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Commentary

by Garrett Thornburg, CEO

For over ten years we have been publishing a study of “Real Real Returns”. Over this time interest rates have fluctuated, stocks have moved up and down, taxes on investments have gone up and down, and inflation has been higher and lower. No matter what the circumstances, inflation and taxes have both continued to take a large bite out of one’s investment returns. Also, for all of this time we have used the broad-based CPI (Consumer Price Index-Urban) as measure of inflation. We always knew it wasn’t completely accurate, but we assumed that over time it captured something approaching the real rate of inflation. For the last two years we are not so certain.

The CPI has been grossly understating the cost of housing. The CPI uses a owners’ equivalent rent value to determine housing costs. Housing costs make up 22% of the CPI so they have a major impact. If one substitutes the House Price Index provided by the Office of Federal Housing Oversight for last year instead of the owners’ equivalent rent the CPI increases from 3.41% to 5.82%. For the last five years the change in the CPI ranges from 2.52% to 3.95%. Clearly, the CPI has been understated for anyone buying a house. A good working definition of inflation would be that “inflation is when the cost of an identical object is higher the next year than the previous year”. Buying an existing house for 20%, 30%, or 40% more than the previous year is inflationary.

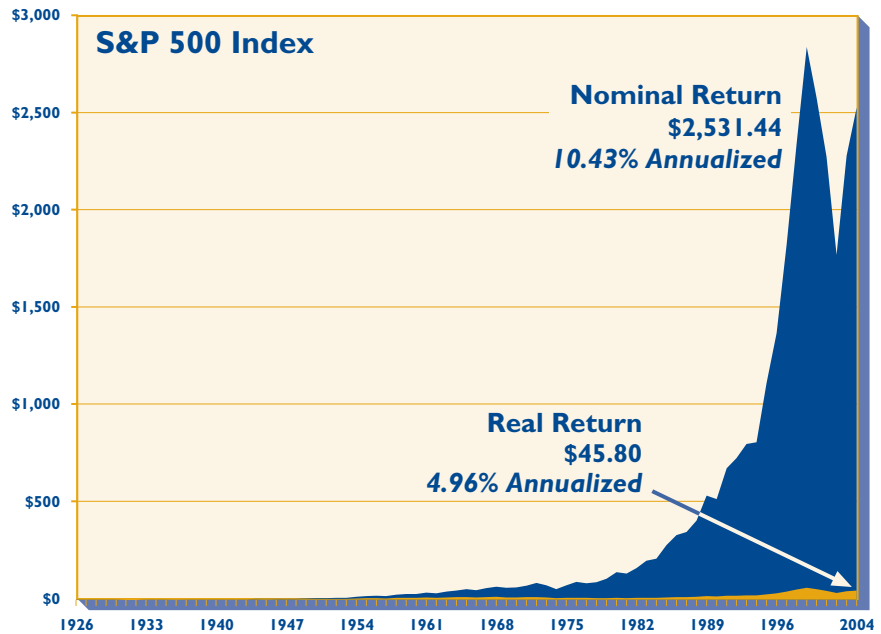
Once again, whatever the rate of inflation, the intelligent investor uses common stocks and municipal bonds to create a “Real Real Return” for him or herself.

A Study of *Real Real Returns*

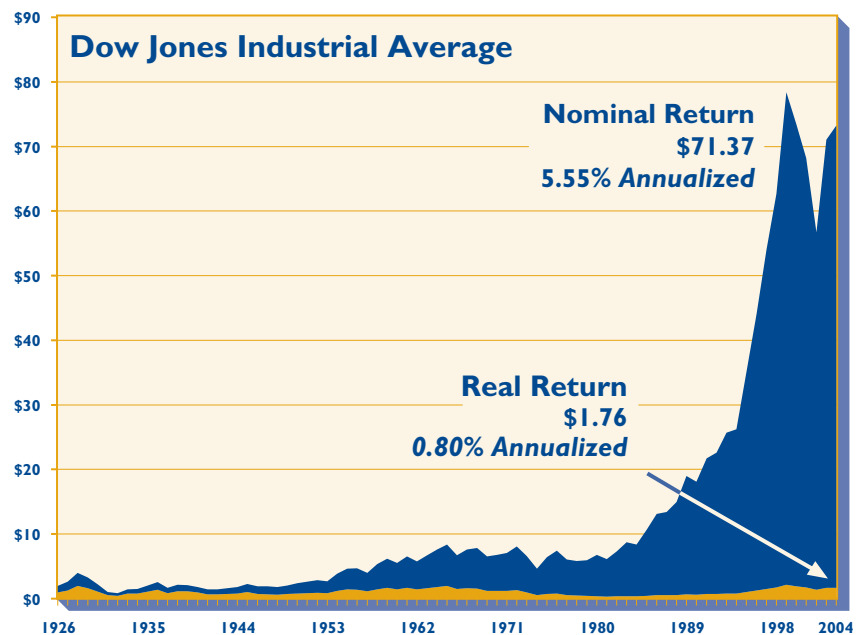
The Winners are ...

Common Stocks and Municipal Bonds

The Real Real Returns



Source: Ibbotson and Associates and Bloomberg



Source: Ibbotson and Associates and Bloomberg

Thornburg Investment Management’s *real real return* index shows that a hypothetical \$1 investment in the S&P 500 Index grew, in nominal terms, to \$2,531.44 but actually increased to only \$45.80 after taxes, inflation and expenses are properly accounted for. **The much-quoted S&P average annual compound rate of return of 10.43% drops to 4.96% on a *real real return* basis.** But it did increase real wealth, and that’s the good news! The annualized return for the Dow Jones Industrial Average drops from 5.55% to 0.80% on a *real real return* basis.

Real Real Returns

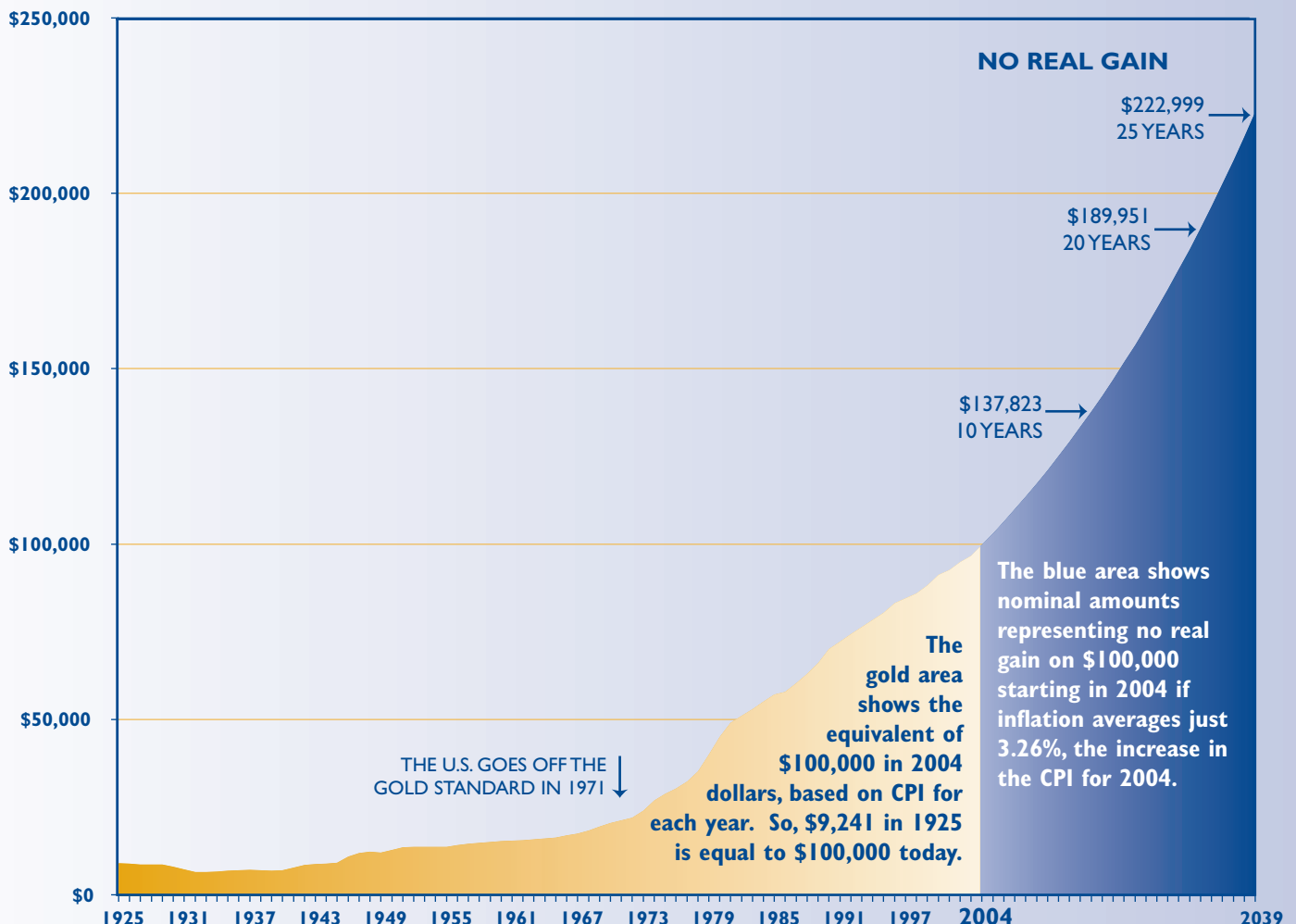
Deduct Taxes, Inflation, and Expenses

Taxes on investments are double-edged. The first cut against returns comes from taxes on dividends, which, despite the recent reduction, must be factored out of the annual compounding. The other cut against returns comes upon the sale of the investment when any increase in value is taxed at the capital gains rate. Worse yet, the IRS does not care that a dollar invested in 1974 is worth only 25 cents today – it taxes you on the nominal amount gained over the initial amount invested.

Inflation over the period 1926-2004 averaged 3.04% per year. In a world without taxes, an investment had to return 3.04% compounded annually just to stay even with inflation. From 1926 to 1965 inflation averaged 1.56% per year. For the last twenty years it has averaged 3.00%. For the last 10 years 2.45%.

Expenses are involved in almost any investment that cannot be purchased directly from the issuer. Residential real estate brokerage commissions average around 6% on the nominal sales price. For the purposes of this study, we have assumed a very modest securities' expense of 20 basis points (0.02%) annually on the nominal value of the stock portfolio.

A Picture of Inflation



These Are Investors' *Real* Real Returns

Average Annual Returns After Inflation, Taxes, and Expenses:

Holdings Period	Inflation	S&P 500 Index	DJIA Index	Municipal Bonds*	U.S. Treasury			Single-Family Homes
				"A" Long	T-Bills	5-Year Notes	Long Bonds	
78 Yrs 1926-2004	3.04%	4.96%	0.80%		-1.04%	-0.41%	-0.04%	
40 Yrs 1964-2004	4.62%	2.93%	-0.40%	1.75%	-1.59%	-1.05%	-0.87%	
20 Yrs 1984-2004	3.00%	7.20%	5.76%	3.11%	-0.02%	0.87%	1.31%	1.15%
10 Yrs 1994-2004	2.45%	6.57%	5.61%	2.80%	0.03%	0.68%	1.25%	1.19%

Source: Ibbotson and Associates and Bloomberg *Income data, not total return.

A Look at The Results

The S&P 500 Index shows positive returns during all holding periods shown above. But even the bull market of the 1990s only boosted the last 20 years' average annual *real* real return to 7.20%.

In each of the time periods shown above, municipal bonds have averaged approximately 85% of the income return (before taxes) of long U.S. Treasury bonds. However, Federal income tax rates for an investor in the top tax bracket have averaged 40% over the last 20 years! Don't give the Federal government almost half of your income.

Treasury bills provided a negative *real* real return in every holding period except for the last 10 years.

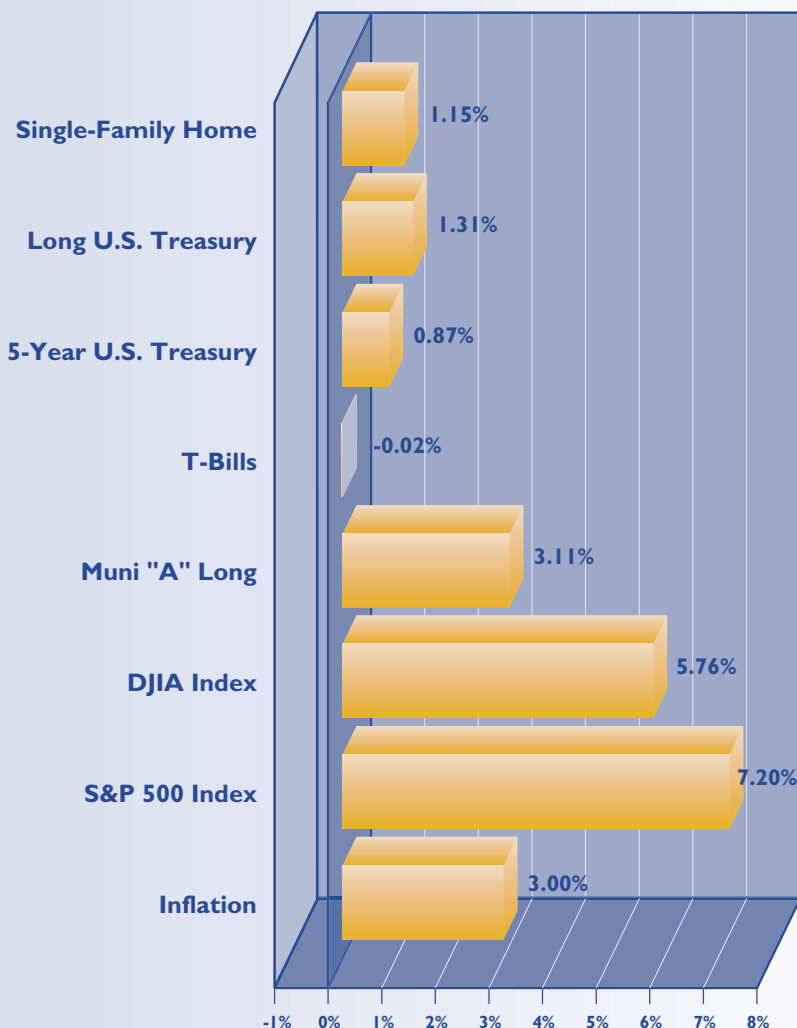
Five-year U.S. Treasuries provided a negative *real* real return except for the last 10- and 20-year holding periods.

Long U.S. Treasuries provided a negative *real* real return except for the last 10- and 20-year holding periods.

Single-family homes provided a *real* real return of 1.19% and 1.15% for the last 10 and 20 years. Many will be disappointed to learn that homeowning is not quite the investment they thought it to be. (Moreover, this analysis does not include maintenance costs.) If one takes into account the \$250,000 (\$500,000 per couple) exclusion from capital gains tax, results improve. However, the returns remain unattractive for 10 and 20 years at 2.32% and 2.15%, respectively.

Treasuries are negotiable debt obligations of the U.S. Government, secured by its full faith and credit and issued at various schedules and maturities. Treasury bills are short-term securities with maturities of one year or less issued at a discount from face value. Income from Treasury securities is exempt from state and local, but not federal, taxes.

20-Year Average Annual Real Real Returns (after Inflation, Taxes and Expenses)



Source: Ibbotson and Associates and Bloomberg

Conclusion:

It's Best to Analyze Every Investment for its *Real Real* Return

Taxes and inflation are an investor's two primary concerns. Inflation has averaged 3.00% over the last 20 years. For the investor in the top tax bracket, marginal Federal tax rates averaged 40% over the past 20 years.

The government is the main culprit, of course. In addition to the overt tax on income and capital gains, the covert tax, inflation, is levied when the Federal government pays its bills with newly printed dollars that are worth less than the dollars they borrowed. Tax increases have not raised enough revenue to offset the relentless increase in Federal spending. Future growth of entitlements means that the covert tax of inflation will continue to penalize investors.

Every investment professional and investor should deflate nominal gain numbers and apply appropriate tax rates to the interest, dividend, or capital gains. If an investment is not earning real returns after taxes, inflation, and expenses, it is gradually losing wealth. When returns are reduced by reality, 5% becomes slightly less than 1%, even with recent dividend tax reductions taken into account. How? Take a dividend yield of 5% and subtract Federal taxes at 15%, and state income taxes (generally deductible on the Federal level) at 5%. From there (4.03%), deduct a more realistic inflation rate (as measured by the trailing 12 months' CPI at December 31, 2004) of 3.26%. That leaves the investor with a 0.75% *real* real return. Compare this to *real* real returns under the previous dividend tax schedule: using a Federal tax rate of 38.6% and state income taxes at 5%. From there (2.92%) that investor was left with a -0.33% *real* real return. Investors seeking income have been given a healthy raise by the tax reductions!

In the *real* world, a 3% real return is a fair objective. More volatile stocks should aim for more than 3%. Less volatile bonds might aim for less. For example, an intermediate term tax-free bond paying 4.00% interest yields a real return of 1.70%. By historical standards that is a moderately attractive real return for a conservative investment.

Taxable fixed-income securities only make sense for the tax-exempt or tax-deferred investor, such as 401(k), pension or profit-sharing plans, charitable organizations and state and local governments. If you are in a 28% or higher tax bracket, consult a financial professional about the advantages of municipal bonds and tax-exempt investing.

Comments

A note on the use of *total return*: We used so-called total return figures in this study (except for municipal bonds) because total return is the standard measure used in the financial community. Total return data for fixed income securities assume that an investor purchased an entire portfolio at the beginning of each year and sold it at the end of each year. First, this ignores transaction

Historically, one can conclude that two investments stand out:

Common Stocks & Municipal Bonds

costs. Second, no one does this! Using only the income (coupon) component of fixed-income securities (as we have with municipal bonds) also does not provide a precise picture, because it attributes no weight to the change in market value of bonds due to changes in interest rates. Total returns on the S&P 500 Index are also distorted. The stocks making up the S&P 500 change as the fortunes of the included companies ebb and flow. Similar criticisms can be made of single-family homes. Total return is really only an adequate measure of the return one could achieve with U.S. Treasury bills, because investors in bills effectively roll the entire portfolio every 90 days. There is simply no perfect way to track a hypothetical portfolio, whether it consists of fixed income or equity securities. *While some details may be unclear, the general picture of real returns – after inflation, taxes and expenses for the different classes of investments – is clear and indisputable.*

Sources

Inflation/Consumer Price Index–Urban (CPI-U), T-Bills, 5-yr U.S. Treasury Notes, Long U.S. Treasury Bonds, and S&P 500 data are obtained from Ibbotson and Associates' *Stocks, Bonds, Bills and Inflation 2004 Yearbook*.

Long Municipal Bond and 10-year General Obligation data are obtained from *Bloomberg*.

Housing data for Single-Family Dwellings, U.S. averages, are obtained from Bloomberg Indices, which are derived from the U.S. Dept. of Commerce sources.

Carefully consider information regarding the Fund's investment objectives, risks, sales charges, and expenses: this is found in the prospectus, which can be downloaded from www.thornburg.com/download or obtained from your financial advisor. Read it carefully before you invest or send money.

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The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market, without regard to company size.

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 actively traded "blue chip" stocks, primarily industrials, but includes financials and other service-oriented companies. The components, which change from time to time, represent between 15% and 20% of the market value of NYSE stocks.

Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

The Consumer Price Index (CPI) measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts, and tax brackets. Also known as the cost-of-living index.