Hilliard Lyons Trust Company

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Reasonably Certain Advice from Mark Nickel

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Let me introduce myself: I am Mark Nickel, recently named President and Chief Investment Officer of Hilliard Lyons Trust Company (HLTC). Most recently, I served as CIO for Hilliard Lyons. In that role, I developed Hilliard's view of markets while overseeing all internally generated client-facing investment strategies, including all HLTC investment offerings. Active in financial services for over two decades, I started with Hilliard in 2002 as a Financial Planner, then moved to HLTC in 2006 as a Portfolio Manager.

Every quarter, I will use this space to address a current event or "narrative" popular in financial media.

Emotion vs. reason

Financial reporters eager for clicks don't get attention with "Dog Bites Man" headlines – so sometimes financial news gets sensationalized. Over the last 20 years, I have often found that clients can get emotionally (sometimes irrationally) affected by an event or trending narrative. I've even had them call me, asking whether they should sell everything immediately in response to apparent bad news. If, as in that case, they are overreacting, I add the most value by addressing the issue, providing fact-based context. That context usually means reminding clients of tried-and-true principles such as patience, prudence, and sticking to one's investment plan.

What narrative has captured my attention this quarter? It's uncertainty, coming from many sources – geopolitics (Iran), politics (2020 election cycle), trade policy (China, Europe, Mexico), Fed policy (will they cut rates?), yield curve (is it inverted?), corporate earnings (back-to-back negative quarters), investor sentiment (bullish to bearish and back again), etc.

The financial news echo chamber

Do we have more uncertainty now? Or does it just feel like it? Are our telescoping news cycles and social media presence preying on our emotions more than ever? It's easy to get caught in a financial news echo chamber. The more we are connected to media, the more uncertainty is generated and the more we then need to check our news sources to reassure us. Then a fresh set of headlines can start that crazy cycle again.

The prudent thing to do is to take a deep breath, turn off the constant barrage of media, and remind ourselves that we are adhering to our financial and investment plan. I hope to use this column to raise the voice of reason, giving you the perspective you need to reliably separate the true signals the market is sending from noise you may hear in financial media.

HLTC and Baird

One last thing: As you may already know, HLTC is now part of Baird. I was fortunate enough to join a group of Hilliard Lyons Trust Company associates at Baird's 100th Anniversary celebration at their Milwaukee headquarters in June. To a person, we came away convinced that Baird truly does focus first on clients. (A close second is Baird's focus on its associates.) I feel strongly that you will benefit from our joining this employee-owned, privately held firm that consistently puts clients first.

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Don't Fight The Fed

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Investors may be feeling a bit of whiplash: The stock market plunged late in 2018, with the S&P 500® declining 13.5% in the fourth quarter – the third-worst Q4 performance in nearly 70 years. Then, in the first half of this year, the stock market roared back, with a surprisingly strong gain of 18.5% – the index's best first-half performance in 22 years.

This abrupt about-face left many investors baffled. We think a change in the direction of monetary policy by the Federal Reserve (Fed) explains a lot of the stock market's unusual activity over the past nine months.

An inverse relationship

Noteworthy investor Martin Zweig is credited with coining the advice "Don't fight the Fed" several decades ago. Basically, he meant that the stock market and interest rates are inversely related: The market tends to rise when the Fed is cutting interest rates and to fall when rates are rising. This phrase has some true believers within the investment community who are always striving to predict the stock market's direction. Recent market swings may reinforce this group's beliefs.

Rates up, stocks down

The current cycle of Fed rate increases began back in December of 2015, with a .25% increase in the Fed funds rate following seven years of "ZIRP" (Zero Interest Rate Policy). In 2018, the Fed raised rates more aggressively with four .25% increases, the last coming in December. It also telegraphed plans for further rate increases in 2019. This turned out to be too aggressive for investors who feared the Fed was making a policy mistake just as the global economic growth rate was already slowing. With growing fears of a deep economic slowdown or recession, some investors sold their stocks aggressively.

Rates stable, stocks rally

Early in 2019, the Fed shifted its policy to neutral (or no further interest rate increases) for the time being. The declining stock market quickly reversed direction and rallied strongly in the first quarter. Fed policy shifted yet again in June, when it stated that interest rate cuts will likely be necessary to aid a slowing economy. This change further fueled the rally in stock prices and largely explains the market's dramatic moves.

Why the inverse behavior?

Stocks react so positively to lower interest rates for many reasons:

- Lower borrowing rates encourage economic activity by making it less expensive for individuals and businesses to make large purchases and fund new projects.
- Lower rates also let borrowers refinance existing debt at lower rates, putting more money in the pockets of consumers and boosting earnings for businesses by lowering their interest expense.
- Lower interest rates also make bonds a less attractive investment, and some of the money from bonds flows into the stock market.
- Finally, lower interest rates have a powerful impact on business valuations. Businesses are valued much more highly in a low-interest-rate environment because the stream of earnings they generate are more valuable when prevailing interest rates are low.

All of these factors contribute to higher stock prices in a lower-interest-rate environment. These are also reasons that the adage "Don't fight the Fed" has become accepted Wall Street wisdom.

So why would the Fed ever increase rates?

If lower interest rates result in all of these positive developments, why not keep rates at rock bottom levels forever? The primary risk in doing so is overstimulating the economy, which can result in higher inflation, an increase in speculative and irresponsible economic and investment activity – or both. Too much inflation and excessive speculation always ends badly. Fortunately for the US economy and the Fed, the rate of inflation actually declined over the past year and continues to run well below the Fed's target rate of 2%. This gives the Fed comfort with its stated plan to stimulate the economy through lower rates.

The anomaly of negative interest rates

Any discussion of interest rates today must acknowledge that worldwide interest rate levels are unprecedented, somewhat unbelievable, and likely unsustainable. A pool of about $13 trillion in bonds issued by a handful of countries carry negative interest rates! (This means that investors are actually paying for the "privilege" of lending money.) For most of economic history, this would have been considered impossible, because it makes so little sense from the lender's standpoint.

While the current yield on the 10-year US Treasury bond is amazingly low at 2%, it is one of the highest government rates in the world. Many countries in Europe and Japan have negative rates on their 10-year bonds. Underlying reasons for these unprecedented interest rates are systemically sluggish economic growth rates, fears of deflationary forces, and central banks continuing their Quantitative Easing policies to try to lift their countries out of economic quagmires.

I simply don't know what to say about the worldwide interest rate structure today. Trillions of dollars of bonds with negative interest rates break many market rules governing how bonds should be priced. The new rules seem to be that there are no rules! Significantly higher interest rates in the United States are unlikely while negative interest rates exist around the globe.

The aging economic expansion

Speaking to a group of economists in early January at the annual meeting of the American Economic Association, the past two Fed chairs had an interesting exchange: Janet Yellen said "I don't think [economic] expansions just die of old age," to which Ben Bernanke added "I like to say they get murdered." While these comments got a big laugh from the gathering of economists (no easy feat!), historical evidence confirms their assessment.

The current US expansion is now 10 years old and counting, although there are still pundits who worry that it will soon die of old age. When the Fed raised rates several times in 2018, many investors concluded it was going to murder the economic expansion with a policy mistake. The Fed now seems to agree with the negative signals sent by the investment markets late last year and is ready to pursue interest rate cuts. Perhaps the current members of the Fed were listening when the two former Fed leaders made their comments.

Tuning in to the signal, tuning out the noise

As we begin the second half of 2019, it is important not to get distracted by crosscurrents in the daily news. From politics to trade wars, from geopolitical tensions to predicting the Fed's next move, there are plenty of headlines vying for attention. We think it is a mistake to let the news of the day drive investment decisions. In our rapidly changing world, it is vital that we remain disciplined and steadfast in our strategies to help you achieve your investment goals. With a high-quality emphasis in all that we do and a singular focus on the long term, we remain committed to your investment success.

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Retirement Assets: The Neglected Stepchild in Estate Planning

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"What do you want your monetary legacy to be?"

In reply, most people say they want to help their children, grandchildren, or other heirs. They want their wealth to be enjoyed or spent on education. Many people also express a desire to benefit a favorite charity or house of worship.

The most colorful response I've heard is, "We want to die broke. When the last of us is on our deathbed, we want to be down to our last few pennies." Of course, that is easier to say than to do, as few of us know the day we will die.

Even if dying broke is your goal, you are likely to outlive at least some of your assets. I'd like to focus on one asset type that gets treated as a neglected stepchild – retirement assets.

Most people know that real estate, investment accounts, cash, insurance proceeds, vehicles, collectibles, and household items will become part of their estates, and often make specific plans to distribute those assets in their wills or trusts. But few of us think carefully about our retirement accounts, such as traditional IRAs, Roth IRAs, 401(k) accounts, or 403(b) accounts. Even though we often fund those accounts as fully as we can while employed, we rarely think concretely about their becoming part of our estates.

Pension plans vs. other retirement assets. "Defined benefit" pension payments that pay a specific monthly amount starting at retirement normally end with the death of the person entitled to them (or that person's surviving spouse, if the payout was based on their joint lives). So, generally, once a person with a "DB" plan chooses how funds are to be paid out, he or she has no other estate planning concerns with them.

But the amount left in other retirement accounts, including "defined contribution" accounts such as 401(k)s, can be significant. So, when it comes to thorough estate planning, it is essential to account for the distribution of your retirement account assets and make sure that the distribution aligns with your estate plan as set out in your will or revocable trust.

Giving your retirement assets the attention they deserve when planning your estate

Here are five general considerations – most of which focus on naming the account beneficiary carefully. As always, we urge you to consult your attorney, tax advisor, or HL/Baird financial adviser for help:

1. Retirement accounts pass pursuant to your beneficiary designation

It is difficult to overemphasize the fact that, **at your death, retirement account assets will go to the beneficiary (or beneficiaries) you designate for each retirement account** – independent of the terms of your will or trust. Consider how the distribution of your retirement account coordinates with your overall estate plan to avoid potential unplanned outcomes.

For example, let's say you revised your will or revocable trust terms to leave everything to your child, Alex, in a "spendthrift" trust because Alex has proven to be bad with money as a young adult. But you never update the beneficiary designation of your $500,000 IRA (your most valuable asset) from "Alex" to "Alex's Trust" before you die. Result? When you die, Alex will get direct, immediate access to $500,000 in cash and can spend it at will, prudently or otherwise. You've just frustrated one of the main goals of your estate plan.

2. Who is the primary beneficiary?

Answering this question largely depends on the type of retirement asset you have: is it a taxable (traditional IRA or 401(k)) or non-taxable (Roth IRA or Roth 401(k)) retirement account? Baby Boomers typically have traditional retirement accounts, so most of the considerations below are for traditional accounts. Roth accounts are treated separately.

Spouses: Most married people want to ensure their spouse is provided for after they are gone. Naming a spouse as the primary beneficiary outright (as opposed to in trust, discussed later in #4) is one way to support this goal. It is also typically the most advantageous from an income tax perspective.

Spouses get special treatment under our tax laws: Surviving spouses can elect to be treated as the owner of an IRA or can roll the IRA over into their own name and take required minimum distributions (RMDs) over their own life. At death, unless there is a specific reason to leave assets in trust, the surviving spouse can name children as beneficiaries (see below).

Note that some states (and ERISA for 401(k)s and 403(b)s) require retirement assets to pass to a surviving spouse or require spousal approval to name a non-spouse as beneficiary of any retirement assets.

Individuals other than spouses: A non-spousal beneficiary has a few options for dealing with the inherited account (options depend on the IRA owner's age at death):

- take the money in a lump sum;
- take the money within five years; or
- keep the money in an "inherited IRA."

The latter option will require the beneficiary to take required minimum distributions. If the beneficiary is younger than the IRA owner was at death, those RMDs can be based on the life expectancy of the beneficiary; this is often referred to as "stretching out RMDs." To stretch out RMDs, the beneficiary must be a "designated beneficiary," which is usually not difficult where an individual is named.

Also, when naming individuals as beneficiaries, consult the IRA account terms so that you have a clear sense of what happens if that individual dies before you and to ensure the above options aren't further limited by the terms of the account agreement.

Charitable organizations: If you want to leave money to a charitable organization at your death, the easiest, most tax-efficient way to do so is by naming the charity as a beneficiary of taxable retirement accounts. Unlike individuals, qualified charities won't pay income taxes on the withdrawals made from a retirement account, and anything left to charity at death is excluded from estate tax.

It is also easier to manage how much and which charities receive the benefits this way. To make changes, you simply execute a new beneficiary designation with your account provider (like your Hilliard Lyons/Baird financial advisor) rather than having to formally amend your will or trust terms with your attorney. And this isn't an "all or nothing" option – you can specify that your charity should receive a certain amount (such as a percentage of the account or a specific sum) before passing the rest to one or more other beneficiaries.

Roth accounts: Roth accounts are a different beast. Though non-spouses must still take RMDs, there is usually no tax when money is withdrawn from a Roth account, and Roth accounts grow tax-free. So leaving a Roth account to a child (or even a grandchild) can be particularly advantageous if the beneficiary can be trusted to keep it in an inherited IRA.

3. Should you name a contingent beneficiary?

If you name an individual (rather than a charity or trust) as the primary beneficiary, consider having a backup beneficiary in case the primary beneficiary dies before you do.

If you name a charity, consider what might happen if the charity becomes unqualified (loses tax-exempt status for federal income tax purposes) or ceases to exist. Do you care if it still goes to that charity? Would you prefer the money go to a similar charity instead? Would you rather the money go to one of your other charities? Or would you rather the gift lapse and have the amount pass to your other individual beneficiaries?

4. Should you bequeath your IRA in trust?

In thinking about how you want to leave assets to your primary or contingent beneficiaries, you may want to start with your current estate plan as governed by your will or trust terms (or, if you are planning on updates to those plans, what those terms will look like).

Maybe you created a marital trust because you wanted to provide for your surviving spouse but you wanted to make sure anything left over passed to your children from a previous marriage rather than your stepchildren. Maybe you left inheritances to your children in trust for tax reasons or to protect them from creditors. Did you leave assets for a beneficiary in trust for life with a corporate trustee providing oversight because you don't trust the beneficiary to manage their finances? In light of these considerations, would it be best to name a trust as beneficiary of your IRA rather than the beneficiary outright? Consider, too, the size of your retirement account(s): Accounts with smaller values might more appropriately be left outright or, if a significant portion of your wealth is already set to pass to a lifetime trust for a beneficiary, perhaps the value of the retirement account would be a nice sum to leave outright for them so they have more control?

If trusts aren't part of your estate plan, consider whether certain heirs can handle inheriting an IRA outright or whether the benefits of a trust might be more suited to their situation. Inherited IRAs held in trust can provide many benefits and, where an experienced or corporate trustee is involved, you can rest assured that the complex rules governing inherited IRAs to help maximize tax savings are followed.

If you think your heirs might benefit from a trust, you can name a trust for a child (or another individual) as a beneficiary rather than leaving it to them outright. Basically, the assets would pass according to the beneficiary designation into the trust, and then the trust's terms would spell out how the assets can be distributed to the child. But if you intend to name a trust as a beneficiary, trusts should contain specific language anticipating the flow of retirement assets to avoid excessive income taxation. If this is of interest to you, tell your attorney so that the appropriate trust language is included.

5. Rinse and repeat

Review your retirement accounts in context with your overall estate plan periodically, whenever tax laws change (see sidebar below), or as major life events occur (such as retirement, divorce, remarriage, death of a spouse).

You've worked hard. You prudently put away money in your retirement plans. Give those plans the attention they deserve when planning or updating your estate. Doing so can optimize the tax consequences of your bequests and help to establish the monetary legacy you intend.

Caution: The SECURE Act could change how you treat retirement assets

Note that, in May 2019, the U.S. House of Representatives passed legislation that, if enacted, will change some rules for retirement accounts. The SECURE Act (the "Setting Every Community Up for Retirement Enhancement Bill of 2019") will make it easier to save for retirement.

In its current form, the SECURE Act has several provisions that might affect how you plan to distribute retirement assets after your death:

- the maximum age for making IRA contributions will be repealed (so IRAs could be even more valuable when passing to heirs);
- the age for starting RMDs will increase from 70-1/2 to 72;
- the "stretch-out RMD rule" will limit the stretch to ten years.

So watch for tax law changes and work with your estate planning attorney or other financial professional to update accordingly.