2012 2nd Quarter Stock Market Commentary

CHANNELING CAPTAIN LOUIS RENAULT

"We contend that for a nation to tax itself into prosperity is like a
man standing in a bucket and trying to lift himself up by the handle."
- Winston Churchill

Long before David Letterman's stupid pet tricks, a psychology graduate student at Harvard taught a pigeon to play the piano, and taught two other pigeons to play ping pong. He accomplished this through the ingenious application of a piece of laboratory equipment which has had such profound influence that a recent survey ranked its inventor as the most influential psychologist of the 20th century. The man was Burrhus Frederic Skinner (more usually referred to by his initials B. F.) and the device was an operant chamber, known colloquially as a Skinner box.

The original operant chamber was simply an enclosed box with a lever. A rat was placed inside and whenever it pressed down on the lever, it received a pellet of dried food. Initially, the rat was unaware of the function of the lever and only triggered feeding when it happened to touch the lever by accident. But after scoring several such lucky contacts, it learned the connection, and consequently the time that elapsed between pushes on the lever became ever shorter. Skinner had discovered a simple means of measuring the rat's changes in behavior, namely the frequency with which a particular behavior occurred. Unlike Pavlov's dogs, the animal in Skinner's experiment wasn't exhibiting an innate reaction, but was learning a new behavior. The theory that Skinner developed on the basis of this has three components. Animals constantly exhibit spontaneous behavior. The consequences of any particular behavior, positive or negative, increase or diminish the chances that the animal will repeat that behavior. Last, it is the environment that determines these consequences. He called the whole process "operant conditioning" to distinguish it from Pavlov's "classical conditioning". The branch of psychology which holds that all behaviors are simply the result of operant conditioning is called behaviorism, so that we can think of a behaviorist as someone able to pull habits out of rats.

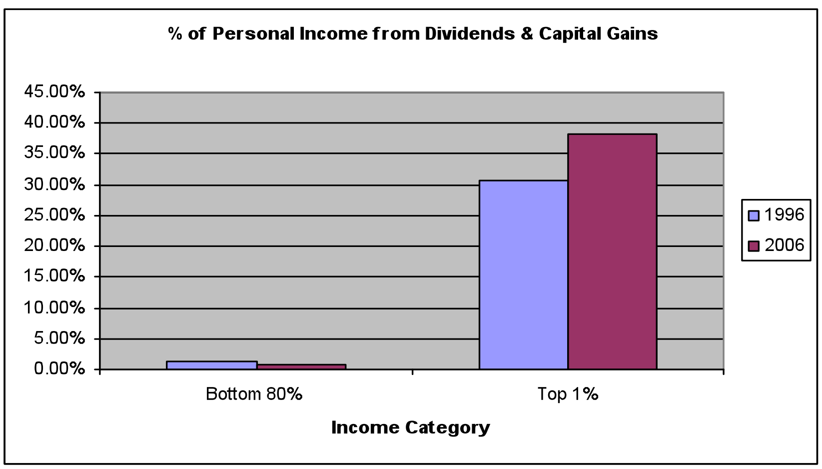
At first glance, the method behind operant conditioning appears quite simple. Reward reinforces a particular behavior, while punishment discourages it. Yet Skinner used it to teach animals far more than simply how to press a lever. The key was not to reward the animals only for attaining the overall goal, but for every step along the way. Thus, the pigeon was given grain when it just happened by chance to hit the correct first note with its beak on the toy piano in the Skinner box, and then again when it got the second note right, and the third, and so on until it could play an entire children's song.

Operant conditioning is just as applicable to changing human, as animal, behavior. A case in point is the government, which uses credits and taxes to provide rewards or punishments, rather than food pellets or electric shocks, to influence citizen behavior. Ronald Reagan summed this up perfectly when he observed "If you want more of something, subsidize it; if you want less, tax it."

Consider the fact that in 1986, before the top marginal income tax was lowered to 28% from 50%, more than half of all businesses in the United States were organized as C-Corps. Because the tax rate for corporate income was lower than that for personal income, it was tax efficient for small businesses to choose that form of organization. Of the top 1% of filers in that year, only 5.6% of income came from businesses organized as flow-through entities, such as Subchapter-S Corps, limited liability companies, partnerships or sole proprietorships.

Twenty five years later, a whopping 95% of business entities are organized as flow-through entities. Approximately 20% of personal income of the top 1% now comes from what previously would have been considered as business income. This shifting of small business income onto personal tax returns is one (but by no means the only) cause of the rise in income inequality over the last quarter century.

Probably the largest factor contributing to the growth of income inequality has been the sharp rise in the percentage of earnings of the top 1% derived from dividends and capital gains. In a detailed report by Congressional Research Services titled *Changes in the Distribution of Income Among Tax Filers Between 1996 and 2006: The Role of Labor Income, Capital Income, and Tax Policy*, the effect of tax law changes becomes immediately apparent. The tax rate change to a 15% rate in 2003 caused the wealthiest Americans to shift their investments into tax-favored



categories. The bottom 80% of tax payers do not have the discretion to adjust their sources of income, since the vast majority of it has been, and always will be, derived from wages.

In 1996, when the tax rate on capital gains was 28%, realized capital gains were only 2.5% of GDP. Holders of capital assets were reluctant to re-allocate capital when the penalty to make changes was high. After the tax rate on capital gains dropped to 20% in 1997, realized capital gains rose to 4.6% of GDP. Post the 2003 tax cut, when the rate was dropped once more to 15%, realized capital gains rose above 5% of GDP. Thus, ironically, the government coffers were a lot better off when tax rates were low, since the lower rates increased the mobility of capital and encouraged investors to unlock the values in appreciated assets.

In the classic movie, *Casablanca*, Claude Rains played Captain Louis Renault, who is famously quoted as saying that "I'm shocked, shocked to find gambling going on in this establishment" even while accepting a bribe to perpetuate it a moment later. Today, many legislators express outrage over the rising income disparity in our country, while doing nothing to change the labyrinthine tax code that they created that has helped to foster it.

The fact that people and corporations modify their behavior to respond to changes in the tax code seems perfectly obvious. After all, if Massachusetts imposes a high estate tax, and Florida has none, rich people of retirement age will relocate from the former to the latter. If California raises its state corporate income tax, as it has done, while adjacent Nevada has none, companies will change their domicile to reduce their tax burden (as Apple has done by opening an office in Reno to tax shelter its investment portfolio from California taxes). Incredibly, though, the fact that tax policy changes provoke changes in individual, and therefore aggregate, behavior seems obvious to everyone - except politicians.

In trying to assess the likely effect from a proposed change in tax law, the common practice is to assume that tax-policy changes will have *no* effect on behavior at all. In projecting the likely outcome of a change in tax policy, a mathematical model assuming no change in behavior is called a "static model." For example, suppose that the aggregate personal income of all the citizens of a particular state is $100 billion, and the state imposes a 5% income tax. That tax would raise $5 billion. In a static analysis, an increase in the tax rate to 6% would then be assumed to raise $6 billion. Early in 2011 Illinois imposed very sharp increases in both individual and corporate tax rates in an effort to close a yawning budget deficit: individual rates went from 3% to 5%, while corporate rates rose from 7.3% to 9.5%, increases of 66% and 30%, respectively. Unfortunately, and not surprisingly, the projected tax revenues never materialized. Large employers such as Sears and CME Group threatened to leave the state, forcing lawmakers to make sweetheart deals worth $235 million, negating the tax increases. These examples are by no means isolated. In 2005 Intel, headquartered in Santa Clara, California, elected to build a multi-billion dollar chip making facility in Arizona because of Arizona's 6.97% corporate tax rate compared to California's 8.84%. In 2010 Northrup Grumman moved its headquarters from Maryland, with its 8.25% corporate income tax, to Virginia, where the rate is 6%. Individuals are voting with their feet, too. California reported a whopping 21.5% drop in personal income tax payments thus far this year, at the same time that income tax collections rose an average of 8.9% nationwide. Overall tax collections (corporate and personal income taxes plus sales taxes) are running more than 20% behind projections, which were made under the assumption that individuals and businesses would simply pay higher rates. But a recent study has found that there has been a fivefold increase in the number of businesses leaving California's hostile business climate in the last three years.

In a rational world, tax rates would be relatively flat, and all deductions would be eliminated. Individuals and corporations would then allocate capital solely on economic return expectations. But this has almost no chance of happening. Politicians are able to legally buy votes by dispensing tax breaks - depreciation allowances for oil drillers, energy tax credits to solar panel makers and ethanol producers, and mortgage interest deductions to support home ownership. It is difficult to imagine them relinquishing this power.

But as investors, this irrational complexity creates opportunity. Just as some companies are more innovative at product development, some are much more adept at reducing their corporate tax burden. Consider General Electric, one of the world's largest conglomerates. The company manufactures jet aircraft engines, power generation equipment, medical imaging devices and household appliances, in addition to operating a huge consumer and industrial finance business.

In 2010, GE earned more than $14 billion, but paid not one penny in federal income taxes. More than $9 billion of those profits were earned overseas, for which the company actually got a $3.2 billion tax credit, but even its U.S. profits were sheltered from taxes through the aggressive use of tax credits. This situation is far from anomalous. In 2009, the company earned roughly $11 billion, and did not pay any federal taxes in that year, either. In fact, for the decade since 2002 GE earned a cumulative $81 billion and paid an average tax rate of 2.3%, according to a report by Citizens for Tax Justice. It is important to note that there is no allegation that GE did anything illegal. Management simply has been creative at exploiting the loopholes that Congress has created to steer behavior, while legislators simultaneously pretend that static analysis is useful in predicting revenues from changes in policy.

GE is far from the only company which employs sophisticated tax avoidance strategies. Between 2008 and 2010 twenty nine major companies paid no federal income tax. The list includes Boeing, DuPont, Verizon and Wells Fargo, arguably the best-managed companies in their respective industries. Apple, which has the largest market capitalization of any company in the world, earned over $34 billion last year, but paid only $3.3 billion in federal income taxes, for an effective tax rate of only 9.8%. It utilized a variety of methods to accomplish this. Despite being headquartered in Cupertino, California, it opened a small office in Reno, Nevada, to invest its vast cash hoard, since Nevada has no state income tax. It set up two Irish subsidiaries and another in the Netherlands and transferred intellectual property overseas, to take advantage of lower rates in certain tax havens. This strategy is known as a "double Irish with a Dutch sandwich". Such strategies are common for technology companies, which collectively pay a tax rate one third lower than the average company. After all, it is not as easy to transfer a WalMart store overseas as it is to transfer a patent.

Our point here is not to create a sense of outrage at the unfairness of the U.S. tax code, although it is certainly unfair and outrage is a reasonable reaction. Just as none of us as individuals have any obligation to pay the federal government more than we owe at tax time, so corporate managers have no obligation to overpay, either. In fact, to the contrary, corporate leaders have a fiduciary obligation to shareholders to try to enhance shareholder value. In assessing a potential stock investment, investors routinely consider numerous factors which speak to the quality of management and its ability to create shareholder value: the pace of product innovation and strategy for capital allocation are examples. But certainly, management creativity in legally minimizing corporate taxes is another.