FINANCIAL DECISIONS

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The Most Important Financial News From 2018

The most important financial news of 2018 was that Modern Portfolio Theory (MPT), the strategic underpinning of prudent investing, worked. Yet you just don't see front-page headlines saying conventional wisdom worked. Why? Because when what's expected to happen actually occurs, it's not news. Nonetheless, the fact that modern portfolio theory worked, just as academia expected it would, was the most important financial news of the last year.

In January 2019, the Jubilee year of the 49-years averaged a 10.21% return annually and a 16.98% standard deviation (risk rating), compared with a 10.23% risk rating and 9.48% return on a broadly diversified portfolio. This big news happened in plain sight — as it does every year — and, as always, it occurred so very slowly that it was easy to overlook. Based on monthly portfolio design research reports we license by Craig Israelsen, Ph.D., who's taught this class annually for three decades, here's what happened.

Multi-Asset Portfolio

1970-2018	Large US Equity	Small US Equity	Non-US Equity	US Bonds	Cash	Real Estate	Commodities	7-Asset Portfolio
49-Year Average Annual Return	10.21	10.60	8.42	7.37	4.80	11.41	6.51	9.48
49-Year Standard Deviation of Annual Returns	16.98	21.41	21.75	6.55	3.53	18.59	24.92	10.23
Number Of Losing Years	10	15	15	3	0	9	15	7
Worst Three-Year Performance	(37.61)	(42.24)	(43.32)	4.39	0.14	(35.61)	(55.60)	(13.37)

Equity-like return with less risk

Past performance is not a guarantee of your future results.

Performance of an equal-weighted portfolio of seven assets for the 49 years through 2018 validated the theory pioneered in academic research in 1948 by Harry Markowitz. MPT holds that a broadly diversified portfolio rebalanced periodically is the best way to get equity-like returns with less risk. The Standard & Poor's index of the 500 largest publicly-held companies over the modern era of investing, the wisdom of MPT was confirmed: A broadly diversified portfolio over the near half-century long period averaged a return annually on par with stocks but with much less risk! The data on these seven indexes representing these asset classes only goes back to 1970, which is why having another year of

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Ten Years After:

Last month marked the 10th birthday of the current bull market in U.S. stocks (and concurrently, the 10th anniversary of the lowest-lows of the market during the "Great Recession"). Looking back, many of us may not remember that the Dow briefly dipped below 6600 on March 9th, 2009, but we definitely remember all of the anxiety, angst, and frustration we experienced that winter.

Query: How many of us were equally ebullient this past September, when the U.S. stock market hit new record highs? In fact, the U.S. equity market had quadrupled (yes, quadrupled) during the previous decade! Yet, nobody was dancing in the streets. Investors' minds were fixed on the uncertainty of the mid-term elections, Fed rate hike-fueled recessions, and trade tariffs. These fears spiraled into a brutal fourth-quarter sell-off that cost the market almost 20% of its value.

Then, remarkably, the market turned itself around and started 2019 with an incredible run, eclipsing last year's losses. But all that the media, and investors, can seem to focus on are... you guessed it, recession signals and trade wars.

So, apparently, here's the new Post-Great Recession normal: The stock market goes up, and down, but mostly up. Only now, no one enjoys the ups anymore. Ten years after, let's all agree to put the pain of the past behind us, and celebrate the wealth that thoughtful investing has brought us.

Florence Dupont, Ken Gutwillig, and Linda Schoenthaler

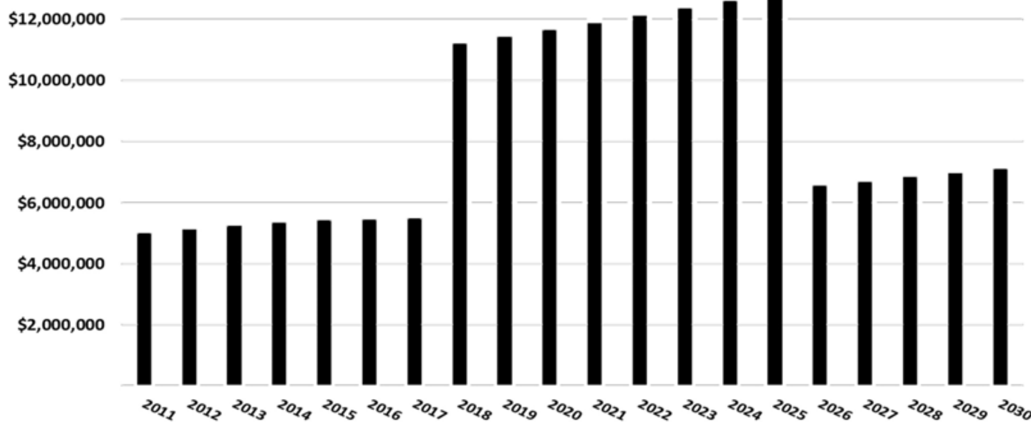
Be Prepared For Tax Policy To Swing Back

For business owners, professionals, and wealthy families, tax rules are about as favorable as they've been in decades, but the tax policy pendulum could swing back again. Be prepared to make some important financial decisions much sooner than had been expected.

For example, the lifetime tax exemption for gifts made in 2019 is $11,400,000, up from $11,180, 000 in 2018. It doubled over the $5.43 million in effect in 2017 and is scheduled to ratchet higher through 2025, as a result of the enactment of the Tax Cuts & Jobs Act (TCJA). In 2026, the exemption reverts back to the level in effect before the TCJA became effective in December 2018.

That means families should have many years before they would be forced to decide whether to make gifts in 2025 to maximize their tax exemptions in passing their wealth to family members. The 2025 peak in the exemption amount forces a decision about whether to give assets to loved ones while you're still alive or hold onto your assets and give them away after you die. In 2025, you use the $12-million-plus exemption or lose it, and the exemption reverts back to a much lower amount in 2026 and beyond.

However, the tax policy pendulum — a politically charged issue — could swing in the other direction in the months ahead. High-net worth individuals may need to make decisions about gifting assets much sooner. There is no assurance that you will have until the end of 2025 to make this important strategic decision about passing on your family wealth.



Point is, if tax policy changes, business owners, professionals and individuals benefiting from strategies enabled under the TCJA, may be forced to make decisions about income tax as well as estate and gift tax strategies much sooner than they might have expected. It's not an issue you want to fall behind on and will require personal and professional tax advice. ●

7 Reasons To Update Your Financial Plan

Have you developed a comprehensive financial plan? Even if you have, it may need additional attention. Consider these seven reasons to revisit your plan.

1. Keep on track for meeting goals. While having a plan is an important first step, success will depend on staying focused on what's needed to meet the plan's objectives. A review shows how you're progressing and what your next action items need to be.

2. Reflect major "life events." If something significant has happened—you've gotten married or divorced or changed jobs, for example, or you have a new child or grandchild—you may want to consider changes to your financial plan. You'll also need to think about revising beneficiary designations for retirement plans, IRAs, and insurance policies. A review of your estate planning documents and reassessment of insurance needs is also in order.

3. Take the latest tax legislation into account. State and federal tax laws are in constant flux, and it's crucial that your plan reflect recent changes—such as the new estate tax law that provides a larger individual exemption and could require adjustments in the language of your will or any trusts you may have.

4. Re-think your risk tolerance. The stock market continues to be volatile, and a mix of investments that seemed comfortable before may not fit your current needs and risk tolerance. Be sure your portfolio reflects your current risk tolerance.

5. Tighten your budget due to a job loss or reduction in compensation. Not having your normal (or prior) income will throw any plan out of whack. You'll likely need to reexamine your priorities and look for ways to cut back on spending, particularly for major purchases that you had planned to make. Unexpected

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The New Math Of Renting Out A Vacation Home

If you've ever thought about becoming a landlord, here's an update on recent tax breaks that changed the equation for weighing whether to rent a property or be the sole tenant throughout the year.

If you bought a home in 2018, only the first $750,000 of the mortgage interest is deductible, down from $1 million under the old rules. But a rental property is not subject to these limits.

Renting out a property for at least 15 days a year means you can take a partial property tax deduction

While the math of renting out your place may not have worked before, you may want to look at it again. Your mortgage could be several million dollars, but you'd still be able to deduct *all* of the interest on it — just as you did before the new law. If you live in the residence for part of the year and rent it out for the rest, you're entitled to a partial break.

Another advantage for rental property owners is that now you can deduct only $10,000 in state and local income tax and property tax annually on a home if you are not renting it out. But if you rent out a property for at least 15 days a year, you can take a deduction on part of the property taxes paid.

A homeowner who pays $12,000 in property levies annually, for example, may deduct only the first $10,000. Renting out that property for three months qualifies you for a deduction on 25% of property taxes paid, or $3,000, and you could separately deduct the other $9,000 in property taxes paid.

Rental property owners also get a break on making home improvements. Under tax reform, landlords may immediately deduct capital spending on equipment and machinery. Gone is the requirement to take the break over many years. If you install a new kitchen in a rental property, for instance, it's deductible all at once.

Becoming a landlord is fraught with issues beyond finances, chief among them: privacy. Letting others invade your personal space literally is no small decision and a very personal one. However, the economics of renting out a vacation home have changed, and you may want to reconsider your options.

In the era of Airbnb, deciding to rent a vacation home requires advice from a professional who understands the strategic tax and financial planning as well as your personal situation. Please give us a call if you have any questions. ●

medical expenses could also require belt-tightening.

6. Utilize new sources of income. On the other hand, if you've landed a high-paying job, sold a business, or come into an inheritance, you may be able to save more for retirement or your children's education or set aside cash for a memorable vacation.

7. Review options as retirement nears. If you're retiring soon, it's a good idea to review your financial plan and make sure you're on track for a secure retirement. We can project your annual retirement income and adjust your portfolio risk as you enter your golden years.

How often should you review your plan? While your investment portfolio should be reviewed at least once a year, most financial plans can be reviewed every two to three years to keep it on track. If you're nearing retirement or facing major life events, an annual review is best. If your plan is out of date or if it's been a while since your last review, please give us a call. ●

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Planning For A Child With Special Needs

The daily demands of caring for a child with autism or another developmental disability are daunting enough without worrying about future care. That may be why, in a recent survey, 62% of parents with disabled children said they hadn't established a plan for what would happen when the parents were no longer around. Moreover, about half of the surveyed parents said they planned to leave assets directly to the child, and 58% expected to designate the child as a beneficiary. Those decisions could make the child ineligible to receive public assistance, which could be crucial for the child's long-term welfare.

A better approach may be to create a "special needs trust" that can be funded now or through your will. (The money often comes from life insurance death benefits.) Structured correctly, this irrevocable trust will enable a special needs child to receive public assistance benefits while the trust covers other expenses—including for travel, recreation, and rehabilitation—that aren't fully paid for by government funds.

If the trust assets are used as a primary means of support, the disabled child may be disqualified from public assistance, just as would happen if the child received a direct bequest. To avoid problems, a special needs trust will have an independent trustee who controls distribution of trust assets but uses the money only to supplement government aid. A provision in the trust will typically prevent the trustee from using assets for "support, maintenance, welfare, and education" of the child.

Keep in mind, however, that laws governing trust language and operation may vary from state to state. In some states, for example, assets that remain in the trust after the disabled child's death must be used to pay back the government for public assistance benefits. But that provision doesn't limit the trust's ability to help a living child.

A special needs trust, like any other estate planning vehicle, needs to be part of an overall estate plan. One wrinkle here is that money you move into this kind of trust doesn't qualify for the annual gift tax exclusion ($15,000 in 2019) that otherwise limits tax liability on yearly gifts to individuals. Because of restrictions in the trust language of special needs trusts, transfers are classified as gifts of "future interest." That means parents who fund such a trust during their lifetimes will need to use all or part of their lifetime gift tax exclusion. Because this exclusion is currently unusually high, at $11.4 million, now is an excellent time to consider funding this type of trust.

Good advice from experienced experts can make sure your special needs trust accomplishes its goals without shortchanging other family members. We can work with your attorney to help you establish a trust that protects everyone's interests. ●

Source: December 2008 study of 580 households by The Hartford Financial Services Group Inc. and Harris Interactive®.

Important Financial News From 2018

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data supporting the theory is important confirmation that this relatively new theory of investing is correct. Despite the stagflation of 1970s, high inflation of the 1980s, boom and tech crash of the 1990s, the credit bubble and financial crisis of 2008, and current uncertainty, a prudent course of moderation and quantitative analysis has worked as expected for another year.

The 9.48% total return on the diversified portfolio is comparable to the return on a 100% large stock portfolio, the best return of the seven assets, but the diversified portfolio's risk was much lower. The third-best return across the seven types of asset classes was the 8.42% annualized return on non-U.S. equities, which was an equity-like return, but its 21.75% standard means it carried more than twice the price risk of the diversified portfolio.

The number of losing years and worst three-year performance also add context for understanding the relative risk of the seven asset classes versus the equal-weighted diversified combination of the seven types of assets. In seven of the 49 years, the diversified portfolio suffered negative returns versus 15 losing years on the top-performing asset class, and the worst three-year loss was 13.37% on the diversified portfolio, much lower than the 37.61% drawdown on the S&P 500.

Although the news that a broadly diversified portfolio from 1970 through 2018 worked just the way conventional wisdom said it would did not make headlines, it was the most important financial news story of 2018. ●

Past performance is not a guarantee of your future results. Calculations by Craig Israelsen, Ph.D. Indices are unmanaged and not available for direct investment. Investments with higher return potential carry greater risk for loss. Raw data source: Steele Mutual Fund Expert. Asset class and style data reflects performance of the following indexes: US Large Cap: S&P 500 Index (TR). US Mid Cap: S&P Midcap 400 Index (TR). US Small Cap: S&P Small Cap 600 Index (TR). Non-US Developed: MSCI EAFE Index NR USD. Emerging: MSCI EM Index GR USD. Real Estate: S&P Global REIT Index TR USD. Natural Resources: S&P North American Natural Resources Index TR. Commodities: Deutsche Bank Liquid Commodity Optimum Yield, Diversified Commodity Index Total Return. US Bonds: Barclays US Aggregate Bond Index TR USD. TIPS: Barclays U.S. Treasury US TIPS Index TR USD. Non-US Bonds: Barclays Global Treasury Index TR. Cash: USTREAS Stat US T-Bill 90 Day TR.

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