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THIRD QUARTER | 2020

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Current Outlook & Portfolio Strategy

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Much has transpired across global capital markets since our last update. I wrote our last Outlook/Strategy article in the middle of March just after the World Health Organization officially declared Coronavirus (COVID-19) a pandemic. Stock markets were aggressively selling off on a daily basis, oil prices were collapsing, and economic activity was grinding to a halt. The unknowns surrounding the virus and the global economy seemed innumerable at the time.

While substantial risks remain (both from a public health and economic standpoint), stock markets have rebounded significantly higher since the low point in March. Social distancing measures helped flatten the infection curves, allowing investors to begin focusing on the future amidst the backdrop of unprecedented fiscal and monetary support by central banks and governments across the world.

Never before have we experienced such a massive coordinated effort by major central banks to lower interest rates and provide nearly limitless liquidity to keep markets functioning. At the same time, governments across the globe were providing massive amounts of stimulus money to their citizens. While we applaud the efforts taken to deal with a global pandemic that took everyone by surprise, we also acknowledge the considerable risks that remain.

In no particular order, the following list summarizes what concerns us most as we work our way through this unprecedented period:

- Will we get a second wave of COVID-19 infections during flu season, and how harmful will it be?
- Will a vaccine be developed and when?
- How long will it take for economic activity and employment to fully recover?
- What are the long-term implications of increased government borrowing on global economies?

As investment practitioners, we are quite accustomed to investing in a world with considerable unknowns. At the risk of sounding a bit glib, to some extent this period of time is no different than any other – there are simply new and unique things to be concerned about. Instead of focusing entirely on the risks and allowing fear of the unknown drive our decision making, it's important to keep an eye toward the long term and remind ourselves that we will get through these uncertainties. Economies and corporations will once again flourish. Moreover, during any period of time, whether we are in the midst of a pandemic or enjoying economic prosperity, quality long-term investments can be found.

From a stock market perspective, we continue to see good value amongst many dividend-paying companies in particular. Income-producing stocks have largely been ignored by market participants over the past few years in favor of growth stocks – primarily in the technology industry. While we own many of these growth tech stocks in client portfolios – where appropriate for our clients' goals – we will continue to make long-term investment decisions based on company fundamentals, focusing on revenue and earnings growth, balance sheet strength, and ultimately valuation. To the extent fixed-income securities (bonds) are appropriate, we are intentionally favoring shorter-term bonds with good credit quality. Interest rates remain historically low, diminishing future returns for bond investors – particularly those who own longer duration bonds.

Considering the risks we highlighted above as well as the improving economic landscape, and thanks in large part to the coordinated action of governments and central banks, we remain cautiously optimistic as we head toward the latter half of 2020.

Retirement Accounts & COVID-19

Cherry W. Smith
Wealth Services

Since Congress created the Individual Retirement Account (IRA) in the 1974 Employee Retirement Income Security Act (ERISA), it has constantly tinkered with the law's provisions to adapt to both economic and wage/salary conditions over the past 46 years. The first IRAs, for example, only allowed $1,500 yearly contributions, and workers could buy mostly bonds or annuities with their contributions. Likewise, the legislation that enacted ROTH IRAs – the Taxpayer Relief Act of 1997 – has changed significantly with the times.

These IRAs, of course, became instantly popular, garnering contributions of $1.4 billion in the very first year. Contributions continued to rise steadily over the years, and as of 2018, nearly one-third of American households owned IRAs (more than 42 million households) with a value of approximately $9 trillion. Of that amount, about $800 billion was held in Roth IRAs and the balance in traditional IRAs.

There have been many changes to IRAs over the years, and one impactful change for clients occurred in 2006 with the passage of the Pension Protection Act. This established the Qualified Charitable Distribution (QCD) that enabled an IRA owner to contribute directly to a charity from an IRA without having to pay income tax on the withdrawal. The charitable distribution was limited to $100,000 and required debate and yearly renewal by Congress. Members finally made the provision permanent in 2018.

Another round of sweeping changes has occurred in recent months, first under the 2019 Setting Every Community Up for Retirement Enhancement (SECURE) Act. Provisions include, among others:

- Required Minimum Distributions (RMDs) are now required to begin in the year the IRA owner becomes 72 (previously it was age 70 ½).
- IRA owners can continue to contribute to their IRA at ANY age, as long as they have earned income (previously you couldn't contribute past age 70 ½).
- For most inherited IRAs, the stretch provision has been curtailed. Your spouse can still roll the IRA to his/her IRA and take the RMD over his/her lifetime, but inherited IRAs for non-spouses (for the most part) now must be distributed within 10 years (previously it was over the lifetime of the non-spouse beneficiary).

More recently, the Coronvirus Aid, Relief and Economic Security (CARES) Act of March 27, 2020, enacted the following changes:

- Required Minimum Distributions (RMDs) from IRAs have temporarily been waived for 2020. As of 6/23/2020, the IRS issued Notice 2020-51 which allows you to redeposit to your IRA any withdrawals made after 1/1/2020. The rollover back to your IRA must occur before 8/31/2020.
- The deadline for making contributions to an IRA, ROTH, or SEP was extended to July 15, 2020.
- The 10% penalty for an early withdrawal has been waived for 2020, limited to $100,000, if the person (or family) has been infected with COVID-19 or is economically harmed by COVID-19. We recommend you consult with your Tax Advisor if any of the exceptions in this section are of interest to you.

Due to the ongoing retirement of Baby Boomers, the transfer of IRA wealth from one generation to the next has been made more significant by these two acts of Congress, as many of our clients have amassed great wealth in their IRAs. The major changes in the stretch provisions mean you may need to revisit your estate plan. We're happy to assist with those discussions at The Trust Company.

The Role of the Fed

Edwin C. Ciskowski, CPA
Senior Portfolio Manager

Given the amount of news surrounding efforts taken by central banks and governments worldwide to dampen the economic impact from COVID-19, we thought it might be helpful to explain the role of the Federal Reserve System (the Fed) and the impact its decisions can have more broadly on the banking system and the economy.

The Fed was established in 1913 following a number of financial panics beginning in the 1800s.

Congress initially established two key objectives for the Fed when it mandated the Fed conduct the nation's monetary policy: maximize employment and stabilize prices. The Fed's objectives have expanded through time and now include the following:

- Conduct monetary policy – maximize employment, stabilize prices, and moderate long-term interest rates
- Stabilize the financial system – minimize and contain systematic risks by actively monitoring and engaging financial markets here and abroad
- Promote the safety and soundness of individual financial institutions
- Foster safety and efficiency of payment and settlement systems involving U.S. dollar transactions
- Consumer protection and community development – supervise, examine and administer consumer laws and regulations through the Consumer Financial Protection Bureau

In benign economic times, the Fed's actions barely get noticed, except when its Federal Open Market Committee (FOMC) sets monetary policy. The FOMC is a twelve-voting member committee that implements its monetary policy through three primary tools: open market operations (buying and selling government bonds to maintain bond prices and to give bond sellers more cash to recycle through the economy); reserve requirements (setting the amount of cash banks need on hand relative to deposits); and the discount rate.

The federal funds discount rate (the rate at which depository institutions lend to one another) is the key interest rate that the FOMC controls, and by extension, nearly all other interest rates that affect our daily lives. The interest you earn on a bond investment or the amount you pay in interest to a bank for a mortgage or car loan are all influenced by the federal funds discount rate. Lower rates are designed to incentivize more consumer and business spending and more lending by banks to increase economic growth. Conversely, higher rates are designed to moderate prices, slow down aggressive borrowing, and reduce inflation concerns.

To support the U.S. financial system and to aid in economic recovery following the Great Recession of 2008-09, the Fed implemented extraordinary liquidity and funding measures to support open market operations. These facilities, which include the purchase and sale of securities in the open market, provide much needed liquidity when markets become disorderly – like we experienced again in March when the Fed agreed to buy $4 trillion worth of Treasury, municipal, mortgage, and corporate bonds as concerns over COVID-19 resulted in forced liquidations of bonds and an absence of buyers. The Fed recently held around $7.2 trillion of bonds, mostly the result of purchases made in the Great Recession and again this Spring.

While the actual printing of currency is managed by the Department of the Treasury, the Fed does use its monetary tools to control how much of that currency is in circulation to achieve its price, interest rate and employment goals. Moreover, the Fed and Treasury work together to borrow money for government spending. The Fed issues and sells U.S. Treasury securities such as bonds, bills, and notes on behalf of the Treasury.

The Fed certainly has a significant impact on the direction and pace of overall economic activity, but like many other areas of government, its power and influence are limited. However, in times of market disruption as in mid-March, the Fed has served a vital role in the functioning of capital markets.

Maximize Estate Benefits as Asset Values Fluctuate

James McArthur
Wealth Services

While it is always a good idea to periodically review one's estate plans, the passage of the Tax Cut and Jobs Act of 2017 (the "Act") provided increased opportunities for estate planning. Certain provisions in the Act, along with the reduced asset values in today's Covid-19 environment, may provide incentives for additional lifetime gifting.

The Act contains some of the most sweeping changes to the IRS Code in decades. It doubled the unified lifetime exemption for estate and gift taxes, raising the current amount to $11.58 million per individual, $23.16 million if married. The lifetime exemption is the amount that can be sheltered from federal estate and gift tax. Gifts that exceed theses exemptions are taxed at a flat 40% rate. A critical part of this provision is that it sunsets, or reverts back, to the previous limits of $5.49 million per individual (indexed for inflation) for any gifts made after December 31, 2025.

Timely transfers or gifts of stock before the exemption recedes is a viable strategy to preserve wealth for successive generations. When stock or securities are gifted, the value is based on their current value. Given that current values are relatively low in today's market, more shares can be transferred tax free to your children. In addition, future appreciation will be protected from exposure to estate taxes.

Stock or interest in closely held entities may qualify for additional discounts for "lack of marketability" and "lack of control" if minority interests are gifted or transferred to children or grandchildren. These discounts can typically create a 25% to 35% reduction from the sale value of a privately held company.

Whether using marketable securities or closely held stock, the primary strategy is to transfer appreciating assets, such as real estate and stocks, before they

begin to appreciate. The result is there will never be any gift or estate tax on the appreciated value.

An extension of this strategy is to transfer assets to grandchildren and great grandchildren, eliminating the need for parents to worry about re-gifting wealth as tax laws change in the future. When considering gifting assets to multiple successive generations consult an advisor as the generation skipping transfer tax (GSTT) will apply. Like gift and estate tax exemptions, the current GSTT exemption for 2020 is $11.58 million and expected to revert to a significantly lower amount in 2025. The same strategy applies - transfer appreciating assets before they gain value and the exemptions expire.

How you structure your gifts to beneficiaries is important. Irrevocable trusts are often used to transfer assets out of an estate and to minimize taxes. As the grantor, you may make gifts to the trust instead of directly to the beneficiaries. You can also specify the amount and frequency of distributions.

Family limited liability companies (FLLC) can be used to gift assets to the next generation while parents are still living and want to maintain control of their interests in the FLLC. This vehicle is often used to transfer stock of closely held companies to family members while multiple generations are active in the business.

Regardless of the options chosen to transfer assets, this is an excellent time to start or continue the conversation on estate and business planning with your family and trusted advisors. We are available if you have questions or would like talk through options.

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