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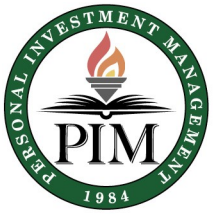

PERSONAL
INVESTMENT
MANAGEMENT, INC.

Quarterly News Release

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Welcome to 2020!

In this edition of our News Release: 1) 2020 Retirement Plan Contribution Limits, 2) The SECURE Act is Law, 3) Markets and Investments.

2020 Retirement Plan Contribution Limits

The maximum amount that an employee may contribute to their 401(k) or 403(b) for 2020 is $19,500, up from $19,000 in 2019. The total that may be contributed by the employee and the employer combined is $57,000, up $1,000 over 2019. The additional, "catch-up" contribution that can be made by those 50 and over is $6,500, up $500 over 2019. Therefore, plan participants over age 50 may contribute a total of $26,000 during 2020.

The income phase-out ranges for Roth IRA contributions for 2020 increased as well. For single persons, the phase-out range is $124,000 to $139,000 (after which one cannot contribute to a Roth). For married filing jointly, the phase-out range is $196,000 to $206,000 (after which neither may contribute to a Roth).

If you wish to make an IRA contribution for 2019 (Traditional or Roth), you may still do so, as long as your contribution is deposited or post-marked by April 15th, 2020.

The annual contribution limit to IRA accounts will remain the same at $6,000 for 2020. The 50-and-over additional catch-up contribution limit remains unchanged at $1,000. There have been slight upward adjustments to the income phase-out ranges that determine eligibility to make tax-deductible traditional IRA contributions. Eligibility to make deductible IRA contributions also depends, in-part, upon participation in an employer retirement plan, and if married, whether one, both, or neither spouse participates in such a plan. Please consult the IRS website or your tax professional for the rules that apply to you.

The Secure Act is Law

In our most recent News Release, we discussed the "SECURE Act" (Setting Every Community Up for Retirement Enhancement."). The act was signed into law on December 20th, with little fanfare. The following are the provisions that we assume are of greatest interest to PIM clients.

1. *The elimination of what is known as the "stretch IRA" for most non-spouse beneficiaries*. Under prior law, a non-spouse beneficiary of an IRA could take distributions over the remainder of their lifetime, using the appropriate IRS table. The SECURE Act standard is that the inherited account must be fully distributed by the end of the 10th year following the year of the passing of the original account owner. During the intervening 10-year period, no distributions are required, which does provide for the possibility of effective tax planning (for those who intend to retire during the 10-year period, for example).

Spouses are exempt from the 10-year rule, as are some others. Disabled and chronically ill persons may be exempt from the 10-year rule, if they meet the relevant IRS definitions (sections 72(m)(7) and 7702B(c)(2)). Individuals who are not more than 10 years younger than the deceased are exempt. Finally, minor children of the original account

owner are exempt, albeit only temporarily. A minor child who inherits an IRA is immediately subject to RMD based upon his/her age. When the minor child turns 18, the 10-year rule starts, such that the account must be fully distributed by the time the beneficiary turns 28. Unless the child is a student, in which case the 10-year rule does not begin until the education period concludes or the person turns 26, whichever is earlier. Minors who are not the children of the original account owner, such as grandchildren or non-family members, are not exempt.

NOTE: The above refers to IRA accounts only. Qualified employer retirement plan accounts are subject to the new rules, unless said plan is part of a collective bargaining agreement. In that case, the new rule begins when the current agreement expires. Providing additional details on qualified plans and some government plans is beyond the scope of this discussion. Should such a case materialize, the guidance of a tax professional is required. Finally, these rules are not retroactive, and therefore only apply for cases in which the original account owner dies on January 1st, 2020 or later.

2. *Required Minimum Distributions at age 72*. If you did not attain age 70.5 by December 31st, 2019, then you will not be subject to required minimum distributions until the year during which you turn age 72. However, if you did achieve age 70.5 by December 31st, 2019, then you are subject to RMD as if the new rule does not exist. Applying a specific birth date to the calculation, if you turned 70 on, or before, June 30th, 2019, then the old rules apply. If you turned 70 on July 1st, 2019 or later, then the new rule applies; you aren't subject to RMD until age 72. Like before, RMD for the first year may be taken any time before April 1st of the following year. Should this first RMD be delayed beyond 12/31 of the first year, then two years of RMD must be taken in year two. In year two and beyond, the deadline is 12/31.

3. *Qualified Charitable Distributions remain*. There is no change to the QCD rule. After a person attains age 70.5, they may make qualified charitable distributions of up to $100,000 per year. There was concern that QCDs may be disallowed until age 72. This didn't happen. Even though QCDs may not count towards RMD before age 72, it's still a tax-free IRA distribution (tax free to both the donor and qualified charity). And it reduces the account owner's IRA balance, which theoretically lowers future RMD.

4. *Elimination of prohibition on IRA contributions*. Formerly, once a person attained age 70.5, they could no longer contribute to an IRA, even if they were still working. This prohibition has been eliminated. Going forward, persons of any age may contribute to an IRA account as long as they have "compensation" at least equal to the IRA contribution. Generally speaking compensation is employment income, self-employment income or possibly spousal income. For 2020, the maximum IRA contribution for a person age 70.5 or older is $7,000.

IMPORTANT NOTES:

Qualified Charitable Distributions and post-70.5 IRA Contributions are related in one important way. The IRS is concerned that when taken together, these may provide an opportunity for abuse. Therefore, any Qualified Charitable Distribution will be offset by any deductible IRA contribution that has not previously been offset. Example 1: A person age 70.5 makes a QCD of $20,000 in the same year as they make a deductible IRA contribution of $7,000. In this case, $13,000 of the charitable distribution will be considered qualified. Presumably, the remaining $7,000 will be considered a taxable distribution, offset by the deductible IRA contribution. Example 2: A person age 70.5 or older makes a $7,000 deductible IRA contribution for three consecutive tax years, then retires completely. In year four, the person makes a $30,000 QCD. In this case, only $9,000 of the charitable distribution is considered qualified, as the remainder is offset by $21,000 in post-70.5 deductible IRA contributions.

PIM is not a qualified tax advisor. None of the preceding should be considered specific tax advice. Nor is the preceding a complete explanation of the elements of the SECURE Act. Please consult a tax professional to determine how any provisions of the act may impact you.

Markets and Investment Discussion

Defining Terms

Before launching into a discussion of 2019, we'd like to pause and offer some educational content that we hope you find interesting and useful to this, and hopefully future discussions.

When stocks rise and fall, they typically do so in a way that can be explained by various factors. While nobody can

predict with absolute accuracy what will happen in capital markets, there is wisdom in seeking to understand market behavior after the fact. Often this "rear view mirror" analysis informs current decision-making.

The terms we wish to introduce are "multiple expansion" and "multiple contraction". First let's define what a "multiple" is. Every stock price is a "multiple" of earnings. The basic math is this; Corporate earnings / number of shares outstanding = earnings per share (EPS). Earnings per share X some multiple = current share price. The "earnings multiple" is often aggregated for various indexes, such as the S&P500 (US large cap stocks). Multiple expansion is when stock prices rise with the expectation of better earnings in the future. Multiple contraction is when stock prices fall on pessimism about future earnings. Multiples beyond the historic average means that stocks are relatively expensive. Multiples lower than the historic average means that stocks are relatively inexpensive. Generally speaking, stocks are deemed undervalued, fairly valued or over-valued based upon this measure. Keep this in mind as you read forward.

2019

Equity Investing: We adhered to our investment models throughout 2019 because we believed the US consumer and job market would be strong enough to offset the challenges of political uncertainty and resulting slower growth. This turned out to be correct, though we honestly didn't expect the nearly 10% equity rally in the fourth quarter. While we maintained equity exposure, we instituted a more defensive posture within client portfolios. We added investments in areas of the global economy that are less subject to economic headwinds due to market position, stronger balance sheets, lower debt and/or that sell important products with pricing power. We sought to avoid more cyclical sectors such as energy and financials. This proved to be an effective approach for the ambiguity that dominated much of 2019.

The key to success in 2019 was uninterrupted market participation. Political volatility and policy uncertainly prompted many retail investors (private individuals) to flee for the safety of the sidelines. In fact, the calendar year saw more selling pressure from retail investors, in dollar terms, than during the bottom of the financial crisis in early 2009. Those who exited the market missed out on the biggest equity rally in six years.

The single biggest reason for the soaring equity market was multiple expansion. At the end of 2018 the S&P500 was trading at 14.5 times earnings. A year later, at the end of 2019, the S&P500 was at 18.5 times earnings. Some multiple expansion was expected after the sharp decline we experienced during Q4, 2018. But actual earnings growth, on a per share basis, was a very modest 2%. The Federal Reserve proved once again that it is willing to prop up asset prices with low-cost borrowing rates and market intervention. We ended 2019 with unemployment at fifty-year lows, interest rates that are negative after adjusting for inflation and a US budget deficit that, in dollar terms, is larger than the American Recovery and Reinvestment Act of 2009. These factors explain why investor sentiment about the path of future earnings improved and why the S&P500 is 12% more expensive that its 25-year average in terms of earnings multiple.

Fixed Income Investing: On the fixed income side, our defensive approach was not quite as successful. Our fixed income performance was competitive for the year, but it didn't outperform to the same extent as our equity allocation. During 2019, taking credit risk and interest rate risk was rewarded. Our approach was to lean on higher quality investments with shorter maturities – when longer-dated fixed income performed better.

We continue to have concerns about the fixed income market that support our more conservative approach, primarily safety of capital. At this point in the business cycle there aren't many gains to be made, but the downside can be substantial. Our main concern is the debt service ratio in corporate America, which is the amount of interest and principal due on outstanding debt divided by gross income available to firms in aggregate. This ratio is currently at 42.5%, a level that typically signals economic fragility, if not recession.

When the bond market goes south, years' worth of gains can evaporate in a matter of weeks. There was no pullback in fixed income assets in 2019. But in economics, events often take longer than expected to materialize and then happen faster than you can believe. We simply don't want to risk a dollar to gain a dime in an asset class that we depend upon for safety. We are committed to the view that patience will deliver better returns.

2020: What's Next?

This wouldn't be a PIM newsletter without an attempt to temper expectations. The last time the unemployment rate was below 4% for any length of time was the late '90s when GDP growth was consistently around 5%. Compare that to the

2.0-2.5% consensus expectation for 2020. Since the consumer is the biggest driver of the US economy, this divergence deserves an explanation. The structure of the labor market has changed since the '90s. Specifically, fewer people, as a percentage of the working age population, are seeking employment. The workforce participation rate has fallen from 67% to 63% since 2000, which helps to explain why the headline unemployment number may be less impactful in terms of economic growth in 2020. If we had the workforce participation we saw in the early '00s today, the unemployment rate would be closer to 7.5%, not 3.5%.

Wage growth is another reason that the employment rate is less meaningful. Wage growth for most Americans has been chronically low for much of the past decade and is only now showing signs of life with the help of higher minimum wages in many states. Good manufacturing jobs have been replaced with service and hospitality work, often at much lower levels of compensation. People have made political careers by trying to address this disparity.

The ever-resilient US consumer was largely responsible for protecting the US from recession in 2019. Unfortunately, their relatively low wages, and surprisingly high savings rate are likely to keep the economy from reaching higher levels of growth this year. In more academic terms, the labor force historically keeps 70% of the profits from the economy, with capital (employers) keeping 30%. Since the financial crisis, employee's share of profits has fallen to 65%. At the aggregate level, workers aren't earning their same share of overall profits and the consequence is slower economic growth.

Political economy aside, the health of corporate America is the biggest concern for equity investors this year. 2017 saw record profit margins after the tax law changes. The collective response from US firms has been to use the increase in after-tax earnings to buy back shares of their own stock ever since. Buybacks accounted for the single largest source of equity demand in 2019, completely offsetting record outflows from retail investors. This is good for the equity markets but does little to improve the long-term prospects of the economy.

The 2017 tax law changes did incentivize companies to invest in themselves, but for various reasons firms have passed on making capital investments in their property, plant and equipment in favor of equity buybacks. This is an important distinction to draw because capital investment is directly connected to increased wages and higher levels of employment. Capital investment is the channel that connects the Federal Reserve's low interest rates and low US corporate tax policy to Main Street America. Without it, we're unlikely to see the levels of growth seen in the late 90's. It's that level of growth which would be needed to create another year of double-digit gains in the equity market.

The outlook from the big six investment banks for 2020 is largely neutral on the S&P 500. Most predictions range from 0-6% total returns for the year. One prognosticator is moderately bearish, with a -6% forecast, just to keep things interesting. It's important to remember that the reasons listed above that helped fuel the equity rally also keep downside risk moderated. It appears that overseas investments may power returns for the year due to their undemanding valuations, a weakening US dollar, improved sentiment from trade negotiations and lower borrowing costs. The Chinese central bank cut their short-term interest rate already this year, for example.

The outlook for fixed income is similar to the equity market in terms of low return expectations. There is consensus around the forecast of modestly higher (7-10 year) interest rates, but overall stability and a small chance of one more rate cut. Given that the US Aggregate bond index is currently yielding 2.2%, total returns for our mix of assets within bond allocations should be around 4-5%.

2020 should bring modest equity and fixed income returns, with potential outperformance from foreign assets. This is the environment we are currently prepared for and do not expect to make fundamental changes to our model portfolios in the next few months. The market moved strongly to the upside in the 4th quarter of 2019, effectively making a down payment on 2020 performance. Actual economic data is now beginning to modestly follow those expectations.

Closing Remarks

Should you have any questions about information presented herein, please contact your PIM Financial Advisor. Our sincere thanks for allowing us to serve you and for the trust you have placed in PIM. Our best wishes for a happy, peaceful and prosperous 2020.