May 16, 2018

Re: Taxes and Inflation Are Detrimental to Your Wealth

Dear client,

This month's newsletter is different than many of the other letters I have written because it examines the effects of inflation and taxes on your wealth but are nonetheless just as important.

In a sense, taxes and inflation are the same. Inflation is a tax because it reduces your real returns and it increases the cost of your purchases and living expenses. Taxes reduce your net worth. Therefore, you have to earn more to insure you can pay your bills and save for the future. Any tax or inflation increases the amount that you must save and reduces the value of what you have.

In an inflation example, let's say you get a gross investment return of 4%. You may think that is perfectly acceptable in today's low interest rate environment. However, if inflation is running at 2% then you have 2% real return. After taxes, the situation becomes worse because the nominal return could drop to 2% for those in the highest tax brackets, which would be a (0%) real return (4% nominal return- 50% tax-2% inflation=0). You can see that after a long period of time, you might think that you have an adequate amount of money saved up, but you really don't. Your investments have not kept up with purchasing power or inflation. So, it's not the nominal return that counts, but the real return. This leads us to a very important question. If the goal is to maintain purchasing power and to achieve a real return net of inflation, what can we do?

There are two ways in which you can achieve your goals. The first way is to achieve a rate of return above inflation. In general, if you can achieve a real rate of return of 3% to 4%, then you should be in pretty good shape. A good example of this would be a 5-year portfolio starting in 2013 and ending in 2017. This portfolio had a nominal return of 6%, which consists of 60% stocks and 40% bonds. If inflation were at 2%, then your real return would be a satisfactory real return of 4%. Yes, your returns could be higher with a larger stock component, but your risk would increase quite a bit. Therefore, we don't recommend a total stock portfolio - just too risky in my opinion. Diversification is the key and although bonds generally have a lower rate of return, they can cushion any stock market decline.

Another way to beat inflation is to save more money and spend less. This is a good way to overcome inflation by having a bigger pot. When I do financial plans, I look at the client's monthly spending patterns and figure out how much of a money pot they will need to sustain their lifestyle. I also adjust these figures for inflation. In some of the financial plans I have done, the best solution was to add more to the pot. However, in any case, good management of your invested assets is paramount to beat inflation.

The catch is that the majority of stocks and bonds do well in zero to low inflationary environments and do poorly in high inflationary times. There are stocks that do well with inflation so careful consideration of these is paramount in any portfolio. For example, timberland does well in an inflationary environment as land prices and timber grow in value. One reason why stocks perform poorly in an inflationary period is because interest rates rise when the U.S. Federal Reserve and other global central banks raise rates to combat inflation. However, at times the U.S. Federal Reserve have let inflation rise without stopping it and that was a disaster for most stocks. Right now, inflation as measured by the consumer price index is running at a reasonable 2%. Most economists don't think it can rise much above 3%, but I'm not so sure. Surely, an inflation rate of the 1970's and 1980's, when the average inflation rate was above 6% would be harmful. I don't see that happening at the current moment, but it is wise to think about the possibilities.

In most cases, investors need to have a decent allocation to stocks, even though they're volatile, in order to keep ahead of inflation. Bonds alone won't do it. Although there are long stretches of time with the stock market indexes not going

anywhere, it is my opinion that active managers such as myself can produce solid results over time even if an index is not going up.

The other destroyer of wealth is the abusive tax system run by politicians without any regards for those who pay the tax. This is especially true in Washington D.C. and in California.

For most people who make over $150,000, they will not be seeing any reduction in taxes especially if you live in high tax states such as California and New York. In many cases, their taxes will be going up. For professionals such as doctors, lawyers, accountants, investment advisors, writers, producers, directors, consultants, and others, their taxes will rise dramatically because their subchapter S corporations have limits on tax deductions and the majority of state income tax is no longer deductible on Federal returns. The combined property and state income tax is limited to $10,000 per year. The standard deduction rises to $24,000 for married joint-filling couples and $12,000 for single taxpayers. Mortgage interest on loans initiated after December 2017 is capped at $750,000, but mortgage interest prior to December 2017 will be grandfathered in.

Currently, there is a proposal in the California Legislature to increase California taxes once again even though the state has a $10 billion surplus. The Herzberg SB 993 bill, if passed, will levy an 8% sales tax on professional services. This means your hairdresser, accountant, investment advisor, lawyer, garage mechanic, landscaper, gardener, party rental company, nail salon, gymnasium, taxi and Uber, and other service businesses will be required to collect those taxes from you and send them to the state. This will raise the cost of living because those taxes will pass on to you in the form of higher prices and more paperwork regulation.

Another new tax is the newly passed regulation by the California Public Utilities Commission without any legislative authority that will require new homes built after 2020 to have solar installed on their roofs. This adds about $10,000 to the cost of a home. Add permit fees for new homes exceeding $60,000 per home site and it is no wonder we have an affordability problem in this state.

Any increase in taxes will reduce your wealth and require you to save even more.

A few years back, the State of California floated several billion dollars of bonds for the high-speed rail system from Los Angeles to San Francisco. The budget for this train has blossomed from $19 billion to $62 billion. There will be another tax at some point for this project because of the shortfall of funds to finish the rail system. Sales taxes went up in Los Angeles County last year for more massive transit and to build homeless housing. Interestingly enough, the Los Angeles Aids Foundation has been able to build nice rooms for homeless men at a cost of approximately $273,000 per room while the City of Los Angles spends close to $500,000 per room. Elon Musk's Boring Company most likely can build mass transit tunnels at a fraction of the cost of what it would take the State to build a rail system or to have Metro build out transit rail projects.

This puts another question on the table. How safe are California tax-free bonds? Maybe ok - for now, but I wouldn't be too sure about that in the future. In the cases of the City of San Bernardino and the City of Stockton, the courts ruled in favor of pensioners over bondholders even though the law has stated for many years that bondholders have the first claim on assets. The bondholders of Stockton, San Bernardino, Vallejo and Half Moon Bay got scalped as the State of California interpreted the law as the politicians saw fit. One needs to be selective and careful going forward about any California tax-free issues, especially the City of Los Angeles, or Los Angeles City Unified School District. Although both the City and the School District are highly rated at this moment, their pension and funding abilities are, in my opinion, highly questionable.

Where has this discussion led us? Inflation, taxes and costs are going up so it is imperative that we maintain a long-term outlook and a balanced approach. Some years, gains in the stock market may be fabulous while in others they may be

dismal. However, beating the rate of inflation and taxes is the most important concern of all. At this juncture, we are maintaining our current asset allocations and riding out any bumps in the road.

I just got back from a timberland investment conference in New York in which I learned some additional interesting topics that I will share within the following months.

Follow me on our SFP Facebook page, as I become a student once again at the Harvard Business School this May.

All the best,

Steven L. Yamshon
Investment Counsel