Your ***Real*** Real Return
By Gary Case

What is your REAL real rate of return?

Taxes and inflation are the twin dragons (or drags on) an investor's portfolio, with expenses close behind. Inflation has averaged 3.00% over the last 20 years. In fact, according to Garrett Thornburg, CEO of Thornburg Investment Management, substituting a Housing Price Index for the Rent Equivalent Index when computing inflation, the overall inflation rate rises to 5.82% over the past 10 years! Tax rates for those in the highest Federal bracket have averaged over 40% over the same time frame.

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, especially social security retirement benefits, 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 interest, dividend, and 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 of 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. If you are in a 25% or higher tax bracket, ask your advisor about how municipal bonds might benefit you.

Sources

Inflation/Consumer Price Index–Urban (CPI-U),T-Bills, 5-yr U.S.Treasury Notes, Long 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.

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