HILLIARD LYONS TRUST

A Baird Company

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# Hilliard Lyons Trust Market Commentary

## This Year Is Testing Everyone

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I learned an important lesson early in my investment career roughly 38 years ago. My first and most important mentor in the business said, "You will get tested on every investment you make, and you need to be prepared to pass that test."

He further explained that as the price of any stock you own declines, it will seem as though the market is questioning your wisdom. This will test your conviction in that holding and your ability to avoid selling due to fear of further loss. The best way to pass the test is through diligent effort, preparation and research before you are even tested. Since there is no perfect investment or certain outcome, the best you can do is try to stack the odds of success heavily in your favor. Even then, you will be tested.

That mentor gave me this sage advice concerning individual stock and bond holdings, but this idea of being "put to the test" applies much more broadly in today's world. We are being tested simultaneously in the investment markets, the economy and even in the fabric of society.

### The Fed to the Rescue

Both the bond and stock markets experienced extreme volatility in the first half of the year. When the COVID-19 pandemic began its most aggressive spread in late February and March, bond market liquidity rapidly dried up. Traders had no idea how to accurately price bonds due to uncertainty created by the developing health and economic crisis. Just as the markets were on the verge of paralysis, the Federal Reserve (Fed) stepped in with great resolve on March 23 and pledged to do whatever it takes to support the economy and stabilize the functioning of markets. Aggressive Fed actions since then restored a more normal functioning bond market.

### Extreme Volatility

In the stock market, the shutdown of the economy in response to the spread of the virus led to a 34% decline in the S&P 500 in the span of just five weeks. Then, after the massive policy responses by the Fed and Congress, the market rose an equally shocking 40%, ending the first half of the year down only 3%.

During these six months we experienced three of the largest 25 daily percentage declines and two of the largest 25 daily percentage gains in the past 90 years. After seeing daily market moves of 3% or more only eight times in the past seven years, there have already been 26 so far in 2020. The speed and depth of the decline followed by the vigorous recovery left many investors dazed and confused.

### Lockdown Leads to Recession

In the first half of the year, the economy experienced what is likely one of the shortest and deepest recessions in history driven by the two-month economic shutdown. The U.S. economy went from the lowest unemployment in 50 years to the highest in 90 years in a span of two months. A year ago, continuing jobless claims in the U.S. were 1.7 million people, the lowest in 50 years. This jobless number peaked at 25 million in early May and now stands at slightly over 19 million. You get the idea - the amount and velocity of economic destruction is staggering. As parts of the economy began reopening in May and June, the economic numbers bottomed and started improving. At this point, we believe the recession is likely over. However, the reopening has been bumpy and is leading to another surge in cases of the virus. The economic future is, of course, uncertain, but we are optimistic the worst is behind us.

## Social Unrest Adds Uncertainty

Near the end of the second quarter, a massive social justice movement swept across the streets of America. Scenes of protestors clashing with police, destruction of property, and even loss of life rocked the nation. This comes at a tough time for a country already dealing with the societal and economic devastation caused by the response to the COVID-19 pandemic. At this point, we believe it is highly likely that government and business leaders will take action to address some of the societal inequities that have burdened our nation for so long.

The first half of 2020 was one of the most turbulent and volatile periods on record. We are being tested on multiple fronts as individuals and as a country. The shelter-in-place orders, rapid shift to working remotely and lack of social interaction creates an unhealthy amount of isolation and rising anxieties. We are all feeling it. And yet, one of the key ingredients to successful investing is to look rationally and optimistically toward the future.

## Looking Forward with a Healthy Mindset

Investing is always a forward-looking activity. We invest today with the expectation of some rate of return in the future. We know the past with certainty, but the future is uncertain. To make a successful investment, an investor must have a rational sense of optimism about the future. That explains why it is so difficult for some people to make a new investment near the low point of a long market decline or the bottom of a grueling recession. During such difficult circumstances, many investors focus on the near-term negativity and lose their optimistic, long-term outlook.

It's in these times when it is most helpful to turn to the wisdom of Warren Buffett. At Berkshire Hathaway's annual meeting in May he said this: "It has never paid off to bet against America. We have come through things, but it's not always a smooth ride." He continued, "We always live in an uncertain world. What is certain is that the United States will go forward over time." It is important to put today's challenges into historical context. We should remember that this country has faced some very difficult challenges in the past, some much more difficult circumstances than today. Despite this, we have always moved ahead to a brighter future. In fact, many of today's challenges offer our nation an opportunity for long-term improvement and growth.

The range of possibilities for the second half of the year is quite wide. It could be a glorious time of successes or continued tough times. We do not know how quickly we can get the virus hotspots under control and make further progress in reopening the economy. But we do know how to slow the spread if we have the will. We do not know when we will have more effective therapeutics to treat and eventually a vaccine to prevent the virus. But we do know that the smartest minds in medical research are working around the clock to bring robust treatments and vaccines to market at speeds never thought possible. Medical breakthroughs might be attainable in the next few months. We do not know how much progress will be made in addressing the underlying causes of societal inequities. But we do know that leaders appear ready to make substantive and lasting change. To top all this off, we also have an election in November that has a wide range of potential outcomes.

## Living with Uncertainty

Life is always uncertain, but sometimes we have trouble recognizing uncertainty. September 10, 2001, was uncertain; we just did not know it until the events of the next day. In January of 2020, as the economy was humming along and the stock market was setting new highs, it was a highly uncertain time, although we did not recognize it as such. Contrary to those examples, the uncertainties faced today are easy to see. But history tells us that we should remain humble about our ability to know what the future holds. That is why Hilliard Lyons Trust has always structured your portfolios with financially strong and durable stocks and bonds. Experience tells us that occasionally, tough times come along unexpectedly, and portfolios should be assembled with that in mind. For decades, our strategy has enabled our clients' portfolios to stand the test of time. Those portfolios are being tested again today, and we feel they are well prepared to pass the test.

Thank you for entrusting your financial assets to the care of Hilliard Lyons Trust. Especially during these challenging times, we are working hard to earn your continued confidence in us. We hope you and your loved ones remain in good health in the months ahead.

# Understanding Environmental, Social and Governance (ESG) Investing

**Ross A. Demmerle**
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Demand in ESG investing (Environmental, Social and Governance) has seen a significant increase with investors in recent years. At its core, it is simply a set of criteria used to screen potential investments with a socially conscious focus. Also known as socially responsible investing, the initial aim was to exclude companies in unfavorable industries (fossil fuels, tobacco, firearms, gambling, among others). However, ESG investing has evolved to also be inclusive of companies that encourage sustainability.

The investment industry is beginning to embrace ESG investing. Asset managers are adding ESG funds or changing the names of old ones to be associated with the movement. Unfortunately, definitions of ESG criteria can vary widely across firms, resulting in a lack of consistency and potential confusion for investors. Terms like green, impact, values-based, social or ethical investing can mean different things to different people. In the coming months and years, it is likely that regulatory bodies will need to push for increased reporting, transparency and consistency.

We believe the rise of ESG investing, while not perfect, is a positive development for both business and society. It will increase accountability and push investors and companies to think more holistically. In August 2019, 181 Chief Executive Officers of the Business Roundtable released an updated Statement on the Purpose of a Corporation. This new statement emphasized that a corporation's purpose is to serve all stakeholders rather than solely its shareholders. The change embodies an ESG-oriented mindset with a broader focus on delivering value to customers, investing in employees, dealing fairly and ethically with suppliers, supporting the communities in which they work and generating long-term value for shareholders. While these principles are not new, they are being brought to the forefront today so leaders can better understand what it means to be a good corporate citizen.

The evolution towards an ESG-oriented mindset from corporate leaders and investors has been underway for years. In addition to the legally required regulatory disclosures, many companies are now providing annual sustainability reports outlining how they are living up to these higher standards. Analysts and investors are increasingly integrating these reports and data into their analysis of companies as a supplement to traditional financial analysis. Furthermore, third party ESG scoring companies are another new development, providing additive analysis of ESG criteria, increasing transparency, but also adding another layer of fees.

At Hilliard Lyons Trust, the foundation of our time-tested investment philosophy is our long-term business owner mindset. Our process aims to find high-quality companies with attractive financial characteristics, durable competitive advantages and strong leaders trading at compelling prices. We believe the appropriateness of an investment should not only be based on quantitative economic considerations but also on the qualitative aspects of its management team and board of directors. We do not pursue an ESG investment objective, but we believe the companies we typically look for often do embody an ESG-oriented mindset. For a company to be highly successful over time it must take all stakeholders into consideration.

While we do not consider ourselves to be an ESG manager, it is reassuring to find our portfolio companies continuing to recognize the needs of all stakeholders in the current environment. In a number of different ways, we've seen companies take actions to provide some relief to stakeholders impacted by the pandemic, including:

- deferring loan payments (CarMax, JPMorgan Chase, Bank of America, Northern Trust, U.S. Bancorp, Wells Fargo)
- committing new lending to underserved communities (JPMorgan Chase, Bank of America, U.S. Bancorp)
- refunding auto insurance premiums (Progressive, Berkshire Hathaway)
- medical donations (Apple, Johnson & Johnson, Microsoft)
- researching and testing for a COVID-19 vaccine on a nonprofit basis (Johnson & Johnson, Pfizer)
- procuring personal safety equipment (Fastenal)
- remaining open as an essential business while protecting employees and customers (Expeditors, Home Depot, Union Pacific, O'Reilly)
- accommodating employees' ability to work from home (many companies)
- providing supplemental employee bonuses or hourly pay increases (JPMorgan Chase, Home Depot, U.S. Bancorp)
- donating to COVID-19 relief funds and organizations (many companies)

While these constructive actions may diminish near-term financial results, we believe these actions are likely to benefit shareholders in the long run. A firm's ability to report strong fundamentals over time is enhanced by being a good corporate citizen.

Our ultimate objective is to responsibly manage and grow your wealth at an attractive rate over the long term. In order to achieve this goal, we invest in high-quality businesses that create value for all stakeholders – customers, employees, suppliers, communities and shareholders. Your portfolios contain numerous stocks and bonds of these types of businesses, which we believe will help you achieve your investment goals over time.

# Estate Planning Under the Secure Act

**Willis W. Hobson, J.D.**
Senior Vice President
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On January 1, 2020, the provisions of the "Setting Every Community Up for Retirement Enhancement Act" (the "SECURE Act") became effective. Included in the terms of this act is a requirement that, after the death of the owner of an Individual Retirement Account ("IRA"), most named beneficiaries must fully withdraw the assets in the account by December 31 of the 10th year starting with the year after the Account Owner's death (hereinafter referred to as the "10-Year Rule"). All withdrawals are subject to income taxes. There are a few exceptions to this rule, such as the Account Owner's spouse and any minor children, as well as disabled and chronically ill beneficiaries or a beneficiary who is less than 10 years younger than the Account Owner.

No distributions are actually required under the 10-Year Rule until the end of the entire period, but all assets in the decedent's IRA must be distributed by that date.

This is quite a change from the previous law, which allowed correctly designated non-spouse death beneficiaries to defer withdrawals from an Inherited IRA (and therefore defer income taxes), over a period determined by the beneficiary's life expectancy at the time of the Account Owner's death. The benefits of long-term income tax deferral made careful beneficiary designation planning an integral part of a person's estate plan. Now, due to the SECURE Act, the opportunities for income tax deferral are limited, and depend on the Account Owner's choice of beneficiaries.

**1. Spousal Beneficiary**

If the Account Owner's surviving spouse is designated as beneficiary, upon the Account Owner's death, he or she may elect to treat the IRA as his or her own. If that election is made, no distributions need to be taken until the spouse reaches age 72. Thereafter, minimum annual distributions will be based on the surviving spouse's life expectancy. The surviving spouse may designate additional beneficiaries to receive any undistributed proceeds remaining at his or her death, but those beneficiaries will be subject to the 10-Year Rule.

**2. Minor Children as Beneficiaries**

The Account Owner may designate his or her minor children as the death beneficiaries of an IRA. A minor child receiving an interest in a deceased parent's IRA is allowed to make annual withdrawals based on his or her life expectancy at the time of the parent's death, until the child reaches the age of majority under the laws of his or her state of residence. Once the child reaches the age of majority, the account becomes subject to the 10-Year Rule. It is important to note that only the minor children of the Account Owner qualify for the life expectancy deferral.

**3. A Disabled and/or Chronically Ill Person as Beneficiary**

A "Disabled Person" as defined under I.R.C.§ 72(m)(7), or a "Chronically Ill Individual" as defined under I.R.C.§7702B(C)(2), may defer income taxes over a period based on his or her life expectancy at the time of the Account Owner's death. The disabled status must exist at the time of the Account Owner's death. A beneficiary who becomes disabled or chronically ill after the death of the Account Owner is not allowed to use life expectancy deferral treatment.

**4. Charity as Beneficiary**

If a charity is designed as the beneficiary of the plan, the benefits will pass to the charity without the imposition of income or estate tax. The 10-Year Rule does not apply.

**5. Charitable Remainder Trust as Beneficiary**

If a Charitable Remainder Trust is designated as a beneficiary, the IRA is paid to the trust at the owner's death. The trust, being a charitable entity itself, pays no income taxes, so the 10-Year Rule is not a factor. The trust will make the annual required distributions to the non-charitable individual beneficiary and, when the trust ends, the remaining proceeds will be distributed to the charitable beneficiary, tax-free.

**6. Non-Spouse as Beneficiary**

A person designated as the death beneficiary of an IRA who is not the spouse of the Account Owner, and who is more than 10 years younger than the Account Owner, generally must withdraw, and therefore pay income taxes on, the entire contents of the IRA by December 31 of the 10th year after the Account Owner's death starting in the year after the Account Owner's death. Under the 10-Year Rule, the beneficiary can withdraw the resources of the IRA at leisure. There is no requirement that annual withdrawals be made during the period, but all resources MUST be withdrawn by the end of the tenth year.

Under the 10-Year Rule, the beneficiary may strategically plan withdrawals from the IRA to minimize income taxes. In years the beneficiary has lower taxable income from other sources, he or she may choose to withdraw larger amounts from the IRA. Likewise, the beneficiary can choose to withdraw smaller amounts, or even make no withdrawals at all, in years that he or she enjoys larger amounts of taxable income from other sources. But, again, all assets remaining in the account must be removed by December 31 of the 10th year, after the Account Owner's death, starting in the year after the Account Owner's death.

An individual who is not the spouse of the Account Owner and is less than 10 years younger than the Account Owner, or even older than the Account Owner, may take required minimum distributions over a period determined by his or her life expectancy at the time of the Account Owner's death, even if that period is actually longer than 10 years.

**7. Trust as Beneficiary**

It is possible to designate a carefully created trust as the death beneficiary of an IRA. If the trust qualifies as the beneficiary, the trustee may establish an inherited IRA account in the name of the trust.

The type of trust involved determines how the trustee will utilize the Inherited IRA.

- Conduit Trust – If the terms of the trust indicate that the trustee is required to distribute all resources removed from the inherited IRA directly to the beneficiary of the trust, the trust is known as a "Conduit Trust." In that case, the other possible beneficiaries of the trust are disregarded and the conduit beneficiary is considered to be the sole death beneficiary of the IRA. If the beneficiary is the surviving spouse of the Account Owner, a Conduit Trust allows income tax deferral over a period of time based on the life expectancy of the surviving spouse. At the death of the surviving spouse, if any assets remain in the account, they must be distributed according to the 10-Year Rule. If anyone else is the beneficiary, all assets must be removed, and therefore paid to the beneficiary, under the 10-Year Rule unless the conduit beneficiary falls under one of the exceptions outlined above.
- Accumulation Trust – If the terms of the trust do not require that all distributions taken from the trust's inherited IRA be passed directly to the beneficiary of the trust, the trust is considered to be an "Accumulation Trust." In that case, the inherited IRA must be withdrawn according to the 10-Year Rule. The terms of the trust will direct the trustee as to the use of the withdrawn IRA funds.

Due to the imposition of the 10-Year Rule, the use of a trust should be carefully considered.

**8. Failure of Beneficiary Designation**

If the Account Owner designates his or her estate, or simply fails to designate a beneficiary at all, or if the designated beneficiary and any contingent beneficiaries all predecease the participant, the beneficiary will be the participant's estate.

Any IRA resources remaining in the estate at the end of administration may be distributed to the heirs of the estate. The income taxes must be paid within five years of the participant's death, if the decedent died before April 1, of the year after the year of the Account Owner's 72nd birthday. If the Account Owner died after that date, the income taxes may be deferred over a period of time determined by the life expectancy of a person the owner's age at the time of his or her death. This period of time can never be more than 15 years. The period is determined by reference to the Single Life Table, Reg. Section 1.401(a)(9)-9,A-1.

For additional information, please contact a Trust Officer or Portfolio Manager. Hilliard Lyons Trust Company, LLC does not provide tax or legal advice. In order to determine the appropriate tax and legal actions for your individual situation, you must consult your own attorney and/or accountant.

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