SPRING 1997 VOLUME 3:1

PDV *OBSERVATIONS*

Investment Strategies to Save Taxes

Have you finished doing your taxes or are you one of those still procrastinating to find out how much Uncle Sam took from you this year? Unfortunately, taxes are a fact of life. ***What can you do to try to mitigate the tax bite?***

Here at *PDV Financial* we take our clients' particular tax situation into account when developing an appropriate investment strategy for each of them. There are in fact quite a few investment techniques that we use to help our clients legitimately mitigate taxes. This article discusses one such technique relating to the selection of *stock mutual funds.* To explain this technique, first we have to discuss briefly the tax aspects of mutual funds.

A stock mutual fund is an investment company that pools the collective assets of its shareholders for the purpose of investing in a portfolio of stocks. (Please revisit the Summer 1995 issue of ***Observations*** for a more detailed primer on mutual funds). The composition of the portfolio will change over time as a result of the fund manager's buy/sell decisions for stocks that may or may not already exist as part of the portfolio. Until stocks are actually sold from the portfolio, any appreciation/depreciation with respect to such unsold stocks is commonly referred to as "unrealized" (i.e. a "paper gain/loss"). Only by selling a stock will a previously unrealized gain/loss become ***realized***. One of the many advantages that mutual funds offer is their ability to avoid taxation if by

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A Market Update

Two steps forward, one step back. That's the way markets usually behave. But since 1995, it *seems* that the law of gravity has been repealed. We say "seems" because the market has not been as uniformly strong as the popular press has portrayed (more on this below).

Many stocks began weakening in the May-June period of last year. The approximate 10% drop during July 1996 in the most visible indexes [i.e. Dow Jones Industrial Average ("DJIA") and Standard & Poor's 500 ("S&P 500")] disguised a much larger drop in many individual securities as well as indexes made up of small and mid-sized companies.

Even though the DJIA and S&P 500 subsequently recovered to new highs, the rest of the market has not. Just to give you a flavor of what we mean, *Barron's* reported in its April 7, 1997 issue that as of early April 1997, nearly 44% of all stocks on the NASDAQ had fallen over 30% from their peak! Some of the most speculative companies that were selling for up to 100 times earnings (assuming they even had

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year end they distribute most of their income and ***net realized capital gains*** (i.e. total realized capital gains minus realized capital losses), if any, earned during the year. By doing this, the mutual fund (unlike other companies) avoids being taxed at the entity level, though its shareholders continue to be taxed on the income and capital gain distributions they receive from the fund.

For those of you in the higher tax brackets, it is important to get a good handle on whether a stock mutual fund has a habit of generating huge net capital gain distributions each year end. As one of many shareholders, you are unable to influence the fund manager's daily buy/sell decisions. You therefore have *no control* over how much net capital gain, if any, will be realized and passed through to you as a shareholder by year end (i.e. the amount on which you will pay tax).

Though a shareholder has no control over the amount of net capital gain distributions, if any, that are passed through to her in any given year, there are certain factors that tend to reduce the size of such distributions. If you are in a high tax bracket, your goal should be to find stock mutual funds with two primary characteristics: (1) they are reasonably likely to produce satisfactory long-term returns that are consistent with your particular investment parameters, and (2) most of their returns consist of unrealized (i.e. non-taxable) rather than realized (i.e. taxable) gain.

We consider stock mutual funds that possess the latter of these two characteristics to be "tax efficient." The tax efficiency of a stock mutual fund is one of many factors we analyze when selecting stock funds for our clients. While the tax efficiency of a stock fund held in a client's tax-deferred IRA account may not be particularly important, it is of paramount importance to our clients in high tax brackets holding stock funds in taxable accounts.

So just what are the factors that tend to make a stock fund tax efficient? Some of these factors include the following: how frequently the fund manager trades; the typical holding period for the fund's underlying investments; the nature of the investments favored by the fund; and the fund manager's willingness in appropriate circumstances during the course of the tax year to realize paper losses to offset realized gains, thereby reducing the taxable net realized gains generated by the fund.

Here at ***PDV Financial*** we may in appropriate circumstances research, identify and use such tax-efficient stock funds that are reasonably likely to generate satisfactory long-term returns, in conjunction with other tax-mitigating investment techniques (e.g. investing in tax-exempt municipal bonds) to add value for our clients in high tax brackets. ***Please contact us at (310) 559-0898 if you think you might benefit from our assistance in structuring an investment portfolio that will reduce your taxes.***

A Market Update (*continued from p.1)*

earnings) or 20-30 times ***sales*** went down anywhere from 50-90%. Don't look for them to recover to their former overvalued lofty levels any time soon (if ever). "Investors" who bought these concept stocks, hoping to find a bigger fool to take the "investment" off their hands at a higher price, found out the hard way that there weren't enough bigger fools left.

The "momentum investors" (see the Summer 1996 issue of ***Observations*** for more on momentum investing) who practice this art ran some of the "hottest" mutual funds during 1995 and the first half of 1996, and were idolized by the mass media. Since July 1996, however, many of these funds have been decimated, with some down 15-25% since the beginning of 1997. Pity those people who were attracted by the sizzling short-term records of these funds *without understanding that the foundation for their short-term success was weak and unsustainable.* They kept piling on before the funds and their portfolio holdings imploded.

As the party for these speculative investments selling at outrageous valuations

came to an abrupt end, investors accelerated their move to large blue-chip companies in the name of a "flight to safety" ***regardless of price***. ***Thus one mania was replaced by another.*** Wonderful companies like Coca-Cola, Gillette and Microsoft (not exactly lacking in popularity to begin with) were bidded up in price to 30-40 times their earnings.

Here at ***PDV Financial*** we believe what these people fail to recognize is the critical distinction between a good *company/business* and a good *investment*. Even a good company/business can be a risky investment if you overpay for its *normalized* earning power. The widespread complacency about the unsustainable valuations of these fine companies and the almost universal consensus that these stocks are safe and rewarding actually make them risky.

If you find it difficult to believe these fine companies are risky from an investment standpoint, look back at history which often offers valuable guidance. ***As it turns out, we've been here before.*** In the early 1970's, Wall Street became enamored with a group of blue chip companies (known as the "nifty-fifty") that were universally considered so outstanding that it did not matter what price you paid for them, because their wonderful franchises would guarantee a handsome return on your investment if you simply bought and held on to them.

Just as this consensus opinion became universally accepted as fact, a crushing bear market evolved. As is typically the case with bear markets, the most overvalued companies (even if they are good companies) generally see their share price suffer the most. When the market hit bottom in late 1974, many of these blue-chip "can't lose" investments fell with a thud, in some cases losing up to 90% (yes 90%!) of their value. We hasten to point out that the collective valuation for the "blue-chips" today is not as extreme as that for the nifty-fifty, but the mindless acceleration of investments into the blue chip companies *regardless of price* escalates the risk in a similar manner.

Since the DJIA peaked a few weeks ago, the DJIA has lost over 600 points! Because the DJIA is so visible (even though it's actually a very misleading index in tracking the progress of the market), people have begun to take notice. The fact, however, is that many stocks have been in a slump since last summer. If the valuation of the blue-chip companies ever returns to rational levels, their downward price movement will have a disproportionately large *adverse* effect on the market capitalization-weighted indexes like the S&P 500.

Where's the market going anyway? Despite the fact that there are alot of people who would enthusiastically oblige by telling you with a straight face (as long as it is for a handsome fee) what the market ***will*** do, let's say, three Tuesdays from now, we at ***PDV Financial*** will readily admit we don't have any idea what the market ***will*** do.

What we do know, however, is that we are not buying the market, but individual companies ***within*** the market. The art of successful investing is about ***managing*** risks and not the impossible task of *eliminating* risks. People won't make themselves rich with market timing, but they will make their brokers very wealthy through lots of trading.

So how do we manage investment risk? To answer this question, it is important first to understand what is likely to make a company's stock price go up over the long run. While mass psychology permeating the market as a whole can adversely affect all companies/stocks over the short run, over the long term it is a company's *normalized* earnings power, its growth prospects and asset values as well as the proper valuation multiple for these business attributes that will likely determine its stock price.

We manage investment risk for our clients by researching companies one by one to find situations where the short-term stock price quotation is ***underpricing*** the long-term *normalized* business potential of the company. Essentially, we see these investments as out of favor ***discounted bargains*** that in all likelihood

have already experienced undue selling pressure, with attractive risk/reward characteristics going forward. We believe that a diversified portfolio of such investments will help mitigate the risk of ***a permanent loss of capital*** because at least a reasonable number of such investments will likely appreciate towards fair value over time.

We would not recommend that our clients retreat to cash reserves since we continue to find such attractively valued investments. Many of these stocks have begun to recover even as the broad market heads lower. The time to buy these fine companies is when the broad market has temporarily dumped these companies into the discount bargain bin.

How Making IRA Contributions Can Benefit You

It's approaching that time of year again - April 15. We want to highlight one of the few ***tax breaks*** that Uncle Sam gives all of us, which you should consider utilizing.

As you probably know, anyone with at least $2,000 of earned income in any year is able to make up to a $2,000 IRA contribution for that year. If you have not made your $2,000 IRA contribution for tax year 1996, you have until April 15, 1997 to do it. With respect to your $2,000 IRA contribution for tax year 1997, you can make it any time between now and April 15, 1998.

You should seriously consider making both contributions for tax years 1996 and 1997 (i.e. a total of $4,000), if *(1) you have adequate reserves to take care of your everyday expenses, and (2) you have already "maxed out" on your company retirement plan contributions*. Contrary to popular belief, even if your IRA contributions are ***not*** deductible in whole or in part because you are already covered by a company retirement plan ***and*** your income exceeds certain prescribed levels, you can still benefit from making IRA contributions because the investment returns generated on your contributions continue to be ***tax deferred***.

If you decide you are in a position to make the 1996 and/or 1997 IRA contributions, it is advisable to make them as soon as possible. The earlier the contributions are deposited in your **contributory IRA**, the sooner any gains will be shielded from taxation.

Here at ***PDV Financial*** we are fortunate to have the opportunity to serve many clients who have entrusted both IRA's and taxable accounts for our investment management. ***For those who currently have or are in a position to set up both an IRA and a fully taxable account, we would be happy to show you how you can take advantage of the different tax status of the two types of account by allocating taxable investments to your IRA (to defer taxes) and tax-efficient investments to your taxable account (to reduce the amount subject to taxation).***

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