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Fourth Quarter, 2019

Safe and SECURE

Senate approval of the SECURE Act (Setting Every Community Up for Retirement Enhancement Act. got all that?) which was passed overwhelmingly by the House on May 23, 2019, was reached at the 11th hour on December 19, and signed into law on the following day. The just-in-time passage was achieved by the bill's attachment to year-end appropriations and tax-extender bills.

For decades, data provided by many government or private financial institutions, has demonstrated the critical deficiency in Americans' retirement planning. Like earlier bills, the SECURE Act includes many sections affecting various groups of individuals or businesses, all aimed at improving the U.S. retirement system through changes in the regulations of tax-advantaged retirement accounts.

For retirement plan participants soon subject to required minimum distributions (RMD), the mandatory age has been pushed back from 70 1/2 to 72 years old. While not a large change, it postpones the uncomfortable time when you must begin to deplete tax-advantaged savings and pay income tax on them. Moreover, figuring out the year in which you hit 70 1/2 can be a nuisance.

Are you someone who would remove only the required amount of RMD each year? If so, you'd be one of only 20% of retirees in that category. A delay in RMD withdrawals will be to your benefit. However, the 80% who will withdraw more than the RMD minimum that is required by the IRS, likely won't gain by this change.

While making contributions to a traditional IRA after age 70 1/2 was prohibited before, it is now permitted if funded by earned income. Note that the age at which one can make a Qualified Charitable Distribution from an IRA is not changing, but remains at 70 1/2. Also, as with the prior ruling, the first RMD for those having a requisite age of 72 may be delayed until April 1 of the following year.

There are several new rules making it easier, or more likely, for employees to participate in corporate retirement plans:

- Small businesses will be better able to join other employers in setting up multiple employer plans which reduce liability worries and come at a lower cost.
- Lifetime annuities may be offered inside qualified retirement plans, subject to ERISA's fiduciary requirements. SECURE also enables in-kind distribution of an annuity from a retirement plan if it is eliminated from the plan's investment options.
- Part-time workers, previously barred from participation, will now have access to employer retirement plans if they work at least 1000 hours in a year, or at least 500 hours in three consecutive years.
- Greater employee participation in retirement plans is being stimulated by increased credits for those employers adopting automatic enrollment arrangements. Also, SECURE allows an increase in the maximum default percentage that an employer can set aside from an employees compensation, from 10% to 15%. Automatic increases in an employee's contribution rate encourages them to contribute more to the plan.

Non-retirement SECURE provisions include:

- The act allows new parents to take penalty-free distributions, within one year, from their 401(k) accounts to meet expenses of childbirth or adoption.
- The medical expense deduction threshold is back to 7.5% of AGI for 2019-2020.
- Expenses listed as Qualified Higher Education Expenses for 529 Plans includes Apprenticeship program costs. And it adds Qualified Education Loan Repayments.
- Qualified Disaster Distributions from retirement accounts may be up to $100,000 for one disaster. They are exempt from the early distribution penalty (10%) and from mandatory withholding requirements. Taxes may be spread evenly over 3 years, and the distribution amount may be repaid within 3 years.

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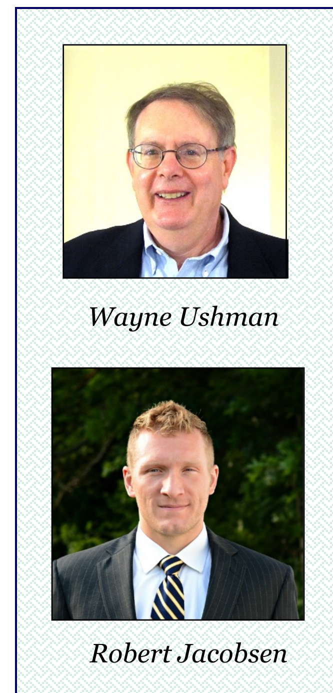

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Security continued

- In SECURE, the Kiddie Tax was restored back to the parents' top marginal tax bracket rather than trust tax brackets.

This is always an important question: **Q**: How will the government pay for some of these improvements? **A**: By accelerating income tax collection on inherited IRAs and retirement plans, from non-spousal beneficiaries. To date, the law permitted these non-spousal beneficiaries to "stretch" their RMDs over their lifetime, thus deferring the tax effect. In SECURE, the "Stretch IRA" is replaced by the requirement of withdrawing *all* the assets from the tax-sheltered status within 10 years. Withdrawals can be made flexibly, (even all at once), but after 10 years, the beneficiary must have paid income tax on the full inheritance, will have lost the tax protection of the account, and must start paying the tax on dividends, interest and realized capital gains on the reinvested assets. This change will affect individuals differently. Depending upon the inherited amount, the age and financial status of the beneficiary, and the rate of return on the IRA, losing the lifetime stretch option could be extremely expensive. One outraged commentator suggests: "A more appropriate name for the bill would be the 'Extreme Death-Tax for IRA and Retirement Plan Owners Act'." Wow.

The sudden enactment of SECURE requires brokerage service and investment companies such as Fidelity, to struggle with an extremely short implementation window. They will need to study interpretations of the act's provisions, and update their systems in unusually short order. Thus, clients are cautioned to consult with their various tax advisors concerning the potential impact on their own options and requirements.

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Stashing the Cash

What do you have stashed under the mattress, or in a cookie jar? Any cash? It may surprise you that in this high-tech era, for the U.S. and other advanced countries, the use of physical currency has expanded in recent years. Approximately 8.2% of our GDP, roughly $1.7 trillion, is held in cash, around the highest level in more than 36 years. This is notwithstanding our government's efforts to eliminate cash in order to decrease tax evasion or other crimes. And it is despite all the downside to holding and using cash as opposed to credit or debit cards. Cards are simpler to carry, they needn't be replenished, and they maintain a spending record. Cash may be lost or stolen. And those are just the practical differences. From a financial perspective, cash holding (or hoarding), somewhat like money market investment, makes you vulnerable to opportunity costs when the markets climb. Both may drop in purchasing power when inflation rises.

What causes consumers to favor use of the currency? Seeing it, or touching it, may be reassuring to individuals who are anxious about potential chaos in the markets. (The rise in cash usage began after 2008.) It may calm those, particularly seniors, who are not comfortable with internet interaction, fearing their own inability to review their assets, or to make transactions online. They may feel greater protection against identity theft. Certain types of expenses seem to invite squirreling away cash; a Christmas fund, or savings for a coveted item, for instance. It can be gratifying to see yourself nearing your goal. Some of us prefer to tip with cash. Some like to have some bills readily available to offer a panhandler.

Some consumers prefer cash as a way to curb spending. As Dave Ramsey points out, unlike a credit card, cash is not "an endless stream of purchasing power." And because we have to physically hand over our cash, money that we earned ourselves, spending cash is somewhat more painful than signing a credit slip.

There is a behavioral difference between small, or everyday purchases, and larger ones. The use of cash diminishes, debit cards drop, and the preference for credit cards rises as the purchasing price climbs. There are age differences as well. Cash is most popular with shoppers under 25, and over 65. The aging of our population may help explain the growing fondness for cash. Also there are differences among income levels. Those with incomes over $100,000 are more comfortable with credit cards.

However, the use of cash is likely to drop, and not just when inflation rises. Trends already are shifting because of the growth in e-commerce, and in mobile technology which offers alternatives to cash, debit, and credit cards.

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Economic and Financial Overview

We hear it everywhere: "The economy is terrific!" Depending upon your place in society, that feels more or less true. It certainly feels true for the approximately 54% of Americans invested in the stock market, as the U.S. equity markets were particularly strong. The S&P 500 gained +8.53% for the final quarter, bringing the annual return to +28.88%. Somewhat lower, the Dow grew by +6.02% in Q4, and +22.34% in 2019. Smaller capitalization stocks, as measured by the Russell 2000, rose by +9.52% for the quarter and +23.72 for the year.

Most investors don't experience those high returns, of course, because they are not 100% invested in equities. The current bull market has survived for 126 months, 78 months longer than the average of 48. As a result, while investors are delighted with the longevity and the returns of the market, they are somewhat wary about the future. As expressed in a recent survey, participants may be reducing portfolio risk by adjusting asset allocation, just to play it safe. Meanwhile, analysts generally are predicting continued economic growth and market advances in the near future. After all, recent strong returns were accomplished in an environment of temperate volatility, and moderate expansion in most major economic indicators. Earnings growth was modest. Real GDP growth was +2.1 in November (consistent with prior quarters) and is expected to remain in the same range or slightly below, in 2020. The largest components supporting this growth were consumer spending (68.1%) government spending (17.5%) and investments(13.7%). Consumers were encouraged by continued low unemployment, controlled inflation, and wage increases that were positive, if not as large as might be expected in such a tight labor market. Overall industrial output declined. Housing starts increased at year end, boosted by low mortgage rates and an eager market. In all, the economy maintained moderate but steady expansion.

With monetary easing by the Fed, rate cuts in July, September and October, and a flattened yield curve, fixed income investment was rewarding in 2019. Corporate and high-yield securities returned +14.54% and +14.32% respectively. Barclay's Aggregate Bond Index increased by +18% in the quarter, and +8.72% for the year.

Foreign equity markets also prospered in 2019 despite a third quarter drop. The MSCI EAFE index of developed markets was up +22.1% with Emerging markets only slightly lower. Global economic growth was sluggish in the year.

Raiding or Rescuing?

Does "Private Equity" bring to mind a greedy investment firm which demolishes struggling businesses for short term gains? Or do you think of organizations which take knowledgeable and gutsy investment risks, hoping to rescue a company while achieving substantial reward? Villain or hero? Private equity (PE) is an alternative investment class making private (or non-exchange traded) funds available to institutional investors such as banks, insurance companies, pension funds, and also to individual "accredited investors." Because the funds are unique and private, and therefore not listed or described by government regulators, they represent very high investment risk for those lacking investment sophistication. All of their "accredited investors" attained eligibility by demonstrating that given their experience and wealth, they are able to survive a significant financial loss.

A fund is created by a PE firm which raises money from a small number of accredited investors. This is simply one common format: the firm invests in a struggling private company (or buys out a public company, making it private). The ultimate goal is the company's reorganization and its eventual sale at a healthy profit. If purchased with leverage, the new investment typically is a combination of equity and debt, although greatly overweighted in debt. The PE investors supply most of the purchase money while the debt is the burden of the new company. PE firms profit from charging the investors with management and performance fees and by reaping 20% of the profits when the company is sold.

PE critics contend that the game is heavily stacked in the firm's favor, at the expense of the controlled company and its workers. They argue that PE makes money regardless of the outcome. Company staff may be stripped to reduce wage costs, pension assets can be grabbed, and the PE can increase income by adding management and consulting fees. Senator Warren's Stop Wall Street Looting Act of 2019, proposes many changes that require the PE to share the liabilities of the company as well as assets.

On the other hand, the American Investment Council retorts that PE is an "engine for American growth and innovation," providing or protecting jobs, and enabling distressed companies to recover. PE also provides efficient investment models for larger shareholders. And, after all, the AIC reasons, they take on the risks and therefore are entitled to rewards. The question: is there an appropriate balance between the profit motive and the goal of benefitting the target company?

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Man of His Time

When Paul Volcker died on December 8, at the age of 92, he left an extraordinary legacy of dedicated public service. Certainly one of the most celebrated government money men, even called "the closest thing to a rock star economist," Volcker led the Federal Reserve as Chairman through 8 turbulent years, earning him admirers and critics. Both were vehement in their appraisal. At his death, most media remembrances attributed to Volcker some outstanding achievements, some gave him less credit, and some would never forgive him for his policies. However, the assessments of his personality and character were comparable, describing a man who conducted himself personally and professionally within the values of his era, values not consistently celebrated in our time: service to country, integrity, courage, discipline.

Volcker towered over most others physically (6'7") and in his powerful status as Fed Chairman. Yet he was frugal and maintained a modest lifestyle, reportedly wearing flimsy suits and smoking cheap cigars. Volcker's career included chapters in private financial institutions but his broadest objective was to perform skillfully as a public servant, and to develop civil service practices able to inspire the trust of the citizenry. This desire was most apparent in the Volcker Alliance, a New York based effort started in 2013 to renew public trust. To Volcker, effective and service-driven government was essential to a democracy.

He worked intermittently in public and private economic institutions, the Federal Reserve Bank of New York, Chase Manhattan Bank, the Treasury Department (under JFK and Johnson), back to Chase Manhattan and then back to the Treasury, this time under a Republican administration. Under Nixon, Volcker helped to develop an international monetary system, supplanting the system of fixed exchange rates and the gold standard, in place since Bretton Woods in 1944.

Volcker's years as president of the New York Fed, 1975-1979, set him up for his most renowned role. Having achieved the reputation of an inflation warrior, Volcker was President Carter's choice for chief of the Fed. Between his appointment in 1979 and his departure in 1981, Volcker waged a fierce battle against runaway inflation, not flinching when his tough efforts to limit growth in the money supply caused a hefty jump in interest rates. He maintained his strict policy despite a weakening economy and spiking unemployment, a 6 month recession starting in 1980 and another in 1981 that lasted 18 months. Volcker was so vilified that he was assigned a bodyguard. His commitment to the goal of beating inflation may have reflected stubbornness or discipline, or both.

The economy did rebound, and Volcker has been credited with beginning the "Great Moderation," a period of two decades in which the U.S. enjoyed rather even economic growth, employment and inflation. But the painful period probably cost Carter his second term. At Volcker's death, Carter said, "Paul was stubborn as he was tall, and although some of his policies as Fed chairman were politically costly, they were the right thing to do." The relationship between the two men contrasts strikingly with our current blatant tension between Fed Chair and President.

Volcker's accomplishments, his broad experience, and his reputation for service and integrity, brought him a diversity of assignments as a trouble shooter. In 1996, he was invited to lead a commission to explore what Swiss banks did with the assets of Holocaust victims during and following the war. In 2004-2005, for the UN, he investigated possible corruption in their program to supply food aid to Iraq in trade for oil. Obama engaged Volcker as an economic advisor after the financial crisis of 2008. As advisor, he was particularly motivated to limit the freedom of banks to use their own assets to trade in the financial markets, and to invest in hedge funds and private equity. The resulting regulations, called the "Volcker Rule," were incorporated into the 2010 Dodd-Frank law, although in a weakened state very disappointing to Volcker.

Always ready to serve, always with the courage to argue his own views, never flashy or pretentious, and adamantly committed to his own principles, Volcker was his own man. Right or wrong, love him or don't, his kind is not seen often today.

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