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Divisions of The Sanibel Captiva Trust Company

MARKETWATCH

Deeply Rooted in the Community | Second Quarter 2019

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Current Outlook

Craig J. Holston
Chief Operating Officer

After a dramatic sell off in the equity markets to end 2018, the S&P 500 rallied 13.65% in the first quarter of 2019. Investors looked past ongoing trade negotiations and focused instead on the continued strength of the U.S. economy and the companies that would most benefit from long-term growth. The Industrial and Energy sectors (which benefited from a 28% increase in crude oil) were big winners in the quarter along with Information Technology.

Investors also seemingly took advantage of temporarily cheaper prices to bid stocks back up toward their autumn 2018 highs. Indeed, we commented at the beginning of January that stock prices seemed sufficiently cheap to us, and that the S&P 500 could rally 10% or more in 2019 just to get back to "fair value." Since then, the price to earnings ratio (P/E) of the S&P 500 has moved back up to its historical average. Once a market reverts to fair value, stocks tend to appreciate at the rate of future earnings growth, holding interest rates constant.

The move by the Federal Reserve Board to pause its campaign of steadily hiking interest rates also played a big factor in the equity rally. The yield on 10-Year Treasury bonds fell sharply below 2.5% in late March from 2.8% at the end of 2018, and 3.2% in October. After underperforming in 2018, real estate companies, utilities, and other high dividend payers rose in price as these companies benefited from the relative value of the income they provide versus traditional bonds.

Corporate earnings grew more than 20% in 2018, as the reduction in the corporate tax rate to 21% led to a quantum, one-time leap in profits. We would, however, expect both earnings and equity market returns to be more muted for the balance of 2019, as recent data points to a continued slowdown in Europe and Asia, as well as pockets of the U.S. economy. In addition, the decision by the U.S. government to initiate tariffs on some of its trading partners, and keep those tariffs in place, has sowed growing concern that U.S. companies will pay more for their input costs and see their sales slow overseas. We are watching closely how our portfolio companies are affected by, and try to fly around, a trade-induced slowdown.

Despite this more cautious tone, we still feel that high-quality equities remain appropriate for long-term investors depending on their overall risk tolerance and income needs. For clients who may benefit from the volatility reducing properties of traditional fixed income, we have been building individual bond portfolios. We are careful to emphasize shorter maturities, however. Because the yield curve is nearly flat (meaning yields on short-term and long-term bonds are essentially the same) we can protect our clients from future interest-rate moves to the upside by avoiding longer maturities.

Although most clients own both elements of growth and income in their portfolios, there are some who rely on larger distributions from their portfolios to help fund living expenses. For this group of investors, we continue to recommend higher dividend-paying equities that have a long history of increasing dividend payouts over time. In periods of higher market volatility, the consistency of the income stream of dividends has allowed investors to "weather the storm" better than those owning pure growth investments.

Why We Buy and Hold Good Companies

Timothy P. Vick
Director of Research

The investing world is forcefully and rapidly reinventing itself. Computer algorithms and artificial intelligence offer efficiencies never before available to wealth managers, yet enable rapid-fire, ruinous trading habits and threaten to remove all critical human judgments from decision-making. Likewise, the craze toward index investing and packaging together low-cost portfolios offers younger generations a chance to participate in market returns as they save for retirement. Yet the same craze ultimately commoditizes the investing process and does away with the diligence and common-sense prudence that have well served parents and grandparents for a century.

Like an old church that wants to incorporate modern music into its service, we think constantly about how to fit in with the changing landscape, and promise that as we grow and adapt, our core footings will continually be strengthened but stay intact. Since inception, the Trust Company has built portfolios around strong, growing companies that we know intimately and that fit your risk profile – for four essential reasons:

Know what you own – Managers are under undue pressure today to cobble together time-efficient portfolios and to paste these "models" across the firm. Often forgotten is that an analyst's chief role is still to evaluate and forecast the returns of an asset and make sure that asset can deliver the risk-adjusted returns you require. One cannot forecast the returns of, say, an index fund or ETF that holds dozens of the best, and worst, of an industry's or country's corporations.

Control what you can – A common stock investor can control very little, other than what securities to own, and what price to pay for them. Everything else – the economy, interest rates, politics, corporate sales and profits, stock market fluctuations – is subject to exogenous forces. Once a portfolio is completely "packaged" into products, however, all control is lost. Owning individual stocks remains the best way to try to control clients' returns, their income, and their taxes, and dovetails best into families' estate plans.

Focus on growth: It overpowers everything – When you own a company that can increase sales and operating profits at respectable rates, a lot of positive things naturally happen to its share price. In the world of finance, this correlation is wonderfully dependable, and drives our thinking. Show us a company growing its sales at, say, 6%-8% annual rates, and we can count on 6%-8% growth in the value of the firm's shares over time. Fill an entire portfolio with 6%-8% growers, and you can expect the same result. Often, it's best to sit back and let executives of growth companies keep working their magic and enlarging their companies for your benefit.

Don't "di-worsify" – Many of you amassed your wealth, ironically, by concentrating your resources. Now in retirement, the best practices call on you to diversify to temper both the growth and volatility of your wealth. But there are limits. A 100-stock portfolio chosen by a computer serves no end when a 40-stock closely watched portfolio can deliver the same results. Layering endless alternative investments onto a core stock, bond, and cash portfolio often just increases fees without enhancing clients' financial plans. Chasing emerging markets stocks without fundamental justification often has led to disappointment.

Nobel Prize-winning economist Paul Samuelson once remarked that sound investing should be like watching paint dry. "If you want excitement," Samuelson said, "take $800 and go to Vegas." How true. Decades of research, as well as real-life examples, have shown us the value not only of investing heavily in stocks (as opposed to other asset classes), but maintaining a disciplined, patient approach to holding stocks and matching all our investment choices exactly to clients' needs and goals.

Portfolio Review & Strategy

Ian N. Breusch, CFA
Chief Investment Officer

Following a rather tumultuous December, stock markets quickly rallied higher during the first quarter of 2019. In fact, stock markets have largely erased much of what transpired in December. We believed much of the selling activity, particularly late in December, did not reflect the fundamentals of the economy or individual companies. Nonetheless, it was encouraging to see how quickly market participants reversed course in the new year. As is often the case, a rapid sell off is often followed by an equally speedy recovery.

As we look forward to the second quarter, some of the concerns regarding a global economic slowdown remain, but many have subsided. Earnings for U.S. companies remain solid overall, but are not nearly as robust as what we experienced last year on the back of corporate tax reform. We continue to expect positive GDP and earnings growth in the U.S. this year, but results will be more muted than in prior years. Europe is struggling with anemic economic growth, and the ongoing "Brexit" saga is not helping matters. The U.S. and China continue to negotiate their trading relationship, and concerns remain about China's economic growth prospects, regardless of whether the two sides reach a new deal.

On December 19th, the Federal Reserve Board raised the federal funds rate another 0.25%. The stock market volatility that ensued is well documented, but the reaction in the bond market was equally notable. The yield curve flattened out further, and the inversion between two-year and five-year Treasury bonds remains. Given the market's reaction to the Fed's latest increase, we do not expect any further rate increases in 2019. Furthermore, investors (via futures contracts) are betting that we have already experienced the peak for interest rates in an economic expansion that began 10 years ago. For the first time in many years, market participants expect the next Fed action to push rates lower, instead of higher. While we do not anticipate a recession in 2019, the fact that we are reaching an inflection point with interest rate policy coincides with our view that we are closer to the next recession than farther away.

As a matter of investment philosophy, we believe wholeheartedly that investors should not make significant portfolio changes simply because we may be drawing closer to the end of an economic expansion. Instead, we believe in building an asset-allocation mix between high-quality stocks, bonds, and cash that makes good sense in any market environment (good or bad) and that ties back to each client's unique long-term goals. The long-term performance objectives we set with our clients already assume we will have periods of time (like December) when stock markets move lower.

Given the backdrop highlighted above, we believe we are well positioned for the long term. Our growth-oriented stocks continue to post pleasing results. The more mature companies that pay higher dividends have largely underperformed growth stocks the past few years. However, if interest rates are indeed peaking, these types of defensive companies should do measurably better. By having a mix of both growth and value stocks alongside some high-quality bonds (when appropriate), we are confident we can continue to deliver consistent solid investment results through time.

Saving Taxes While Helping Others

Michael R. Dreyer, CPA
President, The Tampa Bay Trust Company

Financially successful individuals often look for ways to fund charitable interests in a tax efficient manner. Charitable trusts can be an effective tool in meeting this objective. Several variations of a charitable trust exist, and each serves a specific purpose.

When a **Charitable Remainder Trust (CRT)** is established, a gift of cash or property is made to an irrevocable trust. The donor retains an income stream from the trust for a specified number of years (no more than 20 years) or for life. At the end of the term, the qualified charity specified in the trust document receives the remaining assets in the trust.

The grantor of the trust receives an income tax deduction, in the year of the transfer, for the present value of the remainder interest that will ultimately pass to the charity. The grantor is taxed based on the amount of the payments to him and the income earned at the trust level.

A Charitable Remainder Trust (CRT) is often used when an individual has a highly appreciated asset which is being sold. The individual transfers the appreciated property to the CRT, the CRT then sells the asset. Because the CRT is not a taxable entity, the gain on the sale is not recognized at the time of the sale. This allows the entire sale proceeds to be invested in a diversified portfolio. Had the asset been sold at the individual level, capital gains tax would be payable immediately, reducing the sale proceeds available for reinvestment by as much as 23.8% due to federal taxes. The CRT is an excellent method for deferring or possibly avoiding the capital gains tax on the sale.

There are two types of **CRT: A Charitable Remainder Annuity Trust and a Charitable Remainder Unitrust.** With the annuity trust, the annual annuity payment remains the same over the life of the trust, while with the unitrust, the payment changes each year based on the value of the trust's assets at the predetermined payout percentage.

A **Charitable Lead Trust (CLT)** is established when an individual (or a corporation) transfers cash or property to an irrevocable trust. A charity then receives an annuity payment for a number of years. At the end of the term the assets in the trust are transferred to the non-charity remainder beneficiary - typically, a child or grandchild. The donor receives a charitable income tax deduction in the year the trust is created. The deduction is based upon the present value of the annuity payments the charity is to receive. For gift and estate tax purposes the value of the gift to the trust's remainder beneficiary(s) is discounted by the present value of the annuity payments to the charities.

Charitable lead trusts can be established during one's lifetime or through a Will. In the right circumstances, they can be an excellent way to avoid gift or estate taxes. It has been reported that CLTs were used extensively in Jacqueline Kennedy's estate plan. Before executing a charitable trust, one should consult with their tax advisor and estate attorney.

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