CLIFFORD SWAN

THE Investment Counselor

FIRST QUARTER 2020

WISDOM *for* GENERATIONS

RALLYING INTO 2020

By Daniel J. Mintz

Early in the new year, after experiencing strong gains in their U.S. stock portfolios in 2019, investors saw geopolitical risk pulled into the spotlight as the U.S. strikes against the Iranian regime threatened an already delicate status quo in the Middle East. At the time, one might have suspected that 2020 would be a year wherein risks to the economy—and to the bull market in stocks—from political conflict or exogenous events unrelated to the Fed, trade wars, or other market drivers would dominate the news flow. One would not have been alone in this view. The Global Risks Report 2020, published by the World Economic Forum in January, surveyed 800 leaders from business, government, and non-profits. The report defined the most serious risks as those having an above-average rating on both likelihood of occurrence and impact on the global economy. The conclusion: interstate conflict, global governance failure, cyber-attacks, and extreme environmental events are the top risks in 2020.

To complicate the geopolitical landscape further, the U.S. entered an election year with polls pointing to another close race. With policy rhetoric from both parties growing farther apart, investors are facing yet another political event that is both difficult to predict and characterized by two very different outcomes.

The good news is that the types of risks discussed so far have had little impact on long-term investment returns. LPL Financial Research looked at stock market drawdowns (as measured by the S&P 500 Index) after various major geopolitical events since World War II, analyzing the magnitude and length of the drop as well as the number of days until recovery. The data shows that Pearl Harbor, Iraq's Invasion of Kuwait, and the 9/11 attacks did correlate with double-digit market corrections. But in these extreme cases, the market recovered from its decline well inside one year. On average, across twenty significant events, stocks suffered a 5% drawdown over 22 days and recouped their losses in just 47 days. For long-term investors, that's a blip.

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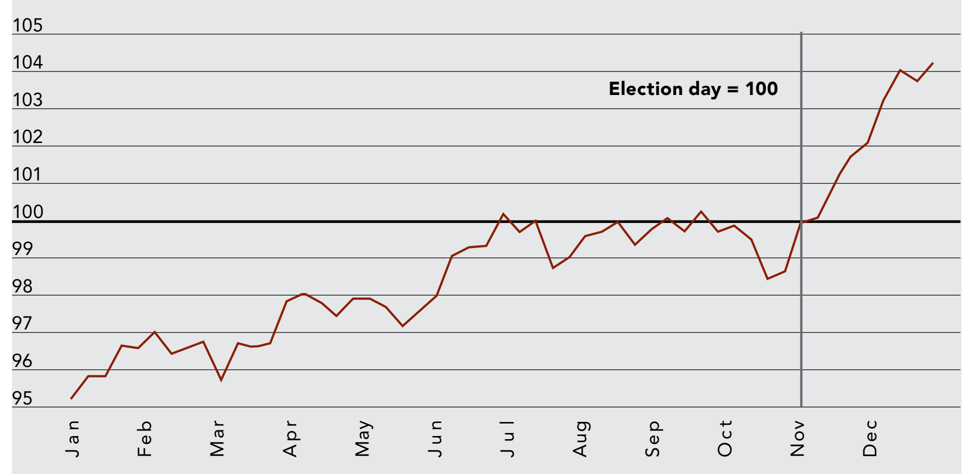
A similar analysis of stock market performance before and after close presidential elections shows that the removal of uncertainty over who would win has mattered more than who actually won. Beginning with Eisenhower/Stevenson in 1952, Deutsche Bank looked at the seven elections in which the candidates were polling within 3 percentage points of each other during the election year.

RALLYING INTO 2020 | Continued on page 2

S&P 500 Index Performance in Close Presidential Election Years



Data based on presidential elections when poll gap was <3pp (1952, 1960, 1968, 1976, 2004, and 2016); excludes 2000 election as the election result was contested

Source: Deutsche Bank Research

RALLYING INTO 2020 | Continued from page 1

On average, the market rose until the summer, flat-lined from July through the election, and rallied immediately afterwards through the end of the year once a winner was declared.

Although it is impossible to predict the future based on the past, the data on market performance around geopolitical events and presidential elections puts context around the media's favorite topics and allows us to focus on what matters most to the market: earnings. The outlook remains positive. An analysis of S&P 500 constituents' quarterly earnings growth by Goldman Sachs frames the situation well (see the chart below).

The U.S. has had two "earnings recessions"—two or more consecutive quarters of earnings declines—over the past five years. The first was in late 2015 into early 2016. The second was more recent, during the last two quarters of 2019. At the time, each period had multiple forecasters predicting a deeper economic downturn. In 2016, that never materialized, and 2020 looks likely to repeat the pattern.

The 2015-2016 earnings recession was primarily driven by the energy sector. Oil had fallen from over $100/barrel in mid-2014 to less than $30 in early-2016. Energy producers, servicers, suppliers, and partners were hurting, and there was speculation that their pain would spread to other sectors of the economy. That never happened. Although energy companies caused S&P 500 earnings growth to turn negative in the aggregate, the *median* company's earnings continued to grow, which is to say *most* companies continued to do just fine.

In late 2019, trade tensions between the U.S. and China exacerbated a slowdown in manufacturing activity, as it is difficult for producers of goods to take the risk of ramping up output when the tariff picture is unclear. But in early 2020, trade uncertainty subsided, as evidenced by rosier manufacturing surveys in the U.S. and China. It appears that earnings growth will resume in 2020, with declines in 2019 having been isolated to certain industrial sectors.

Though the overall earnings environment looks healthy in early 2020, the other key driver of market returns —multiples on those earnings—appear stretched, though not overly so. Since 1935, the S&P 500 has traded below its current 19x price/earnings multiple about 80% of the time per Deutsche Bank research. Granted, that makes 19x seem expensive. However, the most

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common level of 15-19x, which has occurred on 40% of all trading days, is not far below where we currently are. A correction to 16x, for example, would only represent a 16% downward move.

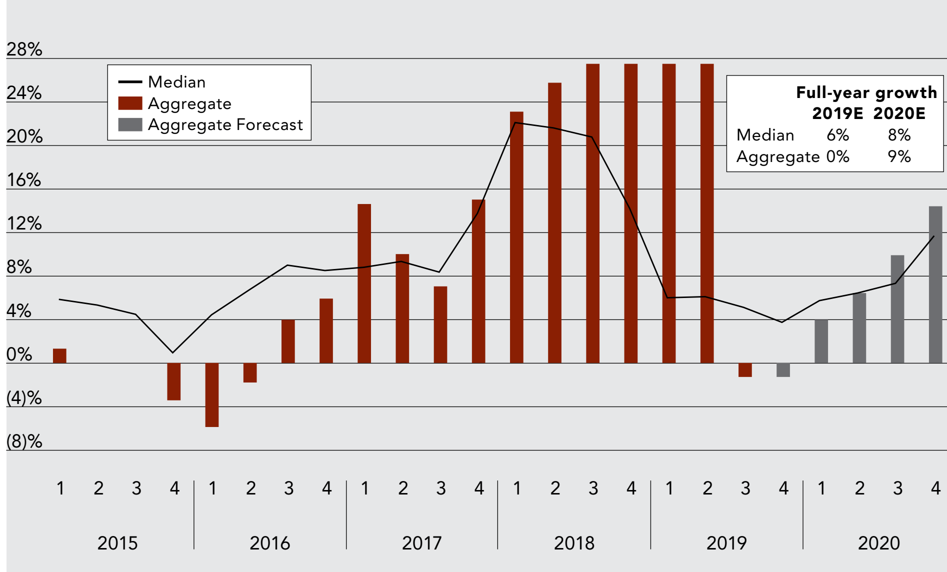
Market sentiment, like multiples, also strikes us as being optimistic, particularly toward growth companies. As we have written in previous updates over the past several years, low interest rates continue to push investors into paying higher valuations for companies that can grow, and, ideally, generate the returns investors are seeking even if those returns are years into the future. The situation can be boiled down to supply and demand. The narrative goes like this: decades ago, when the economy was growing mid- to high-single-digits, investors could expect that level of growth as a baseline in the typical stock they owned. But today, with GDP in the low-single-digits in developed economies, the supply of growing companies has declined. A low supply of such companies combined with unsatisfactory returns in fixed income and less risky asset classes is the perfect recipe for demand to exceed supply, leading to higher prices being paid for companies that can grow.

Nevertheless, in contrast with the last time we can remember the market being so infatuated with growth stories—the dot-com era—there are signs that investors still require a path to profitability before committing capital. The failed

RALLYING INTO 2020 | Continued on page 3

S&P 500 Index Quarterly Earnings-per-Share Growth

The U.S. has experienced two "earnings recessions" in five years; in each case, weakness was isolated to specific sectors of the economy



Source: Goldman Sachs Investment Research

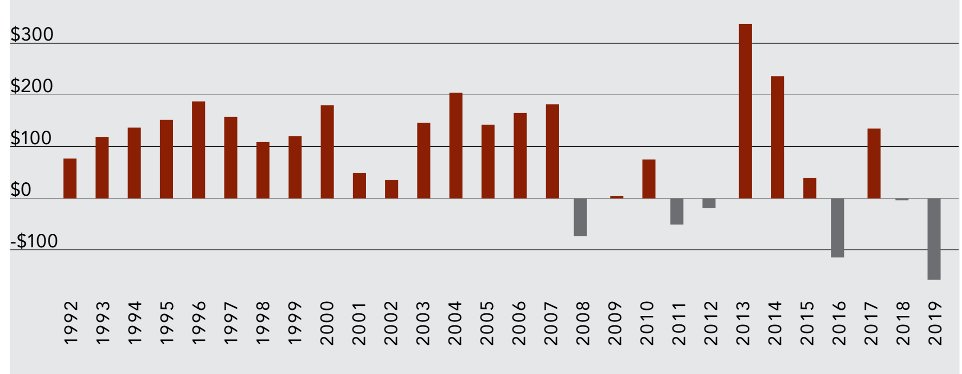
RALLYING INTO 2020 | Continued from page 2

initial public offering of WeWork is a good example. Intense scrutiny of a new offering's business model is healthy in a properly functioning stock market. If we do reach another period when any company with plausible growth prospects can attract capital, we will know that sentiment has become frothy.

It seems that the Great Recession left such a mark on the investing public that no matter how long the bull market lasts, many are still wary of putting money in the market. The *Financial Times* recently noted that in the 11 years from 2008-2019, five of those years saw net outflows from stock-focused mutual funds and ETFs, with 2019 experiencing the largest outflow of any year. Contrast that with the 16-year period from 1992-2007, during which flows were positive every year.

Net Money Flows Into/Out of Stock-Focused Mutual Funds and ETFs ($ billion)

In the wake of the Great Recession, investors have been cautious about investing in stocks



Source: Financial Times

Until the market fully embraces risk and stocks become loved, the case for the decade-plus rally will survive. ◆

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NEW TAX LAW COULD BENEFIT YOU

By George Hasbun

The Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed in December 2019. It is one of the largest pieces of retirement legislation to be approved into law in over a decade, and it changes rules that have been in effect for well over 30 years.

The SECURE Act tackles several enhancement areas for retirees, which could have a significant impact on long-term estate plans. It makes some interesting changes to existing retirement rules including:

- A new exemption to the 10 percent early distribution rule that allows for a $5,000 penalty-free withdrawal for a birth or adoption
- New tax credits for small businesses that adopt auto-enrollment in retirement plans and for establishing retirement plans such as a 401k, SEP IRA, or 403(b)

The two changes most likely to impact Clifford Swan clients are:

- The change in the age to begin required minimum distributions (RMDs) from 70 ½ to 72
- The elimination of the "stretch" provision in IRAs for nearly all non-spouse beneficiaries

REQUIRED MINIMUM DISTRIBUTIONS NOW BEGIN AT AGE 72

If you were born on or after July 1, 1949, you can now wait until age 72 to take your first RMD. If you were born before July 1, 1949, the previous rules apply (you must take your first RMD by April 1 of the year following the year you turn 70 ½). As more individuals postpone retirement and prefer to delay their RMDs, this is a welcome change in the law.

You may always pull money out of your IRA without penalty after age 59 ½, but many choose to defer withdrawals as long as possible in order to defer unnecessary income tax. Under the new law, once you reach age 72, you must take your first RMD by April 1 of the year following the year in which you turn 72. Therefore, if you turned 72 on January 1, 2020, you may take your first RMD as late as April 1, 2021 (keep in mind that a second RMD would also need to be distributed in 2021).

Unfortunately, if you turned 70 ½ in 2019, the SECURE Act changes do not apply, and you need to follow the old RMD schedule.

Example:

Sally was born on June 12, 1950 and will turn 70 ½ on December 12, 2020.

NEW TAX LAW | Continued on page 4

NEW TAX LAW | Continued from page 3

Because of the SECURE Act, Sally can wait until 2022 to take an RMD.

Example:
Steve was born on June 30, 1949 and turned 70 ½ on December 30, 2019. Despite the changes in the SECURE Act, Steve is still required to begin his RMDs before April 1, 2020. He cannot wait until age 72 to begin taking RMDs because he turned 70 ½ before December 31, 2019.

THE ELIMINATION OF THE "STRETCH IRA"

In order to offset the decrease in tax revenue from the change in RMD age, our lawmakers chose to make a significant change to inherited IRAs. Before the SECURE Act, you could name a beneficiary to an IRA, and upon your death, that beneficiary could "stretch" RMDs over the length of their lifetime. For younger beneficiaries, the law allowed tax-deferred growth to continue for decades.

Example:
John's IRA was worth $1 million upon his death at age 85. He named his daughter (age 50) the beneficiary of his IRA. Under the old law, his daughter would only be required to make RMDs based on her life expectancy (which according to the IRS was 34 more years).

Many estate plans capitalized on this rule and named younger beneficiaries to prolong the life of the IRA. In fact, these accounts had the ability to continue for generations if the owner named a beneficiary that would be prudent with the funds and only withdraw the minimum.

> "Now, beneficiaries of inherited IRAs must withdraw all funds from the account within 10 years."

The SECURE Act changed the rules that were in place for many years. Now, beneficiaries of inherited IRAs must withdraw all funds from the account within 10 years.

There are no annual distribution requirements during the 10-year window; the only requirement is that the account must be completely depleted by the tenth year. For beneficiaries who are still working and inherit an IRA, the 10-year withdrawal requirement could push them into a higher tax bracket.

If you were planning to use the "stretch" strategy to extend the life of an IRA, now is an opportune time to review your IRA beneficiary information with your investment counselor to determine whether the current beneficiary information is still accurate. There are multiple financial planning opportunities to consider for the 10-year window.

Example:
On March 3, 2020, Alex's father passed away, leaving Alex his $400,000 IRA. Alex (age 60) is still working and earns roughly $150,000 per year. He plans to retire in five years (at age 65). Given that Alex's income will substantially decrease when he retires, it might make sense for him to avoid taking any distributions from the inherited IRA while he is still working. Since the 10-year window does not require any annual distributions, Alex could wait until he is retired and opt to distribute the funds during years six to 10, when he expects his income to be much lower.

There are some exceptions to the 10-year rule window:

- Spouses
- Disabled beneficiaries
- The chronically ill
- Individuals who are no more than 10 years younger than the decedent
- Minor children (until they reach the age of majority, which in California is 18 years old)

If an IRA beneficiary falls into one of these five categories, then the old rules apply, and the 10-year window does not. This is good news for most people who designate their spouse as the beneficiary of their IRA.

> "It is important to remember that tax law isn't written in stone (more like pencil)."

It is important to remember that tax law isn't written in stone (more like pencil). As laws change, it is prudent to review your estate plans, just as you would if your personal circumstances change (e.g., death, divorce, lottery win, etc.).

WE CAN HELP

For those of you looking to react to these recent changes, we are exploring ROTH conversions under certain circumstances. In addition, because of our expertise in charitable remainder trusts (CRTs), we know that CRTs could be used in specific situations to stretch an IRA and prolong the distributions over the lifetime of the beneficiary.

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At Clifford Swan, we seek to provide exceptional investment and wealth management advice; doing so includes considering your estate plan and the tax code. Should you have any questions about how the SECURE Act affects you, we urge you to contact your investment counselor. ◆

KEEPING CLIFFORD SWAN STRONG

By Gretchen E. Lee

We all face potential loss from natural disasters. Regionally, we endure storms, fires, earthquakes, and floods. In order to give ourselves comfort we prepare for such unforeseen threats. Emergency preparedness includes taking inventory of what we have and how to protect against the loss of those items. This personal risk assessment allows us to reduce the stress of what could happen if faced with an emergency.

Similar to your personal inventory to prepare for a natural disaster, we inventory our firm to make it stronger for our clients. We take snapshots of our business in order to identify and alleviate threats to our firm's stability. Risk management is viewed through a client-focused lens, with the ultimate goal of being in a position to provide exceptional investment and wealth management advice. We are here for the long term, to support you and your future generations.

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This commitment to our clients is embedded in the foundation of our firm. We are charter members of the Investment Counsel Association of America (now the Investment Adviser Association), established in 1937, which provides the "Standards of Practice" for our industry, set forth to support our loyalty to clients. These standards assert, "An investment adviser should run its business responsibly and ethically, including ensuring that its financial condition, operations, and compliance structure are appropriate to protect its clients' interests." Additionally, as a Registered Investment Adviser (RIA), our firm is regulated by the Securities and Exchange Commission (SEC) and held to the fiduciary standard by the Investment Advisers Act of 1940.

STRUCTURE TO PROTECT CLIENTS' INTERESTS

In my role as Chief Compliance Officer (CCO), I work with the firm's management team to scrutinize areas of potential vulnerability in our ability to provide the utmost care to our clients. These areas are organized in a risk matrix. This fluid document is categorized by type of exposure to our business: reputational, credit, operational, or market. Specific risks that fall under these categories are assigned a numerical risk level. Additionally, the matrix includes a description of our controls, how we are responding to or remedying a risk, and monitoring and testing protocols. In order to mitigate identified risks, we create and implement specific policies and procedures.

Our management team actively monitors our business risk by supervising the daily operations of the firm through a comprehensive compliance program that includes risk assessment and management. As CCO, it is my responsibility to oversee the risk assessment, keeping in mind the effects of potential risk on clients. I also enforce our established policies and procedures, which are designed to reduce threats to our firm's strength. These policies and procedures are woven into our daily business routines, which I monitor for their effectiveness throughout the year. Any recognized weakness in a policy is documented and immediately modified to improve the protection of our business. The risks are summarized and presented to Clifford Swan's Board of Directors annually.

Hiring and retaining exceptional employees—who possess a "clients first" mindset—is the cornerstone of our firm's ability to follow our established procedures. When hiring new employees, we follow protocols to be sure we know who joins our team. We seek employees who ascribe to our culture of providing exceptional service to our clients. Additionally, as a 100% employee-owned firm, we have committed, long-term partners in place as well as next generation talent to ensure continuity and excellence. We promote a culture of high ethical standards and all employees abide by our Code of Ethics. The Code is based upon our fiduciary duty as an investment adviser. As a fiduciary, we have an overarching responsibility to act in our clients' best interests. Each employee annually attests to, "…act with integrity, competence, diligence, respect and in an ethical manner with our clients, and colleagues." Our Code is refined to protect our reputation and commitment to excellence.

> "As a fiduciary, we have an overarching responsibility to act in our clients' best interests."

MAINTAINING FINANCIAL STRENGTH

Monitoring our financial strength, in order to stay solvent and in business, sits near the top of our list of commitments to ourselves and our clients. One way we protect the financial strength of our firm is through vigilant oversight of our clients' assets. Investment counselors and client service specialists (CSS's)

STRONG | Continued on page 6

STRONG | Continued from page 5

work as teams, with investment counselors managing investment risk and CSS's following procedures to guard against non-investment risks.

Our Board of Directors employs prudence when managing the firm's finances. A thorough accounting of expenditures is discussed at each quarterly meeting to safeguard our firm's solvency. Potential vulnerabilities to the firm's financial strength are discussed and mitigated through placement of appropriate insurance policies.

MONITORING CLIENT PORTFOLIOS

On a daily basis, CSS's review client portfolios for cash inflows and outflows and coordinate with investment counselors as appropriate to make sure cash does not sit idle and that trades are placed to cover debits. CSS's monitor availability of cash for regular distributions and alert investment counselors of low balances. To further protect client assets, any requests for distributions are verbally confirmed with the client. This procedure helps us avoid acting on fraudulent requests, which can be sent from either hacked email accounts or accounts impersonating clients. While rare, any trade errors are reported to our management team and notated within our risk assessment.

> "Importantly, our policies and procedures evolve as the risk landscape changes to avert errors that could affect our financial strength."

Our policies and procedures are revised as necessary, and training provided to our employees to diminish any vulnerabilities. Importantly, our policies and procedures evolve as the risk landscape changes to avert errors that could affect our financial strength.

KEEPING DATA SECURE

To protect client privacy and the safety of our electronically stored data, our operations team guards against cyberattacks or threats to personal data privacy. Tests are in place to confirm that our firewall is active, sufficiently functioning and in compliance with our state's requirements. We protect your data and defend against hackers looking to gain access to our systems. By regularly testing our systems and providing training to our employees, we lessen the possibility of threats on our clients' personal information.

FIRM GOVERNANCE

Clifford Swan's Board of Directors plays a vital role in the successful mitigation of risk. Members of the Board commit to a shared responsibility for the well-being of the firm. Each member is an active advocate for the values, mission, and vision of Clifford Swan. Corporate governance by the Board is defined by an exemplary fiduciary, financial, and legal duty to the firm. Through identifying and minimizing risks, providing oversight to the financial affairs of the firm, and by placing the interests of the firm above all others, the Board advances the purpose of the firm. It provides the foundation necessary to maintain our reputation and our clients' trust.

> "The task of managing business risk is a continual process."

The task of managing business risk is a continual process. Clifford Swan is committed to this practice through the structure we have in place. Our daily procedures create a set of tools to reduce risk of loss. Preparedness begins with knowing your perceived threats; mitigating them occurs through planning and action. While this article has considered how we keep Clifford Swan strong from a business perspective, we view each of our areas of risk equally. Our focus may rotate between the types of risk, but our emphasis on continual monitoring is paramount. As you rely upon our expertise in wealth management, we know you also place faith in us to manage our firm appropriately in order to remain your longstanding investment counselor. ◆

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