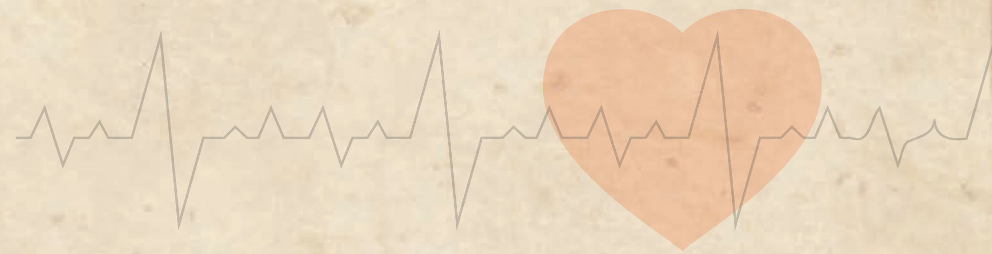
Winter 2018 Edition

The Ultimate Guide for the Successful Steward



Welcome to the Winter Edition of *The Ultimate Guide For the Successful Steward,* Fourth Dimension Financial Group's newsletter.

As our Ohio wintry wonderland continues to remind us why we love spring so much, we're enjoying seeing many of you in our office for progress reviews. It's always fun to reconnect with the families we serve, especially when so much progress is being made. And while the world is still turning on its axis as I write this, our start to 2018 has been shaped by the tale of two markets; the stock market before the decline and the market after. Because of timing, some of our reviews were warning of a pending market decline…someday, while others were discussions of what had just happened.

In some ways, the stock market decline is very helpful to investors and to the markets as a whole. Uninterrupted prosperity is not a real thing, and the stock market was beginning to make people wonder if this time really was different. Not only do we need to have a stress test from time-to-time to ensure our income plans are secure, and proper investment risk management is in place, but declines serve as real opportunities to rotate from safer investments - like bonds - into quality dividend-paying stocks that are now on sale. This is one way that investment managers like Steve Hanley (who's featured here in *The Steward*) are able to help retirees grow their investment income over time, by capitalizing on market disruptions. In other words, bad news can often become good news, given enough time and the right strategy with which to take advantage.

During our reviews, we've also been looking closely at beneficiary arrangements on all accounts to ensure you've named the right people or trusts to receive your assets at death. Not only do these relationships change, but many retirees are finding that a full and proper review of their estate planning may be wise. Richard Chamberlain, an Estate Planning Attorney, shares some wisdom in this issue in a discussion of irrevocable trusts, a topic that is very often misunderstood.

Also check out the *Briefcase Study* and *Back To the Basics*, where I share some concepts and discussions that may help you feel more confident in your planning, and understanding of some economic fundamentals.

As always, we're extremely grateful for the trust you place in us, both in your retirement planning and the introductions you make to friends. Fourth Dimension exists for you and because of you, so thank you for all that you do.

All the best,

Adam B. Cufr, RICP®

Six month-old Josie celebrated Valentine's Day with a big smile, which is how she spends most of her days.

Back To The Basics: The Relationships Among Stocks, Bonds, and Interest Rates, Explained Simply

When investment gurus and market commentators speak of the happenings in the markets, you'll often hear them discuss the effect that interest rates have on bond values and how those bond values also affect stock prices. In fact, it could be any manner of combinations of these, depending on the direction of interest rate movements. But how does it all really work? Asked simply: how do interest rates impact the values of your investments?

Ultimately, interest rates inspire certain behaviors among investors because the rates being paid – and charged – change incentives. These incentives make assets more or less attractive compared to other assets. This relative attractiveness changes supply and demand characteristics, which impact prices.

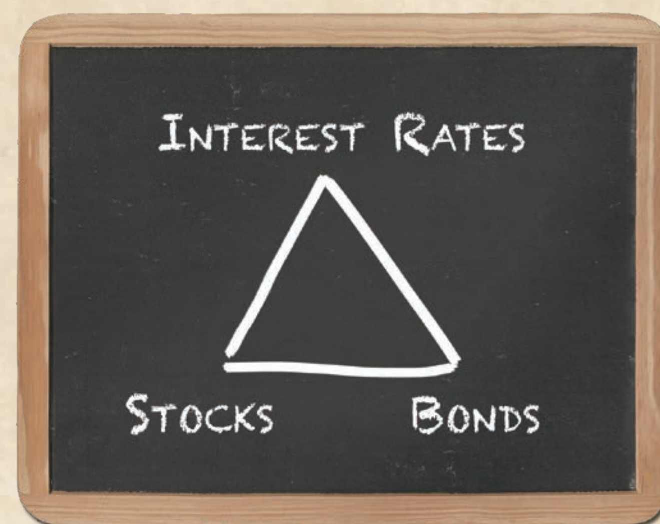
For example, if interest rates paid by banks to savers are close to zero, as they have been for quite some time, keeping a lot of money in a bank savings account doesn't offer much in the way of reward. Sure the money is safe at the bank, but without much being paid in the way of interest, the money isn't working very hard for the saver; it lacks incentive. As a result, savers seek higher interest elsewhere in the way of bonds. And while bonds now introduce some amount of risk into the equation, the higher interest potentially earned draws money into bonds and away from bank savings at a greater rate.

But what if bonds are also paying low interest rates to bond holders? Well, that causes many would-be bond owners to move that money up the risk ladder into stocks instead. After all, if stocks aren't deemed too risky a bet, but are paying dividends and/or earning higher returns for the investor than bonds or savings, then stocks become more popular. This drives up stock prices and the stock market.

The relationships among these various asset types are defined by a combination of interest paid to the owner of the asset and the relative amount of risk present. In other words, a no-risk asset that pays high relative interest looks much better at the time than a high-risk asset that isn't growing or paying an income to the investor.

As a result of this interplay, rising interest rates – like we see now – have the effect of incentivizing investors to move away from riskier assets (stocks) to lower risk assets (bonds and savings) that are now paying an interest rate that is acceptable.

With these relationships in mind, we can look back in time and see that historically high returns earned in the stock market were often during times of declining interest rates. Now that interest rates are going up, we're seeing a shift of some money from higher risk stocks to lower risk bonds and bank savings. This 'resetting' of risk process is very naturaal and usually very temporary. And while it's tempting to try to time all of this, it's very difficult to do because the glue that holds all of these markets together is investor behavior, and people don't always act rationally, or within your desired timeframe.



Briefcase Study

With our progress review season well underway, we've had an opportunity to see inside the plans and minds of many families who are intent on building and maintaining a successful retirement. In doing so, one theme remains central to financial success: planning. Not hoping, not wishing, planning. And while this may sound a bit like a broken record from me, the point I'm hoping to illustrate here is one that is critically important when the markets are so wild and seemingly unpredictable.

In one particular conversation, the couple had grown quite concerned about the recent stock market declines. With so much scary news, was their retirement in jeopardy? Would they still have enough to live the life they'd enjoyed or should they do something drastic to get out of the way of the wave of bad news coming from Wall Street?

In any situation where fear is present, it pays to step back from the ledge and seek perspective. The way we did this, and do frequently, is to pull up their retirement plan and revisit the objectives they've defined for themselves. By looking at available income sources, like Social Security, pensions, annuity income; incomes that are guaranteed and independent of the whims of the stock market, it's quite comforting to know that running out of money isn't going to happen. In fact, these folks set themselves up to have almost all of their lifestyle expenses covered by these guaranteed sources… for the rest of their lives. Their market-based investments were really just a way to provide themselves some nice extras rather than their necessary income.

Whenever we've had significant market volatility, we've always suggested going back to the plan. More often than not, a calm is restored, even when times are tough. When we compare objectives to available resources, even if some resources are currently on the decline, we find that a clear head allows for better decision making.

As always, let us know if you'd like to revisit your plan. Like we found with this couple, even a small dose of plan review can provide a large boost to confidence.

What does the tax cut mean for the stock market?

Many people are wondering what the tax cut means for the US stock market. We thought it might be helpful to take a look at some historical patterns and overlay a bit of common sense to consider what tax cuts might mean for the future. With that said, let me quote famous investor, Warren Buffet, in saying, *"If past history was all that is needed to play the game of money, the richest people would be librarians."*

Key Starting Points

- Some portion of tax cuts will be passed along to investors.
- History generally shows that companies don't see as big a benefit from tax cuts as many may think, on aggregate.
- Market valuations relative to interest rates are likely a stronger driver for 2018 returns, but may be overshadowed by tax talk.
- Removing uncertainty is the real win for markets.

Part of the stock market's growth in 2017 was directly related to the possibility of tax cuts coming. Many companies built some amount of future tax cuts into their 2018 earnings projections. As a result, this optimism for increased earnings helped add to the market rally in 2017. Additionally, lower corporate tax rates certainly will not hurt companies in 2018, and will allow some added money flow into the economy. Higher dividends, stock buybacks, bonuses, increased salaries, debt pay down, buyouts, expansion, among other items, are ways in which companies may deploy the benefit of the tax cut; while all of these moves are likely to be beneficial, some of them have greater employee, market, and economic benefit than others.

History shows the actual benefits of a tax cut are usually not as large as many may think. For example; after accounting for tax breaks and structural work-around, U.S. corporate rates are well below the 35 percent top statutory rate and are currently in-line with corporate rates in similar countries.
(source: The Treasury Office of Tax Analysis)

*Specifically, the average corporate tax rate on profits from new investments made in the U.S. is 24 percent; the average corporate rate on profits from new investments made by companies in other "Group of Seven" (G-7) industrialized, democratic countries, weighted by the size of their economies, is 21 percent.**

While cutting the corporate rate from 35% to 20% will certainly help some companies, many larger companies pay around 24% under current law, using existing tax breaks and allowable structures. Therefore, the new tax code will simplify this element, but the tax-break may not be as profound as it appears at first glance.

*Since 1927, corporate taxes have been reduced 10 times, and the year following a tax cut, U.S. stocks have risen six times - 60% of instances - averaging 11.3% increase per year. Conversely, corporate taxes have been increased 13 times over that period, seeing stocks rise the next year nine times - 69% of instances - averaging 12.5% annually. Cuts? Hikes? The stock market seems to experience the same frequency and size of gains, regardless.**

The bigger driver of stock returns long-term, tends to be valuations relative to interest rates.** Visualize buying a home for a moment. With interest rates at 15%, the amount of home you can afford is much less than it is today when rates are much lower. Why? Higher interest rates cause your monthly payments to be much higher because of the greater cost of borrowing. If your mortgage rate dropped to 2%, you could afford a much larger home. The same dynamic holds true with valuation of a stock market made up of companies, which are comprised of assets that drive earnings. Companies can return much more cash to shareholders when interest rates are lower. If rates get too high, the company will need to allocate more of its earnings to pay down debt, which slows growth, netting less money returned to shareholders in the form of dividends.

The current market expectation of 6-8% annualized returns over the next 5 years may seem low relative to possible temporary declines of 20, 30, or 40%. However, when compared to a 2.4% yield on a 10-year Treasury Bond, a 7% return possibility still looks really good. Until we experience a major fear event or higher interest rates; stocks will continue to look like the best game in town, albeit at a much higher level of risk than eight years ago. With Jerome Powell as new Fed Chairman, and pressure to leave interest rates very low while reducing bank regulations, we may have an environment for continued market appreciation. With the trend already in motion, corporate tax reform will certainly not hurt the cause of market growth, but the real driver is likely a relationship between interest rates and stocks. In other words, do you want a bond that earns 2.4% or a stock with a 7%+ potential? Until fear intensifies, most investors are choosing stocks.

The ultimate win from tax reform has been the removal of uncertainty. Similar to the presidential election, we have less uncertainty today than we did before the tax law changed. Inevitably, some companies and people will win and some will lose from the change. The certainty now provided allows us as managers to more accurately evaluate each investment with a deeper understanding of the tax consequences of each company's business strategy. We know companies whom compete solely on price will have increased competition as a result of lower taxes, as new competitors might now be able to underbid them. Companies who maintain stronger brands and service offerings will likely be able to capitalize on retaining more benefit from the tax cut. Moreover, additional clarity around taxes will improve investors' ability to perform quality analysis of stocks considered for investment, which is always good.

Stephen L. Hanley,
Investment Strategist
Evergreen Wealth Management

History shows the markets win after a tax cut OR tax hike more often than not, simply due to added clarity about the future. We are bullish because of this clarity but we understand each event and time is unique. Interest rate fluctuations will loom large in moving the long-term market dial, and we must keep a close eye. The future will not be the same as the past and we must remain disciplined to not exercise poor judgment of extreme optimism or pessimism but rather choose a balanced path, rooted in data and fundamentals, to best achieve your objectives.

Disclosure and References

*(The Treasury Office of Tax Analysis, USA Today, Ken Fisher)

**Vanguard Research, Forecasting Stock Returns by Joseph Davis, Ph.D., Roger Aliaga-Díaz, Ph.D., Charles J. Thomas, CFA

***Methodology for projected 6-8% nominal equity return.

Method 1: Vanguard Research, Forecasting Stock Returns by Joseph Davis, Ph.D., Roger Aliaga-Díaz, Ph.D., Charles J. Thomas, CFA.

Method 2: Dividend +Earnings Growth + Valuation = current S&P 500 dividend of 2% + 5 year Earnings Growth of 3-5% + Valuation of -2 - +2%. = 3% to 9%

Method 3: SPY: Book Value: $798.64, Average ROE: 12.7%, Reinvestment Rate: 40%, Price (SPY): $2,716

Using this information, we can compute growth in equity and earnings at 5% annually ([$798.64*.127*.4]/$798.64) and shareholder payouts (dividends and share repurchases) of $76.20 (.127*.6*$798.64), which gives us a yield of 2.8% on the price of $2,716. US stocks could expect earnings power to increase by around 7.8%/year, owing to 5% growth in book value (and therefore earnings at constant ROE) and a 2.8% yield. Returns over time would equal this gain in earnings power after adjusting for any changes in valuation.

Gifting With Irrevocable Trusts?

When we talk with our clients about how to protect their financial legacy, we will often recommend that property be gifted into an irrevocable trust. Invariably, the client will ask whether they can just gift property to the children instead. After all, wouldn't that be simpler and less expensive?

The answer to this question is "yes," a person CAN gift property directly to the kids and forego the irrevocable trust. The better question, however, is whether you SHOULD?

In this article, we'll take a look at why an irrevocable trust is usually the preferred way of holding gifted property.

Why not just gift the property directly to a child or other person or entity?

When property is gifted to an individual instead of held in an irrevocable trust, the gifted assets are at risk. Having the asset owned by the individual will subject that asset to that person's liabilities (debts, health care expenses, lawsuits, divorce, etc.). Also, if that person dies, those gifted assets will be subject to probate in that person's estate, which can be public and costly. Some may suggest that a solution is to gift the property to several people, but the more people's names you put on an asset, the greater the risk. For example, the property will avoid probate if one dies, but it is now subject to all of the owners' potential liabilities.

If you want to protect assets from the cost of a potential nursing home stay or to make sure that a special needs child is cared for without giving it outright to the child, then you should use an irrevocable trust. By putting assets into an irrevocable trust, rather than giving them directly to the child, you can accomplish a number of things:

1. The assets will not be in your name, and therefore they will not be counted against you for Medicaid purposes;
2. The assets will not be in any child's name (which would cause them to lose their benefits if they have special needs);
3. The assets will not be in the child's name, and are therefore not subject to the child's potential liabilities (for example, divorce, disability, creditors);
4. The irrevocable trust keeps the assets out of probate – if the child dies, a new trustee steps in and manages the property in accordance with the trust instructions;
5. The trust provides clear, written, and enforceable instructions for how the trust assets are to be used, ensuring that the assets will be used for their intended purposes; and
6. The trust can allow for co-trustees, which allows the trust assets to be co-managed and for the co-trustees (usually your kids) to work together and share the responsibility.

Richard Chamberlain,
Founder and principal attorney
of Chamberlain Law Group, Ltd

As you can see, using an irrevocable trust to gift property can be much better than gifting property outright to children or others. However, it is extremely important to ensure that the trust is drafted properly and that the proper procedures are used to ensure the most efficient transfers.

If you are interested in talking about how an irrevocable trust can help you, please call our office to set up an appointment and meet with one of our attorneys.

Fourth Dimension Financial Group, LLC
27121 Oakmead Dr. Suite B
Perrysburg, OH 43551

Fourth Dimension
Financial Group, LLC

Fourth Dimension Financial Group exists to help people seeking financial retirement achieve enough, live fully, and help others do the same. Appearing regularly in national industry publications and local media for retirement planning insights, Adam and his team of highly-focused and passionate advisors help clients achieve greater clarity in their planning.

Fourth Dimension's clients benefit from the use of world-class income planning, tax reduction, and risk management strategies, resulting in a retirement plan that works in any economic conditions rather than one built on hope and luck.

To your success,

Founder, Principal, and Retirement Income Certified Professional®

Adam Cufr, RICP®
Fourth Dimension Financial Group
Call (419) 931-0704
Email adam@fourthdimensionfinancial.com
Visit www.FourthDimensionFinancial.com