

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Mr. Obama's budget is out and the message for investors is as clear as any missive from Washington in a long time. Get the defense on the field and keep 'em all well watered. . . they may be out there for a while!

Of course we hope all this spending will find some success and only time will tell, but history suggests otherwise. Higher taxes do not create jobs. Pork, public works, and healthcare reform do very little, if anything to stimulate an economy. Mr. Obama's tax increases may look good on paper, but they will likely have a less than optimistic outcome in the real economy.

According to the latest statistics from the US Census Bureau, 98% of all American firms have less than 100 employees, 90% of all firms in the US have less than 20 employees and those firms are responsible for over 97% of all new jobs in this country. Nothing in the bill contains specific language to direct any stimulus spending to the 98% of American firms that create over 97% of all new jobs. In fact it punishes those who create jobs.

Mr. Obama's budget unfortunately targets job creators, whether intentionally or not. The Wall Street Journal cites a Tax Foundation finding that merely restoring the higher Clinton-era tax rates on the top two brackets hits 45% to 55% of small-business income, depending on how inclusively "small business" is defined. Small business owners make economic decisions based on possible returns. If their projected income from risks taken is reduced by another 5, 6, or 7% (plus potential state tax hikes coming) many may simply take the safe road. As profit potential declines, so go hiring and investing plans.

This budget strategy might be likened to General Washington ordering his best front-line troops off the charge and assigning them to carry the wounded and make bandages. It is a strategy for retreat, not for advance.

What Should Investors Do?

If you are a long-term investor, in the market for long-term growth, and are not drawing money from your account, stay put. Every study of individual investors demonstrates the fallacy of trying to time the market. It is impossible. Mr. Bernanke and the Treasury will eventually fix the banking mess and business will return to profitability, albeit with significantly reduced growth expectations.

If however, you depend on your portfolio for income, the new tax landscape dictates distinct strategies for success. We have developed two new defensive income-oriented

portfolios which maximize the benefits remaining under the coming tax structure. There are three primary areas our new portfolios seek to benefit investors while minimizing risks and costs: Tax Free Municipals, Qualified Dividends, and High Grade Corporate Bonds.

We are in the midst of a strong bull market for fixed income, with US Treasuries at the heart of it. As the crisis subsides and the credit markets begin to thaw, the broader fixed income market will likely participate. The Federal Reserve is considering buying long-term Treasuries in order to reduce long term rates and to add yet more liquidity to the markets.

Investment grade corporate bond trading in the US is rising to the highest levels in two years even as stocks languish. An average of \$17 billion corporate bonds have traded during the last two months, up from a low of \$9.4 billion in August. Yields of investment grade corporate bonds rose as high as 9.3% last December and stand at roughly 7.5% this week. Investors are betting yields are high enough to compensate for defaults that Moody's Investors Service forecast will rise to 16.4% by November '09, the highest since the Great Depression and about three times the current rate of default. Broad diversification across strong sectors of the economy can mitigate risk substantially.

Municipal bonds offer very attractive yields as well as the backing of a taxing authority or insurance. The S&P Municipal Bond Index currently offers a yield to maturity of 4.5% or 7.5% after the proposed highest tax bracket. This highly diversified bond index is available through an iShares exchange traded fund.

Finally, the preferential dividend tax treatment of corporate dividends enacted by Bush will likely survive, in theory, the otherwise total repudiation of his policies. Before Bush, dividends were taxed as ordinary income, at rates as high as 39.6% in the 1990s. The new budget raises taxes on capital gains and dividends to 20% for top earners, up from the 15% set by former President. Our portfolios will offer index funds which concentrate their holdings in high quality dividend paying companies which have a history of increasing and maintaining their dividends over long periods.

Please give us a call if you would like to discuss the appropriateness of our Income Portfolio for your situation.