



Romano

# Investment Update

## Between a Rock and a Hard Place

**W**hen I wrote our Spring newsletter 6½ months ago around May 1<sup>st</sup>, the Dow stood at 11,200 exactly the same place it stands as of this writing (December 1, 2010). To recap, once reaching this pinnacle, concerns about the EU's fiscal condition ignited, and after tossing in a 1,000 point drop based upon an intraday technical glitch (the infamous "Flash Crash") for some extra volatility and consternation, and voila—suddenly just two months later the market was at 9,600, a nearly 15% drop.

But not to fear, Ben Bernanke and the Fed posse, though out of interest rate bullets, would come to the rescue guns ablazin' to combat low growth and the threat of deflation. With interest rates already at 0%, conventional rate decreases were no longer an option, for these were no longer ordinary times. The posse, fresh from their summit in Jackson Hole, Wyoming or the economic equivalent of Los Alamos, had their own Manhattan Project. Having already dropped "Little Boy" they were set to unveil their next WMD—"Fat Man" or "QE II" as they would refer to it. A new rally would ensue, with the market's best September on record since 1939, and suddenly we were back at Dow 11,200.

QE II stands for Quantitative Easing, a process by which the Fed



Joseph Romano

would print \$600 billion of new money which would be used to purchase Treasuries in the open market in an attempt to inject additional liquidity into the marketplace. The first such injection of this type came during the height of the panic, hence QE II. The theory is that by purchasing a large enough sum of treasuries they would increase the demand, thereby inflating their prices and lowering their yields. Hence a lowering of rates, presumed to be stimulative to the economy.

But would it work? Questions remain, as this is a highly experimental strategy. Would this be perceived by the marketplace as inflationary, thereby backfiring and causing rates to rise, not fall as anticipated? I have written about the plight of retirees and savers who have seen their income severely cut and have been the sacred cows in the Fed's low interest rate stance, which only seems to reward the borrowers (with lower debt payments) and lenders (with more profitable loan spreads) that got us into this mess in the first place. By lowering bond yields, the idea was to force capital into riskier assets. By strangling savers further, might it drive them into stocks and form the foundation of the next bubble?

**A**pparently yes, as at least in the short term the market stands back at 11,200 or up 17%. The longer term effects are less certain and the history books have yet to be written on the outcome. But the National Bureau of Economic Research put a

start to the recession in December of 2007 and just this September (2010), announced that we reached the trough in economic activity in June of 2009. They thereby declared it an 18 month recession, the longest since WWII. Now after 17 months into the "recovery", does it make you feel any better to know that we are resorting to a second round of experimental measures at this stage in the ballgame?

So with the market back at post-recession highs, we remain cautious as

We remain committed to our values and committed to protecting your hard earned wealth.

we see a distinction between a market fueled by artificial stimulus and one driven by fundamentals—solid economic footing and associated earnings growth. We continue to favor good dividend paying stocks when we can find them, viewing their cash flow as added insurance and protection. We are proceeding with caution in bonds due to interest rate and inflation risk, and as Doug Geisser will address, are concerned about the formation of a bond bubble.

So this is and has been for some time now, a market that in our estima-

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# 30 Year Bull Market in Bonds Could Be Over

**BY DOUG GEISSER  
VICE PRESIDENT**

*Douglas Geisser has more than 25 years of industry experience and has served as Vice President of the firm since 1990. Doug oversees the fixed-income department, including bond research, underwriting and trading operations.*



If you could go back in time to 1980 you would have been able to lock in double digit returns by investing in 10 year U.S. Government bonds. The same 10 year bond return has steadily declined for three decades to levels rarely seen before. (See chart) This drop in yield (thus increase in price for existing bonds) has given the fixed income investor a solid advantage over equity investments over the same period. However, with interest rates currently near historical low levels, the bond market appears to have run out of room for further price appreciation.

The government's current plan to reduce interest rates may work temporarily but ultimately it may be the

catalyst that ends the bull run. Uncle Sam has not been concerned with fiscal deficits and is now on a huge buying binge of our own government debt. The only way you can loan money to yourself is to print more of your own dollars. Check writing in the trillions is not a bondholder's friend and is in fact inflationary over time. So while this strategy has currently enabled a bond market rally by reducing rates and raising bond prices to create an illusion of high annual returns, eventually the weakening of the dollar and future inflation expectations will end the bull run.

We have always advocated that our client bond investors focus on the yield to maturity when purchasing bonds and not be as concerned with the price movement after purchase. Most bond investors have seen a sharp increase in the value of their positions as rates have dropped the last two years. Remember that increase in the value of the bond is not realized unless an investor sells the position. If the investor does sell his higher rate bond he will be forced to reinvest the proceeds (after capital gains tax) at a lower

return thus negating the advantage of the sale.

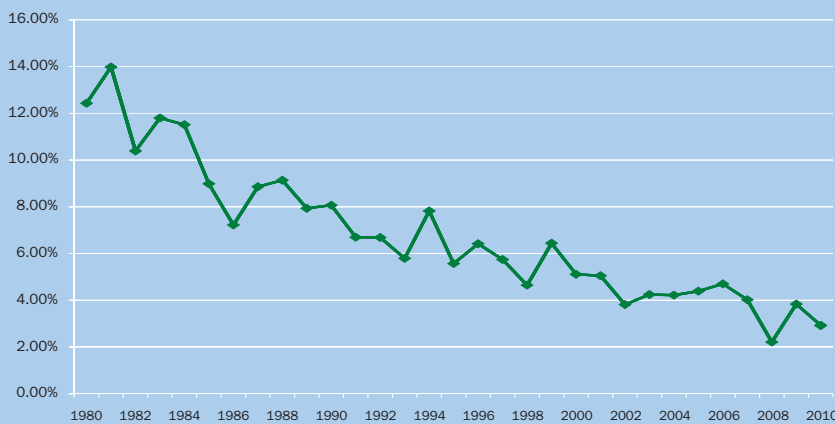
The current appreciation in the market value of bonds will begin to be a negative to portfolio performance going forward. Remember, if you bought a 5% bond at 100, you will earn 5% a year until maturity. If the

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bond is currently valued at 110, your return has been greater than 5% from purchase date (not realized unless you sell) but eventually the bond price will amortize back to 100 the closer you get to maturity. The best measure of your fixed income portfolio's return is the average yield of all of your holdings. Since it is our intent to hold a bond to maturity, you will know your return from the first day you invest.

We have recently been successful in capitalizing on some inefficiencies in the municipal bond market. We engage in extensive credit research in this sector allowing us to identify investment grade issuers even though they may no longer have a published rating due to the downgrade of a bond insurer or other circumstances. Our willingness to dig a little deeper allows us to purchase solid credits at yields that can be 1% to 2% higher than bonds of similar quality with published credit ratings. This strategy has benefitted our clients in this low rate environment. ■

**Historical 10-Year Treasury Yields, 1980-2010**



## Between a Rock and a Hard Place

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tion provides few compelling investment alternatives and an environment rife with risk. But with my 15 years in this business and the nearly 50 year battle tested investment philosophy of the firm in my DNA, we have all learned to first protect capital and only secondarily to seek return. We have seen that when it comes to forcing an investment decision and compromising one's investment values by putting a square peg in a round hole, that decision generally comes back to

bite you at some point down the line. Sometimes patience rules the day and less is indeed more. Lack of activity shouldn't be confused with lack of vigilance. We remain committed to our values and committed to protecting your hard earned wealth.

Another year has passed and we once again thank you for your continued trust and confidence in us, as evidenced by our growing asset and client base, a result no doubt of your referrals and efforts to spread our

message. We hope 2011 is a year of growth for you and your families—personal, economic, and otherwise—and we look forward to growing together.

*Happy Holidays 2010.*



*Joe Romano  
President*

# Potential Year End Tax Strategies for an Uncertain Tax Environment

**BY JOE ROMANO  
PRESIDENT**

**W**ith the looming expiration of the Bush era tax cuts on January 1, we have fielded two essential questions from our clients: What will the new tax landscape look like? What moves should we be making within investment portfolios in anticipation?

Many investors' fears were eased with a Republican victory in November as they interpreted this as an automatic extension of the Bush tax cuts. The fact of the matter however, is that even as of this writing (Dec. 1) this is far from a certain reality before year end.

The current top tax rate on long-term capital gains and dividends is 15% and if the Republicans have their way both will stay there. However, if the Bush tax cuts expire, the top rate

on dividends would increase to 39.6%. At this moment, it appears the Obama administration favors a top tax rate of 20% on both capital gains and dividends (Source: WSJ, 11/27/10).

In reality, there is probably little investors can do to protect themselves against a rise in the dividend tax rate. Nonetheless, when that rate is finalized we will compare the after tax yields of dividend paying stocks against the after tax yields of other asset classes (primarily tax exempt and taxable bonds) to make sure we are efficiently positioned.

In regards to capital gains, regardless of where rates go we will "tax loss harvest" as we do each year to minimize taxes. When efficient to do so, we position our non-retirement accounts to realize \$3,000 of net loss, the maximum amount that can be used to offset ordinary income. For an inves-

tor in the highest tax bracket, this can result in an out of pocket tax savings in excess of \$1,000.

One additional strategy can be to accelerate realized gains into this year while the gains rate is low. Many investors do not realize that the wash sale rules apply only to losses, not gains. Therefore, a position can be sold and immediately bought back in effect stepping up the basis and sheltering existing gains from future higher tax rates. A word of caution: it is generally better to defer taxes but any benefit is highly dependent on the difference between the future tax rate and today's rate.

The moral of the story: stay tuned and be rest assured that we will be closely monitoring political developments and are prepared to discuss and employ the appropriate strategies when agreement is reached. ■



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## *Happy Holidays!*

*The 2010 Evanston Symphony Orchestra Christmas Concert*  
made possible by a generous donation from Romano Brothers & Co. was great fun for all.



*Left to right: Santa, Chris Knorr, Dave Davenport, Deb Cross, Joe Romano, Larry Eckerling, ESO Music Director; Dick Romano, Rick Hemwall, Doug Geisser, Cheryl Haack, ESO President; and members of the Evanston Dance Ensemble.*