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IMPORTANT THOUGHTS
ON RISK, TAXES, AND CHANGE

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Investing or having your money managed can seem very easy at times, especially during periods like last year when almost every investment made money. It felt like a statement higher than the last one was in your mailbox almost every month as the market set a series of new all-time highs. I certainly found the surprising jump of nearly 29% - as measured by the S&P 500 – a welcome relief. I'm also encouraged by the quick start to the new year, with the DOW up 2.8% and the NASDAQ up 5% in just a few short weeks.

After such a dramatic run, it's perfectly natural to "feel" that the market has come too far, too fast. There's certainly no shortage of talking heads on TV echoing that sentiment and urging investors to take action to protect their gains. However, the worst mistakes I've seen in my career happen when investors react to feelings – making qualitative judgments – about markets being too high and making changes to avoid a drop they think is coming. That's not to say you should ignore your feelings, or your portfolio for that matter. We are overdue for a correction – they're a normal part of investing. What I would like to suggest is a reasoned three-step approach I've developed over thirty years to help reassure my clients when market valuations "feel" stretched. First, it's imperative you understand <u>our</u> investment philosophy. Next, take a moment to review and reconfirm the personal investment strategy we've implemented for you. The final step is to perform a "lifeboat drill" which tests your comfort with how your portfolio would react given a "worst case" scenario.

Our investment process is straightforward. Our Investment Policy Committee (IPC) runs two distinct portfolios: an equity portfolio built for long-term growth and an income portfolio constructed for relative stability. These portfolios are carefully crafted with different types of investments to provide true diversification, as well as defined levels of expenses, volatility, and expected return. Both are always fully invested to meet their objective; either long-term growth (our growth bucket) or relative stability (our income bucket). This means that, although we continually monitor market valuations and nine economic data points, we only use this information to "tweak" or make small strategic adjustments to our positioning. Since NOBODY KNOWS what the market will do and when, we remain fully invested at all times.

I like to think of risk as the possibility of you running out of money, while market drops and temporary declines in account values are what we refer to as volatility. We control both of these for you when we design your particular investment strategy. Our "bucket approach" lies at the heart of this strategy, used successfully since my first wave of Xerox retirees in 1994. All clients have their own individual mix of the long-term growth and relative stability portfolios. For retirees, income need dictates the size of the income bucket. Typically 8 to 10 years of payments are set aside, protecting your long-term growth investments from forced withdrawals when the market is down. Your allocation – this mix between relative stability and growth – is a pillar of the personal financial plan developed and already put into action by your advisor. This allocation will have far greater impact on the magnitude of the swings you experience and your long-term success than any move made by Ken and his talented investment team. So, is your strategy appropriate? It's an important question we revisit at every review.

If you are ever feeling anxious about the markets, I would urge you to perform a lifeboat drill. This exercise gives you a rough idea where you would stand if we experienced a repeat of the '07-'09 financial crisis. Simply split your investments with us into the income bucket and growth bucket. Next, tally up all of your money outside of us. Add all bank accounts, bonds, and stable investments to your income bucket. Add all stocks and equity mutual funds to the growth bucket. Finally, cut the growth bucket in half and combine it with the income bucket. This would approximate your total investments should the market drop 50% suddenly.

Of course the result will be shocking - only the Great Depression was a worse time for investors. It's reasonable to believe this would be your worst case scenario prior to any market rebound. Ask yourself, "How would this affect my income? My lifestyle?" With a proper allocation to the income bucket, you should be years away from either being impacted. What should you do if you're seriously troubled by the result of the drill? The very first step is to have an honest conversation with your advisor. Keep in mind successful adjustments are generally dictated by life events and within the context of income need, rather than by emotion and comfort levels.

I would like to make an additional comment about risk. After a decade of rising markets, many people have gotten used to making lump sum withdrawals in addition to normal monthly distributions. Much like the period of the late 90's, unsustainable withdrawal rates have been supported and masked for years by stellar returns. With interest rates low and the market high, it's prudent to expect somewhat muted returns going forward. Sustainable withdrawal rates appropriate for your age will be a key discussion at reviews this year!

It would be wrong to infer pessimism on our part given the tone of this letter. To the contrary, my goal is to give clients a process to avoid acting on feelings and qualitative judgements. That's because quantitatively the future looks particularly bright. At our weekly IPC meeting Tuesday, we discussed our expectations for the coming year given the indicators we follow. Although anything can happen, the current level of inflation, stock buybacks, Fed policy, dividends, and projected corporate profit growth could possibly spur another year of surprisingly positive stock market returns. We expect to see only a slight rise in interest rates. Since the market is fully valued and we're in an election year, it would be normal see volatility as the year progresses. Overall, we believe the future looks bright and maintain our positive intermediate term view.

Significant changes were made to the tax code when the Setting Every Community Up for Retirement Enhancement Act (SECURE) was tacked on to the budget compromise last month. There's a good chance you're unaware of the specific changes, since it was passed by the House the night before the impeachment vote and was literally uncovered by the mainstream press. This legislation sprinkles a few token gifts upon retirees and then robs us of the primary tool we use to help our clients pass along intergenerational wealth.

I'm talking about the concept of the stretch IRA. Until the SECURE Act took effect January 1st, any beneficiary of an IRA could retitle it to an inherited IRA and begin minimum distributions based on their own life expectancy. An example might be helpful. Say Grandpa Jones passed last December leaving his $300,000 IRA to his only grandchild John, age 30. If John were to re-register the account as a "beneficiary IRA" he would only have to take and pay taxes on a small annual distribution (starting at 1.88% of the account balance) while the remainder was left to grow tax deferred. Of course John is always free to take more than the required minimum and pay tax.

By requiring that IRA's be liquidated completely 10 years from an owner's death, the new law effectively eliminates the ability for adult children and grandchildren to utilize the stretch IRA. There are a few important exceptions to this rule. Spouses can always utilize the stretch IRA regardless of age. Beneficiaries aged within 10 years of the deceased can do the same, possibly helpful if siblings are your heirs. Lastly, minor children are not required to liquidate IRAs they inherit for ten years or until age 21 – whichever comes later.

There are a few positives within the Act. Previously, folks over 70½ with earned income were not allowed IRA contributions, now they are. Also, the starting age for Required Minimum Distributions (RMD's) has been changed to age 72, as long as you haven't reached 70½ prior to this year. This tax grab reminds us that with unfunded mandates, a trillion dollar deficit, and 23 trillion in debt, it would be wise to view the tax code as being written in pencil. A desperate political class can't be trusted. I would expect a push to make Roth IRA's subject to lifetime liquidation by RMD's gain traction next. Regardless, it is clear that people with higher than average incomes (or assets) will be targeted to pay much more and receive far less in the future.

Many clients are distraught over the elimination of the stretch IRA. We had worked on and set up a sound plan for kids and grandchildren, and it *was completely done for them*. Although I would have preferred the stretch was left intact, I see a significant silver lining in the new rules for those to whom you are leaving a legacy to. Rather than filling out a form and receiving your bequest effortlessly, the new law will encourage them to *engage in the planning process*. A cash flow and tax projection will be necessary to maximize your gift. I've seen tremendous personal growth in many grief stricken beneficiaries as they assume stewardship of a life's work with our guidance. Rest assured we stand ready – with a tremendously skilled and empathetic team – to help your loved ones in any way they need should the time ever come.

While we are on the subject of taxes, please don't attempt to file too early. Companies have until mid-February to get you documents and the IRS is not even accepting returns until January 27th this year. If you took distributions from both your NFS and TD Ameritrade IRA last year, please remember you will need two different 1099's – one from each company. Your previous log on information will still work if you were getting documents electronically. As always, we are here to help should you need assistance accessing required documents.

Why all the changes? By far, this is the question I'm asked most often by clients. I certainly understand why. After 22 years of relative quiet, The Horizon Group has undergone an extensive transformation from a financial planning practice to a full service firm with our own in-house money management unit. It's been a whirlwind since we decided to leave Cadaret Grant nearly five years ago. Why all this work and effort?

There are two basic reasons to undergo change – either you make changes proactively to position yourself for success in the future, or you have change thrust upon you from forces beyond your control and you adapt to survive. In reality, we've had a healthy serving of both these past few years. In the end, we find ourselves with the people, processes and capabilities necessary to meet the needs of our clients. Most importantly, we find ourselves today with firm positioned for the future.

I say this to give our clients a "tip of the hat" and acknowledge the angst and frustration these changes thrust upon some of you. Change is rarely easy and is harder to accept the older we get – it's a fact of neurobiology. I'd like to thank you for allowing us to drag you from the comfort of the familiar to deal with paperwork, new systems, and even new faces in the office to meet our increased responsibilities. In the end it was worth it, and I'm fairly certain you will feel the same if you don't already.

I wish this was the end of the story. The fact is our industry is being bombarded with change from regulators, legislation, and market forces at an increasing pace. In just the past two months we've seen SSN's parent company Ladenburg Thalmann sold, TD acquired by Schwab, and the SECURE Act enacted. We manage the life savings of hundreds of families. We have a duty to continually scan the horizon for threats and opportunities and act accordingly on your behalf. Rest assured, if we make a change we believe it's necessary <u>and</u> in your best interest!

Mark

We will be hosting a shredding party once again this year at the cobblestone on Friday, May 1st from 10a.m. to 1p.m. There's no limit to the amount of shredding you bring! We'll be sending an official invitation in March along with a helpful guide of what to shred and what to keep.

We're happy to announce that we'll be sponsoring Deer Run Winery's Summer Concert Series held every Thursday at 6:00p.m. from June 4th to September 3rd. Bring a lawn chair, listen to live music, drink some great local wine (and beer), and visit with your friends from The Horizon Group outside of the office. We'll send a band schedule and more information later in May.

I'm heading out tomorrow for my largest southern swing ever to see over 60 clients in 6 states. I've extended the schedule to accommodate a bit more time for some rest and relaxation, as well as return trips back to Rochester for a week of appointments in both February and March.

On December 22nd our office had the opportunity to spread some holiday cheer by cooking dinner for families staying at the Ronald McDonald House next to Strong Hospital. It was a wonderful experience for our team and something we'd highly recommend to anyone looking to get friends and family involved together in a volunteer activity. If you are interested, please call Carrie at our office or visit http://www.rmhcrochester.org/get-involved/make-a-meal/ for details.