CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 3, 2012

## The Election, 'Fiscal Cliff,' Taxes…
## … more Wall Street Corruption

*The drama surrounding 'fiscal cliff' negotiations is a bit overdone. A deal of some sort will be made, either before or after January 1.*

*One likely outcome of these negotiations and of the election is higher tax rates on investment income. We are making a few sales of positions in which portfolios have unrealized gains, so as to realize those gains in this low tax year.*

*We are also shifting portfolios for equity-oriented investors, by cutting investment in US stocks and adding to European stock investments. The Euro crisis has resulted in considerable weakness in European stocks as compared to American stocks. This has created value in Europe, particularly with the far lower risk of catastrophe in Europe .*

*We will write more fully about these trades after completing them.*

**By**

**Jack Mayberry**

The election seems decisive in some respects and inconclusive in others. It is inconclusive in that the same divisions in our government will prevail next year. The president will continue for a second term; the Democrats still hold a slim, but somewhat larger majority in the Senate; the Republicans still hold a substantial, if slightly smaller majority in the House. It may be decisive in that some hard-fought fiscal issues appear to have been resolved by voters. The composition of the federal courts will not shift further to the right; the health care law--Obamacare--will be implemented; taxes on the rich will rise; taxes on investment income may rise.

The immediate post-election issue concerns the so-called 'fiscal cliff', a set of already-enacted tax increases and spending cuts that will become effective as of January 1, unless Congress and the Obama administration can agree on changes to them. The term 'cliff' is not terribly apt. The effects of the tax increases and the spending cuts, while substantial, will be felt only over a period of many months after January 1. Hence, it is misleading to suggest, as the term 'fiscal cliff' does, that our economy will tumble into the drink on the stroke of the New Year, unless the government acts in the final weeks of the year.

Nevertheless, it is probably useful to employ somewhat apocalyptic terms to describe the situation, because without a sense of imminent danger it is unlikely that our government will rouse itself to act in a constructive fashion. It is widely believed that, without changes to the present tax and spending laws, our slowly-growing economy would slide back into recession. In the days just after the election, House Speaker John Boehner and President Obama both addressed the issue. Before Thanksgiving, Congressional leaders came to the White House to meet with the president. After the meeting, the participants spoke of the constructive tone and looked toward an agreement With Congress back in session after Thanksgiving, a good deal of noise emanates from Washington, mostly rancorous, some soothing.

Because an agreement to resolve the fiscal issues seems reasonably likely and because the December 31 deadline is not all that significant, we continue to invest on the view that the American economy will grow modestly. Although the countries using the Euro continue to suffer from terribly weak economies worsened by policies of fiscal austerity, the resolve of Europe's leaders and its central bank appear likely to keep the calamity at bay. Moreover, because selling in European markets in the last two years has been extreme, many European stock markets offer unusual value. In short, the investment environment is acceptable. Recent selling in stock markets does not seem like the beginning of large decline, but a respite after the rally of the summer and early autumn.

Tax changes appear inevitable. It seems a fair bet that the income tax rate on high-income individuals and on capital gains will rise. During December, we plan to sell some positions in which we have unrealized capital gains and to replace these with similar securities so as to maintain investments in the asset classes we want. The result of this 'tax selling' will be to take some of our unrealized gains at the present low rate, against the possibility that capital gains will be taxed at a higher rate after the new year. For reasons mentioned in preceding paragraphs, we will add to positions in European stocks for Core clients that invest in equities. We will write of these explicitly after we complete the project.

*The insider trading investigations by the US Attorney for the Southern District of New York over the last three years have revealed far more corruption in the highest levels of Wall Street than had been known. The latest round involves the very large and successful hedge fund group, SAC, and appears to be targeting its principal, Steven Cohen.*

*Why do high level and very successful participants in the securities businesses feel compelled to commit crimes or to push to the edge of criminal behavior in the quest for more money? Is it not abundantly clear that, when financial markets and securities companies are well-regulated and supervised by government agencies, the public will have confidence in the fairness and integrity of the markets, to the benefit of all its participants?*

*Unfortunately, the seemingly unending line of high-level miscreants undermines this confidence. Perhaps the diligent work of the US Attorney's office will give the public reason to believe again that the government is acting to protect the public interest.*

**Corruption.** Another dispiriting tale is unfolding in the securities business. In the last few years, we have come to hear of 'expert networks', employed by hedge funds and other institutional investors, in which insiders in various industries are employed to ferret out information useful to these investors. Recently the US Attorney for the Southern District of New York, the key federal prosecutor for financial markets who has successfully prosecuted high-profile insider trading crimes in the last three years, arrested a portfolio manager for SAC Capital Advisors, a very prominent hedge fund, and brought a criminal action against him and the firm, a subsidiary of SAC, in which he worked. The complaint asserts that the SAC manager, Mathew Martoma, received information from Dr. Sidney Gilman, a neurology professor at Michigan Medical School, about clinical trials at the FDA for Alzheimer's drugs developed by Elan and Wyeth, which pharmaceutical companies had hired Gilman to oversee aspects of the trials. The US Attorney alleges that the SAC company had paid Gilman $108,000 for consultations with Martoma.

SAC funds had large long positions in Elan and Pfizer (of which Wyeth is a subsidiary). It appears that Dr. Gilman informed Mr. Martoma of adverse results in clinical trials of the drug. SAC funds sold its holdings in Elan and Pfizer and took short positions instead, thereby, according to the complaint, avoiding losses on the long positions and gaining on the shorts in the amount of $276 million. The principal of SAC, Steven Cohen, is not named in the complaint, but reference is made to 'Portfolio Manager A', apparently Mr. Cohen. Cohen and his funds have been enormously successful and he has been very highly regarded. In earlier insider trading cases investigated by the US Attorney, six former or current employees of SAC have been tied to insider trading; three have pleaded guilty. Last week the SEC announced its own investigation; it appears that Steven Cohen is the ultimate target of the SEC and the US Attorney. Mr. Cohen has not been charged and asserts his innocence.

How pervasive is insider trading at the highest levels of Wall Street? Far more so than we had imagined. The investigations and prosecutions in insider trading cases brought by Preet Bharara , the US Attorney for the Southern District, have brought convictions against another prominent hedge fund manager, Raj Rajaratnam, and Rajat Gupta, the former head of McKinsey and a board member of Goldman Sachs. Insider trading and corruption by small scale Wall Streeters is regrettable but not so disturbing as that by Steven Cohen or Rajat Gupta. Those at the top of the profession should be well aware that a robust regulatory system and integrity by key figures on Wall Street gives the public confidence in the fairness of the system and its participants. Corruption destroys that confidence and undercuts the businesses from which they earn their handsome livelihoods.

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