▶ Tax Math: Weirder Than Regular Math ... 1-3

▶ April 15 Is Approaching - When Will I Receive My Tax Forms? 4

▶ Remembering Japan – No Sirens 4-7

ISSUE 8 | VOLUME 13 | FEBRUARY 2025

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Tax Math: Weirder Than Regular Math

By Steve DeBoth

No one really looks forward to tax season, do they? Many of us enjoy the end of winter and the beginning of spring, and when you think of it that way it's pleasant enough. As soon as you call it "tax season", well, that doesn't usually evoke the same emotions. Call it spring, and you think of flowers and sunshine; call it "tax season", and you think of forms, deadlines and checks to write.

With the negative feelings "tax season" evokes, it's no wonder that along with it comes some frequent misperceptions. For example, how do you feel about paying taxes on investment gains? And, would you rather owe the IRS, or receive money back from the IRS? What if your feelings on these matters, for lack of a better word, were wrong?

Owing Income Tax on Investments

Taxes are due on 401(k)s, IRAs, and other similarly structured and IRS-provisioned investment accounts only when money leaves the accounts, with few exceptions. Interest earned, investment gains, and dividends that occur within the accounts are not taxed as they happen. However, when cash leaves the account, every dollar is considered taxable at current income tax rates.

Non-retirement accounts are the exact opposite of that, tax-wise: no taxes are due when cash leaves the account, however any calendar year that interest or dividends are received, or an investment is sold at a gain or a loss will have an effect on that year's tax returns. The majority of investors have more in their retirement accounts than in non-retirement accounts, so they are not as used to their investments kicking off taxable gains. It is not uncommon for we advisors to hear our clients note that their non-retirement accounts were negatively affecting their taxes. This leads to the discussion on why it's better to have to pay taxes on these investments than not to have the investments at all.

Consider a married couple that made $300,000 in 2024. They saved 15% of that, or $45,000, into their workplace retirement accounts and took the standard deduction of $29,200. Without any other additions to their taxable income, they would be solidly in the 32% federal income tax bracket and owe the IRS $40,277 for 2024.

If they had started 2024 with a certain mix of mutual funds and exchange-traded funds, as well as short and medium-term treasuries worth $100,000 in a regular (non-retirement) brokerage account, these investments would have grown by 7.09%. How can I be that precise? I looked at a client account nearly identical to this when creating this example. That investment mix would have generated $545 in taxable interest, $1,754 in taxable dividends, and $5,725 in short-term capital gains. This would increase their federal income taxes due by $2,231, leaving them with a net investment gain after federal income taxes assessed of $4,859.

I agree, paying $2,231 more in federal income taxes is not what anyone prefers to do, however, isn't it worth it if, overall, you have nearly $5,000 more in your pocket? In simplified terms, paying may be "bad", but keeping is "better". I will hand over $2,231 to anyone who will turn around and hand me $7,090 in return. That's a 4.9% net gain on the initial $100,000 investment, but it's a 218% gain on the taxes due. When you write that check, know that you're better off than if you had no reason to write that check. $4,859 better, to be precise.

Owing the IRS versus getting a refund

Isn't it nice to complete your income taxes and see the federal government owes you money? It's definitely better than owing the IRS, isn't it? Well, maybe for one reason I'll mention later, but mathematically it is better that YOU owe THEM, regardless of how much it hurts to write that check. Let's look at the math.

Let's say you're due $3,000 back from the IRS. That's not chump change by any stretch. Unfortunately, that is a $3,000 interest free loan that you gave the US government. Helping your country fund its obligations and, increasingly, pay the interest on its debts has a certain nobility, but you can do the same by buying a $3,000 treasury bill, note, or bond and for much of 2024 have earned 5% on it. So, would you rather get a check for $3,000 from the IRS, or have $3,154 already in your account?

Let's take this further. Let's say that instead of getting $3,000 back from the IRS, you owed them $1,000. Now it's the IRS that is giving you the loan. With that loan, just like when they owed you $3,000, you make a little over 5% on it, $51 to be precise. From your $1,051 account, you write the IRS a $1,000 check when the time comes, and you keep the $51. Overall, the financial benefit of owing $1,000 versus receiving $3,000 is over $200, before taxes, of course. At the beginning of 2024, if you'd invested $1,000 in the Schwab government money market fund and liquidated that amount to pay your federal income taxes due of $1,000, you'd be left with $51. Had you over-withheld by $3,000, you never would have earned that $154. That all adds up to $205.

As previously mentioned, there is one instance where it can be argued getting a check from the IRS is better than owing them: were you to have completely wasted that money were it in your possession instead, AND if when you receive it from the IRS you do something productive with it, THEN it's better to be owed than to owe. Consider that $3,000 to be a form of forced savings. I struggle a bit calling it that because I think many of the people who use their federal income tax refund as a savings mechanism will end up putting that money to non-productive use any way. If you need the forced savings, then how good are you going to be with the money when you do get your hands on it?

If you were to take a vacation every year and pay for it with your IRS refund, I cannot argue that's not a beneficial thing to do. I know it's mathematically not the best way to do it; I'd rather you withheld less, accumulate $4,000 over the year, owe the IRS $1,000, pay them, and take your $3,000 vacation. When you get home, you'd still have $205 dollars in that account. If there's no other way to get that vacation money, and we all need the mental health breaks vacations can provide, then maybe, just maybe, you're better off getting money back from the IRS to pay for it. You'd have to convince me, though, and I am in the mood to argue this point.

When is a tax loss also an investment gain?

Tax season is also the time of year more clients take a close look at the specific gains and losses of the individual investments inside their accounts. It is a quirk of the Charles Schwab client website that gains and losses reported on the website don't reflect actual gains and losses.

Mutual funds, and to a lesser extent, exchange traded funds generate taxable interest and dividends, especially bond funds. Every time an account holding an investment receives a dividend or interest payment, the cost basis of that investment gets adjusted to account for the taxability of the transaction, even when no tax has yet been assessed, and even when that investment is inside an IRA and no tax will ever be assessed on that transaction. That's just how the system reports the cost basis of the individual investments.

In taxable accounts, these taxable transactions get reported on the various 1099's clients receive early each calendar year, and from those reports the various income items get added to the tax return. As you pay taxes on the investments year after year, the cost bases of the investments increase over time. We have covered the benefit of having investments to pay taxes on in the first place early in this article, but another benefit of paying taxes along the way like this is that it is possible to book a tax loss on an investment that has actually increased in value and paid you interest.

Looking in an actual client account, I see a holding, the BlackRock Strategic Income Opportunities Fund, with a ticker of BASIX. When I log in to the account to see what a client would see, this position is showing a loss of -2.5% since she owned it. However, when I look at the same position in the same account in the system we advisors use to report client returns, that investment is showing a 38% gain. Which one of these is the truth?

Well, they both are. When it comes to the client, she really has made 38% between appreciation of the investment itself, as well as the dividends and interest earned on the investment. As far as the IRS is concerned, on the other hand, there is a -2.5% loss on the investment, as all the taxes paid along the way in relation to the value of the investment today actually results in a current tax loss were the position liquidated. In this way, the client can enjoy both a 38% gain on the investment as well as a -2.5% tax loss she can claim on her income taxes. So, don't be mislead by what you see in the Schwab system when you log in. A high percentage of the investments that system shows you have lost value in have actually earned you a positive return. If you are in doubt, ask your advisor.

Spring brings out the optimism in many of us. The end of winter is a time to be celebrated as we emerge from our hibernations. Tax season, however, even though it runs simultaneous to spring, is not celebrated in similar fashion. Melting ice and snow, lengthening daylight, and grass turning green are all happening while 1040's, 1099's, and W2's are making their way to us. In this way, tax season actually happens at the perfect time of year. While our tax math is happening, at least we can look out the window to a world getting more green and less gray. Don't let the idiosyncrasies and oddities of tax math and the Charles Schwab website fool you. A few of the things that appear to be negatives this time of year are, in fact, just the opposite.

April 15 Is Approaching - When Will I Receive My Tax Forms?

By Tom Shiffer

As the days get longer and we wait for Punxsutawney Phil to let us know how much longer winter will last, it is also time to begin the task of gathering all of the forms necessary to prepare one's taxes for another year. Depending on the types of accounts you have, there are many different forms that are produced and they all appear online at various times. 1099-R forms have already come out and the next most common form, the 1099-Composite, usually appears mid-February. We caution, however, not to prepare your taxes as soon as the forms arrive, since frequently mutual fund companies make mistakes and issue corrections. Our suggestion would be to wait until early March to make sure no amended/corrected 1099-Composites were sent out, and if they were, make sure to use the corrected form.

To access your Schwab forms, log into your accounts on Schwab Alliance, click on the **"Statements & Tax Forms"** heading and you'll see your 1099 Dashboard. Your accounts will be listed on the dashboard with the forms either already attached or the date when you can expect the document to be available.

As always, please reach out to your Cadence advisor should you need any assistance.

Remembering Japan – No Sirens

By Casey Clarke

In the decade leading up to the 1989 peak in the Japanese stock market, there was little to complain about. Almost everybody with shares of stock or real estate was watching their net worth rise, month after month, nearly uninterrupted. It became so easy to make money in the stock market that work ethic declined, leisure time increased, and many corporations found it easier and more profitable to augment their core business activities with stock market activity. According to Edward Chancellor in "Devil Take the Hindmost", "Japanese politicians were not solely guided by public duty in their desire to support the stock market. They also maintained a private interest in its continuing ascendency". Virtually everyone with money to invest across Japanese society was playing the stock market game, and the wealth it created rippled into other asset markets. By the end of the 1980s, the gearing of the Japanese economy was largely powered by the stock market, rather than the more typical and fundamental relationship of economic activity driving stock market returns. That was to finally change in 1990 as the horribly bloated Japanese financial system began its long recovery toward something more recognizable, healthy, and sustainable with the Japanese stock market losing over three quarters of its value by 2003. This massive asset deflation helped to reclaim a system that incentivized hard work over gambling, financial discipline over profligacy, and true material wealth over the more ephemeral paper variety. It's more common to use the term correction for this sort of thing, but recovery seems appropriate given how distorted the system became and its need to reclaim health. Although paper wealth evaporated over time, the deflation of asset prices and disinflation of consumer prices arguably improved the standard of living of those without high income and asset levels as daily expenses moderated and assets became more affordable to own. All it took was a decline of ~-80% through 2008 and a 35-year period

of markets being underwater. The Nikkei index is currently right around where it was in the final days of 1989, which is to say, a buy and hold investor buying the Japanese market 35 years ago would just now be getting back to even.

What we can be nearly certain of is that very few investors saw this coming. A bad year or two, defined as low single digit returns, maybe. A negative performance year at some point in the future, possibly. But an -80% decline in stocks that would take 35 years to recover from, no way. When so many people are engaged in something day after day, with the perceived benefits being so widespread, it's hard to imagine the status quo being anything but the norm. That psychological recency bias aside, another reason the average investor didn't see this coming is because it wasn't really anybody's job within the financial system to show it to them. Big banks and investment companies all make money for their employees and shareholders when credit is expanding and money is flowing. To do or say anything that puts that process at risk is well outside of standard operating procedure. Ideally, regulators step in, but only if their incentives align with future investors more strongly than with current actors, which unfortunately isn't always the case. Government monetary and regulatory authorities are very often found in close proximity to the financial feeding trough. In addition to being in public service positions, they are also human. In the case of the Japanese financial and monetary authorities, after falling asleep at the wheel and facilitating one of the biggest bubbles in history, for a host of reasons, they finally began raising interest rates and tightening credit, sowing the seeds for the eventual market deflation that followed. Only investors who stepped back and recognized the insanity of the situation were able to protect themselves from significant portfolio and balance sheet damage.

(The chart below maps out the journey the Nikkei index took from the early 1980s to present day.)

There are far too many parallels between Japan in the 1980s and our recent experience in the U.S. to feel confident that our situation is unique. Between persistently low interest rates, indiscriminate credit expansion, a market-centric societal shift leading to a prioritization of capital over labor, a rise in speculation and decline in work ethic, and "wealth effect" over tangible, total wealth, the basic structure of the two situations share a resemblance.

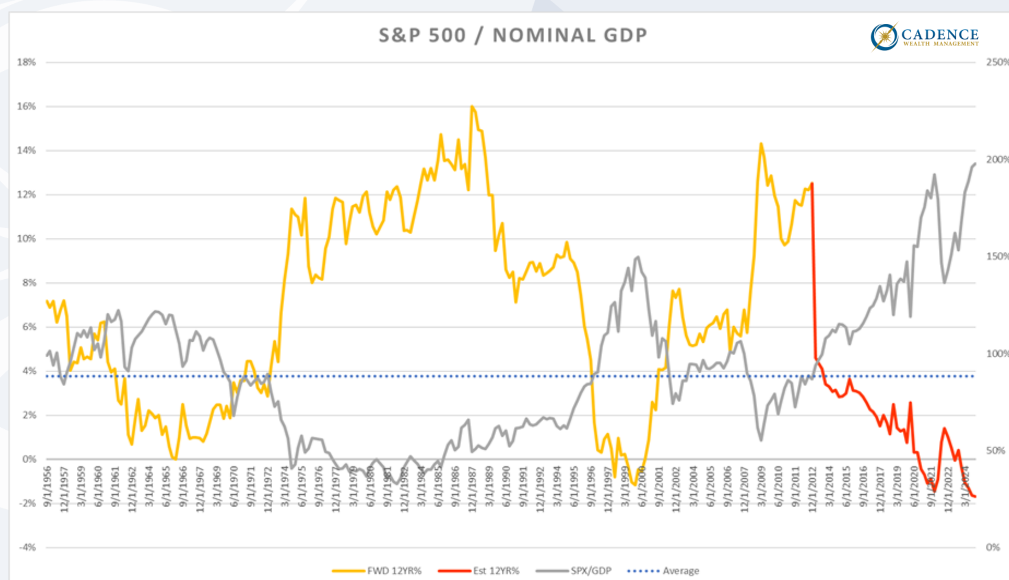
The absolutely critical takeaways from the Japanese experience are the following:

- The peak valuation that preceded the 35 years of lost returns was roughly 140% stock market to GDP, which means that the total value of the Japanese stock market was 140% of the value, or 40% larger than one-year's-worth of Japanese economic output. By comparison, our stock market to GDP ratio is currently around 208%, more than double our annual economic output. Our bubble is bigger than Japan's was prior to 35 years of no stock market progress; and not by a little.

- Nobody within the financial system is obligated to warn you. In fact, most are financially incentivized not to. In addition, there are myriad reasons why regulators may not step in to protect investors until it is too late. You'll only hear warning sirens from sources outside of the system, and the responsibility is on the investor to discern which of those sources is credible and trustworthy. That can't be delegated without ending up right back in the same conundrum; stuck within the echo chamber of the system. This bears repeating – you will never hear warning sirens from the system whose profits depend on you continuing to do what you've been doing, in any industry, with respect to anything. If you want to hear heterodox arguments that push against current inertia, aka warning sirens, you have to step outside that system.

It's important not to look at this phenomenon as negative, deceitful, or nefarious in any way – it just is. In a capitalistic system where products are manufactured with the specific intent to satisfy consumer preferences, there will always be incentives for a company and its employees to sell more of that product. It's on the consumer to be aware of the fact that a particular company and its employees will always be biased toward recommending their own product over the competitors, even when the competitor's may be superior, and even when the customer may not necessarily need the product. You can't blame a Ford salesperson for trying to sell a car. You also can't blame him for not recommending a Chevy. This is true in every industry. Financial services are certainly no different. The last point I'll make here is that it all changes when there is intentional deception. Selling a perfectly good stock mutual fund or product at the wrong time is providing a service, even if its purchase is ill advised. Selling a product using deception or a defective product outright with the intent to deceive is a different story. Sadly, this happens. It's what good regulation is for. It's also what reviews, word of mouth, and karma are for.

The chart below looks at the S&P 500 relative to nominal GDP and expresses the same relative relationship as the 208% market cap to GDP ratio I referenced above. The gray line plots this relationship over the last 60 plus years, and as is easy to observe, we're well above the peak valuation we saw prior to the Tech Bubble in early 2000. The yellow line represents the annual returns that investors in the S&P 500 would have experienced over the next 12 years had they invested at various points in time along the way. As you can see, twelve-year returns are highest when investments are made from LOW valuation levels and worst from high valuation levels. The red line is the estimated 12-year return from valuation points over the last 12 years. Most important, from today's valuation, the expected return based on the relationship between the two over the last 60 years is close to -2% per year. Probably more important, that estimate assumes that markets only revert to average valuation levels. Of course, the average is derived from points above and below it, so it's fair to expect that returns could be much worse than we're showing here, just as was the case in the Japan experience and most other bubble bursts in history.



Most people struggle to hold two competing concepts in their head at one time. It creates dissonance. It's messy – not nearly as simple as we'd like it to be. Binary viewpoints feel cleaner. They save us time. We can turn off our brains sooner – delegate our thinking to others, ironically who've often times done the very same thing. Embracing the messiness of existing conflicts, incentive structures, biases is liberating in that it allows us to see things more clearly, operate on a better-lit path, and make more informed decisions. Wall Street and its products can be both great and problematic. Government can do immense good, but also fail miserably at times. Corporations have the power to innovate beyond comprehension and improve our quality of life in untold ways, while also, on occasion, harming us deceptively and intentionally through their products and services. Stocks, and their ability to compound, can create astounding financial wealth while also, at times, destroying it. These things are neither positive nor negative, but just realities.

As we move forward into 2025, we'll continue to hear a plethora of arguments for why the economy can rebound, stocks can continue to rise, and inflation at a minimum of 2% is still somehow a good thing. We should expect these narratives. We should also expect that what we won't be hearing much of is the other side of the story. The side that doesn't reward the players in the system when it's told or as it plays out. It's on us as investors and individuals within the system to understand that dynamic and seek out the less profitable arguments. Our clients pay us to grow and protect their wealth and our sole source of revenue comes from them – we've made a conscious decision to keep other interested parties from renting control of our brainwaves. Thinking critically about events like the Japan bubble, and appreciating that the people operating up to and throughout that experience were no less intelligent and well-intentioned than we are now, is crucial. Expecting that we are somehow immune to a similar outcome is naïve. Seeing and acknowledging risks like these, and fighting hard to resist the strong human impulse to ignore them, gives us an opportunity to be more resilient when things get hard. As we've written plenty about, avoiding bubble risk doesn't have to mean we stop investing. Quite the contrary. It actually means we stop speculating and start investing – something most still overly exposed to traditional stocks haven't yet done.

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.