The Commonsense

INVESTLETTER

Volume 7 Number 2

Wall Street:

- DJ 8001
- S&P 500 826
- NASDAQ 1476

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The Rich Strike it Rich

Recently fat cats have gotten fatter which is not all too different than the experience leading up to the great depression.

Last year we wrote an article discussing who pays the taxes in the U.S. This article intends to shed some light on how changes in income, taxes and government spending affected the economy at varying points in history. Tax rates varied widely over the 20th century as did government spending. Drawing out cause and effect relationships is very difficult in complex systems, especially social systems like markets. So our intent is not to make any bold statements about cause and effect in this article, we will leave that to those more brazen, who have willing appetites to risk appearing foolish. We can point out some interesting facts, propose possible relationships and highlight some uncanny similarities in the time frame leading up the depression and the period we are currently experiencing. In no way are we trying to imply we are headed for a depression and in no way are we stating that another depression is impossible. It is you and I and those around us who hold the keys to the financial future of the U.S., by how we react to the media and the spread of ideas. People, society and markets are all tough things to figure out, too tough for anyone.

Examining history gives us clues to how others have reacted when put in the same situations and what events may have been influenced by those actions. Our article on taxes highlighted how the rich are paying less as a percentage of income in taxes and are capturing more of the income in recent years. The rapid decline in the economy sparked our interest in exploring whether any similar conditions presented themselves at the time of the depression, and, with little surprise we did find strong similarities. So many factors influence the economy that the impact of factors we did not consider may have played a more significant role in triggering the depression than the ones we will look at in this article. With that said, it seems, likely that the ideas we will elaborate on probably played some role in triggering the depression. How much, can be debated.

We know that in the recent past the very rich have grabbed a greater share of the wealth in the country and a greater share of income. As recently as 1983 the wealthiest 400 Americans controlled about 1.1% of the country's wealth. By 2006 that figure had showed an astronomical jump to 3.1%. Capturing a larger portion of income and a strong stock markets has certainly help this rapid increase. It has been a good time to be rich with cuts in the capital gains, income tax and estate taxes. Add to this, captured Boards of Directors rubber stamping runaway pay increases, lax regulatory oversight combined with a political system that encourages politicians to favor those who contribute the most and we have a system with hardly any checks and balances on fairness.

The chart below shows the richest of the rich and how their share of wealth has changes since the early 1980's.

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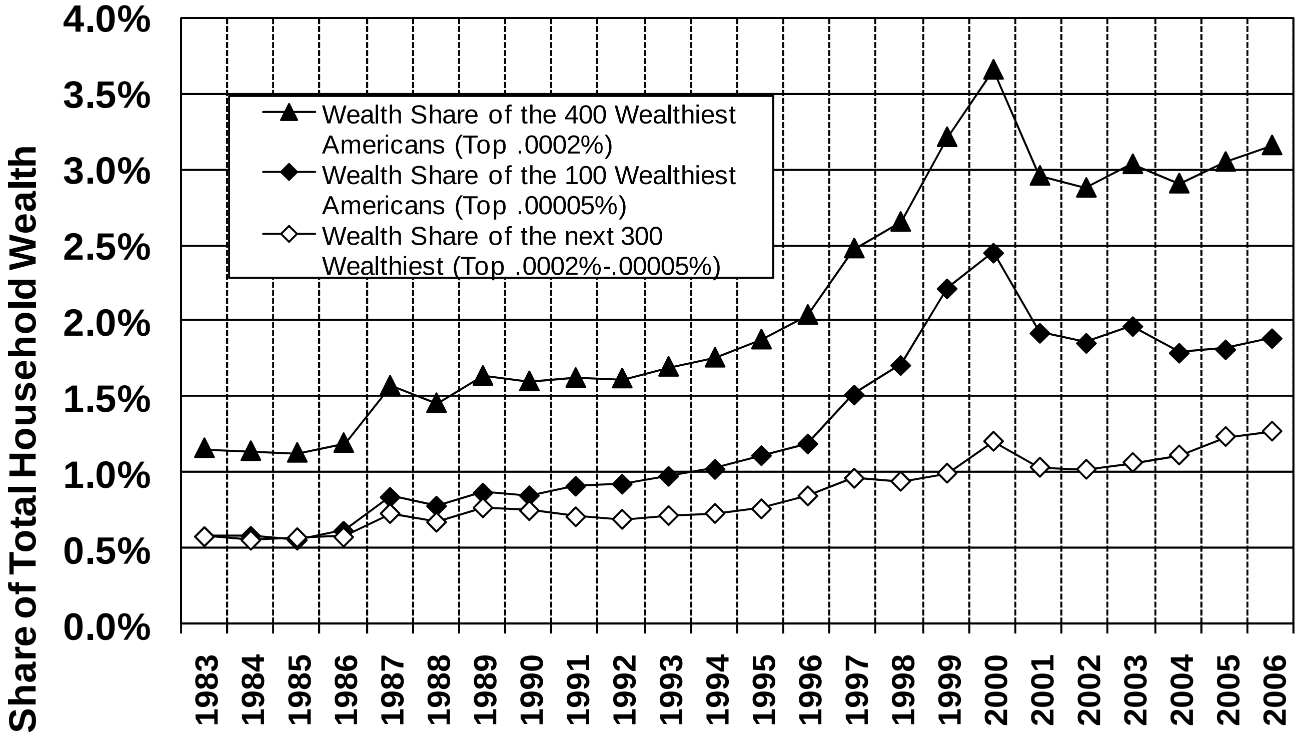
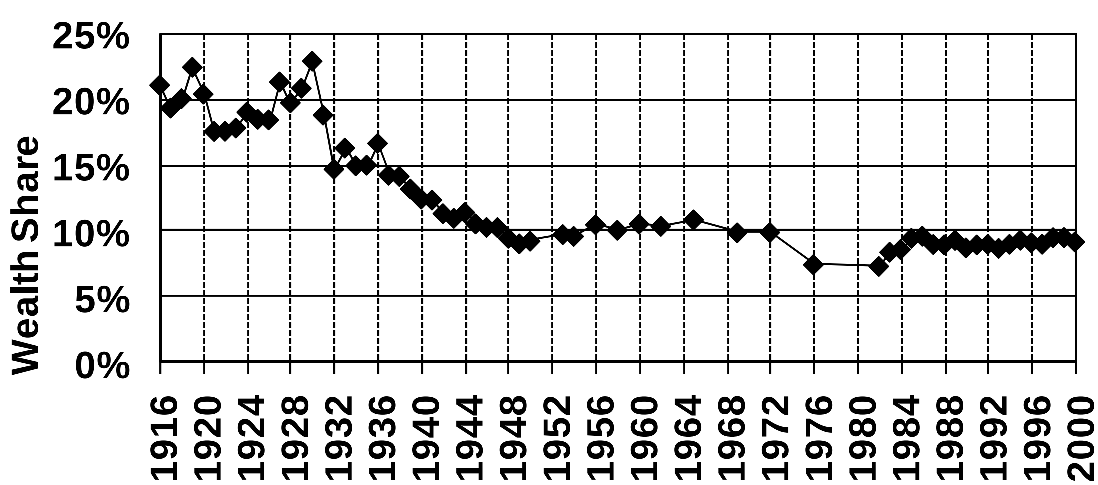


Taking a look at the long term (below) and switching to the top .1% of taxpayers, the wealthy showed a spike through the 1920's leading to the highest levels of wealth by such a small portion of citizens in the history of our country. In the 1980's the wealthy again showed a sharp increase in the percentage of the country's wealth they controlled. Not at the same absolute levels seen in the 1920's, but still sharp increases on a percentage basis.

The Top 0.1% Wealth Share in the United States, 1916-2000



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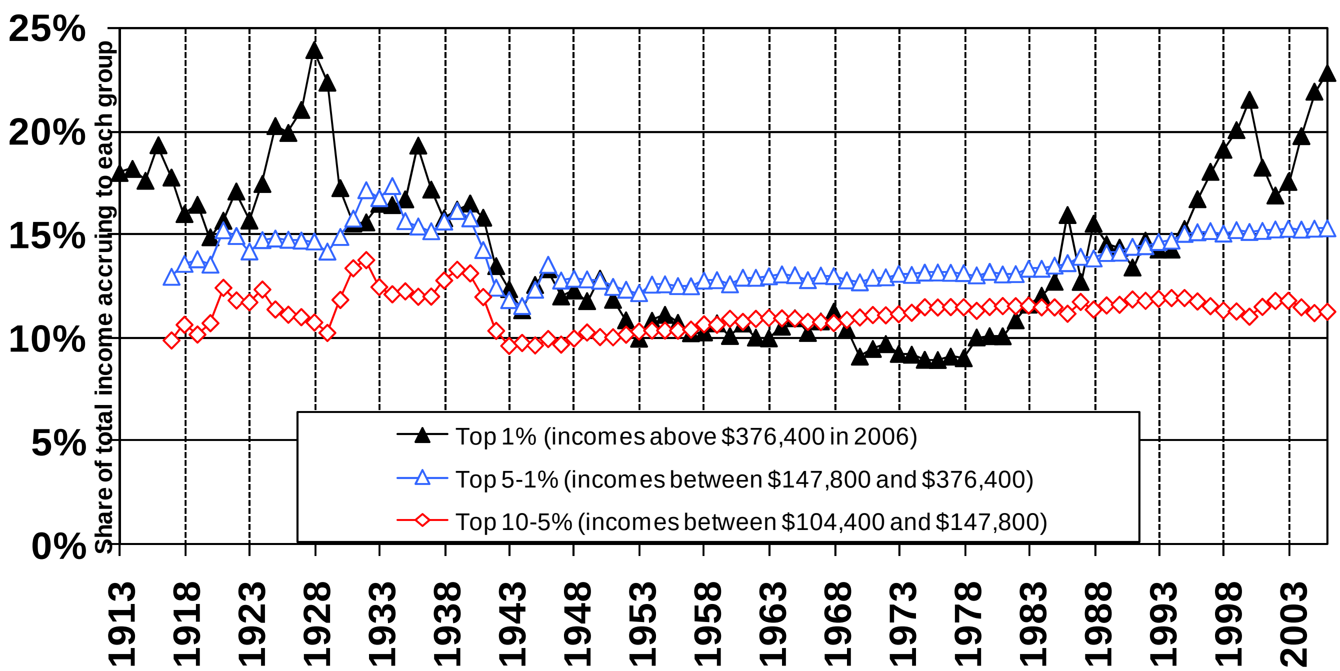
The increase in wealth was certainly aided by the wealthiest seeing sharp increases in income. The super rich have benefitted more than the top .1%, although both groups have made out much better than those in the middle and lower class. One account is highlighted below.

From the book The Great Crash by John Kenneth Galbraith. "The distribution of income is no longer quite so lopsided. Between 1929 and 1948 the share of total personal income going to the 5 percent of the population with the highest income dropped from nearly a third to less than a fifth of the total. Between 1929 and 1950 the share of all family income which was received as wages, salaries, pensions, and unemployment compensation increased from approximately 61% to approximately 71%. This is the income of everyday people. Although dividends, interest, and rent, the income characteristically of the well-to-do, increased in total amount, the share dropped from just over 22 to just over 12 % of total family personal income."

1 Sema Goldsmith, George Jaszi, Hyman Kaitz and Maurice Liebenberg, "Size Distribution of Income since the Mid-Thirties," The Review of Economics and Statistics, February 1954, pp. 16, 18.



The 1920's saw rising corporate profits while workers barely saw any increase in real wages. Even those in the top 10%, minus the top 1%, did not see the sharp increase in income. It is the highest paid, the top 1% that saw sharp increase in income in the 1920's. This culminated in 1929 when the income for the top 1% plummeted. If you follow the top 1% in the 1980's the trend began to re-emerge. The top 1% of incomes have seen their share of total income rise from around 10% to nearly 23%, a 130% increase. If the wealthy are making sharply higher wages compared to everyone else it is no surprise that they saw their wealth increase from the 1980's through today.

2 Piketty and Saez (2003) The series constructed in this excel sheet are based primarily on income tax statistics. Full details on the construction of the series are provided in appendix of Piketty and Saez (2006), available online at: http://emlab.berkeley.edu/users/saez/piketty-saezOUP04US.pdf

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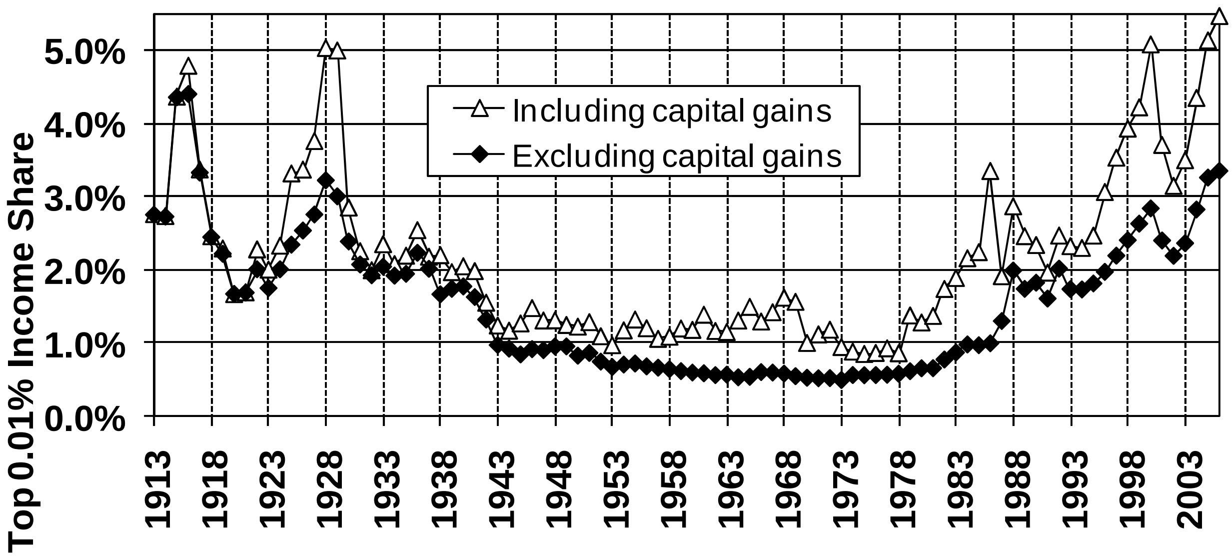
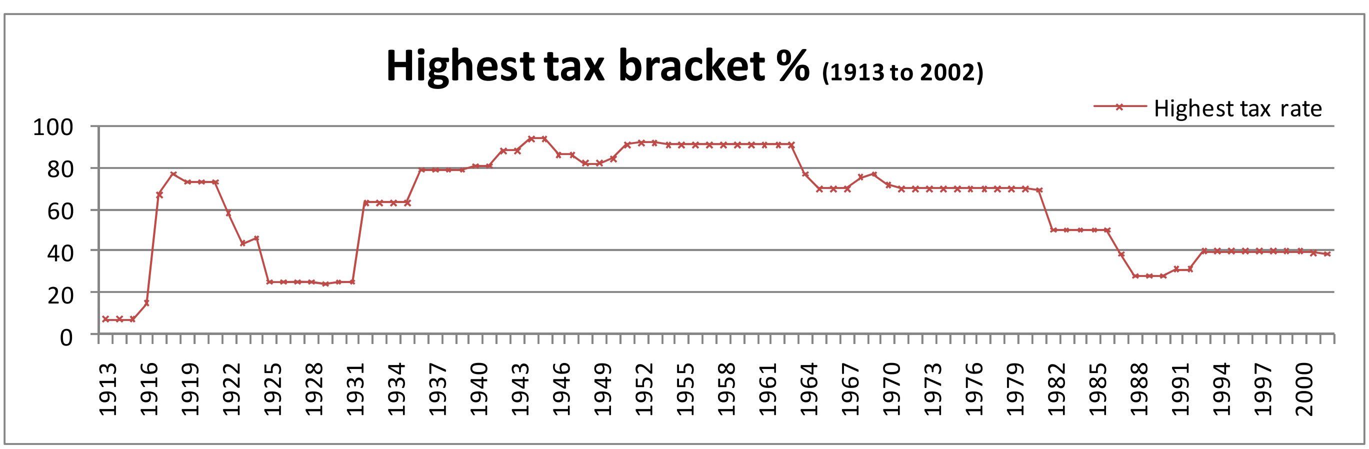
If you thought the top 1% did well with a 130% increase in income now feast your eyes on the country's highest .01% of wage earners. As a percentage of all income earned they have seen their share of total income (factoring out capital gains) increase from less than 1% to more than 3%, a more than 200% increase. Over the same time frame, those in the middle an lower classes did not make out nearly as well.



In data provide by the US Census Bureau, when household incomes are broken up into fifths, only the highest earning group has seen their incomes rise over the time frame 1980 to 1998 in real wages, the last year of the study. The bottom 80% saw their incomes decline as a share of total income and in real wages. The time period from 1998 to 2008 undoubtedly showed similar results.

It is pretty clear that the highest earners and the wealthiest have had it pretty good, both in the years leading up to the great depression and from the mid 1980's to now. Could this have led to demand destruction? It is certainly a possibility. No matter how much money you have you can only use so much toilet paper. If those who are already spending everything they have to survive and are seeing a shrinking part of the pie, it may provide some of the rationale (but definitely not all of it) for the increases in personal debt and the drop in spending over the past year.



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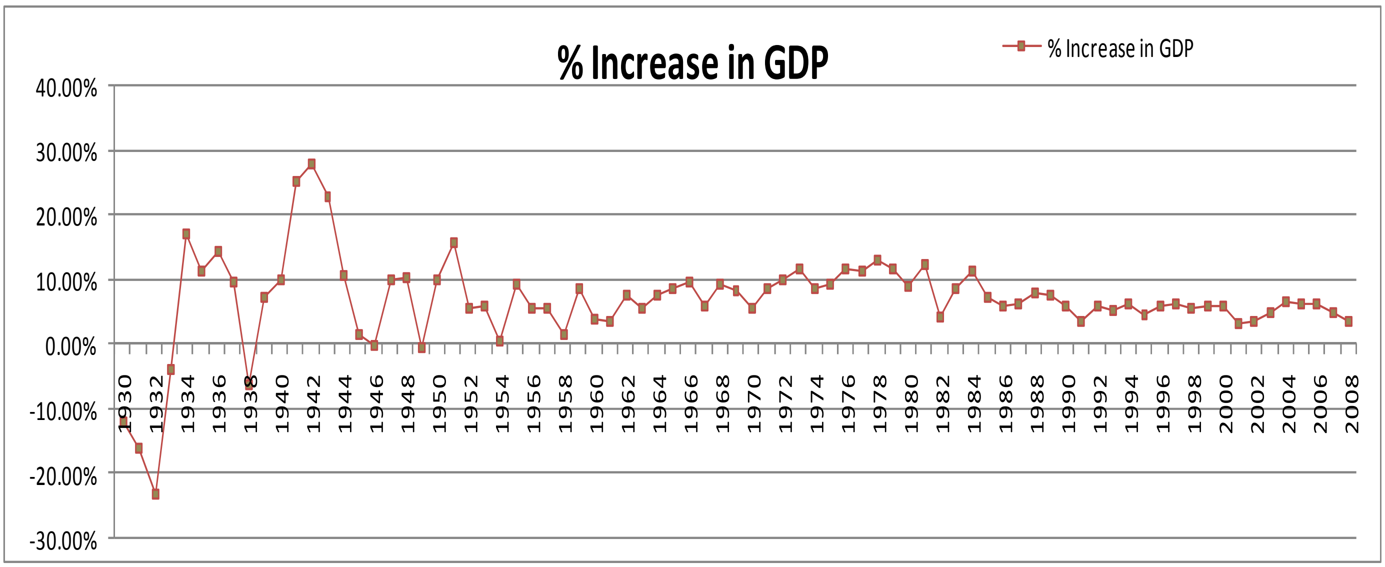
Can too much in the hands of too few lead to major financial shocks? For added clarity we looked at taxes and Gross Domestic Product (GDP) growth. One quick way to earn more money is to be taxed less on it. And, as you might expect that is exactly what happened over the same time frames we have investigated already. In the 1920's taxes on those with the highest incomes plummeted. Those in the top tax bracket saw their tax rate drop from 73% in 1921 to 24% in 1929. By 1932 the rates were raised back up to 63%. If you look at the chart above you will see a similar trend beginning in 1980 with taxes dropping from 70% down to 28% in 1988 and remaining at no higher than 39.6% since then.

If you look at the two graphs on the prior page and mentally superimpose one over the other, you can see that when taxes fall, the rich grab a larger share of all income. When taxes rise, the rich see a declining share of income. All of this makes sense but our discussion is interested in what impact this has on the economy.

Sometime there is nothing common about common knowledge. In economic circles certain factions repeat that taxing the rich is a poor idea and if we do, investment will drop and the economy will decline. Well it is certainly difficult to ferret out the basis for that idea from an analysis of the data. It appears the opposite may have some truth. Too much income and wealth in the hands of too few and problems may result. Lets see what the GDP data looks like.



GDP plunged after taxes were dropped in the 1920's. Tax rate on the rich were increased in the 1930's and GDP growth rose to record levels. Again, do not confuse chronological order for cause and effect. In the 1980's the tax rates on the rich were slashed and GDP growth has been trending down since. There are many other factors that influence GDP growth, but raising taxes on the rich doesn't seem to harm the economy. In the period from 1936 to 1981 the tax rate on those in the highest bracket did not drop below 69%. From 1962 to 1981 GDP growth rates did not drop below 5% in any year. This extended period of economic growth was a huge change from the wild swings in the 1930's and 1940's that followed the depression and then World War 2. So high taxes on the rich can occur at the same time that extended strong economic growth occurs.

Another recent topic of a great amount of debate has been government spending. We hear repeated warnings how we are going to pass on huge debts to our children and how we need to cut back spending and lower taxes. Examining the depression sheds some light on how government spending worked in the past. The results are pretty emphatic. When consumers and business stop spending it leaves only one spender of last resort, government. This is exactly who was left spending in the 1930's and 1940's. And boy did government spend. In 1940, 1941 and 1942, government spending rose 77%, 137%

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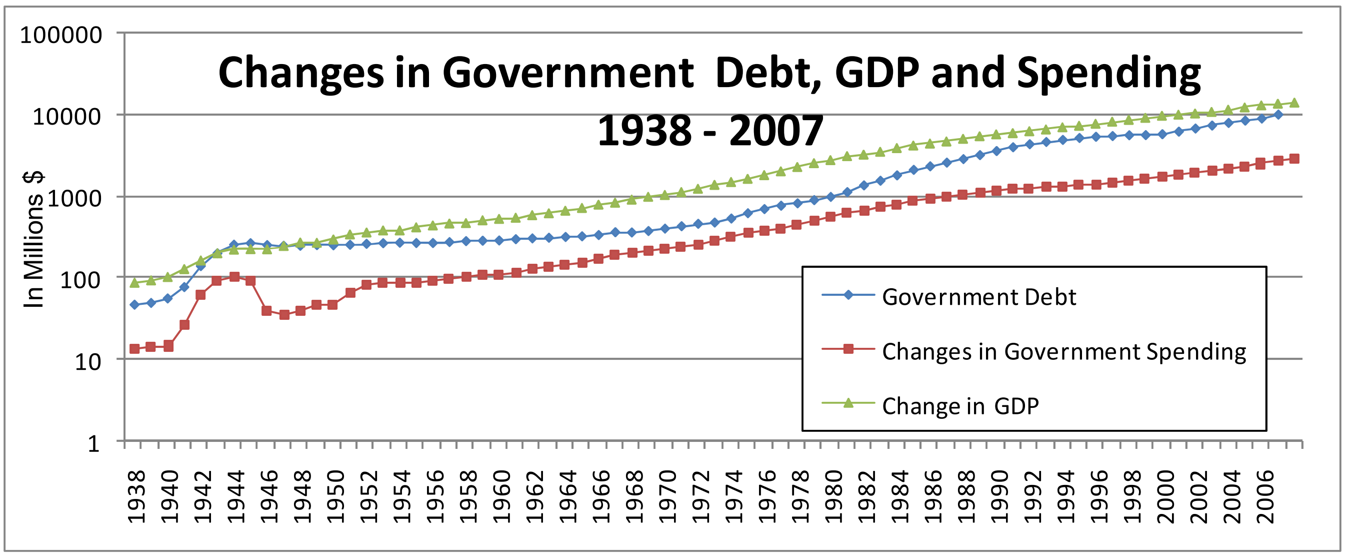
and 51%. These were the largest increases in government spending in the 20th century. The economy responded with 25%, 28%, and 23% growth in GDP, again the highest recorded in the 20th century. Huge government spending resulted in huge growth in the economy. In 1946 after the war had ended, government spending plunged 57%, but GDP growth showed only a –.4% contraction. The huge spending appears to have created momentum that not even a sharp drop in spending could slow down. The massive spending had jump started the economy and set the country up for the huge economic expansion that occurred in the following five decades. We have had only one year of negative economic growth, up until this past year, over that time frame.



The hump in the "Changes in Government Spending" line indicates this period of massive government spending. The light blue line indicates changes in government debt. For a time in the 1940's the debt actually exceeded the yearly GDP. A situation we may soon see ourselves in again. Solid growth coupled with among other things, higher taxes on the rich, helped reduce debt levels until the 1980's , roughly the time of the Reagan revolution and tax cuts for those in the highest tax brackets. Again, there are thousands of other variables that we are not mentioning that impact these relationships and this in no way establishes any kind of cause and effect relationship. It does indicate that these factors may influence changes in government debt. Having debt that is higher than yearly GDP is not necessarily cause for concern either. Our country has had higher debt levels and we experienced a 50 plus year period of solid growth following these highs. There is no guarantee that high government spending now will prompt the same response, but there is no evidence that says that increased government spending is certain doom either. Rising debt levels in and of themselves are not a major concern based on the results of the past century.

Another common knowledge axiom that is tossed around is that cutting taxes increases government revenue. If that is the case, all of the "added government revenue" since the tax cuts in the 1980's has not been used to pay down the debt. If you look at the "Government Debt" line above, debt showed a sharp increase beginning in the 1980's, growing faster than the economy, and only slowing a bit in the late 1990's, before continuing its trend upward.

It is clear that large government spending is an economic stimulus and that is clearly what we need currently. Continued large doses of government spending could certainly be problematic. A solid boost to get the economy growing again is an important role that government plays when no other participant is in position to spend the money. The alternative is to

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watch the economy continue to contract and that serves no one.

Waiting for enough studies to be done to ferret out reliable cause and effect relationships would take an eternity or longer. As so often occurs in other facets of life, decisions must be made using imperfect information. Fixing a broken economy is no different. What has happened in the past can be used as a guide, but there is no guarantee that what worked in the past will work the same the next time around.

So far, what has been offered is a whole bunch of graphs and some general interpretations of what we see. All of this is leading to a diagnosis of the problem. This is one man's view of what ails us and what to do about it.

The period leading to the great depression and to the current debacle were both characterized by sharp drops in taxes on the wealthy at which time they captured both an increasing share of income and wealth. Earlier we stated that you only need so many rolls of toilet paper no matter how much money you have. A shift of buying power away from those in the lower income brackets results in increasing debt levels in general. At the point that further increased debt levels becomes hard to justify, demand destruction starts to occur. Along with this, the inflated asset prices created in part by the increased debt begin to deflate, further crimping demand. Stated simply, those who need the money the most no longer have enough to afford the roof over their head or to put food on the table, the toilet paper in our example above.

An economy needs limits. The lure of becoming rich is an important motivator. At the same time an economy is not a tool solely to serve the rich. It needs to function well for all participants. If the past is an indicator of a possible future course, to me it indicates that raising taxes on the wealthiest in our society will function best for all participants, including the rich. The rich stand to perform worse in severe downturns. Billionaires losing 50% of their wealth will pay a heavy price. Avoiding severe economic contractions will benefit the rich more than the poor.

The massive government spending we are currently seeing is a necessary evil. It would be nice if we could get away without it, but my opinion is that the alternative would be much worse. Huge government spending like before World War 2 was a huge boost to the economy. I don't think we need spending on that scale, but when consumers and business are not spending government provides an important function by stepping into that role.

Tighter regulation appear to be necessary just as it was after the great depression. Too many crooks have fleeced working Americans of their savings and retirement funds. You have heard many of our rants in past articles and communications.

Much of our solution is very similar to what was done coming out of the depression. I have reached this conclusion in a different fashion than I have seen discussed in many of the texts covering the emergence from the depression. Nonetheless I seem to have arrived at the same conclusion that the powers to be arrived at back then. It neither makes me right, or wrong because of it.

I am providing the spreadsheets containing the data I used to put this article together, along with other articles I found useful. At heart I am a fiscal conservative. You would have a hard time telling it from much of this article.

It is relatively easy to fit a story to the data after the fact. That doesn't mean the story accurately explains why things happened the way they did. My interpretation is just that, an interpretation. Sometimes you need to act on imperfect information and the above explains what my actions would be. There is no guarantee that following the course of action I see fit would be the most effective or even have any positive effect at all. You can certainly reach a different conclusion. What we have been doing seems to have led us down the wrong path. Maybe any change in our future course of action will have little impact on what is to come. But...maybe we can change things for the better. Count me among those who think it is worth a shot. You know what I would do.

The Investletter Portfolio / Transactions / Watch List

Company	February price	January price	Change from January	P/E	52 Week High	52 Week Low	Estimated '09 EPS	Dividend Yield
Alico/ALCO	$25.98	$28.00	-7.21%	83.3	$50.32	$22.34	n/a	4.20%
American Pacific/APFC	$5.00	$7.83	-36.14%	5.8	$18.89	$4.91	$0.89	n/a
Arbitron/ARB	$12.94	$15.02	-13.85%	9.5	$51.50	$9.90	$1.49	3.10%
Arch Coal/ACI	$13.90	$15.19	-8.49%	5.7	$77.40	$10.43	$2.13	2.60%
Atrion/ATRI	$75.16	$81.80	-8.12%	9.6	$118.00	$63.00	n/a	1.60%
Consolidate Tomoka/CTO	$22.60	$29.05	-22.20%	26.8	$60.00	$22.06	n/a	1.80%
Culp/CFI	$2.05	$1.88	9.04%	n/a	$8.30	$1.30	$0.20	n/a
Graham Corp./GHM	$8.20	$9.96	-17.67%	4.6	$54.91	$6.85	$1.63	1.00%
Landauer, Inc./LDR	$50.01	$68.58	-27.08%	19.6	$74.51	$46.82	$2.67	4.20%
Mesa Labs/MLAB	$18.01	$20.10	-10.40%	12.2	$24.65	$15.54	n/a	2.20%
Rayonier/RYN	$26.60	$29.44	-9.65%	13.9	$49.54	$26.14	$1.33	7.50%
Servotronics Inc./SVT	$5.20	$5.85	-11.11%	3.7	$22.48	$4.53	n/a	2.60%
Span America Medial Sys/SPAN	$8.25	$10.75	-23.26%	5.0	$13.52	$7.93	n/a	4.40%
Torm/TRMD	$8.95	$10.78	-16.98%	2.5	$37.97	$8.95	n/a	n/a
Twin Disc/TWIN	$4.85	$6.57	-26.18%	2.6	$23.34	$4.02	$1.15	5.80%

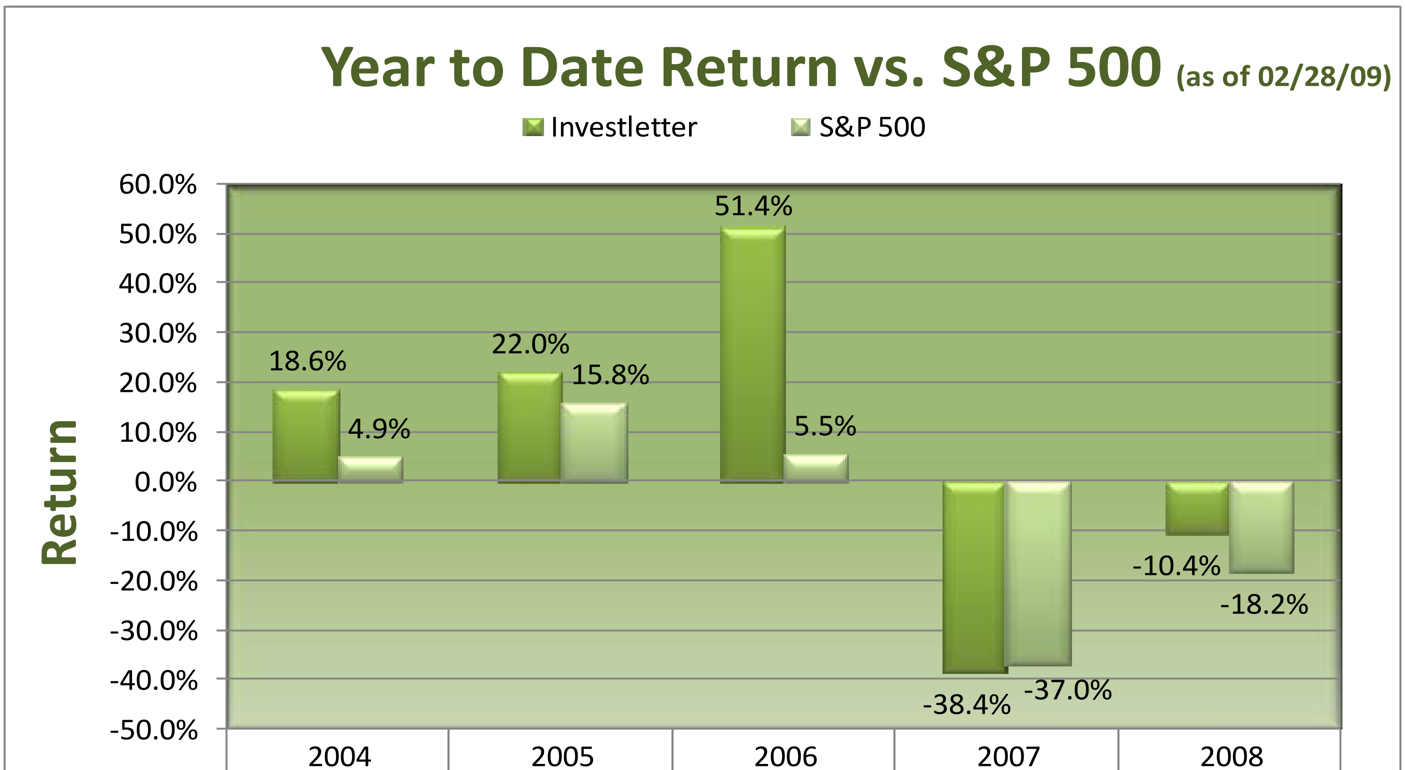
Date	Security	Symbol	Price	Order Type	Qualifiers	% Portfolio or Position	Outcome
01/09/2009	Constellation Energy	CEG	$26.50-$26.65	sell	limit	50%	filled
1/2/2009	EDCI Holdings, Inc.	EDCI	$3.65-$4.50	buy	limit	5%	filled
12/30/2008	Rohm & Haas	ROH	$59.75	sell	limit	6%	filled
12/30/2008	CSP, Inc.	CSPI	$2.65	buy	limit	2.5%	filled
12/18/2008	QLT, Inc.	QLTI	$2.32	sell	limit	3%	filled
12/15/2008	QLT, Inc.	QLTI	$2.09	buy	limit	3%	filled
12/03/2008	Constellation Energy	CEG	$28.00	sell	limit	50%	filled
11/16/2008	Rohm & Haas	ROH	$73.00	buy	limit	6%	filled

Company	Portfolio Percentage	February price	January Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
American International/AMIN	4.80%	$1.13	$1.89	-40.21%	n/a	n/a	n/a
Astronics Corporation/ATRO	14.90%	$8.16	$8.90	-8.31%	$8.25	8.7	n/a
Berkshire Hathaway B/BRK.B	7.00%	$2,564.00	$3,214.00	-20.22%	$2,700.00	15.6	n/a
Cash	31.40%	$1.00	$1.00	n/a	n/a	n/a	n/a
Chesapeake/CHK	4.30%	$15.64	$16.17	-3.28%	$20.00	13.7	1.90%
CSP Inc./CSPI	13.90%	$2.80	$2.91	-3.78%	$4.00	45.9	n/a
EDCI Holdings, Inc./EDCI	8.60%	$4.35	$3.60	20.83%	$4.00	n/a	n/a
Gencor/GENC	5.30%	$6.39	$6.99	-8.58%	n/a	34.0	n/a
K-Tron International/KTII	7.60%	$55.48	$79.90	-30.56%	$80.00	6.1	n/a
QEP Corporation/QEPC	2.20%	$0.90	$2.81	-67.97%	n/a	n/a	n/a

Performance

We created further distance between our performance and the performance of the S&P 500 market average. Unfortunately, it still resulted in increased losses for the year to date. For the time period we have published the newsletter we are still up 52% as compared to the 27% loss in the S&P 500. The same bargains we have seen in the market over the past six months remain bargains. There is limited value in researching new investments when so many companies are selling at fire sale prices. Preserving capital and analyzing the companies we currently own to determine their prospects in a weak economy and any ensuing recovery.

Limited signs are beginning to appear that the economy may be beginning to stabilize or at least not deteriorate as fast. While it is easily possible to see a second year of negative returns, another large drop in prices would be against the odds. As evident from last year, events that seemingly have small odds do happen. Slipping into another great depression had been written off as nearly impossible. Recent events have poked some holes into that line of thought.



	2004	2005	2006	2007	2008
Investletter	18.6%	22.0%	51.4%	-38.4%	-10.4%
S&P 500	4.9%	15.8%	5.5%	-37.0%	-18.2%

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