Scarsdale Investment Group, Ltd.

All Bond Portfolios

Vol 2, number 3, 2010

Summary:

"Now more than ever, Wall Street seems to resemble an immense game of chance in which tables are often tilted and house always wins."[1]
Jason Zweig

Fred Schwed's classic book: ***Where are the Customer's Yachts? or A Good Hard Look at Wall Street, NY: 1940.***

Questions Questions Questions

Overview:

What to Do When You Don't Know: When the game of chance is stacked against you, how do you decide to act in the financial game?

Short Takes:

Taxing Matter: How will the Medicare surtax affect your municipal bond income?

Ratings: A new player in the rating field for munis: NAIC.

Supply of Long-Term Tax-Exempt Munis: Why can't we get more yield now if inflation is anticipated?

Interesting Read: Unquenchable: America's Water Crisis and What to Do About It by Robert Glennon: A wake-up call on the demands of water and how it might affect us.

What to Do When You Don't Know, or When You Don't Know that You Don't Know

When Wall Street blows up, it is easy to see just how tilted the game is in favor of the house. The games always vary but the underlying assumption remains the same. If the house can keep the individual actively engaged in making new transactions, the house can win just by deducting all manner of fees and occasionally scoring big. This process is encapsulated in the humorous and entertaining classic book written 60 years ago by Fred Schwed: Where are the Customer's Yachts? This question was asked in passing by a visitor to New York who wondered why the investors had no yachts, even though the brokers did. Hadn't the investors followed the broker's advice?

Hope springs eternal as the individual investor believes in promises of high returns that will eventually materialize. The tech stocks in the New Economy peaked in March of 2000 and then began a long and steep decline. Believing that the downturn was temporary, investors piled in again only to be pummeled again. "In 2009 the

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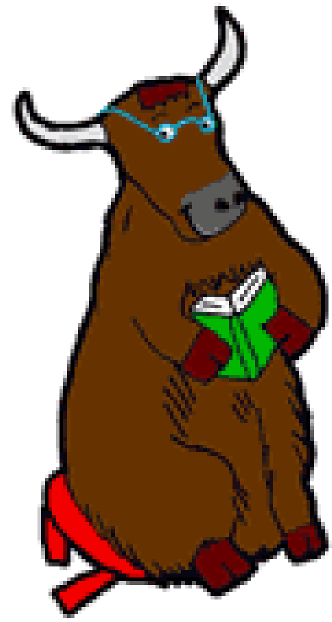
Dow Jones industrial average plunged to a level that, in inflation-adjusted terms, was last seen when LBJ was president in the 1960s.”[2]



Wall Street tells us that if we invest in complexity, we will be rewarded. Now we are not so sure we like complexity because it gives us a headache. Brenda Zimmerman, a professor at Schulich School of business in Ontario observes that the “… complicated financial instruments that helped bludgeon the economy… should have been subject to elemental tests: Is this good for consumers? What are the risks involved?” For most investors, these assets are more than complex; they are unfathomable. You might think you know, but you don’t know what you don’t know.

Long before the current Great Recession descended upon the world, we thought long and deeply about asset selection that would meet the needs of individual investors at all times and in all markets. Although bonds are complicated, many are knowable. The field is narrow, but very deep. If you stick with what you can know then you will protect yourself from the worst problems.

It will come as no surprise to readers of our newsletters and our latest bond book entitled Bonds: The Unbeaten Path to Secure Investment Growth, Bloomberg Press, 2007, that we believe that investing in what we call “plain vanilla bonds” is the best solution for individual investors. These bonds enable you to escape from exposure to complex risky assets, and from indigestion due to stock market volatility and stock market losses. Portfolio growth from plain vanilla bonds is not sacrificed due to the wonders of compound interest, if you reinvest the interest income. Our concept of investing in plain vanilla bonds allows individuals to invest in bonds without having to understand all of the complexities of the financial world. Instead of wondering “if you will have” you will know “when you will have” the planned-for funds.

In early 2007, well before the stock market and exotic financial instruments blew up, we observed that in the complex world of new financial products, you face the co-

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nundrum: “What do you do if you know that you don’t know even if the new securities promise higher returns? We observed that with new financial products multiplying faster than rabbits, it’s easy to conclude that you don’t know enough.”[3] Wall Street has in the past promised great riches and will again in the future - if you will only buy their latest complex product. We concluded that you should just walk away from complex securities and be guided by the concept of plain vanilla bonds. We believe that our advice regarding investing in plain vanilla bonds will continue to help investors successfully meet their financial goals.

SHORT TAKES

<u>Taxing Matters</u>: The good news is that the interest from tax-exempt bonds will remain tax-exempt from the new 3.8% Medicare surtax. The surtax is on unearned income of single filers with modified adjusted gross income (MAGI) over $200,000 and joint filers above $250,000.

<u>Ratings</u>: The life insurance rating company, National Association of Insurance (NAIC) was hired by the state of Maine to judge its May bond issue.[4] It is a not for profit rating agency that rates insurance companies, and it now rates municipal bonds on the same basis as corporate bonds. Maine received its highest rating, NAIC-1, which is the equivalent municipal bond rating of A-minus. NAIC-2 is the equivalent of a triple-B rating and anything lower than that is no longer considered investment grade. The ratings indicate likelihood to default. The state of Maine was rated Aa2 by Moody’s and AA with a negative outlook by S&P for its May, 2010 issuance.

<u>Supply of Longer-Term Tax-Exempt Bonds:</u> Are you wondering why the yields on longer-term tax-exempt municipal bonds are so low? One reason is that the Build America Bonds are siphoning off tax-exempt supply for new money issues at the longer end of the scale. The Bond Buyer reports: “The 30-year triple-A municipal bond yields about 4%, according to Municipal Market Data, which is only

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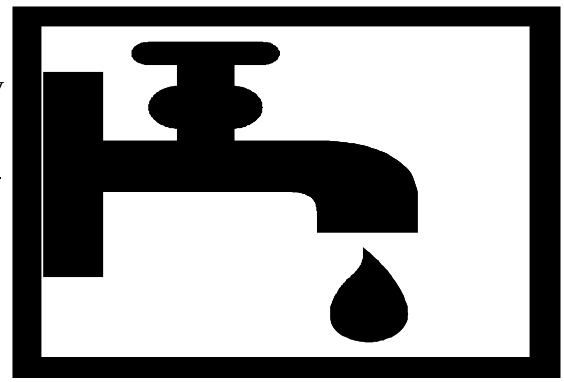
Bonds backed by water and sewer revenue are deemed one of the safest municipal bond sectors. Water is an essential service. However, there are no political accolades for replacing old pipes and other infrastructure needs.

20 basis points higher than its all-time low."[5] Traditionally 80% of new issuance of municipal debt was tax-exempt; now it is about two thirds. The BAB subsidy should drop in 2011, so there may be a rush to issue as many BABs as possible before year end. Whether that will spell an increase in tax-exempt issuance next year is an open question.

Interesting Read: Unquenchable: America's Water Crisis and what to do About It, by Robert Glennon is a very entertaining read by a water conservationist. For those of us who purchase water bonds as an essential service, it is interesting to get a grasp on the politics and business surrounding water. You are guaranteed to look at the water in your faucet in a totally different way.



[1]Jason Zweig, "Intelligent Investor," The Wall Street Journal. Saturday/Sunday, May 1-2, 2010, B7.

[2]Robin Farzad, "The Small Investor Sits This One Out," Bloomberg Business Week, May 3-May 9, 2010, Pp. 41-42.

[3]Hildy Richelson and Stan Richelson. Bonds: the Unbeaten Path to Secure Investment Growth, Bloomberg Press, 2007. Pp. 33-34.

[4]Lynn Hume, "A Good 2nd Opinion," The Bond Buyer, May 19, 2010.

[5]Dan Seymour. "Taxables Boost May Figures," The Bond Buyer, June 1, 2010

Important Disclosure Information

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