TABELL'S MARKET LETTER

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February 5, 1982

We devoted this letter three weeks ago to a discussion of recent legislation allowing every American jobholder to place $2,000 in an Individual Retirement Account. The occasion of President Reagan's recent State-of-the-Union message is as good an excuse as any to bring up this subject once again. The President announced that he is standing by the centerpiece of his program, the personal income-tax cut, and much of the debate between him and his critics has centered around whether the deficits which may or may not result from that cut are too high and thus require "revenue enhancements" to bring them down. While our legislators valiantly argue about the advisability of tacking 50¢ onto the price of a bottle of booze, the IRA has gone largely unnoticed --- in the news columns of the press if not in its advertising lineage. This is not without irony since, in our view -- in terms of long-term potential for transferring wealth from the public sector to the private sector -- the IRA dwarfs anything else in the entire administration tax package.

In our prior discussion, we likened the impact of the IRA to that of the various government programs to encourage housing. We think the analogy continues to be apt. Effectively, in terms of the tax advantage provided to owners of their own homes, housing policy encouraged the individual to become a borrower at what had been historically low interest rates. With that policy now foundering on the rock of expensive credit, the government is now using tax policy to encourage saving at currently high interest rates.

Another similarity between the IRA and the housing program is that they are each founded on a simple, but not too widely understood, concept of financial mathematics. In the case of the housing program, that concept was leverage. In the case of the IRA, the concept is compound interest. The dramatic power of compound interest over long periods of time has been illustrated in many ways. One of our favorite illustrations involves the purchase of Manhattan Island from the Indians by the Dutch for a reputed $24. The price is widely held to be unfair, yet had the Indians simply invested that $24 at 6% interest annually compounded, their total wealth would, today, exceed the total value of Manhattan real estate. The power of compound interest has, of course, also been alluded to in those bank advertisements which promise to make millionaires out of those who will cross their threshholds bearing $2000. Let us, however, try to discuss some possible realistic effects of compound interest from the point-of-view of the average IRA saver.

Let us assume that this individual is in the 30% tax bracket and let us further assume an interest rate of 10% (one purposely lower than that available at the moment). Such an individual's after-tax return on savings is 7%, and were said individual to save $2000 today at that 7% rate he would have, in 30 years $15,224. The IRA, however, allows him to compound those savings at the full (assumed) 10% rate. At that rate, the $2000 saved today is in 30 years worth $34,898. The IRA has effectively handed him $19,764.

Now it is true that the IRA is a tax deferral program, and when he starts withdrawing those savings that withdrawal will be taxed, presumably at the same 30% rate. Thus his $34,898 is worth only $24,429 after taxes. However, even allowing for this, a difference of $9,205 remains between what he has been able to save under an IRA and what he could have saved on his own. The present value of that difference (at the 7% after-tax saving rate) can be computed. It is $1,209. To this must be added the $600 tax saving arising from the tax deductability of the original $2000 investment. For the $2000 he invests, the United States is handing this individual $1,809 in present value of foregone current and future government revenue.

The compound interest effect can also be used to gauge the eventual magnitude of wealth which might reside in IRA programs. We assumed three weeks ago an annual infusion of $18 billion annually, a figure based on, roughly, a 10% participation by those eligible. Under this assumption, plus a 10% interest rate, some $315 billion will reside in IRA accounts after a decade. This is, interestingly, just under one-third of the total present U.S. government debt. Totals of this magnitude could accumulate much faster or be even greater given the continuance of present interest levels or a higher participation than the 10% we have assumed.

We noted in our original commentary our feeling that it was appropriate for a letter devoted to the stock market to comment on the IRA legislation. We continue to think this is so because, as the elementary exercise above has tried to suggest, we are dealing here with very large numbers. These very large numbers are, in our view, going to find their way directly or indirectly into financial markets, admittedly over the longer term. Over that long term, however, we think the magnitude of the effect could turn out to be astonishing.

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AWT:rs

Dow-Jones Industrials (12:00 p.m.)	847.03
S & P Composite (12:00 p.m.)	116.58
Cumulative Index (2/4/82)	1077.67