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THE ADVISOR

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Credit Spread Compression 'Softens' the Impact of Rising Rates

For much of the past year, we've seen long-term interest rates go down and Covid-19 numbers go up. That trend reversed itself dramatically in February, with coronavirus infection rates continuing to decline from their January peak, and interest rates finally topping their pre-pandemic high. The first trend is obviously great news. The second trend might sound like a concern for bond investors, but is not necessarily, thanks to a factor called credit spread compression. We've discussed how it works before in this newsletter, but now is a great time to discuss it again since you'll see its "softening" effect demonstrated on your next statement.

The inverse relationship between bonds and interest rates is one of the best-known principals of investing: when interest rates go up, the values of bonds and bond-like instruments go down, and vice-versa. At the start of 2021, the yield on the 10-Year US Treasury rate was at 0.93% — still below 1%, as it had been since March 20th of last year. By the end of February, it was near 1.5%.[1] Technically speaking, that means the value of a 10-Year Treasury bond in your portfolio should have been down by about 5% on the year. In other words, if you had $100,000 in 10-Year Treasuries on January 1st, you should have had approximately $95,000 on March 1st. At these low rates, it would probably have taken you several years to earn that money back.

However, when you look at your February statement once you receive it this month, you'll see your values aren't down by 5%; they're down by much less. Everyone's statement will be different since each strategy is customized, but some of you may see your overall portfolio down by only 1%. The reason for this is credit spread compression. Also, if you've been reinvesting your interest and dividends along the way, your portfolio may not have dropped in value at all.

A 'Natural Softener'

The simplest way to explain it is to note that when we talk about bond values going down when interest rates go up, it must be the interest rate commensurate with that specific class of bonds. For example, if you have a risk-free US treasury bond, it tracks the US treasury rate. If, on the other hand, you have a triple-B corporate bond, then the rate that affects your bond is the one commensurate with triple-B corporates, which is different from the US treasury

Continued on page 2

Leaving a Legacy

Many of us want to do our part to leave the world a better place. Below are five different ways you can leave a financial legacy.

1. Give gifts in your lifetime. If you have the financial freedom to do so, making financial gifts while you are still alive is a great way to leave a legacy. Money you donate to qualified charitable organizations can be deducted from your taxes, saving you money while also helping you support a good cause. If you want to leave a family legacy, consider giving gifts to loved ones while you are living, like helping pay for your grandchild's college education. Just make sure you're aware of annual limits on what you can give to individuals without triggering gift tax ($15,000 per person in 2021).

2. Make a bequest in a will. Many people use their will to make philanthropic bequests, leaving funds to their favorite charity, alma mater, or church. For people who have money to give, recognizing an organization in their will is a relatively easy way to leave a legacy. Bequests in a will don't require any additional planning and are exempt from estate tax, provided the recipient is a qualified charitable organization. However, if you plan to make a substantial bequest to a charity, you may want to inform them of your plans in advance. This is particularly important if you plan

Continued on page 3

Credit Spread

Continued from page 1

rate. It's different still for a double-B corporate bond. These differences are important when it comes to how volatility within the bond market affects your portfolio.

When interest rates go down, it's typically because consumers and investors are worried about the economy. This has certainly been the case for most of the past year as the coronavirus has continued to fuel economic hardship and uncertainty. On the flipside, when interest rates rise, it's usually because people are growing more confident about the economy, as well as the prospect for more growth and inflationary pressure. With vaccine distribution ramping up, Covid-19 cases dropping, and more federal aid likely on the way, that kind of confidence is now on the rise.[2]

Why is all that so important to understand? Well, when you're worried about the economy, you might be willing to buy a risk-free US treasury at a certain interest rate. However, in order to go from that investment to a triple-B corporate bond, you might demand a much higher rate to feel that it's worth your while. Although, when you're confident about the economy, that rate difference between the government bond and the corporate bond might not need to be nearly as great for you to make the move. That's called the risk premium, defined as the amount of extra interest an investor would require to go from a risk-free treasury to a corporate bond of a particular grade. As interest rates rise due to investor confidence, risk premiums shrink, creating a "natural softener" for actively-managed income portfolios. This is the phenomenon known as credit spread compression.

So, even though the yield on the 10-Year Treasury rate has gone up by over six-tenths of a percent since the start of the year, the rate on certain triple-B and double-B corporate bonds may only have gone up by one-tenth of a percent. For you, that means even though long-term rates have skyrocketed overall, your specific allocation has helped prevent your portfolio values from dropping. The impact has been significantly softened, thanks to credit spread compression.

It Gets Better

This phenomenon illustrates an important point: the notion that bond values drop whenever interest rates rise is a huge oversimplification. Many factors affect bond values, including risk premiums. What's even better is that typically when interest rates rise as rapidly as they have been, they'll eventually level off and perhaps even drop slightly again. When that happens, income investors will have a little tailwind that could bring any drop in values back by about halfway, at least.

The even better news, of course, is that regardless of whether your bond values go up or down on paper, you can still count on getting the full value of your principal investment returned when the bond matures, provided there is no default. Even more importantly, no matter what happens between now and then, you know that your income return is unaffected!

[1] YCharts.com

[2] "US Consumer Confidence Improves as Covid-19 Cases Fall," Reuters, Feb. 23, 2021

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Discussing Your Estate with Your Family

Having this conversation before your death, when choices can be explained, will help avoid the potential relationship damage that can happen if no one is aware or understands your decisions.

Choose the Right Person for the Right Job

While you are likely to consider the feelings of your family members, try to take the emotion out of your decisions and select the people who will be best at certain tasks. Once people understand the various roles and what they entail, they tend to understand why a particular person was selected.

The roles can range from being the executor of the estate, to the guardian of your children, to making medical decisions on your behalf. For example, you need to select a very strong person to be your healthcare proxy, because this person may have to remove you from life support during a medical crisis. This is a very difficult choice to make even when they know that's what you wanted, so you have to name appropriate individuals whom you are confident will be able to carry out your wishes.

Prepare the Appropriate Documents

Once you have determined who will handle the key roles in your estate, you will want to get the proper paperwork drafted and notarized to officially document your wishes. These documents may include: your will, trust, durable power of attorney, healthcare power of attorney, and guardianship designations.

Before you have the conversation, you should have the proper paperwork with copies for all involved individuals, so there is no room for misinterpretation and everyone understands the parameters of your decisions.

Prepare for the Conversation

You'll want to take the time to think through this conversation and anticipate the questions people will have. You will want them to understand what your goals are for the estate plan, what the various roles are and what they entail, and why certain people were chosen for certain roles.

It is important to think through your family dynamic in approaching this conversation. Should it be a more formal conversation that includes an attorney or financial advisor to help explain the roles and your choices? Should it be a more casual discussion around the dinner table with only family?

Either way, you will want to make sure you set ground rules to avoid confrontation. You will want people to express their thoughts, but if it becomes argumentative, let them know the meeting will be canceled until it can be discussed rationally.

Keep the Conversation Going

Let your family know that this will be an ongoing discussion as circumstances change, such as new marriages, new children, divorce, etc. By having regular conversations, you can avoid the "Mom would have wanted this" argument. Setting this expectation can help prevent future family tension.

Leaving a Legacy

Continued from page 1

to donate physical property, like real estate or artwork, as not all charities will want or be able to accept such donations, or if you plan to place restrictions on how the gift is used.

3. Create a charitable remainder trust. If you would like to make a substantial gift to a charity but also want to provide for your heirs or continue to receive income during your lifetime, a charitable remainder trust (CRT) may be an option. Here's how it works: You transfer property to the trust (and get a tax deduction at the time of the transfer), and you or your heirs receive income from the trust for a specified period of time. Then, when that period ends, the remaining assets go to the charity of your choice. A word of caution: CRTs are irrevocable, which means once you've made this decision, you can't reverse it.

4. Set up a donor-advised fund. Know that you want to leave money to a charity, but not ready to hand it over just yet? Consider setting up a donor-advised fund. A donor-advised fund allows you to make contributions to a fund that is earmarked for charity and claim the associated tax deduction in the year you contribute the funds. You continue to make more contributions to the fund, which are invested and grow free of tax. Then, when you are ready, you can choose a charity to receive all or some of the accumulated assets. It's a great way to earmark funds for charity now while also accumulating a more substantial amount of money to leave as a legacy.

5. Fund a scholarship. Endowing a scholarship is a great way to make a difference in the life of a talented student. Here's how it typically works: You give a certain amount of money to the school of your choice, which earmarks it to fund scholarships, often for certain types of students (e.g., female math majors, former foster children, or people suffering from a certain disease). Other scholarships are established through community foundations. A seed gift of $25,000 or $50,000 may be enough to get started. Be aware, however, that while you may be able to have a say in selection criteria for the scholarship, there's a good chance you won't be able to select the recipient yourself. If you want to do that, you'll need to distribute the money in another way, perhaps by setting up your own nonprofit organization.

6. Start a foundation. Starting a family foundation is appealing to many, especially those who like the idea of having greater control over how their money is used as well as the prestige that comes with running a foundation. Well-managed private foundations can also endure for many generations after you're gone. But you'll need substantial assets to make setting up a foundation worth it. Plus, foundations are complicated and expensive to set up and administer. But, if you are committed to the idea of giving back, and especially if you want to keep the entire family involved in giving (a concern for many wealthy families), a private foundation could be the way to go.

Curious about steps you can take to leave a meaningful legacy? Please call to discuss this topic in more detail.

Do You Really Need a Will?

Many people believe they don't need a will. But how valid are the more common reasons for not preparing a will?

Your estate is too small. Some believe that if their estate won't be subject to estate taxes (in 2021, your taxable estate must be over $11.7 million before estate taxes would be owed), there is no need for a will. However, a will's purpose is not to save estate taxes, but to:

- **Provide for the distribution of your assets.** Without a will or other estate-planning documents, your estate will be distributed in accordance with state law, which may or may not coincide with your desires.
- **Name guardians for minor children.** Without a will, the courts decide who will raise minor children when both parents die.
- **Select an executor for your estate.** The executor assembles and values your assets; files income, estate, and inheritance tax returns; distributes assets; and accounts for all transactions. You will typically be in a better position, based on family relationships and individual qualifications, to decide who should be named executor of your estate.

All your property is jointly owned. When one owner dies, jointly-owned property passes directly to the joint owner, regardless of provisions in a will. Also, the unlimited marital deduction allows you to leave any amount of your estate to your spouse without paying estate taxes. Thus, many married couples use joint property ownership as their sole estate planning technique. However, individuals with very large estates may save estate taxes by distributing some assets to other heirs or there may be other reasons to distribute some assets to other heirs.

A living trust will distribute your assets. Only assets actually conveyed to the living trust are controlled by the trust document. Typically a pour-over will is also needed, which places any asset not held by the trust at your death in the trust.

You expect your estate to grow significantly in the future. Some feel it is premature to plan their estate while it is being built. However, a will can be changed. In fact, you should periodically review your entire estate plan to see if changes in your personal situation, preferences, or tax laws require changes to your plan.

Please call if you'd like to discuss the role of a will in your estate plan.

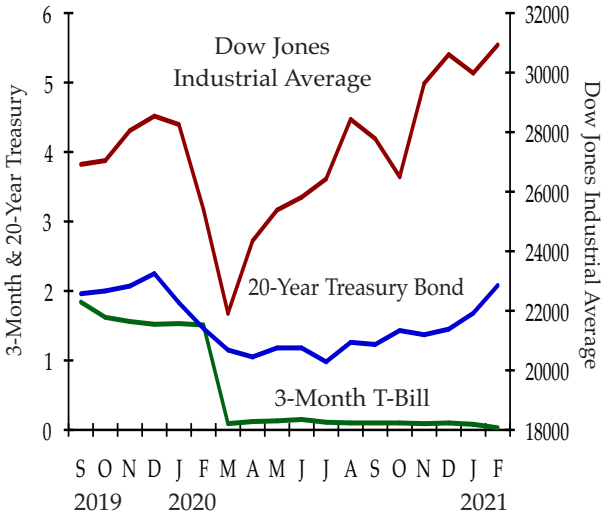
Business Data

Indicator	Month-end Dec-20	Jan-21	Feb-21	Dec-19	Feb-20
Prime rate	3.25	3.25	3.25	4.75	4.75
3-month T-bill yield	0.10	0.08	0.03	1.52	1.51
10-year T-note yield	0.93	1.11	1.44	1.92	1.13
20-year T-bond yield	1.45	1.68	2.08	2.25	1.46
Dow Jones Corp.	1.93	2.04	2.32	2.84	2.52
GDP (adj. annual rate)#	-31.40	+33.40	+4.10	+2.10	+2.10

Indicator	Month-end Dec-20	Jan-21	Feb-21	% Change YTD	12 Mon.
Dow Jones Industrials	30606.48	29882.62	30932.37	1.1%	21.7%
Standard & Poor's 500	3756.07	3714.24	3811.15	1.5%	29.0%
Nasdaq Composite	12888.28	13070.69	13192.35	2.4%	54.0%
Gold	1887.60	1863.80	1742.85	-7.7%	8.3%
Unemployment rate@	6.70	6.70	6.30	-6.0%	75.0%
Consumer price index@	260.23	260.47	261.58	0.5%	1.4%

— 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan 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
September 2019 to February 2021



Handling the Financial Aspects of a Death

The emotional trauma of dealing with a loved one's death can be devastating. If you also have to handle the financial aspects, it can seem overwhelming. Following is a checklist to consider:

- Your most immediate concern will be to notify family and friends of the death and to make funeral arrangements. If you aren't sure of the deceased's burial wishes, look for a letter of instruction or a will that details preferences. You'll probably need to contact a funeral home as well as your loved one's religious organization. An obituary will need to be prepared, a burial site may need to be purchased, and death certificates must be obtained.
- If a surviving spouse and/or minor children are involved, evaluate their means of support and determine whether care for the dependents needs to be obtained. In terms of the loved one's home, you may need to deal with security at the residence, provide for the care of pets, send mail to another location, and arrange for the care or disposal of perishable property, such as plants and food.
- Locate any safe deposit boxes and follow necessary procedures to have them opened.
- If the deceased was employed, contact his/her employer to start the process of collecting any outstanding pay, life insurance proceeds, or other benefits. If the deceased was retired, notify Social Security and any pension plans.
- Locate important documents, including wills, trusts, deeds, investment records, insurance policies, business and partnership arrangements, and other evidence of assets and liabilities.
- Meet with an attorney to discuss the deceased's estate matters. Depending on the estate's complexity, you may need to retain an attorney, accountant, and/or financial advisor.

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