

Central Plains Advisors, Inc.

November 2002

Interim Update

Get Real !!!!

Please note the following hypothetical comparison
of yesterday and tomorrow

	\$10,000 Annual Income			
	<u>Assume</u>	<u>Old Days</u>	<u>Assume</u>	<u>News Days</u>
Nominal Rates	7%	\$ 700.00	3%	\$ 300.00
Inflation/Deflation	2%	\$ (200.00)	-2%	\$ 200.00
Tax Rates (Fed.)	40%	\$ (280.00)	40%	\$ (120.00)
Real After Tax Return	2.2%	\$ 220.00	3.8%	\$ 380.00

The story here is that the American taxpayer is about to enter a prolonged period which might well be characterized as IRS payback time. Inflation bracket creep may soon become deflation bracket abatement. Think of it – tax abatement may come to the whipping boy of the politicians – people who work hard, save, and invest.

If one assumes 2% annual deflation, it could well mean 4% tax-free returns, plus the coupon. As projected by Central Plains Advisors, we expect 3% nominal rates on 30-year government bonds before long. If things grew linearly, but of course they don't, total annual returns after tax would be as follows:

	\$10,000 Annual Total Return			
	<u>Assume</u>	<u>Old Days</u>	<u>Assume</u>	<u>New Days</u>
Nominal Rates	7%	\$ 700.00	3%	\$ 300.00
Inflation/Deflation	2%	\$ (200.00)	-2%	\$ 200.00
Principal Loss/Gain*	2%	\$ (200.00)	-2%	\$ 200.00
Tax Rates (Fed)	40%	\$ (280.00)	40%	\$ (120.00)
Tax Rates (Fed)**	20%	\$ (40.00)	20%	\$ -
Real After Tax Return	-0.2%	\$ (20.00)	5.8%	\$ 580.00

* Annual effect of inflation/deflation on \$10,000 investment

**20% tax on capital gains

In our opinion, this percentage return in the foreseeable future will be quite attractive. Deflation, however, can cause problems, particularly for less than quality debt instruments. As all corporate debt is marching toward junk, the ugly possibility of default is rather great, therefore, we suggest only direct government debt be used. Compare, if you will, the above estimated *real* after tax return with what you are obtaining in other fixed income investments.

If we are correct in our interest rate and deflation projections, as of today a possible taxable capital gain of 60% is possible, which then becomes an after tax 5.8% total annual return. We are not adding the after tax (80% of 60% = 48%) gain in principal from today to “D Day.” That increase would not better the 5.8%, but would give us almost half again more principal to invest. Under this scenario, \$10,000 @ 5.8% becomes \$16,000 @ 5.8%. Thus, today, not only does one have the opportunity to obtain a higher percentage of *real* after tax income but also would have more money to invest at that rate.

Hey, you have the highest quality asset in the world: the best and most liquid market in the world, as well as being able to sleep at night. This assumes you can and will ignore Wall Street’s banter and other inflation mongers. Other debt instruments of lesser quality will not work due to the many one-sided provisions favorable to the issuer in most bond indentures.

Just as we needed to deduct inflation from nominal numbers in days past, we will need to add deflation to nominal numbers in the days ahead. It’s “new math” folks. Many say rates cannot go lower. They’re not; on a *real* after tax basis, they are going higher.

A Final Thought

The recent 50 basis point cut in the Federal funds and discount rate initiated by the Federal Reserve is causing many money market funds to consider closing shop. This, in our opinion, could be a very significant event on the road to much lower long term government interest rates. Why? Many money funds will find that paper they have purchased may not have a buyer, forcing the issuers into the banks, assuming the banks want the business. This will also move those who want some semblance of reasonable income, out on the yield curve. They must stay with government securities however, as defaults are rising day by day.

GET REAL !

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