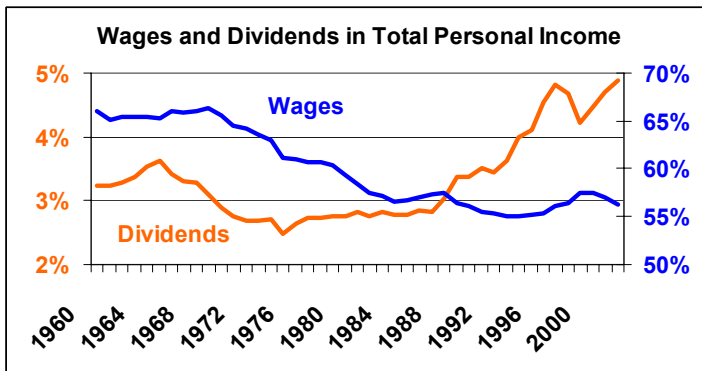




Cascade Investment Commentary

The year 2003 opened with a startling and bold move by the President to finally address the Wilsonian era notion that the income from a person's personal labor (earned income) should be treated differently than a person's income from rents, dividends and capital (un-earned income). This ideology of organized labor continues to cause distortions in the allocation of capital, and the behavior of management towards shareholders.

For a perspective on the issue of dividends, we have provided a graphic showing the percentage contribution of wages and dividends into total personal income.



Since 1960 wages (earned income) has dropped from 66% of total personal income to 56%. Dividend (unearned) income rose from 3.2% to 4.9%. Increased transfer payments fill the gap. Total household income was running at \$9.1 trillion last quarter, \$5.1 trillion of which was wages, \$1 trillion interest income, \$1.3 trillion transfer payments and only \$443 billion was dividend income.

Currently earned income is taxed only once at the federal and once at the state level. Interest income is taxed likewise. Only dividends are taxed twice at the federal level, and in many cases twice at the state level. The disincentive to give shareholders cash is great indeed.

The President's reform initiative as we read it would allow dividends that have been taxed at the maximum 35% federal level to be tax free to shareholders. Dividends from corporations that paid no federal taxes would be fully taxable, and there would be a sliding scale between the two. This is good policy.

First it is good political governance. There is broad consensus that income should be taxed only once, but the problem is raw politics. The primary delivery vehicle in the "reward your friends and punish your enemies" part of American politics, is the tax code. In every election cycle corporations line up behind candidates that will help lessen *their* corporate tax burden with various shelters and relief schemes. The best interest of the shareholder is far from the best interest of a congressman.

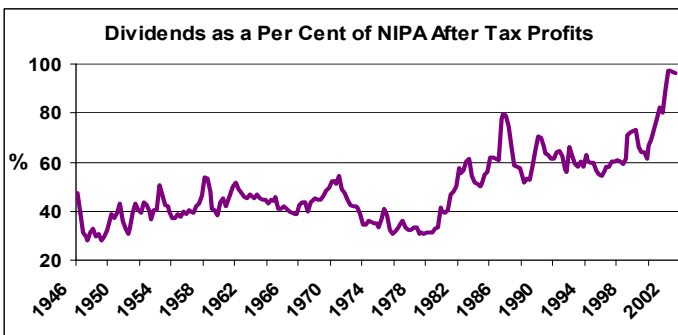
It is also good tax governance. Justice Oliver Wendell Holmes famously said that it was not the responsibility of citizens to maximize their taxes. In addition to seeking Congressional favors (making the tax code a scandal), corporations have been induced by the double taxation of dividends to enlarge their capital base by adding tax deductible debt over equity. This "leverage" or "gearing ratio" works fine when revenue is rising and marginal costs are falling. It is a disaster when the reverse is true. WorldCom, Enron, and Global Crossing didn't fail because they had too much equity.

Third, it is good corporate management. CEO's have squandered billions by using retained earnings to wander into fields where they had no expertise. Remember Coca Cola going into the wine business, Sony buying MCA, Seagram's buying MCA from Sony, AT&T borrowing \$68 billion to buy cable franchises, and AOL buying Time Warner? Each of these (and many other) ill advised plans fed the ego of the company's CEO at the expense of the shareholder.

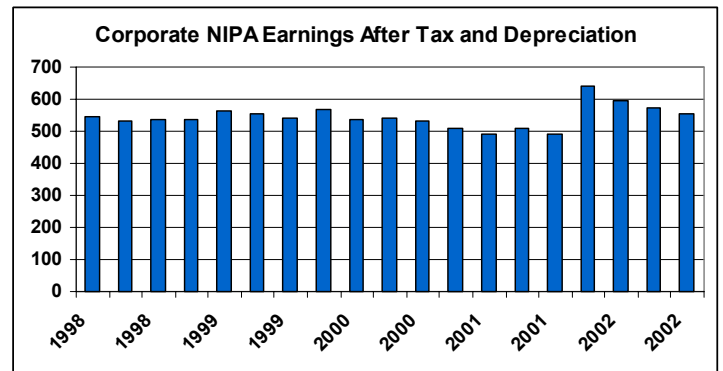
Paying a significant dividend is a tough discipline that keeps good firms centered on their core competency.

And last, it would remove the big fig leaf over stock options. Burton Malkiel of Princeton argued that the shareholder was better off if a corporation used its free cash flow to repurchase stock in the open market (lowering the number of shares and thus boosting per share earnings) than to raise or pay dividends because capital gains is the lower rate. This fig leaf has been used to cover many overly generous stock option plans that have diluted stockholders significantly. In many cases, the share buyback plans don't even cover the options exercised. We don't suggest ending options programs, but it would be better to grant outright the shares of stock paying tax free dividends than to play games on Wall Street with accounting tricks hoping to get share prices to rise.

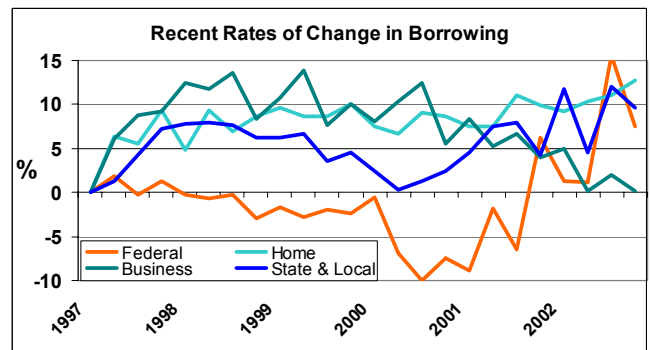
The capacity to raise dividends is an issue we follow closely. In the current point of the economic cycle, many cyclical companies are paying more in dividends than they have in real earnings. Rising dividends have boosted consumption in past years, but they may not be of much help until full recovery in the economy.



As the chart above suggests, corporations are already paying out about as much as they can. The National Income and Product Accounts (NIPA) uses the actual federal tax return data of corporations, not reported earnings. On a NIPA basis earnings have not been truly robust since 1998. While Microsoft may have the cash to pay, many firms are paying money they don't have, or too much of their free cash flow.

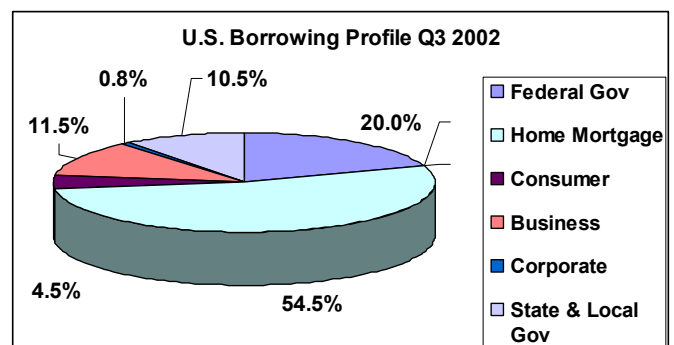


From the beginning of 1998 to the 3rd Quarter of 2002, after tax earnings grew hardly at all. Capacity expansion was funded almost entirely with debt. With capacity utilization down to 75%, new capacity building has virtually stopped, and so has new corporate borrowing.

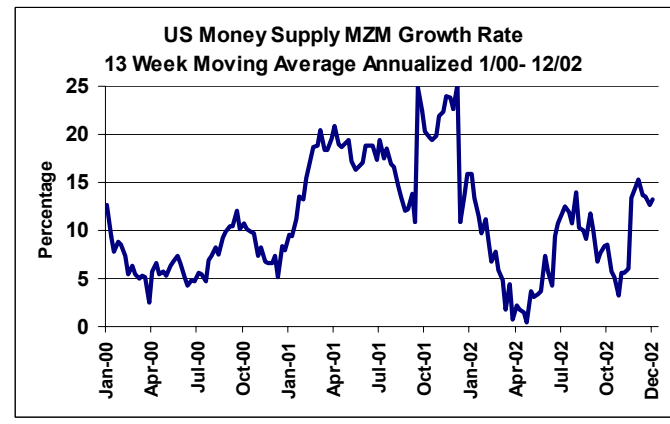


The chart above tells us what we already know: Federal borrowing has gone from negative to positive, state and local borrowing is going up, business borrowing has gone to zero, and home mortgages are still on a tear.

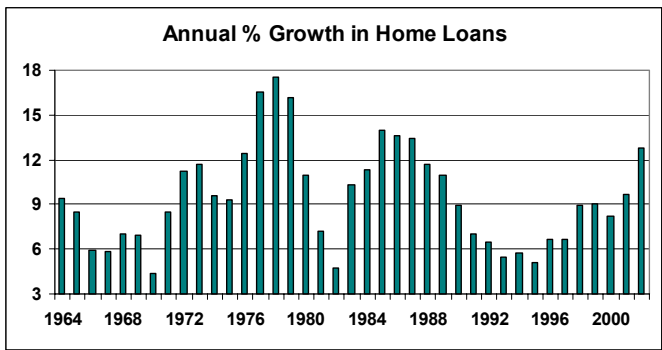
Home mortgage borrowing in 2002 was at the rate of \$2.7 trillion (54.5% of all borrowing), and consumer debt an additional \$240 billion, about 4.5%.



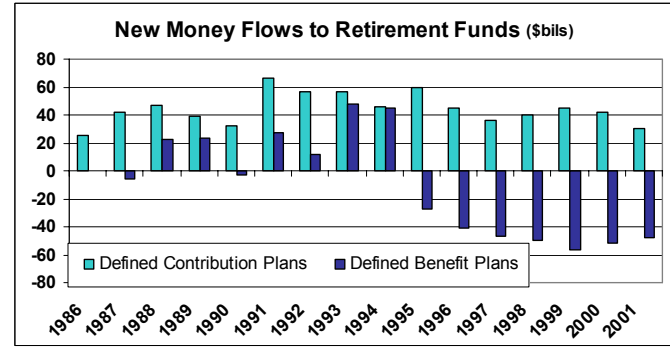
Many in the media seem terribly frightened of a “housing bubble”. As we have shown in a previous *Commentary*, this is a phenomenon of bear stock markets and interest rates. People are very smart about home values and mortgage rates, and huge swings of money move into the housing market when prices of housing rise and rates fall. Households are currently choosing a deductible new mortgage on rising home prices over a taxable 1.75% dividend return on falling stock values.



The current post bubble appetite for bond funds and fixed income securities including packages of low coupon mortgages may prove fleeting. For one, a trend likely to continue is more money is going into Defined Contribution (DC) plans than into Defined Benefit (DB). DB funds are the ones with the big appetite for bonds. DC plans are directed by individuals, and are generally more equity oriented. The current charm of bonds funds will fade quickly when the stock market recovers or interest rates rise. With interest rates at or close to their nadir, only a small move upwards would stall re-financings and sour investors on bonds.



To our thinking, late 2003 and particularly 2004 will witness a change again. While the rate of growth in home mortgages is not out of the “norm” as seen through the past 40 years, the economic chemistry in this cycle (page 2) is different, and a very slight change in interest rates will have magnified consequences.



What we are speaking of is “crowding out”. This term, coined in the early 1980’s defined the process where the most creditworthy borrower removed the marginal borrower from the market due to price competition.

In summation: consumption at the household level will at some point return to only the growth in wages and income. With the ability of corporations to raise dividends in the short term diminished, there will be growing support to make at least a portion of them tax free at the household level. Congressmen will notice.

Competition from government borrowers is growing, and accommodating all of the federal, state and local deficits will be an act of reflation (creating excess money) that will not occur without the consequence of rising inflation.

With the Producer Price Index growing at zero the Fed has little to fear at the moment by flooding the market with excess liquidity. That liquidity will flow into government bonds and even to equities (including homes). It is the fear of reflation both here and in Euroland that has recently pushed up the price of gold.

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