Insight Newsletter

THIRD QUARTER 2021

Litman Gregory
WEALTH MANAGEMENT

What's Inside

Investment Commentary

Market Recap

A September slump put a pause in the global equity bull market. The U.S. stock market, as measured by the S&P 500 Index, dropped 4.7% for the month, while developed international equities (MSCI EAFE Index) fell 2.9% and emerging-market stocks (MSCI EM Index) dropped 4.0%. For the third quarter, the S&P 500 was up just 0.6%, MSCI EAFE was down 0.4% and EM stocks declined 8.1%. However, year to date, the S&P 500 is up an impressive 15.9%, MSCI EAFE is up 8.3%, and the MSCI EM Index is down 1.2% as of quarter end.

The culprit behind emerging-market (EM) stocks' poor recent showing is China (more on this below). The MSCI China Index was by far the worst-performing stock market in the third quarter, down 18.2%. For the year to date it is down 16.7%. Chinese stocks comprise roughly 35% of the EM equity index. We should note that EM stocks have bounced back since quarter end and were positive for the year to date as of late October.

Meanwhile, smaller-company stocks and growth stocks outperformed the broader U.S. market while value stocks lagged for the second straight quarter, with sector performances reflecting a somewhat more risk-averse investor mindset, consistent with the COVID-19-related economic growth slowdown during the quarter.

Core bond returns and yields were essentially flat for the quarter, but it was a roller-coaster ride, with the 10-year Treasury yield plunging below 1.2% before shooting back up in the last two weeks of September (bringing prices back down). Credit-sensitive segments outperformed core bonds, and for the year to date, core bonds are now down 1.6%, while high-yield bonds and floating-rate loans are up 4.6% and 4.4%, respectively.

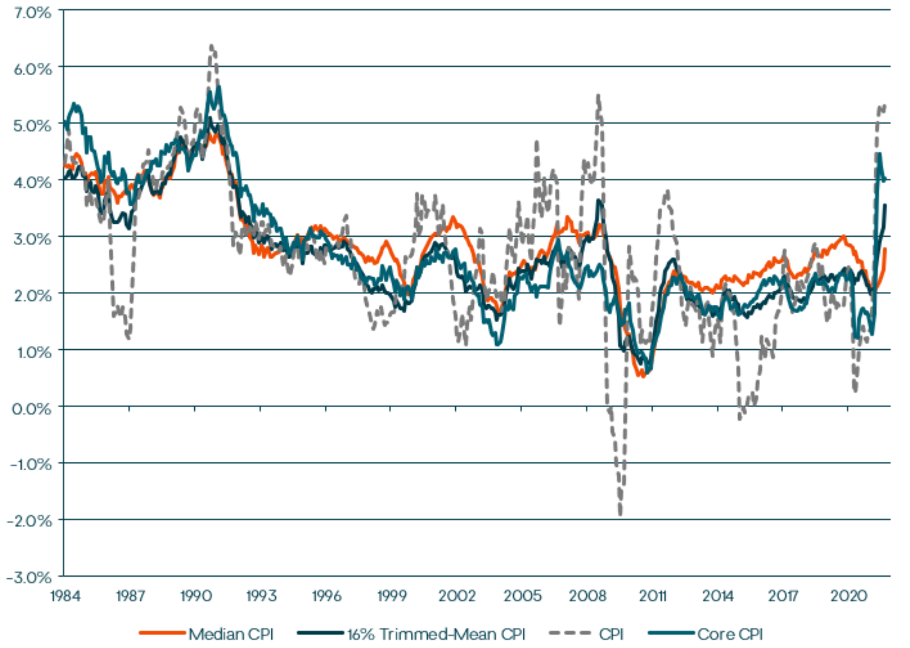
Investment Outlook

Last quarter we summarized our view that higher inflation is more likely a transitory effect of COVID-19 and supply chain disruptions versus the start of a damaging inflationary spiral. We do expect modestly higher inflation in the years ahead, but all in all, we are satisfied that our portfolio positioning, which includes allocations away from core bonds in favor of flexible credit strategies and liquid and private alternatives, is appropriate for a return to more historically normal levels of inflation. We will continue to monitor inflation closely and adjust our views and positioning as needed.

A new concern that emerged in the third quarter is around the excessive borrowing in China's property sector and within Evergrande Group, one of the country's largest property developers. Moreover, this has come amidst other regulatory crackdowns in China (such as in the for-profit education industry).

We have followed these events closely as part of our ongoing research on China and emerging markets. Thus far we are of the view that these risks will be contained, and therefore we are not currently contemplating any changes to our portfolio positioning. Looking further ahead, the short-term pain could result in new opportunities for investors in China, as we are hearing from some of our portfolio managers.

Different Measures of "Core" Inflation Tell Different Stories

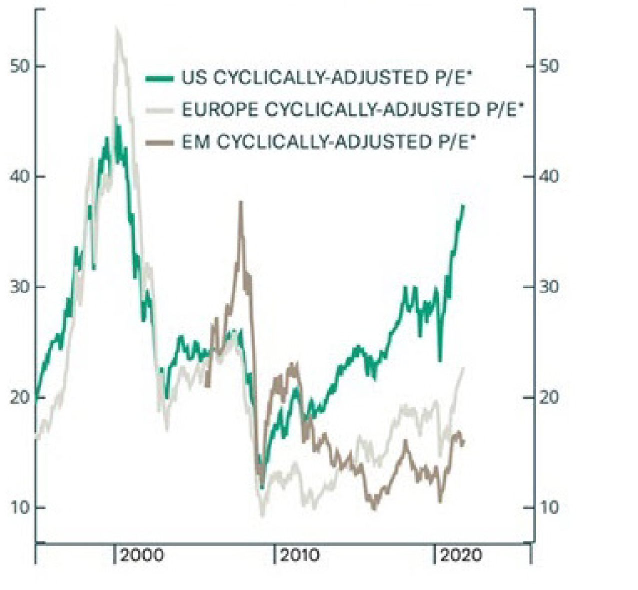


We take higher risk into account, including China specifically, when assessing the relative attractiveness of emerging markets, by requiring a significantly higher extra return (return premium) than we would for a less volatile asset class. We have also haircut long-term growth assumptions for China until there is more clarity on evolving regulations and credit conditions there.

We remain comfortable with our current emerging markets allocation after taking into account the risks, opportunities, and diversification benefits we see in China and EM generally. Ultimately problems such as Evergrande's are quickly priced in (and often over-priced in) so the question is whether this is transitory or a more fundamental long-term change. This question is the focus of our analysis.

A catalyst for the Evergrande-related turmoil is the Chinese government's steps to rein in speculation that they believe is leading housing to become increasingly unaffordable. This in turn is surfacing issues related to excessive leverage in the property sector that have built over many years. We are focused on understanding how large the problem is and how China will manage this adjustment.

Emerging Market valuations are historically low relative to the U.S.



* BASED ON A 10-YEAR MOVING AVERAGE OF REAL EARNINGS PER-SHARE.
** CYCLICALLY-ADJUSTED EARNINGS YIELD MINUS REAL 10-YEAR GOVERNMENT BOND YIELD. BOND YIELD DEFLATED USING HEADLINE CONSUMER PRICES AND 10-YEAR CPI SWAPS.
NOTE: GLOBAL IS THE MARKET CAPITALIZATION-WEIGHTED AVERAGE OF THE US, EURO AREA, JAPAN, UK, CANADA, AUSTRALIA, SWITZERLAND, SWEDEN, AND EMERGING MARKETS.
SOURCE: REFINITIV DATASTREAM AND MSCI INC. (SEE COPYRIGHT DECLARATION).

Source: BCA Research

At present, we share the widely held view that a more orderly restructuring is the more likely scenario. It is in China's best interest to avoid a chaotic wave of defaults and the government has the means to stabilize the financial system since it is the majority owner. That said, we will continue with our analysis and if we conclude the impact is likely to be long term versus temporary, we will factor that into our portfolio positioning.

Closing Thoughts

Our base case for the next several years remains relatively sanguine. We expect the economic cycle, interest rates, and government policy to remain broadly supportive of equities and risk-asset markets.

However, our base case also suggests we should be prepared for an extended period of much lower absolute investment returns for U.S. stock and core bond market indexes than the last five to 10 years. (The S&P 500 has gained 17% annualized over the past 10 years and core bonds are up 3% annualized.)

Absent significant further U.S. equity valuation (multiple) expansion from already near-record-high levels, double-digit U.S. market annualized returns are unlikely. Record-low bond yields and above-trend earnings growth (driven by mega-cap tech leaders) have driven strong returns but mathematically and economically, that is extremely unlikely, if not impossible, to repeat over the next five to 10 years, given where we are now starting from in terms of yields, profit margins, and earnings growth.

Nevertheless, in our medium-term "upside" scenario we estimate still-attractive upper-single-digit returns for U.S. stocks. And in our base case, while their absolute returns are uninspiring, we expect U.S. stock returns to be attractive relative to core bonds. So, we are only modestly underweight to U.S. stocks in our balanced portfolios.

Meanwhile, non-U.S. equities and EM in particular remain attractive, which is the primary reason for our tactical overweight to them. But as we wrote at the end of our Q2 commentary—and as we experienced with EM stocks in the third quarter—equity investors should be prepared for a bumpy ride.

As always, we thank you for your trust and welcome questions you may have.

Visit www.lgam.com/blog to read the full Commentary from our Chief Investment Officer, Jeremy DeGroot.

—Litman Gregory Investment Team (10/6/2021)

Tax Planning for All Seasons

As we write this piece, President Joe Biden and Congressional Democrats are in the process of negotiating the final provisions of the so-named "human infrastructure" spending bill. We are following the tax legislation closely and will provide updates and planning suggestions as final details of any changes are announced.

In the meantime, we wanted to share a list of some timeless tax-wise practices, many of which we focus on in our discussions with clients around this time each year:

- **Maximize the use of tax-deductible retirement plan contributions** each year to lower your tax liability as much as possible. The SECURE Act now permits savers to continue contributions to IRAs even after age 70½.

- **Make annual or one-time gifts to family members** to transfer taxable income and future gains from your portfolio to others, potentially reduce family-wide tax liability, and reduce your taxable estate during your lifetime.

- **Gift appreciated securities held for more than one year directly to charities or to a charitable donor-advised fund (DAF).** The tax deduction is based on the value of the gift, and tax liability for you on any built-in capital gains are eliminated.

- **Concentrate multiple years of charitable deductions into one year** to maximize the tax benefits of giving, using the technique of "charitable bunching."

- **Consider qualified charitable distributions (QCDs) from IRAs for those over age 70½,** especially if you would not otherwise receive as advantageous a tax deduction for gifting taxable assets.

- **Consider a Roth IRA or Roth 401(k) conversion or even discretionary distributions of IRA assets,** especially if this will be a low-income-tax-rate year for you. If you have not already begun taking required minimum distributions from IRAs, one strategy we often recommend is to reduce or eliminate your traditional IRA assets before they kick in.

Throughout the year, we regularly look for opportunities to maximize after-tax portfolio returns beyond investment selection, allocation, and periodic rebalancing. We utilize these techniques in our client portfolios as part of our tax sensitivity in managing investment strategies:

- We aim to **hold investments in taxable accounts for more than one year** before selling them so that long-term capital gains rates will apply. The tax difference can be significant. (However, we always assess the potential risk and return tradeoffs that result from any decision to extend an investment holding period.)

- We seek to **place the interest-earning portion of portfolios in tax-deferred accounts** given interest income is taxed at the top marginal rate, unlike long-term capital gains.

- We **consider carefully before selling investments with large built-in gains,** unless the sale is justified by a higher expected return from another investment or is necessary to maintain portfolio asset allocation objectives.

- When raising cash in your portfolio, we do so by **selecting securities or individual lots of a security that have the lowest taxable gain** consequences.

- If there is market volatility throughout the year, as well as regularly during our year-end review, we **look for opportunities to "harvest" capital losses.** These realized losses can then be used to offset realized gains elsewhere within or outside the portfolio, and within the same tax year or rolled forward to future tax returns. In either case, proceeds can be placed in a comparable investment so the portfolio allocation remains intact.

- For portfolios without significant tax-deferred assets, we will generally recommend **holding tax-exempt bonds in lieu of taxable bonds,** depending on the client's marginal tax rate.

We welcome the opportunity to discuss these planning topics with our clients and to coordinate with tax advisors to determine the best techniques for each tax profile. Please contact your Litman Gregory Advisor for more information and to review your situation. *Note: As with all tax planning, every person's tax situation is different. We suggest consulting with your tax advisor before implementing any of these tax planning techniques.*

Advisor Showcase: Guiding Clients Through Post-Recession Uncertainty

Litman Gregory's advisors were asked to participate in the North Bay Business Journal's Wealth Manager Survey, which asked advisors to respond to questions about the financial markets post the pandemic-induced recession, new investment opportunities, risks, inflation concerns, lessons learned, and advice from their experience.

On the next page, we share a selection of responses from Senior Advisors in our North Bay-based advisory team: Monica Muñoz, CFP®; John Baxman, CFP®; Chris Wheaton, CPA, CFP®; Bill Thompson; Craig Keller, CFA; Lesley Cannan, CFP®, and Gretchen Hollstein, CFP®.

In addition, Senior Advisor John Baxman, CFP® was featured in North Bay Business Journal's published article, "Road ahead for your money: North Bay wealth managers unpack what's known and possible in this challenging year".

In the pandemic, more people saved. Did they sock money away in safer, but lower return vehicles like saving or money market accounts? And if so, are they already moving money to more return-driven investments?

In ongoing discussions with our clients, we help them determine an amount of money to set aside in safer investments like cash or money market funds which can provide for shorter-term cash flow needs and provide an "emergency fund" as needed. The pandemic, and market volatility that followed in the early months, reinforced the importance of this strategy, and provided another opportunity to revisit these discussions with our clients. Having funds set aside in cash allowed clients to "stay the course" and remain invested during a market downturn, and also provided some clients with the comfort to reinvest any additional savings in their investment portfolio during this time. ~ *Monica Muñoz, CFP®*

Related, have you moved on your outlook, now that there are signs that the economy is quickly shaking off the pandemic, to a more aggressive stance with your investment suggestions for clients?

We expect that the global economy will continue to recover, and that corporate earnings growth will be solid. We believe that this backdrop will favor higher-returning asset classes. While our portfolios are diversified across many types of investments, we have slightly increased our allocation to stocks across our portfolio strategies. Because there is still a high level uncertainly around the course of the pandemic, we are sure to be in contact with our clients to continually discuss their portfolio strategy and any changes that should be made as their circumstances, or our investment outlook changes. ~ *John Baxman, CFP®*

You have experienced the very brief recession from the pandemic, perhaps even the Great Recession of a few years back. Survived or thrived? Did you learn some lessons that you take forward now?

We thrived during the pandemic. We stayed the course, kept almost all of our clients fully invested in their chosen investment strategy and kept clients on course to meet their long-term goals. In terms of lessons learned, after going through the dot-com bubble, the Great Recession and the Pandemic Recession the lesson that has been reinforced in my mind is to not sell into a bear market. In all of these downturns, long-term investors benefited from keeping their target stock allocation, rebalancing the portfolio to buy more equities when the stock prices drop and sticking to their long-term investment policy. In short, when seas turn stormy, stay the course. ~ *Chris Wheaton, CPA, CFP®*

As an institution's outsourced Chief Investment Officer (OCIO), I often play the objective voice at the table and remind individuals who serve on foundation or endowment Boards and investment committees that while their individual experience and judgement is critical to making the best collective decisions, they must recognize when their personal experience and goals deviate from that of the institution's. The pandemic has been a good reminder to have a sound investment strategy in place, reflecting long-term investment goals and risk tolerance; and while it is important consider near term-risks, investors should let their investment strategy influence investment decisions, not emotions. ~ *Bill Thompson*

Real estate is hot, at least for now. What are the investment opportunities there, or is it something you'd suggest people go easy on?

Historically low interest rates have increased the valuations for many asset classes, and valuations can be justified by such a low discount rate. Higher interest rates will challenge these valuations, for real estate as well. Our recommendation in real estate is to be opportunistic, and to allocate where a successful outcome is a function of more than just access to cheap capital and high leverage rates. The means partnering with highly experienced sponsors and operators that understand unique real estate investments and can influence the outcomes. ~ *Craig Keller, CFA*

Inflation talk abounds, without real clarity on its direction. What's your advice now to cover the future risks if inflation spikes, or are you not seeing that as a true risk at this point?

Some of the recent inflation numbers have been surprisingly high but can be attributed to a bounce back in demand for travel and leisure services hit hardest by the pandemic. We believe these will normalize and that the probability of broader run-away inflation is low. If our ongoing assessment changes this outlook, we have the flexibility to tactically adjust positioning. Currently our portfolios have exposure to investments – including cyclical/value stocks (such as financials, energy, materials, and industrials), trend-following managed futures strategies, and emerging-market equities – which we expect would do well in an extended period of high inflation. ~ *Lesley Cannan, CFP®*

From what you have seen in your practice, what are the three qualities of an ideal investor and why?

In my experience as an advisor, the qualities I've most appreciated in my clients that have made them better investors are Engagement, Forward Thinking, and a Having a Decision-Making Process. Investors who are engaged tend to learn more about their investments which helps them better understand what they own and why. Forward thinking investors shape their investments and decisions towards specific goals for the future, which serves to reinforce their strategy. And, having a process to follow for decisions, which can be different for each person, leads to objectivity and confidence when making investment choices, especially in uncertain environments. These qualities are all reinforced and supported by our advisory process, so in effect we are helping our clients grow these skills and gain confidence in their own abilities as investors. ~ *Gretchen Hollstein, CFP®*

Just as we are honored to be a resource to the readers of the North Bay Business Journal, we welcome questions from clients, friends, and new acquaintances.

7 Tips for Protecting Against Cybersecurity Risks

October is cybersecurity awareness month, and with more of our daily activities being conducted online since the beginning of the COVID-19 pandemic it is a good time to revisit important safety reminders to protect yourself against common fraud and cyber-attacks, especially around your finances.

Here are some ways to protect yourself:

1. **Know what to look for.** Visit www.lgam.com/cyberfraud-examples to see visual examples of fraud attacks and the tricks to spot them.

2. **Protect your email account.** Do not click on any links or open any attachments whatsoever unless you're expecting the communication and you're completely sure they are coming from legitimate sources. When in doubt, review the full email address in the "from" field to help determine if it could be from a fraudulent source.

3. **Protect all passwords.** Use strong passwords (or passphrases) and do not use the same password for different accounts. (A strong password includes letters, possibly both caps and lower case, along with numbers and symbols.) Regularly reset your passwords, and do not store your passwords in email or other folders on your computer. Consider using a password manager program such as LastPass or 1Password.

4. **Protect account access.** Use two-factor authentication when available. Do not reveal personal or financial information in an email. Deliver sensitive information through a secure means. If sharing with a Litman Gregory team member, you can use our secure client portal.

5. **Manage your devices.** Always use the most up-to-date antivirus software and update software regularly. These programs are most effective when users set them to run regularly rather than just running periodic

scans, which may not provide maximum protection to your device.

6. **Surf the web safely.** Do not connect to the Internet via unsecured or unknown wireless networks, such as those in public locations like hotels, airports, libraries or cybercafés. These networks may lack virus protection, are highly susceptible to attacks, so should never be used to access confidential personal data.

7. **Protect information on social media.** Sharing too much information can make you susceptible to fraudsters and allow them to quickly pass a variety of tests related to the authentication of your personal information. Do not share details such as birthdates, home addresses, phone numbers, or social security numbers. And, consider whether to post content that make it obvious you are away from your home.

Other helpful tips:

- Be wary of unsolicited inbound phone calls potentially from tech support, government agencies, banks and other financial services firms, software companies, utility companies, or even supposed Litman Gregory employees. Never give information over the phone unless you are able to verify the caller is legitimate, which you can do by hanging up and calling back using the official number you have on file.

- Remember that the IRS and the Social Security Administration will not call you.

- Proactively enroll in an identity theft protection service to safeguard personal data.

Here is what Litman Gregory does to protect your financial information:

- We have established policies and procedures for handling suspected/confirmed client account compromises, which may include disabling the ability for fund transfers or establishing new account numbers.

- In many cases, especially around money transfers, our team will call you to verbally verify instructions and information.

- We train our team members regularly on cyber fraud topics and test employees using cyber fraud simulations.

- We have established security policies and procedures to protect client sensitive data that include minimizing authorized access to the data, appropriate handling of the data, device and network management, and physical security.

For many years, we have aided clients as they navigate the threats of cybercrime and work to protect themselves from attempted security breaches. Looking forward, we remain focused on staying abreast of new ways that we, and our clients, can work to protect their identity and finances.

Wealth Management Team Updates

We are committed to providing a deep team of experienced professionals to support our clients' financial success in the decades and generations to come. Below, we share news of the recent industry accolades, developments, and other updates within the Litman Gregory team.

Gretchen Hollstein Named to 2021 Top Wealth Advisor Moms List

Senior Advisor Gretchen Hollstein, CFP® was named by Working Mother and SHOOK Research on their 2021 Top Wealth Advisor Moms list for the third consecutive year. The list spotlights 500 mothers across the country who work as advisors in wealth management services.

Monica Muñoz Named to Forbes 2021 Top Next-Gen Wealth Advisors List & Top Wealth Advisor Moms Lists

Senior Advisor Monica Muñoz, CFP® has been named to Forbes magazine's 2021 Top Next-Gen Wealth Advisors list, which showcases the top 500 rising advisors under the age of 40 who combined manage more than $1 trillion in client assets. Monica was selected from a group of over 3,300 individuals considered for the Next-Gen ranking. She was also named by Working Mother and SHOOK Research on their 2021 Top Wealth Advisor Moms list for the first year.

Wealth Planning Webinar - Save The Date

Join us on Wednesday, November 17th at 10 a.m. PST for a webinar with Litman Gregory Senior Advisors as they provide an update on various wealth planning topics, including income tax updates, charitable giving strategies, long term care planning, and more. Visit www.lgam.com/2021-year-end-webinar for more information and to register for the event.

Introducing Litman Gregory's Updated Logo

For many years, our team at Litman Gregory has referred to the services we offer to our individual and family clients as "wealth management", and for our nonprofit clients as their "outsourced CIO". To us, these descriptions communicate that we provide both investment management and financial planning in an integrated way to support our clients' broader wealth planning and mission-based goals. Although we've used this terminology internally and in conversations, our company name and logo have still read Litman Gregory Asset Management. Today, you will see that we updated our name to better represent the breadth of our services. We hope you enjoy our Litman Gregory Wealth Management logo!

Contact

Contact our team for more information on our services

415-461-8999 | INFORMATION@LGAM.COM | WWW.LGAM.COM