Tax Policy and Stock Prices

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Michael D. Axel, CFA
Jacob D. Benedict
David J. Manger

We are commonly asked how we think the stock market will perform over the next year. Our consistent answer – "we don't know" – typically leaves the questioner unsatisfied. We believe, though, that the time horizon is simply too short to forecast with any accuracy. Analysts that predict what will happen over the next month or year should be eyed with caution. Warren Buffett puts it more colorfully:

> We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.[1]

It is too difficult to forecast how macroeconomic and geopolitical events will affect investment markets over the near-term. We simply work hard to find investments that we believe offer attractive returns at levels of risk we feel are below average. Our hope is that our "margin of safety" will protect us from the unpredictable risks that are always present.

This doesn't mean that we don't think about fundamental economic or political challenges that could affect the underlying value of our investments. For instance, a topic that has come up recently is whether increases in the tax rates on dividends and capital gains will drive the stock market lower. A recent editorial in the *Wall Street Journal* concluded that "it's simple arithmetic…unless current law is amended before year-end, the stock market has to fall by at least 30%."[2] The author argues that if current tax laws are allowed to expire and dividend tax rates increase from the current 15% rate to around 40% for high-income earners, investors will drastically push down stock prices so that they receive an equivalent *after-tax* dividend yield (see footnote for further explanation).[3]

It is true that higher taxes on capital gains and dividends make taxable investors worse off – higher taxes on a certain source of income involve a transfer away from those affected to the government. Since most corporate earnings are retained and used to build future value and long-term investors with low portfolio turnover can delay capital gains taxes for extended periods, the impact would likely be smaller than some might assume. But the argument that increasing tax rates on dividends and capital gains will have a large, adverse shock on stock prices as a matter of "simple arithmetic" is fundamentally flawed.

[1] "1992 Letter to Berkshire Hathaway Shareholders," Warren Buffett, March 1, 1993.
[2] "The 2013 Fiscal Cliff Could Crush Stocks," Donald Luskin, *Wall Street Journal*, May 4, 2012.
[3] The arithmetic: Assume you own a stock worth $100 that pays a 5% dividend yield, or $5 per year. Under current dividend tax rates of 15% you receive $4.25 in cash, or a 4.25% after-tax yield based on the $100 stock price. If dividend tax rates increase to 40%, you will receive just $3.00. If investors demand a constant 4.25% after-tax yield, the stock price will have to fall around 30% to $70.59 ($3.00/70.59 = 4.25%).

The stock market is a textbook example of a free, competitive market – millions of buyers and sellers come together to set prices. The aggregate price level of the overall stock market is determined by the intersection of supply and demand between buyers and sellers. In order for stock prices to undergo a large one-time shift, there must either be (a) a drastic decline in the demand for stocks (i.e. purchases) or (b) a drastic increase in the supply of stocks (i.e. sales). Yet even the author notes that only one out of every four stock investors will be meaningfully affected by a change in tax rates – the majority of stocks are held by tax-exempt entities such as pension funds, endowments and retirement accounts. For these investors, changes in tax rates have no effect on their view of the attractiveness of stocks. The author tries to suggest that taxable investors may be the marginal price setters in the stock market (an unsubstantiated and unlikely claim). Even if there is some downward pressure from high income earners selling dividend-paying stocks, it is hard to believe that prices would have to fall anything remotely close to 30% to entice tax-exempt investors, who already make up the majority of the market, to soak up the increased supply.

Further, where would high income earners put their money if they pulled it out of the stock market? Most investment assets are in stocks, bonds or cash. Many high quality bond investments trade with interest rates lower than the dividend yields one can get on high dividend stocks and interest payments are already taxed at marginal income tax rates. Going to cash would likewise be an unattractive alternative – cash earns nothing and does not keep pace with inflation. To the extent higher tax rates make the returns on stocks slightly less attractive, those returns would still be quite attractive relative to investment alternatives and therefore a large block of sellers looking to exit the market would be unlikely to materialize. Buffett recently opined on this topic:

> Back in the 1980s and 1990s, tax rates for the rich were far higher…According to a theory I sometimes hear, I should have thrown a fit and refused to invest because of the elevated tax rates on capital gains and dividends.
>
> I didn't refuse, nor did others. I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9 percent in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain. People invest to make money, and potential taxes have never scared them off.[4]

There are other issues that refute the "arithmetic" argument:

- Companies are free to pay dividends or retain and reinvest capital. Now if capital gains tax rates go up as well, retaining capital in order to generate returns through higher stock prices as opposed to dividend payouts is also affected. However, capital gains aren't paid until a stock is sold, and by deferring such a sale into the future the impact can be meaningfully lessened. When the dividend tax rate was drastically reduced both absolutely and relative to capital gains tax rates in 2003, corporations aggressively increased dividends and cut back share repurchases; the opposite would happen if the situation reversed, shielding shareholders from the adverse impacts. Further, many stocks pay low or no dividends and would be much less impacted by a change in tax policy. [As a side note, while the optimal tax rate on capital gains and dividends is a matter for debate, we feel that it is incredibly important that tax rates on the two activities remain identical so as not to distort corporate financial decisions.]

- According to James Montier of GMO, the average holding period for a stock on the New York Stock Exchange (NYSE) is just 6 months, down from 8 years in the 1950's.[5] When a stock is sold for a gain after being held less than a year, it is taxed at the marginal tax rate. Accordingly, this illustrates that the market is simply not overly concerned with elevated tax rates on investment activity.

- The value of a stock is equal to *all of its future cash flows* discounted back to the present period, not just next year's. Any change in tax law would not necessarily translate into permanently higher taxes and therefore, *even if* there was an impact in the market, it would be muted to a certain degree.

- The stock market is forward looking, so *even if* a tax hike would have an adverse impact on stock prices, the probability-weighted outcome would already be priced into markets.

[4] "Stop Coddling the Super-Rich," Warren Buffett, *The New York Times*, August 14, 2011.
[5] "Was It All Just A Bad Dream? Or, Ten Lessons Not Learnt," James Montier, *GMO White Paper*, February 2010.

- All of this assumes that dividend tax rates will increase by approximately 25%; if tax rates on capital gains and dividends do rise, the actual increase will probably be much more modest (most debate has discussed an increase from 15% to 20%).

We don't need to rely on theory alone to examine this issue. Dividend tax rates have only fallen since the 1950's. However, if a dividend tax hike would be a negative shock to the stock market, then the reverse should be true as well – a dividend tax cut would be a positive shock to the market. In the spring of 2003 the *Jobs and Growth Relief Reconciliation Act of 2003* was signed into law by President Bush. The bill marginally lowered capital gains tax rates from 20% to 15% for high income earners but drastically reduced dividend tax rates from 38.6% (the marginal personal income tax rate in 2002) to 15.0%. Now the stock market did rise materially during 2003, but it is impossible to figure out to what degree that was due to low stock prices and an improving economy versus the new tax regime. However, we can test the hypothesis in a different way – if tax rates have such a large effect on stock prices, than stocks that paid high dividends should have performed much better over that period than stocks that paid no or low dividends, since capital gains tax rates shifted much less than dividend tax rates. James Kwak of *EconoMonitor* runs this test by comparing the Vanguard Growth Index (VIGAX, low dividend-paying stocks) to the Vanguard Value Index (VVIAX, high dividend-paying stocks). As one can see in the figure below, while there was some slight outperformance from the high dividend-paying stocks, it is nothing near the magnitude suggested by the *Wall Street Journal* editorial.[6]

So in conclusion, we reject the idea that an increase in dividend and capital gains tax rates will be a large, one-time negative shock to stock prices. That doesn't mean the development should be ignored – taxable investors who are affected will need to ensure that they are maximizing *after-tax* returns. But for long-term investors who already employ an investment program that thinks about after-tax returns and utilizes a low turnover approach, the practical impacts on how the portfolio is managed will probably be small.

Please note that we have not said that stocks won't fall based on developments out of Washington this coming winter. We have only said that they won't fall *as a matter of arithmetic* in response to tax hikes on dividends and capital gains. As we saw last fall, it is entirely possible for the observable absence of leadership and compromise among our policymakers to have a decidedly negative impact on both the economy and investment markets. But this is a result of a general skepticism that the country will rise to meet our challenges or a belief that lawmakers may do something misguided such as default on our national debt, not a mathematical reaction to a change in tax policy. And forecasting not only what policymakers will do in the future, but also how that will impact investment markets, is much too uncertain an endeavor for us to base our investment policy on. Instead, we will focus on finding attractive risk-adjusted investment opportunities within our circle of competence.

[6] Google Finance.