Quarterly Newsletter

Roth FINANCIAL PARTNERS

Q4

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The Noise

By: Peter Roth
Financial Advisor

2023 turned out to be an interesting year from just about any angle you viewed it from: politically (discord), monetarily (policy), geographically (wars/immigration), climatically (weather extremes), health care (continued pandemics), socially (woke), technologically (think cyber/ AI), etc. The net result was a great deal of emotions on ever shifting sands that continued to cause an even greater level of uncertainty across all fronts. And that is a perfect recipe for volatility, which is exactly what the capital markets exhibited. After a somewhat stable and profitable start to the year for the first six months (and after a very ugly 2022), investment returns took it on the chin starting last August through October, leaving our noses slightly above water for the first ten months of the year. A sudden and complete reversal then took place and stocks (i.e. S&P 500) when straight through the roof during the last two months of the year: up over 16%. That final push enabled portfolios to end on a very positive note and offset a significant portion of the negative returns endured in 2022.

The downdrafts are never fun, but they are the very reason that have enabled stocks to deliver substantially higher *long-term* compounded returns over bonds or cash. The key is to *not* react emotionally and stay the course. There will always be a short-term reason to doubt, second guess, change course, or try and time the markets.

At the end of the day, if you open the hood and look at what you own, you have equity ownership in great companies that have real and tangible products or services managed by very smart people diversified across a broad spectrum of industries across the world. You (we) own those companies for what the anticipated future value will be in a *minimum* of five to seven to ten years down the road. *Not* months, *not* weeks, and *not* days. These are real business. What you can't control are the day-to-day emotions (that God wired us all with) in others. It is those knee jerk reactions that can cause severe short-term turbulence, and that is never fun. In summary, your portfolios are built for the long-term flight, and short-term turbulence is sometimes just part of the ride. Addendum: I suspect the background noise will pick up substantially as we close in on what may prove to be a very contentious election this fall. Remember we have been going through this cycle for almost 250 years. It's just part of the ride.

S&P 500 Comments

The S&P 500 (index) was created in 1957 and the 500 stocks represent the largest publicly traded companies in the U.S. The stocks fall within eleven different sectors (i.e. technology, communication services, financials, industrials, energy, etc.) and the index is intended to be represent a bellwether for the U.S. economy. It is one of the most widely quoted indexes (similar to the Dow Jones 30) and, for most people, can represent a benchmark for performance comparison purposes.

There is a caveat, however. The S&P 500 is a market capitalization-weighted index. Market capitalization represents the total dollar market value of a company's outstanding equity shares: calculated by multiplying the total number of outstanding shares of stock by the company's current stock price. As a result, the more valuable an individual company's stock becomes, the more it contributes to the S&P 500's overall return. Case in point: on average, 3% of the stocks (a total of 15 companies) routinely contribute up to 50% of the index return. It is not uncommon for three-quarters of the index's return to be linked to only 50 -75 stocks.

Last year, The S&P 500 index was up 26.3% (dividends reinvested). The technology sector, which makes up 28% of the overall weighting, was up just under 56%. Rough math says that sector contributed about 15.8% of the 26.3% of the overall return. Huge. Take it a step further. Apple (AAPL), which makes us 7.6% of the S&P 500, was up 45% in 2023. That equates to a contribution of 3.4% of the 26.3% overall return. Had all eleven sectors been equally weighted, the S&P 500 index would have been up just under 17% last year.

Where am I going with this? Higher concentrations in a fewer number of stocks/sectors can be very rewarding (and a lot of fun) while they are going up, and equally disappointing and sometimes devasting when they are going down (i.e. tech bubble in 2000 – 2002). Our goal, as investment managers, is to tailor and match your portfolios to your overall financial objectives and the appropriate level of risk (that you need to take, want to take, and are able to take) that will result in a high level of probability of sustaining you and your family until the end of your life and enable you to do all the things that are important to you.

For almost every single one of our clients, beating the S&P 500 index is probably not one of the objectives. Having said that, we do want to harness those raw returns and we do have that direct exposure in your portfolio. We then wrap other strategies (i.e. equal weighted index, fixed income, international exposure, etc.) to dampen and reduce volatility to the extent we can. In summary, it is a bogey we keep our eye on and a tool we use in our portfolios, but it is not our end objective.

Delayed Gratification

By: Eric Johnson
Financial Advisor

One of the books on my "wish list" (which keeps growing longer and longer) is "Your Future Self," written by UCLA management professor Hal Hershfield. The book discusses how we can "connect" to our future selves to do things today to potentially make an improved future self a reality. One concept discussed in the book is a psychological bias known as "hyperbolic discounting." It is well known that humans struggle with delayed gratification – we would much rather receive an immediate reward than wait for a bigger prize. Hyperbolic discounting takes it a step further and states that humans will disproportionally discount rewards that they could receive in the near future. In other words, rewards in the distant future that you already expect to receive are easier to wait for (and therefore, you are less likely to choose to negatively impact the reward) than shorter delays of rewards sometime soon.

At the end of 2017, the Republican-controlled Congress passed the Tax Cuts and Jobs Act ("TCJA"), which amended the Internal Revenue Code of 1986 by, among other changes:

1. Modifying both individual and corporate tax rates (mostly decreasing rates for a similar amount of income as pre-amendment),
2. Altering the decision between taking a standard deduction or compiling a list of itemized deductions by increasing the dollar amount of the former (while also ending personal exemptions for filers and dependents) and reducing instances of the latter (such as limiting state-and-local tax ("SALT") and mortgage interest deductions), and
3. Doubling the estate tax exemption, which reduced the number of estates potentially liable for estate taxes.

Like all Congressional budget measures, the Congressional Budget Office (CBO) produced a cost estimate for the Act that (unsurprisingly!) anticipated that the bill would add to the deficit over the next ten years. To reduce that deficit estimate figure, Congress added a sunset provision that would allow for many of the changes to revert to pre-TCJA levels after December 31, 2025. Only an additional act of Congress can keep tax rates where they currently stand. The drafters of the 2017 bill "kicked the can" of long-term tax policy to their future selves. As we are now within a two-year period until this sunset occurs, we are in the "short-term" period in which hyperbolic discounting can rear its head.

Let us set up a hypothetical example of a married couple taking required minimum distributions (RMDs) and receiving Social Security income. Below are their estimated and planned income items for 2026:

For this couple, though total income is $102,000, only $86,000 counts when looking at the tax brackets (as only 85% of this couple's Social Security income is taxable and the qualified dividends and long-term capital gains are tax-advantaged at a lower rate.)

If there was no sunset provision and we inflated the tax brackets (and other tax items) to 2026, assuming a standard deduction, the couple would be in the 12% marginal tax bracket with room to spare. If, however, we revert to pre-TCJA levels (again, inflation-adjusted), then the couple would be in a 15% marginal tax bracket. As a reminder, the marginal tax rate is the tax rate on your next dollar of income (while an effective tax rate is your total tax bill divided by your total taxable income).

On the face of it, a 3% difference in marginal tax rate seems small, but note that I included the term "planned" in my lead-up to providing the income items. And in running the math, the increase in tax between the TCJA and pre-TCJA brackets with this amount of income is only about $1,000. However, what if there is a $50,000 unplanned expense that must come from the wife's IRA? This would increase the tax increase from $1,000 to almost $3,000 – and the years going forward (as far as we would know) would have that same potential increase if the couple needed additional funds above what is planned. It may make sense to take advantage of the space in the current 12% marginal bracket in the next two years if it keeps you from potentially being liable to be in the 15% (or higher) bracket in the future.

It is not as simple, though, as assuming taxes will increase if we revert to pre-TCJA levels. It would be a fair assumption that the tax *rates* would increase, but there was also a change in the deductibility of certain items, such as SALT and mortgage interest. If your SALT is large enough (and has been limited to the $10,000 maximum since TCJA passed), it may overwhelm the change in your tax rate, decreasing your tax bill (though the issue above about marginal tax rates and unplanned expenses still stands.)

From an estate tax perspective, the federal estate tax exemption increased to $13.61 million per individual in 2024 (so married couples can double that). The exemption means, on an extremely high level, that you would not be liable for estate taxes upon your passing until your estate is greater than that value. If roughly halved when TCJA sunsets in 2026, then it is married couples with estates around $15 million (and/or individuals with about half that) that may have additional planning to do in the years ahead. As a reminder, there is no "claw back" on gifts made during this increased exemption period under TCJA – if you give more than the revised exemption amount during this period, an additional exemption will be granted up to the excess estate tax exemption.

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Around The Office Updates

Looking Into Q1

Preparing for Tax Season

Round one of 1099s will be sent by February 15th. If necessary, rounds two and three will be on February 28th and March 15th, respectively.

PJ Party!

Jimmy and Sandi had a very fun and hilarious Christmas with their three kids (Kaylee is 6, Maggie is 4, and Casey just is turning 1 in February!) Traditionally, the pre-bedtime routine is supposed to be calming in nature; however, these three seem to ramp things up and get even more energetic when they get their PJs on. It's very loud, but very fun!

Rollin' Rollin' Rollin'

Eric, Jonah, and Abe all got scooters for Christmas and now, whenever it isn't freezing or raining, you can find them rollin' all around the neighborhood!