January, 2018

My Views from Wall St. to Center St.

"Don't tax you, don't tax me, tax that fellow behind the tree"
– Senator Russell Long, Chairman, Senate Finance Committee, 1966-1981

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This past year, Halloween was barely over when House Republicans introduced their version of tax reform. Few observers thought such a massive undertaking could be signed into law within seven short weeks. But that is exactly what happened. In the hectic days that preceded Christmas, the president signed into law the most sweeping change in the tax code since 1986.

"The legislation will result in substantive tax reform for corporations, with the elimination of the corporate alternative minimum tax (AMT) and consolidation down to a single 21% tax rate (from 35%), all of which are permanent, " Michael Kitces, a respected authority on tax issues, wrote on Kitces.com.
"However," he added, "When it comes to individuals, the new legislation is more of a series of cuts and tweaks, which arguably introduce more tax planning complexity for many, and will be subject to another infamous sunset provision after the year 2025."

I know the often-stated goal of tax reform was simplification. But simplification means that much lower tax brackets can only be achieved if cherished deductions and credits are done away with.
It's easier said than done. Sure, simplification is a lofty idea, but, "Don't take my deductions or credits from me," has always been the taxpayers' battle cry. And yes, Congress heard and listened to several of those pleas. While some deductions will disappear, others remain or have been reduced. Senator Long probably would have sported a grin when President Trump signed the massive bill.

Sharpen your pencils — the new tax code and tax planning

Over 80% of Americans will get a tax cut next year, while just 5% of taxpayers are expected to pay more (Tax Policy Center, Washington Post). In most cases, cuts are expected to be modest; however, much will depend on individual circumstances.

Due to the complexities of the new law, I am always happy to talk with you, but I also encourage you to check with your tax advisor. Many experts are struggling with the details of the bill, and that's to be expected this early in the game. What I would like to do is touch on the high points. It's not all-inclusive and not a deep dive, but given many of your questions lately, I believe an overview is in order.

So, let's get started. (Sources for this review include Kitces.com and the Tax Policy Center.) This applies to tax year 2018.

1. The 10% bracket remains unchanged, while the 15% bracket declines to 12%, the 25% to 22%, the 28% to 24%, the 33% to 32%, the 35% holds steady, and the 39.6% slips to 37%. The thresholds are modestly adjusted above the new 22% bracket.

2. The standard deduction nearly doubles to $12,000 for single filers and $24,000 for married filers, reducing the incentive to itemize and simplifying for some taxpayers.

3. The $4,150 personal exemption is eliminated, and the $1,000 child tax credit doubles to $2,000. In general, rules for charitable contributions remain unchanged. By itself, the combination of points one, two, and three will provide modest tax relief for most families. But I must caution, it depends on your individual circumstances.

4. Those in high-tax states could see the biggest hit, as there will be a $10,000 cap on state, local and property tax deductions.

5. For investors, the preferential treatment for long-term capital gains and dividends remains intact, as is generally the case for retirement accounts. One important change — the new law repeals rules that allow for recharacterizations of Roth conversions back into traditional IRAs. Once you convert into a Roth, there's no going back.

6. The 3.8% Medicare surtax on investment income for high-income taxpayers was retained. Since the levy entered the tax code, we have crafted strategies that reduce its bite; however, the tax survived tax reform and is likely to remain a permanent feature of the tax code going forward.

7. The AMT for individuals was not repealed, but exemptions have been widened. According to the Tax Foundation, Congress passed the AMT in 1969 after the Secretary of the Treasury said 155 people with adjusted gross income above $200,000 had paid no federal income tax on their 1967 tax returns. The AMT was never adjusted for inflation and grew into an onerous feature for many Americans. In inflation-adjusted terms, those 1967 incomes would be roughly $1.2 million in today's dollars. Ideally, it would have been eliminated from the tax code. But Kitces points out, "While the AMT commonly impacted those around $150,000 to $600,000 of income, in the future, AMT exposure will be much smaller, and it will be extremely difficult to be impacted at all, especially given more limited deductions."

8. The estate tax survived, but the exemption will double from $5.6 million to $11.2 million, and $11.2 million to $22.4 million for couples.
9. The new tax bill also repeals the Obamacare mandate that requires all individuals to obtain health insurance. It becomes effective 2019. Finally, it's important to point out that many of the more popular changes in the tax code for individuals will sunset in 2025. While many may eventually be made permanent, as we saw with the Bush tax cuts of 2001 and 2003, there's no guarantee this will happen again.
10. And for businesses: Given that the 21% corporate tax rate applies only to C-corps, there will be a 20% deduction for pass-through entities, such as S-corps, partnerships, and LLCs. I believe this will be a welcome benefit for many business owners, but complex rules may limit the pass-through for some entities. I can guarantee you that I am sitting down with my accountant trying to figure out what we can do to reduce my taxes under the new law.

Additional thoughts on the new tax code

I fully expect that the rewrite of the tax code will produce unintended benefits and unexpected consequences. From an economic standpoint, Congress and the president hope to unleash the "animal spirits" that have been lethargic for much of the economic expansion. They hope that changes, especially as they relate to business, will encourage firms to open new plants, expand in the U.S., and level the playing field with the global community. Prior to reform, the U.S. corporate rate was the third highest among 188 nations (Tax Foundation).

The $64 million-dollar question — will it work? About 90% of economists surveyed by the Wall Street Journal expect a modest boost to growth in 2018 and 2019, but after that, opinions diverge. If tax incentives boost productivity, it could lift long-run GDP potential, which would yield a significant benefit. If the economic benefits end after a two-year sugar high, it will likely be deemed a failure.

Early anecdotal data offer some encouragement, as several large firms announced year-end bonuses or wage hikes tied to the lower corporate tax rate. At a minimum, the lower tax rate increases longer-run after-tax earnings, which played a big role in the late-year stock market rally. It could also boost corporate stock buybacks and dividends going forward, which would create an added tailwind for stocks. That said, I'm cautiously optimistic it will encourage entrepreneurship and economic growth, which would benefit hard-working Americans.

Again, I understand that uncertainty breeds questions and concerns. If you would like to talk or have an analysis of how your taxes will be impacted, I'm simply a phone call or an email away. I'd be happy to talk with you and answer any questions you may have.

Happy New Year and a Peek at 2018

I know I sound like a broken record, but as the U.S. market indexes continue to set new records, my "worry Index" goes higher as well. I'm not worried about what I can see, I'm worried about what's around the corner, down the road. While my "worry index" may be flashing yellow, most of the indicators I follow remain green. So core portfolios continue to be in a "risk on" bias and broadly diversified. I quote Benjamin Graham often but it bears repeating again, "Investment management is the management of risk, not the management of return."

I have been in the wealth management field for almost 30 years and trying to predict markets is about as reliable as a 15-day weather forecast. But, here goes.....

I believe 2018 will be a positive year in the U.S. and global markets. That might not seem like such a bold prediction considering as of this writing, 1/29/18, the market is already up almost 7.5% (S&P 500). I do believe that 2018 will be a much "bumpier ride" than 2017, which really was an anomaly with almost no downward movement and 12 consecutive months of positive returns – 1st time that has ever happened. Things tend to revert to the mean and this year will require more conviction in our beliefs and investment process. Let me be clear, however, I do not believe we will experience a recession in 2018 (U.S. or global). The economic picture is strong ("green lights"). So, when we experience these bumps, I believe for now, they will be temporary and the upward bias of stocks will continue. Of course, all bets are off if there is a geopolitical "event" somewhere in the world.

Performance Dashboard for month ending December, 2017

SUMMARY STATISTICS	1 MTH	YTD	1 YR	5 YR (Annlzd)	10 YR (Annlzd)
Core Multi-Asset	1.6%	13.8%	13.8%	5.9%	4.4%
1 US Large Cap	1.1%	21.8%	21.8%	15.8%	8.5%
2 US Mid Cap	0.2%	16.2%	16.2%	15.0%	10.0%
3 US Small Cap	-0.5%	13.2%	13.2%	16.0%	10.4%
4 Intl Developed	2.0%	26.7%	26.7%	8.6%	3.0%
5 Emerging Mkts.	3.8%	35.6%	35.6%	5.3%	2.3%
6 Global REITs	1.2%	8.6%	8.6%	8.1%	5.3%
7 Natural Resources	5.7%	22.7%	22.7%	2.5%	-0.4%
8 Commodities	3.0%	1.7%	1.7%	-8.5%	-6.8%
9 US Bonds	0.5%	3.5%	3.5%	2.1%	4.0%
10 US TIPS	0.8%	3.0%	3.0%	0.1%	3.4%
11 Intl Bonds	0.3%	11.3%	11.3%	0.4%	2.5%
12 Cash	0.1%	0.8%	0.8%	0.2%	0.3%

Source: S&P Dow Jones Indices

Themes and Core Portfolio Construction

The basics of our core portfolio are that it can thrive and survive all 4 seasons. It is broadly diversified with 7 asset classes – US Stocks, International Stocks, Real Estate, Natural Resources, U.S. Bonds, International Bonds, and Cash. Diversification manages risk and these assets will behave differently from one another. In other words, they will not all go down at the same time, but conversely they will not all go up at the same time either. They will however, "smooth the ride" and get you to your financial destination more safely than owning just one or two asset classes. The wealth management process is "managing risk, not managing return".

I will be making some core portfolio "tweaks" over the next several weeks to reflect what I believe will be some "themes" for 2018:

- International & Emerging Market Stocks are more attractive than U.S. Stocks (a slight overweight in core since 9/17)
- Commodities and Natural Resources are attractive due to synchronized global growth
- Global Infrastructure Investments are attractive – (added to core 9/17) due to the government trying to implement infrastructure improvement projects
- U.S. Mid and Small Cap Stocks are more attractive than Large Cap Stocks
- International Bonds and alternative assets are more attractive than U.S. Bonds

I hope you've found this review to be educational and helpful. Let me emphasize again that it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call. Once again, before making any decisions that may impact your taxes, please consult with your tax advisor.

Personal Note ~

Januarys are an eventful month for everyone I suppose. We close the book on the previous year and set our sights on the New Year. For many of you, myself included, we set out to execute our "resolutions" to improve our "future self." Good luck to you all in achieving your goals!

This January also brought great sadness to our family. On January 18th my mother-in-law, Suzanne Berry passed away after a 17 year battle with Parkinson's. Parkinson's is an insidious disease that eats away at your physical body a little at a time, day after day, year after year. Suzanne handled her fight with the disease with the same determination, elegance, poise, and humor that she displayed during her "healthy life." Suzanne was the best mother-in-law any husband could hope to have. She was supportive and never "meddled" in our lives. We joke, although it's true, that Suzanne did not initially approve of me, but over the years she became one of my biggest allies. She trusted me to marry her daughter, raise 3 of her grandchildren (she had 9), manage her financial affairs, and make critical medical decisions regarding Jennifer when she was undergoing cancer treatment at Duke. As a parent with adult aged children, I know that trust does not come easy. I will do my best to continue to honor that trust. So I ask everyone reading this to raise a glass and toast and/or say a prayer in tribute to Suzanne Berry. You will be missed by your family and friends. Goodbye.

As always, I'm honored and humbled that you have given me the opportunity to serve as your financial advisor and now that 2018 gets underway, I want to wish you and your loved ones a Happy and Prosperous New Year!

Jeff

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