# The Advisor

QUARTERLY NEWSLETTER

**2020 Q4 REVIEW:**


- General Market Commentary
- Financial Planning



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GENERAL MARKET COMMENTARY

## 2020 – What a Year! It has been a trying year for everyone. As we enter 2021, the world continues to grapple with containing the effects of COVID-19.

Restaurants, small businesses, service sector workers, and others still are struggling and over 10 million Americans remain unemployed. But there are factors and events taking place to give people a reason to be hopeful. Vaccines are being rolled out around the world. There is optimism that the U.S. and world economy will improve to some degree. The election is over with a new administration coming into office.

Interest rates remain low. The housing market is robust and people are purchasing cars and trucks. Manufacturing activity is improving and the farm economy is strong. Electric vehicles, autonomous driving vehicles, battery technology, and green energy are an exciting and growing future trend. The savings rate is at an all-time high and credit card debt is declining. People are trying to shop local, supporting small businesses, tipping generously, and helping less fortunate individuals. There are now more entrepreneurs starting small businesses than a year ago.

The stock market appreciated significantly in November and December with all three averages ending the year at record highs. Who would have ever thought this could happen back in mid to late March, 2020? It just reinforces the importance of being fully invested at all times.

### OUTLOOK

Overall, the outlook for business conditions and earnings growth is encouraging. Q2 saw earnings affected due to companies making adjustments for employee safety, technology spending, and shoring up finances. The business environment improved towards the end of the third quarter. In listening to Q3 earnings conference calls, one could detect a sense of cautious optimism from management teams going into the fourth quarter and looking into 2021.

The stock market responded to this positive tone by appreciating throughout the remainder of the year. The breadth of the market advance was quite encouraging. Value stocks such as manufacturing, material, bank, and energy as well as commodities all performed well. Small and mid-cap stocks had a strong quarter as well.

The fourth quarter saw a noticeable increase in the amount of stock buybacks being reinstated and announcements of dividends being raised. There were several double digit increases from companies such as AbbVie Inc., Abbott Laboratories, Motorola Solutions, Zoetis Inc., and others. This trend portends well for 2021. We suspect after a year of softness and dividend cuts in 2020, dividend increases could be exciting and

beneficial to shareholders as earnings growth improves. Prior to year end, the Federal Reserve allowed member banks to resume stock buybacks and increase dividends within limited parameters. Of course, this will be very helpful to investors as interest rates are likely to remain at low levels for another year.

The near-zero interest rate environment continues to create challenges as our goal for our clients is to see an increase in the annual cash flow generated by their portfolio. Cash flow is the "life blood" of financial planning, your future financial security, and is integral to successful portfolio management. This is the reason you want it to be increasing and compounding as your portfolio and overall net worth grows.

Cash flow gives investors choices and flexibility in planning for individual needs. It aids in portfolio stability and can reduce stress levels in rapidly declining or frustrating markets. Investors of all ages who aren't withdrawing money from their accounts can reinvest the cash and take advantage of attractive investment opportunities, thereby compounding future returns. And finally, it enables retired investors to keep up with inflation or to refrain from selling as much of their principal to meet annual distribution needs.

When you receive your December 2020 Charles Schwab statement, either electronically or via paper, we encourage you to compare your total cash flow in 2020 with that shown in your December 2019 statement. Most clients will see this information presented on page 5 of the statement under Year to Date, Total Income. We believe that you will see a small increase in 2020 vs. 2019 even with the low level of interest rates.

#### LOOKING FORWARD

In 2021, we will look forward to larger percentage increases. For fixed income allocations, we continue to use a bond ladder typically stretching out for 3 years. We also have been selectively adding 25 - 33% of the maturing bond proceeds to selective equities and rolling over the remainder into a new bond. Our goal is to effectively increase the total income on the entire matured proceeds helping to stabilize or increase one's cash flow for the upcoming year.

Investments that we have been making in coordination with bond maturities to offset lower interest rates include companies such as Johnson & Johnson (JNJ), Nestle S.A., 3M Company, and others. These companies are all very attractive for long-term investors looking for stability, growth, and consistent income. JNJ, a high quality, well-managed company pays a 2.6% dividend yield and will benefit as more elective or non-time sensitive procedures are completed after a decline due to COVID- 19. They have raised their dividend consistently for over 60 years. Also, their one dose vaccine may be approved in January and ready for distribution in February.

Nestle S.A., the world's largest food company, has created value for shareholders consistently for many years. They are socially conscious, environmentally friendly, and have a well-diversified work force. Along with long-term growth potential they pay investors a 2.35% dividend. 3M Company, a world-wide diversified manufacturer, provides products for public safety (PPE and face coverings), transportation, housing, healthcare, and the manufacture of electronic products. Similar to JNJ, they too have raised their dividend for over 60 years. Management has done a great job in creating shareholder value and currently pays a 3.38% dividend.

We can't predict what will happen in 2021 to the markets or to the economy. What we do know from 2020 is that the U.S. economy remains strong and resilient. But in order to remain strong, the most important goal is to provide future hope and encouragement to all individuals by stabilizing COVID-19, opening businesses, and getting people back to work. There is plenty of money in bank accounts ready to be spent. Once business restrictions are eased and people are returning to work earning a steady paycheck, we expect demand for goods and services, including travel, shopping, and entertainment, to be robust.

We are watchful of some current indicators that suggest the potential for future inflation. Commodity prices across the board have been increasing. You may have seen food costs and lumber prices climbing. The dollar has declined against other major currencies and will likely remain weak for the foreseeable future. With pent-up demand for goods and services and massive stimulus programs passed by Congress, higher interest rates and inflation could emerge.

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FINANCIAL PLANNING

## After the presidential election, clients contacted us asking what actions, if any, they should take due to potential tax law changes the incoming Biden administration may implement.

Our response then was—and still is—no changes should be made right now. Why? Remember it takes a long time for a new administration to enact major tax law changes. The likelihood of significant tax law changes prior to 2022 is small. Could there be minor changes that both parties agree on? Yes. But it is not worth doing wholesale changes in your portfolio today until the provisions of the new law are known. Once known, then you can determine the potential effect on your cash flow, savings, and investment portfolio and make adjustments accordingly. In the meantime, there are many small things that a taxpayer can do to create an effective tax planning strategy that over time will minimize taxes and compound into a more secure financial future.

### CLIENT CONCERNS

Below we will review these options and discuss some of the concerns raised by clients.

The biggest concern on clients' minds is the potential of an increase in the capital gains tax rate. Keep in mind that the Biden campaign proposal was to tax capital gains and dividends as ordinary income for people with taxable income above $1 million. However, changing the capital gains tax rate significantly at any income level is difficult. Capital gains facilitate economic activity by spurring investments. This is why, historically, Congress has tried to keep the rate on long-term capital gains (usually considered as assets held longer than 1 year) low. Today's long-term rate of a maximum 20% compares to an effective tax rate of 28% during the Carter and Reagan administrations. Thus, the likelihood of it going above 28% at any income level is slim. In any case, it is not worth being concerned at this time. We will be paying attention to the political winds throughout 2021 and keep you advised.

Another post-election question was: should I consider a Roth conversion of existing retirement assets to avoid potentially higher future income taxes rates? Here there is no simple or easy right or wrong answer because we need to look at what is appropriate for you after considering many issues. Included in this analysis are quantitative issues such as your current and expected future tax bracket, your current age and income needs, the total value of your retirement accounts, the possibility of Medicare Part B and D surcharges (called IRMAA) being triggered as well as other income tax surcharges such as the net investment tax as income levels increase. There are also qualitative issues such as income needed for retirement, your general health, your remaining life expectancy, and the ages and future needs of the designated beneficiaries. Also, if savings are not available to pay the tax at conversion and have to be withheld from the converted amount, the conversion then becomes much less attractive.

In lieu of a Roth conversion, we encourage clients of all ages to consider contributing to a Roth IRA assuming you are under the income limits. In 2021, the Roth IRA income limit to qualify for a full Roth IRA contribution is $125,000 of modified adjusted gross income for single filers and $198,000 for joint filers. If you qualify, the maximum contribution is $6,000 (or $7,000 if you are over 50). If your income is above these levels, there is a phase-out of the amount you can contribute.

If your company offers a 401(k) Roth option and your income is above the levels mentioned above, you might want to consider making contributions. Under a 401(k) Roth option, contributions up to $19,500 of income ($26,000 if 50 or over) can be made. Over time this, plan yields excellent long-term tax-free benefits when millennial and mid-career workers retire.

Another item to consider is to inquire if your company's 401(k) plan allows for after-tax contributions once your yearly maximum contribution is met. If so, the after-tax contribution can be converted into a Roth IRA. It is most beneficial if this conversion is done immediately after the contribution is made. This process is called "back-door funding of a Roth IRA" and we have written about it in previous newsletters.

As more people work after terminating full time employment, they are able to make deductible contributions to traditional IRAs at any age if they have taxable earned income. However, once they are age 72 and older, required distributions will be mandatory. Conversely, Roth contributions have always been allowed, regardless of age, again based on having taxable earned income. However, unlike the traditional IRA, no annual minimum distribution is required. This is a great planning vehicle to save for expenses later in life or to pass on tax free money to future generations.

The pandemic has created many new entrepreneurs that currently are earning self-employment income. These entrepreneurs are eligible to open an i401(k) Plan—a self-employed retirement plan that is simple and easy to establish. The beauty is that up to $19,500 of income ($26,000 if 50 or over) can be contributed to this tax deductible account. There is even a profit sharing component to the i401(k) to add an even greater sum. Even small amounts contributed by the new or young entrepreneur is an attractive financial planning strategy. The account needs to be established prior to year end. But the

contributions can be made right up until the day you file your income taxes, including extensions. It is a tremendous tax savings vehicle and very beneficial for future financial security.

#### OTHER TAX SAVING STRATEGIES

An often misunderstood and underutilized tax savings vehicle is the Health Savings Account. This is an account where one can contribute pre-tax dollars to pay current or future medical expenses provided that you are covered by a high deductible medical insurance plan. It is possible to invest these contributions and have them grow tax deferred. This is similar to having another IRA or 401(k) account. Funds withdrawn to pay for qualified medical expenses come out tax free. The benefit is that you can let the account compound and appreciate and still reimburse yourself for the medical expense incurred in the future. If you have a high deductible medical insurance plan and your budget allows, consider opening an account.

Another tax savings that we regularly see being overlooked are contributions to a College Savings Plan, commonly known as a 529 Plan. In a number of states, including Illinois, the contributions that you make are tax deductible on your state income tax return up to certain limits. This is true even if you are the grandparent making a contribution to your grandchild's 529 Plan. Most people, even parents funding the account on a regular basis, forget about deducting their contributions, causing them to lose valuable tax savings over time. In Illinois with a 4.95% tax rate, every $1,000 contribution made by an Illinois taxpayer saves that person $49.50. The Illinois maximum contribution limit for tax deductibility is $10,000 for a single filer and $20,000 for married filing jointly resulting in a significant tax savings of up to $500 or $1,000. In any case, keep good records and don't forget to deduct the contribution amount if allowed by your respective state.

Last, don't overlook the tax advantages of holding a portfolio of stocks that pay dividends. Until 2004 corporate stock dividend income was taxed as ordinary income at rates similar to wage income. Beginning in 2004, the dividend tax rate was lowered to 15% at the federal level where it remains today (higher for incomes about $250,000). Interest is still taxed at ordinary tax rates. A simple example can show you the benefits. Let's say I own stock in Pfizer, a popular security today, with a 4.2% dividend yield as this is being written. If this security is held in a non-IRA where I pay a 15% tax rate, the net return to me will be 3.6%. If there are state income taxes, the net return will be slightly less. But, one can see the benefits particularly for a millennial or mid-career saver with many years ahead of them to save and invest. By putting a priority on investing for dividend income and growth, not only is the tax cost small but you will be creating a future portfolio that will help you achieve financial security.

There are numerous other tax savings strategies available that will likely maintain their tax advantages even if the tax law changes. These include the gifting of appreciated property to charity or the establishment and funding of a Donor Advised Fund, an increasingly popular and low cost way to benefit charities and save income taxes, too.

We have found over the years that in tax planning the people who effectively manage their annual tax liability take advantage of some of the perfectly legal strategies mentioned above. Remember, the tax collector benefits when taxpayers borrow to buy things and accumulate debt. The more money that is spent and more debt that is accumulated the fewer dollars available to make tax advantaged investments. The fewer tax advantaged investments made, the more federal and state taxes are then paid.

In any case, we will always be looking for value in the financial markets. We will stay abreast of potential tax law changes and its effects on your overall financial planning. And as always, we will continue to provide you with information and advice. Don't hesitate to contact us with any questions.

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**NEWSLETTER DISCLOSURES:**

1. This newsletter may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.

2. Past performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor.

3. Inclusion of index information is not intended to suggest that its performance is equivalent or similar to that of the historical investments whose returns are presented or that investment with our firm is an absolute alternative to investments in the index (if such investment were possible). Investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance.