CLIFFORD SWAN

THE Investment Counselor

THIRD QUARTER 2018

WISDOM *for* GENERATIONS

PLAYING DEFENSE

By Daniel J. Mintz

With summer vacation season coming to a close, the stock market back within striking distance of its highs after a bout of volatility early in the year, and the economy by most measures firing on all cylinders, now is the perfect time to take a step back and ensure that our portfolios are positioned for environments that are not so sanguine. Pilots and military personnel agree that the best time to plan for adverse events is when conditions are calm, and heads are clear. The same applies in investing.

In last summer's newsletter, we noted that U.S. stocks were doing very well in both absolute and relative terms. The broader market, as measured by the S&P 500 Index, was trading near all-time highs. Valuation multiples, or stock prices in relation to corporate earnings, were generally in the upper quartile relative to history. Fortunately, the market's performance could be tied to economic reality. Employment, retail sales, incomes, and industrial production were moving higher. The number of S&P 500 companies exceeding revenue and earnings estimates for the second quarter of 2017 was at a 13-year high. We noticed, however, that investors seemed to be experiencing some fatigue, as the stocks of companies beating earnings estimates were not reacting as favorably as they had over the past 15 years. While we avoided making a directional call on stocks, our tone was cautious.

Since then, the S&P 500 has returned approximately 15% with dividends reinvested. That performance came amid various global developments that threatened to kill the bull rally. Every month, Bank of America issues a global survey of fund managers that asks what the biggest risk is to stocks. In early fall of last year, the answer was tensions over North Korea. In the winter, it was fears of aggressive central bank interest rate hikes. More recently, the survey stated that tariffs and potential trade wars are the most significant risks facing investors[1]. Still, despite a brief but dramatic correction earlier this year, the market resumed its upward climb.

Second-quarter 2018 earnings again showed that corporate financial results are living up to, and often exceeding, expectations. According to Thomson Reuters, as of early August, 79% of S&P 500 companies have reported earnings above analysts' estimates, compared with the long-term average of 64%[2]. Further, analysts project earnings for the third-quarter 2018 through the second-quarter 2019 to continue growing well above the long-term trend[3]. As earnings ultimately drive stock prices, and as the economic backdrop ultimately drives earnings, it follows that a strong labor market, high consumer and business confidence, and healthy corporate capital spending plans show that the case for the continuation of the current bull run can be argued.

What could go wrong? What might derail the earnings train? A survey by FactSet Research asked the companies themselves, polling management teams on which factors either negatively impacted second-quarter 2018 earnings the most, or were expected to act as headwinds in the near future. The results showed that unfavorable currency movement (i.e. a stronger dollar) was the biggest concern, followed by inflation of raw materials, transportation and freight costs, oil and gas prices, and wage and labor costs[4]. The common thread among these concerns is that they are traditionally developments that occur late into an economic cycle. Typically, the late-cycle narrative involves a strong economy and tight labor markets causing inflation to pick up, which prompts the Federal Reserve to raise rates, which shrinks the money supply, which combats inflation but leads to a stronger dollar and a slowing economy.

Historically, economists and investors have a poor track record of predicting economic cycles. At the same time, at Clifford Swan, it is our job to protect, as well as to grow, capital. Our portfolios need to be appropriately defensive and able to withstand a variety of market conditions. Not only is the timing of a downturn uncertain, but the causes

> ". . . it is our job to protect, as well as to grow, capital. Our portfolios need to be appropriately defensive and able to withstand a variety of market conditions."

PLAYING DEFENSE | Continued on page 2

PLAYING DEFENSE | Continued from page 1

of one are as well. Those could involve a tariff war slowing the worldwide flow of goods and services, a geopolitical crisis, or countless other events.

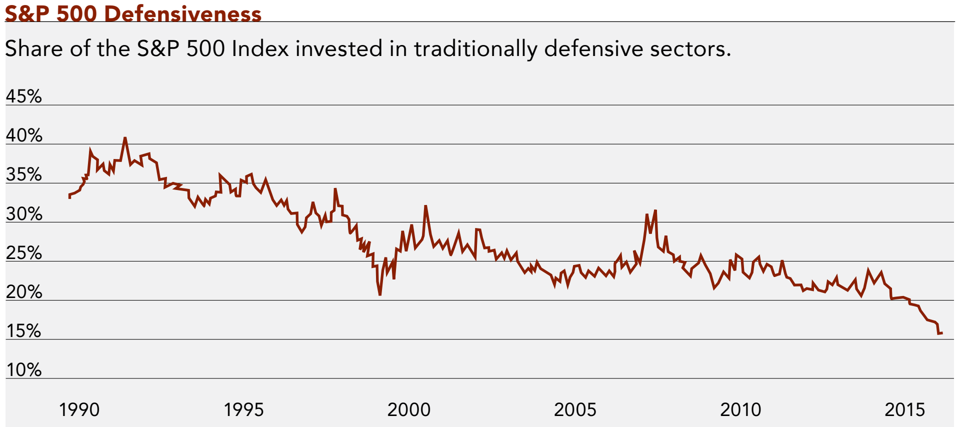
Evidence of a lack of defensiveness is showing up in many areas of the capital markets. The volatility index, also known as the "fear index"—a measure of expected future S&P 500 volatility—is back down near record lows after spiking earlier in the year. "Covenant-lite" loans—loans that place fewer restrictions on the borrower when it comes to collateral and financial health characteristics required—are widely used by lenders and in high demand by investors, as covenant-lite's share of the loan market keeps climbing[5]. Venture capital funds and start-ups are raising money hand-over-fist, with questionable companies like Theranos receiving funding without multiple stages of deep due diligence[6]. Bitcoin, though off its high of just under $20,000 reached in December of last year, still trades north of $6,000 as of this writing. These developments are uncommon in risk-averse markets.

It is even difficult for investors to remain defensive in one of the most traditional asset classes—the S&P 500. Led by Apple, Microsoft, Amazon, Alphabet (Google), and Facebook, the technology sector now comprises roughly a quarter of the S&P 500 Index by market value. Defensive sectors, such as utilities, consumer staples, health care, and telecom services, now make up just over 15% of the index[7]. That ratio is down from approximately 35% in the early- to mid-1990s, a level which it again approached in risk-averse periods such as the post-9/11 market and the March 2009 post-financial-crisis low. The implication for the average investor is significant. Part of the pull of S&P 500 index funds—broad company diversification—gives the investor comfort that he or she is taking risk off the table. The reality is that, today, the risk profile of the index is much different than it was in the past. Consequently, the same applies to funds that track the index.

At Clifford Swan, we believe that the market's lack of cautiousness in the ninth year of an economic expansion and bull market run should serve as a signal for investors to look closely at how their portfolios are positioned for a variety of future economic conditions. Our strategy of building portfolios security by security, with an uncompromising focus on the quality of the companies in which we invest, allows us to manage your exposure to a range of economic outcomes with confidence. ◆

1. Kawa, Luke. "Investors with $542 Billion Fret Biggest Risk since Euro Crisis." *Bloomberg*, 17 July 2018.
2. Aurelio, David. "S&P 500 Earnings Dashboard." http://lipperalpha.financial.thomsonreuters.com/2018/07/sp-500-17q1-earnings-dashboard/ 3 August 2018
3. Otani, Akane. "The Bull Market's Next Test: Slower Earnings Growth." *The Wall Street Journal*, 17 June 2018.
4. Butters, John. "More S&P 500 Companies Seeing Negative Impact from FX than Tariffs in Earnings Calls for Q2." *Insight.factset.com*, 6 July 2018.
5. "Leveraged Loans: As Cov-Lite Levels Grow, Debt Cushion Shrinks." *Leveragedloan.com*, 28 June 2018.
6. Rowley, Jason. "Inside the Global Q2 2018 Venture Market: New Records and Titanic Late-Stage Rounds." *News.crunchbase.com*, July 2018.
7. Otani, Akane and Michael Wursthorn. "Investors Double Down on Tech in Rocky Quarter for Stocks." *The Wall Street Journal*, 29 June 2018.

S&P 500 Defensiveness



Source: The Leuthold Group

NEW COLLEAGUES JOIN CLIFFORD SWAN

By Linda Davis Taylor

Over the summer, we welcomed three new colleagues to the firm—Preeti Chamber, Emily Kirby, and David Lin. Preeti joins our outstanding team of client service specialists, working closely with Roger Gewecke. Emily provides additional depth to our capable operations team. David's experience in portfolio management and equity research make him a valuable addition as an investment counselor. In addition to adding investment and client service capabilities to our firm, these individuals each bring the intangible but essential qualities of energy, commitment, and collegiality—ingredients that are the hallmarks of our Clifford Swan culture. We look forward to having you get to know them in the months and years ahead.

David Lin, Emily Kirby, and Preeti Chamber

GIVING UNDER THE NEW TAX LAW
TAX CUTS AND JOBS ACT OF 2017

By Kenneth H. Dike
Esq., CPA, CLPF

We can only either spend or save the income we receive. And, since *you can't take it with you*, income that is initially "saved" must eventually be "spent" through bequests, both charitable and non-charitable (heirs). Some spending is not discretionary, such as tax, medical, housing, food, utilities, and other living expenses. Income less this non-discretionary spending is available for further spending or saving. Charitable giving is funded by discretionary income or savings. Therefore, to understand how charitable giving could be influenced by the *2017 Tax Cuts and Jobs Act*, we need to look at how the law will impact discretionary income and savings.

THE BASICS

Married Taxpayers Filing a Joint Return	2017	2018 to 2025[1]	Change
Estate (and gift) Tax Exemption[2]	$10,980,000	$22,360,000	+104%
Standard Deduction	12,700	24,000	+89%
Maximum Home Mortgage for Deduction[3]	1,000,000	750,000	-25%
Maximum State Tax Deduction[4]	no limit	10,000	
AGI Limit on Charitable Gifts of Cash	50%	60%	+20%
Federal Tax on Taxable Income of:			
$ 25,000	$ 2,818	$ 2,619	-7%
50,000	6,568	5,619	-14%
100,000	16,478	13,879	-16%
250,000	57,717	48,579	-16%
500,000	143,231	126,379	-12%
1,000,000	341,231	309,379	-9%

1 After 2025, these amounts revert back to the 2017 levels.
2 Amount of non-charitable gifts and estates exempted from tax assuming the joint taxpayers combined their individual exemptions (portability).
3 Maximum post-2017 home mortgage that qualifies for the home mortgage interest deduction.
4 This limit is the same for individuals and married couples filing a joint return. The limit is $5,000 on each return for a married couple filing separately.

ESTATE (AND GIFT) TAX EXEMPTION

In 2017, lifetime gifts and estates less than about $5.5 million were exempt from gift/estate tax. Married taxpayers combining their *exemptions* could exempt $10.9 million. These exemptions more than doubled in 2018 when the gift/estate tax *exemptions* are $11.2 million and $22.4 million, respectively.

Charitable giving was not subject to gift or estate tax in 2017 and still is excluded under the new tax law. Although a specific gift/estate tax benefit from this charitable exclusion is harder to realize given the significant increase in the gift/estate tax *exemption*, less gift/estate tax will be paid increasing the amount available to "spend" through charitable, or non-charitable, lifetime gifts and estate bequests.

STANDARD DEDUCTION VS. ITEMIZED DEDUCTIONS

Turning to income taxes, a taxpayer may either *itemize* their deductions or take the *standard deduction* that has almost doubled (89%) from 2017 to 2018. Married taxpayers filing a joint return with 2017 *itemized deductions* of no more than $12,700 would not itemize and therefore not get any particular tax benefit for their charitable giving *itemized deduction*. In 2018, this "joint return" threshold is $24,000. The 2017 and 2018 *standard deductions* for individuals are half of these "joint return" amounts.

Typical *itemized deductions* include home mortgage interest, state and local income and property taxes, and charitable contributions.

- The 2017 limit on the value of a home mortgage qualifying for an interest deduction was $1 million. In 2018, this limit was reduced to $750,000 for post-2017 mortgages. The related "lost" home interest *itemized deduction*, assuming a 4% interest rate on a mortgage acquired after 2018, is at most $10,000.
- There was no limit to the amount of state and local income and property tax (SALT) payments that could be included as an *itemized deduction* in 2017. In 2018, the SALT *itemized deduction* is limited to $10,000 for individuals and married taxpayers filing joint returns. The limit is $5,000 per return for married taxpayers that file separate returns.
- In 2017, a taxpayer could deduct up to 50% of their adjusted gross income (AGI) for cash contributions. In 2018, that AGI limit increases to 60%. The AGI limit on gifts of long-term appreciated securities remains at 30% for 2018.

For most taxpayers, it will be more difficult to exceed the *standard* deduction with *itemized* deductions in 2018. But, since a taxpayer would only take the *standard deduction* if it resulted in lower tax, the increase in the *standard deduction* will reduce income tax and increase the discretionary income available for charity.

Some taxpayers will continue to *itemize* despite the reduction in their "non-charitable" *itemized deductions*. In such situations, there will be a direct tax benefit for each dollar of charitable giving up to 60% of their AGI (30% for gifts of appreciated securities).

Taxpayers with large home mortgages and those in high-tax states may experience an increase in taxable income. The possible loss of itemized deductions for

GIVING UNDER THE NEW TAX LAW |
Continued on page 4

GIVING UNDER THE NEW TAX LAW |
Continued from page 3

home mortgage interest and SALT payments (assuming deductions are itemized) must be compared to the reduction in tax rates to determine the net effect on federal tax and therefore discretionary income.

LIMIT ON HOME MORTGAGE INTEREST VS. REDUCED TAX RATES

The maximum "lost" itemized deduction for interest paid on post-2017 home mortgages is $10,000. This translates into a federal tax increase of between $1,200 and $3,700 depending on the level of taxable income. The mid-range of this increase is $2,450 for joint incomes of $200,000 and single incomes of $100,000. The reduction in federal taxes due to the decrease in tax rates more than offsets the increase in tax from this "lost" home mortgage interest deduction for joint returns with taxable income greater than $60,000 and individual returns with taxable income greater than $95,000.

Although it's unlikely that a taxpayer will pay more tax in 2018 because of the lost home mortgage interest deduction (offset by the tax rate reduction), consideration must be given to the effect on federal tax of the 2018 limit on the SALT deduction.

LIMIT ON STATE TAX (SALT) DEDUCTION VS. REDUCED TAX RATES

The 7% to almost 15% reduction in federal taxes from reduced rates as applied to a taxpayer's taxable income (after the *standard* or *itemized* deductions) generally offsets the potential increased federal tax from the $10,000 limit on the deductibility of state and local income and property (SALT) taxes.

Even in a high-tax state like California, joint taxpayers with taxable income of less than $750,000 will pay less federal tax due to the reduced rates after the effect of the SALT deduction limitation (see table below). This net reduction in federal tax exceeds the maximum increase to federal tax from the reduced limit on the deduction of interest on post-2017 home mortgages for almost all joint taxable incomes between $75,000 and $400,000.

Taxpayers in other states with lower tax rates will fare better and some will be unaffected by the $10,000 SALT deduction limit. Overall, most taxpayers will have more discretionary (after-tax) income to spend, including charitable gifts, or save.

BUNDLING OF CHARITABLE CONTRIBUTIONS

A simple technique to achieve a specific federal tax deduction for charitable gifts is to "bundle" multiple years of giving into one year. Combining three years' $8,000 gifts into one year's $24,000 gift would achieve the standard deduction for spouses filing a joint return. Any other charitable giving, or itemized deduction, would result in a related federal tax reduction over what would be paid using the *standard deduction*.

GIFTING OF APPRECIATED SECURITIES

The ability to bypass tax on appreciated securities is still a tax benefit of charitable giving. As in the past, the donor values a gift of an appreciated security as the security's gift-date market value and the donor is not required to recognize any gain from the appreciation on their tax return. Occasionally, a donor will gift appreciated securities and use the cash they would have donated to repurchase the gifted securities in order to achieve a step-up to their tax basis. This tax-avoidance technique is more important given the decline in other tax reduction opportunities due to the reduction in allowable *itemized* deductions and increase in the standard deduction.

IRA QUALIFIED CHARITABLE DISTRIBUTIONS

There is no change to the Sec. 408(d)(8) *IRA Qualified Charitable Distribution* provisions of the federal tax code that were made permanent by the *Protecting Americans From Tax Hikes (PATH) Act of 2015*. Since no income is recognized by the donor, there was never a charitable deduction available.

When a donor reaches the age of 70½ he or she can instruct their IRA administrator to transfer up to $100,000 to a charity each year. Although this transfer qualifies for the donor's required minimum IRA distribution, it is not included in the donor's gross income for tax purposes. This $100,000 limit is an annual limit and the donor can transfer $100,000 to charity each year. This limit is also "per person," allowing the donor's spouse who has his or her own IRA, if filing jointly, to transfer another $100,000 to a charity each year.

The transfer must be directly from a traditional IRA or a Roth IRA, and the IRA donor cannot take any possession of the distribution prior to it being transferred to a charity. The permissible charities exclude donor advised funds, private foundations, and charitable remainder trusts.

These *IRA Charitable Rollovers*, that sidestep the charitable deduction issues

GIVING UNDER THE NEW TAX LAW |
Continued on page 5

California Married Taxpayers Filing a Joint Return

Taxable Income	CA State Tax[5]	Change in U.S. Taxes		
		CA Tax[6]	Tax Rates[7]	Net
$ 50,000	$ 1,056	$ 127	$ -948	$ -821
150,000	8,663	1,906	-4,098	-2,192
250,000	17,963	4,311	-9,138	-4,827
500,000	41,213	14,425	-16,852	-2,427
750,000	**67,331**	**24,912**	**-25,352**	**-440**
1,000,000	95,581	35,365	-31,852	3,513
1,250,000	125,301	46,361	-38,352	8,009

5 Based on the 2017 California state tax rates (the 2018 rates will not be published until 2019).
6 Increase in U.S. tax due to the state tax deduction limit of $10,000 using the 2018 marginal federal tax rate for that income level. Assumes all CA income tax exceeds the 2018 SALT limit (allows for a $10,000 deduction for property taxes).
7 Decrease in U.S. tax from 2017 due to the reduced tax rates in 2018 assuming no change in the *itemized deductions*.

GIVING UNDER THE NEW TAX LAW | Continued from page 4

since they were never taxed as income, will become more attractive. It is like getting a 100% charitable deduction without having to itemize and regardless of what the charitable deduction rules may be at the time.

MORE DISCRETIONARY INCOME AND SAVINGS TO GIVE

Most taxpayers will have more discretionary income or savings to donate in 2018 than they did in 2017. The increase in the gift and estate tax exemption, the increase in the standard deduction, and the lower tax rates will reduce federal tax for most and therefore increase discretionary income and savings available to give. A charitable gift, even after any related tax reduction, is almost always a net financial outflow to the donor. Any related tax efficiencies will *reduce*, but do not *eliminate*, the net amount given away by the donor. The decision is what to do with the additional discretionary income and savings since *we can't take it with us.* ◆

HOW TO INVEST IN A TEMPERAMENTAL MARKET

By George Hasbun

"In the short run, the market is a voting machine but in the long run it is a weighing machine."—Benjamin Graham

After an eventful first quarter of 2018, in which the S&P 500 Index first surged over 5% in January and subsequently briefly tumbled as the calendar progressed from January to February, the stock market quickly recovered and returns have been relatively flat since. Concerns over tariffs, trade wars, and rising interest rates have dominated news headlines and resulted in a somewhat bumpy ride, but have not been enough to move the market significantly. Of course, ups and downs in the stock market are nothing new—swings in stock prices have been around since stocks began trading on an exchange. The recent market gyrations provide us with an opportunity to explore an old parable about stock price fluctuations popularized by Benjamin Graham, who is widely regarded as the father of value investing. Value investors generally make buy or sell decisions by comparing price against the intrinsic, fundamental value of a security.

Benjamin Graham was born in 1894 and graduated from Columbia University in 1914. Mr. Graham went on to work on Wall Street, started an investment partnership, and taught investment courses at Columbia Business School. He later published two seminal books on investments, *Security Analysis* and *The Intelligent Investor*, in which he drew a clear distinction between investment and speculation. He defined the difference as "an investment is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculation." He advocated valuing companies as if they are private businesses, without any timeframe or sale price in mind. He supported having a willingness to hold investments indefinitely as long as one continues to expect the business to increase its intrinsic value at a satisfactory rate. In our current environment, where investors trade stocks daily and many on Wall Street consider a long-term investment to be mere months, this approach might seem like a breath of fresh air.

The legendary investor and businessperson Warren Buffett, a student of Graham's, has described *The Intelligent Investor* as the best book on investing ever written. In the book, Mr. Graham described a helpful mental attitude with which to view the stock market's ups and downs, which Mr. Buffett has adhered to throughout his investing career and still resonates today. In his parable of the market, Graham explains the concept of Mr. Market, who is a fictional individual. In his example, you imagine you are one of the owners in a successful private business—perhaps a stable manufacturing operation that has successfully operated for decades. One of your partners, named Mr. Market, gives you a daily quote for what your interest in the business is worth and furthermore offers to either buy your interest or sell you his interest. Occasionally the valuation from this individual appears plausible when you take into account the current cash flow of your business and its outlook. Other times enthusiasm or fear get the better of this person and the value proposed appears quite silly. The swings between optimism, euphoria, pessimism, and depression occur frequently and can last for months at a time. As the long-term owner, you have witnessed the ups and downs of the economic cycle and understand the long-term value of your operation. As a prudent, sensible businessperson, you should act upon these daily valuations only if it is to your advantage to do so. You may be quite happy to sell your interest when you are quoted an unreasonably high price and thrilled when you can buy more when the price is low. The remaining time you can sit back, amused by the daily communication and listen only when, based on your own idea of the value of your business, the price looks attractive. Mr. Market's job is to provide you with prices; your job is to decide whether it is to your advantage to act on them.

Viewing the stock market through this lens, according to Buffett and Graham, is highly important for suc-

HOW TO INVEST | Continued on page 6

HOW TO INVEST | Continued from page 5

cessful long-term investing. The fluctuations in the stock prices have only one significant meaning for the true investor. They provide the opportunity to buy wisely when prices fall sharply or sell wisely when they advance greatly. The daily market quotations are provided for your convenience, either to be taken advantage of or ignored. The best part of this situation is that Mr. Market does not care how many times you take advantage of him. No matter what, he will arrive the next day ready to do business. In the short-term, returns are subject to the emotions and whims of Mr. Market and his friends; business success is confirmed (or disproven) in the long run.

Here at Clifford Swan, our security selection methodology centers around valuing companies like private businesses in which we anticipate buying an interest and owning for a long period of time. Our focus is on companies with a long-term record of profitability, a capable management team, strong balance sheets, and a sustainable competitive advantage, among other metrics. Over time, we expect many of our investments to grow their intrinsic value at a satisfactory rate. Our attitude toward stock market movements differs greatly from those of a speculator, who profits from correctly predicting the timing and direction of stock price movements. The fluctuations in the price of a company are important to us in that they provide an opportunity to buy when the price gets low and to sell (or refrain from buying) when the price gets too high.

At the moment, Mr. Market's attention is particularly focused on trade wars and rising interest rates, which has translated into some fluctuations in stock quotes. We are assessing whether these factors change our calculation of a company's intrinsic value. If we determine that Mr. Market's latest concerns have little impact, we will remain disciplined and only use the market fluctuations to our advantage. On the other hand, if our analysis indicates that Mr. Market's concerns have long-term merit, we will adjust our calculations of intrinsic value accordingly. Our behavior is guided by our conviction that time reveals the true measure, or value of a company. In the short-term, we evaluate whether contemporary factors will ultimately affect companies. Our long-term capital preservation approach allows us to let Mr. Market serve us, not direct us. Through Mr. Graham's intellectual framework, we can take price volatility in stride and patiently wait for our next opportunity to pick his pocket. ◆

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
David Y. Lin, 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

Both this and past editions of *The Investment Counselor* are available on our website.

SUMMER INTERNSHIP PROGRAM SUCCESSFULLY COMPLETES FIFTH YEAR

WISDOM *for* GENERATIONS

Clifford Swan's internship program aims to provide talented undergraduate students who have shown interest in the investment and wealth management business a fundamental educational experience and the opportunity to develop skills in a number of areas of an investment advisory firm.

Charles Mangum and Henry Stellwagen were selected from over 200 applicants for the fifth year of Clifford Swan's summer internship program, which was led by Jennifer Maqueda. Charlie is a native of Boston and a rising junior at Claremont McKenna College, where he majors in both Economics and Government. Henry is a rising senior at the University of Southern California, where he majors in Economics, and is from Pasadena.

During the two-month internship, Henry and Charlie completed several projects and learned about key aspects of the firm, including portfolio management, securities analysis and research, trading and execution, compliance, and marketing. ◆

Charles Mangum and Henry Stellwagen