CLIFFORD SWAN
THE Investment Counselor
DECEMBER 2021
WISDOM *for* GENERATIONS

SEARCHING FOR OPPORTUNITY

By Anil Kapoor
CFA

As we approach year-end, it's natural to reflect on the investment year that was and, more importantly, consider where to find investment opportunities going forward. Given domestic stocks have performed exceptionally in 2021, investors are increasingly interested in the outlook for equity returns globally.

Stocks have come a long way since the depths of the Covid pandemic, particularly within the universe of the largest domestic companies. The chart below shows 2021 performance of various categories of stocks through November. U.S. large-capitalization stocks are firmly in the lead, with U.S. small-capitalization and international companies lagging. Given U.S. Large Cap is the core component of the equity portfolios Clifford Swan manages, our clients have benefitted handsomely. While we continue to see attractive investment candidates in this space, other asset classes are looking increasingly compelling.

So how did the U.S. Large Cap cohort gain such popularity, and thus experience such strong gains? A combination of strong fundamental business characteristics and a favorable macroeconomic environment drove extraordinary profits.

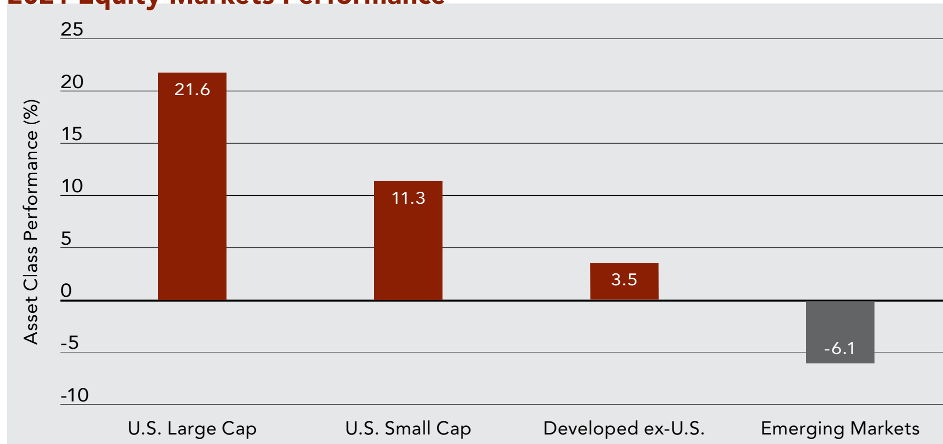
The five largest stocks that comprise the S&P 500 Index are all technology related—Apple, Microsoft, Meta (formerly Facebook), Alphabet (Google), and Amazon—and combined they are worth almost $10 trillion. These mega cap technology firms profited extraordinarily from Covid. Demand for their products increased dramatically as individuals used their products daily, both personally and professionally, when the world went on lockdown. This macroeconomic-driven scenario resulted in stronger business fundamentals and valuation expansion. The high levels of revenue growth and profits commanded increased investor interest and subsequently led to price-to-earnings (P/E) multiples (a measure of valuation) rising.

Beyond the demand boost Covid provided these mega companies, the Federal Reserve took extraordinary measures to prop up the economy during the pandemic, giving even more of a lift to corporate America. The Fed engaged in fiscal easing measures unseen in history, ballooning the size of their balance sheet to almost $8 trillion. By comparison, the Fed's balance sheet was only around $2 trillion a decade ago —which was already elevated after the financial crisis of 2007-2008. One of the results of this 4x increase in the Fed's balance sheet has been excess liquidity in the economy, and this cash found a natural home in U.S. Large Cap investment, particularly blue-chip technology stocks which dominate the indexes. On top of this,

"Beyond the demand boost Covid provided these mega companies, the Federal Reserve took extraordinary measures to prop up the economy during the pandemic, giving even more of a lift to corporate America."

SEARCHING FOR OPPORTUNITY |
Continued on page 2

2021 Equity Markets Performance



Source: Bloomberg as of 11/30/2021

Continued from page 1

interest rates have remained extremely low during this timeframe. This scenario of "lower for longer" has exaggerated the upward move in stocks. The Fed recently committed to moderating their interventions, and this tapering process could make markets more volatile. Finally, fiscal support in the form of government stimulus checks has led to even more speculation within supposedly "safe" large-capitalized U.S. equities.

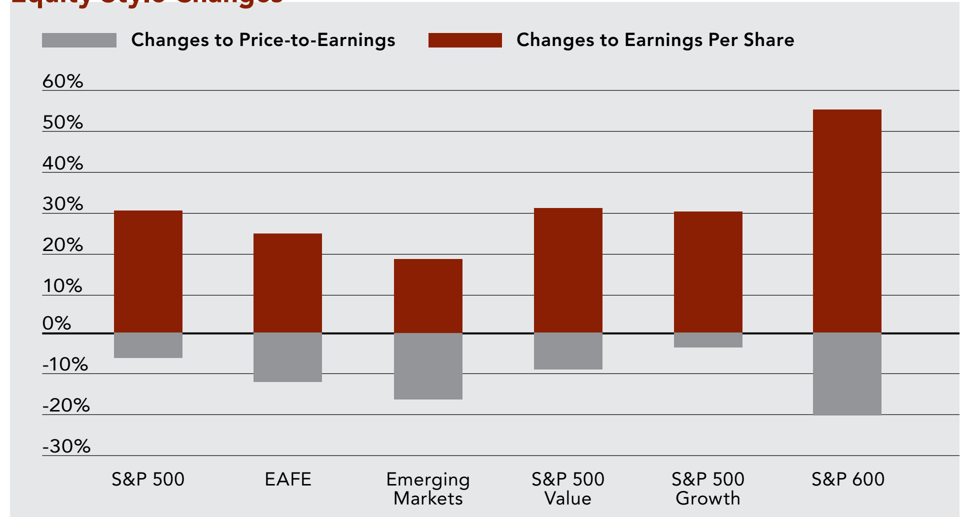
Given this backdrop, we believe there could be a potential shift in the marketplace. As we emerge from Covid, new market leadership may take hold. Different economic sectors or asset classes often revert to long-run mean (average) price levels after extended periods of

> "As we emerge from Covid, new market leadership may take hold."

under or overperformance. The reason for this is simple; conditions have been so perfect for so long that eventually some of the businesses that have struggled in the current environment begin to get better as well. For example, the travel and energy industries struggled during the pandemic and will likely start to return to normalcy as we emerge.

So which asset classes might provide compelling investment opportunities going forward? While we expect many large-capitalization stocks to continue to grow, we believe that international and small-capitalization stocks may play catchup to their U.S. Large Cap counterparts. Valuations in those areas are reasonable on a relative basis and, more importantly, they are expected to exhibit higher earnings growth. In the chart above, year-to-date performance is broken down into earnings growth and changes in P/E. U.S. Small Cap is represented by the S&P 600 Index, and International by the EAFE Index (Europe, Australasia,

Equity Style Changes



Source: State Street Global Advisors, FactSet as of 10/29/2021.

Far East) and Emerging Markets. Significant earnings growth is expected for the small-capitalization range of American stocks, yet stock prices for the asset class do not reflect this outlook. Eventually, the price multiple should play catchup and, given strong fundamentals and earnings growth, we think there is now potential for relative future outperformance in Small Cap and International.

Looking more carefully at statistics, International and Small Cap are exhibiting more attractive prices relative to U.S. Large Cap across many traditional valuation metrics, including P/E, Price/Book, and Price/Sales. Over the last 15 years, these valuation metrics for U.S. Large Cap, as represented by the S&P 500 Index, are all above the 90th percentile range. Meanwhile, Small Cap and International are below the 50th percentile of their valuation ranges. These comparatively more attractive valuations support potential upside opportunity over time for investors in these currently out-of-favor asset classes. Simply put, many large domestic companies appear overvalued by investors, while small domestic and international companies are generally undervalued.

The investment backdrop of high valuations for large domestic companies, combined with the Federal Reserve's tapering process, suggests a rougher road ahead for some of the highflying large domestic companies. Given the macroeconomic environment, we are interested

> "...many large domestic companies appear overvalued by investors, while small domestic and international companies are generally undervalued."

in the investment opportunities provided by International and U.S. Small Cap. To decide whether to increase portfolio allocations to these areas, we consider each client's unique circumstances, including balancing investment time horizon against the typical investment cycle for each of these asset classes. Where appropriate, we utilize individual securities and/or mutual funds to obtain exposure to these other asset classes. Whether by choosing individual stocks or selecting funds whose managers share our same investment philosophy, our investment selections are based upon fundamental analysis of the underlying companies we own, which includes scrutinizing both valuation and quality characteristics (like the strength of a company's balance sheet and growth potential). As events unfold, we will continue to share our observations on the markets and developing investment opportunities with you. ◆

DIFFERENT WAYS TO GIVE

By Kenneth H. Dike
Esq., CPA, CLPF

Philanthropy is top-of-mind for many of our clients during the holiday season. In this theme, we are pleased to republish an article that Ken Dike, our Executive Director of Planned Giving Services, wrote for one of our nonprofit clients. Ken explains the differences between charitable gift annuities and charitable remainder trusts and answers common questions on these investment vehicles.

WHAT IS A CHARITABLE GIFT ANNUITY (CGA) AND WHAT ARE THE BENEFITS?

A charitable gift annuity is an arrangement whereby assets are given to a charity in return for the charity's promise to make lifetime payments of a fixed amount to a beneficiary, who is often the donor. A CGA may be "deferred" in that the beneficiary payments may begin at a future date. The beneficiary receives income for life and the charity gets about half of the gift at the end of the annuity payments.

WHAT IS A CHARITABLE REMAINDER TRUST (CRT) AND WHAT ARE THE BENEFITS?

In a charitable remainder trust, a beneficiary receives distributions from the trust and whatever remains in the trust when it terminates goes to charity. The beneficiary payments can be fixed in amount as in a charitable remainder annuity trust (CRAT) or vary each year based on the trust's market value as in a charitable remainder unitrust (CRUT). The trust can last for the lifetime of the beneficiary or can terminate at a predetermined date or upon the occurrence of a predefined event.

WHAT IS THE DIFFERENCE BETWEEN A CGA AND CRT?

Most charities follow the age-specific CGA beneficiary payout amounts suggested by the American Council on Gift Annuities (ACGA). The CRT donor can set any payout allowed by the IRS.

The beneficiary payments from a CGA are guaranteed by the charity while CRT payments are subject to the availability of trust assets. Since CRUT payments change each year based on the trust's value, the income beneficiary and remainder charity share in any trust appreciation or decline in value. For these reasons, CGAs are favored over CRUTs by donors who are looking for certainty in their periodic payments and do not satisfy the current IRS-required beneficiary age minimum of 76 to qualify for a CRAT.

A CRT is a separate legal entity created by the transfer of assets to a trust governed by the terms of a trust agreement that is administered by a trustee who may be the donor, beneficiary or the charity that receives the trust remainder at termination. Annual tax trust tax returns are required that produce a K-1 for the beneficiary income reporting based on the type and timing of the trust income. CGAs do not require a trust agreement, trustee, or annual tax return. Since the cost of creating and administering a CGA is significantly less than a CRT, CGAs are most appropriate for smaller gifts while CRTs are preferred by donors making large (>$250,000) gifts to a trust that can be invested at the discretion of the trustee.

> "The beneficiary payments from a CGA are guaranteed by the charity while CRT payments are subject to the availability of trust assets."

> "...CGAs are favored over CRUTs by donors who are looking for certainty in their periodic payments..."

> "...CRTs are preferred by donors making large (>$250,000) gifts to a trust that can be invested at the discretion of the trustee."

WHAT TYPES OF ASSETS CAN BE USED TO FUND A CGA OR CRT?

Legally, nearly any type of asset can be used to fund a CGA or CRT. However, illiquid assets such as real estate are usually placed in a *net income unitrust* which is a type of CRT where the beneficiary distributions are limited to trust income. Except for *net income unitrusts*, the donated illiquid asset would have to be sold when received by the charity or trust in order to provide the liquidity required for the beneficiary payments.

DIFFERENT WAYS TO GIVE |
Continued on page 4

Continued from page 3

Additionally, there are California-imposed restrictions on how CGA funds must be invested that require about half of the assets to be held in government-backed bonds.

A charity issuing a CGA or serving as the trustee of a CRT may also have internal policies regarding what types of assets they will accept for these giving vehicles.

IS THERE A GOOD AGE TO OPEN A CGA OR CRT?

Like many things in life, "it depends." However, certain aspects of the two vehicles help answer this question from a general perspective.

The amount paid the income beneficiary of a CGA depends on the expected duration of the payments that is determined by the age of the beneficiary when the payments begin. CGA beneficiary payments may be deferred, accommodating young donors who want to receive beneficiary payments later in life. In general, the shorter the duration, the larger the payment. Donors that prioritize a larger payment should either delay payments or wait until they are older to open a CGA.

> "...CRTs are usually created near retirement age in conjunction with the donor's estate planning or following a significant financial event."

Due to their relatively large size, CRTs are usually created near retirement age in conjunction with the donor's estate planning or following a significant financial event. Since the beneficiary payments can be stopped at a pre-determined time instead of continuing for the donor's remaining life, the age of the donor is not necessarily a significant factor in the decision to create a CRT.

As with the type of donated asset acceptable by a charity issuing a CGA or serving as trustee of a CRT, the charity may have internal policies regarding the minimum age of a life beneficiary reflecting the charity's concerns related to the duration of their future administration of these giving vehicles.

IF I OPEN A TWO PERSON CGA OR CRT ARE THERE ANY RESTRICTIONS ON WHO I CAN NAME AS MY SECOND PERSON?

About any person who is alive when the CGA or CRT is created can be named as the second beneficiary, although there may be transfer tax implications if the other beneficiary is not the spouse of the donor. Under certain circumstances, even a trust or charity may be the beneficiary of a CRT.

HOW CAN THESE VEHICLES HELP BOTH AN INDIVIDUAL AND CHARITY BENEFIT?

The donor, or those chosen by the donor, receive payments for their life or a term of years, and the charity receives whatever remains when the CGA or CRT terminates. The amount ultimately received by the charity (remainder) from a CGA will be about half of the initial gift value assuming the ACGA rates are followed. The remainder paid to charity by a CRT depends on the relationship between the trust's investment returns and amount paid the beneficiaries. If the investment income exceeds the beneficiary payout, the charity will receive more than was transferred to the trust at inception.

> "The remainder paid to charity by a CRT depends on the relationship between the trust's investment returns and amount paid the beneficiaries."

The CGA and CRT donor also avoids the immediate recognition of capital gain income from donated appreciated securities and receives a tax deduction based on the market value of the assets donated, the amount paid to the beneficiaries, and the expected duration of the CGA or CRT. ◆

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
Murcy Huang, CFA
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.

The information contained in this publication is for educational purposes and should not be considered a recommendation or investment advice. If you have any questions, please contact your investment counselor.

WISDOM *for* GENERATIONS