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THE ADVISOR

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After a Calmer April, the Market Is Offering a Gift to Those Who Need It

Since the start of the coronavirus pandemic, we've been keeping you updated on the financial markets. In this month's newsletter, we'd like to share some important recurring messages, along with some things to keep in mind as the economy progressively reopens in the weeks ahead — or at least attempts to.

As you know, the financial markets took a beating in March when the coronavirus crisis really took hold and much of the global economy was forced to shut down. However, income-based investors generally saw less negative impact on their portfolios than those still invested primarily in common stocks and mutual funds. More importantly, even if your bonds and bond-like instruments dropped in value in March (as most did), it was really only a paper loss. That's because these instruments continue to generate income at the same fixed dollar amount regardless of any drop in value, and because they have a par value that ensures the return of your full investment if you hold them to maturity, assuming there are no defaults.

We want to stress that point again this month even though your statements for April are likely to show a recovery in value on these investments, since both the stock and bond markets saw partial rebounds last month.[1] Just as the loss in value on your statement in March was only a paper loss, you should really view the recovery as a paper gain. Yes, it may feel good to see the increase, but it still doesn't matter because — again — the income on the majority of your investments stays the same and the par value means your principal will be returned at maturity or call regardless of any ups or downs in the market. We're stressing this point because we strongly believe we still have another shoe to drop where the markets are concerned despite April's partial comeback. There's a reason why.

A W-Shaped Comeback

Confirmed cases of COVID-19 in the U.S. surpassed the million mark by the end of April, and the death toll was close to 60,000. Additionally, at the end of the month, unemployment stood at an estimated 18%, and economic shrinkage for the first quarter was reportedly almost 5%.[2] That all sounds bad enough, but the picture looks even worse when you consider a few factors. First, unemployment during the Great Recession peaked at around 10%, and even at the height of the Depression it topped out at 25%. In other words, we're nearing Depression-level unemployment already!

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Taxes and Your Investments

One of your portfolio's largest expenses is probably taxes. One way to help keep your portfolio growing is to invest in a tax-efficient manner. Some suggestions include:

- **Contribute to your 401(k) plan.** Contributions are made on a pretax basis, so you don't pay income taxes currently (Social Security and Medicare taxes are paid) and earnings grow on a tax-deferred basis until withdrawn. In 2020, you can contribute a maximum of $19,500 to a 401(k) plan, although your contributions may be limited to a certain percentage of your pay to comply with nondiscrimination rules. Individuals over age 50 may be able to make an additional catch-up contribution of $6,500 in 2020. Many employers also match your contribution, so you get additional funds at no cost to you.
- **Make contributions to an individual retirement account (IRA).** In 2020, you can contribute a maximum of $6,000, plus those over age 50 can make an additional $1,000 catch-up contribution. Investigate whether you're eligible to contribute to a traditional deductible IRA or a Roth IRA and decide which option is best for you. While you can't deduct your contributions to a

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After a Calmer April

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As for the GDP, that 5% contraction was a result of the economy being shut down for less than a month. Estimates for shrinkage in the second quarter range as high as 25 to 30%, which are numbers that surpass even what we saw in the Great Depression.[3]

So why is it that Wall Street rallied in April, with the markets gaining back roughly two-thirds of what they'd lost since the start of the crisis? Who knows, except we can say it was further evidence that Wall Street has been detached from economic realities for some time. Investors seemed to be cheering the progress we made in flattening the infection curve but ignoring the true scope of the economic damage being done. We don't believe they'll be able to ignore it for good, which is why we are convinced we still have another big shoe to drop when it comes to the stock market. While some Wall Street cheerleaders are saying the worst is over and talking about a V-shaped recovery or a U-shaped recovery, a W-shaped recovery may be more likely. When the market dropped by almost 40% in March, that formed the left side of the W. The next drop and slow recovery will form the right side, and we believe the next down-wave will likely surpass the first — possibly ranging between 55 and 80%, according to market history.

The Good News

The good news for our clients is that most of you have very little money in common stocks or mutual funds, which are likely to be hit hardest when and if that next big down-wave occurs. You may see values drop on some of your own investments, but we've already explained why that doesn't really matter when you're invested for income. However, even if you do have higher-risk investments elsewhere, there's still good news: the April rebound means you have time to lower your risk before the next shoe drops.

Remember, there's no law that says you can't buy into the market at another time if you take money out now. You don't have to ride it all the way to the bottom in order to ride it back to the top. One reason the rich get richer is that they have cash reserves to take advantage of buying opportunities in real estate and the stock market. You can use that same strategy by taking some cash off the table now while the market is giving you the chance.

When the market first dropped in March, it happened so quickly there wasn't really time to take action. But with the partial rebound and lower volatility we've seen more recently, the market is basically giving you a gift. It offered up a similar gift in 2008, and those who didn't take advantage ended up riding that 56% correction all the way down. Those who did take action and lowered their risk then had money to buy back into the market when it bottomed out. Think about it: when you can buy something at a 50% off sale, that's a great deal! In looking at all the data — we believe that's where we're headed with this market.

So, stay safe and be patient as the economy reopens, and realize that there are likely to be setbacks. Hope for the best but prepare for the worst. Also keep in mind that the current crisis illustrates exactly why you switched your investment focus from growth to more protection and income in the first place! If you still have money in stocks and mutual fund elsewhere, now might be a good time to think about the gift the market is giving you, and to accept it!

[1] macrotrends.com

[2] "Millions of Layoffs Set to Push Unemployment Rate to Highest Level Since Great Depression," MarketWatch, May 4, 2020

[3] "Worst Economy in a Decade. What's Next? Worst in Our Lifetime,' New York Times, April 29, 2020

Tax Treatment of IRA Losses

If you sell stocks with losses in your taxable account, you can offset losses against gains and deduct an additional $3,000 of excess losses against ordinary income. Any excess losses can be carried forward to future years. But what about losses in your individual retirement accounts (IRAs)?

First, keep in mind that you must withdraw the funds from your IRA before there are any tax consequences. The tax treatment of any losses on those distributions depends on whether you received a tax deduction for your original contribution. If you made deductible contributions to a traditional IRA, your distribution, including contributions and any earnings, are taxable as ordinary income when withdrawn. Thus, if your IRA has losses, you will withdraw a lesser amount, paying less income taxes. You get no specific benefit for the investment loss.

When nondeductible contributions were made to a traditional IRA, you pay taxes only on the earnings when making withdrawals. Your contributions are withdrawn with no tax consequences. If your account balance is less than your total contributions, you can take a deduction for the difference, but only by completely liquidating all your traditional IRAs.

The same is true with Roth IRAs. You can deduct a loss when your account balance is smaller than your contributions, provided you completely liquidate all your Roth IRAs.

Those losses, however, are not deducted as a capital loss. Instead, they are a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limitation.

If the Roth IRA was converted from a traditional IRA, you could incur a 10% federal income tax penalty by liquidating before age 59½ and before the fifth year after conversion. However, if you only made annual contributions to your Roth IRA, the 10% penalty would not apply, since it is only assessed on Roth IRA earnings. Since the value of the IRA is less than your contributions, you would not have any earnings.

Before implementing this strategy, you should carefully evaluate your tax situation to determine whether the tax benefits justify liquidation. Please call if you'd like help with the decision.

Your Investments

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Roth IRA, your earnings grow tax free as long as you make qualified distributions from the IRA. With a traditional deductible IRA, your contribution is deductible on your current year income tax return and earnings grow tax deferred.

- **Carefully decide which investments to hold in tax-advantaged and taxable accounts.** Gains from investments held in retirement accounts, such as 401(k) plans and traditional IRAs, are taxed at ordinary income tax rates when withdrawn, rather than the lower capital gains tax rates. It may make sense to hold investments that produce ordinary income or that you want to trade frequently in retirement accounts, and investments that generate capital gains in taxable accounts. But factors such as your investment period should also be considered.
- **Analyze the tax consequences before rebalancing your portfolio.** Portfolio rebalancing is a taxable event that may result in a taxable gain or loss. In general, avoid selling investments from your taxable portfolio for reasons other than poor performance. Bring your asset allocation in line through other methods.
- **Consider municipal bonds or stocks generating dividend income if you are in a high tax bracket.** Since municipal bond interest is exempt from federal (and sometimes state and local) income taxes, your marginal tax bracket is a major factor when deciding whether to include municipal bonds in your portfolio. Thus, you should determine how a muni bond's yield compares to the after-tax yield of a comparable taxable bond.
- **Look into tax-advantaged ways to save for college.** If you are saving for college, look at education savings accounts (ESAs) and Section 529 plans. The annual contribution limit to ESAs is $2,000. While you can't deduct the contribution on your tax return, earnings grow tax free as long as funds are used for qualified education expenses. With Section 529 plans, you can contribute up to $75,000 to a qualified plan ($150,000 if the gift is split with your spouse) in one year and count it as your annual $15,000 tax-free gift for five years. However, if you die within the five-year period, a pro-rata share of the $75,000 returns to your estate. Distributions from 529 plans to pay qualified higher-education expenses are excluded from income.
- **Consider owning a home.** Owning a home has significant tax advantages. Mortgage interest and property taxes can be deducted on your tax return. When you sell your home, you can exclude up to $250,000 of gain if you are a single taxpayer and up to $500,000 of gain if you are married filing jointly, provided the home was your primary residence in at least two of the preceding five years. You no longer have to purchase another home to qualify for the exclusion.

When to Use Tax-Advantaged Accounts

Tax-advantaged savings plans, like 401(k) plans and individual retirement accounts (IRAs), help your money grow faster than taxable investments, but they're not always the right place for your savings. Here is a rundown on when one choice or the other might be appropriate.

Put your money in a tax-advantaged saving plan when:

- Your employer matches your contribution. It's rare that taking advantage of this free money doesn't make sense.
- You already have savings equal to at least three months of living expenses and, if you have dependents, adequate life insurance coverage.
- You already own a home and are comfortably meeting your monthly mortgage payments.
- You haven't yet met your goal for a retirement nest egg and need the return-enhancing advantage of tax-free compounding to reach it.

Consider *not* contributing to a tax-advantaged plan when:

- Either you're already at the limit of your employer's matching contribution or your employer doesn't offer one. (Though even in these cases it may still make sense to contribute to your 401(k) plan, as long as the plan's fees and expenses are low and it offers sufficient diversification.)
- The investment choices in your employer's plan charge high annual expense fees. The pre-tax advantage of contributing to a 401(k) plan can be eroded by fees.
- You're in a high tax bracket and want to invest in individual equities for long-term capital gains. Rates on long-term gains are well below the highest federal income tax bracket, and unless you contribute to a Roth IRA or Roth 401(k) plan, you'll have to pay ordinary income taxes on the gains on stocks in a traditional IRA or 401(k) plan.
- You want to diversify beyond the choices available in an employer's retirement plan. If this is the case, you may still want to contribute to an IRA, but through an account with sufficient diversification options.
- You want municipal bonds to be part of your portfolio. If you hold municipal bonds in a traditional IRA or 401(k) plan, any interest income, even tax-exempt income, will be taxed at ordinary income rates when withdrawn. It is better to hold municipal bonds in taxable accounts so the tax-exempt interest income is not taxable.

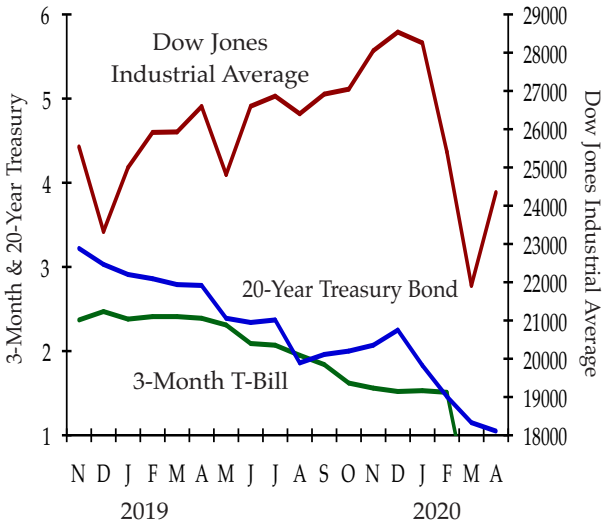
Business Data

Indicator	Month-end Feb-20	Mar-20	Apr-20	Dec-19	Apr-19
Prime rate	4.75	3.25	3.25	4.75	5.50
3-month T-bill yield	1.51	0.09	0.12	1.52	2.39
10-year T-note yield	1.13	0.70	0.64	1.92	2.55
20-year T-bond yield	1.46	1.15	1.05	2.25	2.78
Dow Jones Corp.	2.52	3.81	2.72	2.84	3.74
GDP (adj. annual rate)#	+2.10	+2.10	-4.80	+2.10	+3.10

Indicator	Month-end Feb-20	Mar-20	Apr-20	% Change YTD	12 Mon
Dow Jones Industrials	25409.36	21917.16	24345.72	-14.7%	-8.5%
Standard & Poor's 500	2954.22	2584.59	2912.43	-9.9%	-1.1%
Nasdaq Composite	8567.37	7700.10	8889.55	-0.9%	9.8%
Gold	1609.85	1608.95	1702.75	11.8%	32.8%
Unemployment rate@	3.60	3.50	4.40	25.7%	15.8%
Consumer price index@	257.97	258.68	258.12	0.4%	1.5%

— 3rd, 4th, 1st quarter @ — Jan, Feb, Mar Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
November 2018 to April 2020



Planning Year Round

Many people confuse tax planning with tax preparation and only think about it when preparing their annual tax return. However, there is little you can do to actually lower your tax bill when preparing your return. If your goal is to reduce income taxes, you need to be aware of tax planning opportunities throughout the year.

Take time early in the year, perhaps as part of the tax preparation process, to assess your tax situation, looking for ways to reduce your tax bill. Consider a host of items, such as the types of debt you owe, how you're saving for retirement and college, which investments you own, and what tax-deductible expenses you incur. It often helps to discuss these items with a professional who can review strategies you might not have considered.

During the year, consider the tax consequences before making important financial decisions. This will prevent you from finding out later that there was a better way to handle the transaction for tax purposes.

Look at your tax situation again in the fall, which gives you plenty of time before year-end to implement any additional tax planning strategies. At that point, you'll also have a better idea of your expected income and expenses for the year. You may then want to use strategies you hadn't considered earlier in the year, such as selling investments at a loss to offset capital gains.

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