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CORPORATE TAX REFORM AND THE PURSUIT OF VALUE

By Daniel J. Mintz

One of the most widely accepted principles of investing is that the intrinsic, or fundamental, value of an investment equals the present value of all future after-tax earnings to the owners of that investment. Simple math shows that a lower tax rate leads to higher after-tax earnings, in turn creating a higher intrinsic business value. Said more eloquently by Warren Buffett when commenting on the Tax Cut and Jobs Act, which permanently lowered the U.S. federal corporate tax rate to 21% beginning this year: "You had this major change in the silent stockholder, the U.S. government, in American business, who has been content with 35%, and now instead of getting a 35% interest in the earnings, they get 21%, and that makes the remaining stock more valuable." Lower tax rates will boost earnings and make owners' claims on those earnings worth more, all else being equal.

But all else is not equal. We, as relatively passive shareholders, rely on company management teams and boards to decide how to invest or distribute our companies' earnings—a process known as capital allocation. Skilled managers' capital allocation decisions often lead to increases in future earnings per share, and therefore intrinsic business value. Due to the lower corporate rate as well as two other provisions of the new tax code which involve the treatment of overseas earnings and capital investments, companies will have more earnings to put to work. What they do with the extra cash will be a significant driver of the future intrinsic value of our investments.

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Aside from the U.S. corporate rate, "repatriation" was addressed in the final version of the bill. Prior to the new legislation, U.S. companies doing business internationally had to pay a top tax rate to bring those earnings home. This created an incentive to keep or reinvest those earnings overseas. The new law mandates a one-time tax of 8% to 15.5% on past foreign earnings, after which those earnings may be repatriated tax-free or at a potentially lower rate than would be levied in the U.S. As a result, companies have more capital to allocate either at home or abroad. The effect is more pronounced among technology and healthcare companies, which often earn an outsized portion of their profits outside the U.S. Apple, for example, is said to have plans to repatriate almost $200 billion this year.

In addition to repatriation, certain methods of accelerated depreciation made it into the new law. This will allow companies to write off capital investments in certain long-lived assets over shorter periods of time—in many cases during the year in which the assets were purchased—instead of spreading the tax benefit over many years. The resulting lower tax bill will put more after-tax earnings in the hands of company management in the near term. The effect is particularly notable among industrial companies, which tend to rely on expensive long-term assets to generate profits. In turn, it may also boost demand for goods produced by companies that sell such

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long-term assets. For instance, Clifford Swan Research recently spoke to a company that plans to purchase more airplanes in the near term from a major U.S. aircraft manufacturer because of the new law.

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There are several ways company management can put excess earnings to work to increase intrinsic value for shareholders. First, a company can attempt to grow and generate higher future earnings. Growth might involve building new stores or factories, hiring more employees, or buying another company. As increased spending on growth initiatives would work its way through American businesses in a number of ways, many proponents of the tax bill tout its potential to stimulate the economy. Ford, CVS, and AT&T, for example, say they plan to invest for growth. Next, a company can reduce debt, ensuring that shareholders have a greater claim on future earnings. Exxon Mobil, for instance, has expressed an intention to pay down debt post tax reform. Finally, a company may use excess earnings to pay dividends, repurchase stock, or simply save for future opportunities. The effect of repurchases is that a greater proportion of earnings will accrue to you, the remaining shareholders, increasing the intrinsic value of the shares you own. Apple, Cisco, Wells Fargo, Pepsi, Amgen, and Alphabet are all planning to use excess earnings to buy back significant amounts of their own stock.

Strong management teams behave like fiduciaries when it comes to allocating owners' earnings to produce the maximum benefit. If attractive growth opportunities exist, a significant portion of excess earnings should be allocated toward them. If opportunities to grow earnings and intrinsic value for shareholders are more plentiful via share repurchases, then it makes sense to buy back more stock. A company "investing in itself" may simply be good corporate stewardship. In either case, tax reform gives management more dry powder to create value.

There are two important caveats that deserve attention. The first is about the likelihood that corporate tax cuts will remain permanent. The second focuses on what happens if excess earnings are not put to good use. Both have the potential to impact the intrinsic value of your investments.

It is conceivable that corporations will be asked to share more of the federal tax burden under certain circumstances. Since World War II, tax receipts as a percent of GDP have been a consistent 15-20%. Corporate tax receipts as a percent of GDP, however, have declined from approximately 5% to less than 2% during this time. Should government debt and deficits become a problem, particularly given the country's bourgeoning entitlement and demographic situation, corporations may be asked to share more of the burden via higher taxes. That request may garner more political support if the recent act's potential to drive economic growth does not come to fruition.

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Further, there is no guarantee that excess earnings will be spent prudently. Like the lottery winner that goes broke, or the progeny that drives the family business into the ground, corporate history is littered with bad mergers and acquisitions, failed growth initiatives, and share repurchases that left companies without enough cash at inopportune times.

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Ultimately, it is up to company management to grow per-share earnings and create intrinsic value for owners. Though tax reform should be beneficial at the margin, the stakes have been raised. The act will only amplify the difference between good and bad management. Fortunately, our active approach at Clifford Swan allows us to invest in companies we have identified as having the strongest management teams, who will now have more earnings to put to work, and who we believe can create tremendous value investing those earnings. Our approach allows you, as shareholders, to overweight the skills of these leaders instead of taking your chances on the entire S&P 500 Index. We believe choosing wisely is the best way to create long-term value. ◆

MARKET OUTLOOK: VOLATILITY RETURNS

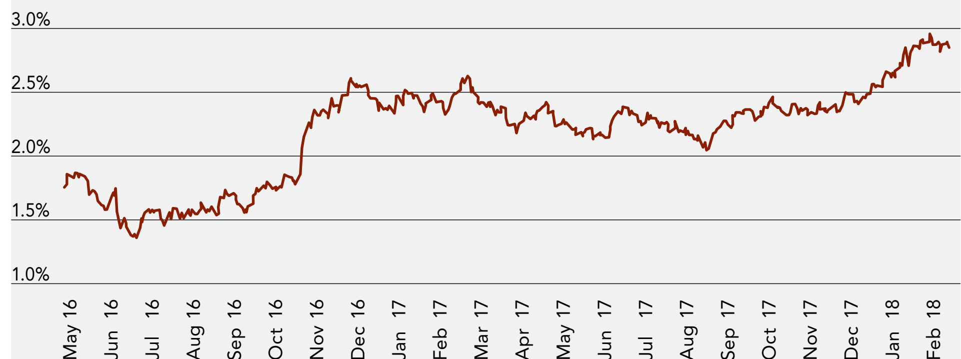
By Anil Kapoor
CFA

The market outlook published in the June 2017 edition of this newsletter examined the relative calmness and lack of volatility, or dispersion of returns for individual stocks, within the U.S. stock market. We used the CBOE Volatility Index (VIX) to measure volatility, which at the time was experiencing 10-year lows.

This lack of volatility continued through January 2018. Finally in February, exaggerated changes in daily price movements returned with a vengeance. It is amazing how quickly and dramatically market dynamics have changed. Now, daily price ranges in the stock market are greater than entire monthly ranges were last year. Only two months into the new year, the S&P 500 Index notched 15 days in which it moved one percent or more in either direction. That's almost twice as many such days as occurred in all of 2017. As the chart below illustrates, the recent spike in volatility has been massive.

Let's consider the factors that may be causing the volatility that equity investors have been experiencing of late. More likely than not, the volatility can be attributed to a combination of the following dynamics, along with others we may never know.

10-Year U.S. Treasury Yield



Source: Bloomberg

PULLING CENTRAL BANK LIQUIDITY

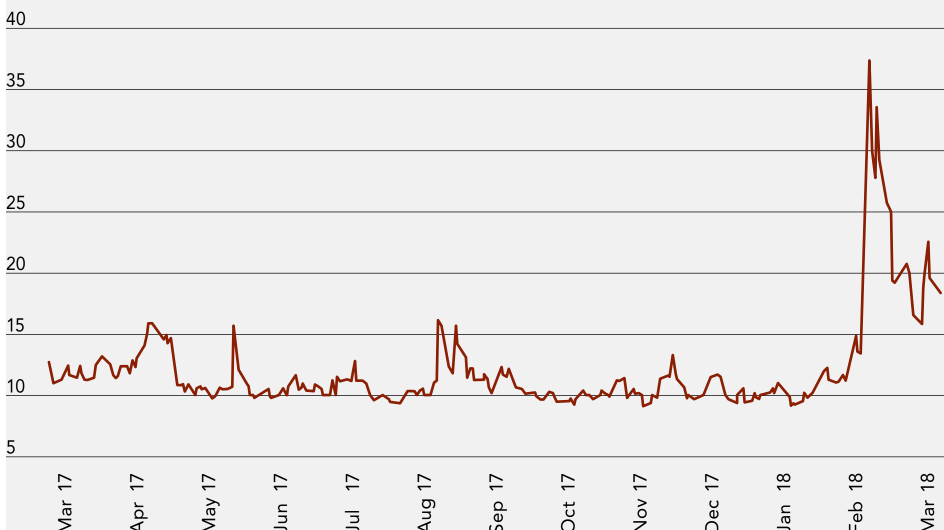
Over the last 10 years, there has been a coordinated effort amongst global central banks to inject liquidity into the system. Known as quantitative easing, this included both purchasing bonds in the open market and decreasing interest rates, and was pursued in an unprecedented fashion. Essentially, central banks flooded the system with money. These maneuvers were part of a grand plan that included gravitating investors towards stock purchases by making it less beneficial to buy bonds, which earned very low rates of interest. Some sovereign (foreign country) bonds actually had *negative* interest rates! In this environment, those who sought either income or capital appreciation were left with pretty much only one investment choice: stocks.

Recently, the Federal Reserve began to reverse course in the U.S. and increase rates at a rapid pace. They have also stopped purchasing bonds in the open market. *The easing has now turned into tightening.* Given that we have never had such low interest rates, pulling "free money" from markets could potentially have negative ramifications. As a proxy for interest rates, see the yield of the 10-year U.S. Treasury above. You will note the large increase since the beginning of the year.

There are two adverse events that can potentially occur in the stock market in an increasing interest rate environment:

1. Rotation into bonds from stocks, as yields on bonds become relatively

CBOE Volatility Index



Source: Thomson Reuters Eikon

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more attractive than yields on stocks compared to before.

2. Higher borrowing costs could lead to less corporate spending and halt economic growth.

We think the first point is of particular concern, as many investors have been "hiding" in stocks. Stocks are not meant to be hidden in as, historically, they are a riskier asset class than the bull market we've experienced since March 2009 indicates.

FEAR OF RECESSION

Leading economic indicators are a "basket" of 10 guidepost financial/economic data points that often provide a warning flag for the economy. These indicators do not currently show many signs of a recession. However, we are nine years into an unabated expansion of the economy. This is the second largest expansion in history and will end eventually. One can argue we are "due" for a recession.

INFLATION

The U.S. economy continues to gain momentum and unemployment is at historic lows. At this point in an economic cycle, inflation (the rate at which prices for goods and services is rising) is usually pretty high. Inflation partially results from increased wages and the consequent higher prices companies charge for products. However, this time around, inflation has been benign. Some investors fear inflation could now tick meaningfully higher given persistent strong employment data across the country. This is negative for stocks, as the Federal Reserve—in their pursuit of relative price stability—will potentially engage in maneuvers to put the brakes on the economy in response to higher inflation, ultimately leading to higher bond yields and lower stock prices.

EXTENDED VALUATIONS

Overall, the S&P 500 Index was trading at approximately 20x Trailing Price/Earnings (P/E) when the selloff hit in early February. This is on the high end of its historic range (11x to 20x) and implies that valuations have been stretched. The higher a P/E ratio, the more expensive a stock is relative to its earnings. A mid-teen multiple would represent a more normalized level and provide room for stock valuations (and markets) to increase.

EXCESSIVE MARGIN

Buying on margin is borrowing funds from a broker to buy more stock than one would normally be able to, in the hopes of amplifying stock returns. On February 25, 2018, *The Wall Street Journal* reported that retail investors have borrowed a record $643 billion against their portfolios[1]. As stock values fall, brokerages conduct "margin calls," asking investors to either sell stock or pledge additional collateral in the form of cash or securities to repay the loan. Most of the time, investors simply sell stock to satisfy margin calls. This exacerbates downward price movements during periods of market stress and volatility.

INVERSE VOLATILITY ETF SELLING

As stock markets remained calm, there were increasing amounts of monies flowing into inverse volatility exchange traded funds (ETFs). These instruments increase in value as long as volatility remains low. When volatility spiked in February, some of these ETFs collapsed almost 90% in one day. Such high levels of losses in an asset class can create panic within the broader marketplace and lead to the selling of other asset classes. To demonstrate how dramatic the selloff in inverse volatility ETFs was, below is a chart of one of these vehicles, the Pro-Shares Short VIX ETF (ticker: SVXY). Now that is scary!

While we can never pinpoint the exact reason for daily market fluctuations, hopefully this article has provided some clarity on the recent volatility. That being said, our ultimate goal is the long-term preservation of capital during market cycles, which inevitably include downturns. When this sort of volatility presents itself, we expect to take advantage of lower prices. Clifford Swan companies are some of the strongest, most stable, cash generative firms in the marketplace and we look for opportunities to invest when prices become attractive as we expect that they will perform well over time. We do not panic in these environments, but instead use our disciplined approach to identify value in the market. Combined with an appropriate asset allocation, we aim to protect capital and grow it over the long term. ◆

1. Wursthorn, Michael and Chelsey Dulaney. "Investors' Zeal to Buy Stocks With Debt Leaves Markets Vulnerable." *The Wall Street Journal,* 25 February 2018.

Pro-Shares Short VIX ETF Tumbles with Spike in Volatility

Source: Thomson Reuters Eikon

PROTECTING OUR ASSETS AS WE AGE

By Kathleen Gilmore
CFP®

"Today is the oldest you've ever been, and the youngest you'll ever be again."
—Eleanor Roosevelt

Much has been written and said about our aging population, about the retirement of boomers, and about the fact that many of us are living longer than generations that came before. According to the U.S. Census Bureau, residents age 65 and over grew from 35.0 million in 2000 to 49.2 million in 2016, accounting for 12.4 percent and 15.2 percent of the total population, respectively. Boomers began turning 65 in 2011, and will continue to retire in large numbers as time goes on[1]. The Social Security Administration's website calculates that a man reaching age 65 today can expect to live, on average, until age 84.3, and a woman turning age 65 today can expect to live, on average, until age 86.6[2]. Those are just averages. About one out of every four 65-year-olds today will live past age 90, and one out of 10 will live past age 95.

Unfortunately, these statistics are not lost on another class of people—those who would prey on the aging or the cognitively impaired. As a firm that is dedicated to the financial well-being of our clients, financial elder abuse is of particular, acute concern to us. We hope this article will inform our readers regarding the many forms of financial abuse and encourage all to take preventative action before it happens.

WHO IS AT RISK

According to *The True Link Report on Elder Financial Abuse* published in 2015[3], almost 37% of all seniors are affected by financial abuse within any five year period. And of those affected, more than 40% shared that the costs were not just financial, with many suffering from depression, anxiety and loss of independence as a result of this abuse. While the study found that, not surprisingly, cognitive impairment had a high correlation to financial abuse amongst the respondents, it also discovered three additional correlated characteristics: friendliness, education, and financial sophistication. Specifically, the research indicates that friendliness may increase exposure to predators and the likelihood of abuse (the "friendly grandma syndrome"), while being financially sophisticated and well educated might give seniors a sense of complacency that actually increases their vulnerability. According to the *True Link* study, there is no strong correlation between gender or marital status and the likelihood of becoming a victim of financial abuse, but older adults with independent, active lifestyles "have more to be concerned about because they inadvertently provide perpetrators with more ways to target them."

TYPES OF FINANCIAL ABUSE

The first step in prevention is awareness. There are many different categories of financial abuse ranging from outright criminal behavior to clever exploitation within legal bounds. The perpetrators are similarly diverse, from strangers, to hired help, to family members. If we break down the types of abuse by the offenders, the table below provides a good summary.

The largest category by annual cost, according to the *True Link* 2015 report, is *Exploitation*, accounting for over 46% of all dollars lost annually. *Identity theft*, a crime that has a much greater share

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Types of Financial Abuse

Category	Defining feature	Examples	
Exploitation	Operating openly claiming consent of the victim	• Hidden shipping and handling or subscriptions • Work-from-home schemes	• Quack weight loss or dietary products • Excessive gifts • Misleading financial advice
Criminal fraud	Anonymous illegal activity		
Con artists	Attempt to get you to give them money	• Grandparent scam • Nigerian prince emails	• Fake lottery winnings or government grants • Sweetheart scam
Identity theft	Opening or using accounts without authorization	• Opening new credit cards, bank accounts, or payday loans • Car title or home equity loans on your property	• Using card data gained by phishing, in data breach, or from the mail
Caregiver abuse	Abuse of trusting relationship	• Theft by family members or caregivers • Rewritten wills or powers of attorney	• Borrowing money hoping senior will forget • Sometimes combined with physical abuse or neglect

Source: The True Link Report on Elder Financial Abuse 2015

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of the national headline news, has the smallest financial impact of the categories listed in the summary on the previous page, for only 8% of annual dollars lost. *Con Artists* and *Caregiver Abuse* are responsible for 27% and 19% of annual losses, respectively.

WHAT YOU CAN DO

The examples provided in each category of the table on the previous page may sound familiar to many of us. Who amongst us has not received a phone call or email asking for contributions to a charity that sounds illegitimate, or warning us that we owe money to the IRS, or pretending to be a loved one in trouble? To reduce our vulnerability to this onslaught, there are several rules of thumb to keep in mind:

1. **Remove your phone number from solicitation lists** by registering at www.donotcall.gov/.
2. **Never give personal or financial information over the phone, or via email, especially if the call or email contact was not initiated by you.** Ask for the caller to send information *in writing*, and for a number where you can contact the organization for verification.
3. **Identify a Trusted Contact** who has your best interests at heart and can be another set of eyes on any offers or paperwork you are considering. Consider a select group of contacts who might fill this role, and keep them in the loop regarding your financial life.
4. **Do not sign anything without reading it carefully**, and never be in a rush or feel pressured to close a "deal." Take the time to have your Trusted Contact(s) review any contracts.
5. Recognizing that there may be a time when you become more vulnerable to elder abuse, **register your Trusted Contact(s) with each of your financial organizations** as someone who may be contacted if these organizations suspect suspicious activity.
6. **Consider establishing a Durable Financial Power of Attorney** which will allow someone you trust to manage your financial affairs in the event you become incapacitated.
7. **Organize important documents** and review with your Trusted Contact(s) or Durable Financial Power of Attorney as necessary.

WHAT CLIFFORD SWAN CAN DO

One of the great rewards of our work at Clifford Swan is the deep relationships we build with our clients. We are in a privileged position of getting to know you over time, recognizing your financial habits and typical transaction patterns. If we see unusual activity or behavior, we will reach out to you for clarification. In the case of elder abuse, this communication may lead to further suspicions and the need to reach out to a previously identified Trusted Contact. If you have not already done so, please talk to your investment counselor about sharing your Trusted Contact information with our firm. As fiduciaries, we are mandated reporters and will contact the appropriate agencies, including the police and Adult Protective Services on our clients' behalf if we suspect financial elder abuse.

". . . some simple contingency plans, and an increased awareness of the ways in which we are vulnerable to this abuse, should go a long way toward protecting us when we need it most."

Finally, there are many resources for support, intervention and recourse on the internet. Great places to start are the websites for, or by calling, the National Adult Protective Services Association (www.napsa-now.org/policy-advocacy/exploitation/), the National Center on Elder Abuse (www.ncea.acl.gov), and AARP. The Federal Trade Commission also lists some helpful hints regarding how to deal with phone scams and identity theft: www.consumer.ftc.gov/articles/0076-phone-scams and www.consumer.ftc.gov/features/feature-0014-identity-theft. In summary, some simple contingency plans, and an increased awareness of the ways in which we are vulnerable to this abuse, should go a long way toward protecting us when we need it most. ◆

1. United States Census Bureau. *The Nation's Older Population is Still Growing, Census Bureau Reports.* www.census.gov/newsroom/press-releases/2017/cb17-100.html. 22 June 2017.
2. Social Security Administration. *Calculators: Life Expectancy.* www.ssa.gov/planners/lifeexpectancy.html.
3. *The True Link Report on Elder Financial Abuse 2015.* www.truelinkfinancial.com/true-link-report-on-elder-financial abuse-012815. 28 January 2015.

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS
Carolyn S. Barber, CFA, CIPM, CIC
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
George E. Hasbun
Anil Kapoor, CFA
Jennifer I. Maqueda
Daniel J. Mintz
Maxwell R. Pray, CFA
Linda Davis Taylor
Erica S. White, CFA
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

OFFICES
Pasadena
177 E. Colorado Blvd., Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

cliffordswan.com

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