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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Stay Focused - Nobody Cares More Than You

The ability for investors to screw up their financial future has never been greater. Debt is being thrown at us like confetti, asset prices broadly have never been more expensive, and all the financial media seems to focus on is celebrating new all-time highs. Staying disciplined and keeping perspective has never been more important. Quite literally, one's financial future depends on it.

First, a word about the financial media and Wall Street in general. It's really important for people to understand the inherent biases here and the potential conflicts of interest. Put simply, Wall Street makes money when people invest and the large financial media outlets make money when Wall Street advertises. As a result, there will inherently be a bullish bias coming from both and you rarely see honest assessments or warnings to investors coming from either. This isn't to say there's no benefit in tuning in, but it's up to the investor to recognize this bias and think for him/herself. Media is everywhere today, so it's crucial that one takes the time to either do this thinking, or align themselves with a professional whose perspective and philosophy makes sense.

A refresher on our perspective and philosophy…

When markets are cheap or reasonably priced, a long-term investor can take risk and expect to be rewarded over time with good returns. Waiting out downturns can be part of the journey. Markets will likely bounce back.

When markets are expensive, a long-term investor taking risk should not expect much reward as returns will likely be lower than average. Downturns can take longer to recover from. This needs to be considered when constructing a portfolio for the long haul.

When markets are the most expensive they've ever been, very bad things can happen both over the short and long term. THIS is where we are now. Candidly, it's where we've been over the last few years – it's just gotten worse. Expensive markets tend to get more expensive. They sometimes rise further than most think they can, and at some point, logic goes out the window and new explanations for their rise start circulating. Every bubble has its new narrative, but they all share the same characteristics. In the end, they go up because they've gone up. Greater fools keep stepping in until the moment they don't. This is the point where fortunes can change very quickly.

Perspective

In the 1980's, Japan's stock market was booming. It became part of Japan's culture. Everyone talked about it and by the late 80's, corporations were getting distracted from their primary businesses and began using profits to invest in shares of publicly traded companies. With the stock market returning more than could be gained by investing in the business itself, it became a good way for companies to juice the bottom line and keep profits growing. Before long, corporate profit growth became a function of stock market growth. In other words, the process became circular. The stock market became the economy in many respects. Below is a chart comparing the Nikkei index in Japan to the S&P 500 here at home – 467% return from Jan 1 1980 to December 25 1989, compared to 204% for the S&P 500.

Imagine investing in something other than the Nikkei at any point along this trajectory. It would have been tough. With annualized returns over 15%, keeping money in cash, bonds, or even the S&P 500 would have felt like a huge compromise. By historical standards, stocks became very expensive throughout this timeframe until by late 1989, they became one of the biggest bubbles in market history. A long-term investor focusing on valuation however, would have been justified in taking a pass and "settling" for something else. If they employed this discipline in 1985 or 1986, they would have had to endure a grueling few years as the bubble got even bigger and their friends richer. They would have to wait for their prudence to pay off – and it eventually did.

After the unwind was set in motion on Christmas Day 1989, it would only take a year and a half for Japanese stocks to fall all the way back down to where an investor in the more reasonably priced S&P 500 would be – in the process, wiping out three years of gains. Losses happen very fast (see below).

But that isn't the whole story for Japanese stocks. Because of the extent of the bubble and the way it changed the Japanese economy and society along the way, the aftermath was quite a bit more extensive than just a sharp correction followed by a recovery. As of today, the Nikkei 225 Index still sits -38% below where it was at its peak in 1989 more than 30 years later. When we factor in the bubble years of the 1980's, the average annual return more than 40 years later works out to just over 3%. Japanese stocks have been eclipsed many times over by the S&P 500 since the bubble popped, and it's not even close (below).

There are two points to be made here. First, really expensive markets can be extremely problematic over time. Maybe not tomorrow, next week or next year, but eventually that high price comes back down. Japan, Dutch tulips, the American 1930's, even the 1970's. There are countless examples of how this can impact investors over really, really long periods of time.

Second, U.S. stocks have reached 1989 Japan levels, and as we've noted multiple times, have eclipsed all previous U.S. bubbles in history. In addition, and this is really important, the extent to which the stock market has baked itself into American culture/society and has driven the behavior of corporate executives via stock buybacks over more productive capital expenditures is eerily reminiscent of 1980's Japan. The stock market IS the economy here in the U.S., and if it weren't, the Federal Reserve wouldn't panic every time stocks fall by -5%.

Now that you know how Japan played out, flip the script and ask yourself this question: If stocks went down and stayed down for 5, 10, or even 20 years here in the U.S., how would that affect my financial goals? If that thought provokes anxiety and makes you sweat a little, then turn off the T.V. and tune out your neighbors. None of what they have to say about new highs or hot stocks pertains to you. As an informed, disciplined investor, only you should decide when the risk/reward is favorable and when the long-term outlook looks appealing.

Here's something to consider; if the price of something is too high, then now's probably not the time to invest in it heavily. That time will likely arrive though, it just requires patience. In addition, the timing might be better for other asset classes. Possibly ones that aren't being discussed as much by the masses. Think about why they may not be getting attention; is it possible they aren't as profitable to those doing the talking? Or, it could be that they just haven't performed that well recently. Either way, this is the critical thinking that we as investors and the stewards of our financial future must contemplate. Nobody cares about your financial well-being more than you do… although we're a close second.

SECURE Act

On December 20, 2019 the President signed into law the **S**etting **E**very **C**ommunity **U**p for **R**etirement **E**nhancement Act (the **SECURE** Act). The new law is intended to expand opportunities for individuals to increase their retirement savings. Some of the changes give people more flexibility and others, less so. We'll start with the changes that will impact the most people first and work our way down.

A new start date for Required Minimum Distributions (RMDs) from IRA's and retirement plans

The SECURE Act raises the age after which you must begin taking RMDs from 70 ½ to 72. This is nice and gives you more flexibility for disbursements but only applies to people who reach 70 ½ after 2019. If you turned 70 ½ in 2019 or earlier, you are not affected. But if you will turn 70 ½ in 2020 or later, you won't need to start taking distributions until age 72. Unchanged from prior law is if you are still working after reaching the RMD age and you don't own over 5% of the company that sponsors the plan, you can postpone taking RMDs from your company's plan(s) until after you've retired.

No more age restrictions on Traditional IRA contributions

Before the SECURE Act, you could not make any contributions to a Traditional IRA for the year you reached age 70 ½ or any later year. For the 2020 tax year moving forward, the SECURE Act repeals the age restriction on contributions to Traditional IRAs. (There is no age restriction on Roth IRA contributions and the SECURE Act does not change that.)

Stricter rules for Inherited IRAs

The new SECURE Act rules will restrict 'Stretch IRAs'. The change, effective January 1, 2020, requires most non-spouse IRA and retirement plan beneficiaries to drain inherited accounts within 10 years after the account owner's death. Accounts inherited by 12/31/2019 are unaffected, but all new accounts inherited after January 1, 2020 fall under the new rules. This can be especially problematic for people in their higher earning years inheriting a traditional IRA or other pretax retirement assets. Now one has to pull a much larger amount out of those plans over just 10 years.

Example: Let's say you inherited a $300,000 Traditional IRA in 2020 and you wanted to pull the same amount out each year over 10 years, you'd need to withdraw $30,000 which would get added to your 2020 income for tax purposes. Compare that to the rules for IRAs inherited by 12/31/2019. Here the old rules still apply and a 40 year old could use the IRS-defined life expectancy table which would allow them 43.6 years to take out the same $300,000. $300,000 divided by 43.6 years equals only $6,880.73 that needs to be withdrawn in the first year – a much smaller tax hit.

Roth IRA's still fall under the same above rules. You'll have to take larger distributions each year compared to the prior law's life expectancy table, but at least the tax burden will not increase.

There are exceptions to the new SECURE Act RMD rule where certain eligible designated beneficiaries can still take distributions according to the prior rules. Eligible designated beneficiaries are:

- The surviving spouse of the deceased owner

- A minor child of the deceased owner
    - ⇒ Though once the child reaches age of majority under applicable state law, they have 10 years to distribute the balance after that date
- A beneficiary who is no more than 10 years younger than the deceased owner
- A chronically-ill individual (as defined)

Part-time workers can participate in 401(k) plans

Employers have been able to exclude part-time workers from participation in 401(k) plans, but under the new law, people who have worked 1,000 hours in 1 year (about 20 hours a week), or 3 consecutive years of at least 500 hours, will now be able to participate in retirement plans.

Retirement Plan Conversion to a Lifetime Annuity

The SECURE Act creates a safe harbor for employers to offer annuities in their 401(k) plans. The thought is this could allow employees to pick from different annuity companies who will guarantee lifetime income streams once the employee retires. We will need to closely monitor this new option and see how the new features and benefits compare to the new costs associated with such an option. Currently, nothing prevents someone from rolling over some or all of their 401(k) assets into an annuity IRA once they separate service if lifetime income is a goal/need. We'd say the insurance company's lobbyists won this battle.

Lifetime Income Disclosure for Defined Contribution plans

Employers are now required to disclose to employees the amount of sustainable monthly lifetime income their balance could support in their statements. Many plans we currently see do disclose this number to their employees, but now it will become the norm, not the exception.

Increased Access to retirement plans for Small Business employees

The SECURE Act makes it easier for small businesses to offer retirement plans for its employees by allowing multiple employer plans with fewer liability concerns and less cost. This is helpful because not a lot of small businesses offer retirement savings options so the hope is that more small business employees will be able to take advantage of employer sponsored plans.

Student Loan repayment through 529 Savings Plans

Individuals will be able to withdraw up to $10,000 to make student loan payments. A nice step, but it would be great if there was no cap.

Penalty-free Withdrawals for New Parents

The SECURE Act now allows new parents to take penalty-free distributions from their retirement plans within a year of the birth of a child or adoption to cover related expenses, up to $5,000. Income taxes would still be owed, but at least there would not be a penalty to help cover first year child expenses.

In Summary

The new SECURE Act is the biggest piece of retirement legislation since the Pension Protection Act of 2006, and these days a rare instance of bipartisan support among lawmakers and the Oval Office. Since everyone's situation is different, we suggest meeting with your advisor to see how these changes will impact you, answer any of your questions, and to help you best prepare for the future. (At least until the next round of retirement legislation makes its way through Congress!)

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