STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS JANUARY, 2014

LUMBARD INVESTMENT COUNSELING

INSIGHT

S&P 500 1,847 * Dow Jones Industrials 16,557 * 30 year U.S. Treasury Bond 3.96%

HAPPINESS

Our economy is accelerating. Monthly employment gains have grown from 150,000 to 200,000, and the net worth of US households has hit a new high. Dirt-poor farmers and ranchers are getting rich; we just heard of a hardscrabble North Dakota rancher whose oil royalties are now $1.2 million *per week*.

This is the acceleration that Paul Wright (page 3) has been talking about. Mostly it's a rebound from the depressing effects of $177 billion in tax increases (they're three times as impactful as spending cuts) in January. Paul is now calling for 2.5% growth in 2014 and beyond, which is about as fast as the Federal Reserve governors will allow. They'll want to take every opportunity to withdraw the amphetamines (0% interest rates and a trillion dollars' worth of freshly-printed money) that they've been feeding us every year.

Still, this is great time to be alive! Instead of dwelling on continuing unemployment, let's rejoice in how prosperous we *all* are—relative not just to the rest of the world, but to the poverty and malnourishment of our own nation just 100 years ago.

Most Americans can't seem to remember how expensive and tasteless food was, even a short time ago. Did you ever visit the wintertime vegetable "aisle" of a General Store in the 1970s? And today you can buy a hamburger for just 8 1/2 minutes of minimum-wage work; seventeen cents, in 1970 dollars.

Our oldest citizens remember, and that's one reason why they consistently claim in surveys to be happier than the rest of us. Happier than *all* the rest of us; Americans over the age of 75 are happier than college students. This surprises the elderly just as much as it surprises you, but all over the world citizens report less happiness as they progress through life to middle age—the global average low point is 46—and then a startling reversal that climbs steeply for the rest of their lives.

The graph at right (from The Economist) shows American happiness on a scale of 1 to 10, ages 18 to 85. Similar results have come up in study after study, worldwide. If you're in your 40s, fear not; it's going to get better!

The U.N. just published its World Happiness Report for 2013, listing 156 nations; from ecstatic Denmark to miserable Togo. The U.S. was #17, just behind Mexico and well behind Canada at #6. All of the top 9 were cold, snowy, wealthy countries . . .

Studies on happiness are pouring in from all over. Happy people are grateful and generous, and they don't wallow in envy. They get

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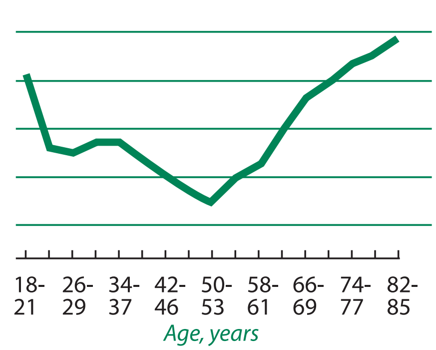
The U-bend

Self-reported well-being, on a scale of 1-10



Source: PNAS paper: "A snapshot of the age distribution of psychological well-being in the United States" by Arthur Stone

HAPPINESS

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outdoors often—away from TVs and computer screens—for exercise, fresh air, and the light therapy and vitamin D that comes from sunlight (not always an easy thing for #2 Norway). They're good at managing expectations and wanting, and feel they have a lot of freedom to make choices.

Our region (North America, Australia, and N.Z.) topped the UN rankings in freedom, and was tops in "perceptions of corruption", and charitable donations.

Biggest surprise? The people of Costa Rica (#12), handicapped by a warm climate and modest wealth, but nevertheless maintaining an attitude of gratitude that they express as "pura vida". Tourism and medical tourism—important pillars of the economy—have encouraged environmental protection, education, and a health care system that works. Their universal health care is cost effective, and if you think the public hospitals seem understaffed and chaotic you have the option of paying up—not so much—for world-class private care.

Those private hospitals have to be world class, because they're competing for European patients who don't want to wait 6 months for a knee operation, and Americans who know that they'll save many thousands of dollars.

Don't Worry, Be Happy! ■

HOW 'BOUT SOME GOOD NEWS IN HEALTH CARE?

The growth of health-care spending—as distinct from health insurance—slowed in 2012 to less than 4%. It was *barely more than two percent* in 2013.

A big reason was a long-overdue change in the attitudes of insurance companies (who are often described as greedy and rapacious, even though they're mostly nonprofits; this year Anthem Blue Cross will have a monopoly in New Hampshire). For the first time insurers are offering their customers an incentive to get their blood tests and MRIs at low cost providers, thus saving shocking amounts of money. "We Care Medical Mall" is advertising that its CT Scans start at $190, and that some MRIs are just $300.

Our "non-profit" hospital is still pricing diagnostic tests as if it still enjoys a monopoly, and for the most part it does. The doctor tells the patient to go downstairs for an X-ray and he goes downstairs . . . But now we know that we can get a cash reward by calling our insurer and making a short drive to an alternate provider, and know that if we use the service often we'll get a better deal on our insurance premiums next time they're calculated.

These are baby steps, with small incentives offered to a small number of people. Bigger incentives bring bigger results. The general rule of thumb is that they always exceed your wildest dreams. ■

You know that pill you've been searching for? That Holy-Grail combination of vitamins, minerals, anti-cancer compounds, blood-sugar management, and therapy for aging eyes? It's broccoli.

AN EVOLVING POINT OF VIEW . . .

"Over the past 5 years, our federal debt has increased by $3.5 trillion to $8.6 trillion. That is "trillion" with a "T." That is money that we have borrowed from the Social Security trust fund, borrowed from China and Japan, borrowed from American taxpayers."

"Increasing America's debt weakens us domestically and internationally. Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren . . . I therefore intend to oppose the effort to increase America's debt limit."

- Senator Barack Obama, March of 2006, Page S2237 of the Congressional Record, just before voting against an increase in the debt ceiling.

ALL IS WELL

In 2013 the stock market soared 31.9%, including dividends, while U.S. Treasury bonds (Lipper Index) *lost* 9.1% and the price of gold collapsed. Down 28%!

For more than four years we've been telling you to buy common stocks, and we still like 'em. They're roughly at fair value, up more than 100% from the dramatically undervalued levels of 2009 but with plenty of room to run. Corporate earnings are always rising, so stocks could return 8% (including dividends) even if they continue to sell at a bit less than 17 times last year's earnings.

We think they'll go a good bit higher. 16.3 times is the average for the last 50 years; from 1991 to 2007 the average was more than 20 times. This is a long business cycle, lengthened by cautiousness and sluggish growth, with very low interest rates that should encourage higher stock prices. Inflation should continue low, primarily because wages will continue to be held down by the large number of people looking for work.

Gold could fall below $700.

We believe that the economy will grow at roughly a 2.5% pace over the next four (yes four) years. "Nominal" GDP growth (unadjusted for inflation) should average 4.5%, and corporate revenues should grow at the same pace. Corporate earnings *per share* should advance at a 6% rate, with 1.5% of that coming from share buybacks. Stocks might return 10% a year (8% from price and 2% from dividends) if investors keep their greed in check.

They might not keep their greed in check. We're living in a period of extraordinarily easy monetary policy, and the Federal Reserve will be extremely reluctant—it's human nature—to take the punch bowl away as quickly as it should. It's almost inevitable that there will be too much money sloshing around in the economy in the next three years, and where's it going to go? Commodity investors are still reeling from the collapse of gold, and it's been just 7 years since the most-recent real estate bubble burst. But damn, it's been almost 15 years since we built a stock market bubble . . .

We're not in a bubble yet. The nuttiness of Facebook and Tesla is highly localized, and there's no need to forecast that a bubble is coming. Stay invested, and enjoy the ride. ■

NONSENSE!

In October retail sales accelerated, after a flat and sluggish summer. Building permits rose, and the economy added 200,000 jobs in one of the best gains of the year. This was the month of the Government Shutdown; a terrifying event, for those who get their news from a TV set. It did not, after all, knock 50% off the year's GDP growth, as predicted by the warlocks at Goldman Sachs. And breathlessly repeated by the media, every 30 minutes for weeks. ■

Paul K. Wright, CFA

CURVES

Our most recent purchases were Qualcomm (QCOM -- $73) and Broadcom (BRCM -- $29), which make the chips that run most of the world's top-of-the-line cell phones. Both stocks are cheap, because investors feel that growth is slowing, competition is rising, and innovation has ceased—hurting royalties that are tied to phone prices.

We don't share these concerns. In the next year or two the "flat black slab" design ethic of today's phones will be replaced by body-hugging curves, because of an innovation in glass ("Willow Glass") produced by Corning (GLW, 17 ½). We've owned Corning for a while, partly because these new phones—sleek, sexy, and functional—will be the must-have items of 2015. How often do you get to buy unloved stocks that are lovable? ■

YOUNG IN AMERICA

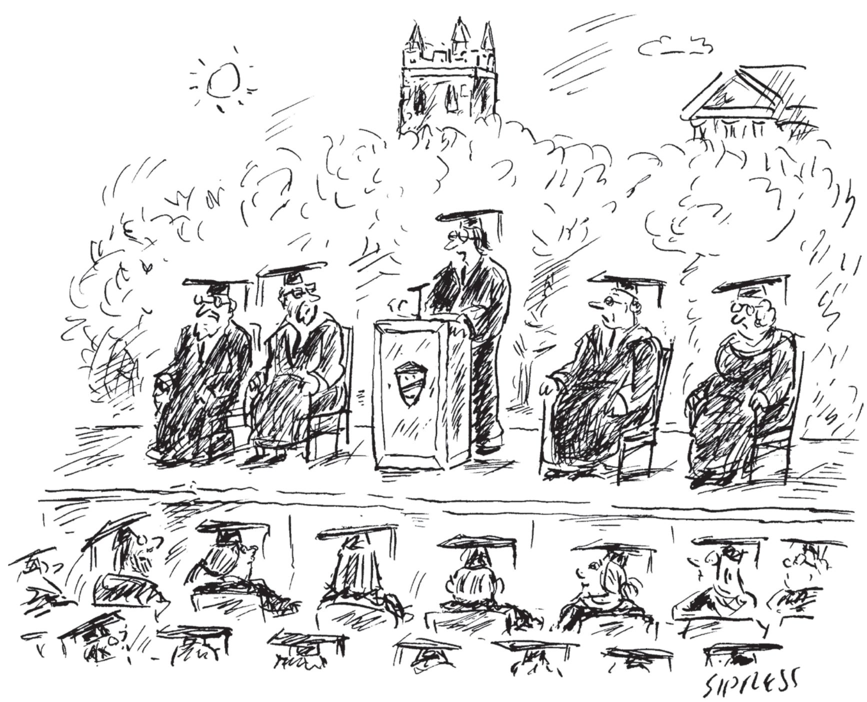
According to The Daily Kos, 27% of recent college graduates (ages 21 to 24) are either unemployed or underemployed. The Democratic Underground says that recent college graduates earn $3,200 less than they did 13 years ago. Of course, it's not just college graduates; low starting salaries and meager opportunities for training will follow today's 20-somethings throughout their working lives—depressing their lifetime earnings by hundreds of thousands of dollars.

Meanwhile, Fidelity Investments wants you to know that the average 2013 college graduate carries $35,200 in debt. Her generation (60% of grads are women) is staggering under a trillion dollars' worth of student loans. The default rate is one in seven, and it's rising. Default is a rational response, because this is also the generation that will have to carry the $17 trillion in federal debt that is mostly the result of vote-buying by politicians. If you assume that the burden of the federal debt will fall on the young half of the population (people 38 and under), they're each carrying $100,000 in federal debt right now. In 2014 they'll assume additional federal debt of $4,650 each.

And that $17 trillion is only part of the story. Our government's accounting rules are more like Enron than GAAP. Our true liabilities are much higher; the trustees of the Medicare trust funds say that future Medicare outlays will exceed future Medicare taxes by about $38.6 trillion, or $244,000 for each American under the age of 38. The Social Security trustees have a similar (but happily smaller!) complaint.

These issues have been front and center for more than 20 years, but we haven't made any headway at all. No President has even spoken frankly to the nation, as the future crisis has drawn closer and closer.

And, oh, one more thing. Health insurance premiums for the young have just been increased by 100% or so, in the name of *fairness*. The extra cash will be used to subsidize the health insurance of Baby Boomers, who spend lots more on doctors and hospitals. If, that is, Young America decides to sign up for insurance at all . . . This is a great nation, and it is absolutely in our power to fix this intergenerational injustice. ■



"My fellow-graduates, today we leave behind the trappings of youth, step boldly onto the road of life, and move back in with our parents."

When people say "it's more art than science", they're often describing a mental challenge that involves too many variables for the scientific mind to grasp. Enter Watson, the IBM computer system that's much more than a faster, smarter machine. It can truly learn—millions of pages of text and data at a time—but it needs the input of top experts before it can take their knowledge to a higher level in medicine, drug discovery, and other fields. Unloved IBM ($186) is also the go-to expert for problems of security, in a world in which the bad guys have infinite time and computer power at their fingertips, and millions of customers to Target.

~~DI~~SABILITY

Guy walks into a bar, orders a beer, and stands there drinking it while he watches a Bruins game. Orders another beer, and stands there drinking it . . . While he's drinking the third one, he's asked what he does for a living. "I've been on disability for the last couple of years."

That's no joke; we were there. We were also there to hear a Boston bricklayer (met on a ski lift) who told us that he collects unemployment benefits all winter every winter—along with ski-house roommates, also bricklayers; the self-styled "Government Ski Team".

This is big trouble for our economy, and an important change in society. Collecting undeserved benefits is now something that you proudly announce to strangers. When JFK was President the male labor participation rate was 82%, because a worker who hurt his back in a physically-demanding job would soon transition to a desk job. It's now below 70%.

72 former NYC firefighters and policemen were just charged with disability fraud . . . Social Security says that there are now 11 million people in its disability program, and that it has grown every single year since 1983 (there are another 5.2 million on SSI). There are fewer than 40 million on regular ol' Social Security . . . Let us hasten to add that many of the recipients really need the help. But your favorite personal-injury lawyers are all over this.

Jim Sokolove, who has an office across from Bunghole Liquors in Peabody, advertises that he'll "fight for the benefits you may be entitled to." ***May???*** Ginger Lanigan advertises daily on Oldies station WROR in Boston, and Citizens Disability of Waltham runs radio ads assuring us that "**there are a vast number of conditions that could make you eligible.**"

The Wall Street Journal says that Social Security *pays the cost of your lawyer*—it shelled out $1.4 billion last year—on the theory that lawyers speed up the process.

A stronger economy won't fix this. In 2012 Gary Alexander, Pennsylvania's Secretary of Public Welfare, wrote that the cash and non-cash benefits available to unemployed single parents (with two children) in the Keystone State total more than $45,000 annually. If they take jobs at $9,000 a year their total annual income, including the value of their benefits, will rise; but from that point they have almost no incentive to work longer, harder, or smarter—unless they can find positions that pay $69,000 a year.

According to the Social Security Administration, the average wage in this country is $44,300. ■

Drew D. Kellner, CFA

NONUPLED

A few months after we opened our doors in 1990, one of our wonderful clients opened an account with $100,000**. She never made any additions or withdrawals, and has always paid a full fee.

We manage the account without favoritism, diversifying globally and conservatively among stocks, bonds, and cash. Over the course of 23 years the portfolio has grown nine-fold, to **$912,131**.

***Our minimum is now $1.5 million. Past performance is not indicative of future results.*

"Are you sure you want to order the small? The last five times you ordered both sizes [small and medium], you only kept the medium."

– The CEO of Rue La La, describing the pop-up messages that the online retailer will use to discourage returns. Industrywide, returns now approach a *third* of shipments. We've enjoyed a good run with Fedex . . .

COOPERATION, SIMPLICITY, HUMILITY

In late December movie mogul Michael Moore, writing in the NY Times, described Obamacare as "awful" and said that he'd known this all along—but didn't want to say so because it would give comfort to the President's "enemies". Maybe it's time we stopped the hyper-partisan hyperventilating, and gave some thought to making our health care system better. People want lower costs, and they want to feel assured that they won't have to file for bankruptcy if they become seriously ill. If we can agree that those are the really important things, we can start looking around the world for field-tested solutions.

There are two ways to control costs. One is to force hospitals and doctors to compete for patients. This works very well in Costa Rica, Singapore, and other medical-tourist nations; and even here the 'States, at Quest blood labs and the new MRI clinics, and in laser eye and plastic surgery.

The other way is to have government set the salaries of doctors and nurses, and hire only the minimum numbers needed. Equipment, drugs, beds, and all other items are managed at a micro level. There are nations, such as Switzerland, that do this quite well; but Swiss trains run on time and under budget. Everything in Switzerland, from the post office to the DMV, runs like clockwork; and that doesn't happen here. We already have government-run health care, in the form of Medicare, and every year the Medicare Trustees issue lurid warnings of future bankruptcy. Medicare also drives up the cost of everybody else's care, by demanding huge discounts on everything from drugs to doctor visits to major surgery.

So how about if we start by giving free catastrophic care to every American—when the sky begins to fall in, the government pays the bills—and then try to promote competition? This is a nation in which the consumer is king, in ways that seem astonishing to those who've never been exposed to it. Health care is the only industry where consumers are submissive and ignorant of prices and costs. Let's give them the information they need to make comparisons, and also give them an incentive to shop for better prices.

Free catastrophic care—"high deductible" insurance—is not terribly expensive, and the cost will come down if we can drive down prices by unleashing competition. The best model is Singapore, which has universal care that the World Bank says costs just 4.6% of GDP—a lot less than we spend on Medicare and Medicaid alone.

Our average life expectancy is 79; Singapore's is 82, tied for world's highest, and they have the lowest rate of infant mortality.

John Lumbard, CFA

Like Costa Rica, Singapore has a medical-tourism sector that attracts patients from wealthy European countries, and the island nation has also employs Healthcare Savings Accounts and other sophisticated free-market concepts. "No medical service is provided free of charge, regardless of the level of subsidy." Everyone has skin in the game, and this has proven to be a powerful incentive to shop and drive down prices. It's also a powerful disincentive to visit the doctor when you have a bad hair day.

The voters want bipartisan effort, and truth and transparency. Let's give it a try.

– John Lumbard

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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