Vol. 6, Issue 31
Sept. 28, 2012

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

If you read the news enough, you could conclude the world increasingly doesn't understand the very basic risk/reward paradigm. Essentially, the amount of reward you receive is commensurate with the amount of risk you take. To businesspeople, this makes perfect sense; it is how it should be.

That is how you create wealth: you take risk. It helps if you are insanely brilliant and devilishly attractive, but, where the rubber meets the road, the common denominator I have found amongst all truly wealthy people I know is: they have taken risks along the way. Interestingly enough, they would probably tell you they didn't even know they were taking the risks they were.

This isn't brain surgery: we all understand this as individuals. However, when it comes to the economy as a whole, something gets lost in, uh, translation. We want to eliminate risk from the system, and still somehow expect the same rate of return, if not higher.

It doesn't work that way. When you reduce the amount of risk taken, you reduce the expected rate of return. If your system encourages risk, over time it will become wealthy. If it discourages it, over time your system will lose its wealth.

This is what confounds me about regulations and taxes. Certainly, we have to fund our government, or else we would live in a lawless state. Further, we have to ensure as even a playing field as is possible in order to encourage competition. As such, some measure of regulation and some amount of taxes are necessary.

However, make no mistake: regulations and taxes are costly, and reduce the amount of return a business or a business owner can and/or will make. If they are significant enough, well, investors and businesspeople simply won't take the necessary risks.

This makes sense, doesn't it. Think of it this way: would you be willing to scream "FIRE" in a crowded theater on a dare? If you are like most people, you probably wouldn't, as the negative ramifications from your actions, namely being arrested, would be far greater than the reward, whatever that reward might be. However, what if someone were willing to pay you $100,000 to do such a thing? Would you do it then? That is a different question isn't it? You still might not do it, but you would probably wouldn't dismiss the idea quite as easily.

People are rational; far more rational than our leaders apparently believe. If you reward people for not taking risks, they won't. On the flipside, if you constrain the potential for return, they won't take the necessary, or better yet appropriate, risks.

As a result, the society which produces the most wealth will be the one that fosters the greatest amount of risk taking. The goal is determining the right mix of activities/programs which engenders risk taking at all levels and in all elements of society.

This presents a problem when your population base is ageing, as people are inclined to take fewer risks the older they get. Unfortunately, in the United States, the older generations control a higher percentage of the nation's wealth than at any given point since the dawn of history. In short, older people have the means to generate more wealth, but do not have the inclination to do so. They stand

Inside this issue:

Poverty is not socialism. To be rich is glorious.

Deng Xiaoping

too much to lose, or so the thought process goes.

In the financial services industry, there is an old rule of thumb which states: your allocation to bonds should be equal to your age. So, if you are 65 years old, you should have 65% of your assets in fixed income. That sounds simple enough, and folks have been preaching this so long, it has become almost a given. But does it make sense?

Well, it does if the average life expectancy at age 65 was only another 5 years or so. However, according to the CDC, the average life expectancy at age 65 in the United States in 2009 was 19.2 years. That is a different kettle of fish, as a 5 year investment time horizon will suggest one asset allocation, and a 19 year time horizon will demand something else altogether, one with decidedly more risk.

So, what happens if the wealth in a country is tied up in sovereign debt and banking products? As opposed to stocks, private equity, and other business development activities? Well, take a look at Japan to get the answer. What happens when the wealth in a country is tied up in the government? Look no further than Cuba or North Korea. Finally, what about a society where the wealth of the country is transferred from the younger generations, the ones with the proclivity to take more risk, and given to the older generations, who happen to be more risk averse and wealthier on average?

That is where Europe and, increasingly, the United States are now, and the results are not to anyone's liking.

But...but...the older generations paid into the system, and are simply getting back what the government promised. Well, there is the promise thing. However, the amount? That might be a different story altogether. For example, assume Mr. X entered the workforce in 1967, and earned the national average wage each year, according to the SSA, before retiring in 2010 at age 65. Let's further assume he paid an average of 6% into Social Security over that time, and that inflation averaged 3% per year, and future COLAs will too.

If we make all those assumptions about Mr. X, we will find he, personally, paid $55,427.19 into Social Security, which works out to be $93,142.40 when adjusted for inflation. *Those are the numbers, and it took longer to input all of them than I would care to admit.* Now, if Mr. X lives for 19 more years, as is the life expectancy from the CDC I mentioned above, he could expect to collect $356,709.77 from Social Security before expiring. This number comes from the average monthly payout in 2011 times 12, and compounded 3%, annually, for 19 years.

So, $356,709.77 in payouts, in nominal terms, for $55,427.19 in contributions. When adjusted for inflation, Mr. X still brings home a tidy $269,838 compared to the $93,142.40 he paid in. Make no mistake about it: Social Security is a pretty good deal for the average American. Why? Our society is simply living longer than it was, meaning people are drawing on it more.

But...but...what about the money businesses paid on behalf of their employees? Shouldn't it count? Okay, let's include it, and it is still a good deal. But what if people invested it at 7%? What then? Hey, we could play this game all day long, and delve into gray areas as much as you like. If you think Mr. X, the average American, was disciplined enough to take 6% of each and every paycheck, and invest it into something earning 7% per year, be my guest. I am focusing on what people actually pay in, and what they actually receive; and Social Security has been a slam dunk.

Unfortunately, the government didn't squirrel this money away and invest it properly. Nope. They used it to fund other aspects of the government, and replaced it with IOUs from the Treasury. As such, there really isn't anything in Social Security, as all Washington is doing is robbing Peter to pay Paul internally. Your social security money? They spent it, and now it is a "pay as you go" system, which is a fancy way of saying a Ponzi scheme. As such, yep, the younger generations are shelling out money to pay a good deal for retirees simply because Washington couldn't help but spend the Social Security tax receipts as they came into the system, and couldn't find anything else for them but Treasury debt.

In the end, it is a transference of wealth from the younger generations, who can least afford it, to the older generations. This leaves less money within the former to finance or otherwise fund businesses and other entrepreneurial activities, and more money in the latter to essentially take less risk, because that is what older people have been conditioned to do. When you look at it from a purely wealth generating standpoint, it doesn't make a lot of sense.

At some point the entire system will grind to a halt, because it isn't creating enough wealth to meet its responsibilities to its former wealth generators. It is a problem. But what can we do about it? Particularly, what can we about it with the least amount of pain?

I have been in this business for over two decades, and a huge culprit to the free flow of capital to its highest and best use is the capital gains tax. There is no other regulation or tax I know of which inhibits effective and efficient portfolio diversification and construction. Obviously, if something inhibits efficient investing, it inhibits the free flow of capital., and that is a bad thing, a very bad thing.

Another item is the tax-advantaged status of municipalities. Enabling an entity to borrow funds below its true market rate allows it to be less efficient than it would be ordinarily. Further, plenty of investors are lulled to sleep with the concept of tax-free income; they forget or overlook the risks associated with lending money to a municipality. As such, money is misallocated to potentially inefficient municipal borrowers, which do not create much wealth, and away from more productive, wealth-generating endeavors in the private sector.

When you add the two together, capital gains taxes and tax free municipal bonds, you create an investing environment which actually discourages the free flow of capital to its highest and best use, and potentially even reduces the overall level of income investors receive.

With all this in mind, we have a problem in this country: the transfer of wealth from the youngest, more risk tolerant to the older, less risk tolerant. This will result in an overall decrease in economic activity, because the amount of reward received is commensurate to the amount of risk taken. Compounding this problem is the tax code which inhibits the flow of capital. The solution? Well, first things first, lets speed up the flow of capital in the country. We can do that by eliminating the long-term capital gains tax, and severely limiting the tax-exempt status of municipal issuance.

The end result would be free moving capital, a negligible impact on tax receipts (as the two would largely offset one another), and more efficient municipal budgeting. The short-term? It might not be too pretty as everyone adjusts to the new reality. However, the benefits will ultimately far exceed the initial costs.

Oh yeah, I forgot to mention: older investors would have more efficient portfolios, allowing them to invest more wisely for a longer life expectancy, and the younger generations would have greater access to capital, allowing them to take the risks necessary to generate wealth in our society.

...and that is the end game when it comes to the secular dynamic, because when you do the paragraph above, a lot of societal ills will fall by the wayside.

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Consumer Confidence (Sep)	63.1	70.3	61.3	The Durable Goods Orders number was a shocker, but whenever you see something that outrageous in this series you immediately know aircraft orders were down. Everything else was, you know, okay...bottom end of average….top of the fourth quintile, that type of thing.
New Home Sales (Aug)	380K	373K	374K	
Durable Goods Orders (Aug)	-5.0%	-13.2%	3.3%	
Initial Jobless Claims	375K	359K	385K	
Personal Income (Aug)	0.2%	0.1%	0.1%	
Chicago Purchasing Managers (Sep)	52.8	49.7	53.0	
U of Michigan Confidence (Sep F)	79.0	78.3	79.2	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
9/6/12	13,292.00	1,432.12	3,135.81	837.95	8,680.57	2,524.95
9/13/12	13,539.86	1,459.99	3,155.83	856.12	8,995.15	2,543.22
9/20/12	13,596.93	1,460.26	3,175.96	851.51	9,086.98	2,553.03
9/27/12	13,485.97	1,447.15	3,136.60	843.54	8,949.87	2,506.06

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
9/6/12	0.10	0.13	0.26	0.68	1.68	2.80
9/13/12	0.10	0.12	0.24	0.64	1.72	2.93
9/20/12	0.11	0.14	0.26	0.69	1.77	2.95
9/27/12	0.09	0.13	0.25	0.65	1.66	2.84

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
9/6/12	3.25	0.25	0.41	1,703.20	95.53	1.263	78.86	1.593	0.983
9/13/12	3.25	0.25	0.39	1,769.50	98.31	1.299	77.48	1.616	0.968
9/20/12	3.25	0.25	0.37	1,767.80	91.87	1.297	78.24	1.622	0.977
9/27/12	3.25	0.25	0.36	1,777.60	91.85	1.291	77.60	1.624	0.981

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