



Gordon B. Fowler, Jr.
President, Chief Executive Officer & Chief Investment Officer

Clear Air Turbulence

Summary

- Based on valuation and sentiment gauges, it is possible to argue that markets should be higher 12 months from now.
- Unfortunately, to get to this point, investors will probably endure a very uncertain and potentially turbulent period.
- The potential funding crisis amongst European financial institutions will likely cause near-term market instability and increase the probability of a global recession.
- Given the potential for a fair amount of turbulence, our recommended portfolios have reduced risk relative to policy allocations.
- The author closes by ruminating on an aspect of the current debate on taxation and argues for a dull and thoughtful approach that respectfully recognizes the complexity of the issue rather than the potential for headline grabbing declarations.

Sunny Skies Over the Horizon

My summer vacation was spent shuttling our firstborn, a rising high-school senior, around the country visiting colleges. When flying, I enjoy looking out the window, particularly over the West Coast where the terrain is stunning and varied. So despite riding in a tiny jet from Ontario, California to Portland, Oregon, I was happy to gaze at the mountains and valleys shaped by years of volcanic activity. That was until the plane, without a cloud in the sky, began to shake violently. When something similar happened a few years ago, a pilot seated next to me, noticing my handprint indentations in the metal part of the armrest, explained that the shaking was nothing more than “clear air turbulence.” Attempting to arrest my concerns, he said these substantial and undesirable altitude shifts would end once the plane was on the ground. I wish pilots would announce that “we will be landing shortly” rather than “we will be on the ground shortly.” This distinction is important, as it matters tremendously how one achieves the goal of reaching the ground.

When financial markets experience cycles like those seen in July and August, I often think of clear air turbulence. Given the substantial pullback and extreme investor sentiment readings, it is possible to argue quite convincingly that markets should be higher 12 months from now. But if horizons are sunny and blue, why are we bumping up and down so much—is it time to tighten our seatbelts and place our heads between our legs?

Before reaching for the oxygen mask, let's first assess the current source of turbulence.

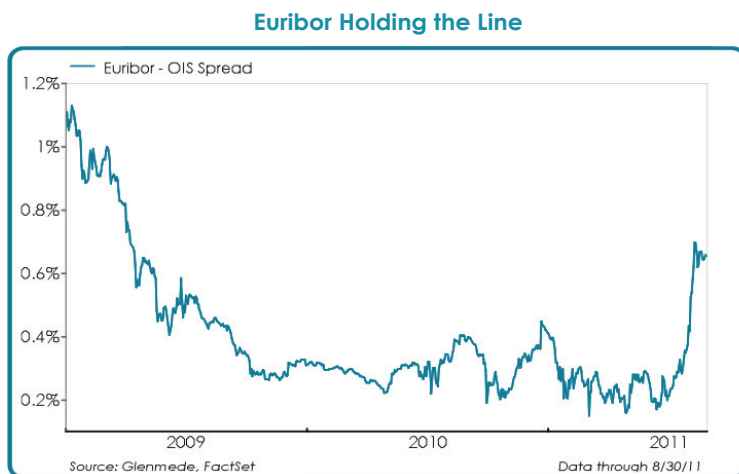
Leverage and Turbulence

Air turbulence, despite the shifting upward and downward motion, rarely causes structural harm. The exception, however, occurs when a plane is close to the ground and in the process of either taking off or landing. At this point, as a result of the turbulence that comes from a microburst and wind shear, a plane can be “on the ground” and reach what mathematicians might call “an absorbing state.”

For most companies, recessions generally are just a blip on long-term results and, theoretically, should not impact stock valuations. Recessions, like air turbulence, merely shake things up. Though, there is an exception here too; in this scenario, it occurs when companies are running a little too close to the ground by carrying too much debt or leverage. Without the financial staying power to persist through a recession, companies may be unable to bypass the “absorbing state.” A recession becomes a real problem for these companies and, potentially, the broader economy.

A few years ago, U.S. financial institutions, along with pension and post-retirement healthcare plans of companies like General Motors and Chrysler, were in this position. Currently, European financial institutions face toxic housing-related debt as well as the debt of wayward sovereign governments.

A particularly troubling output of this current turbulence is noticeable in the difference between the rates European banks pay on three-month interbank deposits (3-month EURIBOR) and the rate paid to investors who receive a 3-month average of the difference between fixed and daily floating interest rate payments (the 3-month OIS rate). In the former transaction,



investors are lending to institutions (which, in today’s environment, could become worthless if the bank goes belly up) and in a swap transaction, no principal is actually at risk. Normally, either transaction is viewed as extremely safe.

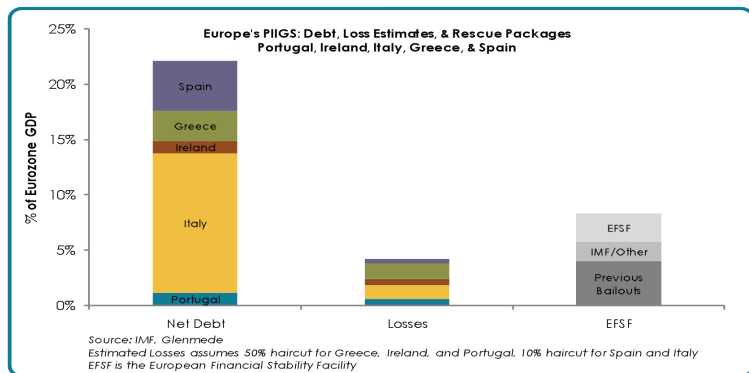
Currently, however, the gap between these numbers indicates that lenders view lending to European banks as much riskier over the next three months. While the “spread” between these two

rates is normally 0.2 to 0.3 percent, presently it is approximately 0.65 percent. Although not an earthshakingly high disparity, it is the same sort of spread widening that occurred in the United States in 2007 and 2008 prior to the sub-prime crises. If we stick with our air turbulence analogy, we could say that in the case of the U.S., these spreads were the small bumps that foreshadowed the more violent shaking that came later.

A Political Problem, First and Foremost

As we have previously suggested, the problems in Europe are more political than economic. Europe has the financial wherewithal to survive this present crisis. If we assume a generous amount of PIG debt (Portugal, Ireland and Greece) has been written off, as shown by the chart to the right, the losses will be a smaller fraction of European GDP than the write-offs “enjoyed” by the U.S. following the subprime crisis. European politicians need to create the same sort of financial backstop as Paulson and Bernanke engineered in 2008. The problem, should politicians take too long to reach an agreement, is that the markets may panic. As was recently the case in the U.S., one could argue that politicians may require a crisis to spur them to act.

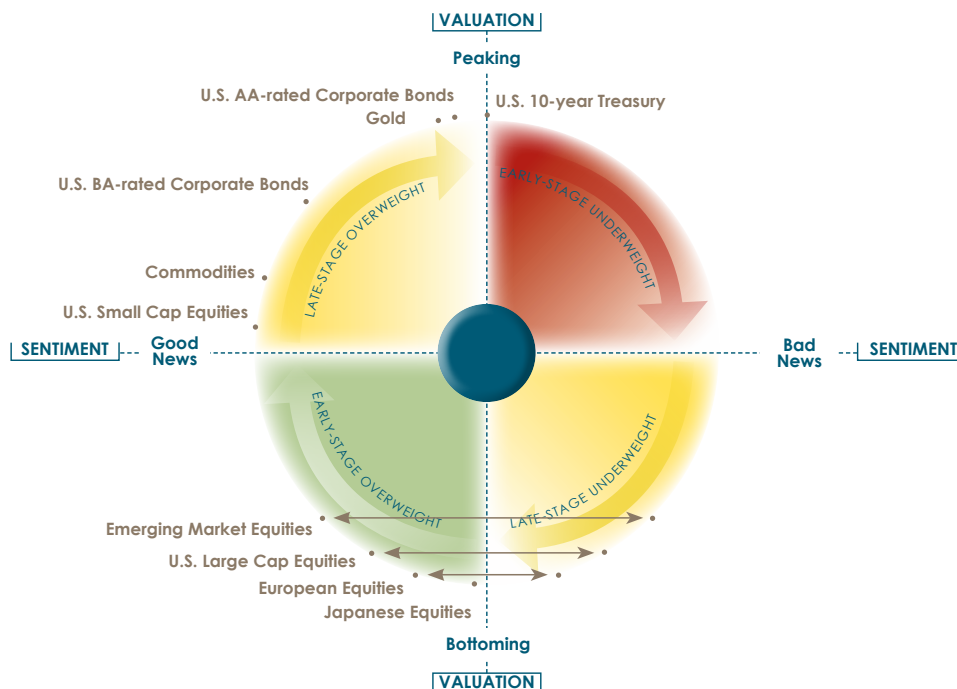
Silver Lining: Europe's Debt Crisis Losses Are Manageable



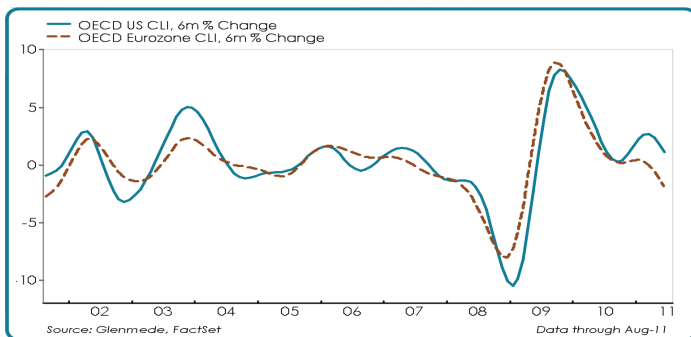
Where are the Blue Skies?

So, things seem a little bleak. The two positive factors worth noting are valuation and sentiment. The graphic below shows where various asset classes fall in terms of the investment cycle. The optimal time to invest is when valuations are cheap and fundamentals, such as economic growth and earnings, are improving.

August 2011: The Typical Cycle is in Question

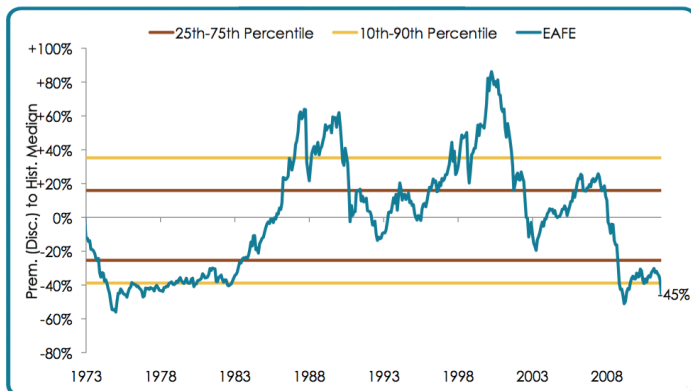


Leading Indicators Are Declining



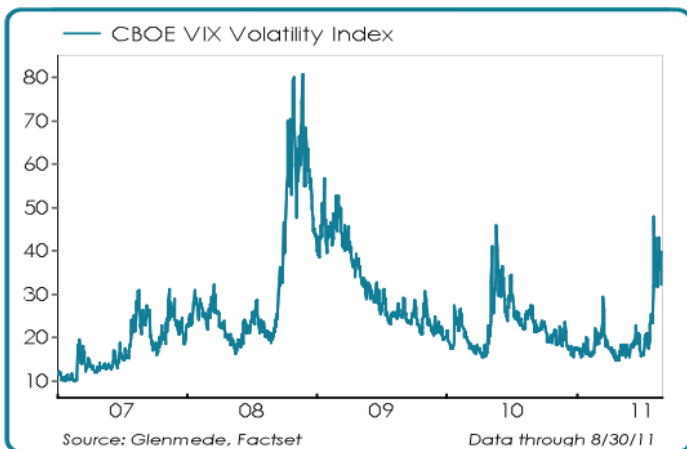
Before delving into the positives, let's remain with the negative outlook a bit longer. Clearly, fundamentals are, at best, uncertain. Several months ago the leading economic indicators (LEIs) we watch began to deteriorate, leading us to reduce the risk in our recommended portfolios. Because the future course for the world economy is very uncertain, these numbers will have to reasonably improve for us to become truly bullish.

EAFE: Historically Cheap



This, however, is a timing consideration. There are numerous positives that could and should play out over a longer period of time. Asset valuations, thanks to the pullback, actually look quite attractive. In particular, some of the developed international equity markets appear to be at extreme valuation readings as shown to the left by the EAFE index of developed country stock markets. With EAFE valuations below the 10th percentile, there is an indication of attractive valuation levels.

Has Market Sentiment Gone Too Far?



Another more timely investment signal is market sentiment. When investors become intensely despondent, it often provides a good buying opportunity. The chart on the left shows the value of the VIX index, which measures market fear embedded within the pricing of stock index options—the insurance market for equities.

When fear and insurance premiums are high, the VIX goes up. Currently the VIX is at approximately 35 percent, having reached as high as 40 percent in the past month. In past market cycles when the VIX has exceeded 30 percent, markets have tended to rise 86 percent of the time, earning an average 16.3 percent return.

Is High Volatility Encouraging?

CBOE Market Volatility Index (VIX)

VIX Levels and Subsequent 52-Week Returns for S&P 500

VIX Level	Subsequent 52-Week Returns	
	Average Return	Positive Frequency
<12.5	12.5%	90%
12.5 to 15	12.8%	97%
15 to 17.5	13.4%	94%
17.5 to 20	11.1%	81%
20 to 22.5	6.6%	64%
22.5 to 25	4.4%	61%
25 to 27.5	7.0%	65%
27.5 to 30	11.6%	75%
>30	16.3%	86%

Price performance is another measure of sentiment. When the market has declined by more than 15 percent, stocks tend to rebound nicely over subsequent time periods, earning roughly double on average. In the most recent downturn, the stock market declined 19.6 percent from peak to trough.

Forward 12-Month Price Returns when S&P is off >15% within given window
Data: Jan., 1946 to July, 2011

	Months Forward						All Periods
	1	3	6	12	24	36	
Median	8.9	20.4	18.8	18.6	16.6	18.1	9.4
Positive Frequency	100%	100%	87%	74%	82%	96%	71%

Source: Glenmede Research

So, are we out of the woods yet? There is a strong case to be made for the longer term potential for a market rise. We are comfortable that things will work out in Europe through a push and shove process. The question, as noted by one analyst, is how much shove will be required to make painful political decisions. Unfortunately, the remaining European issues will cause markets to continue to fluctuate. Further, markets will be exacerbated by concerns of a double-dip recession. Given the prospect for a fair amount of near-term turbulence, we have lowered risks relative to policy. If we do encounter a volatile sideways market, our recommended portfolio should fluctuate less in value.

The good news, however, is that periods of turbulence often are followed by a market rally. Investing in equities does not necessarily need to reach an absorbing state. In fact, history suggests there will be a quite smooth landing 12 months from now. While we may want to fasten our seatbelts, we should remain focused and aware of the changing landscape.

A Dull and Technical Viewpoint Unlikely to Grab Headlines

Recently, Warren Buffet wrote an article, published in the *New York Times*, in favor of raising taxes on the very wealthy. He cited himself as an example of how the rich were being “coddled.” Apparently, Mr. Buffet pays only 17 percent of his earnings in taxes while his employees who earn substantially less pay much higher levels.

As the country debates how to close the deficit, raising taxes on the wealthy should be on the table for discussion. According to the Congressional Budget Office, letting the “Bush” tax cuts expire would eventually stop the growth of the country’s debt to GDP ratio. By our estimate, approximately one-third of the amount needed would come from tax increases on the wealthy.¹ The rest of the gap would be made up primarily by taxes on the middle class.²

Buffet’s perspective, while headline grabbing, doesn’t improve the quality of the debate. Sometimes it is the responsibility of leaders to be not only principled but a little dull. What should be noted is that the same point, the ultra wealthy will pay less on a percentage basis in personal income taxes than the middle class, can be made in most developed economies for some rather rational reasons.

The reason the very rich tend to pay less as a percentage of income than the somewhat wealthy and middle class is that capital gains are generally taxed at a lower rate than wage income. Billionaires like Buffet don’t earn much of their income from wages. Rather, they earn it from their investments. Since Berkshire Hathaway doesn’t pay a dividend, presumably most of his earnings are generated from sales of investments. This is taxed at a much lower rate, which at the U.S. Federal level is 15 percent or roughly 42 percent of the top personal income tax rate.

Taxing capital gains at a lower rate is a fairly common practice in economies globally, including countries with large welfare states like Canada and Sweden. On the following page I have included a survey of capital gains rates versus the top marginal personal tax rate. I include this data with a few qualifications and apologies. Comparing tax rates across borders is very complex as tax codes can be quite intricate. The extensive footnotes just scratch the surface on the complications of making such comparisons. These notes don’t even mention relatively common practices of avoiding taxes in some countries, such as holding investments in undeclared offshore accounts. The United States has one of the most advantageous tax rates on both capital gains and wage income for high income individuals as well as a fairly high level of compliance. It is, however, comparable in terms of the relative preferences given to capital gains versus income taxes.

¹ This is based on the Administration’s definition that households earning more than \$250,000 a year are considered wealthy.

² These results assume that the economy returns to a healthy level of growth. Many would argue that the act of debt reduction will cause growth to be slower. Others will argue that raising taxes now would also lessen near-term growth.

Capital Gains Generally Receive Favorable Tax Treatment

	Top Capital Gains Rate (1)	Top Personal Income Tax Rate (2)	Cap Gains Rate as a % of Income Tax Rate
Australia	22.5%	45%	50%
Brazil (3)	15.0%	27.50%	55%
Canada (4)	20.1%	40.20%	50%
Germany	25.0%	45%	56%
Hong Kong	0.0%	15%	0%
India (5)	0.0%	30%	0%
Ireland	25.0%	41%	61%
Israel (6)	20.0%	45%	44%
Japan	13.5%	52%	26%
Netherlands (7)	20.0%	50%	40%
Norway (8)	28.0%	48%	58%
Spain	21.0%	43%	49%
Sweden	30.0%	59%	51%
United States	15.0%	35%	43%
United Kingdom	28.0%	50%	56%

(1) Some countries offset a high capital gains tax with a low corporate tax rate. The U.S. corporate tax rate according to some authorities is one of the highest globally. I have not done the work to verify that claim.

(2) Personal Income Taxes are, in many countries, subjected to payroll taxes to cover social insurance. Some of these are quite large. Generally capital gains are not subject these taxes making the ratio of capital to income tax more favorable to capital gains.

(3) Brazil has a very high payroll tax.

(4) Personal income and capital gains are subject to fairly high Provincial Taxes. I have assumed Ontario tax rates.

(5) Stocks must be sold on a recognized exchange to receive favorable tax treatment.

(6) The cost basis of securities is indexed in Israel. In a world where 1/3 of capital gains come from inflation, this would have the effect of reducing the gains rate to 13.3%.

(7) The Dutch tax 30% of an assumed annual capital yield (dividends plus capital gains) of 4%. If stocks have a total return of 6% over time this equates to a tax rate of 20%. In effect this is closer to a annual "property tax" on stocks of 1.1%.

(8) Norway has a wealth tax of 1.1%. In a world where the total return to stocks is 6%, this equates to a further 18% in capital gains taxes.

(9) It would have been nice to have a line for France. In all honesty, I could not figure out the tax system other than the fact that very little income receives preferential tax treatment in France.

Why is taxation on capital gains less than the tax on wage income? There are two possible answers. The first answer is somewhat cynical. Capital gains taxes are very difficult to verify because they rely on accurate historical records of the cost basis of a security. The older the security, the harder it is to really know the purchase price thanks to stock splits, mergers, spin-offs and other capital events. The other problem with capital gains taxes is that, to a certain degree, they are a voluntary payment. One generally only pays when transacting in a security. Governments prefer relatively steady revenue streams that are easy to measure and collect (e.g., wage income, sales taxes and property taxes). The table below shows how the UK, a country with a fairly well developed social welfare system, sources tax revenues principally through fairly easy to measure items (sales, payrolls, incomes and property).

Projected UK Tax Receipts are Tilted Towards Easy to Measure Items

(Tax Year 2008-2009)

Taxation Type	% of Total
Income Tax	29%
Sales Tax (VAT, Fuel, Tobacco)	22%
National Insurance Tax (Payroll)	19%
Property Tax (Council, Business)	10%
Corporate Income Tax	9%
Capital Gains Tax (1)	1%
Other Taxes (over 10 other taxes)	10%
Total	100%

(1) The Capital Gains Tax was raised from 18% to 28% in 2010. Given that gains recognition is often voluntary, raising rates doesn't always raise revenues.

There is a second more fundamental reason why capital gains are lower than taxes on wage income. They end up being a form of double taxation on corporate earnings. If I own a company and it earns a profit, I will pay up to 35 percent of the income in taxes. Presumably stock prices rise with accumulated income. So when I sell my company, my gains get taxed again. This time they are taxed, in this country, at 15 percent. In essence I will pay 50 percent on the accumulated earnings.³ If I paid the top marginal wage income tax rate, 35 percent, on capital gains, I would be in essence paying the government 70 percent of accumulated income. Many large companies can figure out how to avoid paying corporate taxes by shifting operations off shore. This really isn't an option for the typical American entrepreneur who will probably get one big crack at a windfall gain in their lifetime.

Wage income is not subject to the same level of double taxation. If an owner of a public company pays him/herself a high wage, that wage is deductible for corporate income tax purposes and hence is not subject to double taxation.

³ Company stock can appreciate or depreciate for reasons other than accumulated earnings. If investors think a company will generate higher earnings growth than in the past, they may pay a higher earnings multiple for a company. In general, though, a company must have earnings growth to see stock price growth over the long-term.

Why get worked up about this rather complicated and mind numbingly dull piece of the tax code? I can think of two reasons.

Unfortunately, quotes that make good headlines often lead to very poor tax policy. The best example of this would be the Alternative Minimum Tax (AMT). This tax was devised in 1969 and 1982 following the discovery that a number of wealthy individuals were not paying much in income tax due to numerous perfectly legal tax shelters, deductions and interest on tax-exempt bonds. This discovery led to the creation of AMT, a truly monstrous piece of the tax code which is virtually impenetrable to understand. Thanks to the fact that it was not indexed to inflation, the AMT is progressively affecting more and more middle income Americans in high wage states with high property taxes and high home values.

A second concern relates to the wisdom of raising the tax rate on a rather substantial driver of economic incentives. Raising taxes on Mr. Buffet by raising the gains rate would risk taking the combined corporate tax and capital gains number to a fairly healthy level. This may not matter to Mr. Buffet who has ample financial resources for his personal and family needs. Given the size of his wealth, raising capital gains taxes might not really impact any economic or personal decision of his. Mr. Buffett is a rich and powerful person who will be rich and powerful nearly regardless of the tax rate.

However, as Milton Friedman pointed out a long-time ago, taxation is the enemy not of the rich but the people who wish to become rich. The act of creating a successful business and then selling it for a large capital windfall is part of the American Dream. I am not sure it is wise to be too cavalier about the incentives that drive the American entrepreneurial culture that so many around the world now envy.

It is worth having a long and constructive debate over the amount the wealthy should pay to help close the deficit. The wealthy are, at least partially, the beneficiaries of a stable social structure and an educated and healthy workforce. They may also have family members over time who are unable to compete successfully in a soulless Ayn Rand-shaped world with no safety nets or bumpers to smooth out some of life's potential air pockets. However, the entrepreneurs that have the potential to pilot the economy through turbulence toward clearer skies deserve an appropriate incentive system. Perhaps it is still right for capital gains taxes to increase. But a dull and thoughtful understanding of the tax code wouldn't lead you to say that these people, as a rule, are necessarily being "coddled" as a result of the capital gains tax. Rather, giving preferential tax treatment to capital gains is a consistent global practice that recognizes the complexity of taxing both corporate income and capital gains. When speaking about this issue, there is a case to be made that leadership should not "Dare to be Great" but rather to "Dare to be Dull."

Review & Outlook is intended to be an unconstrained review of issues, topics and considerations of possible interest to Glenmede's clients and is not intended to be applicable to any one particular client. Actual investment decisions for particular clients are made in light of applicable considerations and may be different from the views expressed here. Likewise, actual portfolio performance may differ from the results discussed. Clients are encouraged to discuss the applicability of any topic or view contained in any Glenmede publication, especially Review & Outlook, with their Glenmede representative.