CLIFFORD SWAN

THE Investment Counselor

FOURTH QUARTER 2018

WISDOM *for* GENERATIONS

MARKET ARM WRESTLING

By Peter J. Boyle
CFA, CIC

At market highs and deep into multi-year economic recoveries, a wrestling match often ensues as the market begins to contemplate its next chapter. Add rising tariff rhetoric and a fairly new Federal Reserve Chairman, and you have the recipe for increased market volatility. As these words will find their way to you a few weeks after they are written, we will outline the forces at work and try to keep a longer-term focus, versus attempting to suggest the market's shorter-term path.

The important news is that the U.S. economy is strong, corporate profits are booming, and consumer confidence as well as small business confidence are high. Growing corporate profits and reduced corporate tax rates mean corporate cash positions are healthy and companies feel more confident to invest. The unemployment rate continues to grind lower. We do not see the risk of a recession in the near future, as the economy is likely to continue to grow, albeit probably at a slower pace. All of this is very good support for the stock market.

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However, late in this recovery and for the first time since the late 1990's, the economy is starting to exhibit growing pains. There are budding inflationary pressures from higher wages and increases in the costs of doing business (parts shortages/supply chain issues). These are signs of economic health. Still, the risk of inflation brings with it a Federal Reserve response: higher interest rates to prevent the economy from overheating. While still quite low by historic standards, interest rates have recently moved to the highest levels seen in the past few years. This is also a sign of a healthy economy, but can cause the financial markets to experience more volatility. We expect interest rates to continue their ascent, so volatility could remain with us for a while.

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> "...the risk of inflation brings with it a Federal Reserve response: higher interest rates to prevent the economy from overheating."

The other near-daily news story is threats of tariff escalations, mainly between the U.S. and China, but to a lesser extent with our other trading partners as well. It is the current U.S. administration's belief that our trading partners are using their own tariffs to protect

> "The other near-daily news story is threats of tariff escalations..."

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their domestic industries. In particular focus is China, who the U.S. asserts is providing financial support to its domestic industries, giving them an unfair advantage in international markets. Additionally, China is being pressured to stop stealing intellectual property and to recognize international property laws.

Used as a trade negotiation stick, tariffs act to raise the price of select goods imported into the country. The intended consequence is to inflict pain on the foreign economy, as higher prices shift demand away from imports and toward domestic producers, leading to lower import volumes. There are, however, a couple of secondary impacts. Tariffs increase input costs for domestic manufacturers, making their final products more expensive to produce. Depending on the demand dynamics of these products, this additional cost can either be passed through to the consumer or result in lower profits to the selling company. Additionally, there is the risk of retaliatory tariffs on U.S. exports resulting in our products becoming more expensive overseas. Neither is good, as prices go up (inflation) or company margins go down (reduced company value). A relevant data point—as of the end of October, according to CNBC, more than one-third of the S&P 500 Index companies who have reported third-quarter figures addressed tariff concerns in their earnings announcements.[1]

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Against this economic and political backdrop, we entered October with valuations on stocks high relative to history, and the technology sector, in particular, over-extended. We quickly found ourselves in yet another October correction. These kinds of periodic corrections are healthy, as they temporarily chasten speculators and offer opportunities for investors. Carter Worth, a CNBC commentator, recently put this current correction into perspective. He noted that since 1927 there have been 218 corrections of five percent or greater. The average of these corrections resulted in a decline of 12% and lasted for an average of 40 trading sessions.[2] As of this writing, the S&P 500 Index is down 11% and has thus far lasted 25 sessions. Importantly, he points out, we remain in an upward trending trading channel (a range of security price levels) that began with the market bottom in 2008—a calming sign for those who chart market movements.

> "These kinds of periodic corrections are healthy, as they temporarily chasten speculators and offer opportunities for investors."

Has the correction completely played out? It is hard to know, since the math above implies that, thus far, this is only an average correction. However, keep in mind that the "market" is a collection of stocks, so some (down 30% from recent highs) may have bottomed, while others have farther to fall. The tea leaves do not portend a major bear market, such as the one experienced in 2008-2009. Bear markets almost always coincide with a recession, and we do not forecast a recession. In fact, with the recent pullback and continued earnings growth amongst our companies, we are finding good value in certain sectors of the market.

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As market returns have been above average with below average volatility for the past several years, it is easy to forget that, as long-term investors, we need to be prepared for market pullbacks, corrections, and even bear markets in order to achieve attractive returns over time. Being prepared means maintaining an appropriate asset allocation and reserves such that we can afford to ride out volatility for longer-term gain. We don't time the market as studies continue to show that is a loser's game. Looking ahead, the economy continues to look good, the Federal Reserve is moving deliberatively, and the market appears to be discounting the possibility of any positive outcome in the tariff dispute. As a result, we recommend striving to focus on the longer-term horizon and using this volatility to establish positions in high-quality companies that temporarily find their share prices a bargain relative their company's value. ◆

1. Franck, Thomas. "Tariffs are dominating earnings calls with more than a third of companies discussing the fallout." https://www.cnbc.com, 24 October 2018.
2. Worth, Carter. "Chart master says it's about to get worse before it gets better." [Video file] https://www.cnbc.com/video, 29 October 2018.

MANY PATHS, ONE DESTINATION: FORGING YOUR WAY TO RETIREMENT

By Maxwell R. Pray
CFA

I want to save for my retirement; what type of plan should I use? A traditional IRA or a Roth IRA—or another vehicle?

Saving for retirement is a big subject and important for every person to think about, plan for, and execute. If this topic is not currently relevant to you, it likely is to one of your family members, whether a spouse, sibling, a child, or even a grandchild. While Social Security benefits can serve as an important part of income during retirement, for many retirees these funds are not sufficient to cover expenses during retirement years. Historically, many workers could count on pensions, programs in which companies would "save" on behalf of employees during working years and then "return" these funds to employees during retirement years. These "defined benefit" plans have largely been replaced by "defined contribution" plans such as 401(k)s and Individual Retirement Accounts (IRAs), which place most of the responsibility for retirement savings and planning with the employee.

> "One of the key questions for many is whether to use a traditional IRA or a Roth IRA."

This fundamental shift of responsibility from companies to employees makes it important for workers to have a basic understanding of the retirement vehicles that are available to them as individuals accumulate savings while working and plan to access those funds during retirement. The primary options are IRAs, Roth IRAs, 401(k)s, Roth 401(k)s, and 403(b)s. One of the key questions for many is whether to use a traditional IRA or a Roth IRA. As we explore this question in some detail, keep these two points in mind:

- A key factor in the choice between a traditional IRA and a Roth IRA is whether one's tax rate will be lower during working years or in retirement.
- Having options can be beneficial, so consider having both a Roth IRA and a traditional IRA.

Some of the principles of traditional IRAs and Roth IRAs are the same. In both cases, any funds contributed to one of these accounts grow tax-deferred or tax-free while in the account. This means that no taxes are paid on the capital gains, dividends, or interest that is earned inside the account. In the case of traditional IRAs, income taxes are deferred until withdrawals of funds begin, while withdrawals from Roth IRAs are not taxed because the funds were already taxed when they were put into the account.

> "...any funds contributed to one of these accounts grow tax-deferred or tax-free while in the account."

A key differentiator between the two is the required minimum distributions (RMDs) that must be taken from a traditional IRA beginning at the age of 70 ½. In the first year, about 3.6% of the account value (IRA value divided by 27.4, according to Internal Revenue Service tables) is distributed and recognized as taxable income. This contrasts with Roth IRAs, for which there are no required distributions. Under current law, distributions are 100% tax-free because taxes were paid on the original earnings.

BASIC FEATURES OF RETIREMENT SAVINGS VEHICLES

Named after Delaware Senator William Roth (thank you Bill!), Roth IRAs were established with the Taxpayer Relief Act of 1997. A Roth IRA is a type of retirement plan in which after-tax dollars are contributed to an account. These funds grow tax-free until used, and upon use are not taxed at the federal or state level. Funds can be left in a Roth IRA for the owner's entire life and be passed to the next generation. The maximum amount that can be contributed to a Roth IRA is the lesser of the owner's earned income for the year or the limits noted in the table on the following page. There are also income limits for Roth IRAs. For those above the income restriction levels, a Roth 401(k) might be utilized if offered by one's employer.

Traditional IRAs were established as part of the Employee Retirement Income Security Act of 1974 (ERISA). The before-tax contribution limits for traditional IRAs are identical to those of Roth IRAs, and, like a Roth IRA, the owner (or the owner's spouse) must have earned income of at least the same amount as the contribution. A key point is that if neither member of the couple is covered by a retirement plan at work, the traditional IRA contribution is deductible. However, if either is covered by a work-sponsored plan, then modified adjusted gross income (MAGI) based limitations apply to the deduction. However, "after-tax" contributions can still be made.

The other retirement vehicle for which the Roth concept applies is a company sponsored 401(k) plan. A

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401(k) plan is a defined contribution plan in which an employee can contribute either before-tax or after-tax dollars. Similar to IRAs, no taxes are paid on capital gains, dividends, or interest while the investments are in the plan. One of the large advantages of 401(k) plans in comparison to traditional IRAs is that the contribution limits are higher and there is no income limit for the deduction. Some company plans include a Roth 401(k) option. The choice of whether to use a 401(k) or Roth 401(k) is similar to the IRA choice; it depends on one's current versus future tax rates and desire for flexibility (the Roth offers more flexibility in the future because distributions are not required). Basic elements of these retirement savings vehicles are summarized in the table below.

ROTH VS. TRADITIONAL DECISION FRAMEWORK

The framework for choosing between a traditional IRA and Roth IRA has been summarized with simple statements. The most prominent is to consider a traditional IRA if one anticipates a lower tax rate in retirement. If one expects a similar or higher tax rate, then consider the Roth IRA route, if eligible.

This thought process also applies to regular and Roth 401(k)s. The key benefit of a 401(k) is a tax deduction of up to $18,500 (much larger than for an IRA). The largest advantage of a Roth 401(k) is that for those over the Roth IRA limits there are only two ways to establish a Roth—either through a Roth conversion (explained below) or by establishing a Roth 401(k) through one's employer. Recognize that not all employment 401(k) plans offer a Roth option. Generally, if an individual is younger, has extra cash flow, and anticipates having substantial funds at retirement (for example, above $2 million, where the RMD for an IRA could push the owner into a higher tax bracket), our guidance is to fund a 401(k) with a partial or full Roth.

One reason we suggest utilizing both a traditional and Roth account is because it provides the owner (the investor) flexibility. By having both traditional and Roth IRAs, an investor's overall portfolio can be structured with

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Retirement Savings Vehicles: Key Elements

	Roth IRA	Roth 401(k)	Traditional IRA	401(k)
Contributions	Contributions made with **after-tax dollars** Contributions **permitted** after age 70 ½	Employee elective contributions made with **after-tax dollars** Contributions **permitted** after 70 ½ if still working	Contributions are made with **before-tax dollars** (if ***not*** covered by a work-sponsored retirement plan) Contributions **not permitted** after age 70 ½	Employee elective contributions made with **before-tax dollars** Contributions **permitted** after 70 ½ if still working
2018 Income Limits	**Modified adjusted gross income (MAGI) limits apply** (married $199,000/ single $135,000)	**No income limitation** to participate	MAGI-based tax-deductible **limits apply if covered by a work-sponsored retirement plan** (married $121,000/ single $73,000)	**No income limitation** to participate
2018 Maximum Yearly Contribution	$5,500 (plus an additional $1,000 if age 50 or over)	**Aggregate*** employee contributions limited to $18,500 (plus an additional $6,000 if age 50 or over)	$5,500 (plus an additional $1,000 if age 50 or over)	Same **aggregate*** limit as Roth 401(k) account
Taxation of Withdrawals	**Same as Roth 401(k)** and can have a **qualified distribution** for a **first time home purchase**	Withdrawals of contributions and earnings **not** taxed provided it's a **qualified distribution**—the account is held for at least 5 years and made: • On account of disability, • On or after death, or • On or after age 59 ½	Withdrawals of contributions **and** earnings subject to federal/state income taxes	Withdrawals of contributions **and** earnings subject to federal/state income taxes
Required Distributions	Distributions **not required** while owner is alive	Distributions **must begin** no later than age 70 ½ unless still working	Must withdraw **required minimum distribution (RMD)** starting at age 70 ½	Distributions **must begin** no later than age 70 ½ unless still working

*Limit is by individual, rather than by plan. While annual 401(k) contributions can be split between Roth and traditional pre-tax contributions, the combined contributions cannot exceed the deferral limit ($18,500 in 2018, or $24,500 if eligible for catch-up contributions).

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> "One reason we suggest utilizing both a traditional and Roth account is because it provides the owner (the investor) flexibility."

stocks in the Roth account and bonds in the traditional piece. This could be done so that the higher growth assets are in the IRA that is not taxed (the Roth) and the lower growth assets are in the traditional IRA.

A traditional IRA may be worth more to a person who earns, for example, $120,000 per year than an individual with $30,000 in income per year because the higher earner receives a larger tax deduction. If the high earner takes the tax deduction savings and also invests those funds, then the longer-term value of the traditional IRA may exceed that of a Roth IRA. Again, this depends on the tax rates at contribution and withdrawal. If tax rates at withdrawal are lower, then the traditional IRA will prove more valuable.

SPECIAL CONSIDERATIONS: CHARITABLE CONTRIBUTIONS AND ROTH CONVERSIONS

For a traditional IRA, under the Tax Cuts and Jobs Act of 2017 (TCJA) the strategy of donating to charities directly from an IRA after age 70 ½ is now included in the law. The qualified charitable distribution (QCD) allows those who meet the minimum age of 70 ½ to give money to charities directly from IRAs in a tax advantageous manner. The advantages are that the QCD counts toward satisfying the RMD and the distribution is excluded from the taxpayer's income. With fewer individuals expected to itemize deductions under the TCJA, the income tax deduction may be lost for many people. Besides the age requirement, one restriction is that the QCD is limited to $100,000 per year.

Another way to establish a Roth is to complete a conversion process from a traditional IRA to a Roth IRA. This may be more attractive today due to the lower tax rates that were a result of the TCJA. While prior to 2010 this was only allowed for those with a MAGI under $100,000, today anyone can utilize this option. A conversion involves withdrawing funds from the traditional IRA (or a portion of it) and contributing the funds to a Roth IRA. Taxes are due on the amount withdrawn for the conversion, but the funds then grow tax-free in the Roth. This process is a bit tricky, because the extra taxable amount from the traditional IRA may push a taxpayer into a higher tax bracket in the year of the conversion. Multi-year conversions are also an option that can reduce or spread out the tax implications of the change. We recommend seeking advice and assistance from one's accountant and investment counselor before taking this step.

OTHER FAMILY-FRIENDLY WEALTH PLANNING TIPS

- Help a child or grandchild who is working set up a Roth IRA, even if he or she simply has a summer job that only pays a few thousand dollars. Following the contribution limits outlined in the table on the previous page, make a personal gift to the child or grandchild to fund the Roth IRA. This could provide multiple benefits: 1) directly enhance the younger generation member's financial future; 2) improve the child or grandchild's financial literacy by allowing them to learn about investments; and 3) the benefit of long-term compounding can be significant.
- Subject to joint income limits, a working spouse can contribute funds to a non-working spouse's IRA. Therefore, if one spouse is not covered by a plan at work, the other spouse does not work, and each is over the age of 50, both the working and non-working spouse can contribute $6,500 to an IRA and receive a deduction of $13,000 (provided the working spouse's income is over $13,000).
- If one's employer offers a Roth 401(k) option, consider a combination of normal and Roth 401(k) contributions.
- Roth IRAs, which are inheritable, could help build multi-generational wealth because the saver is never *required* to take a withdrawal, and because withdrawals are tax-free. Distributions will be required once the beneficiary inherits the IRA funds, but those distributions would be based on the heir's life expectancy. For example, distributions for a 50-year-old heir will likely stretch out over 30 or so years. Again, for Roth IRAs all those distributions are tax-free!

> "The qualified charitable distribution (QCD) allows those who meet the minimum age of 70 ½ to give money to charities directly from IRAs in a tax advantageous manner."

CIRCLING BACK TO WHERE WE STARTED

While the exact circumstances are limitless, the key variables in the decision process for investing in a traditional IRA or a Roth IRA are age, current and retirement-based income levels and tax rates, the retirement plan offered by the employer, cash flow circumstances, and spending habits now and during retirement.

Consider Roth IRAs as a tool that may fit into a long-range financial planning picture with the potential for being a very valuable (and flexible) asset. One of the main reasons we encourage considering a mixture of Roth and traditional accounts is that with so many variables—including the possibility of changes in tax laws—having a blend can provide more options in the future. ◆

LESSONS LEARNED BY A PATIENT INVESTOR

By Carolyn S. Barber
CFA, CIPM, CIC

I began my investment counseling career in 1979. The Dow Jones Industrial Average (DJIA) ranged between a low of 797 and a high of 897 that year (the DJIA is currently trading around the 24,000 to 25,000 level). I recall the euphoria investors felt when the index crossed 1,000 in November 1980, for the first time since 1972. It quickly retreated and did not sustain levels above 1,000 until three years later. The index did not surpass 2,000 until 1987.

> "When I started working in this field, the everyday mechanics were very different from today."

When I started working in this field, the everyday mechanics were very different from today. No one had a desktop computer. The big excitement in my office was when we got an IBM Selectric typewriter, with autocorrect! Another tool was a ten-key adding machine, and I became proficient on that. We didn't have the internet, so we watched the tape on a small black and white TV, set to a financial channel. We couldn't trade electronically; we called brokers to place trades for our clients. We didn't have the option of using portfolio management software for record keeping and reporting to clients. Instead, our clients' trading records were kept by hand, backed up by paper copies of custodial statements and trade confirmations. When I first started, we didn't even have a fax machine.

In spite of these limitations, our firm conscientiously invested our clients' portfolios in high-quality stocks and bonds. We did our own research, reading company filings, and we also subscribed to third-party research. We had our own method for determining which stocks were undervalued or overvalued, and used a Texas Instruments financial calculator (which was state of the art) to execute our valuation formulas. We were a small shop, and the universe of stocks we followed was limited to about 40 companies. We analyzed each of those companies in depth. We understood their management teams, financial statements, product lines, and the opportunities and impediments faced by each firm that we followed.

We paid close attention to asset allocation for our clients. We were aware of studies showing that asset allocation is a significant component of investment returns. We also used asset allocation decisions to help manage risk, using the bond component of the portfolio holdings to provide income and stability, reducing the volatility of returns. We selected individual bonds using printed bond guides, which were updated quarterly. We also had relationships with brokers who helped us find good quality municipal bonds for our clients' taxable portfolios. We were careful to diversify the bond holdings as well as the stock positions in each portfolio.

> "These investment principles should be familiar to our Clifford Swan clients because we follow the same philosophy today."

These investment principles should be familiar to our Clifford Swan clients because we follow the same philosophy today. We have more tools, more speed, more information, and a greater capacity to follow more stocks. However, we still aim to know our companies well, and we still construct our clients' portfolios stock-by-stock and bond-by-bond. We pay close attention to asset allocation and diversification.

In the early 1980s, one of our clients (a retired engineer) bought a personal computer. He became a computer enthusiast and volunteered to run our stock valuations for us. Each Friday, I would call him and read a list of the closing prices for the stocks we followed. He fed them into his program and mailed us the printed results. Eventually, this process sped up when we both got fax machines!

Our technology evolved. We started using an outside service that provided portfolio management software. We eventually acquired personal computers and learned to use the Microsoft Office suite of programs, including Excel, Word, Access, and PowerPoint. While these tools made our work more efficient and convenient, they did not change the fundamental aspects of the investing decisions we made on behalf of our clients. We did not change our low-turnover practice by trading more often. We continued to focus on the long term and on the quality of our clients' holdings.

During the early 1980s, the DJIA went from 824 in January 1983 to a high of 2,740 in August 1987 and seemed to be headed on a steadily upward path. We all got a big shock in October 1987. On Friday, October 16th, the DJIA fell 108 points on record volume. The carnage continued on the following Monday, referred to as Black Monday, when the index fell 508 points, a 22% decline. That is still the largest one-day percentage decline on record. The DJIA fell by 26% in just two days. The rapid decline and record volume was unprecedented in our lifetimes. There didn't seem to be any fundamental cause

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for this event. Reading later about the cause of the swift, unchecked selloff, we learned two new terms: "portfolio insurance" and "program trading."

"Portfolio insurance" was a new product, used by large institutional investors with the goal of protecting investors when the market declined. The plan was that when stocks declined by a certain percentage, the "insurance" would kick in and automatically sell the declining stocks. This type of transaction was only possible due to "program trading" whereby a computer program took over and placed trades without human intervention, according to pre-determined instructions. The "insurance" backfired. As the market declined, the program sold stocks, which led to more declines, which led to more sales. It was emotionally devastating for those of us helplessly watching the market crater. It seemed that nearly all stocks declined together, without regard to quality or earnings. The baby and bathwater went out together. It shook our core understanding of how the market should behave. Still, we did not panic; we did not sell.

Fortunately, the decline was short-lived, although the market remained volatile for the rest of the year. We felt tremendous relief as the index recovered. By the middle of 1988, the DJIA was holding above 2,000 again. We had learned about the new reality that computing power brought to the market. The convenience and speed of using computers to make transactions was definitely a double-edged sword. On the one hand, this type of trading improved liquidity, lowered trading costs, and narrowed the spread between bid and ask prices (the bid is the price a buyer is willing to pay; the ask is the price the seller wants to receive). On the other hand, computer trading increased the likelihood of market volatility, due to high volume trading at lightening speeds, and the potential for major meltdowns.

"The convenience and speed of using computers to make transactions was definitely a double-edged sword."

Since 1987, investors have lived through a number of market events, including the Dot-Com bubble bursting in 2000 (which impacted the tech-

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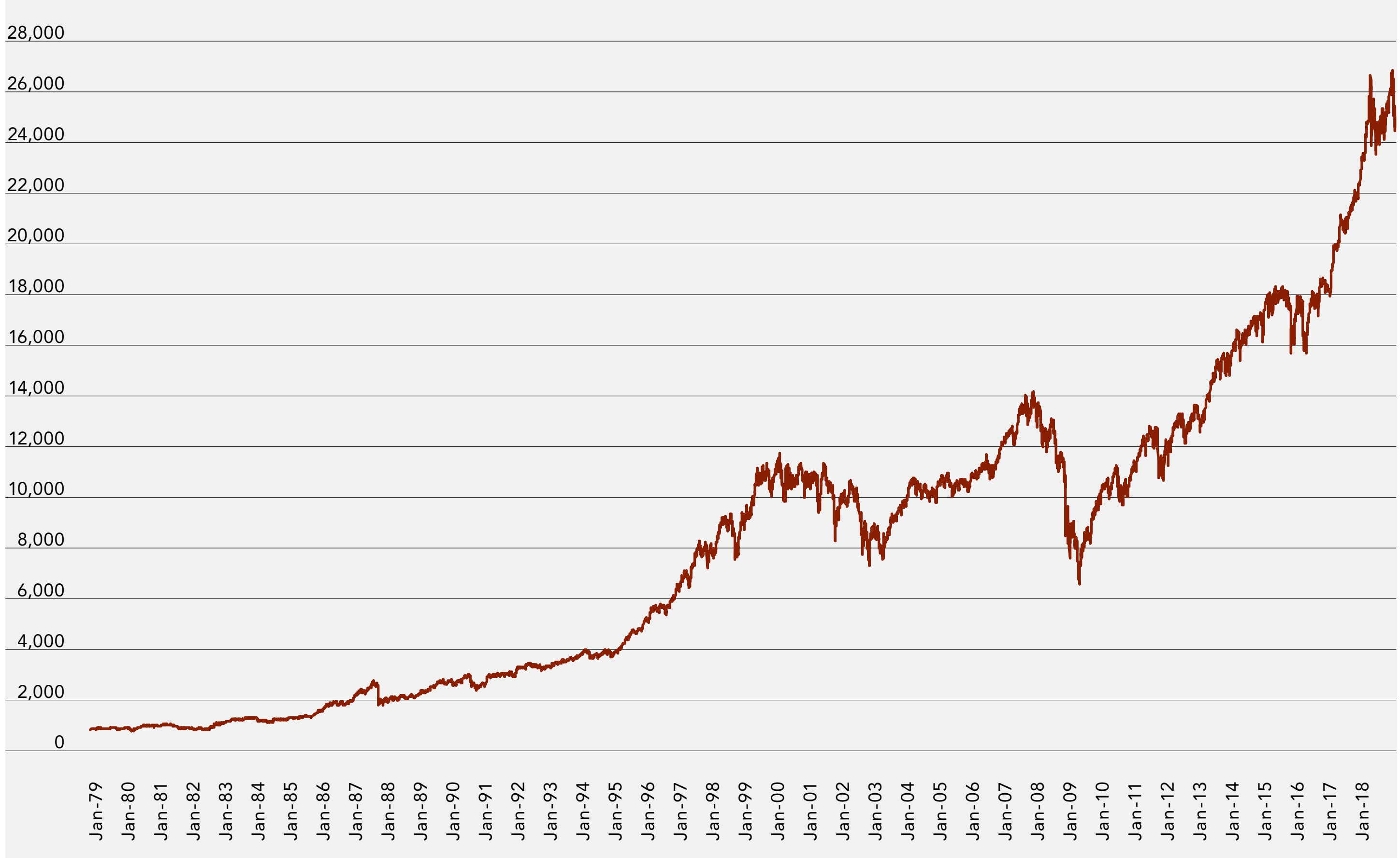
Dow Jones Industrial Average



Source: Thomson Reuters Datastream

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nology stocks traded on the NASDAQ much more than the DJIA stocks). More recently, the Flash Crash in 2010, Taper Tantrum in 2013, and Brexit in 2016 all led to brief but dramatic declines in the index. The 2008 financial crisis was different from all of these market events because it was caused by an underlying economic crisis, not just a market event. Excessive leverage had permeated the world's financial markets. In the early 2000's U.S. real estate prices were riding high on easy money and lenient lending standards. Many home owners came to believe that housing prices would always go up, and they borrowed accordingly. When the asset bubble burst, the leverage was exposed and the interconnectedness of our markets meant that the entire global financial system was under threat of collapse. We were on the brink of another Great Depression like the one in the 1930s, and that fate was only avoided due to major invention by the world's governments. One can debate the benefits or harm of the methods used, but something had to be done, and quickly, to save the financial system and the general economy.

> "The lessons learned in 1987 still apply for investors today."

The lessons learned in 1987 still apply for investors today. Your investment counselor will work to build a well-constructed portfolio, designed to meet your financial goals and objectives, paying attention to asset allocation and diversification, and focusing on the long term. These are the principles that Clifford Swan's founders taught us, and they continue to form the foundation of our work for our clients.

Now we have new lessons, too. Expect the unexpected. Accept that there will be shocks, and periods of volatility. With the market trading in the 24,000 to 25,000 range, pay attention to percentage changes in the index, not just the raw numbers. Be skeptical of headlines, such as the ones that recently declared "Dow Plunges 600 Points," followed by "Dow Surges 500 Points." The "plunge" was a 2.4% decline and the "surge" was a 2.1% gain. Remind yourself that headline writers are looking for drama, to grab the reader's attention.

> "Now we have new lessons, too. Expect the unexpected. Accept that there will be shocks, and periods of volatility."

> "A correction provides investment opportunities. A crisis may require intervention."

Don't expect the market to steadily climb forever. Don't be lulled by the gently rocking cradle of stock market stability. Try to understand and remember the difference between a normal market correction and an actual crisis. A correction provides investment opportunities. A crisis may require intervention. The patient investor, who does not panic, has, historically, been rewarded by the market. ◆

Carolyn Barber is retiring at the end of this year. After 22 years working with clients at Clifford Swan, she is looking forward to the next stage in her life, joining her husband in retirement. They plan to stay in Altadena, and to enjoy the cultural opportunities available in the Los Angeles area, including the many fine art and science museums that they have not had time to visit while working. They also plan to travel more often, and will continue to explore the great outdoors, including visiting more of our country's wonderful National Parks. At home, they will enjoy gardening, yoga, watching Dodgers baseball, and goofing off!

Source: Historical market data obtained from Bloomberg.

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