WOODSIDE ASSET MANAGEMENT

Focus

Volume 15, Number 2 / April 4, 2002

Social Security deficit? Think again.

Michael Boskin, Professor of Economics at Stanford and a former member of the President's Council of Economic Advisers, has been conducting research lately in the area of government accounting. More specifically, he has been looking at the amount of future tax revenues the government will collect when income that has escaped current taxation by being diverted into retirement plans begins to be withdrawn and taxed. Adjusting for expected rates of return, population growth, income deferral rates, etc., his preliminary results suggest that these future revenues will provide a major offset to the expected Social Security and Medicare deficits.

Does this "asset," i.e., the present value of the expected future revenues, appear anywhere on the government's balance sheet? Of course not. But the liabilities do. Politicians rant and rave about future deficits, but they conveniently ignore the asset side of the equation so they can argue against tax cuts. Perhaps the publication (in the near future) of Professor Boskin's work will bring some rational discourse and new insights to the debate. But then, maybe we're expecting too much.

Irrational expectations?

Rear-view mirror investors are expecting the stock market returns of 10-15% and bond market returns of 8-10% we enjoyed in the 1990s to continue into this decade. Many financial planners are using these return levels in their retirement and education planning calculations. We are concerned that if these return expectations are used, retirements may have to be postponed and education funds may fall short because they are unlikely to be achieved.

To see why we, and many others, have these concerns, consider the following forty-year perspective:

YEAR-END	DOW JONES INDUSTRIAL AVERAGE	10-YEAR US GOVT. BOND YIELD
1961	731	4.0 %
1981	875	13.6 %
2001	10,021	5.1 %

During the sixties and seventies, the Dow Jones Industrial Average increased only 20% over 20 years (although dividends did contribute to a higher total return). Interest rates increased dramatically over that same period (with commensurate declines in bond prices). Rates decreased steadily after 1981, and the stock and bond markets exploded.

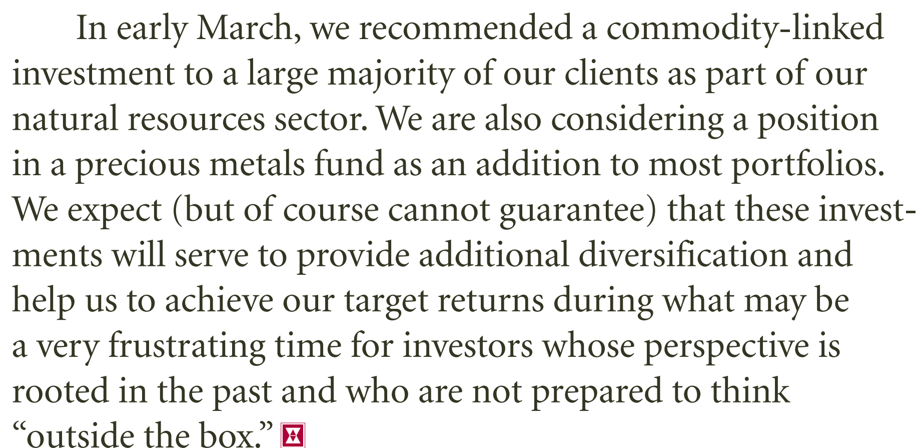
Who knows what the next ten or twenty years will look like, but we need to understand where we are now in order to make investment plans. Inflation is low and stock price-to-earnings ratios are well above historical averages. These facts suggest that it is unlikely that we will enjoy another twenty years of above-average returns in financial assets without some sort of reversion to the mean.

William Reichenstein, writing in the October 2001 *AAII Journal*, reviews six studies by well-known and respected academic and industry observers that project lower stock market returns for the next ten years. The noted Jeremy Siegel, Fama & French, Arnott & Ryan, Brown, and Jagannathan have all predicted real (after-inflation) stock market returns ranging from 3% to 5%. These studies were based upon interest rates, market multiples, and price-to-book, -sales, -earnings and -dividend ratios. The same studies imply real bond returns of 3%.

These returns are certainly lower than those of the last twenty years and even lower than very long-term historical averages. Siegel wrote in his 1998 book, Stocks for The Long Run, that since 1802, U.S. stocks have provided a 7% real

(after-inflation) return. Warren Buffet, in his December 10, 2001 *Fortune* interview, stated that he expects stocks to provide a return of 7%. Allowing for inflation of 2%, the real rate of return, including dividends, would be 5%.

As return projections are reduced, investors and advisors need to review their choices for coping with these lower expected returns. One is to seek higher portfolio returns by allocating more to equities, although this approach may not be appropriate for many investors because it also increases risk. Saving more is an option if one is working but probably not if one is retired. Expenses can be reduced or deferred, but this implies a reduced lifestyle. Finally, goals can be postponed or eliminated, although this may not be possible when there is a known time frame for a goal such as an education funding requirement. Reichenstein concludes that investors should consider expanding portfolio holdings beyond the traditional mix of domestic stocks and bonds. He suggests inflation-linked bonds (generally appropriate only for tax-sheltered accounts), REITs and international stocks.



In early March, we recommended a commodity-linked investment to a large majority of our clients as part of our natural resources sector. We are also considering a position in a precious metals fund as an addition to most portfolios. We expect (but of course cannot guarantee) that these investments will serve to provide additional diversification and help us to achieve our target returns during what may be a very frustrating time for investors whose perspective is rooted in the past and who are not prepared to think "outside the box."

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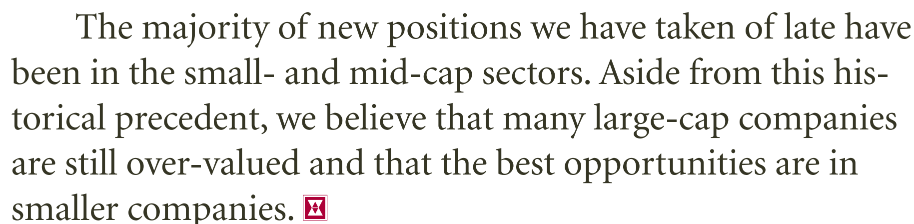
Think small

Based on history, one stock market group that should outperform as the economy recovers is the small-cap sector. Small company stocks have historically done well after recessions. According to data published by the University of Chicago and WEFA Group, in the last ten recessions from February 1944 through May 1991, small companies did better than large ones by an average of 7.5%. Large companies did better than small ones only in 1961 and then by a margin of only 1.5%.

	PERFORMANCE IN NEXT 12 MONTHS		
RECESSION PERIOD	SMALL COMPANIES	LARGE COMPANIES	RELATIVE PERFORMANCE
FEB 44 - OCT 45	(3.4) %	(5.0) %	1.6 %
NOV 48 - OCT 49	34.1	27.6	5.1
JUN 53 - MAY 54	46.5	34.5	9.0
AUG 57 - APR 58	56.0	37.7	13.2
APR 60 - FEB 61	11.9	13.6	(1.5)
DEC 69 - NOV 70	17.2	11.6	5.0
NOV 73 - MAR 75	48.2	26.1	17.6
JAN 80 - JUL 80	26.5	11.8	13.2
JUL 81 - NOV 82	32.7	22.2	8.6
JUL 90 - MAY 91	13.9	10.5	3.0
AVERAGE	28.4 %	19.1 %	7.5 %

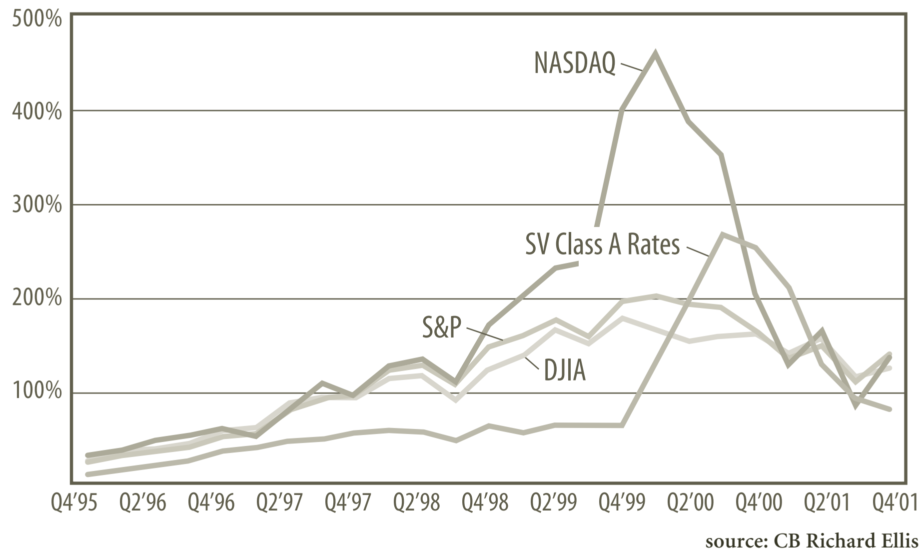


The majority of new positions we have taken of late have been in the small- and mid-cap sectors. Aside from this historical precedent, we believe that many large-cap companies are still over-valued and that the best opportunities are in smaller companies.

NASDAQ— A real estate oracle?

We have yet to find a valid predictor of stock prices. However, we may have stumbled across a reliable predictor of Silicon Valley commercial lease rates. Notice in the chart below how lease rates spiked up in 2000, just about 6 months behind the NASDAQ. If and when another tech stock "bubble" occurs, tenants might be well-advised not to sign long-term leases until the bubble pops.

Silicon Valley Class A Lease Rates vs. Major Indices



source: CB Richard Ellis

From our Financial Planning Department: More on 529 college savings plans

We first wrote about 529 plans exactly a year ago. The popularity of 529 college savings accounts has made them a topic of everyday conversation these days where matters of financial planning are discussed. To review, a 529 account is a vehicle in which funds can be set aside for college expenses for a designated beneficiary. Its attractiveness results from a number of features, one of which is the ability to invest funds on a tax-deferred basis (similar to an IRA). Even better, "qualified" distributions are exempt from federal income taxes starting this year and continuing through December 31, 2010, at which time the exemption expires due to the "sunset" provision of the 2001 Tax Act. Other features include the ability of the owner to retain control over the account while

simultaneously realizing an estate planning benefit.

The estate planning benefit is achieved merely by establishing an account. In other words, upon opening a 529 account and depositing funds to it, a person removes from his or her estate the amount contributed to the account. To gain an appreciation for this benefit, consider that rare are the opportunities to remove assets from one's estate while simultaneously retaining control over those assets (and avoiding gift taxes, within limits). This begs the question: Why not establish a 529 savings account regardless of the beneficiary's intent to go to college? After all, an account owner can designate anyone as a beneficiary (including oneself) and retains the right to change the beneficiary.

One reason not to do so is that the IRS has yet to issue final regulations on 529 savings accounts, which could result in a crackdown on overly aggressive strategies. Additionally, the gift tax and generation-skipping tax laws are so complex that one could encounter significant tax "surprises" many years down the road if the 529 plan were to be established for purposes other than those for which the lawmakers intended it.

All in all, we believe the 529 saving account is a favorable and attractive alternative for situations in which the primary goal is to set funds aside for future college expenses for a specific person. Although not a prediction, we expect its attractiveness, in terms of the essential purpose for which it was created, to remain intact even after the IRS issues its final regulations.

Who we are and what we do

For the benefit of newer readers, and as a refresher for those of longer standing, we publish every other year or so a brief description of the services we offer and the type of clients we serve. In a nutshell, we manage broadly-diversified portfolios on a fee-only basis for wealthy individuals and family groups and small-to medium-sized institutional ac-

counts such as foundations and retirement plans. For individuals and families, we also provide comprehensive financial planning services, both before we begin active portfolio management and thereafter on an on-going basis.

Our minimum account size is currently two million dollars. There are two important caveats to this statement. First, our long-term goal is an average account size of over two million dollars so that we can focus our attention on a relatively small number of accounts and thereby assure a high level of personal service. Second, we are far more interested in developing successful, long-term relationships than in maximizing current revenues. Therefore, we are always open to serving almost any client if there is a high likelihood that there will be significant additions to the account over time, whether from asset sales, inheritance, savings or other sources.

We have several pieces of descriptive material that address the subject of our services and investment philosophy at significantly greater length. If you would like to receive this information, please either contact us or visit out website. And, if you know one or more individuals or organizations who fit our client profile and who may benefit from our services, we would welcome the opportunity to meet with them.

Inside Woodside

Other than the usual Memorial Day holiday on Monday, May 27, we do not have any planned office closures this quarter.

As a reminder, if you need notary services, Denise Carlquist is available to assist you.

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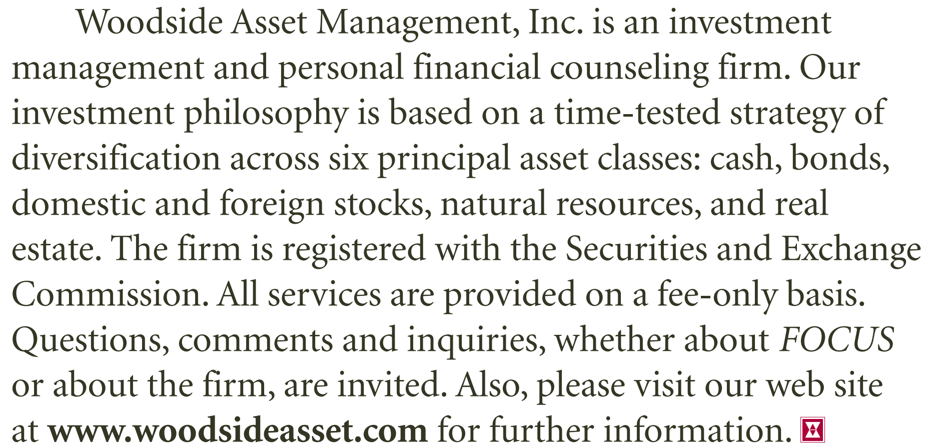

WOODSIDE ASSET MANAGEMENT, INC.

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.

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