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PDV *OBSERVATIONS*

We have moved! Due to the loyal support of our clients and friends, our business has grown in a most gratifying way over the past few years. To accommodate this growth and maintain the high level of service that we always strive to provide to our clients, we have relocated to larger office space. Effective immediately, our new mailing address is: ***PDV Financial Management, 10680 West Pico Boulevard, Suite 400, Los Angeles, California 90064.*** For your convenience, our phone and fax numbers remain the same, as follows: ***Phone (310) 559-0898*** and ***fax (310) 202-9170***. Also, we can be reached at ***pdvfinmgt@aol.com***. Please take this information down for future reference. We'll be sending you updated business cards in due course.

New Changes in Capital Gain Taxes

Recently, the Taxpayer Relief Act of 1997 was enacted into law. The new legislation contains a number of tax law changes that are favorable to taxpayers. One of the most prominent changes is a reduction of the capital gain tax rate. This article briefly describes this change, and how investors might be able to benefit from it.

Prior to the passage of the new law, there were basically two types of capital gains: short-term and long-term. Short-term capital gains are generated when an investor sells an investment held for one year or less at a gain, while long-term capital gains result when an investor sells an investment owned for more than one year for a gain. To encourage longer-term holding periods for investments, the prior tax law gave preferential treatment to long-term capital gains by taxing them at a generally lower rate. While short-term capital gains were taxed at ordinary income rates (which can range as high as 39.6%), long-term capital gains were taxed at 28%.

The new tax laws did not change the treatment of short-term capital gains, which continue to be taxed at ordinary income rates of as high as 39.6%. However, the rate on certain types of long-term capital gains has been reduced to 20% from 28%. With respect to investors in the 15% tax bracket, the rate for these types of gains is lowered all the way to 10%. For the purpose of this article, we will call these gains "Qualifying Long-term Capital Gains".

Qualifying Long-term Capital Gains are *long-term* capital gains that are either (1) realized between May 7, 1997 and July 28, 1997, or (2) realized after July 28, 1997 from an investment held for over 18 months. If the investment was sold after July 28, 1997, and held for longer than 12 months but not over 18 months, then the gain will be taxed at 28%. Whew! Whatever happened to simplification of the Tax Code?

While some of the tax law changes are mind-boggling, investors should spend the time to understand and take advantage of them. The reduction of the capital gain tax rate is

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particularly beneficial. Essentially, the new tax law has further widened the tax rates between (1) ordinary income (e.g. stock dividends and bond interest) and short-term capital gains (which are treated as ordinary income for tax purposes), and (2) Qualifying Long-term Capital Gains.

When designing and implementing investment strategies, there are at least a couple of issues to keep in mind in light of the reduction of the capital gain rate. First, when evaluating several stocks whose total return prospects are roughly equal, you should prefer stocks that pay low or no dividends as long as you have no special need for periodic income/dividend payments. This is because the component of the total return attributable to the dividend will likely be taxed at much higher rates, especially if you intend on holding the stock for more than 18 months.

The other tax-saving technique that may be available under the new law is where an investor has both a tax-sheltered account (e.g. an IRA) and a taxable account. Such an investor should use the tax-sheltered account to shield ordinary income and short-term capital gains from taxation at higher ordinary income rates. Investments that generate ordinary income, such as dividend-paying stocks, real estate investment trusts and fixed-income securities should be held inside such accounts. Also, use the tax-sheltered account to hold stocks that you intend to trade, thereby protecting any short-term capital gains from taxation. Your taxable account should be reserved for stocks that pay low or no dividends, and stocks that you intend on holding for a long time.

Here's a final word of caution. One of the dangers of focusing too closely on taxation issues is to allow "the tail to wag the dog". Any investment should first be analyzed on its own merits before its tax aspects are further studied to determine what are the likely ***after-tax*** returns. For example, just because dividends are now going to be taxed at much higher rates than those applying to Qualifying Long-term Capital Gains does not per se make dividend-paying stocks unattractive. There may be many reasons for an investor to prefer the dividend-paying stock. These might include her need for periodic income payments, added stability to the portfolio, etc. Each individual situation will therefore need to be analyzed separately.

Merger Mania: Should You Take the Bait?

A lot of mergers and acquisitions have occurred over the past few years. There are many reasons for this. In some industries, intense competition has led to the strong swallowing the weak. In others, companies feel they can achieve economies of scale, greater negotiating leverage with vendors, and improved competitive position by merging.

Undoubtedly in some cases, mergers occurred because surging stock prices helped finance the deals. The company doing the acquiring (a.k.a. "acquirer") usually can finance the merger in several ways: it can use cash (obtained through internally generated funds or debt financing), its own stock, or a combination of both. There are many factors behind why a company might use one option over the others, which are beyond the scope of this article.

If you are fortunate enough to hold stock in a company about to be acquired at a premium price by another company offering to exchange its own stock for your stock, should you accept it? In this simple example, you essentially have two options. The first is to sell your shares in the open market and cash out rather than take the acquirer's stock. Alternatively, you can accept the acquirer's stock in exchange for the shares you currently own in the company to be acquired. This second option is often structured, so that you can avoid taxation upon consummation of the merger. You are not treated as having triggered a taxable event because you are not deemed to have cashed out.

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You should be very careful to scrutinize any transaction where the acquirer is offering its own stock to fund the merger. If the acquirer's management is savvy, then the fact that it is offering you its stock probably means the stock is overvalued. Why? It helps to think of this type of acquisition as if it involved two events. It's as if the acquirer is first selling shares of its stock to generate proceeds that in turn are used to buy your shares. By using overvalued stock, management of the acquirer is essentially using an inflated currency to cheapen the purchase. The more overvalued the acquirer's stock, the fewer new shares it has to issue to fund the purchase.

You can also look at it from a different angle. If the acquirer's stock is undervalued, then you would have to question the quality of the acquirer's management, since it should then be repurchasing rather than issuing more of its own shares. You should be reluctant to accept shares in the acquirer in this case since you would be subject to having the merged company run by that same poor management.

You should be reticent to accept the acquirer's stock in exchange for your own unless you think the acquirer is likely to grow its earning power nicely over time, and plan to hold the acquirer's stock for a very long time. This is because the growth in the earning power of the acquirer will eventually grow to a point that might support higher prices despite the stock's current overvaluation. Also, the tax deferral aspects of accepting stock rather than cashing out should be overwhelming given your current tax situation.

It's Time to Temper One's Expectations Regarding Investment Returns…A lot.

Since going nowhere in 1994, the market has performed strongly in the past three years. While that performance can largely be attributed to a fairly narrow group of blue-chip glamour stocks, like General Electric, Coke, Gillette, Microsoft and Intel, the advance has recently broadened out to include a lot of small and mid-sized companies.

With all the investment "gurus" and pundits seeing this party lasting for the indefinite future and failing to see "what can go wrong", it is very easy to get complacent about the risks that are in fact ***escalating*** in the markets. People might think they are not being complacent when their stomachs churn in reaction to indexes like the Dow Jones Industrial Average ("DJIA") gyrating 100-150 points daily, but that's not what I mean. With the DJIA as high as it is, apparently large point moves equate to much less remarkable percentage changes. The truth of the matter is that we are simply returning to more normal volatility after going through a period of abnormally low volatility.

What I mean by complacency is when people accept as a foregone conclusion that the ***extraordinary*** gains we have experienced over the last few years will continue indefinitely. ***They won't***. In this environment, few among the investment herd want to talk about or take actions to address the possibility of losing money. Many just worry about not jumping onto the "momentum stocks" for fear of being left behind. When risks are ignored and returns are taken for granted, the contrarian investor gets very nervous with good reason.

In order to see why returns for the next few years are unlikely to match those of the recent past, it's necessary both to have some historical perspective and to examine whether the reasons behind the recent strong market performance are likely to be repeated over the next few years.

First, let's discuss some historical perspective and a concept called "regression to the mean". Over the past 70-year period, stocks

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It's Time to Temper *(continued from p.3)*

have averaged about a 10% annual return, while bonds have averaged about a 5% annual return. While returns over short time periods could, and are likely to, deviate *substantially* from the above figures, these figures have been remarkably steady over much longer time periods.

"Regression to the mean", as applied to investment returns, is the phenomenon of returns gravitating back towards these historical benchmarks, despite short-term deviations like the ones the markets have experienced over the past few years. Widespread pronouncements of "new investment eras" notwithstanding, investors will be well served by lowering their expectations *going forward* to be more consistent with these historical figures. In fact, while many have projected the recent strong returns to continue for the indefinite future, prudent investors should expect returns to be ***below par*** over the next few years just to bring recent strong returns back to the historical levels.

Not only does "regression to the mean" suggest much less spectacular returns going forward, but there are also fundamental economic reasons to support this view. Over the long term, markets do correspond closely to business and economic realities. Returns over the past 70 years correspond to an economy whose aggregate businesses have grown the bottom line by about 5-6% a year, coupled with an average annual dividend yield of about 4.5% (giving a total annual return of about 10%).

In the past few years, many companies have been able to grow their bottom lines substantially faster for a variety of reasons. These include higher productivity through greater use of technology; massive lay-offs; lower interest and financing costs and slowing growth in labor and benefit costs. While a large part of the recent market advance can arguably be justified by these fundamental economic conditions, the market currently discounts this fully. The truth of the matter is that many businesses have cut their work force to the bone, and labor and benefit cost reductions cannot continue indefinitely and are in fact slowing.

These trends suggest that, at best, it would be very difficult for companies to continue growing their bottom line as strongly as before. At worst, they may experience a period of contraction before growing again. Either of these scenarios would be a rude shock to the markets, which currently continue to project the near-perfect economic conditions in the recent past into the indefinite future.

Here at PDV we do not try to time the market and are not advising investors to sell everything and retreat to cash. We continue to be able to find undervalued investments despite the elevated levels of the general market. Nevertheless, we think investors will be well served to ratchet down their expectations regarding investment returns over the next few years as they are likely to gravitate back towards lower levels that are more consistent with historical norms.

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