Investment Commentary

From H.L. Zeve Associates Inc. No. 64 May 2009

From Harvey L. Zeve

Speed Bumps Slow The Road to Green

While there remains scientific debate about the causes of global warming, most agree it is real. Here are a few of the facts: The 20th century's last two decades were the hottest in 400 years, possibly the hottest for several millennia. Arctic ice is disappearing rapidly. Montana's Glacier National Park now has only 27 glaciers; in 1910, the number was 150.

Since human behavior may be accelerating many of these changes, people are beginning to change their ways. **The Empire State Building, for example, will invest $20 million in energy efficiency. By 2013, owners expect to reduce energy use by 38% and to save $4.4 million annually in energy costs**.

But **some efforts are experiencing setbacks.** Since the Kyoto Protocol was adopted in 1992 (The U.S. didn't sign.), **most signatories haven't met their goals for reducing emissions. Russia and other members of the former Soviet Union achieved the best results,** clearly because the benchmark year was 1990, a time when the Soviet military-industrial complex was still polluting in full force. **In 1991, the Soviet Union collapsed, and its industries imploded. So with factories shuttered and fewer cars and trucks on the roads, emissions declined.**

Canada's Kyoto target was a 6% reduction from 1990 levels. But by 2006, after spending $billions on green initiatives, its **greenhouse-gas output — instead of declining — climbed to 122% of the goal. The culprit was prosperity. In a soaring economy, everything runs nonstop:** factories, cars, trucks, heating, air conditioning,

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From J. Stephen Lee

Individual Municipal Bonds Can Be a Minefield for Unwary Investors

Recently, several people asked us about municipal bonds that were supposedly yielding 8%. The firm promoting them had apparently called attention to the hefty tax-free returns but hadn't said much about the risk. **When top-rated munis are yielding 4%, an 8% bond is judged by the market to carry much more risk. That means it has a higher probability of default.** If you're willing to assume greater peril in exchange for possibly bigger bucks, you should know what you're facing before you take the plunge.

Bruised by the decline of the stock market, **many investors have sought safety** — and solace — **in municipal bonds.** Some were ill served by the sellers. A study by DPC Data Inc. found that **in October 2008, 667 muni bond sales — many to individual investors — were priced at par or higher, even though the issuer had filed a default or stress notice.** A bond selling at par is expected to have the highest degree of safety based on its rating, yield and maturity. **With any announcement of trouble and, thus, possible default, the bond price should drop to reflect the increased risk** and, therefore,

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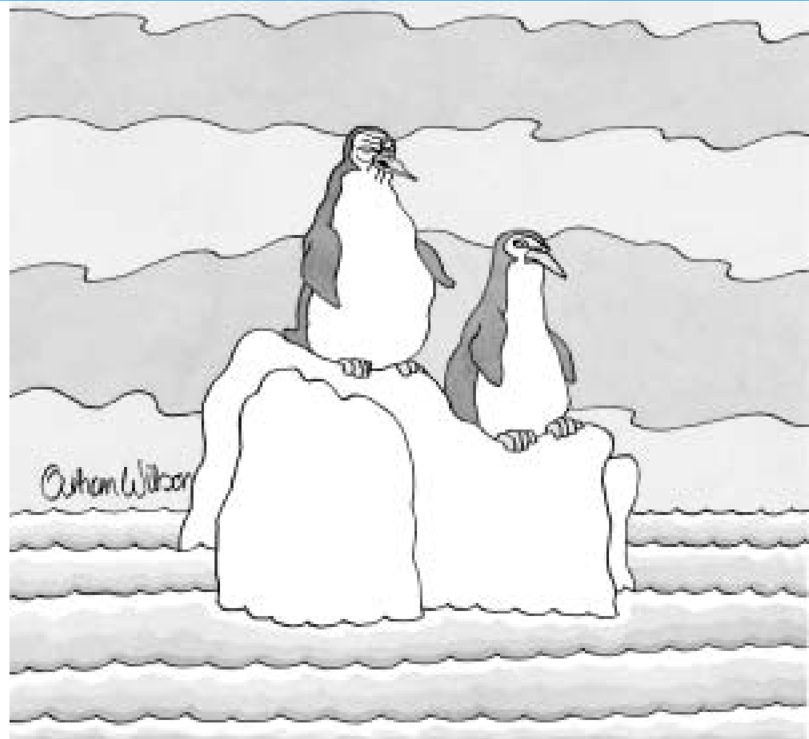

"Call this an iceberg? When I was a kid we wouldn't have called this an iceberg."

From Ronald W. Yost

Credit Card Companies Face a Dilemma

A group of credit card companies is running a series of touchy-feely television commercials that try to make these firms seem like kindly old uncles. In one, a woman has fallen behind in her payments after leaving work to care for her elderly mother. She praises the card company for adjusting her payments so she can continue happily in her new role. **No one mentions the extra fees or interest** that likely go with the deal.

Just as these ads were airing, the news media reported that **Bank of America — matching other issuers — was raising the interest rate on cardholders who carry balances and whose current rate was under 10%.** One woman with a $2,000 balance and an APR of 7.9% was upped to close to 13%. When she adds purchases to her account, the higher rate will apply immediately to the total balance. **Some cardholders are charged 17% and more.**

Until the economy nosedived, credit card companies had a picnic. **Between 2003 and 2008, their profits rose by 45%,** fueled by consumers' willingness to spend way beyond their means and to tolerate interest rates and fees high enough to have once been called usury. Card companies fed the frenzy by reducing minimum payments to as low as 2%, encouraging spenders to take on even more debt. **At the end of 2008, consumer debt equaled a shocking 97% of GDP.**

Now, **the likes of Visa and MasterCard are in something of a pickle.** Debts judged uncollectible reached almost 7.5% in December, up from about 5.3% a year earlier, and they're expected to rise even more. But **their best customers** aren't those who always pay in full. The most profitable **are the "revolvers," people who charge a lot, carry a sizeable balance, pay off only a little every month and fork over high interest and late fees. This group is also the most likely to default.**

As a result, **card companies are trying to dump high-risk cardholders by closing accounts and slashing lines of credit. They're also squeezing more out of remaining customers by raising interest rates sharply,** usually without provocation. (By law, card companies can change their terms at will.)

Consumers are responding to the new reality by **saving more and charging less.** (See chart.) **In the long run, that's good.** Rainy-day funds and nest eggs grow, money is spent for solid goods and services instead of interest payments, and the possibility of a rerun of our current economic debacle shrinks. **The short run is another story. The more we spend, the faster our economy will return to prosperity.** But when we all spend too profligately, the bubble eventually bursts, and when everyone becomes penurious simultaneously, the economy slows down. It's a perpetual dilemma.

In the meantime, **card companies want cardholders to keep paying, and they want Congress to back off from threatened legislation that will eliminate or curtail some of their most egregious — but highly profitable — practices.** Thus, the warm and fuzzy commercials. Their goals, it appears, are to convince cardholders that debt problems can be worked out painlessly and to convince legislators that the industry has a heart. Good luck. ■

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bring a higher return. In these cases, **bond dealers either didn't know about the bonds' change in status, or knew and didn't tell.** Both are almost impossible to combat or prosecute under current enforcement policies.

The heart of the problem is lack of disclosure. Although their **bond covenants require municipal bond issuers** — schools, municipalities, hospitals, cities, states — **to file timely reports on operating results and any material changes in financial conditions,** many don't. **One out of two is more than a year behind in its filings, and one out of four is chronically three or more years overdue.** The SEC, hamstrung by lax regulation, stays on the sidelines. A law from the 1970s allows the agency to pursue nondisclosure

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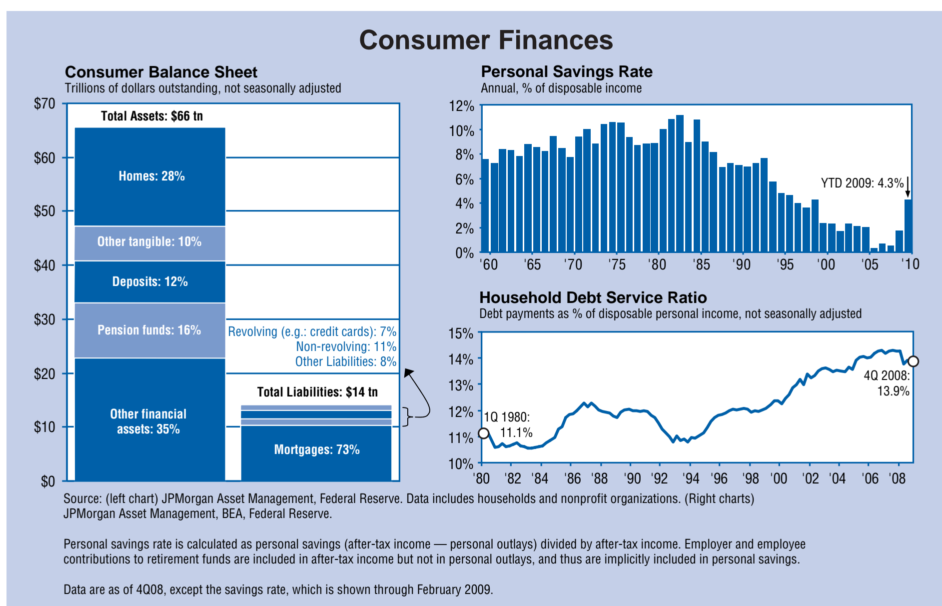
Consumer Finances



Source: (left chart) JPMorgan Asset Management, Federal Reserve. Data includes households and nonprofit organizations. (Right charts) JPMorgan Asset Management, BEA, Federal Reserve.

Personal savings rate is calculated as personal savings (after-tax income — personal outlays) divided by after-tax income. Employer and employee contributions to retirement funds are included in after-tax income but not in personal outlays, and thus are implicitly included in personal savings.

Data are as of 4Q08, except the savings rate, which is shown through February 2009.

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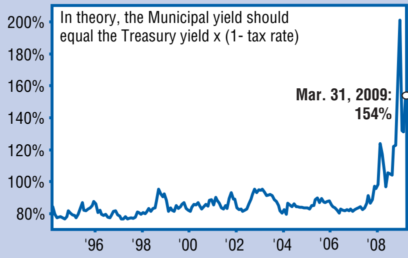
only if fraud is suspected. So it's up to sellers and buyers to perform their own due diligence. **Bond dealers are expected to check on filings and other information before recommending a bond, but there is little penalty if they don't**.

Ratio of Municipal Bond Index Yield to the 10-year Treasury Yield



Source: FactSet, Barclays Capital Inc., JPMorgan Asset Management.

Nondisclosure pitfalls are just one of the factors that should encourage small investors to choose bond funds rather than individual bonds. Funds have both the resources and motivation to check all the nuts and bolts, and they offer the safety of diversity; if one bond fails, it's not a disaster. Fund managers know the real value of the bonds they hold.

Some investors claim to prefer individual bonds because, at maturity, the principal will be intact. (The net asset value will vary along the way.) In fact, **investors will still do better with funds.** Yes, the share price will fall if interest rates rise and move higher if rates fall (the same as with individual bonds), but because bonds held by the fund are maturing continuously, interest payments will be reinvested at current rates. So **the total return will typically exceed that of individual bonds.**

With $1 million required for a round lot in tax-free bonds, individuals are almost certainly assured less efficient execution. In other words, the yield to maturity will be lower. **Most investors are simply better served using only mutual funds for the tax-free, fixed-income portion of their portfolios.** ■

From J. Patricia Calhoun

Wien Announces 2009 Predictions

You may recognize the name **Byron Wien** from previous newsletters. The former Morgan Stanley strategist and current hedge fund advisor **is perhaps best known — since 1986 — for his annual public forecasts, known as his "Ten Surprises."**

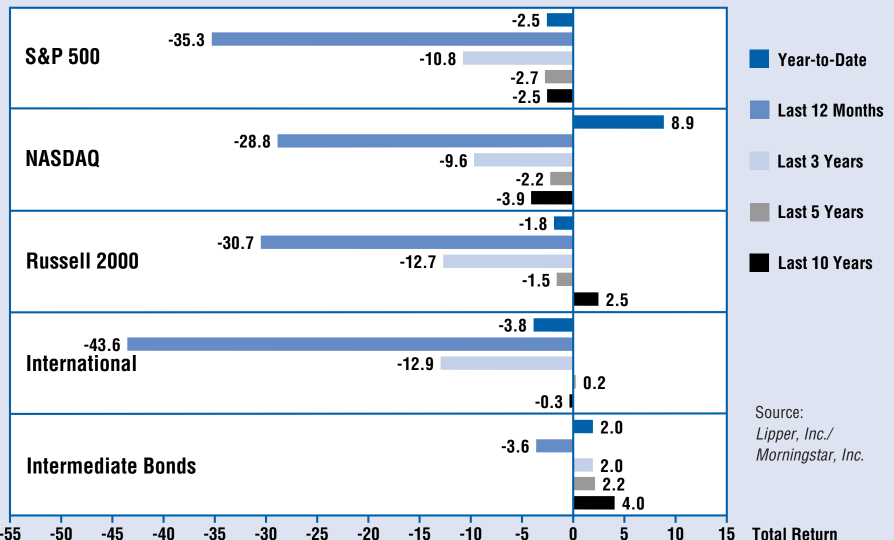
According to Wien, **institutional investors give these predictions a one-in-three probability of coming true. He sees the odds as 50-50 or better.** Whatever this year's outcome, his previous "surprises" have been thought provoking and, often, near the mark. Thus, we thought it worthwhile to share his current comments. Caveat emptor: **Forecasts are notoriously inaccurate, so take them with the requisite grain of salt.**

- **The S&P 500 rises to 1200.**
- Continued **economic uncertainty and concern over paper currencies drive gold to $1,200 per ounce.**
- **Crude oil returns to $80 per barrel, natural gas to $9 per mcf.** Increased Asian demand is the prime culprit.
- **The US dollar** loses value against foreign currencies; it **falls to $1.65 against the Euro.**
- **Inflation becomes an issue** by year-end, and **the 10-year Treasury yield climbs to 4%.**
- **The Chinese economy grows, surprisingly, over 7%.** The Chinese stock market rallies.
- **States and municipalities face increased budget difficulties. The Federal government steps in with yet another bailout** to avoid huge debt failures.
- **The U.S. economy begins slow growth earlier than expected** as housing stabilizes. Third- and fourth-quarter growth is positive.
- The U.S. consumer begins to spend again. **Christmas 2009 breaks the record for retail sales.**
- **President Obama reverses course on troop withdrawals from Iraq,** citing worries about the fragility of their government. That and increased military presence in Afghanistan mean no meaningful drop in military activity or spending.

Byron Wien batted nearly .700 last year (If you want the details, call.), an average that gets everyone's attention. Will he do as well in 2009? We'll let you know. ■

Market Benchmarks

Through 4/30/09



An Invitation

Bring a Friend to Lunch

As many of you know, throughout our years as investment counselors, just about all our new clients have come to us through referrals from those we already serve. We're gratified to know that you and others like you value our services enough to recommend us to friends and family. Since you probably know individuals who might be interested in learning more about H.L. Zeve Associates, we would appreciate your giving us their names or asking them to call. Even better, we would be delighted to have you and your friends join us for an informal, no-obligation lunch where we can discuss investments and investment strategy. Again, thank you for your continued confidence.

If you would like to arrange a luncheon meeting or simply discuss a possible referral, please call Harvey Zeve, Steve Lee or Ron Yost, or give the information to Sandie Neff by phone (412-281-4567, 800-724-4765), fax (412-281-2725) or email (sneff@zeve.com.) Or return the attached reply card.

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Credits

Parts of some articles were based on the following sources:

The New Yorker, James Surowiecki, March 27, 2009, "Credit Card Companies Face a Dilemma."

The New York Times, Gretchen Morgenson, March 21, 2009; Investment News, Dan Jamieson, March 22, 2009; "Individual Municipal Bonds Can Be a Minefield for Unwary Investors."

The Washington Post, George F. Will, April 2, 2009; The New York Times, Leora Broydo Vestel, March 28, 2009; National Geographic News, June 14, 2007; The New Yorker, David Owen, March 30, 2009; "Speed Bumps Slow the Road to Green."

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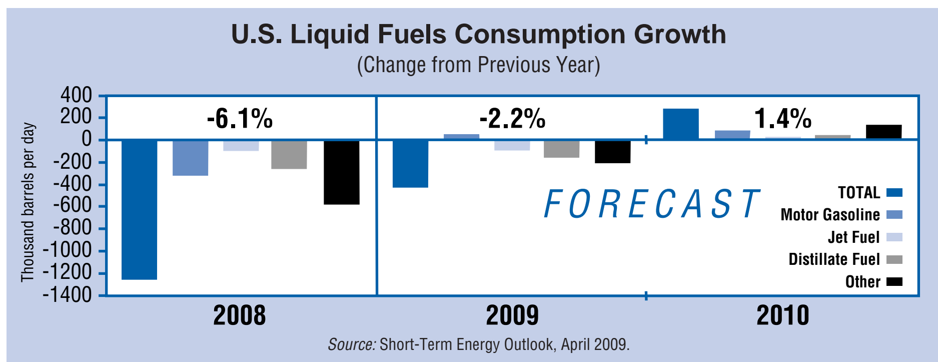
swimming-pool heaters, restaurants.

In 2008, U.S. gasoline consumption fell almost 6%. (See chart.) It wasn't that American drivers were suddenly concerned with pollution; **the stop signs were the prohibitively high price of filling up and the declining economy.** But who would trade high unemployment and long-term bear markets for cleaner skies? **Governments have to keep people working, minimize foreclosures and bankruptcies and still take steps toward carbon reduction.**

One step has been to mandate more fuel-efficient cars. Another has been to encourage drivers to buy hybrids. **Fuel efficiency means we travel farther on each gallon of gas. High gas prices mean we drive less. Both reduce pollution. But with fuel-efficient cars, people tend to drive more.** Thus, unless we can change driving habits or keep fuel prices at their all-time highs or above, we're back to the starting gate. **Electric cars are also a mixed bag.** The electricity that powers them still has to be produced somewhere, and **their lower operating costs encourage driving where public transportation would be better for the planet.**

Compact, fluorescent light bulbs are another green solution that has hit snags. The bulbs are supposed to last 10,000 hours and save as much as $5.40 a year in energy costs. But of the 16 bulbs bought by a San Francisco couple, one didn't work and three died within hours. **A program at Rensselaer Polytechnic Institute** tests residential lighting. Its 2007-2008 tests of Energy Star-certified bulbs **found that five of 29 models failed to meet specifications for such categories as lifespan, luminosity and on-off cycling.**



Source: Short-Term Energy Outlook, April 2009.

Quality improvement will be tough. The government is looking into tighter specifications and better labeling, which should help, but other current drawbacks need attention. **Compact flourescents burn out quickly in confined spaces where heat builds up — recessed ceiling fixtures, for example. Some don't work with dimmers or three-way sockets. And they're made with mercury, a toxic metal, so you can't just dump them in the trash.** They have to be carted to special disposal sites. **If a bulb breaks, you're almost forced to call the hazmat team to follow EPA recommendations.**

These roadblocks aren't insurmountable. We have the skills and ingenuity to overcome them as well as others that are sure to turn up. **The challenge is to find solutions that improve the environment without raising costs or otherwise damaging the economy.** In the meantime, they present valuable lessons for investors. Companies with new —often-unproven — technologies are hyped nonstop on television and the Web, tempting some to jump onto the latest bandwagon. These forays are rarely successful. **Whether you're trying to nurture the planet or cultivate a vibrant portfolio of stocks and bonds, patience and prudence pay off. To repeat our mantra: a balanced portfolio of thoroughly vetted stocks and bonds is the better prescription for long-term investment success.** ■

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H.L. ZEVE ASSOCIATES INC. INVESTMENT COUNSELORS

600 Three PPG Place
Pittsburgh, PA 15222
412-281-4567
800-724-4765
412-281-2725 FAX

www.zeve.com

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