The Commonsense

Investletter

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Wall Street:

- DJ 13372
- S&P 500 1481
- NASDAQ 2661

Who Pays the Taxes?

The rich pay the vast majority of federal income taxes in this country and they pay an even larger percentage of taxes than they did 20 years ago. So who actually pays the taxes in this country? In the media you will see accounts like my statement above implying that the rich are unfairly shouldering a growing portion of the tax burden.

Percentiles ranked by AGI	Percentage of 1986 Federal Personal Income Taxes Paid	Percentage of 2005 Federal Personal Income Taxes Paid	Change in Percentage of Taxes Paid
Top 1%	25.8%	39.4%	52.7%
Top 5%	42.6%	59.7%	40.1%
Top 10%	54.7%	70.3%	28.5%
Top 25%	77.2%	86.0%	11.4%
Top 50%	93.5%	96.9%	3.6%

As Benjamin Disraeli said: There are lies, damn lies and statistics. My opening statement falls in the latter category. Making the statement that the top 1% of taxpayers pay 40% of the taxes and that this has risen from the 26% they paid in 1986 is aimed at creating sympathy for the poor overtaxed rich. How unfair it is for them. That is until you look into the numbers. In 1986 the top 1% of taxpayers represented 11% of adjusted gross income for the year. By 2005 the top 1% had captured 21% of the income pie. At the same time, the bottom 50% saw their share of the yearly income pie shrink from 17% in 1986 to 13% in 2005. Is it any surprise that the pool of taxpayers that is capturing a growing share of all taxable income is actually paying more in taxes? While the taxes the rich pay as a percentage of all federal income taxes paid has risen 53%, (over the 20 years from 1986 to 2005) the income they represent has risen 91%.

Percentiles ranked by AGI	1986 % of Total AGI	2005 % of Total AGI
Top 1%	11.3%	21.2%
Top 5%	24.1%	35.7%
Top 10%	35.1%	46.4%
Top 25%	59.0%	67.5%
Top 50%	83.3%	87.2%

The question that is not being asked is how have the rich managed to see such a tremendous rise in income without a representative increase in taxes paid. If the amount of income that the top 1% of taxpayers control has risen 91% why haven't their taxes paid risen 91%?

Percentiles ranked by AGI	1986 AGI Threshold	2005 AGI Threshold	Increase in Income
Top 1%	$118,818	$364,657	206.9%
Top 5%	$62,377	$145,283	132.9%
Top 10%	$48,656	$103,912	113.6%
Top 25%	$32,242	$62,068	92.5%
Top 50%	$17,302	$30,881	78.5%

If I further explain that at the same time the rich have seen this favorable turn of events, the bottom 50% of taxpayers have seen the amount of taxes paid drop from 6.5% to 4% of the federal income tax bill. A 33% drop in the percentage of taxes paid. Sound like a fortunate turn of events until the fact that their

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share of the income pie has dropped by 24%. If this all starts to get confusing you are not alone, it is this characteristic that allows so many to pick and choose the sliver of information they want you to see and tailor it to buttress their particular agenda.

Maybe the tax rates paid by different income strata shown in the graph below will help clear this issue up to some extent. The top 1% paid taxes at a 33% rate in 1986. By 2005 this group paid taxes at a 23% rate, a 30% drop in the taxes paid. This helps confirm the fact that the rich have made out extremely well as a result of the tax cuts over the past twenty years. The top 50% as a whole saw the rate they pay taxes at decrease from 16% to 14% amounting to a 15% decrease in taxes. The rich benefitted by seeing their taxes cut twice as steeply as the rest of taxpayers in general (Here we consider the top 50% of taxpayers the "taxpayers in general" we referred to, because this accounts for 97% of all taxpayers).

Percentiles ranked by AGI	1986 Average Tax Rate	2005 Average Tax Rate	Decrease in percentage of Income paid in taxes
Top 1%	33.1%	23.1%	30.3%
Top 5%	25.7%	20.8%	19.0%
Top 10%	22.6%	18.8%	16.8%
Top 25%	18.7%	15.9%	15.0%
Top 50%	16.3%	13.8%	15.3%

Now back to my opening statement, the media is correct, the rich are shouldering more of the tax burden. What you often fail to hear is that this is because they have captured and even greater share of the income pie. It is only by the grace of Congress that their tax burden has been allowed lag their rise in income.

When you see a statistic like the top 1% of taxpayers paying 40% of all personal income tax it really jumps out at you. If you take the statement at face value it yields no insight into the reason behind why this is the case. To answer my own question: who pays most of the taxes, you can see it is not a question that is easily answered. So, how have the rich managed to see such a tremendous rise in income without a representative increase in taxes paid? To a large extent it is a matter of the tax policy over the past twenty years being tilted heavily in favor of the very rich. I could go on ad infinitum about tax policy but that is not the thrust of this article. Let it suffice to say that tax policy is social policy. Congress puts incentives in place to encourage certain behaviors and discourage others.

Combine this with a huge increase in executive pay, outsourcing and the lack of regular minimum wage increases and you have part of the explanation. The decrease in the tax rates on dividends and capital gains has helped the rich pay much less in taxes. Taxpayers in the top one percent report dividend income and capital gains on their returns at a much higher rate than taxpayers as a whole. As you might guess, they also report much larger amounts of dividends and capital gains. Over the next few years what changes could help even out this growing disparity (the changes in the tax burden and the stagnation of wages for lower income workers) between the haves and the have lesses? There are rarely easy fixes to complex problems. A modest increase in capital gains rates combined with more frequent minimum wage increase may allow this condition to rebalance over time. Increasing the tax on dividends and capital gains is increasing at tax that affects the rich to a larger extent that those in lower tax stratospheres. A large increase would lower investment which will have a drag on the economy. More frequent increases in the minimum wage will not affect any taxpayer who might make it into the top 50%. It will however, provide a push to wages from the bottom up. It may take a few increase to make an impact. Provided at a measured pace, modest increase to the minimum wage can provide a powerful economic stimulus by increasing disposable income in a group that tends to dispose of all of their income, often out of necessity.

The over arching goal of US economic policy should be to raise all boats. The rich have certainly had their turn over the past twenty years, now it is time for the bottom 75% to move to a new high water mark.

Reference:

Internal Revenue Service: Statistics of Income Bulletin Fall 2007, Washington, D.C. 2007

Watch List

Recently we have added several companies that have appeared on the watch list to the Investletter Model Portfolio. Sometimes it takes a while, but there are some companies that we have an interest in that take years to get to a price we feel comfortable paying like St. Joe. Another recent addition is CSP, Inc. (CSPI). CSPI is a company we previously owned in the Investletter Model Portfolio and have recently added again. We originally owned CSPI in June of 2005 when the company had a market cap of $33 million. At the time the company had $15 million in cash and our hope was that the management would do something useful with the cash. Before we sold in January 2006 (a mere six months later) we spoke to the CFO of the company to encourage the company to pay a dividend or aggressively repurchase shares. He explained they wanted the cash available to make an acquisition. Here is the text of our email:

"Not all of our investments work out as we would like them. CSP Inc. highlights this too well for our liking. We have had several conversations with their CFO and are aware that they have no interest in paying a dividend from the large cash hoard they have. They seek to find an acquisition that they can invest the money in. We have no interest in waiting. Management should be doing more for their owners. The company should be put up for sale instead of looking to buy another small company. In our opinion, this is a classic case of management covering their own tail. The shareholders deserve better".

We sold our shares at a small loss. Two years later the company still has a large cash hoard and is trading even cheaper. Now the company is selling for $25 million with net cash and short term investments totaling $18 million. Strip out the cash and the business is selling for $7 million. Management is just as ineffective as ever. The company did generate $79 million in sales in 2007. They have just completed a large contract so sales may drop off in 2008. This is the perfect time for the company to buy back a large amount of shares while the price is depressed. When their business prospects do turn up, the reduced share count would greatly increase shareholder value. The future prospects are firmly titled in our favor even in light of the poor management performance.

Company	November price	October price	Change from October	P/E	52 Week High	52 Week Low	Estimated '07 EPS	Dividend Yield
Alico/ALCO	$44.39	$47.44	-6.43%	n/a	$65.00	$41.99	n/a	2.40%
Alliant Techsystems Inc./ATK	$116.83	$110.39	5.83%	18.5	$120.90	$76.60	$6.33	n/a
Altria Group, Inc./MO	$77.56	$72.93	6.35%	17.8	$90.50	$63.13	$4.37	3.69%
Arch Coal/ACI	$37.86	$41.00	-7.66%	33.5	$42.59	$27.18	$1.13	0.70%
Bioanalytical Systems, Inc./BASI	$8.64	$8.80	-1.82%	n/a	$8.99	$4.98	n/a	n/a
Canadian Natural Res./CNQ	$65.47	$83.20	-21.31%	15.9	$87.17	$44.56	$4.13	0.50%
Culp/CFI	$8.32	$8.80	-5.45%	15.1	$12.30	$4.37	$0.55	n/a
Graham Corp./GHM	$70.00	$66.04	6.00%	33.7	$70.90	$12.67	$2.08	0.20%
Kensey Nash/KNSY	$26.96	$27.36	-1.46%	30.0	$33.00	$22.26	$0.90	n/a
Landauer, Inc./LDR	$50.21	$49.27	1.91%	22.5	$54.46	$45.50	$2.23	3.70%
Markel/MKL	$482.15	$543.22	-11.24%	13.7	$554.95	$446.50	$35.24	0.40%
ModPac/MPAC	$8.20	$8.71	-5.86%	n/a	$12.50	$7.16	n/a	n/a
QLT Inc./QLTI	$4.94	$4.78	3.35%	35.3	$9.92	$3.51	$0.14	n/a
Servotronics Inc./SVT	$12.40	$13.70	-9.49%	18.1	$17.00	$7.60	n/a	n/a
Specialized Health Products/SHPI	$0.85	$0.82	3.66%	30.4	$0.99	$0.61	n/a	n/a
Tejon Ranch Co./TRC	$38.65	$40.08	-3.57%	n/a	$57.09	$35.80	n/a	n/a
Torm/TRMD	$38.40	$42.19	-8.98%	3.3	$47.10	$30.52	$2.30	13.40%
Universal Forest Products/UFPI	$28.61	$35.81	-20.11%	16.0	$54.61	$28.14	$1.79	0.40%

The Investletter Portfolio

Our recent addition of St. Joe (JOE) to our portfolio adds a company that we became familiar with in 2003. The company was much more complex back in 2003 with a home construction business, resort operations and commercial real estate rentals among other businesses. With the real estate downturn St. Joe has been going through some tough times. They recently announced they have finished divesting their commercial real estate properties, their home construction business and have scaled back their development efforts. What they are focusing on going forward is partnering up with developers to aid in the development of their land and to increases its value.

They have also announced the pending start of construction of the new Panama City, Florida airport, replacing the community's undersized current airport. The company has donated 4,000 acres for the new airport site and will provide for 33,000 acres of green space for the development rights to 15,000 acres in one of the largest planned communities in the country. In the past week the sale of the old airport site was completed for $56 million for 700 acres. This works out to $80,000 per acres. If the land surrounding the new airport is equally valuable this will generate $1.2 billion in revenue. St Joe owns another 650,000 acres. Much of the land is timber land or wetlands that may never be developed. The land that is useful for development in worth a fortune.

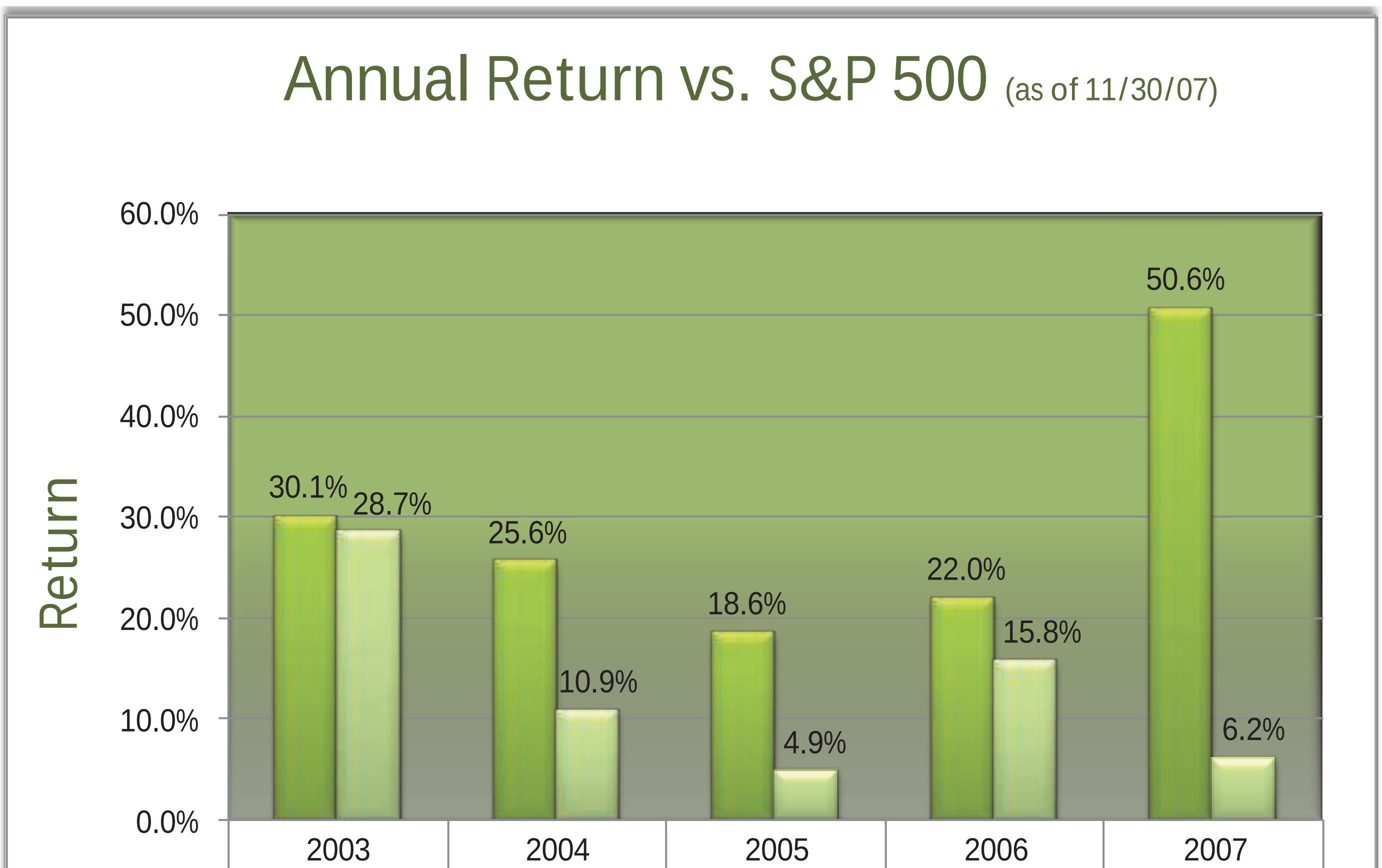
Currently the company is valued at $2.5 billion. As recently as May the company was trading at $60 per share. Has real estate softened in Florida? The answer is a resounding yes. At the same time the Panama city area has had very little impact compared to other areas in Florida like Orlando. Through the first three quarters of this year Panama City has seen a 8% drop in single family real estate deals. Price have held strong with only a 4% drop. Compare this to the 39% and 6% drop in sales and prices in the Orlando area. Overall, Florida is expected to see its population grow 20% over the next twenty years. Florida had fewer than 10 million citizens as recently as 1980. The state currently has over 18 million living there. It is easy to see how the need for more housing will spur additional construction when you consider that Florida averages 1,000 people moving there each day. Over the past 100 years the majority of the growth has been in Southern Florida, averaging 90% per decade. This compares to only 24% growth in Northern Florida. Recently the central and northern regions have seen an acceleration in population growth as the growth in southern Florida has slowed. With St. Joe owning such large landholdings, they are uniquely situated to benefit from the demographic changes that will affect Florida over the next 20 years,

Company	Porfolio Percentage	November price	October Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	6.30%	$5.15	$5.20	-0.96%	$4.95	n/a	n/a
Amtech Systems/ASYS	3.60%	$13.99	$17.44	-19.78%	$11.15	33.6	n/a
Astronics Corporation/ATRO	19.80%	$52.69	$44.50	18.40%	$35.00	31.1	n/a
Atrion/ATRI	6.10%	$118.77	$124.24	-4.40%	$93.00	18.7	0.80%
Berkshire Hathaway B/BRK.B	8.00%	$4,690.00	$4,414.00	6.25%	$3,800.00	15.5	n/a
Cash	5.10%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	6.50%	$37.85	$39.48	-4.13%	$33.00	10.3	0.80%
Gencor/GNCI	5.90%	$9.30	$9.35	-0.53%	$9.70	5.6	n/a
Griffin Land & Nurseries/GRIF	5.00%	$36.65	$37.00	-0.95%	$36.00	30.5	n/a
Headwaters/HW	0.80%	$12.00	$14.35	-16.38%	$14.00	6.0	n/a
St. Joe/JOE	4.80%	$28.45	$34.34	-17.15%	$30.00	34.9	n/a
K-Tron International/KTII	10.50%	$114.00	$106.01	7.54%	$90.00	16.2	n/a
Protein Design Labs/PDLI	0.60%	$17.71	$21.20	-16.46%	$21.00	n/a	n/a
QEP Corporation/QEPC	10.70%	$10.45	$10.67	-2.06%	$12.00	14.4	n/a
Rayonier/RYN	6.30%	$46.38	$48.29	-3.96%	$41.00	20.7	4.70%

Year to Date

November, and more of the same results. We experienced another small gain in the value of our portfolio. The Investletter Portfolio is now up 50.6% so far this year as we have cracked the 50% mark for the first time. For the first almost four years we have published the newsletter our portfolio has risen over 173%. With one month left it is highly likely that no matter what our results in December, we will have our best performance ever. It is nice to have so many of you along with us for this rewarding journey.

Our goal when we began this project was to help average middle class taxpayers experience the same top notch investment advice that is available to those with seven figure and larger portfolios have. I personally come from a blue collar family and strongly identify with a blue collar work ethic valuing hard work, honesty and goodwill towards others. I don’t expect anyone to value my advice standing on its own. It is important to eat your own “home cookin’ ”. Investing in the Investletter Portfolio insures that my results will approximately match yours. A strong dose of do as I do and not do as I say as so often is found on Wall Street. I have the greatest interest an advisor can have in seeing his clients do well; my own money invested exactly as I prescribe others do. In a year when our investments have done so well it is easy to write this newsletter. Inevitably our results will underperform the market over a years time. When this happens is anyone's guess. We remain confident that over time our methods will allow us to outperform the market.

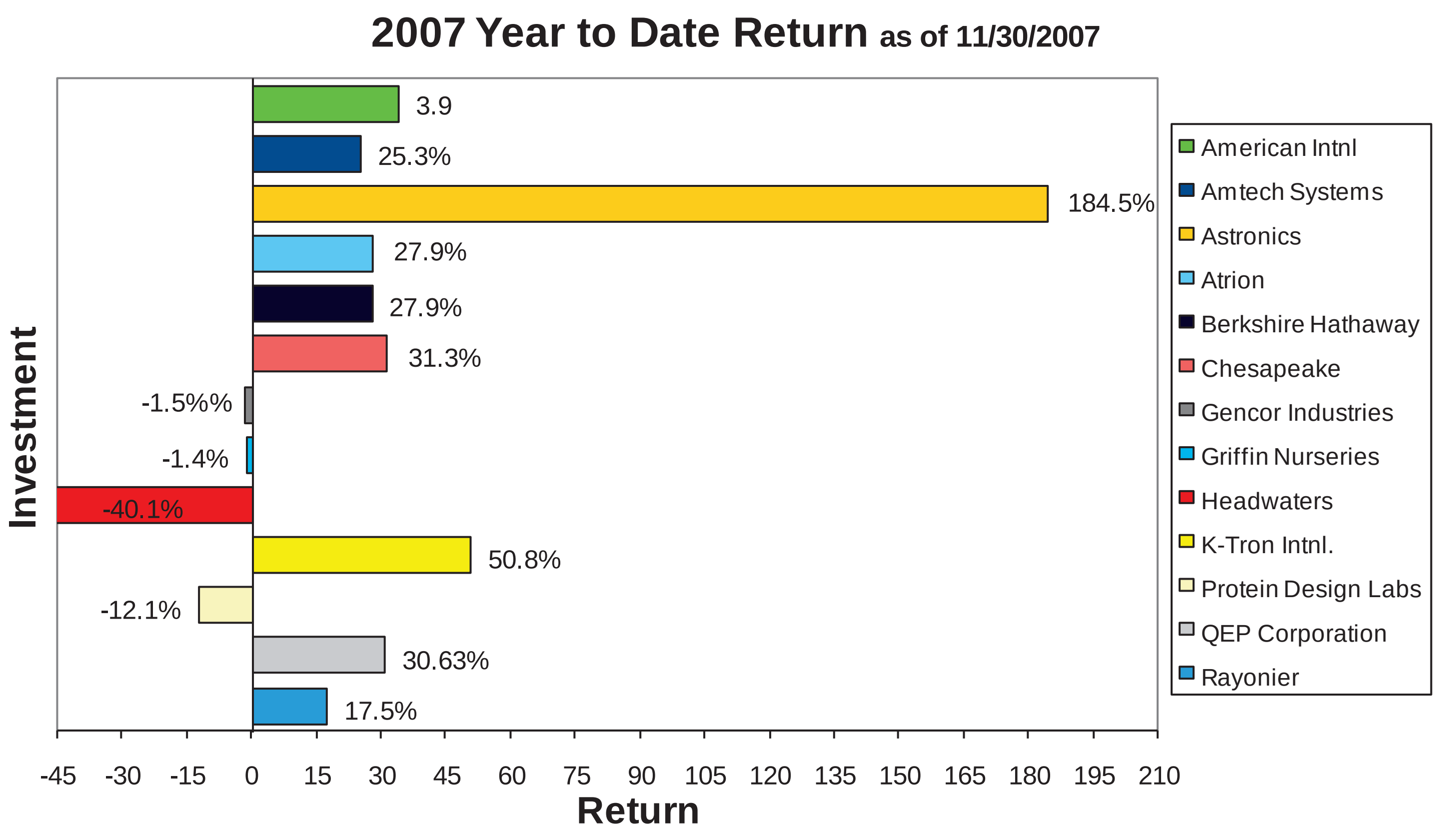


	2003	2004	2005	2006	2007
Investletter	30.1%	25.6%	18.6%	22.0%	50.6%
S&P 500	28.7%	10.9%	4.9%	15.8%	6.2%

Performance

Our performance this past month has become a bit more alarming. K-Tron, Berkshire and Astronics were the only three companies in our portfolio showing an increase in price over the past month. It is easy to see the profound effect that Astronics has had on our portfolio. It has turned a good year into a great year. While it would be nice to have an investment like this every year, the reality is that it is hard to predict when a company will have explosive growth and an even more rosy performance in the capital markets. At the current price Astronics is probably a bit above the true value of the company. In the same way the popular investment community can deal out overly harsh treatment to a company that reports less than stellar results, it can be overly generous in rewarding companies that perform exceedingly well. Astronics has risen from $5.25 to its current price of $52.69 at the end of November. This is a rise of more than 1000%.

If we have one stock in our portfolio that is ready to provide Astronics like returns next year it is QEP Company. Whether or not it happens remains to be seen.



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