ISSUE 4 | VOLUME 8 | OCTOBER 2019

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Ask Cadence: Your Latest Questions Answered

Q With the federal estate tax exemption amount so high, should I still do estate planning to avoid taxes?

The history of estate taxes in the United States is convoluted, and that is an understatement. There is little point in reviewing all the various changes federal estate taxes have gone through over the decades aside from pointing out the taxes that used to be imposed on estates large enough to be taxed were so high that avoiding federal estate taxes was the main reason many people did estate planning. Paying 40% or more to the federal government made paying any state-imposed estate taxes at their much lower rates seem like small potatoes. The objective, then, was to reduce federal estate taxes, and any state estate taxes paid were considered small enough in comparison to not be a major concern.

Federal and state estate taxes were calculated on roughly the same sized estates back then, so if you were taxed at the federal level on amounts above $1M, you were frequently taxed a second time by the decedent's state of residence at a lower rate on the same amount. Now, however, estates at the federal level have to be worth more than around $11.4M, and a married couple gets to pass on a full $22.8M to their heirs before the first dollar is taxed. With the federal exemption set so high, far, far fewer people worry about having to pay the federal estate tax any more. In fact, we all wish we had to worry about that problem. That's the good news.

The bad news, however, is many states did not raise their exemption levels to anywhere close to the federal level. For example, Massachusetts still taxes estates above $1M, and Rhode Island above a little over $1.5M. Getting taxed at up to 16% seemed so much less than the 40% in years past, but it still results in a 16% reduction, or close to that, for what many people intend to pass on to their heirs. Now that the 40% potatoes are nothing to worry about, we're finding that 16% estate taxes are also not exactly small potatoes.

Let's consider the situation where a spouse dies and passes everything on tax-free to a surviving spouse and then that surviving spouse eventually dies and passes everything on to their children. With $500,000 in home equity, $100,000 in insurance policies, and $1,000,000 in financial assets, the estate would lose nearly $96,000 to Massachusetts state estate taxes. That's not as bad as paying 40%, of course, but still, $96,000 is a lot of money.

To reduce or avoid that 16%, investors have a variety of options. However, the solution is very dependent on the structure of the estate, the surviving spouse's income needs, etc, so we cannot say any one solution is the answer for everyone. Just know there are ways to reduce or avoid state estate taxes, they would need to be tailored to each investor's specific situation, and your Cadence advisor is able to help discover the best way to proceed.

Though the high federal percentage may be avoided, giving up to 16% of your estate away is still probably enough money to make estate planning a prudent activity.

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What is a 529 ABLE Plan?

A 529 ABLE account (or 529 A Savings Plan) was created by the Achieving a Better Life Experience (ABLE) Act of 2014 to provide Americans with disabilities the opportunity to save up to $15,000 (2019 limit) per year in a tax-deferred account similar to a 529 college savings plan to supplement their government benefits. Contributions may be made by any person using post-tax dollars. If the beneficiary works, the beneficiary can also contribute part or all of their income to their ABLE account up to the poverty-line amount for a one-person household (which was $12,490 for 2019) unless their employer contributes to a workplace retirement plan on their behalf. Earnings in an ABLE account grow tax-deferred and withdrawals are tax-free when used for qualified disability-related expenses including, but not limited to, education, housing, transportation, assistive technology, employment training and support, financial management and health care expenses. The money can be used over the lifetime of the beneficiary as long as the funds are used for qualified expenses.

Who can qualify?

Individuals who are already receiving benefits under the Supplemental Security Income (SSI) and/or Social Security Disability Insurance (SSDI) are eligible. If not receiving SSI or SSDI, they may still be eligible if they certify that they are blind or disabled and have a written diagnosis of their condition by a licensed physician. However in either case, the onset of the disability must have begun prior to age 26.

How it works

The first $100,000 saved in the account is exempted from the $2000 Social Security Income limit and beneficiaries will still receive Medicaid regardless of account size. Like a 529 college savings plan, each state establishes its own plan and account owners can make changes to their investments two times a year. In Massachusetts, there are no state tax benefits in choosing the Massachusetts plan over another state's plan, so another state may offer a plan with better suited investment options, lower fees, or preferred features. ABLE account beneficiaries can qualify for the Saver's Credit based on contributions they make to their ABLE accounts. Up to $2,000 per year of these contributions may qualify for this special credit designed to help low and moderate-income workers. There is also a maximum contribution limit of $400,000. You may not make additional contributions to the plan when the total value of the account is at or above the maximum contribution limit.

In Summary

A 529 ABLE account may be a great way for Americans with disabilities to save in a tax-advantaged account, similar to a 529 college savings plan, as a supplement to their government benefits. Since the ABLE Act of 2014 passed, Americans with disabilities now have more options in addition to special needs trusts to maintain their government benefits while also saving for qualified disability-related expenses. As always, the Cadence team is available to help you with any questions as to what might work best for you and your family.

References:

https://www.finra.org/investors/learn-to-invest/types-investments/saving-for-education/able-accounts-529-savings-plans

https://www.savingforcollege.com/529-plans/massachusetts/attainable-savings-plan

Q Is there any truth to the talk of a "looming pension crisis"?

Simply put – yes. Most pensions are still calculating their benefits assuming a 7%+ long-term rate of growth. Looking back at the last 30 years of market returns, that doesn't seem so far-fetched, but unfortunately a pension fund's ability to deliver on promised benefits is all about what it will in fact earn going forward over the next 10, 20, and 30 years. Here are the hard facts about current and likely future returns: Interest rates on bonds and credit investments are near or at historic lows. The highest quality government bonds pay under 2% and highly-rated corporate bonds don't pay much more. This is a far cry from the 4-6% historical average, and there is currently no evidence that rates will be returning to those higher levels any time soon.

On the stock front, it's not news to our readers that with stock valuations at record highs, returns over the next 10-15 years are likely to be nearly flat, or low single digits at best. The logic for this is simple and strongly rooted in historical evidence with respect to almost any asset that trades freely on an open market. If you pay too much for something, it usually will come back down in price once the cycle shifts. At best, it will just stop going up for a few years and trade sideways, although this isn't generally how cycles work. Either way, that 8-10% historical stock market return isn't very likely at all to come to fruition given where prices and valuations are today.

With the average pension fund at close to 60% in stocks and the vast majority of the remainder in bonds, the likelihood of achieving that 7% return that all the benefits are based on is, in our opinion, slim to none. If you're wondering how pension funds can assume such an unrealistically high return number, the answer is really quite simple: If they lowered it to a more realistic one, that would shine a very bright spotlight on just how bad the situation really is and would require huge changes. Of course, pushing that moment off is always the easiest course of action.

So, what does this mean? It can only mean a couple things: Either benefits have to be cut significantly as this reality becomes undeniable, or contribution rates and/or taxes need to be increased significantly to make up for return shortfalls. In our opinion, the first is much more likely as the average person simply cannot afford and may not accept additional increases in taxes and/or contribution rates. So, if you are currently working and have a pension, look into taking a lump-sum distribution upon retirement so that you can invest those savings as you see fit moving forward. The lump-sum figure is likely still based on those unrealistic return assumptions. If you've already retired and are collecting a pension, we can hope that any adjustments won't hit you as hard as future retirees/pensioners. Usually the brunt of any unpleasant adjustments are placed on those who haven't yet started collecting. Either way, we are advising our clients to plan accordingly.

Q **Is now a good time to be more aggressive?**

There are so many aspects of investing that make it hard. What's going up now? How am I doing compared to my neighbor? Does this investment sound exciting? Am I running out of time? Regardless of one's portfolio strategy, there will always be a reason to doubt whether we're doing the absolute right thing at the absolute right time. Emotions come into play, and it's difficult. The best way to manage through all this is with a process that we trust will keep us pointed in the right direction and impervious to rogue, damaging emotional inputs. In a nutshell, our process at Cadence consists of the following:

- Understand valuation levels across different asset categories with particular attention being paid to extremes. If no extremes, then valuation is of lesser importance.
- Understand where we are in the broader economic cycle.
- Understand how various asset categories are trending.
- Observe market signals and internals to gauge risks and/or potential cycle transitions.
- Employ differing strategies that are complementary to achieve true diversification.

As it stands now, when we work through this process we're left with the following observations:

- Stock and bond valuations are at historic extremes, which poses tremendous risk for these categories going forward. Most sudden, sharp price drops throughout history have originated from similar valuation extremes.
- We are currently in an economic slowdown. Although we aren't slowing as quickly here in the U.S. as most of the rest of the world, we are no doubt decelerating toward economic contraction. In fact, the most recent Institute for Supply Management Manufacturing data for August came in at 49.1 which indicates contraction in the manufacturing sector. More important, this represents a -19.9% decline from where manufacturing activity was one year ago. This, along with similar leading economic indicators, suggests that the economic expansion that has driven asset prices higher may finally be coming to its natural end. Just as the economy, business conditions, and credit (borrowing and lending) markets cycle, so do stock and bond markets. In the U.S., they have yet to meaningfully follow.
- As hard as it may be to see up close, when we step back and look at asset categories from a distance, it's pretty clear that their prices are reflecting the economic reality above. Global stocks are down from where they were in late 2018, with U.S. stocks about flat. Meanwhile, U.S. government bonds, precious metals and other defensive categories are up since then. In short, price trends are consistent with the slowing economic environment.
- When we look under the "hood" of the asset markets, we see further confirming signs that we may be in the midst of a cycle transition from good/growthy/expansionary to not so good/defensive/contractionary. First, although the S&P 500 is relatively flat over the last year, the Russell 2000 which measures small cap stock performance is down over -10%. In addition, there has been record divergence within U.S. markets over the last few months when looking at the number of stocks making new highs and new lows on the same day. This type of

crosscurrent has been a marker of major market turning points in the past. Finally, when we look at the credit markets, we see evidence of spreads widening. This is when investors in bonds become more aware of risk and demand higher interest on lower grade bonds relative to safer bonds. This too has also presaged meaningful market events in the past – most associated with major cycle inflection points.

➲ Finally, in putting together an investment strategy that ties all these observations together, it's important that we go beyond simple diversification. We know that we don't want to hold much stock in a buy and hold capacity given everything we've outlined, but does that mean we won't own any stock for the next 1-2 years? No. It's important to have strategies within the portfolio that can navigate the ebbs and flows of market events and economic cycles. Although stocks offer poor return potential over the next 10-15 years in our opinion, that doesn't mean there won't be favorable environments for them along the way. Having an active strategy that takes all these things into account and sticks to a process is critical to weathering a turn in the cycle. So, in case this didn't answer the original question for you already: Is now a good time to be more aggressive? Probably not, but ask us again in six months.

Q **Why consider using in-service distributions to move money out of a 401(k), 403(b), or other employer-sponsored retirement plan?**

Employer-provided retirement plans have some tremendous advantages over other investment accounts. They are convenient, allow for relatively large contributions, and usually receive employer-provided matching contributions. Unfortunately, they also have some large disadvantages, some of which matter more today than they have since the last major market crash, like a serious lack of diversification options. If the next major financial crash is like the last one, where both stocks and bonds lose meaningful value, then there is nowhere to hide in a 401(k) or 403(b) plan that does not have alternative investment options. Likewise, seemingly diversified options like retirement date or target date funds do not have a meaningful allocation to alternative investments, and many of them are allocated more aggressively than their owners realize, which we discussed in the June edition of Cadence Clips. Both of those could cause serious issues during the next stock market downturn.

Additionally, many employer retirement plans do not allow the beneficiaries to stretch the distributions out over their own lifetimes, which may lead to a higher percentage of taxes being paid, lower tax-deferred growth, and ultimately a smaller amount being transferred over time.

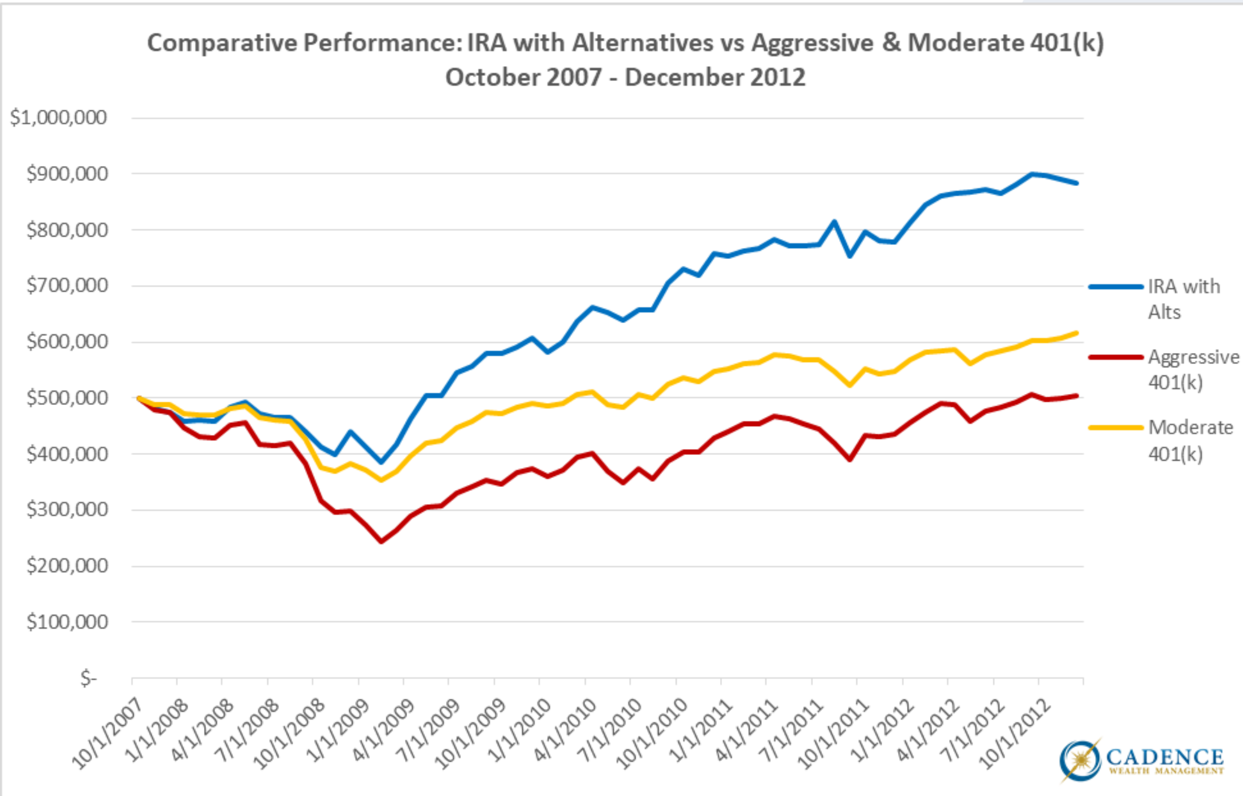
One solution to the lack of diversification and beneficiary options is to do an in-service withdrawal. Most employer plans allow this, though there are rules to follow specific to every plan. Regardless of the details, an in-service withdrawal allows the employee to roll a partial or complete balance from his or her 401(k) or other employer plan while still employed to an IRA under his or her control without paying a premature distribution penalty or income taxes. The benefits of in-service withdrawals include:

1) *More investment options:* Most employer-provided plans have a severe lack of choices in some asset categories, especially those that may help protect investment value during the next major downturn.

2) *More beneficiary options*: Not only do IRAs allow beneficiaries to stretch distributions, and therefore reduce the impact of taxes on the account, but also provide account owners more beneficiary options should their wishes around what happens with their assets involve multiple groups of people and charities.

3) *More control:* With employer plans, you can only choose from what you are given, and these plans are much less flexible than IRAs available elsewhere. Also, employers occasionally change plan providers, leaving employees to choose a whole new set of investments.

Considering the aforementioned lack of diversification, one of the investment allocations we use for our clients specifically to minimize the kind of damage done during the last financial downturn has a meaningful allocation toward alternative investments. The chart below shows the estimated performance of a relatively aggressive 401(k) allocation, a moderate 401(k) allocation, and a moderate IRA allocation with alternatives:



An investment mix with alternatives would have protected more on the downside and still provided upside growth during and after the last market crash of 2007-2009. As you can see, there can be a large enough performance increase from including alternatives in an investment mix during and after meaningful market drops to make their inclusion in a portfolio beneficial.

There are still some things that may cause an investor to keep all of his or her money in the employer plan, like the ability to borrow against those assets, or the presence of post-tax contributions, or something specific to the plan that affects the ability to contribute after a withdrawal is made. The summary plan description has to be reviewed to help make any decision. With around 70% of all employer plans now allowing for in-service withdrawals before age 59 ½, it is a worthwhile move to consider for anyone concerned his or her employer plan will not protect assets to the level they would want during the next downturn.

Q Why does Cadence Wealth Management write a monthly newsletter?

"Just do what you think is right; we trust you."

We hear things like this from our clients all the time when explaining why we recommend a certain investment, change, or strategy. While we value the trust our clients place in us, we still want them to understand why we recommend what we do. Most non-financial professionals only come into contact with a certain level and certain type of financial information, some of which, namely the information provided by the financial news media, we have been critical of and have shared our concerns about on more than one occasion. Even when non-financial professionals research financial topics like retirement planning, insurance, or investing, they do not have years of experience to help them pick out the good advice from the bad. This is not to suggest that we are uniquely capable of understanding these topics, just that we have the ability to spend far more time at it, and in the case of everyone here at Cadence, have already spent years acquiring knowledge in these areas.

But it still works better for us if our clients are educated investors and planners, so we spend a fair amount of time each month researching topics that seem relevant to their investments or their plans to help them raise their level of understanding of the financial areas we believe will help them achieve their long-term goals. Although financial and investment plans focus on the long term, it is still beneficial to connect the short-term opportunities and threats to clients' longer-term plans and to increase clients' understanding of how the things occurring in the world on a monthly basis may affect them years in the future.

Plans and strategies can take years to bear fruit, and many people lose faith when their plans don't seem to be working. It's ironic, actually, that people do long-term planning but then frequently change those plans because they don't seem to be working in the short term. By educating our clients on how the existing conditions support their plans, we believe we help them remain on course to achieving both their long and short-term goals.

So while trusting us to know all we should to add value to your lives, your reading our monthly newsletter still increases the chances of your achieving your goals through a greater understanding of why we recommend what we do. We will continue presenting you information we believe will further your investment and financial planning knowledge; all you have to do is keep reading!

Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice or a solicitation to buy or sell securities. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

Past performance is not indicative of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses and is not based on actual advisory client assets. Index performance does include the reinvestment of dividends and other distributions

The views expressed in the referenced materials are subject to change based on market and other conditions. These documents may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates are based upon certain assumptions and should not be construed as indicative of actual events that will occur. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

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