

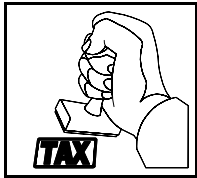
Wescap Management Group

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For WESCAP Clients and Interested Readers

Cinderella Tax

The new tax law is impressive in its post 2001 generosity. Then, in 2011, like Cinderella's pumpkin, it all goes back exactly to the way it was before.



Being just a little skeptical of the tax law remaining the same

through 2011, we will focus on just a few of the current issues and benefits available by 2002.

Tax Free Education Benefits Enhanced

The education IRA is raised to \$2,000 in 2002, now making it worthwhile to consider. All income is tax-free when used for any valid education expense (not just limited to college).

Furthermore, it can be established by someone without earned income; allowing almost anyone to get around the other income limitations.

Also the "529" state college savings plans (ScholarShare in California) have, starting in 2002, also scrapped tax-

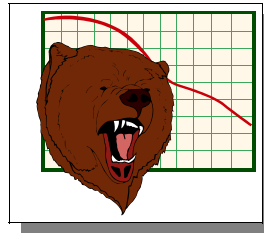
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The Stock Market Trend is *Not* Your Friend

Can the stock market drop another 25%? "Yes" according to Jeremy Siegel, professor at Wharton and author of *Stocks for the Long-Run*.

This is the amount that the stock market is still above its 200 year trend line. It would take either a 25% decline or 4 more years of no return in order to get back to the trend (Forbes June 11, 2001, p186).

In the *short-run*, stock prices are all about fear and greed and our expectations and hopes. The market is *our* mirror—Doing well when we feel well and vice versa.



But in the *long-run*, markets ignore our hopes. No stock remembers the price *we* paid for it! Markets ultimately weigh intrinsic value. It is all about interest rates, earnings, inflation and real sustainable growth—or decay—in a global never-ending competition.

Of course, we do remember. Our hopes and expectations change only gradually. This explains why markets get out of whack in the first place—why speculative bubbles and deeply depressed markets exist. This also explains why transitions from one to the other take so long.

This persistency is manifest in a market's reversion to the mean. When a market goes too high or too

low it eventually returns to its long-term trend. Plus, the greater it goes above or below the mean and the longer it stays there, the stronger is the reversion once it starts.

What is critical of course is the trend. This means nothing if we postulate a new era and thus a new trend. However, both history and theory suggest otherwise. Each "new era" sustains progress, but

does not permanently accelerate it. A look at the Dow Jones trend line starting in 1903 shows remarkable stability (figure 1 attached). One overriding factor contributing to this is

the concept of long-term required rate of return (RRR).

The required rate of return is not what each of us hopes to make, but rather is the *minimum* reward that *must* be paid to investors to entice an investment. Higher rewards are competed away in free markets. For

example, a bank making a loan (an investment for the bank) may find its loan rate undercut by other banks until only one bank makes the loan at the lowest interest rate.

Likewise for stocks, the RRR will be driven down to the minimum needed to compensate for risk. The RRR must be equal to inflation (a return of real principal), plus a component

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No stock remembers the price we paid for it!

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deferred income and adopted the tax-free approach. Between these two education accounts and limited use of UTMA accounts, it is possible to educate a child from savings that avoids all federal taxes on earnings.

Estate Exemption: \$1 Million

Next year, the per person amount exempt from estate and gift taxes increases to \$1 million from \$675,000. This reduces the need for 2nd to die life insurance policies and other esoteric strategies. However, for those with enough assets, you have to die exactly in 2010 to have all estate taxes eliminated.

Alternative Minimum Tax (AMT)

If you have not suffered from AMT, consider yourself lucky, so far. AMT provisions were little changed in the recent new tax law. Thus it is likely that more high income and high deduction tax payers will see their potential new tax law savings negated as they are caught in the AMT web. This increases the need to do multi-year tax projections and to carefully plan the timing of deductions and income.

At least they did not call it tax simplification this time.



The Stock Market Trend is Not Your Friend

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equal to what you can earn on riskless government bonds (usually 1% to 1.5% above inflation).

Then on top of this is an extra return to compensate for risk. Since you can diversify away bankruptcy and other company specific risks, you are only compensated for the risk of the stock market as a whole. Short-term volatility is a risk, but this is a minor risk for long-term investors. Therefore, the long-term risk for a fully diversified investor is not very high.

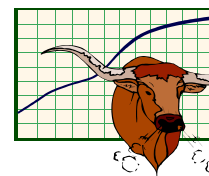
As a result, this extra return for risk, and thus total return, for any stock should not be high. For example, with inflation about 3% (near the long-term trend) plus 1.5% for after-inflation bond returns and a modest 5% equity risk premium (extra return for risk), why should you really expect to make more than 9.5% long-term? (near the long-term total return trend). In fact if we are in a new age of peace, prosperity and consistency, then risk has actually gone down and thus total future returns should come down too.

As real or perceived risk goes down, stock prices go up. This is what happened during the five years prior to 2000. At the same time, rising stock prices reflect a lower future required rate of return. Many investors misunderstand this

and think that high recent returns means they should expect continued high returns. The opposite is true. This also implies that declines in stock markets increase future expected returns. Buying after declines and selling near highs still makes sense.

Reversion to the mean appears as robust as ever. Does this mean no gains over the next 4 years? It may be worse than this. Markets often go to extremes. Once a trend firmly reverses, it is rare to exactly reach and stop at the fair equilibrium price. This is shown in Figure 2 (attached). In 5 out of the 7 times that market price earnings (PE) ratios got above 21, the subsequent decline carried the PE ratio below 10, far past the average PE of about 15. What is likely is for the new downward trend to go too far the other way, resulting in depressed, though attractively priced stocks.

Today's valuation and recent strong downtrend have the hallmarks of a not yet completed reversion to the mean. A more conservative, value-seeking approach is warranted until overall valuations are more attractive.



Only then will the stage be set for a new bull market.



About WESCAP:

Wescap Management Group is a Glendale, California registered investment advisor and fee-only financial advisory firm. Wescap has been serving individuals and families since 1988. For additional information, please contact either Rick Weinlein, Mark Gleason, or Joel Edstrom. We can be contacted at 1314 W. Glenoaks Blvd. Suite 204, Glendale, CA 91201, at 800-820-2453 or contact us via e-mail at wescap@pacbell.net.