LAWSON KROEKER
INVESTMENT MANAGEMENT

# *As We See It*

## Let's Think About Income

Suppose a recent Master in Business Administration graduate is in the latter stages of employment negotiations with a major company. The discussions are going well. Each party seems pleased with the other. Duties, hours, vacation, and dress code have all been covered. They are now down to pay.

The compensation package offered is:

- $70,910 a year in cash, or
- $52,049, of which $19,477 is in cash and $32,572 is in company stock.

Which will the young MBA choose?

Now suppose a dollar or, for the sake of comparable numbers, a million dollars comes to the United States securities market and asks the pay packages offered there. If that million dollars were employed by corporate bonds (using the 12/31/96 Merrill Lynch Master Corporate Bond Index yield to maturity) the pay would be $70,910. If employed in the stock market (represented by the Standard and Poor's 500 Index) the pay would be $19,477 in cash (called dividends) and $32,572 in stock (called retained earnings), or a total of about $52,049.

Probably the young MBA will choose the cash pay package, but the dollars coming to the securities markets are by no means rushing to the higher paying bonds. This may fly in the face of common sense, but there are some sound, and perhaps some not so sound, reasons.

For starters, the needs of the young MBA and the owner of the investment dollar are different. The MBA needs to eat now. The owner of the investment dollar may be a saver; that is, he may already have his meals provided from some other source. In fact, the investor may be one of the Baby Boomers. This population cohort is especially significant now. It is very large in numbers and is in its peak earning/saving years. The Boomers *know* they must save because, "Social Security will be busted when they retire."

Then there is the matter of taxes. The MBA's, or the bond's $70,910 salary is taxed right now. Only $19,477 of the saver's income is taxed currently. The rest, so long as the companies keep it, is reinvested in the business and is taxed later. This tax, the capital gains tax, is postponed and postponement is worthwhile. But the capital gains tax, 28% plus state taxes, is not so insignificant that it explains completely the difference between $70,910 and $19,477.

Perceptions and expectations play a part too. That bond with its superior current income not so long ago was tainted by inflation and its bear market is still remembered. Stocks on the other hand have enjoyed a fifteen year bull market. Long bull markets have a way of winning more and more true believers.

Whatever the reasons, the difference between the way ordinary people look at current income and the way the financial markets are currently accepting low current income from stocks should make each investor stop and think.

His first question should be whether his investments are appropriate to his needs. For example, if retirement is at hand, is the reliable current income at the desired level? If on the other hand, the investor is in a savings/accumulation mode, does his portfolio minimize current, taxable investment income?

A second and broader question is whether the present seeming discrepancy between bond income ($70,910 in hand) and lower stock income ($19,477 current cash dividend income and $32,572 reinvested income) will persist. If stock prices go flat for a time or, heaven forbid, go down for a while, will high current income become much more attractive? When the Boomers start retiring, in the not too distant future, will current income look better and better to them? If the income difference between bonds and stocks narrows, will it be by lower interest rates or lower stock prices?

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