CLIFFORD SWAN

THE Investment Counselor

NOVEMBER 2020

WISDOM *for* GENERATIONS

PUTTING 2020 BEHIND US AND LOOKING TOWARDS 2021

By Randall L. Zaharia
CFA, CAIA®

We can all agree that 2020 has been anything but an ordinary year. In March, the U.S. and much of the world went into lockdown due to the escalation of COVID cases, hospitalizations, and, unfortunately, deaths. Consumer and business spending plummeted, and economic growth dramatically declined by 20% during the first half of the year. In response, the federal government injected over $3 trillion to support our strained economy, and the Federal Reserve bought over $3 trillion in bonds (U.S. Treasury and agency, municipal, and corporate) to calm and bolster the stability of the financial markets. The magnitude of these interventions was unprecedented in U.S. history.

In the midst of the pandemic, 2020 has also been defined by a contentious election year. While we hoped to author an article that carefully covered our perceptions of the outcome on our clients and work, at this moment in time, much remains unknown. As we write this on November 10, 2020, former Vice President Biden is the President-Elect (awaiting official certification by the Electoral College in December). It appears we will have a Republican Senate, although this result is pending Georgia Senator runoff elections in January. The expectation of a divided government will likely result in a degree of legislative stalemate – a status quo, if you will. The lessened likelihood of changes to federal laws, especially tax law, has seemingly boosted the equity markets. However, should the outcome of the elections result in a blue sweep, the resulting increased ability to implement broad tax changes may have consequential impacts on many high net worth households and estates, as discussed in our September article, *Are Tax Increases on the Horizon?* We also are waiting for more direction from the anticipated administration on spending priorities and the agenda for re-regulation.

Moreover, we find ourselves potentially closer to an inflection point in the battle against COVID. Recent announcements by Pfizer and Moderna of promising late-stage drug trials have the potential to be a game changer with respect to our economic recovery.

Clearly, there is much to learn and digest over the coming days and weeks in relation to our nation's political agenda, the course of the virus and recovery, and how that all translates into our client work. However, please see our most current thinking below as to where 2021 may take us.

U.S. ECONOMY

Looking ahead, we expect a modest 1-2% GDP growth rate into 2021. We note a surprising bounce back in the U.S. economy during the third quarter of this year, with growth up at an annualized rate of nearly 32%. This helps offset some of the overall economic deterioration from the first half of 2020, although estimates of GDP growth for the whole of 2020 range from -2% to -4%. Our GDP estimates for 2021 are within a wide range of estimates we see in the marketplace (which span from 1% to 4%). This range underscores the uncertain economic environment predicted by many. As a result, corporate earnings estimates are highly undefined for 2021 as well. And, of course, much will hinge on the potential rollout of a COVID vaccine or a change in the course of the pandemic, as well as additional federal government stimulus.

> "...much will hinge on the potential rollout of a COVID vaccine or a change in the course of the pandemic, as well as additional federal government stimulus."

Our growth estimates account for a federal deficit that continues to grow. As of November 10, 2020, the estimated U.S. debt is $27.2 trillion. Given an anticipated annual deficit of over $1 trillion for Fiscal Year 2021 (8% of GDP), our national debt could cross the $30 trillion line within two years. One of the potential impacts from the increasing debt level is a slowing of overall economic

PUTTING 2020 BEHIND US | Continued on page 2

growth. Nonetheless, with modest productivity growth and an increase in population, we believe growth estimates are reasonable at 1%+ (especially in the longer term). As a result, company earnings in 2021 should also be modest.

STOCK MARKET RESILIENCE AND FRAGMENTATION

Recent positive news about a possible COVID-19 vaccine has added to the upbeat mood on Wall Street. The S&P 500 Index is up over 8% in the first 10 days of November, and up over 11% year-to-date. This performance was notable, given the huge drop in the markets in March. The path this year has been volatile, with markets down over 20% at some points in March and April. Uncertainty and volatility will be the words that mark 2020 in financial market history.

The most pronounced trend in the stock market this year has been the significant outperformance of popular, higher valuation technology stocks, especially the S&P 500's five largest companies, which are referred to as the "S&P 5." In particular, the companies displaying lower valuations (e.g., low price-to-earnings, low price-to-book value, highest dividend yields) have materially underperformed the most popular companies. For 2020, the S&P 5 stocks, which are approaching 25% of S&P 500 market capitalization, have increased in value approximately 45% versus a much lower 2% for the rest of the index through mid-November. This has truly been a bifurcated market—a market of two stories and two trends.

> "This has truly been a bifurcated market—a market of two stories and two trends."

We last experienced such a dramatic market split during the dot-com bubble of 1998-2000. One possible reason for this divergence is the increasing participation of retail investors (e.g., individuals, day-traders) in the stock market. Less sophisticated investors tend to be trend followers (momentum investing) and focus investment in the most popular companies and those that are performing the best most recently. Eventually, the most popular stocks become completely divorced from their fundamental business values, creating a bubble in that segment of the market. We expect professional investors will seek to take advantage of the mispricing in the market and rotate out of the higher valued companies and into businesses that are more appropriately valued. There has been some evidence of this rotation taking place more recently.

LOW INTEREST RATES AND THE LIMITED FIXED INCOME OPPORTUNITY SET

Looking to interest rates, guidance from the Federal Reserve indicates that rates are expected to stay low for at least 24 to 36 months, at least on the short end of the U.S. Treasury curve. Yields on U.S. Treasury securities two years and shorter are at or below 0.20% (basically 0%). In early January, two-year U.S. Treasury notes yielded over 1.5%, resulting in a decline of over 1.3% to current levels. In comparison, the yield on ten-year U.S. Treasury notes, which are less under the control of the Federal Reserve, was as low at 0.50% during the year, and is currently around 0.90%. From March to June, when the markets were very unsettled and disorderly, rates on corporate and municipal bonds increased and spreads to U.S. Treasury securities widened substantially. However, all those yields collapsed during the summer, and most spreads to U.S. Treasury securities shrunk also. Today, municipal bond yields, both tax exempt and taxable, are below 1% out to five years. In this kind of environment, we tend to invest in short maturities for new bond purchases and do not take the risk of longer securities unless the investor is sufficiently compensated for the risk. Unfortunately, with such low yields, opportunities are limited, and fixed income securities serve primarily as portfolio stabilizers with very modest income produced.

Given the growing amount of U.S. debt issuance and potential weakness in the U.S. dollar, one of our long-term concerns is the resurgence of inflation. The Federal Reserve has already indicated that it could tolerate inflation rates above 2% for a much longer period, as compared to the below 2% levels of inflation of the last 10 years. Would the Fed tolerate inflation levels of 3%? 4%? There are arguments for and against the likelihood of higher inflation. At Clifford Swan, we anticipate a higher inflation rate going forward, although the materialization of high inflation could be two to four years away. If a weakening of the U.S. dollar emerges, inflation could see a significant jump as imports escalate in price.

> "...with such low yields, opportunities are limited, and fixed income securities serve primarily as portfolio stabilizers with very modest income produced."

The environment we have described on the horizon for 2021 is largely one of rotation. We believe that in this environment our general focus on companies in growing markets, which includes growing revenues, cash flows, and earnings, should perform quite well. Our bottom-up, fundamental analysis allows us to identify good businesses at reasonable prices under varied economic conditions. We don't chase stocks or look for the hottest tech stocks. Our priority is wealth preservation, which we believe is best achieved by owning high quality, predictable businesses. ◆

GOODBYE TO THE STRETCH-IRA AND HELLO TO TESTAMENTARY CHARITABLE GIFT ANNUITIES AND TESTAMENTARY CHARITABLE REMAINDER TRUSTS

By Kenneth H. Dike
Esq., CPA, CLPF

The *Setting Every Community Up for Retirement Enhancement Act* (SECURE Act) that went into effect at the beginning of 2020 aims to expand, preserve, and encourage retirement savings[1]. One of the many provisions in this act is the elimination of the "stretch-IRA" whereby an IRA owner would make a member of a future generation, such as a child or grandchild, their IRA beneficiary who could then withdraw the IRA funds over their much longer expected lifetime. The resulting inherited IRA funds could be "stretched" for decades after the death of the original IRA owner. Stretching out the IRA withdrawals allowed the assets more time to grow tax-free and then be taxed at a possibly lower rate when withdrawn by the much younger beneficiary.

SECURE ACT ELIGIBLE DESIGNATED BENEFICIARY

As in the past, the SECURE Act bases the annual required minimum distribution (RMD) on the life expectancy of the following "eligible" designated beneficiaries:

- Surviving spouse of the deceased owner,
- Minor child of the deceased owner,
- Disabled person,
- Chronically ill person, and a
- Person that is not more than ten years younger than the deceased owner.

SECURE ACT 10-YEAR RULE

Following the death of an "eligible" designated beneficiary, or when the minor child of the deceased owner reaches the age of majority, the IRA assets must be withdrawn within ten years. All "non-eligible" designated beneficiaries must withdraw the inherited IRA funds within ten years from the death of the original IRA owner. When subject to this *10-year rule*, there is no longer an annual RMD; all remaining IRA assets could be withdrawn in the tenth year.

DEFERRED GIFTS FUNDED BY IRA TESTAMENTARY DIRECT TRANSFERS

IRA owners with a charitable intent who wish to stretch their IRA funds beyond ten years after their death have found a solution that utilizes deferred giving strategies such as a *testamentary charitable gift annuity* and a *testamentary charitable remainder trust*. Multiple IRS Private Letter Rulings have indicated that a direct transfer from an IRA upon the death of the owner to a charitable remainder trust would not result in the recognition of ordinary income by the decedent's estate. The same is true for an IRA testamentary transfer to fund a gift annuity where, in addition to the non-recognition of income by the owner's estate, the charity would not recognize unrelated business taxable income because of the transfer.

> "IRA owners with a charitable intent who wish to stretch their IRA funds beyond ten years after their death have found a solution that utilizes deferred giving strategies..."

TESTAMENTARY CHARITABLE GIFT ANNUITY

A *charitable gift annuity* is an arrangement whereby assets are given to a charity in return for the charity's promise to make payments of a fixed amount to the beneficiary designated by the donor. An IRA owner can designate a charity as their beneficiary in exchange for the charity's promise to issue an annuity to a person selected by the IRA owner. The IRA owner would enter into a gift annuity agreement with the issuing charity that would not be effective until and unless the IRA assets remaining at the owner's death are actually transferred to the charity. It is important to include a provision in the agreement that the amount paid to the annuitant will be determined when the IRA testamentary transfer occurs since there are payout-based "gift annuity qualification" tests that change over time and must be met when the gift annuity is funded.

The payout from a gift annuity could begin immediately, or may be deferred, and continues for the remaining life of the annuitant. Under a *Deferred Gift Annuity*, an annuitant receives payments that begin more than one year after the death of the IRA owner. A *Flexible Deferred Gift Annuity* leaves the determination of the beginning date to the annuitant who may delay their "start-date" decision for several years. The amount paid each year increases the longer an annuitant waits to begin receiving the payments.

GOODBYE TO THE STRETCH-IRA |
Continued on page 4

GOODBYE TO THE STRETCH-IRA |
Continued from page 3

Since the IRA assets transferred to fund a *charitable gift annuity* have a zero tax basis (IRA owner never paid tax on these funds) it follows that all of the annuity payments will be characterized as ordinary income to the annuitant.

TESTAMENTARY CHARITABLE REMAINDER TRUST

An IRA owner can designate a *charitable remainder trust* (CRT) as the beneficiary of their IRA. A CRT makes periodic beneficiary distributions to a non-charitable beneficiary, and whatever remains in the trust upon its termination goes to charity. The beneficiary payments can be fixed in amount, as in a charitable remainder *annuity* trust, or vary each year based on the trust's market value, as in a charitable remainder *unitrust*.

A *standard unitrust* makes periodic payments to an income beneficiary based on a percentage (*payout rate*) of the trust's value determined each year. A *net income unitrust* is an arrangement where the amount distributed to the beneficiaries is the lessor of (1) the *payout rate* applied to the trust's assets (*percent limitation*), and (2) the *distributable trust income*. A *flip unitrust* is an arrangement that begins as a *net income unitrust* then converts (flips) to a *standard unitrust* at a pre-determined date or upon the happening of an event such as the sale of unmarketable/illiquid trust assets.

Unlike the receipt of IRA funds which are characterized as ordinary income by the recipient, the type and amount of income reportable on the beneficiary's personal tax return from the receipt of charitable remainder trust distributions are based on the amount and type of income earned by the trust investments.

As an example, assuming net investment returns of 5% for both the post-death IRA investments and a standard unitrust with a 6% payout to a beneficiary age 55, the 10-year IRA payout would total about $323k compared to the estimated 33-year[2] unitrust payout of $414k. Unlike the IRA payout, all of which is taxed as ordinary income to the beneficiary, the unitrust payout would only be characterized as ordinary income to the extent that ordinary income was received by the unitrust investments. Assuming that interest and dividends comprise 1/3 of the unitrust net return, 2/3 of the unitrust payout would be characterized as realized gains or nontaxable return of principal. Additionally, at the end of the projected 33-year unitrust term about $171k would remain for charity. Lastly, the present value of the unitrust income interest, which is a "gift" to a non-spouse, would be about $185k.

> "Unlike the IRA payout, all of which is taxed as ordinary income to the beneficiary, the unitrust payout would only be characterized as ordinary income to the extent that ordinary income was received by the unitrust investments."

GIFT TAX AND GENERATION SKIPPING TRANSFER TAX

There may be gift tax implications when an IRA owner designates someone other than their spouse as the income beneficiary of a *gift annuity* or *charitable reminder trust*. Generation skipping transfer tax may apply when the income beneficiary is two or more generations below the IRA owner, such as a grandchild or great-grandchild. The amount "gifted" is the present value of the future beneficiary payments. Due to the unusually high exemption of $11.58 million (2020), these taxes are rarely an issue.

We encourage you to speak with us if using a testamentary charitable trust or testamentary charitable gift annuity in lieu of a stretch-IRA is of interest to you. Additionally, a long-form version of this article which explores this topic in greater detail is available. ◆

1 The provisions of the SECURE Act apply to IRA owners who die after 2019.
2 Average of male and female life expectancies of a person aged 55.

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
George E. Hasbun, CFP®
Anil Kapoor, CFA
Gretchen E. Lee
David Y. Lin, CFA
Jennifer I. Maqueda
Daniel J. Mintz
Maxwell R. Pray, CFA
Erica S. White, CFA, CIC
Carlota B. Venegas , CFP®, CDFA®
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

OFFICES
Pasadena
177 E. Colorado Blvd., Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

cliffordswan.com

Both this and past editions of *The Investment Counselor* are available on our website.

WISDOM *for* GENERATIONS