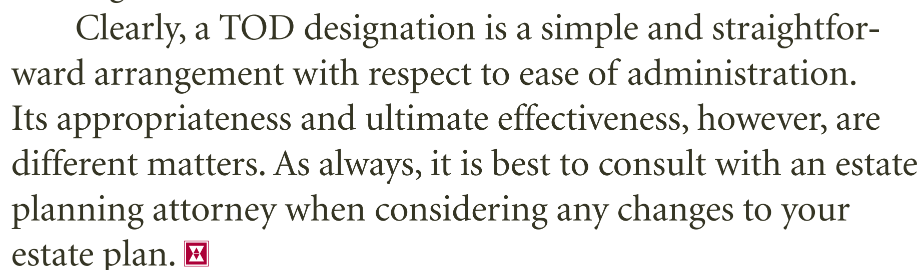
There is a little-known estate planning technique referred to as a "transfer-on-death" designation (TOD). Its use involves the transfer of assets at death and can be implemented without consulting an estate planning attorney. Under the *Uniform Transfer on Death Security Registration Act* (the Act), an investor can designate "beneficiaries" for brokerage accounts, mutual fund accounts, limited partnerships and so forth by naming one or more individual as a TOD beneficiary. At the investor's death, the beneficiaries receive the assets by providing a death certificate to the financial institution. The probate process is bypassed, and the investor's will has no say as to the disposition of TOD assets. It's that simple. The concept is not a new one. In fact, it has long been used for U.S. savings bonds.

FOCUS / *Vol. 16, No. 1* / *January 2, 2003*

The Act, in one version or another, has been adopted by almost all states. The availability of a TOD account varies widely among financial institutions. On one end of the spectrum there is The Vanguard Group, which lobbied lawmakers to get the Act adopted so that TODs could be offered to investors. Then, there are those firms who claim to know nothing of TODs.

As easy as the technique is to implement, improper use of a TOD can potentially undermine a carefully designed estate plan. Improper use in this instance simply means any situation in which a TOD is used without the counsel of an estate planning professional. In other words, it's not the use of a TOD (per se) that can cause a problem, it's the implementation of it in isolation from one's overall estate plan. Remember that assets held in a TOD account are not governed by a will or a living trust. The appeal of a transfer-on-death account, which is its ease of use, is the basis for some caution, therefore. That said, its appeal is understandable in comparison to the more common "joint tenancy with rights of survivorship" designation (JTWROS). With a JTWROS account, each joint tenant is a co-owner, whereas beneficiaries of a TOD have no ownership rights while the investor is living.

Clearly, a TOD designation is a simple and straightforward arrangement with respect to ease of administration. Its appropriateness and ultimate effectiveness, however, are different matters. As always, it is best to consult with an estate planning attorney when considering any changes to your estate plan.



Getting the message across

At a tire shop in Milwaukee: "Invite us to your next blowout."

At a laundry shop: "How about we refund your money, send you a new one at no charge, close the store and have the manager shot. Would that be satisfactory?"

At a towing company: "We don't charge an arm and a leg. We want tows."

In a nonsmoking area: "If we see smoke, we will assume you are on fire and take appropriate action."

At an optometrist's office: "If you don't see what you're looking for, you've come to the right place."

On a taxidermist's window: "We really know our stuff."

In a podiatrist's office: "Time wounds all heels."

On a fence: "Salesmen welcome! Dog food is expensive."

At a car dealership: "The best way to get back on your feet—miss a car payment."

In a veterinarian's waiting room: "Be back in 5 minutes. Sit! Stay!"

At the electric company: "We would be delighted if you send in your bill. However, if you don't, you will be."

In the front yard of a funeral home: "Drive carefully. We'll wait."

At a propane filling station: "Tank heaven for little grills."

And don't forget the sign at a Chicago radiator shop: "Best place in town to take a leak."

Inside Woodside

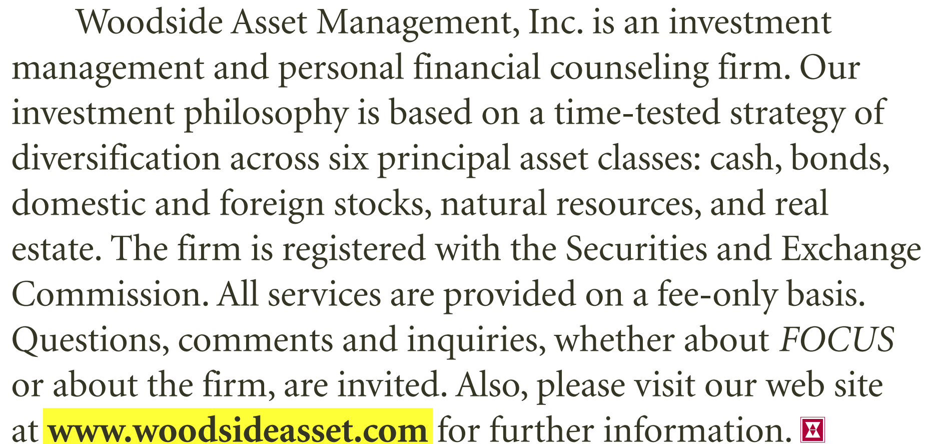
As a reminder, our offices will be closed for the Martin Luther King, Jr. (January 20) and Presidents' Day (February 17) holidays.

And, last but not least...

...a Happy, Healthy and Prosperous 2003 to all!

FOCUS / *Vol. 16, No. 1* / *January 2, 2003*

WOODSIDE ASSET MANAGEMENT, INC.



Woodside Asset Management, Inc. is an investment management and personal financial counseling firm. Our investment philosophy is based on a time-tested strategy of diversification across six principal asset classes: cash, bonds, domestic and foreign stocks, natural resources, and real estate. The firm is registered with the Securities and Exchange Commission. All services are provided on a fee-only basis. Questions, comments and inquiries, whether about *FOCUS* or about the firm, are invited. Also, please visit our web site at **www.woodsideasset.com** for further information.

Woodside Asset Management, Inc. is a wholly-owned subsidiary of Silicon Valley Bank, a Silicon Valley Bancshares company (NASDAQ: SIVB). Silicon Valley Bank serves emerging growth and middle-market companies in targeted niches, focusing on technology and life sciences, while also addressing other specific industries in which it can provide a higher level of service and better manage credit through specialization and focus. SVB Private Banking, of which Woodside is a part, offers a variety of specialized services tailored to the needs of company executives, entrepreneurs and other professionals.

The Bank has 11 offices throughout California and operates regional offices in Phoenix, Arizona; Boulder, Colorado; West Palm Beach, Florida; Atlanta, Georgia; Chicago, Illinois; Boston, Massachusetts; Minneapolis, Minnesota; New York, New York; Durham, North Carolina; Portland, Oregon; Philadelphia, Pennsylvania; Austin, Texas; Dallas, Texas; Northern Virginia; and Seattle, Washington. More information on the Bank can be found at www.svb.com

WOODSIDE ASSET MANAGEMENT, INC.
3000 Sand Hill Road 2/160
Menlo Park, California 94025 (650) 854-5100

www.woodsideasset.com *e-mail: info@woodsideasset.com*

© Copyright as of the date on this publication, Woodside Asset Management, Inc. All rights reserved. FOCUS is published quarterly. The information in this publication has been obtained from sources believed to be reliable, but its accuracy and completeness cannot be guaranteed.

Printed On Recycled Paper