CLIFFORD SWAN

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WISDOM *for* GENERATIONS

A PLAYBOOK FOR UNPRECEDENTED TIMES

By David Y. Lin
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Take yourself back to 2019 when the year was drawing to a close. Imagine being told:

> *2020 will be the year when our hospitals will be overwhelmed, offices will close indefinitely, scores of workers will be sent home and lose their jobs, and the developed world will be on sporadic lockdown.*

Now, imagine also being told that the market would reach all-time highs with household savings reaching record levels.

For most of us, that outcome would have been unfathomable. Yet here we are, coming off a torrid 2020 with the S&P 500 Index ending the year up over 65% off pandemic lows. That momentum has extended well into 2021 with the market up about 10% through mid-May.

It is an incredible turn of events for a market that is now historically expensive on virtually any metric available. Renowned investor Charlie Munger might have said it best at the recent Berkshire Hathaway Annual Meeting in Los Angeles: "If you're not a little confused by what's going on, you don't understand it."

Like Mr. Munger, we have found ourselves scratching our heads more than once. And any attempt at explaining what's happened needs to start with the massive economic experiment that we are now living under. Among the major developments:

- To date, Congress has passed nearly $6 trillion of Covid-related stimulus, dwarfing anything we saw during the 2008 mortgage crisis—an event then considered the most devastating economic event since the Great Depression.
- The Federal Reserve has created about $4 trillion of money supply as a result of efforts to calm the bond market and help absorb newly issued government debt.
- Some of the major banks, flush with new cash, have asked their institutional clients to take their deposits elsewhere (who would have ever thought?).
- The combination of near-zero rates, abundant liquidity, and prophetic narratives about our digital future have supercharged investors' animal spirits.

Now, well over a year into the pandemic, the real economy is finally catching up to the stock market. The U.S. vaccine rollout has made it safer to socialize, dine out, and travel. Analysts are calling for 7% to 8% U.S. GDP growth in 2021, followed up by a still impressive 4% to 5% in 2022. Corporate executives are all too happy to report that earnings are on the mend. And that's to say nothing of the new administration's ambitious infrastructure spending agenda—with a bill numbering in the trillions—being debated in Washington.

Yet, even seeing a domestic expansion in plain sight, it would be a mistake to confidently assume that the market will continue higher. As far back as the data is available, there is actually very little correlation between the market and the economy in the short run[1]. In fact, if there's any dependable relationship between the two, it's that the market and

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the economy have a history of parting ways, sometimes for long stretches.

Which raises the all-important question: what's the right course of action in a market that feels overdone but could conceivably head in any direction? How do we attain peace of mind when there's no playbook for how to behave (massive stimulus heading *into* an expansion)?

Given the challenge of making near-term market predictions, which has been especially true of these unusual times, we think it best to speak to guiding principles.

1. AVOID BEHAVIOR AT THE EXTREMES.

We have long advised clients against tactically moving entire portfolios to cash (aside from unique personal circumstances) for the simple fact that corrections are notoriously difficult to time. In fact, the drag on long-term returns from going too soon and too heavily to cash can prove more costly than the downdraft itself.

At the other extreme, we have

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advised clients against aggressively deploying cash late in a cycle when the fear of missing out may feel overwhelming. There, the reminder is that long-term success is not built upon a short, incredible burst of performance but rather a disciplined plan that produces a lifetime of steady returns.

2. STAY INVESTED WHILE KEEPING DRY POWDER AVAILABLE.

Durable companies compound value over time, even if the short term is littered with fits and starts. We recommend staying invested in the right businesses (more on this later) while having cash reserves on hand to capitalize on bargains as they appear.

In the face of a sell-off, taking action is undoubtedly difficult. But modern history has shown us that, without exception, we have overcome every crisis so far on our way to fresh new highs. We have also seen that a market dominated by emotion—whether it's exuberance or panic—eventually reverts back to fundamentals.

3. FOCUS ON GROWING, DURABLE COMPANIES BUT BE DISCIPLINED ABOUT WHAT YOU PAY.

This may sound like obvious advice. But rarely have we encountered a market so disconnected from business fundamentals. Why is this important? Business fundamentals are the most reliable pricing mechanism available to investors, providing a figurative floor if the market goes awry. For a technology upstart lacking an operating history or even a single dollar of profit, a price correction may feel bottomless. For a time-tested company with staying power, that fall may feel more like a speed bump, and better yet, an opportunity to acquire more shares.

What does a durable business look like? We prefer companies that do not have to undergo constant reinvention. Consider the example of a mission critical service provider operating on a subscription model in contrast to a commodity hardware manufacturer needing to "re-earn" business every year against stiff competition. Durable companies tend to also have ample cash and credit available to help withstand industry shocks, which are almost always difficult to time. And once you've identified durable businesses, the advantage of owning them is that the best ones not only survive crises but use calamity to widen their lead over the competition.

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To be sure, doing the right thing is often easier in theory than in practice. This will be the case for a market that has been filled with surprises and may bring many more. But remember that as much as markets change and companies come and go, our emotions remain a fixed part of the investment experience.

When faced with the unknown, emotions can hijack the decision-making machinery for many of us who are otherwise pragmatic and patient, prodding us to follow the crowds into mania and also towards the exits. And therein lies the power of guiding principles: to protect us from making lasting decisions based on fleeting factors. In a market that's broken all the rules, guiding principles can make the difference between veering off course and staying firmly planted in the driver's seat of our long-term plan. ◆

1. Source: Rekenthaler, John. "The Stock Market Is Not the Economy." https://www.morningstar.com/articles/982525/the-stock-market-is-not-the-economy. 30 September 2020.

A NEW ERA IN DEATH AND (ESTATE) TAXES

By Carlota B. Venegas
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They say nothing in life is certain, except for death and taxes. While neither is avoidable, there may be certain ways to mitigate the impact of taxes at death.

President Joe Biden's recently proposed "American Family Plan" highlights funding the legislation through increased income and capital gains tax on the wealthiest and highest earning Americans.

What is also being proposed is the elimination of a 100-year-old tax favorable rule known as the *step-up in basis,* which occurs at death. Currently, if an individual passes away, appreciated assets pass on to heirs with a new tax basis, valued at the time of death. This means if heirs immediately sell inherited assets, they are not subject to capital gains tax.

Under the new proposal, gains on appreciated assets would potentially be taxable upon death, even if the heirs plan to hold onto the asset. There would be a $1 million exemption on capital gains, however.

Example: If an individual purchased an asset for $200,000 and the market value of the asset was $2,000,000 upon death, capital gains tax would be due on $800,000 of gain ($2,000,000

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market value - $1,000,000 exemption - $200,000 tax basis).

There are also rumblings of potential changes to the gift and estate tax code. Currently, an individual can gift up to $11.7 million over the course of their life—or pass this amount on at death—without paying a dime in gift or estate tax. For married couples, this exemption amount is $23.4 million. Transfers that exceed these amounts are subject to a top estate tax rate of 40%.

Example: If an individual gifts $5 million while living, and he or she passes with an estate valued at $10 million, the total amount excluded is $11.7 million. The additional $3.3 million is subject to estate taxes.

These amounts are slated to revert to a uniform $5.49 million after 2025 (adjusted for inflation) but could be accelerated prior to this date. Biden has indicated that he plans to reduce the federal gift and estate tax exemption amount from a uniform $11.7 million to an estate tax exemption of $3.5 million, including a gift tax exemption of $1 million—with transfers exceeding these amounts subject to a top tax rate of 45%.

Example: If an individual maximizes their lifetime gifting at $1 million, they will have a $2.5 million remaining estate tax exemption at death.

If you combine the elimination of the step-up in basis with lower gift/estate tax exemptions, you may face a very unfavorable tax code. The proposed taxes and long-term impact on multi-generational wealth could be profound.

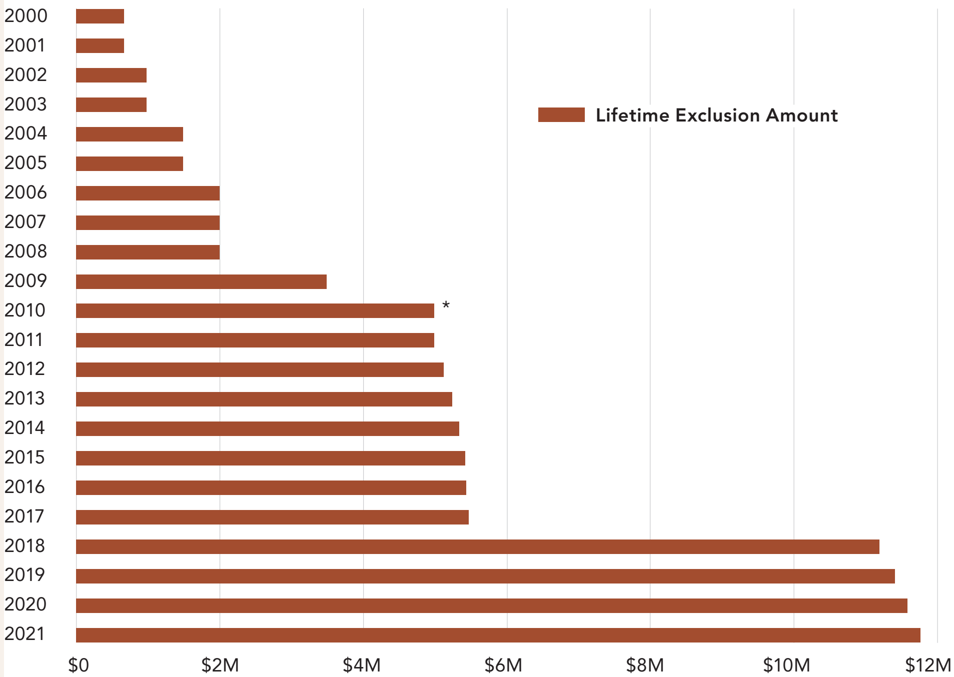
It may be difficult for Congress to enact both tax changes, but let's look at a worst-case example of potential tax on a $5,000,000 estate in California with $3,000,0000 in capital gains (see the table below).

Under the current tax laws, this $5,000,000 estate would pass to heirs free of gift, estate, and capital gains taxes.

Another aspect to consider is tax treatment of real estate assets. Currently there is no limit on 1031 exchanges, but a $500,000 limit on nontaxable gains may be imposed in the near future. For primary residences, the existing $250,000 capital gains tax exemption for individuals ($500,000 for married couples) is expected to remain in place.

So, what are some planning areas that you may want to begin discussing with your investment counselor?

Historic Estate and Gift Tax Exclusion Levels



*Effective 2010, the Economic Growth and Tax Reconciliation Relief Act 2001 (EVTRRA) repealed the federal estate tax, providing estates with the option of utilizing a $5,000,000 exclusion amount or avoiding the tax while applying carryover cost basis on inherited assets.

Source: Internal Revenue Service, 2021.

Impact of Proposed Taxes on a $5 Million Estate

Value of Estate:	$5.0M
Proposed Estate Tax Exemption ($3.5M per individual)	$3.5M
Taxable Estate	$1.5M
Proposed Estate Tax Rate (45%)	45%
Taxes Owed on Estate	($675,000)
Capital Gains Taxed at Highest Proposed Rates:	
39.6% + 3.8% Net Investment Income Tax + 13.3% CA State Tax =	56.7%
Capital Gains Tax owed after $1M Exemption:	($1,134,000)
Value of Remaining Assets in Estate:	$3.191M
Total Taxes Paid on $5M Estate	$1.809M
Effective Tax Rate at Death	36.18%

LIFETIME GIFTING WHILE EXEMPTION IS $11.7 MILLION

Biden has indicated that he plans to reduce the tax exemption for estates and gifts and increase the rates at which they are taxed to "historic norms."

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> "If you gift before limits are lowered, the gifting exemption is not expected to be 'clawed back' retroactively."

If you gift before limits are lowered, the gifting exemption is not expected to be "clawed back" retroactively. Therefore, it may be wise to gift sooner rather than later if the intention is to reduce your gross estate. Keep in mind that when you gift assets, you are relinquishing ownership, control, and use of those assets. It is essential to work with your investment counselor to ensure that all your current and future needs are accounted for before gifting.

There is also an annual gift tax exemption of $15,000 per donor, per recipient. An individual may gift anyone up to $15,000 in assets per year, free of gift taxes.

Example: A couple with three married children and six grandchildren could give away a total of $360,000 per year to these 12 relatives, plus $30,000 to anyone else they choose. Any gifts above the annual exemption are subtracted from the individual's lifetime gift and estate tax exemption.

Another strategy to consider around gifting may be to make payments directly to medical and education providers on behalf of a loved one as these payments are not considered to be gifts.

ESTATE PLANNING DOCUMENTS AND STRATEGIES

There are additional asset transfer methods that may effectively reduce the value of your estate. Some of these may include utilizing various legal structures, trust vehicles, charitable planned giving strategies, and real estate options.

Aside from these strategies, it is important to review existing trust documents on a regular basis to determine if updates are needed as a result of any changes within your personal objectives or the tax law.

IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

A common misconception around life insurance is that the death benefit is not subject to tax. Although proceeds are received by beneficiaries free of income tax, they are included as part of your gross estate, and taxable if the estate value exceeds the exemption amount.

An ILIT creates a tax efficient pathway for wealth transfer using life insurance in conjunction with an irrevocable trust. This strategy removes the insurance policy from the grantor's gross estate, while still providing liquidity to offset wealth transfer taxes.

Life insurance needs evolve over time and insurance policies should be reviewed and factored into your financial plan like any other asset in your estate.

DECEASED SPOUSAL UNUSED ELECTION (DSUE)

When a spouse passes away, it may be implied that the surviving spouse automatically receives the deceased spouse's estate tax exemption (currently $11.7 million). However, this is not the case. To ensure that the unused exemption transfers to the surviving spouse, the executor of the estate should consider electing what is known as the Deceased Spousal Unused Election (DSUE) on an estate tax return (Form 706).

Form 706 is only required if estate assets are above the exemption amount. Therefore, many surviving spouses miss out on this opportunity without proper planning*. This portability election is especially important now that the exemption amounts are at an all-time high, and could decrease significantly with the 2025 sunset provision, or sooner.

Effective wealth planning requires sophisticated strategies implemented in a proactive manner. With potential new legislation on the horizon, now is a great time to review your financial plan with your investment counselor. While we are not attorneys, insurance agents, or tax advisers, Clifford Swan is here to help you navigate the various stages of your life and assemble the appropriate team of professionals to meet your goals, values, and objectives. ◆

* This form is due nine months from the date of death with a six-month automatic extension available.

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