ISSUE 9 | VOLUME 10 | MARCH 2022

▶ This is Why We Think and Don't Follow 1-5

▶ Tax Planning for Inherited Retirement Accounts 5-8

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

This Is Why We Think and Don't Follow

By Casey Clarke

If there's one thing we'd highlight as being a core competency at Cadence, it's that we refuse to follow anyone else's lead nor instantly believe anything we hear without doing some thinking on the matter first. Questions we seek to answer are: What are existing conflicts of interest that may have guided the message and do those words or statements make good fundamental sense given what we know about markets, history, and our general sense of how things work? This is the critical thinking part that we cannot delegate to someone else and neither should you. We encourage our clients to always ask questions and to make sure they are completely comfortable with the financial strategies we employ along the way: things should always make sense. All that said, we are very likely entering a period where people who abdicated their responsibility for critical thought may be very sorry that they did.

We've been saying for years that financial markets are stretched to the extreme. The fact that they haven't yet returned to more normal levels doesn't make that any less true—they are simply more stretched and more extreme than they were before.

Meanwhile, financial assets have continued to appreciate creating an even larger vacuum between price and value. As price increases, speculation increases, and on and on the feedback loop goes… until of course something changes that process, and what that something is nobody knows. It could be a major financial institution failing, a butterfly flapping its wings in Mexico, or anything in between; it's different every time. One thing is as predictable and constant as the seasons however; when investors collectively get to the point of being "all-in" with respect to their speculative behavior, financial markets inevitably find themselves perched atop a mountain of debt, false confidence, and shaky convictions. When these things reverse, and they always do, assets driven up by excessive speculation always come down; and usually quickly. Always.

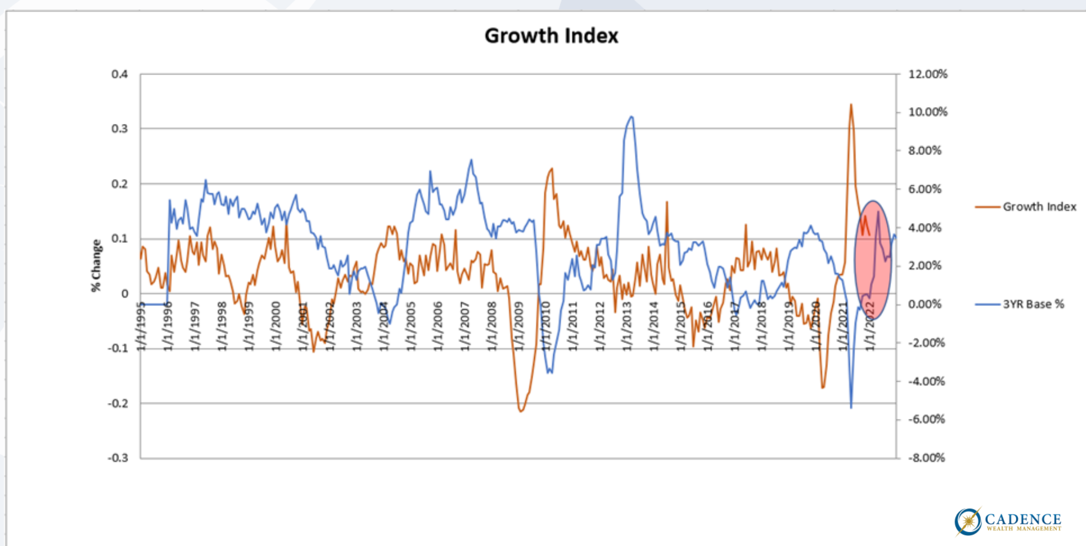
What we've observed over the last few months are markets, one at a time succumbing to asphyxiation from sky-high valuation levels that aren't justified by fundamentals. First, Bitcoin, the primary means of speculating in cryptocurrency, peaked in February of 2021, a full year ago. Next was the Russell 2000 index of small company

stocks that topped out in early November 2021, three months ago. The Nasdaq followed a couple weeks later and the S&P 500 reached its high-water mark in the first week of January this year. Since then, Bitcoin is down ~-50%, the Russell 2000 and Nasdaq are down ~-15%, and the S&P 500 is down ~-8.5% (chart below).

Just a short-term correction?

There is a possibility this is simply a short-term market correction, but the odds are that it isn't. Here's our rationale:

1) Market downturns and larger negative market events tend to occur when economic growth is decelerating. This has been the case since the middle of 2021 and will likely continue to be the case into at least the middle of this year. In fact, as we've been talking about over the last few months, and you can see in the chart below (highlighted in red), the most difficult year over year comparisons are dead ahead of us over the next few reporting months. What this means is that it will be mathematically very difficult for the economy to maintain its current annual growth rate. Again, slowing growth means difficulty for financial markets.



2) This slowing growth is coming at a time when the Fed has been forced to address rising inflation with its intention to raise interest rates and taper asset purchases. This equates to less liquidity for markets as the economy decelerates. This is not bullish for financial markets. Less liquidity equals less oxygen equals asphyxiation.

3) Key borrowing interest rates have already risen significantly with the 30-year fixed mortgage rate around 4% from under 3% just over a year ago. That may not sound like a lot, but when you have a financial system and economy built on low rates for a long time, even the slightest move higher can impact affordability, demand, and solvency.

4) Finally, all of this is occurring with stock markets at historically stretched valuations. The air pocket between where we are and fair value for financial assets has never been bigger. In addition, the only way we can return to a sustainable long-term trajectory not only for future investors, but for broad-based economic growth that benefits a larger swath of society, is to traverse that air pocket. Given the societal fractures everywhere, one could argue that we're ready to begin this healing process.

So, what's a thinking person to do?

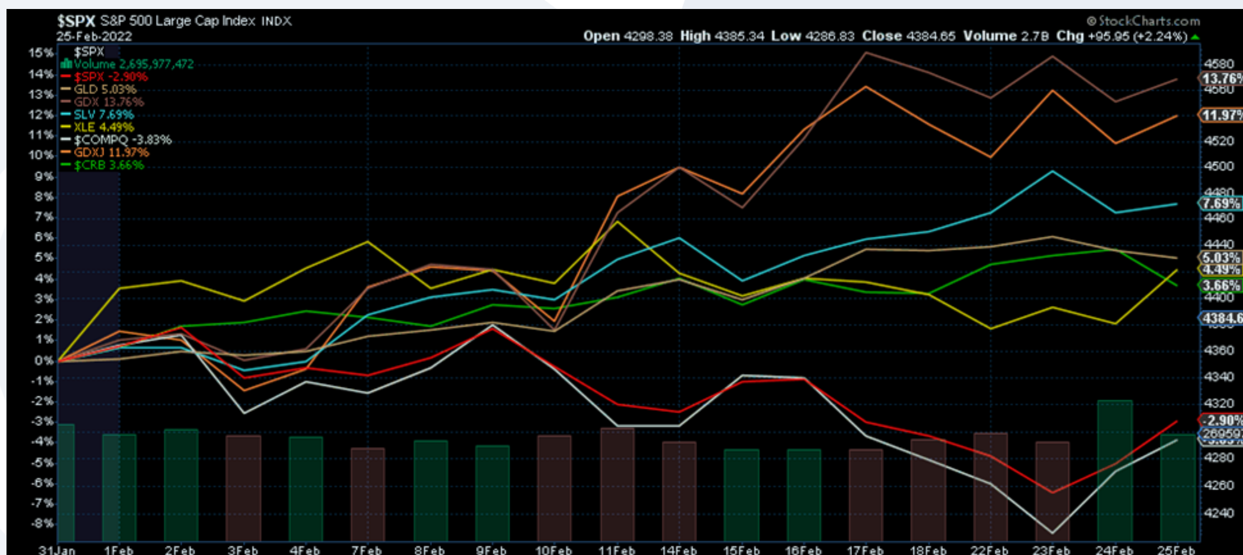
Let's address what's likely to occur if we fail to think through what's happening in markets today and did what most investors tend to do. First off, we'd likely be heavily invested in stocks either because we've fallen victim to the casino of fast gains and ended up chasing hot stocks, or have followed the general guidance of financially incentivized and thus conflicted investment companies who always have us buying more financial assets regardless of value or market cycle. Even age-based and retirement date funds within workplace retirement plans leave people with much heavier allocations to stocks than they should probably have. Most are okay with this when times are good and markets are rising. People tend not to think too hard about risk when things are going up.

But like we said, and as our clients have come to learn about us, we'll only find ourselves running with the herd when we think the herd is right and frankly, we don't think they are. We think they're just as wrong today as they were in 1929, 1965, 2000, or 2007. Regardless of how much longer they can thunder ahead before running right off the cliff, odds are given everything we've outlined above, that's exactly what they'll do. When you're staring at the hind quarters of the buffalo in front of you, you're oblivious to the fact that the first few hundred have already taken flight. There's a certain inevitability of outcome when one adopts a semi-desperate, speculative attitude toward investing at the tail-end of a market cycle. Primal psychology paired with sudden market losses is a disaster waiting to happen.

An amazing thing happens when we apply critical thinking to the investment process. We begin to see and understand conflicts of interest and the incentive structures of the messenger, human psychology and its impact on investors, and the interplay of basic financial and economic principles and how they steer markets over time. We realize that although there is social and psychological comfort in the herd, that's not to be confused with true safety. As we've outlined, market history tells us what happens to those who go along without questioning. Sometimes they do just fine, but at the wrong times, they face total (financial) ruin. We've talked a lot recently about forgetting about the "market" and what everybody else is doing and focusing on our own game. This is never more important that when markets and global events are at extremes.

From an allocation standpoint, there is no rule that says investors need to have exposure to the S&P 500 or anything else at any given point in time. It's instructive to think about why we've come to believe that we must follow these somewhat arbitrary rules about how much we should have in large cap stocks versus small cap, or international, or bonds. The reality is that most of these heuristics are based on the last 40 years of asset class data which also happens to be the most favorable in history. Without this chunk of time and the experiences that came with it, our investing beliefs would be entirely different; and they eventually will be when markets break out of the favorable trends they've been in for four decades – just ask Japan if there were any mindset or investing rule changes over there after 1990. Our guess is that people feel completely differently about how to invest now than they did before stock and real estate markets went down and stayed down for multiple decades. Why wait for markets to break before being convinced we need to change our thinking about markets? We need to play a different game now - get off the Titanic; leave the "safety" of the herd; think about what makes the most sense given the situation we're in.

We've spoken at length in recent letters about those asset classes that we feel give investors the best chance for both return of capital and return on capital given our outlook for financial markets. In short, return of capital will most likely be achieved over the coming months and quarters in cash and U.S. government bonds. Return on capital we feel has a very good chance of occurring over months and years in most commodity categories, not least of which are precious metals such as gold, silver, and the companies that mine for them. Energy and more industrial commodities as well as agricultural commodities have a very good chance of appreciating in price from here as well, all due to their relative "cheapness" to financial assets, where they are in their respective asset cycles, and the outlook for inflation going forward. On the next page, we can see how they've held up in the month of February throughout the recent bout of stock market volatility. What the chart suggests is that while money has been leaving stocks, it's been flowing into commodities. At the end of the day, money has to live somewhere and it always goes where its owners feel it'll be best treated. Since most of the assets we're currently invested in for our clients are the ones that have returned positively in February, it's fair to say that our clients have held up just fine. Of course, anything can happen over short-term periods, but it's always nice to see that the critical thinking that's been put into the process of investing for our clients' futures is rewarded in turbulent times. We have no reason to expect this will be any different when it's evident to most that the herd is in fact running straight off the ledge. Given what we're seeing at the moment, this collective consciousness may arrive sooner than later.



Some outcomes are out of our control, regardless of how much we try to anticipate, plan, and protect. Regardless, as a firm, fiduciaries to our clients, and human beings, we will never put ourselves in a position of having to say we didn't try, make the effort, or think for ourselves on an issue. The world is littered with noise, conflicted interests, and perverse incentives that can throw us off our path. This isn't just important for our financial future, but all aspects of life. Never, ever, delegate critical thinking, especially when others benefit from your doing it. There are many things in the world and financial markets that don't make sense today; don't let anyone convince you otherwise. With eyes wide open, we're positioned well for what lies ahead.

And finally, a word about Ukraine. War is never good and should never be a solution to a problem. Unfortunately, however, what's happening in Ukraine probably won't be of much concern for our markets beyond the day-to-day reactions to headlines and breaking developments. There will be exceptions of course, especially within commodity markets that could get temporarily disrupted by events in Ukraine, but for the most part, market participants tend to be more concerned about what's happening immediately in front of them with respect to profits, personal safety, confidence, etc. Thus, we don't see any need to alter our investment strategy or approach at this point. It's also worth mentioning that if markets experience difficulty over the coming weeks and months, they were primed for that outcome long before Ukraine developed into a serious situation. Ukraine will not be the reason for markets struggling should they begin to really struggle. This is a good example of the importance of thinking things through ahead of time rather than leaving oneself vulnerable to the vicissitudes of the news cycle and global events.

Tax Planning for Inherited Retirement Accounts

By Steve DeBoth

Many people who have inherited retirement accounts since the beginning of 2020 already know this, however many people who have done so more recently, and certainly anyone who has not yet inherited an IRA or 401(k) may not be aware that non-spouse beneficiaries can no longer stretch out distributions over their own lifetimes.

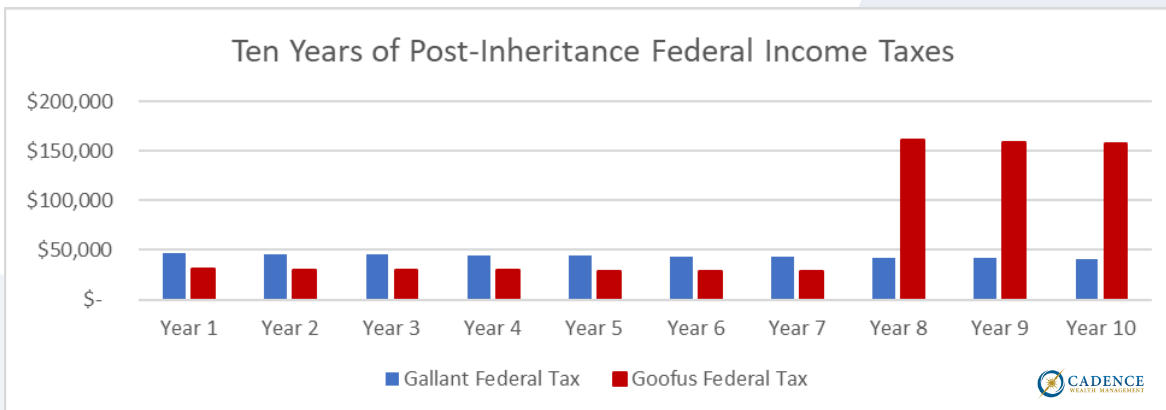
Before 2020, anyone inheriting a retirement account from a parent or a sibling, or from anyone who was not their spouse, was generally able to take required annual distributions from those accounts at amounts based on their own lifespans. That usually resulted in relatively low annual distributions, which allowed more money to stay in the accounts for longer to continue growing tax-deferred, and for distributions to be stretched long enough to take advantage of lower tax brackets in retirement. Since the beginning of 2020, the rules for these distributions have changed. Now, an inheriting non-spouse does not have to take any amount out in any given year for the first nine years. By the tenth year, however, ALL the money must be removed from those inherited retirement accounts. Again, not if you inherit from a spouse as you are permitted to roll those investments into accounts in your own name. There are a few other exceptions, but for most non-spouse inheritors, these new rules apply.

To reduce the tax impact of what could be tens to hundreds of thousands of dollars or more added to your taxable income over the course of years, you will need to plan around your income, the income tax brackets, and the potential to shelter any income you can from taxes to reduce your tax burden. To illustrate this, we'll look at two people: Gallant and Goofus. Gallant decides to take advantage of all ten years he has to work with to reduce the tax impact of his inheritance as much as possible, while Goofus doesn't read our newsletter and is unaware initially that he will have a potentially massive tax burden to pay. Each inherits $1,000,000. We will assume investments left in the

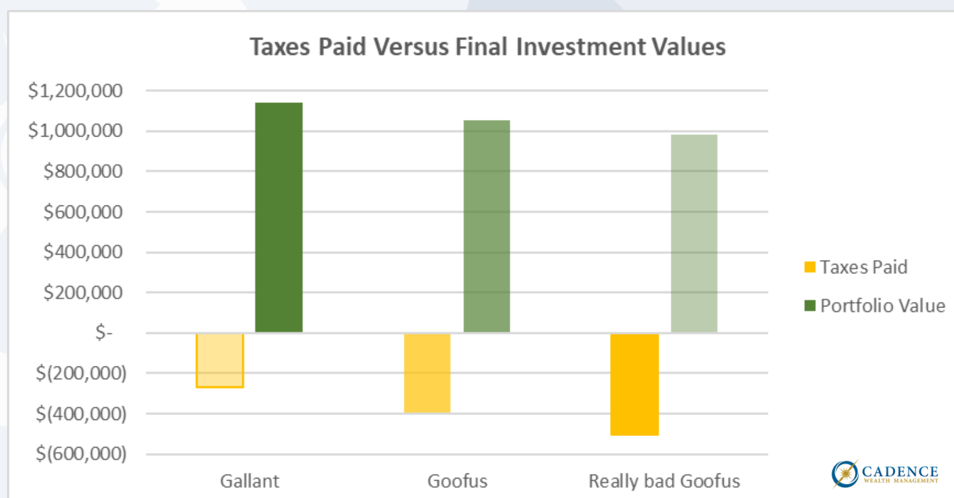
account and investments that are made as a result of amounts being removed from the account will both grow at 4% per year.

Gallant calculates he will need to remove around $120,000 every year to be taking out roughly the same amount, and therefore not bump himself into a higher tax bracket than he needs to. Gallant and his wife make $200,000 per year and are already maximizing their 401(k) contributions. Gallant will pay an extra $270,000 in federal income taxes over the ten years as a result of the distributions. After paying the taxes on his distributions, Gallant invests the money the same as he was inside the inherited account.

Meanwhile, a little over seven years after inheriting the money, Goofus finally hears about the need to remove everything within the ten-year time period. At this point, his $1,000,000 inherited IRA is now worth a little over $1,300,000 and he figures if it continues making around the same as it has been, he will need to withdraw around $456,000 per year over the next three years to not get completely killed by taxes more in one year than the others. Conveniently, he and his wife also make $200,000 per year, though they do not save the maximum in their 401(k)s, nor do they think to change that. As a result of his late realization and lack of taking advantage of deferring taxes elsewhere, Goofus and his wife will pay around $400,000 more in federal income taxes over the ten-year period than he would have had he not inherited the money.



In this case, a withdrawal strategy that took advantage of all ten years available like Gallant used saved him $130,000 more than the haphazard strategy employed by Goofus. However, it could have been even worse for Goofus. Had he waited until the final year to remove the inheritance, he would have paid a little over $500,000 more in federal income taxes over the ten-year period, because every year you wait increases the likelihood some amount of what you withdraw will be at a higher tax bracket. In this final big year, Goofus had half his income taxed at 35% and above, whereas Gallant only had a little of his income taxed at 24%, with the rest being lower.



With his more carefully crafted withdrawal strategy, Gallant not only paid less in federal income taxes, but also had a higher investment value, assuming all taxes paid on the withdrawals were taken out of the investments, at the end of the ten-year period than Goofus's less carefully crated strategy, and certainly than Goofus's more disastrous possible "withdraw all in the final year" strategy.

If you are faced with a similar situation, there are a few things you can do to be more like Gallant, and less like Goofus:

1. Space out your distributions across as many years as you can.

The smaller the distributions are that you have to add to your taxable income every year, the lower your taxes will be, with some exceptions. For example, if your income is high now but will be lower later, it may net you more by withdrawing less in the earlier years. There are some other potential scenarios where dividing the distributions into more and smaller chunks will not be the best strategy, but in general, the smaller the distribution, the lower the taxes.

2. Take advantage of your highest tax bracket.

If you can see that your planned distribution is going to put you into a low enough tax bracket, like perhaps the 22% or 24% bracket, it may make sense to take a larger distribution from your inherited account in the event it will not put you in a higher tax bracket. Taking a larger inherited account distribution to be taxed at the highest rate you are already paying may allow you to reduce the overall value of the account sooner, and may result in smaller distributions later that can be taxed at lower rates.

3. Maximize every opportunity you have to shelter any of your income from taxes.

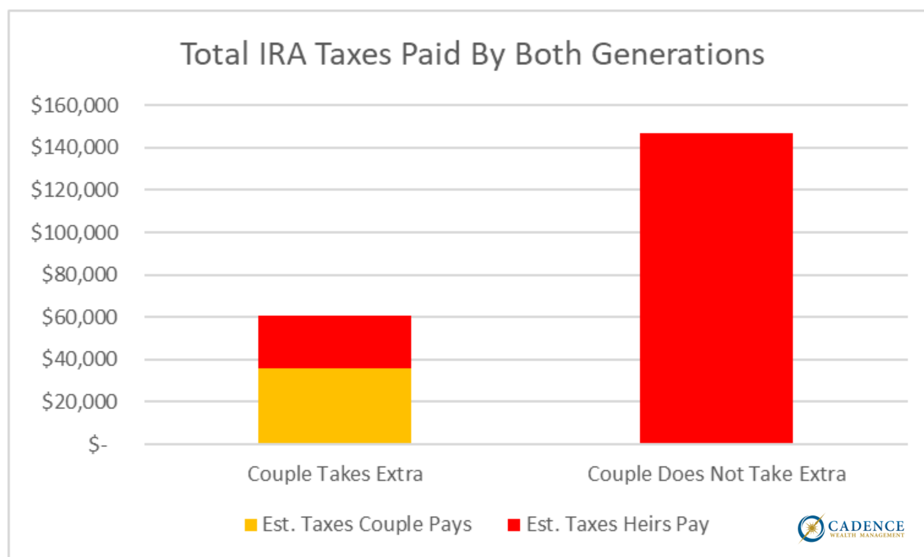
Contribute the maximum you can into the pre-tax portion of your workplace retirement accounts. If you contribute to a workplace retirement plan but your spouse doesn't, see if you qualify to put additional tax deferrals into an IRA for him or her. Also, if you have access to tax-deferred Health Savings Accounts, use those too. Reduce your taxable income as much as you can, because you will be receiving additional taxable income in the form of inherited asset distributions you can live off.

4. Multi-generational considerations: does it make sense to pay extra tax now before assets get passed on to save even more tax later?

Another consideration is for those retirees who do not need all of their investments to pay for their lifestyle in retirement and would like to consider these tax issues before they pass their assets to their heirs. This opens the possibility they can take extra distributions from their retirement accounts now, pay a relatively low income tax rate on them, and then leave a lower amount of IRA investments to their heirs. This works when the heirs are in higher tax brackets than the original IRA owners, and when the IRA owners reinvest the extra amounts they remove from their IRAs in non-IRA accounts to keep growing as they would have had they left them in the IRAs.

Consider this case. A retired couple has $300,000 in an IRA they feel they will never need to use to pay for their retirement going forward. They or their tax professional has estimated they can take $30,000 out of this account every year and it will not push them into a higher tax bracket than their current 12% federal rate. They could then pay the extra taxes from the distributions and invest what is left every year in an account that will not be subject to the required distribution rules. Taking out an extra $30,000 every year would leave them paying $36,000 more in taxes total over 10 years.

When it comes time to pass those assets on, because they reduced the balance in their fully taxable retirement account, the amount their heirs would have to take out over a ten-year period would be far lower than if the couple had left the money in the retirement account to grow. Assuming the distributions their heirs would be forced to take would be taxed at a 24% or 32% rate, the overall tax savings would be tremendous. Assuming a 4% growth rate on the investments, their heirs would save an estimated $100,000 - $140,000 in income taxes over their ten-year withdrawal periods. Passing on such large tax savings may make paying an extra $36,000 themselves worth it.



All that tax savings would leave the heirs with an estimated $150,000 more in investments at the end of their ten-year distribution periods, assuming the income tax and asset growth rates mentioned before, than had the retired couple never taken the extra distributions. There would be some taxes due through the years on the investments in the non-IRA accounts to be paid by both the original IRA owners as well as their heirs. Those taxes are more difficult to anticipate so far in advance and would need to be considered, though it is highly unlikely those taxes would come close to what would be owed on the inherited IRA distributions.

As you can see, minimizing the income taxes from your inherited assets requires looking at where your inherited account value is, assuming a growth rate on those assets, and reviewing your income tax brackets every year and adjusting your distributions accordingly. If you are the one to eventually pass assets on and you want to get an early start on minimizing the taxes your heirs will pay and ultimately the amount they will net from your estate, you need to determine how much extra income tax you can pay without affecting your ability to continue affording your retirement lifestyle. Though it may end up taking some work, the tax savings could make it well worth your while. Another strategy, of course, is to use the services of a tax professional and a Cadence Wealth advisor who are willing to play around with all these variables for you. Either way, it pays to be more like Gallant than Goofus when it comes to qualified inherited account withdrawals.

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