Insight Newsletter

SECOND QUARTER 2021

Litman Gregory
ASSET MANAGEMENT

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Investment Commentary

Market Recap

Equities around the globe continued to surge in the second quarter. The U.S. and developed international markets led the way, with the S&P 500 Index gaining 8.5% and developed international stocks rising 5.7%. Emerging-market stocks trailed in terms of progress on the COVID-19 front and in turn rose by a more modest 4.9%.

Within the U.S. stock market, the rotation from growth to value stocks took a pause, with the Russell 1000 Growth Index gaining 11.9% versus a 5.1% rise for the Value index. Smaller-cap value stocks slightly outperformed their growth counterparts and have been the top-performing segment of the U.S. market this year.

In fixed-income markets, the 10-year Treasury rose as yields dipped below 1.50% in June, ending the quarter at 1.45%, down from 1.75% at the end of March, despite higher inflation readings during the quarter. This contributed to a solid 2.0% return for the core bond index during the second quarter. In fact, inflation fears were felt more strongly last quarter, and core bonds remain down 1.6% for the year as a result of the first quarter selloff. Our selected flexible actively managed bond funds also posted solid gains for the quarter in the 1.5% to 4.1% range. Floating-rate loans were up 1.5%.

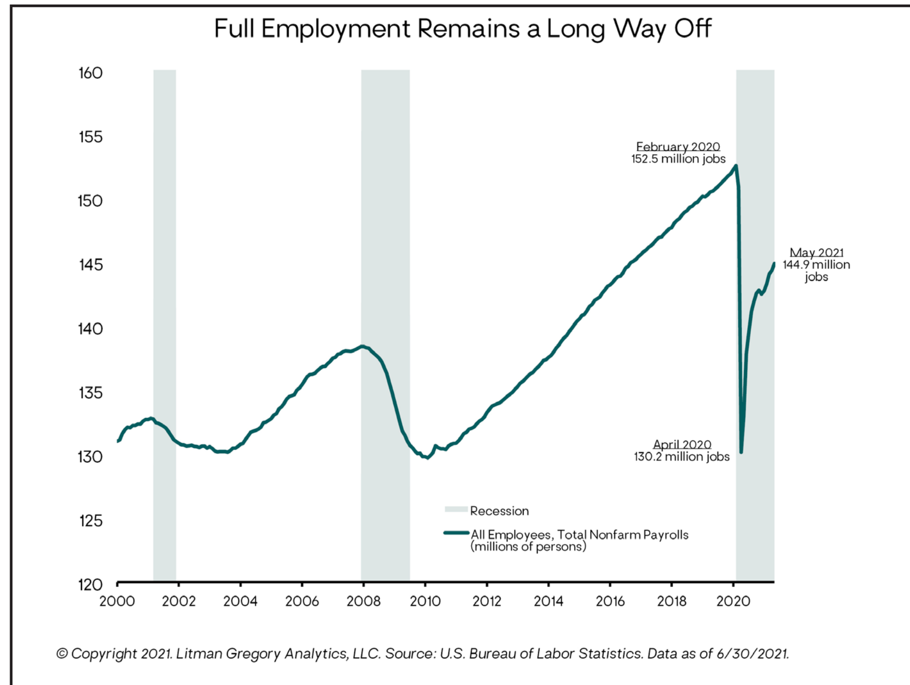
Investment Outlook

As COVID-19 vaccinations and immunity spread across the globe, we continue to expect a strong global economic recovery contributing to healthy corporate earnings growth. This should bode well for riskier but higher-returning asset classes over the near term (next 12 months) at least. Credit markets should benefit as well. While the Federal Reserve is now signaling it is moving closer to beginning to taper its quantitative easing asset purchases, monetary policy and interest rates should still remain accommodative for a while.

Our portfolio positioning reflects this view, with a modest overweight to global equities in most models. We believe non-U.S. equities, which are generally more economically sensitive and trading at cheaper valuations, are likely to outperform and we have a tactical overweight to emerging-market stocks. We also have meaningful allocations to flexible bond strategies that we expect to do better than core bonds, as well as floating-rate loan funds that are not sensitive to rising rates.

On the major question of whether recent signals are harbingers of a sustained period of meaningfully higher inflation, we believe it is too early to tell. But our current base case is that inflation does not get out of control. The U.S. economy still appears to have significant slack before

aggregate demand would start overwhelming the economy's productive capacity (the supply side), leading to the economic "overheating" that could cause significant, sustained, and broad-based inflation.



The labor market is a key supply-side indicator. There were nearly 8 million fewer nonfarm jobs at the end of May compared to February 2020. Meanwhile, more than 9 million people are currently unemployed and potentially available to work immediately.

While there have been recent reports of businesses unable to hire enough workers, this looks to be driven by temporary factors related to COVID-19. As long as there is slack in the labor market, wage inflation is unlikely to surge. This means there is low risk of a wage-price spiral such as the United States experienced in the 1970s.

Meanwhile, consumer price index (CPI) inflation numbers have been surprisingly high, and longer-term CPI inflation expectations have increased from their pandemic lows. That said, they still remain well within their 20-year historical range and consistent with the Fed's long-term 2% core inflation objective. Digging deeper into the numbers reveals that some of the bigger drivers (like spiking used car prices and a sharp rebound in prices for travel and leisure services) are clearly driven by pandemic disruptions. In all, we think it is more likely that most of the recent sharp price increases will prove transitory, as current supply shortages catch up to demand as the pandemic recedes.

The path of fiscal policy in the United States is less certain, given the political dynamics and polarization. The expiration of the pandemic support programs will turn from a fiscal boost to a fiscal drag later this year and in 2022. But this should also lead to increased labor supply, mitigating wage inflation pressures. With the likelihood of a U.S. recession very low—absent a severe external shock—we see low risk of a near-term bear market. Of course, 10%-plus stock market corrections can always occur. And as we move further into the U.S. earnings cycle, the odds of a typical mid-cycle market correction increase. But despite elevated

S&P 500 valuations and a likely deceleration in S&P 500 earnings growth, we believe global equities have additional return potential in this cycle. More specifically, we continue to see superior shorter- to medium-term return prospects in developed international and emerging equity markets, where earnings have more room for positive surprises and valuations are more reasonable. As always, though, equity investors should be prepared for a bumpy ride.

Pandemic-Affected Prices Are Pushing Up Overall CPI

* EXCLUDES FOOD AND ENERGY.

Source: BCA Research

U.S. Fiscal Policy Will Become a Headwind

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Closing Thoughts

While our base case is positive, the range of possible outcomes is always wide, and these are far from ordinary times. As a result, we don't make aggressive bets on a single outcome even if our analysis suggests it is more likely. We are tilted modestly toward reflationary, return-generating assets. But we acknowledge there are scenarios that could drive inflation to be higher and occur sooner than we expect. There could also be shorter-term deflationary shocks like more-dangerous COVID-19 variants or political unrest that leads to a market correction or worse.

While a sustained period of high inflation would be bad initially for most equities, over time many areas would likely do well, including emerging-market stocks, value stocks, and trend-following managed futures funds. And in the event of a macro shock and deflationary pressure, we maintain meaningful positions in core bonds, which would help offset declines elsewhere. Put simply, we are diversified, as always.

We thank you for your continued trust in us and invite you to reach out to your advisor with any questions about the markets or your portfolio. Visit **www.lgam.com/blog** to read the full Commentary from our Chief Investment Officer, Jeremy DeGroot.

—Litman Gregory Investment Team (7/8/21)

Increased Return Expectations for U.S. Stocks

Over the past six to nine months, as we reviewed the changing market and economic environment, our expected returns for U.S. stocks have increased. We are also giving greater weight to more optimistic return scenarios. The result of this analysis has given us confidence in incrementally increasing the target allocation to U.S. stocks across our balanced portfolio strategies. In this post we summarize our recent analysis and why we think an increased target allocation will improve the risk-adjusted return profile of our portfolios as the economy and markets continue their recovery from the pandemic's impact.

Reflation

The Federal Reserve and the Biden administration have been successful so far in their reflation effort. We expect to see higher average economic growth in the upcoming cycle than we have seen since the 2008 financial crisis. That should translate into strong, broad-based earnings growth for U.S. stocks.

Excepting China and other north Asia countries, the United States is emerging from the pandemic as the country in the best shape due to our successful vaccine rollout. Other positives: Bank balance sheets are strong, which will support lending; households have deleveraged and are now flush with savings, which will support consumer spending; and we will likely get more fiscal stimulus in slow drips over the coming years. Coming out of a recession, we are relatively early in the cycle. Double-dip recessions are something investors often fret about, but they are exceedingly rare. There's only been one since the Great Depression.

Low Real Interest Rates Are Likely to Persist and Support Relatively High Valuations

We do not view a sustained and material increase in U.S. inflation as likely over the next couple of years. In the very near term, we see higher inflation, but we agree with the Fed that it is a result of the recovery and will likely be transient. Our upgraded view of U.S. stocks aligns with this view. Without a sustained rise in inflation, the Fed can keep its word and hold real interest rates low for a long time, which we believe would support slightly higher valuations than we have seen since the 2008 financial crisis on average.

Yes, interest rates have risen sharply from their lows in the fall of 2020, but real rates remain quite low compared to history. We see the rise in rates this year as the market pricing in reflation. While we expect interest rates to gradually rise over the next few years, they should remain relatively tame. So, core bonds yielding less than 2% or even 3% will continue to offer weak competition for stocks. In a low-rate environment like that, a mid- to upper-single-digit return from stocks is a fair return. And there are decent odds returns end up being more positive, driven primarily by better-than-expected earnings growth, in our view.

Margins Are Likely to Stay High

The pandemic has accelerated many technology trends (like virtual work) that we think could largely offset many of the pressures we see on profit margins (such as from deglobalization). It is likely that S&P 500 companies will continue to eke out efficiency gains and benefit from scale and network effects as they have the past two decades. In that environment, we may not see profit margins revert or even partially revert back to long-term historical averages, as we had been expecting in our base case. Instead, they may stay high, supporting relatively higher valuations. The bottom chart on the next page from BCA Research shows profit margins have generally been on an upward trend for the past two decades. If anything, we think the odds are good that profit margins will move up a notch further in this cycle. We are factoring this into our upside case, which as we mentioned, we are weighing as part of our overall assessment of U.S. stocks.

The Downside Risks We Are Watching

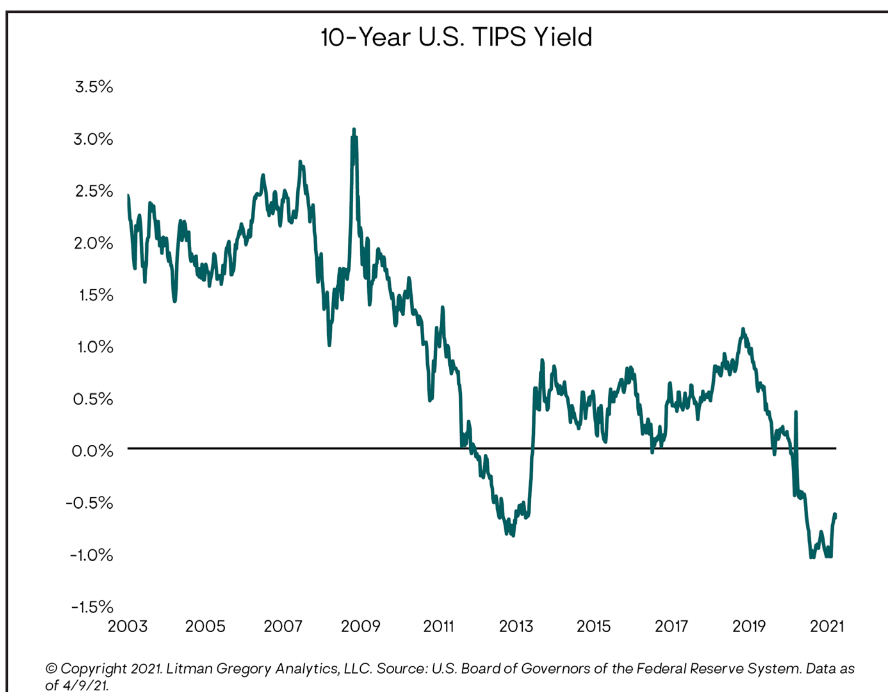
The major risks to our base case, and the mitigating factors, are as follows:

- U.S. reflation efforts may not yield the expected growth. This could mean the underlying fundamentals of the economy turn out weaker than we think. We capture this outcome in our downside scenario, but we think it is unlikely given the fundamental and economy data we are seeing this year.

- If inflation surprises on the upside, the Fed may be forced to raise rates higher and faster than it currently anticipates. This could cause markets to decline steeply in the short term (maybe 10% to 20%) given relatively high current absolute valuations. However, we think the Fed has the tools to manage long-term inflation expectations to keep them anchored.

- Markets could force rates significantly higher given the United States's large deficit spending. We think this scenario is unlikely given the U.S. dollar's reserve-currency status and the Fed's ability to repress long-term rates, similar to what it successfully did after World War II.

- Lastly, the Fed's focus on its employment goals may encourage it to keep monetary policy easy for far too long and risk financial bubbles. There are already some worrying signs of excessive risk-taking in special purpose acquisition companies (or SPACs), cryptocurrencies, and small-cap growth stocks. The odds of this scenario increase if the acceleration in technology trends



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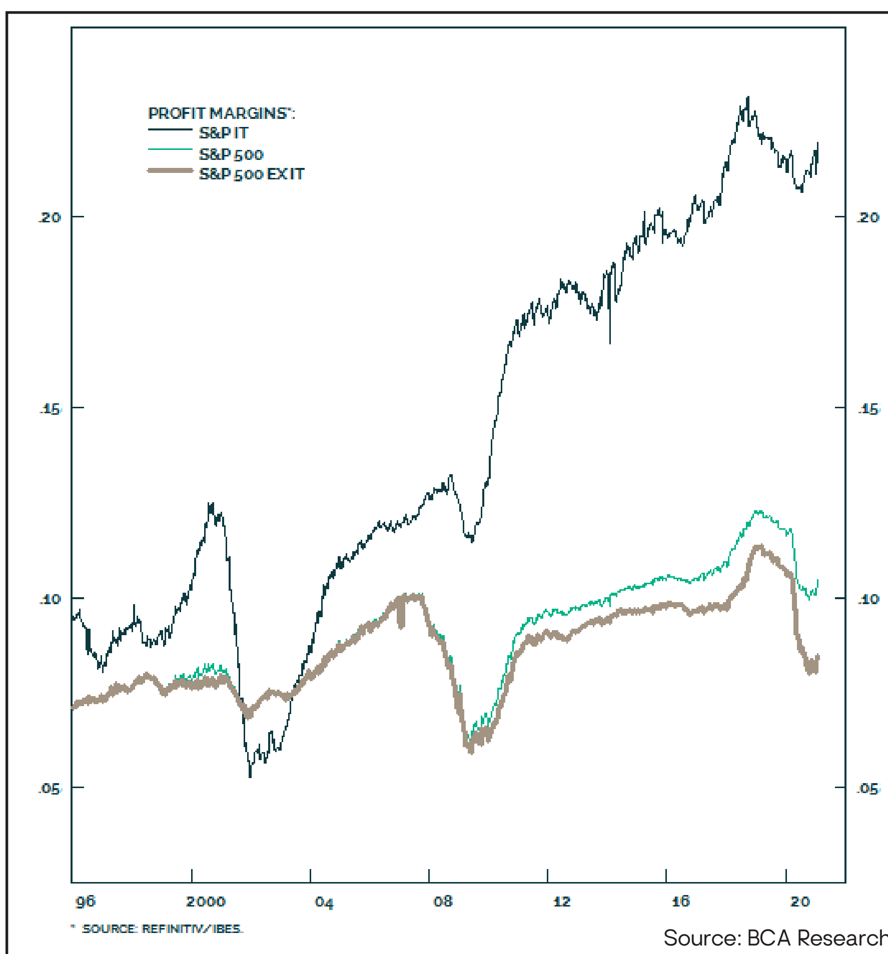


Source: BCA Research

makes it difficult for the Fed to achieve its expanded definition of "full employment." However, at present, we don't think overall markets are close to being in egregious or bubble territory.

Putting It All Together

Given our improved confidence and resulting increase to our U.S. stocks target, our more conservative portfolio strategies will be only slightly underweight to equity risk overall, and our balanced portfolio strategies with larger equity allocations will be slightly overweight. Note, our upgrade of U.S. stocks doesn't change the fact that emerging-market stocks remain *more* attractive in our eyes. Our expectations for U.S. stocks provide a higher hurdle for emerging-market stocks to clear in our relative analysis. But the return gap still favors emerging-market stocks. Moreover, we see potentially additional upside for emerging-market stocks once we move past COVID-19. To sum up, we believe investors are being fairly compensated for taking on benchmark or slightly-above-benchmark equity risk. As always, we will be willing to change our views based on new data points and/or analyses.

For more details on our analysis, or a review of your portfolio, don't hesitate to reach out to your advisor for a discussion.

Advisor Q&A: Tax Planning & the American Families Plan

with Litman Gregory Senior Advisor Chris Wheaton

May 2021

President Joe Biden recently released an outline of the American Families Plan (the Plan), which follows many of the provisions that Biden outlined in his campaign. We asked Litman Gregory Senior Advisor, and former practicing CPA, Chris Wheaton a few questions about the Plan to better understand how it may impact planning with clients.

Chris, before we get into the details of the Plan, can you first explain whether these proposals are set or if we should expect changes as they progress through Congress?

Yes, it is important to point out that there will be changes to these provisions as they move through the legislative process. The Plan contains numerous large tax increases, so it is unlikely to garner support from any of the 50 Republican senators. Therefore, the Plan would need all 50 Democrat or Democrat-leaning Independents to vote in favor of it to become law. As has been the case with other legislation, more moderate senators could ask for changes to the law, which might result in eliminating certain provisions, adding others, and/or lowering the proposed rates. So, while it is wise to start thinking about steps to take to minimize tax liabilities, we think it is best to wait to see what the final legislation looks like before implementing planning moves.

Could you provide a quick review of the key provisions of the Plan based on the Fact Sheet released by the Biden administration in advance of his speech on April 28, 2021?

Here is a summary of what we see as the key provisions of the Plan and their potential impact:

- **Increase the top individual income tax rate to 39.6% for taxpayers "within the top one percent."** The Plan does not cite specific income thresholds that would apply for individual and married filing jointly taxpayers, but past discussions referenced a level of income of $400,000 or greater.

- **Tax income from long-term capital gains and certain dividends at ordinary income rates for "households making over $1 million."** The Fact Sheet does not specify if the threshold would apply to taxable ordinary income or investment income (or both). If coupled with an increase in the top marginal tax

rate, this could increase the federal tax rate on long-term capital gains for households with income above $1 million from 23.8% to 43.4%. (As an example, for residents of California the top state tax rate is currently 13.3%, so their top combined federal and state tax rate could be as high as 56.7%.)

- **Repeal the step-up in cost basis of inherited assets at death for unrealized capital gains greater than $1 million.** Special rules (not described on the Fact Sheet) would apply to protect family-owned businesses and farms that are passed on to "heirs who continue to run the business."
- **Permanently eliminate the "carried interest loophole,"** which is a provision where certain profit-based income earned by hedge fund general partners is taxed at favorable long-term capital gain tax rates vs. higher ordinary income tax rates.
- **Presumably end the Section 1031 like-kind exchange rules for deferring the realization of capital gains on real property greater than $500,000.** Under current rules, unlimited capital gains on the sale of certain real estate can be rolled over into a new property (or, in other words, the cost basis of the old property is carried forward) if certain rules are followed.

Chris, were there any tax provisions that have been in discussion that you were surprised to NOT see mentioned in the Plan?

Yes, the most surprising omission was a change to the estate/gift tax exemption, which is currently $11.7 million per person. Many had expected to see proposals to lower this amount to $5 million or less per person. We will continue to track potential changes in estate tax laws, as this is a key area of wealth planning that we focus on with clients.

Given that these proposals may change before they potentially become law, what do you expect could be the effective date of new provisions of the legislation, and how do you suggest people plan for these changes?

The Fact Sheet does not mention the effective date of the legislation, but many Congressional analysts believe that the legislation would be more likely to pass if the effective date is deferred to January 1, 2022. However, there is no guaranty that the effective date will not be in 2021. Based on past tax legislation, effective dates can be retroactive to January 1 of the current year, or when there is committee action on the bill, or made effective on the enactment date.

In terms of what our clients could consider doing today in anticipation of the potential changes, that is hard to say specifically at this time. While it is difficult to determine what provisions will make it into the final legislation, what seems clear is the desire to raise taxes on high-income taxpayers. If legislation passes that increases tax rates in 2022, the following are some tax minimization strategies we will be discussing with our clients:

- For clients with income that may be over $1 million in 2021 or 2022, and who are considering the sale of a home or business with large built-in taxable gains, we may look at ways they could recognize those capital gains within 2021 when capital gain tax rates may still be lower.
- The same could be true for clients who could recognize built-in portfolio gains now on investments we may have been planning to sell in 2022 or 2023. Because selling investments at gains does not trigger a wait period for repurchase like selling those at losses*, we could immediately repurchase those investments if desired. (*Under the "Wash Sale" rule, an investment sale resulting in taxable capital loss requires waiting 31 days before repurchasing the same investment, or the tax loss will be disallowed.)
- For clients considering a like-kind Section 1031 exchange of real estate, with an unrealized capital gain tax deferral of more than $500,000, we may encourage them to execute the exchange before a cap is put in place.

- In general, we are preparing to help our clients consider accelerating income into 2021. Examples include:
    - If possible, accelerating 2022 bonus income into 2021
    - Accelerating 2022 business income into 2021
- We may also encourage clients to defer itemized and ordinary income deductions into 2022, when those deductions may have a higher tax deduction value. Examples include:
    - Charitable donations
    - State income tax payments
    - Property tax payments
    - Business expenses

Thank you, Chris, for this helpful review and the summary of some tax planning ideas.

As the legislation continues along the review process, how would you suggest that clients keep abreast of changes and additional planning opportunities?

I would suggest that clients be in touch with their Litman Gregory advisors as well as their tax professionals, knowing that we are all watching this tax legislation closely and can continue to provide updates and planning suggestions. We are happy to talk through these planning ideas with our clients, especially given that each person or family's situation is different and needs a customized approach. As always, we recommend consulting a tax advisor before making any tax planning moves.

Finances & Aging: Tips for Planning Ahead

In this interview with Senior Advisor Gretchen Hollstein, we uncover several tips for families as they navigate the issues of financial management that often come with aging. Gretchen explains why this is so important, and how she and the advisory team at Litman Gregory work with clients to follow the steps involved in planning ahead.

Gretchen, is the area of financial planning for aging something that you focus on specifically, or is it a team-wide area of expertise at Litman Gregory?

At Litman Gregory, we have been working with families and their next generations for over 30 years, so our entire team has a great deal of experience working with clients as they age. But this topic does hold a special place in my heart, as I experienced firsthand the impact of aging when my father battled the effects of Alzheimer's. What I learned is that even after planning as well as he did, the experience can still be hard on the family. But being prepared is what also gives you the opportunity to spend precious time creating moments of joy.

How has helping clients plan for the issues around aging changed over the years?

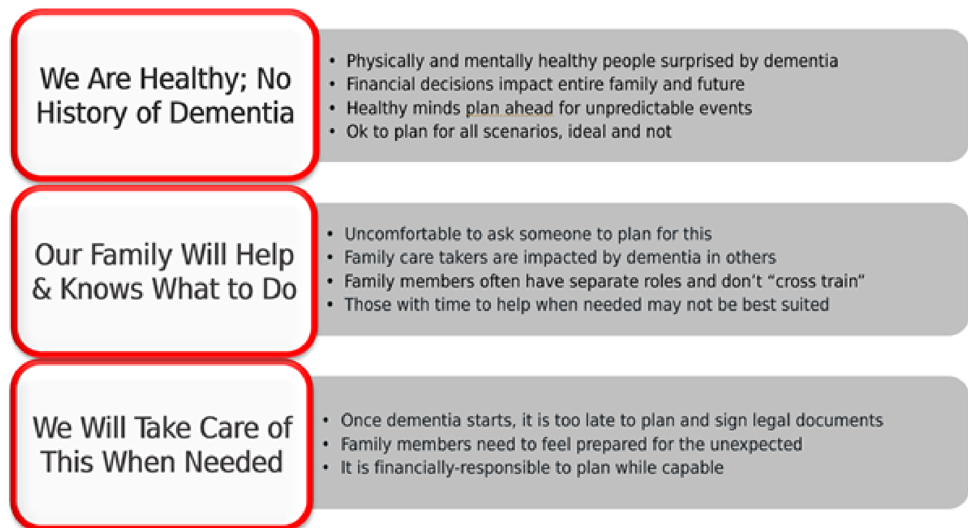
As wealth advisors, our goal is to provide financial guidance throughout our clients' lives, so planning for changes that come with aging is inherent in our work. But, as we see people living longer, we also see more families dealing with the difficult issues of dementia. This decline in cognitive skills limits a person's ability to direct their own finances, so it's imperative that we help clients plan in advance for the stewardship of their assets.

Do you find more people are preparing these days for the possibility of dementia?

Honestly, I see that cognitive decline still comes as a surprise to most families. It can be a shock to watch the most intelligent and talented people become affected by dementia, and it can also progress slowly—sometimes years before being noticeable. Further, it is difficult and painful to acknowledge that either you yourself are losing cognitive abilities or that someone you love is struggling. Because it can come as a surprise, we try to have conversations about this with clients early. The table below shares some of the things we hear and discuss when broaching this subject.

What are some pieces of advice you can give to help get these conversations started?

There are certainly many directions we go in these conversations, from planning ahead for the family's living situation, care taking, medical support, etc. But for the moment, let's focus on planning for finances—here are a few pieces of advice:



1. Do not assume that just because someone is intelligent or financially savvy that they have everything covered. *I've seen clients come to us after a loved one passed without some basic planning steps taken, such as designating beneficiaries. Often the family assumed they would be on top of their financial management.*

2. Don't wait until there is an event or need before making arrangements for backup and protection of a loved one's finances. *I've seen clients have to step in when they needed to protect a family member in cognitive decline from becoming victim to financial abuse, and others need to quickly prepare documents with a family member who could decline beyond being able to sign with a notary.*

3. It's really not enough to have just a Will in place, especially in California. Asset ownership and assignment of decision makers need to be supported by legal documents and kept up to date. *One of my clients went through heartbreak when an independently wealthy family member died prematurely without appropriate legal documents—only an old handwritten will was found, without updated beneficiaries, and required a public legal probate process.*

We always recommend planning early, when everyone is healthy, capable, and can be part of the planning discussion and decisions.

You mentioned that it's important to have the right documents to outline ownership and decision makers for financial assets— would you review these?

There are numerous types of investment and financial accounts, and therefore numerous options for backup and succession. The chart below gives a summary of at least five different types of ownership structures and how those assets receive direction, backup, and later succession.

Account Type	Primary Direction From	Backup Direction From	Succession of Assets
Joint or Individual Bank Account	Owner(s)	Person with Power of Attorney or Durable Power of Attorney	Per directions in Will and/or Probate Court (or beneficiaries in Transfer on Death "TOD" instructions)
Trust Investment Account	Trustee(s) of Trust	Co-Trustee, or Successor Trustee, according to Trust	Per directions in Trust (likely match Will)
IRA, 401k, or Retirement Account	Owner	Person with Power of Attorney or Durable Power of Attorney	Per beneficiary designations
529 Plan or Custodial Account	Grantor or Custodian	Successor Grantor or Custodian, according to rules for account	Per directions in account arrangement for successor Grantor or successor Custodian
Insurance Product	Owner	Person with Power of Attorney or Durable Power of Attorney	Per beneficiary designations

In addition to getting your "docs in a row", what other tips do you have from your work helping clients plan ahead?

One of the most impactful things we do for our clients is what I sometimes call "professional financial organizing"—helping them simplify and organize financial assets and accounts. This is helpful throughout life but becomes even more effective and important in later years. Here are a few ways we help clients simplify and consolidate:

- **Consolidate Investment Accounts: One taxable investment account, ideally in the name of a Trust, and one IRA account per holder.** Having less investment accounts will help simplify the oversight, tax reporting, and asset allocation review. Authorization can be given to another person for viewing an account, and taxable accounts can be registered in the name of a trust to provide backup and succession. For retirement assets, once other account types are not needed (please discuss with your advisor), consolidating to one IRA per holder helps ease the management of required distributions, tax tracking and reporting, and beneficiary designation management.

- **Simplify portfolio selections and investments.** In later years, it can be especially helpful for investors to have more liquid and easily tradable investments. This makes generating cash flow more efficient, creates more streamlined investment reporting, and can be helpful in reducing risk.

- **Update "Trusted Contact" on record with custodian/broker.** Custodians ask for a Trusted Contact as a person who can be contacted if they have any concerns related to the account holder (not as an account decision maker). This is an important resource in case they need to reach out for support.

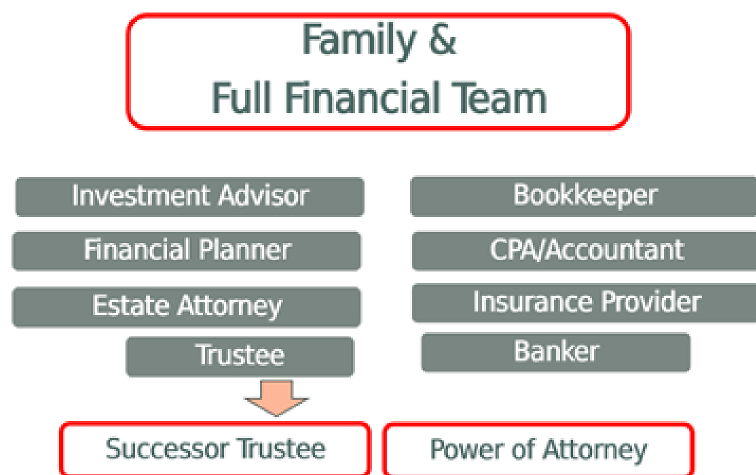
- **Use the brokerage firm's Power of Attorney or have them review your Power of Attorney document.** Estate attorneys often draft durable power of attorney documents, but not all brokerage firms can abide by them as written. It can be helpful to have the custodian's legal team review those documents well in advance of their need, or simply adopt their own if appropriate.

- **Review successor trustees, power of attorney, and other backup decision makers.** If a designated backup is no longer available, or becomes cognitively challenged, it's good to have a backup plan. If there isn't an appropriate choice, a professional fiduciary could be considered as a successor decision maker.

- **Plan for access and succession of non-financial resources and possessions.** In addition to financial accounts, backup decision makers need to know how to access non-financial resources. Examples would be a safe deposit box, medical contacts and prescriptions, signed estate plan documents, social security and/or pension payments, online passwords, insurance policy information, social media accounts, household and car key storage, home security access, photo and video storage, etc.

You have likely seen some families navigate aging and financial issues as smoothly as possible. Can you share what they did well?

There is one consistent theme that we've seen within families that plan ahead well—having a trusted team of advisors. As wealth advisors, we regularly collaborate with tax and estate professionals, as well as insurance advisors, bookkeepers, and even bankers. This collaboration helps our clients receive coordinated support from a team of professionals and ensures their best interests are at the forefront of every decision. Below is an example of the types of professionals to consider as a team to support a family as the current owners begin to transition to their successors.



Do you have any other suggestions to share?

I think the key takeaway is that it's important to be willing to think about these issues and begin planning for multiple possibilities. The first step is simply to start talking; we can help by providing a sounding board and encouragement to think through different scenarios. It's an honor for us to be invited into the process and help our clients as they navigate unique paths into the future.

Thank you, Gretchen, for this overview of planning ahead for finances and aging. For clients of Litman Gregory, please feel free to contact us to discuss these issues and your own situation with your advisor.

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