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October 10, 2010

Dear Clients and Friends,

*“The fashion of the world is to avoid cost, and you encounter it.”*

-William Shakespeare, *Much Ado About Nothing*

You may soon receive, if you haven't already, a notice from our custodians and brokers about forthcoming tax reporting changes which begin to go into effect next year. In a nutshell, the IRS form 1099 on which your annual securities transactions are reported will now include your **cost basis** for the affected securities, as well as gain and loss information that will be sent by the custodians to the IRS.

As your advisor, we maintain cost records for all securities transactions we execute on your behalf, so for the most part we will simply be uploading our data to the custodians' systems as required, and you should not have to lift a finger in this regard. We do want to encourage those few clients with missing cost basis information, say from a long-ago inherited stock position, for example, to try to find that information and pass it along to us. We will then update our records and inform the custodians as well.

The notices also mention the custodians will use a “first in, first out” method for calculating and reporting gains and losses, unless we tell them otherwise. In most circumstances we have traditionally preferred “high cost, first out” instead, as it can be more tax efficient when dealing with multiple tax lots per security. We will instruct our custodians to utilize the “high cost, first out” method for all accounts over which we have discretion, though we still have the flexibility to utilize other methods on a case-by-case basis when needed. Please note that for non-managed accounts, you will need to notify the custodian directly. Feel free to contact your Portfolio Manager here at FBB Capital Partners if you have questions about this.

How and why did this new cost-basis requirement come about? It was tucked into the Emergency Economic Stabilization Act of 2008, more popularly known as the “bailout bill” that was enacted in response to the subprime mortgage crisis, the bursting of the housing bubble, the collapse of Lehman Brothers and the end of Wall Street as we knew it. That economic stimulus bill had a hefty price tag of around \$700 billion, most of which was intended to support the banking system and prevent its collapse. The cost-basis addition was intended to help offset part of that outlay, and is projected by the government increase revenue from capital gains taxes by about \$7 billion. Over ten years. That's correct; it *may* eventually cover 1% of the bailout's initial cost. Much ado about nothing, indeed!

Meantime, **the Federal Reserve has been dropping hints that they will soon be enacting another round of economic stimulus**, via the outright purchase of longer-dated US Treasury bonds. The Fed usually swims in the shallow end of the interest rate pool, but diving in the deep end could effectively lower rates in the ten to twenty-year range, making longer-term debt financing more attractive for everyone from homeowners to industrial businesses. The bond market has already responded, with long bond prices rising and rates dropping precipitously in anticipation of these purchases.

What will be the cost of this additional stimulus? Aside from the initial cash outlay, the long-term cost will likely be summed up in a higher inflation rate. We have argued for more than a year that *deflation* was at least as likely as inflation in the US, given excess industrial capacity, declining wages, rising savings and falling home prices. Indeed, the Federal Reserve finally confessed its fear of deflation last month, in its deftly worded meeting minutes: *“Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate.”*

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Now that the Fed publicly recognizes the risk of deflation, they can take more decisive action to combat it. We'll know more about this later in the month, when Fed Chairman Ben Bernanke delivers a conference speech entitled "Monetary Policy Objectives and Tools in a Low-Inflation Environment." In the meantime, given the rising likelihood the Fed will provide further non-traditional stimulus, **we think the odds have now shifted in favor of higher inflation** over the next several years. We have been increasingly more selective in our fixed income purchases, favoring bonds with sufficient "padding" in the yield relative to other bonds of similar quality and maturity. We will also be taking other portfolio actions, including a review of our commodities exposure and other inflation-sensitive areas.

For now though, until higher inflation expectations lead to an increase in business activity (a theory largely untested in practice), we will hold to our belief the US recovery will be muted and choppy given the numerous headwinds we face - federal and state budget deficits, higher taxes, and the global push toward austerity. As Warren Buffett said earlier this week about the economy, **"We're inching forward, we're not galloping forward."**

If we're right on the slow recovery scenario, and if the Fed is going to keep rates artificially low for the time being, then it's not unreasonable to expect the return on capital to be below the historical norms for the time being. We expect income - whether in the form of dividends, bond interest, partnership income, or other forms of cash flow - to be the chief component of total return for the foreseeable future.

**The dividend rate for the S&P 500 is now greater than the yield on the five-year US Treasury.** Five years is a long time over which to make predictions, but on a relative basis, and assuming only very modest economic recovery and earnings expansion, stocks do appear relatively more attractive than bonds, even if valuations are now somewhat "full." We maintain a strong bias for companies that return cash to shareholders in the form of dividends, share repurchases, or intelligent acquisitions that can add to the bottom line. Of course, we want to maintain balance in portfolios, if only as a hedge, so we will be looking both domestically and internationally for higher yields in both stocks and bonds, with perhaps greater emphasis on the international component.

A potentially important factor in our strategy is the tax rate on dividends. Last month Congress punted on a decision to extend the Bush-era tax cuts, so unfortunately we will not have clarity on this issue until well after the midterm elections in November. We do know that the historical research on stock markets and election cycles shows that the best market period in a four-year election cycle is the one we've recently entered, from just before the midterm election through the following year. Let's hope September's upswing is an indicator of what's to come after this year's election!

Sincerely yours,

Mitch Schlesinger

