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# Hilliard Lyons Trust Market Commentary

## The Willing Suspension of Disbelief

**John C. Watkins III, CFA®**
Vice President
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*"Many times over the course of my career, I've been amazed by how easy it is for people to engage in willing suspension of disbelief… people's tendency to dismiss logic, history and time-honored norms. This tendency makes people accept unlikely propositions that have the potential to make them rich… if only they held water."*

**Howard Marks, "The Most Important Thing"**

It is hard to believe that only 12 months ago my 1Q20 market commentary was titled "This Too Shall Pass" and was written at the depths of the COVID-19 bear market. At that time, the market was in free fall, uncertainty and fear were palpable, and the prevailing sentiment was to avoid risk at all costs. When saying "This Too Shall Pass," I certainly did not think it would pass so quickly and so forcefully. Only one year later, it feels as though the script has been flipped. Extreme risk aversion has given way to risk tolerance and even an affinity for taking aggressive risks.

This embrace of risk is leading to excessive speculation in three general areas:

1. Extreme valuations of unprofitable technology companies
2. Increase in day traders with a short-term gambling mentality
3. Rising popularity of nonproductive assets such as Special Purpose Acquisition Companies (SPACs), cryptocurrencies, and collectibles

We believe participating in these areas of speculation will lead to poor long-term outcomes for those involved. We have never participated in these activities and have no plan to in the future.

### Valuations Detached from Reality

Over the past year, unprofitable technology companies have soared in popularity. This includes businesses in cloud software, financial technology, ecommerce, green energy, and electric vehicles, among others. Because most of these companies are unprofitable, valuation on traditional metrics no longer applies. Instead of earnings or cash flows, it is common to see analysts and investors using a company's revenue as a basis for determining its value.

We believe valuing a business based on its revenue is illogical. The long-term economic value of an enterprise is based on the total cash flows or profits it generates over time *after* expenses (salaries, advertising, research & development, etc.), not *before* them. If a company is perpetually unprofitable (expenses are larger than its revenue), it has no economic value regardless of how much revenue it generates.

The number of technology companies currently trading at a price more than 15x their revenue is at levels not seen since the tech bubble in the 1990s. Bernstein recently published data showing 366 technology stocks currently trade at 15x sales or higher compared to only 25 such stocks in 2017. Their research also shows that over the last 50 years, stocks priced above 15x their revenue dramatically underperformed the broader market over the following five years.

Today, hundreds of companies are being priced as if they are the next Amazon. In 1999, Amazon's stock price peaked at $106/share and over 50x its annual revenue. With the benefit of hindsight, it is easy to point out that purchasing Amazon in 1999 at this extremely high multiple would have resulted in a truly extraordinary return over the next 20 years. Unfortunately, the path for investors was far from easy. Investors would have had to accurately predict that the online bookstore's revenue would increase 241-fold to $386 billion annually. Additionally, investors would have had to endure extreme volatility along the way. Amazon's stock fell 95% from 1999 to 2001, only recovered to its original 1999 peak in 2009, and suffered five declines of 25% or more since 2009.

It is easy to forget the thousands of other companies trading at high price to revenue multiples in 1999. The vast majority of those businesses no longer exist. When we look back on today's extreme valuations 20 years from now, there will likely be a few companies we can point to as huge winners even from today's elevated price to revenue multiples. However, by then, we will have forgotten about the hundreds of similarly positioned companies that no longer exist, and that led to devastating financial losses for investors.

## Short-term Gambling Mentality

In addition to these extreme valuations, investor time horizons are rapidly shrinking with day trading once again gaining popularity. The rise in day trading is driven by apps like Robinhood, which are designed to resemble sports betting apps and have zero commissions. This mentality is exacerbated by the ability to brag about winning trades on social media and portray the illusion that it is easy to get rich quickly in the markets.

Get-rich-quick schemes are almost always a myth, and much of this day trading mania emphasizes strategies that are complex and carry substantial risk. It has never been more popular to purchase stocks using leverage or to use short-term stock options to make bets on daily fluctuations in stock prices. Even penny stocks, an area rife with fraud, are seeing the highest trading volumes since 2000. We believe these sorts of strategies are akin to buying lottery tickets, which carry a low probability of a huge win but a high probability of a 100% loss. When combined with the extreme valuations in the technology sector, this gambling mentality is a recipe for financial disaster.

## Nonproductive Assets are Booming

We define nonproductive assets as those which do not produce any cash flows. Gold and other commodities are classic examples of nonproductive assets. Today, interest is rapidly growing in newer forms of nonproductive assets such as cryptocurrencies, traditional collectibles (sports cards, sneakers, etc.), and even a new kind of digital collectible called a non-fungilble token (NFT).

We would also classify Special Purpose Acquisition Companies (SPACs) as nonproductive assets. SPACs, aka "blank check companies," are shell companies with no operations. They raise money intending to acquire a private company within two years. SPACs are not businesses. They are just pools of idle cash waiting to make an acquisition, often at a high price in one of the popular tech sectors mentioned above.


"This is not a shoe. It's an Asset Class."

We avoid nonproductive assets because without cash flows we don't know how to value them. We believe this makes them much riskier propositions. A cryptocurrency, NFT, or pre-acquisition SPAC has no fundamental intrinsic value. There is simply no way to forecast whether they are worth more or less than their price today. The decision to purchase an unproductive asset can only be based on the hope that someone in the future will pay more for that asset than today's price. Hope is not an investment strategy.

## Fear of Missing Out (FOMO)

As speculation becomes more widespread in the three areas outlined above and prices of these assets continue to climb, it is easy to find stories of people who became multi-millionaires by gambling in these areas. The media promotes these stories as if they were driven entirely by skill rather than luck.

Our human nature sees other people getting rich and urges us to abandon our strategy to participate in these "easy paths to riches." Warren Buffett once remarked, "People start being interested in something because it's going up, not because they understand it or anything else. But the guy next door, who they know is dumber than they are is getting rich and they aren't… It's so contagious." We have seen this story play out over and over throughout history. Excessive speculation like we see today eventually ends badly for those that participate.

## When Will it End?

Unfortunately, excessive speculation has a habit of lasting longer than anyone thought possible. Morgan Housel, the author of the best-selling book "The Psychology of Money," was recently quoted saying, "The end of a speculative boom can be inevitable but not predictable. Unsustainable things can last a long time." Even Federal Reserve Chair Alan Greenspan coined the phrase "irrational exuberance" during the tech bubble of the 1990s. But he first mentioned it in a speech in 1996, a full three and a half years before the peak of the mania.

We have no way of knowing when this excessive speculation will end. It may continue for several years and reach unfathomable heights. Or the beginning of the end could already be underway.

### Sticking to the Process

While we are concerned about this excessive speculation, we simply choose not to participate. On an investment journey that spans many years, there will always be potholes to avoid. Today, we merely see more potholes than usual. However, just because there are pockets of excessive speculation today does not mean that the entire market is poised for a crash. We saw this in 2000/2001 as the tech bubble burst and tech stocks plunged while non-technology companies avoided most of the carnage. More recently, in the first quarter of this year, many highly priced tech companies declined 20-50% while the S&P 500 remained at an all-time high.

In the face of today's pockets of "irrational exuberance," we remain steadfastly committed to our time-tested investment process and are steering well clear of euphoric areas where we see a "willing suspension of disbelief." We will not speculate with your hard-earned capital. Our goal is to protect and compound your wealth over long periods of time. We believe the best way to do this is by owning advantaged, profitable businesses that are run by talented leaders and trade at attractive prices, regardless of what is currently popular in the market or getting the most media attention. We believe this long-term business owner approach stacks the odds in our favor by avoiding speculative potholes along the way.

As always, we thank you deeply for your relationship with Hilliard Lyons Trust. We are humbled by the trust you place in us as stewards of your financial assets. Our ultimate goal is to serve your needs and grow your wealth over time.

# Tax Proposals Reinforce Need for Maintaining Flexibility

**Mark J. McLennon, J.D. CPA, CFP®**
Trust Strategist

There is something in the air, and it may not just be spring. It seems that also wafting in the wind is a sense that big changes may be just around the corner. For many, that may take the form of hope that life is returning to a bit more back to normal, or at least starting to. For others, it may be recognition that some aspects of our daily routines may now forever be altered in at least some way. For one last group, namely those who closely scrutinize any possible changes to estate, gift and income tax laws, there is a strange sense of déjà vu hanging directly overhead. Although most people, through very conscious choice, avoid being a part of this latter crew, the breadth of possible changes recently introduced, as well as potential planning opportunities that may be availed of in response, should not be ignored, even though these proposals could vanish into the same thin air out of which they came.

Originally, this article was going to focus exclusively on the importance of maintaining flexibility, particularly in legacy, trust, and estate planning, which often involves some element of giving up control over assets. Coincidentally, as this goes to print (more figuratively for most readers now) there are several specific proposals in Washington, D.C., that could significantly impact some of the rules of engagement for those engaged in long-term financial planning for their businesses and families. An ever-changing tax landscape may be one key reason to consider taking proactive steps with optionality built-in where possible, although taxes should rank second or third (at best) behind the need to maintain flexibility to meet the primary goal of effectively managing evolving family dynamics and circumstances. What better time to reflect on the need to have flexibility built into an overall plan, and to address planning issues with your advisor, than when uncertainty is in the air?

## Proposed Changes to Income, Estate and Gift Taxes

Congressional changes currently on the table, or at least tossed into the room with the table, include a major overhaul to the estate and gift tax system, introduced by Senator Bernie Sanders, and changes to the taxation of accumulated capital gains at death, introduced by Senator Chris Van Hollen. These are respectively referred to here as the 99.5% Act or the Sanders proposal, and the STEP Act or Van Hollen proposal.

**The Step Act**: One major aspect of the STEP Act is relatively straight-forward to explain, yet history has shown the proposed approach may be difficult in practice to follow. Essentially, this Van Hollen proposal would substantially reduce the benefit of what is referred to as the "stepped-up basis" at death which eliminates the built-in capital gains, and related taxes, inherent in property received from a transferor at the time of their death. Under current law, for applicable assets, heirs receive a tax basis equal to the date-of-death value, meaning any gains accumulated up until that point would forever escape capital gains taxation. For example, if someone buys property for $100,000 and years later one of their heirs receives that property as a bequest under that original owner's will at a time when it is worth $3,100,000, that heir's tax basis becomes that higher fair market value number. If the heir were to subsequently sell the property for that or a greater amount, no capital gains tax would be due on that inherent $3,000,000 gain, due to the "step-up" in basis rule. There is currently no dollar limit on the amount that this step-up may encompass, but the STEP Act would limit that amount going forward to $1,000,000 overall per deceased person. Although this increases potential tax costs within the context of family transfer planning, and is also a potential accounting nightmare to keep track of tax basis, it also has an impact on lifetime gift planning. Under current rules, one compelling reason for maintaining ownership of certain assets until death (as opposed to gifting them away during life), has been to preserve this unlimited step-up, particularly for highly appreciated assets such as family business interests. (Those receiving property through a lifetime gift take on the same tax basis as the individual who gave them the property.) The drastic reduction in the treatment of stepped-up basis being proposed potentially changes that landscape and certain past decisions about lifetime gifts may need to be revisited, as those gifts may now be relatively more attractive. Note that these gifts are often made in trust to obtain additional tax and non-tax benefits that may be accorded through trust ownership and management.

**The 99.5% Act** – On the estate tax side, which is separate, distinct, and potentially in addition to any capital gains or income tax liabilities, there is the 99.5% Act. To vastly oversimplify, this proposal would: decrease the estate tax exemption to $3.5 million per person from its current $11.7 million level; further reduce the lifetime gift tax exemption to $1 million from that same current high estate tax level; limit tax-free annual gifting benefits; increase estate and gift tax rates above the current 40% to as much as 65%; and eliminate the ability to use certain estate planning techniques, colloquially referred to as short-term GRATs and grantor trusts. This Sanders proposal, backed by others in D.C. as well, would be effective beginning in January of 2022, although like everything else, that is potentially subject to change. However, those whom these legislative changes would impact should consider evaluating any potential action steps to take now, while there is still time to potentially act. Those actions would include reviewing current estate planning documents, but may also include making transfers of assets to family members or irrevocable trusts before year end to make full use of existing tax rules.

## A Call to Action?

As alluded to above, for many advisors and estate planners there is a sense of déjà vu, in that the elimination or reduction of more favorable estate, gift and income tax rules is nothing new. Such changes, particularly if and when broadcast in advance of the effective date, are a call to action. This action oftentimes involves the movement of assets amongst generations, through trusts or otherwise, when circumstances warrant it. History gives us examples of periods where such dramatic movements took place, notably 2011 and 2012 when a large estate tax exemption was scheduled to go away and many irrevocable trusts were created and funded. The assumption has been that similar activity will take place as the year 2026 draws nearer as a similar dramatic estate tax exemption change is already scheduled to take place. The Sanders proposal could accelerate that.

Both the 99.5% Act and the STEP Act, if enacted in current form, could favor transferring assets during life as opposed to holding onto them for life, although there are many other factors that need to be considered. Due to the nature of transferring assets out of one's "estate" during life, it is often assumed that this aspect of proactive estate planning is primarily effective only at the cost of a loss of future flexibility. For one thing, there are words like "irrevocable" and "limited" or even "in perpetuity" bandied about by advisors, accountants, and attorneys. Not to say these words are not properly part of the lexicon, but their meanings out of context are often more foreboding than may actually be the case. It is true that, for example, gifts in trust generally need to be made to an irrevocable trust to be considered "complete" (there's another one of those words) and thus obtain certain benefits such as removing future appreciation out of the estate. However, provisions of the trust can provide flexibility if properly drafted, and even actions external to the trust document can enable changes for circumstances not originally contemplated at the time the plan was put together.

First of all, the terms of the trust itself can provide flexibility by giving certain discretion to the trustee, granting withdrawal rights and appointment powers to beneficiaries, and appointing co-trustees (such as family members) for particular decisions or even "trust protectors" where state trust law allows it. These provisions should be considered even in times where tax laws and family dynamics are not in flux (which is likely never the case), but most certainly in the current state. Secondly, even with existing trusts, there are opportunities and techniques available outside of the trust language to potentially modify how the trust can best be used to meet family goals based on changed circumstances, such as things referred to as "decanting" and non-judicial settlement agreements. Each of these could be (and may be) the subject of an article such as this themselves, which is why re-engaging with your professional advisor who understands them and has access to additional resources makes sense in times like these.

As the year progresses, and these proposals either pick up speed into legislative action or die down as though dusk were approaching, information regarding potential impacts and appropriate potential actions to consider will continue to be forthcoming. Like the winds in spring, tax proposals can swirl around Washington coming from any direction. Sometimes they are breezy and refreshing, sometimes they may require taking precautions beyond normal. Appropriate action may be warranted, but should be taken in such a way as to preserve some flexibility in anticipation of the next front moving in.

# Service Spotlight – Trust Strategist

**Will Hobson**
Trust Strategist

*Hilliard Lyons Trust (HLT) provides expertise in irrevocable trusts, retirement accounts, charitable trusts and private foundations. We interpret and fulfill the terms of complex fiduciary accounts, educate trust beneficiaries on the terms and requirements of the trust and navigate challenging family dynamics. In this latest installment of the HLT newsletter's Service Spotlight, we're talking with Trust Strategist Will Hobson about the role of the Trust Strategist and what differentiates HLT from its competitors.*

**How long have you worked at Hilliard Lyons Trust?**

I joined Hilliard Lyons Trust in February of 1990. I had previously worked for a law firm and clerked for an attorney who did estate planning, which is how I got involved in this field. I got here at just the right time – I got to work with some of the original Hilliards and have met some great people along the way.

**What does a Trust Strategist at Hilliard Lyons Trust do?**

Early on, my role was a little undefined. Back then, our trust services were only for existing clients, and I spent most of my day implementing estate planning strategies and answering clients' questions. Soon afterward, though, I started visiting branches and working with Financial Advisors on how to incorporate estate planning into their clients' financial plans. It quickly became an important value-added service for advisors – FAs were able to provide clients with advice they weren't getting and didn't know to ask for.

**Along those lines, how do you work with Financial Advisors? What is the process like?**

It's pretty straightforward. Often I'll get a call from an advisor who says, "Hi, Will, I have a few clients who could use your services." I'll say, "Great!" and I'll reserve a date where the advisor or the advisor's branch will bring in clients who have the appropriate assets and need for estate planning. I'll sit down with them one-on-one, review their particular circumstances and give them some ideas that they can share with their attorneys. It's a very easy, collaborative process.

**In your experience, what are people most surprised by when it comes to trusts?**

Just how broad the range of services we provide really is. Let's say we have a couple where the husband passes away, and a few months later the surviving spouse breaks her leg on the porch. Our trust administrators are there to sit down with her and help make sure she gets the care she needs – making sure her bills are paid, helping her plan through a move if she wants to relocate closer to the kids, ensuring she has the healthcare services she might need. It's a very human side to trust administration that I feel is incredibly important.

**What are some of the most surprising issues you've dealt with in your career?**

Many years ago, we helped a single woman with her estate plan. She was somewhat unusual for that time because she was a career woman who never married and had no close relatives. Her neighbors were wonderful people, and she considered them to be her family. She established a very sound estate plan to provide for them. Towards the end of her life, her sight began to fail. Shortly before she died, we discussed her estate plan, and she emphasized her desire to provide for her neighbors. She was worried that a previous will had not included the neighbors and wanted to make sure it would not be used.

After her death, we found her current will in her safe, but she had cut her signature off the document! Normally, this would have made the will void, and her estate would have passed to cousins in Europe she did not even know. Based on my

conversations with her, and my knowledge of her poor eyesight, we were able to testify in court that her true intentions were expressed in the will that had been tampered with, and that she had probably removed her name because she thought it was the older will. The court agreed and, in the end, her wishes regarding the people who had become her family were fulfilled.

Another interesting story involves a very charitably inclined family in West Virginia. The patriarch has given his business to his children, but still has considerable wealth. His estate plan provides that a special marital trust will take care of his wife, if he predeceases her. At her death his assets will be held in a private charitable trust designed to benefit their community by making annual gifts to museums, schools and parks. One of this trust's specific objectives is to improve the "Urban Forest." Not only is this trust a wonderful gift to the community that will last for generations but, because it is purely charitable in nature, the trust is entirely exempt from estate taxation. This literally is a situation where everybody wins, and it has been an inspiration to me, personally.

**What differentiates Hilliard Lyons Trust from your competitors?**

For starters, I'd say relatively few broker-dealers have an affiliated trust company. But most important is our dedication to these relationships with our Financial Advisors and their clients. All trust companies perform estate and trust administration, but not to the degree that we do, or with our emphasis on personal service. When Hilliard Lyons Trust was created back in the 1980s, it was with very high standards, and we have continued to deliver on them.

**If a Financial Advisor is considering a relationship with Hilliard Lyons Trust for his or her client, what should they know?**

Just how much of an asset we can be in serving their clients, and all the services we bring to the table. We are the apex of the relationship – we can help the advisor care not only for that client, but for generations of that client's family. Often when a client dies, there's a risk of the surviving spouse or the next generation taking that business elsewhere. I can't tell you the number of times I've heard, "I'm staying with you guys – you took such good care of my mother." I consider that personal relationship a point of pride.

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