ALBITZ/MILOE & ASSOCIATES, INC.

REGISTERED INVESTMENT ADVISER

FINANCIAL NEWSLETTER

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AUTUMN 2020

THE CRYSTAL BALL

2020 is a year of distorted vision. Early in the year, no one in their wildest dreams would have imagined the changes in our lives that this virus would bring upon us. The best description we've heard is: "We are all in the same storm, but we are not all in the same boat."

From a health standpoint, we all know that it is up to us to fend for ourselves, to follow protocols, to take care of those most at risk to the virus, and do our best to live life in spite of the virus.

From an investment standpoint, the questions that arise are: What will the rest of this year look like and what is beyond the horizon?

Here are a list of worries confronting us in the current investment environment…a contested election; a lack of action from Congress to stimulate the economy; a resurgence of the pandemic; economic growth withering; corporate earnings falling short of expectations. Of course, we all want a clear winner in the election, of course we expect Congress to get their stuff together, of course we don't want a huge second COVID-19 wave, and of course we want the economy to recover, thus restoring jobs and the confidence that comes with it.

The reality though is that there is a difference in what we would like to happen and what will actually happen. Investment returns will ultimately reflect this. Howard Marks, the co-founder of Oaktree Capital, said it best; "The market is not an accommodating machine. It won't give you returns just because you need them." We learned that lesson a long time ago.

Going forward, we must remember that it is the policies that will drive investment not necessarily the political party in power. Sure, there is always the expectation that the Democrats will do this or the Republicans will do that. More stuff can be done than will be done, and everything that will be done won't be bad. As for a second COVID-19 wave, cross your fingers on that one. It doesn't appear that the virus is going away so we can hope that therapeutics will be made available which will allow for successful treatments. Obviously, that would be the biggest boost to getting back to a semblance of normalcy and a recovering economy. As for another stimulus bill, Congress will most certainly act but maybe it will take a hissy fit from the stock and bond markets to jolt them into action.

No one can tell you for certain if the stock market will be higher or lower a year from now. The loudest voice in the room tends to get the most attention, but the market is the final authority.

Here's some seasoned advice: Keep in mind your goals and objectives when dealing with your finances. Don't be swayed by voices of the doom and gloomer's or the rosy Pollyannas. These are interesting times in which we live but they are not unprecedented. The country has experienced crazy issues in the past; maybe even more so than we are dealing with today. Somehow, someway, we survived, and we will get through to the other side this time too. It may be a rocky ride, so be ready for anything. Don't forget to stay optimistic. That is half the battle.

History

"The extremes of society are being driven further and further apart."

William Jennings Bryan 1901

TD AMERITRADE AND SCHWAB MERGER

Recently the Charles Schwab Company acquired TD Ameritrade. The two custodial firms have always been known for their low costs, great service, and innovative technology, and we expect this to continue. The integration is expected to take 18 to 36 months. We think the combination of these two firms will be beneficial and we look forward to a seamless transition.

UNDERSTANDING COST BASIS

Most investment custodians report a figure called "Cost Basis" for each holding within your investment portfolio. The cost basis is determined by adding the initial investment, any transaction costs to acquire the investment, as well as reinvested dividends or capital gains. The difference between the current market value and the cost basis is your unrealized gain or loss for tax purposes and can provide an indication of how the investment is doing. However, cost basis does not always provide the full picture.

For example, an investor invests $100,000 in a mutual fund. Later that year, the fund pays a capital gain distribution of $5,000 which is reinvested back into the fund. The following year, the fund pays a larger $10,000 capital gain distribution which is also reinvested in the fund. The total cost basis is now increased to $115,000 consisting of the original investment of $100,000 and the $15,000 in reinvested capital gain distributions. The investment experiences a decline in value and the investor reviews their account statement seeing a current market value of $110,000 and an unrealized loss of $5,000.

Did the investor lose $5,000 on this investment? No, but this example demonstrates how an investment can appear to be at a loss despite the actual investment having increased to $110,000 from an initial investment of $100,000. Because dividends or capital gains are taxed upon receipt, irrespective of whether they are reinvested, means taxes have already been paid on the $15,000 of capital gain distributions. Should the investor decide to sell at the current market value of $110,000, an offsetting tax loss of $5,000 is required to ensure the total taxed gain is equal to the actual gain the investor has experienced, in this case $10,000. Understanding what is reflected in the cost basis figures reported on your account statements is often helpful in generating greater insight when evaluating your portfolio holdings, especially those with reinvestments.

Overheard…

"Ignorance more frequently begets confidence than does knowledge."

Charles Darwin

SOCIAL INSECURITY?

According to the recent 2020 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, it is noted that Social Security's total cost is expected to be higher than its total income in 2021 and all later years. Social Security reserves are projected to be depleted by 2034, with the projected annual inflows at that time expected to pay 76 percent of scheduled benefits. (These projections do not include the effects of COVID-19, which have likely further strained the system.)

Social Security assigns a full retirement age, which is currently 66 for those born 1954 and earlier. The assigned full retirement age increases gradually and becomes 67 for those born 1960 and later. This is the age when you become eligible for your full Social Security benefit. You can claim benefits prior to your full retirement age at a reduced benefit amount (as early as 62) or delay benefits past your full retirement age for an increased benefit amount (as late as 70). Assuming no changes to Social Security, the decision on when to claim to maximize benefits is often based on your expected longevity. However, it would be imprudent to ignore the state of the solvency of system that will be paying the benefits.

There are many ways to correct the trajectory of Social Security. Currently eight major categories of changes have been proposed and studied: Cost-of-Living Adjustment, Level of Monthly Benefits, Retirement Age, Family Members, Payroll Taxes (including maximum taxable), Coverage of Employment or Earnings, or Inclusion of Other Sources of Revenue, Trust Fund Investment in Equities, and Taxation of Benefits. Within these categories there are approximately 140 various proposals with detailed projections for each. Individual accounts which could be funded and pay benefits based on several of the proposals are also noted as a potential solution on the Social Security website.

The Social Security Actuarial Life Tables estimate someone who is 66 today will likely live another 18 years, until 2038, past the time the reserves are expected to be depleted and inflows are expected to be insufficient to pay full benefits. It is clear adjustments will need to be made to Social Security, but they will be challenging due to the various proposals revolving in some way around reducing retiree benefits or assessing higher taxes. The path of least resistance may very well be inflating away the value of future benefits. If you are filing for benefits now or in the coming years, it is important to recognize the changes that will need to take place which will likely affect you. Ongoing planning to ensure you maintain financial independence without needing to rely fully on Social Security is recommended.

THE SECURE ACT AND BENEFICIARY DESIGNATIONS

Regulatory changes under the Secure Act (Dec. 2019), have driven the need to review beneficiary designations on qualified retirement accounts (IRAs, 401(k)s, etc.). Prior to 2020, beneficiaries were provided a default option of lifetime distributions using a formula set by the IRS. Following passage of the Secure Act, non-spouse beneficiaries who inherited retirement assets must now fully distribute the assets within 10 years. Below, we look at scenarios under the new rules for qualified retirement account owners who die in 2020 and beyond. [Note, that for anyone who already has an inherited IRA and has been taking Required Minimum Distributions (RMDs), nothing has changed.]

If your spouse is listed as the sole/primary beneficiary, their options have not changed. Your spouse can assume the IRA as their own, establish an inherited IRA and take lifetime distributions, or cash out of the account. Here, most will choose to assume the IRA or take lifetime distributions. The SECURE Act also waives the 10 year requirement for anyone who is chronically ill, disabled, less than 10 years younger than the IRA owner, qualifying trusts, and minor children of the IRA owner (this group, inclusive of spouses, are formally known as Eligible Designated Beneficiaries). For trusts, they would only qualify for a waiver if the IRA can "see through" the trust to the underlying beneficiaries and one of the exceptions noted above also applied. For minors, they are permitted to take RMDs until they reach the age of majority (generally 18), and then the 10 year rule will apply (exhausting the IRA by age 28).

For non-spouses and qualifying (see through) trusts that do not meet one of the exceptions (known formally as Designated Beneficiaries), the new 10 year rule applies. Under the rule, the only requirement is that all assets within the account are withdrawn within 10 years. During the 10 year period, there are no RMDs required. Thus, a beneficiary subject to this rule could distribute as much or little as they want each year, but they must ensure that all funds are out by the end of the 10th year. Depending on the size of the IRA, this can create the need for careful tax planning as waiting until the 10th year could result in significant taxation.

The final group under the new rules are known as Non-Designated Beneficiaries. These include charities, your estate, and some trusts. Here, all assets in the IRA must be distributed within 5 years. Figuring that charities will likely seek to close the IRA quickly, and that most IRA owners do not leave assets to their estate, trusts can be most affected. These trusts would be any that don't have a "see through" provision or those that include a charity as part of the distribution. If you want to ensure that your beneficiaries have the 10 year option, any asset earmarked for a charity should be branched off to a separate IRA and the other beneficiaries named outright, or named via a trust that does not include a charity.

As always, whenever there has been a birth, death, divorce, or marriage, be sure to review your beneficiary designations. The passage of the SECURE ACT has enhanced the need for review. We are here to help. Let us know how we can assist.

WHY OWN BONDS WHEN YIELDS ARE SO LOW?

Fixed income investors are currently facing a challenging environment. A 10-Year Treasury is yielding approximately 0.75% meaning you loan money to the U.S. Government for 10 years and they pay you a paltry 0.75% on your money each year. Furthermore, savings accounts, certificates of deposit, and money market rates are all tied to the federal funds rate which the Federal Reserve has set with a target of 0 – 0.25%. Not too exciting.

Despite these low yields, bonds still have a place in a diversified portfolio. Most importantly, fixed income offers diversification from equities. Treasury bonds for example are defensive in nature, and their returns are negatively correlated to the stock market. They tend to rise in price during times of market stress, going up when stock markets decline. This capital preservation is beneficial as it helps an investment portfolio to maintain more of its value following a market setback. The income an investor receives from holding a Treasury bond is also consistent and guaranteed.

Recent comments from Jerome Powell and Fed officials suggest that low yields may be here for some time and point to near-zero fed fund rates through the end of 2022 (even if inflation surpasses their core target of 2%). But investors can look beyond money markets, CDs, and U.S. Treasuries to increase total return. Investors with a higher tolerance for risk can add fixed income investments that provide more yield by taking some credit or duration risk, essentially holding lower quality or longer maturity bonds. We suggest this is done in moderation, keeping in mind that these bonds may be more prone to price declines should the economic outlook weaken, or interest rates rise faster than anticipated.

Do not abandon your bond holdings solely because of low yields. Rather, make sure you stay diversified and own the right bonds to better help you navigate today's challenging environment. Fixed income remains an asset class that is critical to the establishment and maintenance of a balanced investment portfolio.

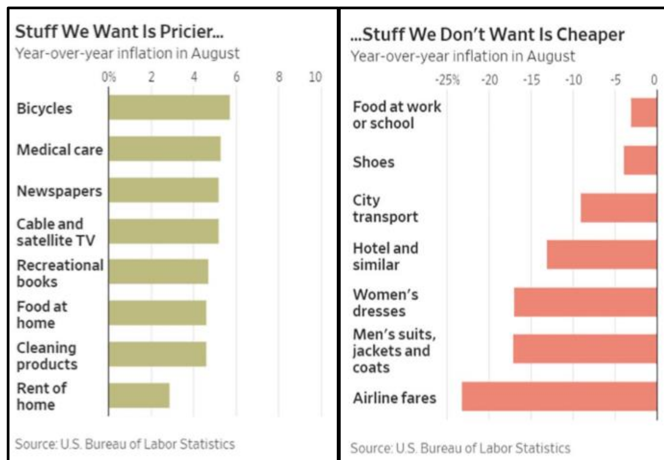
A STORY

Hazel was bothered because her husband tended to just sit around the house all weekend watching television, checking out the ball games and drinking beer. She said to him, "Saturday and Sunday are the only days of the week you have to spend some quality time with your daughter. So instead of being a couch potato, why don't you do something with her?"

So Hazel was surprised to come home the next Saturday at dinnertime and to hear her little daughter say happily, "Mommy, guess what? Daddy took me to a zoo today and we saw lots of animals!"

"No kidding?" said Hazel as she smiled lovingly at her husband.

"And guess what else?" said her daughter eagerly, "One of them paid fifteen to one!"



PERSONAL NOTES

Rick and Susan T – Congratulations on your 50th anniversary… that's so great!

Sally B's Mom – Happy 100th!

Tom G…– It's been a while since we coached together. Isn't it great to see how the "kids" grew up?! Lucky us.

Larry B. – It is good to see you again after many, many years!

Phil's Opinions and Judgments…

On Music…

"I'm Your Puppet" by Dan Penn and Spooner Oldham… Two artists, two instruments, one voice, a great lyric; mix it all together and it equals musical magic. Check out the video. It's beautiful in its simplicity.

On the Election…

"This is the most important election of our lifetime." The last time I heard that sentiment was four years ago. Then I heard the same thing eight years ago. And then again twelve years ago. Etc, etc…. Every election is important but remember that whatever happens, we'll survive.

On Financial Crises…

It is said that financial crises tend to involve one or more of three ingredients: excessive borrowing, concentrated bets, and a mismatch between assets and liabilities. Throw in governmental and personal response to a pandemic and you can add two more issues to this trifecta.

On the 'Cruelest Tax'…

The Wall Street Journal calls inflation the cruelest tax. The Federal Reserve is targeting a 2% annual inflation increase. We know the government likes inflation because it bails them out from their high debt (by paying lenders back with cheaper dollars). Inflation is not good for bond holders. So be wary when you see the 10-year Treasury note yielding .70%. With 2% inflation, doesn't that look like an automatic loser?

On Essential Workers…

Nurses, doctors, police, and fire fighters are all on the front lines and their work is highly appreciated. However, let's not forget about grocery store workers, postal and package delivery people, dockworkers, trash collectors, and the myriad of people behind the scenes that keep things moving and make things work. No one is taken for granted.

Until next time,

Phil Chris Paul Clete Sylvia Vance

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