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Asset Management • Retirement, Tax and Estate Planning • Fee Only • No Commissions • Independent Advisor

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Here is our newsletter for the 4th Quarter of 2021

Market Update
After a strong 2 months the stock market reversed most of their gains in September. U.S. large cap stocks eked out a fractional gain, but all other stock markets had single digit losses, with emerging markets dropping 6.9%. For the year-to-date, the U.S. markets continue their multi-year outperformance over foreign stocks.

The bond market was pretty quiet except for the last few weeks when inflation fears returned to the markets. TIPS rose 1.7%. Year-to-date high grade bonds have lost 1.6%.

The big gainers this year have been commodities and U.S. real estate, with gains of 37.6% and 22.2% respectively.

Asset Class Returns- Ending 9/30/21

Asset Class	1st Qtr	YTD
US Large Cap Stock	0.6	15.4
US Small Cap Stock	-4.4	12.3
Foreign -Developed Mkts Stock	-1.0	7.9
Emerging Mkts Stock	-6.9	1.4
US Intermediate-Term Bond	0.1	-1.6
Emerging Markets Bond	-2.1	-3.3
High Yield Bond	0.7	3.7
Inflation-Protected Bond (TIPS)	1.7	3.2
Cash	0.0	0.0
US Real Estate	0.7	22.2
Commodities	4.9	37.6
Gold	-1.3	-8.1

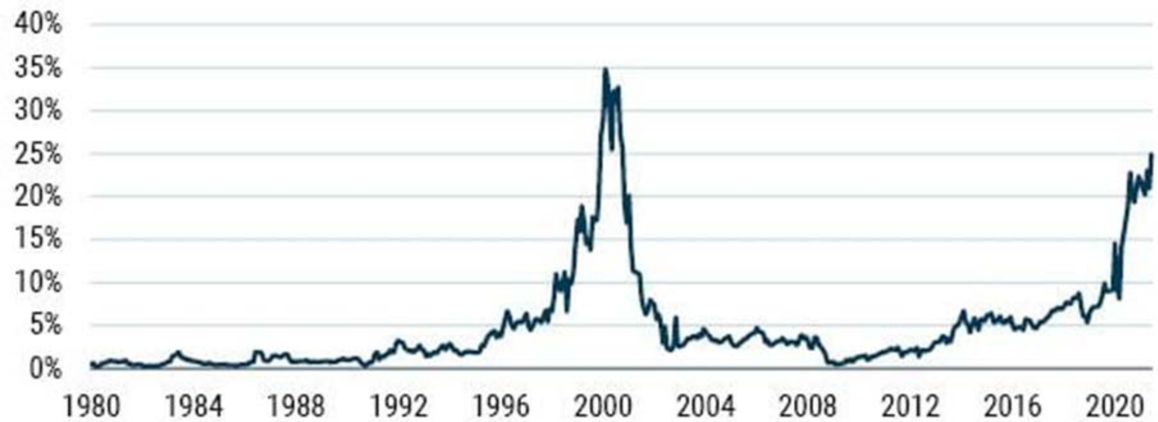
End of Year Tax Strategies
This year will be particularly challenging for those who wish to defer and reduce their tax burden, mostly due to the proposed legislation currently under negotiation. Some of these could have significant impact and the changes look to take effect on January 1st. One change already made this year is the enhancement of the Child Tax Credit and the Child Care Tax Credit. If you have kids under 18 your credits have probably gone up.

Here are a few of the proposals working thru congress.

- Long-term capital gains going up to 25% for those making over $400,000 ($450,000 for couple). The threshold includes all income, including the gains.
- 50% reduction in the Estate Tax exclusion, making estates over around $6 million becoming taxable for individuals and $12 million for couples.
- Income tax top marginal rate increasing to 39.6%.
- Restrictions of Roth conversions and distributions from 401(k) plans of post-tax contributions.

Let’s discuss this by the end of the year, hopefully after they have signed the changes into law.

Investing; -Growth vs. Value
Jeremy Grantham's firm GMO are long-time value investors and the graph below illustrates the current market conditions for U.S. growth vs. value stocks, showing the percentage of the U.S. stock market trading at over 10 years of current sales (10x).



Data from 1/1980-6/2021 | Source: GMO, Compustat

As you can see the percent of stocks trading above 10x sales is usually below 5%, but now it is 25%. The only time it has been higher is during the 2000 technology bubble. So what will happen going forward? The chart below shows how investing in the whole U.S. market (the S&P 500 index) compares to investing only in the stocks that are trading above 10x sales.

Data as of 6/30/2021 | Source: GMO, Compustat, Standard & Poor's
The over 10x P/S portfolio is a market capitalization weighted portfolio of all stocks trading above 10x trailing 12-month sales, rebalanced monthly.

Over the last 40 years the S&P 500 has returned 8.7% on average per year, adjusted for inflation. The returns for investing only on the high flyers by comparison was 4.4%, no more than investing in an all bond portfolio. To quote from the GMO report, "Will some of the high flyers prove worth their valuation in the long run? Almost certainly. But if history is any guide, the vast majority will not."

So what does one do? The alternative is to invest in stocks that have lower prices, or so-called value stocks. Value stocks are currently trading at a 40% discount to their historical average with growth stocks. The chart below illustrates this relationship over time.

As of 7/31/21 | Source: GMO
Composite Valuation Measure is composed of price/sales, prices/gross profit, price/book, and price/economic book. Value and Growth groups are both sliced over 12 months.

Our current portfolios have a value tilt with use of a low-cost index fund for our U.S. large cap allocation that is allocated more to value stocks as compared to the S&P 500 index.

Annuity Rescue Part 2: What Does a Guarantee Guarantee?
Here is a piece I wrote in 2014 concerning variable, deferred annuities. Pretty much still applies today.

Recently we helped a client couple evaluate an existing annuity contract they acquired in 2004 while they were both working. Now that they are retired they wanted to see what, if anything they should do with it. I was able to increase their monthly income from the annuity by 20% for their lifetimes by finding a better option than their current annuity. This is really important as I see so many clients with annuities they don't understand and are not serving them well. I know this won't be easy reading but hang in there.

Annuities are probably the most misused and oversold product on the market. Back in our July 2008 newsletter we wrote about the different types and our thoughts on annuities in general. Here is a link: http://www.compfinancial.com/newsletters/2008q2-newsletter.pdf

My clients were in a variable deferred annuity starting in 2004 from a major insurance company which had been invested mostly in the stock markets using mutual funds. It had a Guaranteed Minimum Income Benefit (GMIB) rider which increased the GMIB benefit amount by 5% per year. Most people think this guarantees you a minimum 5% per year return on your investment. This simply is not true. There are two balances inside the annuity. The first is the real investment balance which is dependent upon the performance of the mutual funds, less the additional contract fees and the rider fees for the GMIB benefit which totaled 1.3% per year. The second is the GMIB benefit value which is the starting value plus 5% per year going forward. If you want to simply withdraw the funds from the annuity over time or in a lump sum or rollover you get the investment balance, not the GMIB balance. You only get access to the GMIB balance if you annuitize the contract and take monthly income for life. So if the investment balance increases less than 5% per year you could annuitize the GMIB balance if it is larger than the investment balance and presumably get a benefit from the GMIB rider.

We contacted the insurance company and asked them to quote us a monthly income the client could receive by annuitizing their balance. Late last year the investment balance became the larger of the two and it was used to calculate the monthly income. I then went to the Income Solutions platform and got quotes from several insurance companies on an identical annuity funded by transferring the existing annuity balance (all annuities have surrender charges that last up to 10 years and fortunately theirs had expired). For the exact same terms the highest quote for the new annuity was 20% higher than the income from the existing annuity.

Why is the new annuity generating more income? The answer is twofold. First, the new annuity is offered with only a 1% transaction cost paid to the platform I use. They do not pay me. The existing annuity was sold by a salesperson paid a commission which reduced the income left for the client. Second, there are many factors which determine the income, <u>not just the balance annuitized</u>. Additional factors include how long the insurance company assumes the client lives to receive payments and the interest rate assumed; a higher rate generates a higher income. It is noteworthy that the new annuity still paid a higher income even though current interest rates are lower than they were back in 2004 when the existing annuity was purchased.

So the devil is in the details. Words like “guaranteed income for life” sells a lot of these products, but the reality of the guarantees are not as implied. It’s not surprising these are sold by commissioned salespeople.

Let me know if I can help in any way.

Sincerely,

Stan Johnson
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Registered Investment Advisor
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