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Commentary
Spring 2004

Market Performance

2004 started off strongly, but by the end of March, the Dow Jones Industrial Average was down almost 1%. The more broadly based Standard & Poor's 500 Index gained 1.29%. The Rikoon-Carret U.S. stock portfolios increased 1.36% and our international stocks, primarily large European companies, gained 3.52% versus the Dow Jones Euro Stock increase of .97%.

The reasons for the disappointing stock market results for the first three months are complex. Manufacturing is weaker than expected at this point in an economic recovery and business orders for new equipment are modest. When you add in the effect of oil prices reaching their highest levels in a decade, the prospects for continued strong economic growth based on cheap material costs has diminished.

We have been talking about the U.S. dollar and gold for several months. At the end of March, gold hit its highest price in 15 years at $427.00 per ounce. The U.S. dollar sank to its lowest point against the Japanese yen in 4 years as Japan's nascent recovery seems well established.

The most important indicator of the long term health of the financial markets is job creation. The first section below focuses on this important issue, but for readers who don't have time to read the more technical discussion offered, suffice it to say that job creation is the most important issue facing the U.S. economy.

There was good news in early April, as 308,000 jobs were created in March. On closer examination, many of these jobs are in lower paying service industries. Another important factor for the markets is the magnitude and direction of interest rate changes. Rising interest rates may stall the market rally for a while, but as falling rates over the last 4 years did not help the market, rising rates will not ultimately choke off demand for equities if business activity holds up well.

No discussion of the economy and markets would be complete without touching on the impact of world events. The terrorist bombings in Spain before national elections resulted in renewed interest in the U.S. and Britain to stepping up domestic efforts against terrorism, especially as our own electoral season comes closer. The easy money policies of the Federal Reserve Bank and tax cuts of the Administration over the last three years have kick started the economy into growing 4.6% annually. This is slightly above the 4% a year rate required to keep the national debt from eating up the U.S. economy. The possibility of a civil or religious war in Iraq adds another factor to the market's prospect for stability.

The bond markets had a slightly positive quarter, with Rikoon-Carret's taxable bond portfolios increasing 1.55% and our tax free bond portfolios gaining 1.01%. We have taken an extremely defensive posture to protect against potential interest rate increases. Our typical income portfolio is comprised of bonds with an average maturity of 5 years.

We are devoting a great deal of research effort to find alternative income producing investments to augment traditional bond portfolios. We have also embarked on an overhaul of our growth strategies by considering investment vehicles that can increase during periods of a sideways or downward moving stock market. We will present the general outlines of the results of our research in future commentaries and during upcoming client gatherings.

Budgeting Gives Peace of Mind

Taking personal responsibility for our financial life is probably the most important sign that we have become adults. Our physical, mental, artistic and spiritual skills are of interest to others in passing moments, and they may be a better source of a deeper and more long lasting happiness than money. But without a firm financial footing or an awareness of the amount of fiscal security we have or have not achieved, however relative, our lives are incomplete.
This summer, at the ripe age of 18, my daughter will no longer have a curfew or be told to eat her peas and carrots. She can go away for as many days as she likes and not even inform us who she is with. Her body may be pierced, tattooed, and her hair can be emblazoned in as many hues as she cares or dares to carry around with her. In exchange for this freedom, her financial life is going to be reduced to one document: a checkbook.

(I hope) the time will have passed when she will be able to run to Mom, well out of Dad's earshot, and plead for this or that. When her friends go hither and yonder, if she has not enough money left out of her monthly allotment, she will have to stay home. It is a frightening prospect to turn off the parental money spigot, but it is a necessary step to giving a young adult a sense of how hard it is to make one's way in the world. I believe that my daughter needs the opportunity to make ends meet her own way.

There are some adults who have never achieved a basic level of self awareness about how much money they spend. As a result, they constantly have anxiety about their financial well being. The real underlying perplexity is not knowing how much money is enough.

Measuring one's spending is a simple task. Write down everything you spend and then add it up. Three rules: Don't cheat, don't forget, and don't wait. To have a taste of how good it feels to know where you stand in your financial life, keep a notebook and write down every single dime you spend for a short time, say one month. It is hard but you will be well rewarded with a piece of mind!

Our daughter's budget is modest by some standards, generous by others. That she has one at all is a blessing that stretches back generations, as my father's father provided him with one so he could go to law school at night. My daughter might choose to go to a formal school or not; we really don't care. The world is a complicated place and young people will likely change careers several times during their lives, either through choice or necessity, so challenging herself and learning how to take care of herself in more or less demanding situations is all we ask.

We know that spending money on travel, gifts, entertainment and personal care could easily consume most of her allowance. There is no way she will live as well as she has in the past. For all of us, thinking about what we have available to spend and whether it is worth the tradeoff of not having enough money left over for later unknowns before we buy is almost as hard as thinking before we speak. This is for good reason, as our culture is dominated by encouragement to spend first and pay later, if at all.

A common result of spending without thinking about one's budget is an out-of-control financial life and therefore a personal life that is insecure. What we want most for our daughter is for her to be in control of her own life. We do not want her to have to make choices out of fear of financial failure or avoidance of her money reality.

There is no better teacher than encountering reality, but many of us try to shield our progeny or ourselves from the hard fact that we often spend more than we earn. I am always reminded of the matching cartoons I used to see in my dad's office. One showed a happy-go-lucky character dancing a jig surrounded by good things; the other was a morose, slumped-over, disheveled ragamuffin. Above the beaming face of the first was the caption "Paid Cash." Over the other poor soul were the words, "Bought on Credit." It's your choice whether to subject yourself or your family to the rigors of living within a budget. I highly recommend it.

Income Opportunities

One challenge facing people trying to live off their portfolios is how to replace higher bonds that are maturing with currently available investments. If there is one thing that we can surmise from current circumstances, it is that long term rates will rise. We anticipate difficulties in the financial markets when short term traders seize the opportunity to make money off our nation's lack of financial discipline as evidenced by growth in the amount of money sloshing around the financial system, high levels of consumer borrowing, the national budget and our international trade deficits. The weak U.S. dollar and increasing credit card forfeitures all point to a bond market heading downwards. Because of the precarious nature of the present economic recovery and the seriousness of these problems, rates may stay down longer than most of us expect, perhaps even into 2005.

We have been researching investments that have some exposure to rising interest rates but which may also benefit from a concurrent rise in inflation, namely, Master Limited Partnerships. Unlike the much ballyhooed limited partnerships of the 1980s, the MLPs referred to here are publicly traded securities. This means they can be bought and sold easily, and they are priced daily. MLPs differ from the older type of limited partnerships in another important way: they are not tax avoidance strategies, though many MLPs do have tax advantages.

MLP's can hold different kinds of real assets. Generally, they own some kind of established network of pipeline or other type of distribution channel that is used to deliver natural resources to businesses and consumers. It could be natural gas, propane, even wood! Companies that have developed these natural resource systems package them so that the public can participate in the ownership of groups of properties. The companies want to get their money out of these assets in order to pursue higher growth investments. They also get tax benefits by spinning off portions of their companies.

MLPs are traded so they have fluctuating values. Given the high level of investor interest in MLPs over the last 18 months, their stock prices have already appreciated. The current income stream from most MLPs is attractive. The cash comes from contracts that MLP organizers have with suppliers of raw materials and with the end users of these natural resources. These relationships are generally long term, and since the demand for energy and raw materials is fairly constant, the income distributions from MLPs are attractive to income investors.

As with any type of investment, it is important to be aware of the factors which might have a negative impact. Here is a list of what could happen to a MLP that might require it to change its payout or adversely effect its stock price:

- Reductions in demand for use of its delivery system
- Damage to physical facilities
- Interest rate increase
- Consumer demand fall off
- Tax regulations changes
- Depletion of natural resources
- Bad weather

Other factors to remember when considering MLPs are that their lower volume of trading can make it less efficient to get in and out. The tax reporting is slightly more complicated since most MLPs issue K-1's as their tax reporting format instead of the more common IRS Form 1099. Investment in MLPs inside an IRA or non-profit organization portfolio could possibly raise some tax issues, as there can be Unrelated Business Income (UBI) earned within the portfolio which may require extra work.

MLPs have their own set of positive and negatives attributes so they are a means for diversifying portfolios. Now that many of America's largest industrial corporations earn a majority of their profits through financing, it can feel good to own a piece of the rock, or at least something attached to the rock!

Good Quality Jobs Are Key To A Sustainable Recovery

A recent government report said that 300,000 jobs were created during the month of March. This caused the stock market to rise but not by all that much. Investors are not sure whether the economy is creating jobs that will be viable for the long-term or whether they may just be filler jobs. The answer to this question will determine the prospects for both stocks and bonds.

As a nation, we are going through massive changes in the types of jobs available. Global trade and the ever increasing presence of technology allow fewer people to produce more. Consequently, many traditional types of good paying jobs, such as factory line and middle management service positions, are likely to diminish over time.

Most observers of the American employment scene agree that jobs that can be broken down into a set of regimented steps or rules are likely to disappear. If someone in another country who speaks English as a second language can perform a job that is now done in the USA, or if a job can be reduced to simple tasks that a device can perform, workers will lose out. What lies ahead is likely to be jobs that are either direct service, relationship-oriented or ones that require complex analysis.

Unfortunately, many service jobs are fairly low paying. Competition for these jobs is intense. Of the 308,000 jobs added in March, 2004, about 75% were in service industries: government, financial institutions and retailing jobs. Retailers, traditionally a source of the lowest paying jobs around, are the greatest area of growth. Technology companies eliminated jobs last month while overall unemployment levels rose. Some people re-entering the labor force have had to change fields and see their earnings power decline. The upshot is that many new jobs do not enhance long-term financial security. Due to competition for service jobs, wages will likely stay low and health and retirement benefits will become increasingly hard to get. For people with focused technical knowledge, jobs will come along with increasing stress.

If job security is a thing of the past, what is the best way to prepare for the job market of the 21st century? There is a tremendous debate regarding the capacity of the American public educational system to prepare its citizens for the knowledge based economy and shifting job market of the future. No one doubts the need for young people to become adept at adjusting to changing workplace demands.

The best prospects for young people who want to do highly skilled or creative work is to approach their education with an open mind. This makes studying liberal arts a better alternative, in my opinion, to seeking specialized technical expertise early on. As future employment numbers come in, watch for monthly job creation of 200,000 jobs or more. This is the level the economy needs to continue growing. The tax cuts put into place by President Bush have created an atmosphere of consumer confidence. However, the real test will come when interest rates rise and we find out whether or not the recently created jobs in 2003 and 2004 are here to stay.

What kinds of jobs are being created and how many people are adequately prepared for the new jobs? Americans have successfully faced challenges such as this in the past. Whether our educational resources are adequate to meet the needs is an open question. Excellence does not come cheap. Schools need funds and raising taxes is politically unpopular. For good quality jobs to be created, investment in the next generation is required.

Personnel News and Other Events

We are pleased to introduce our readers to two new people in the office. Dana Hees is a member of our administrative team. Her background is as a dietitian, craftsperson and art restorer. Dana has extremely strong office skills. We hope all of you will have a chance to meet or talk with Dana as she is extremely helpful and efficient.

Dan Pierpont has joined our staff as a portfolio manager-in-training. Dan recently returned to Santa Fe, where he was raised, from Boston. He worked with various venture capital firms doing financial analysis and is a graduate of Tufts University and the London School of Economics. Dan is currently studying for his Series 66 Registered Investment Advisory designation. We are especially pleased to have Dan join us because most of us are hovering around the half century mark so it's good to have some young blood on board! Dan and his wife, Hannah, have a four month old daughter named Nathalie.

Given Rob's travel schedule, we have decided to schedule our client get togethers on alternate months beginning this May. These are held at our office and include homemade delectables and lively discussions. The event begins at 3 p.m. and will be held on the second Thursday of every other month: May, July, Sept. etc. If you have your calendar handy, pencil in May 13th and July 8th as the next two gatherings.

Seminar on Long Term Care

In response to our clients' interest in learning about Long Term Care strategies, we have invited a specialist on the topic to provide a seminar at our office on Thursday, June 10th at 3 p.m. Bob Huey, Advanced Design Consultant, will be speaking about funding alternatives, which generally include Medicare, Medigap, Medicaid, personal assets and long term care insurance.

You are welcome to bring a friend and a list of your questions and concerns. Please call the office to reserve a space. We are looking forward to a full house.

Name Change

We are excited to announce that starting soon Rikoon-Carret Investment Advisors will become the Rikoon-Carret Wealth Management Group. Due to our association with a new group in New York, we expect to be offering expanded services to our clients. More information on this development will be forthcoming as it is available.