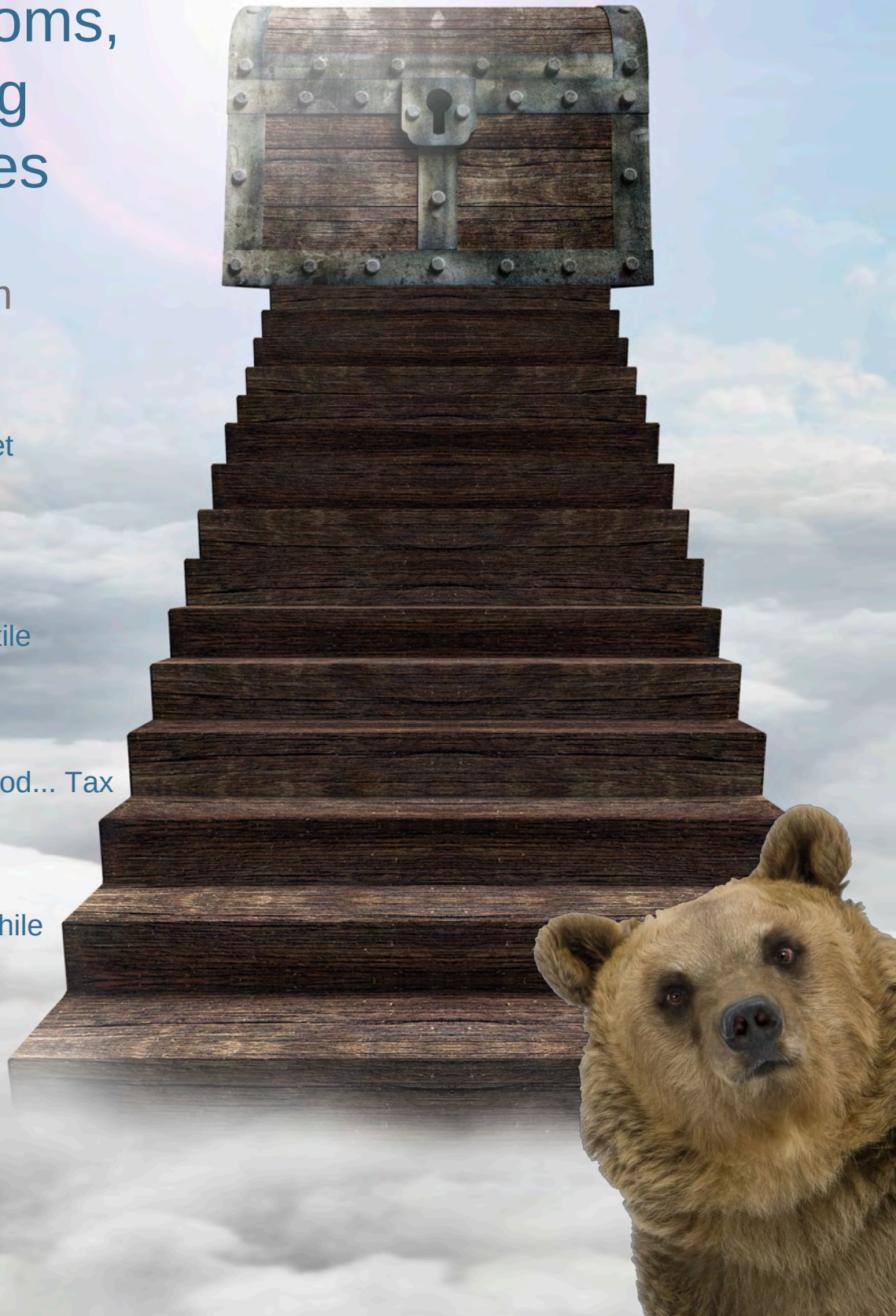
January 2019

PINNACLE QUARTERLY

Bears, Bottoms, and Budding Opportunities

The Pinnacle Investment Team



MOUNTAIN PEAK
WEALTH ADVISORS, LLC
PLANNING, EDUCATION, ADVICE & KNOWLEDGE

January 2019

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How To Find Peace In The Middle Of Market Turbulence

Ken Solow, CFP®,ChFC
Senior Partner, Chair of the Investment Committee

If you're a Pinnacle client, I have some very good news for you. I'll get to that in a moment, but first, I want to share a few observations about recent market activity…

Based on the current status of the markets as related by the media, are investors entitled to be anxious? Nervous? Frightened? *Of course they are*. As human beings we are not immune to these emotions. I have often written that the notion that investors can act like automatons, suppressing all emotion in volatile and dangerous markets, is a fairy tale. In my thirty-five years of experience, the best you can do—with the benefit of significant training—is to recognize your emotions and try to lean against them when making investment decisions.

There are several forces at play that make market volatility seem more frightening than it did "in the old days," no matter what the old-timers might say.

Today's instant communications give us real time reports of market declines as they occur, with alarms sounding on our smart phones. Remember when you used to get the bad news on the radio or the evening news, edited with perspective and put in context? Business and popular media helps to fuel panic as they (the "experts") speculate just how bad things are likely to get, while you helplessly watch the next downtick in stock prices at the bottom of your television or computer screen. Electronic trading creates dizzying, and sometimes frightening, intraday changes in prices that seem out of alignment with the news of the day. And the fact that the Dow Jones Industrial Average is valued at a price close to 24,000 means that an insignificant two-percent price decline becomes a headline grabbing 480-point wipe-out! Scale that down by a factor of ten to 2400 (as it was in 1987) and that two percent drop doesn't look so scary.

Consider that after nine years of what has been one of the longest bull markets in history, we are simply less prepared to digest market volatility. Many investors have created significant wealth since the 2009 market bottom, and barely remember the last financial crisis, not to mention the dot-com debacle that occurred in 2000-2001. But now, despite their best intentions, they find themselves thinking about market news during the day and how it could impact their retirement or other plans. What if prices don't make a new high this time around? What if this is the beginning of the end?

On that note, I have good news for you if you happen to be a Pinnacle client. It is highly likely that your portfolio with Pinnacle is balanced with a variety of different asset classes, many of which are less volatile than the stocks that you hear about every day. Your portfolio returns should be almost soothing relative to the breathless ups and downs of stock market headlines. It is also notable that *Pinnacle clients have their financial plans crafted with market volatility in mind*, and should take comfort that even though any particular news cycle can be nerve wracking, they've already made the portfolio policy decisions that will ultimately serve them well throughout a full market cycle of very good —and very bad—market performance.

And finally, Pinnacle clients are working with experienced financial professionals who have managed money, and offered professional financial planning advice, through some of the worst market environments in history. Yes, somewhere along the line, many of us have actually become the "old timers" I mentioned earlier.

At Pinnacle, we understand how you feel when markets turn violently lower, or higher, and we can help you to keep it all in the proper perspective of a well-crafted financial plan. After all, *that's our job.*

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How To Create A Steady Retirement Paycheck From A Volatile Portfolio

Michael Kitces, CFP®, MSFS, MTAX, CLU®, ChFC®, RHU®, REBC®, CASL®
Director of Wealth Management

For prospective retirees who don't simply want to annuitize most or all of their wealth, determining how best to invest a retirement portfolio to generate income is a substantial challenge. This is the case not only because of the need to invest for enough growth to sustain inflation-adjusting retirement distributions over time, and managing portfolio volatility to avoid triggering an adverse sequence of returns in the first place… but also because, as retirement investing has evolved beyond simple strategies like "buy the bonds and spend the coupons" and into more total return strategies, it's surprisingly difficult to come up with a system to actually generate the distributions themselves.

This makes sense, since most prospective retirees who are looking at making the transition away from work have spent the better part of 40 years paying their ongoing bills from a steady series of monthly or perhaps bi-weekly paychecks. That means the most straightforward way to facilitate retirement is simply to recreate those ongoing retirement paychecks. Except as noted, modern retirement portfolios—especially those that include both income and growth (i.e., capital gains) components—aren't necessarily conducive to generating consistent retirement paychecks… at least not without creating a system behind the scenes to ensure the cash will be there as needed.

Overall, though, the mechanical problem of how to actually generate those retirement "paychecks" is an entirely separate matter from just investing the retirement portfolio itself. In turn, advisors might even consider creating Withdrawal Policy Statements to codify the processes they will use to generate retirement income withdrawals, just as an Investment Policy Statement is used to codify the processes used to invest the retirement portfolio itself!

The Need For Ongoing "Paychecks" In Retirement

For most of our working lives, paychecks are deposited on a regular basis into our checking accounts—most commonly (according to the Bureau of Labor Statistics) on a bi-weekly basis—around which we build our financial lives of paying our periodic (mostly weekly and monthly) expenses. By the time we reach the age of retirement, we have a nearly 40-year history of handling household expenses by receiving bi-weekly or monthly paychecks.

And then suddenly, when retirement begins, the paychecks stop, leading to one of the most pressing yet natural questions for retirees: How will I replace the ongoing paychecks that have been deposited into my checking account for the past 40 years, so I can fund my expenses for the next 30-40 years?

In the early days of modern retirement planning (the post-World-War-II era), the solution to this situation was rather straightforward: Retirees bought bonds and clipped the coupons to generate the additional cash needed to fund retirement expenses. Retirees merely needed to buy enough bonds to have enough interest-payment coupons to regularly cash as their retirement paychecks to pay their retirement bills.

However, the inflation of the 1970s ravaged the purchasing power of bonds by 57% in the span of a decade alone, driving a shift in the 1980s to dividend-paying stocks as an alternative retirement income vehicle that could better keep up with inflation. The essence of the retirement paycheck strategy was substantively the same, though: Simply buy enough dividend-paying stocks to fund a paycheck account to cover the retirement expenses.

The added complication of introducing dividend-paying stocks to the retirement portfolio was that stocks can also produce potentially-quite-substantial capital gains as well. Through the decade of the 1980s, not only did dividend payouts more-than-keep-pace with inflation, but the raw price level of the S&P 500 also appreciated by 150%! That meant retirees suddenly had another very substantial source to generate retirement paychecks… except for the fact that capital gains are not nearly as stable and consistent as dividends or interest, producing outsized potential "distributions" in some years, but little or none in other years. As a result, while capital gains are capable of generating additional retirement income, they are far less conducive to generating retirement "paychecks" for regular deposit.

The significance of this evolution in retirement income from interest to dividends to capital gains—and the potential need to rely on principal in years where capital gains don't occur—is that when the sources of retirement income are so unstable, it effectively begins to dissociate the generation of "income" from simply creating retirement "cash flows" instead. This is further complicated by the fact that tapping principal may or may not be taxable income, which just further dissoci-

ates income (for tax purposes) from retirement cash flows to cover retirement spending needs.

The good news is that there's actually more retirement income potential in navigating the investment intersections of interest, dividends, capital gains, and principal. The bad news is that it becomes remarkably difficult to simply figure out where the actual cash will come from to generate those retirement paychecks in the first place!

Translating Retirement Portfolio Strategies Into Retirement Paychecks

Of course, the simplest solution to generating steady retirement paychecks is to eschew investing altogether and simply purchase a traditional annuity (SPIA). However, for retirees who want to maintain greater liquidity and/or have a desire to leave a legacy from the unused balance, it becomes necessary to use a more diversified retirement portfolio. How then should retirees (and their advisors) generate retirement paychecks from a (diversified, total return) retirement portfolio?

The first option is the more traditional "income-based" approach; to simply invest into vehicles that can produce a steady stream of cash flows in retirement, and then pay out those income distributions as they are received. The portfolio is simply invested into "income-producing" assets, whose ongoing income payments will be transferred to the retiree's retirement account.

The risk of the income-based approach is that investment markets don't always pay the level of "income" that one desires. This can drive some investors to stretch for yield by taking on additional investment risk, and increasing the possibility that the income itself may stop or regress in difficult times.

By adding in the capital gains component of retirement portfolio investments, the retiree literally becomes less reliant on "just" traditional income alone. Of course, relying on not-always-present capital gains requires the development of a system to generate consistent retirement paychecks from inconsistent capital gains.

One approach is to use capital gains to supplement or "top up" retirement distributions. For instance, interest and dividends might still be accumulated first, but on a quarterly or annual basis the available cash position may be supplemented by rebalancing the portfolio to generate *additional* cash for the coming 3 (or 12) months. In the event that markets were down (and there was nothing "up" to rebalance), the next quarterly or annual distribution supplement might be designated to come from "principal."

More recently, some advisors have opted for a "Pure Total Return" approach that invests in a more growth-oriented portfolio, and any interest and dividends are fully and immediately reinvested. In turn, when the retiree needs distributions, it's time to simply sell the desired investments if/when/as needed to generate that cash to fund a retirement paycheck. For tax-sensitive clients, lot-level accounting ensures that the shares sold will be the ones just purchased and will have little short-term capital gains exposure.

Codifying The Nuts And Bolts Of Generating Retirement Paychecks In A Withdrawal Policy Statement

The challenge remains that even from something as "simple" as a total return portfolio, there is a significant amount of work left to turn all the various moving parts into a steady series of retirement paychecks. Additionally, while a retirement portfolio may have multiple sources of return, most retirees simply want to pay their bills the way they always have: with cash that simply shows up in their bank account. Once you retire, that must be accomplished from the available retirement portfolio and other assets.

The point is not necessarily to pick any *particular* methodology for generating retirement withdrawals, but simply to recognize that *some* clear and consistent

policy is needed. In fact, the whole point of a Withdrawal Policy Statement is to recognize that generating retirement distributions is not just a function of how the portfolio will be invested, but includes a range of other issues, from how interest and dividends will be handled, whether/how capital gains will be generated, the proactive use of cash (or not), the frequency of distributions, and how the strategies will be coordinated with other assets and income sources.

The bottom line is simply to recognize that for many retirees, generating "income" in retirement isn't an investment problem, it's a mechanical problem. How will the cash be generated to show up in the bank account regularly, as it has for the past several decades? In practice, generating those retirement paychecks from a diversified portfolio is not as simple as it may seem. It gets easier once decisions are made about the specific retirement income process and policies that the advisor intends to use.

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Charitable Giving Is Good… But The Tax Laws May Not Be

Kelly Wright, CFP®
Director of Financial Planning

Mahatma Gandhi said, "The best way to find yourself is to lose yourself in the service of others."[1] A 2008 study by Harvard Business School found that giving money to someone else lifted participants' happiness more that spending it on themselves.[2] These good feelings are reflected in our biology. In a 2006 study, the National Institutes of Health found that when people give to charities, it activates regions of the brain associated with pleasure, social connection, and trust, creating a "warm glow" effect.[3]

Scientists also believe that altruistic behavior releases endorphins in the brain, producing the positive feeling known as the "helper's high." A December 2014 study in the *Journal of Economic Psychology* showed that giving to others reduces the stress and strengthens the immune system, and that tax subsidies for charitable giving may have positive spillover effects on health.[4]

So why not try to help the world and your own well-being in the most tax efficient manner possible? Fortunately, the tax laws are still written so that we can get a tax deduction when we give money to charities we support, so it makes sense to plan accordingly.

State Tax And Federal Tax Effects

The new tax laws passed in late 2017 can affect the ability to claim charitable itemized deductions for many filers. The new maximum of the aggregate of state and local total tax and property tax (SALT) allowed is $10,000. Miscellaneous itemized deductions have been eliminated. At the same time, the standard federal deduction (married filing jointly) has grown to $24,000, increasing to $26,600 if both parties are age 65 or older. This means that many filers will not be able to itemize their charitable deductions the same way they did in 2017.

Example of TCJA Changes

Let's assume a married couple, under age 65, with a house and modest mortgage. Their itemized deductions are now something like:

State, Local, and Property Tax Limit.....$10,000
Mortgage Interest.....$10,500
Charitable Donation.....$3,300
Subtotal.....$23,800

While it is close, this filer would use the higher $24,000 standard deduction. In that case, the $3,300 charitable donation provides no tax relief. Furthermore, by using the higher federal standard deduction, they must by law (in Maryland) use the lower state standard deduction. While the 2017 Maryland itemized deduction would be $13,800 (mortgage interest plus charitable), in 2018 the standard deduction it is now only $4,500, yielding a net $9,300 at about 8.95% or about $832 more. Now suppose the donor decides to make a slightly higher charitable donation.

State, Local, and Property Tax Limit.....$10,000
Mortgage Interest.....$10,500
Charitable Donation.....$3,550
Subtotal.....$24,050

Now the federal deduction is $24,050, only slightly higher than the standard, and the charitable donation is barely helpful for federal tax purposes. But, the filer can now use the state itemized deduction of $14,050 rather than the state standard deduction of $4,500, netting $9,050 x 8.95% or about $810. By donating $250 more, they saved $810 in state tax.

Another useful strategy for even more impact is grouping of charitable donations. Say you donate $6,600 every other year, rather than $3,300 every year. In the "off" year, the first example would remain the same, as the filer would use the standard deduction, but in the donation year, deductions would be:

State, Local, and Property Tax Limit.....$10,000
Mortgage Interest.....$10,500
Charitable Donation.....$6,600
Subtotal.....$27,100

Now the federal deduction is $27,100 and is in excess of the standard deduction, so the filer would save in federal tax because of a charitable contribution. Plus, this would allow the savings on state tax already discussed above. Consider this strategy if your deductions are close to the federal standard, it could yield some benefits.

Giving Cash

The easiest way to give monetarily is to write checks to the charities of your choice. If, and only if, you can itemize your deductions, these amounts are subtracted from your taxable income, up to a maximum of 60% of your adjusted gross income (AGI). If you are in the 24% federal tax bracket, for a $10,000 donation, you save $2,400 in federal taxes, making your out-of-pocket cost $7,600. While the easiest, this is the least tax efficient way to give.

Giving Shares of Stock, Mutual Funds, or ETFs

In addition to cash, there are several other ways to give to charity. From a tax efficiency standpoint, gifting appreciated securities is far more advantageous. If you invested $2,000 in a stock several years ago and it is now worth $10,000, and you sell it, assuming a 15% cap gain rate, you would owe $1,200 in capital gains tax, netting $8,800 after tax. Assuming you can deduct your charitable contributions and applying the same 24% bracket, you could then give the charity $8,800, and get a $2,112 deduction. Instead, if you give the shares directly to charity, you'll receive a $10,000 tax deduction, which will save $2,400 in federal income tax and save the $1,200 in capital gains tax. You are saving the world and $1,488 by giving shares rather than cash! Everybody wins!

It is important to note the maximum deduction for giving appreciated securities is 30% of your AGI (vs. 60% for cash) in any one year. More than that, and the extra amount can be carried forward for up to five more years. If you own an appreciated security and feel it still has upside potential, you can buy more of it, and then gift the older, appreciated shares. Consult a professional before doing this!

It is crucial in these gifting strategies, that you identify which shares you are giving to charity in order to gift the shares with the lowest cost basis, so that you are removing the maximum in capital gains from your portfolio. Broker / dealer firms do not do this by default like we do, so we recommend you instruct them in writing, as they may not even have a place on their forms for it. Also, donated shares must be held for more than one year, or you only get credit for your cost basis of the security rather than the appreciated amount.

Qualified Charitable Distibutions (QCD)

Another method of making charitable gifts is to do so directly from your IRA's Required Distribution. While you do not get a possible deduction, the income from the distribution is not recognized. You must be at least age 70½ when the distribution is made, it must be made directly to a qualified charity from the taxable portion of an IRA, and the amount is limited to $100,000 per person. One important point: If you do this you must inform your tax preparer. There is no special 1099-R code for a QCD from an IRA, so the only way to report this to the IRS is for your tax-preparer to be aware of it and put QCD on the write-in line where your IRA distributions are shown.

Donor-Advised Funds

What if you have an appreciated stock, want to give to charities now, but don't want to decide which charities to give to right now? You can give your appreciated stock to a donor-advised fund (DAF), which qualifies as an intermediary charity. You can deduct the full market value in the year that you give the stock to the DAF (up to the 30% AGI limit). The DAF establishes a fund in your name. Thereafter, the DAF makes gifts to charities from your fund. Legally, you cannot control these distributions since you gave the stock permanently and irrevocably to the charity. However, you retain the right to make "suggestions" as to recipient. The DAF is entitled to accept or reject those suggestions, but in practice it will not usually reject proper and reasonable suggestions. As always, investigate and compare before selecting a donor advised fund. Generally, DAFs are established with gifts of $5,000 and more, and can offer immense benefit by taking the deduction now and having charities receive donations over time.

OTHER OPTIONS

Private Foundations

At the top of the charitable giving pyramid are Private Foundations. This is basically an organization usually funded and controlled by one family, created for the purpose of managing a large sum of money to be distributed to charities over a very long period of

time, even ad infinitum. They can be created as a trust or a non-profit corporation. This structure allows the most long-term flexibility and control and can instill charitable inclinations in a donor's descendants and elevate the family name in the community. It also is the most complex of charitable structures with are many rules that must be followed, some of which are mentioned here. A private foundation requires at least 5% of investment assets be distributed each year and requires a 990-PF tax return to be filed each year. Cash can be deducted as donated to the foundation up to 30% of AGI and appreciated assets up to 20% of AGI, with a five-year excess carryover. Private foundations usually need a minimum of $1-$2 million in initial donations in order to run cost efficiently

Split Gifting

As charitably inclined as you might be, you may not be able to afford to give away stock or cash to charity. Instead, there are various ways you can give to charities and let them provide you with lifetime income. Included in this group is a pooled income fund, a charitable gift annuity and, a charitable remainder trust.

Pooled income funds usually are for gifts of $20,000 and up. Charitable gift annuities are generally used for gifts above $10,000. Charitable remainder trusts are typically for larger gifts of $200,000 or more and is the only choice where the person giving wants to continue to control the investments.

In each case, you give your shares to a recognized charity and, in return, you receive income of at least 5 percent of the value of the trust each year for life and possibly the life of your spouse or beneficiary. In the year you give your shares, you will be entitled to an income tax deduction. The amount of the deduction is determined by your age, if the income is for your life, and the life of your spouse and the amount or percentage of income you are projected to receive. After you (or you and a designated beneficiary, such as your spouse) die, the remaining principal goes to the designated charity. It is this remainder on which the tax deduction is determined.

In the case of the pooled income fund and charitable gift annuity, you give the shares to a specific charity. It is important to realize all charitable gifts are irrevocable– that is, you can't change your mind as to the gift or the recipient. With a charitable remainder trust, however, you can have the flexibility to designate the charities you want to benefit from your gift and can also reserve the right to change the beneficiaries later. For additional details on these first two strategies, contact your Wealth Manager.

Charitable Remainder Trust (CRT)

The Charitable Remainder Trust (CRT) is a more complex way to gift and is really more suitable for larger gifts ($200,000 or more). If you want to give the money to just one charity and don't want to reserve the right to change your mind as to the beneficiary, the charity will often provide you with sample documentation and may even serve as trustee of the trust.

If you want multiple charities to benefit, or if you might want to change the charities at a later date, then you will need a lawyer to draw up the document for you. (It is important to consult a lawyer skilled in charitable tax planning matters as this is a complex area.)

The CRT will pay you income for your lifetime (plus that of another beneficiary, if you so wish), or for up to 20 years. At the end of this period, the CRT terminates and the assets go to the named charity or charities. (Under a 1997 law change, the charitable interest must have a value equal to at least 10 percent of the amount placed in the trust.) Once the CRT has been established, you can give either appreciated property or cash.

There are two types of CRTs—the unitrust and the annuity trust. Ask your Wealth Manager or your Attorney to review the differences with you and help you make an appropriate choice.

Once the CRT is set up, you must name a trustee. You may be your own trustee, but if so, you must name a successor trustee for the disposition of your assets after your death or in the event of your disability. Of course,

if you choose to serve as your own trustee, you will be subject to fiduciary limitations in investing and otherwise managing the trust, with potential liability for mistakes. The CRT must file a tax return each year and this, too, is the trustee's responsibility.

If you exchange your shares for an interest in a pooled income fund or a charitable gift annuity, you have given up all control over the investments. The same is true if you give your money to a CRT run by a charity—in other words, your gift is irrevocable.

Using one of these planned giving techniques is an excellent financial planning strategy. You can avoid paying capital gains on a stock gain, receive a current tax deduction, obtain regular income (usually at a higher rate than your investment is currently paying) and benefit your favorite charities.

Conclusion

Charitable giving is not a simple matter, particularly since once you have given the money away you can't take it back. Therefore, it is imperative you seek independent professional advice before giving to charity. Also, remember to identify which shares are to be gifted without exception, and that any gifted security had been held for more than a year. Your financial planner, working with your estate planning lawyer, tax counsel and your charity, should be able to provide you with the necessary specific advice.

Endnotes

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Disclosures

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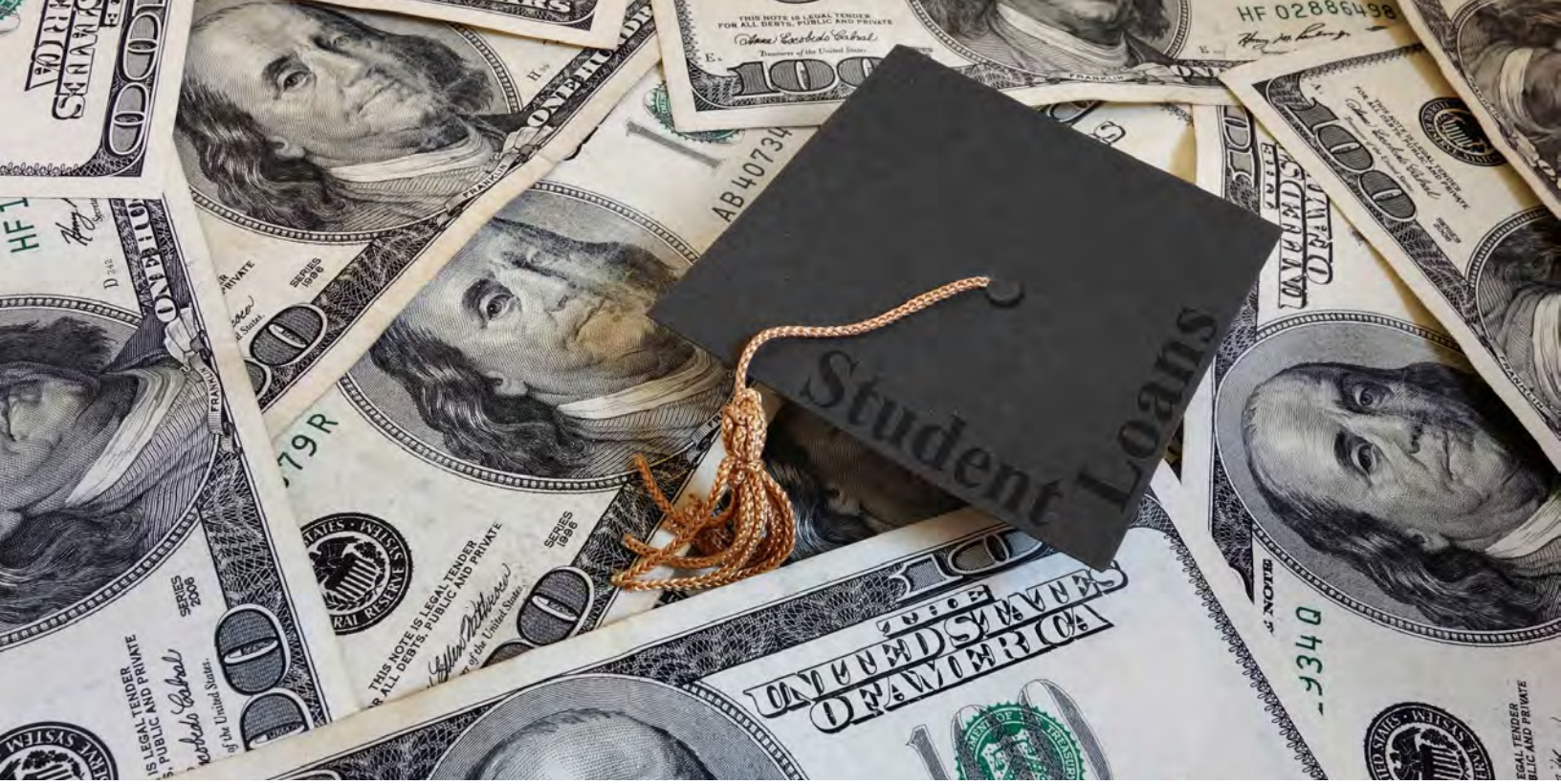

How To Build Wealth While Digging Out From Student Loan Debt

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For many professionals, especially recent graduates, student loan debt is not only an expense item on their budget, it is also a major component of their financial trajectory and often a great source of anxiety. Indeed, the data show that in 2018, Americans are more burdened with student loan debt than ever before. In addition to sometimes staggering dollar amounts, those in debt must contend with a complex array of terms and variables when navigating the student loan landscape.

Like so many issues in financial planning, the solutions are not found in a vacuum, but instead depend upon related factors such as circumstances, resources, income, and priorities. How much debt do you have? Are your loans federal, or private, or both? What is your current income, and expected future income? How do you wish to balance debt repayment versus saving for retirement? The answers to these and many other questions can form a roadmap to an optimal strategy. Below are four case studies containing different scenarios, factors to consider, and possible solutions. While not exhaustive or definitive, they reflect approaches that can be taken in various situations.

The Newlyweds

Recent grads John and Melissa got married this year. John, now employed as a mechanical engineer, incurred $25,000 of federal student loan debt, and has a salary of $60,000 per year. Mary has $75,000 of her own federal debt and makes $45,000 annually as a school teacher. Given those numbers, they will be eligible on their federal loans for an income driven repayment plan. Relative to standard repayment plans, income driven plans allow for lower monthly payments calculated based on current income. Such plans can be very helpful to recent graduates starting their careers with high levels of debt and modest income.

As newlyweds, John and Melissa will be combining resources and can, of course, file a joint tax return. In most cases, the tax bill for couples will be lower if they file jointly than if they file separately, and projections in their case show that they would save approximately $1,270 by doing so. However, their filing status will also have implications on the amount of their student loan payments. Running the numbers, it appears that, under their applicable repayment plan, they would save about $2,100 in student loan payments over the course of the year if they file separately. This extra savings would more than offset the additional taxes due and boost their cash flow, so filing separately would likely be advisable in their case. Evaluating tax filing status, in the context of addressing student loans, is something couples should do on an annual basis.

Forgiveness…I and II

Megan is making nice progress in her career as a fund raiser with her undergraduate alma mater, and recently received a promotion and pay increase. She lives frugally, sharing rental and living costs with several roommates, but looks forward to greater independence in the future. Her financial ledger includes two Federal student loans, a Stafford and a Perkins, each with sizable balances, and each of which is currently on an income driven repayment plan. In addition to lowering monthly payments, such plans provide forgiveness of unpaid balances remaining after a defined period of payments (either 20 or 25 years). On the flip side, they lengthen the life of the loan, may increase the total amount paid over the entire loan term, and result in taxable income if any balance is in fact forgiven.

> **Often, prioritizing between immediate needs and long-term goals is key in formulating the right plan.**

Since her employer is a 501©(3) organization, Megan's Stafford Loan is also eligible for another type of forgiveness stemming from public service. Public Service Loan Forgiveness (PSLF) means that, following 120 timely payments (10 years) made as an employee of a non-profit, any remaining balance will be forgiven, tax free in this case.

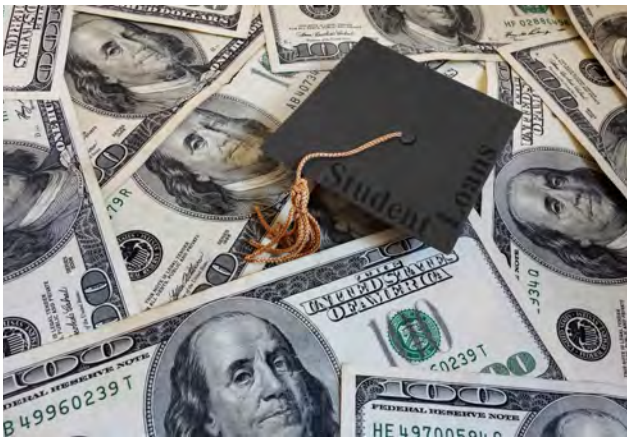
With her career evolving and the recent increase in her cash flow, Megan's priorities may shift somewhat, from minimizing monthly payments to getting out of debt more quickly. She could use her raise to increase her monthly payments on the Perkins Loan, and could also evaluate whether to refinance it through a private lender. While doing so would cause her to lose eligibility for Federal income driven repayment plans on that loan, it could also allow her to obtain a lower rate and position her to pay the loan off more quickly. In the meantime, her Stafford Loan will remain on track for Public Service Loan Forgiveness.

Upwardly Mobile Professionals

Chris, a recently minted lawyer, will soon be completing a judicial clerkship, a job at which he has been making $70,000 per year. Undergraduate and law school loans have left him with a current balance of $170,000 in federal debt. At the conclusion of his clerkship, he will become an associate at a private firm in the city, where his salary will jump to $190,000 per year. Chris will also be marrying Katy, who earns $55,000 per year as a social worker, and who has no student loan debt. While they both wish to reduce debt, they do not want to ignore saving for retirement.

Since graduation and throughout his clerkship, Chris has been operating on an income driven repayment plan known as "Revised Pay as you Earn" ("REPAYE"). In addition to facilitating lower monthly payments, a distinct feature of REPAYE is that it places a cap on the amount of interest than can accrue. This is a benefit that has served Chris well to this point.

With the salary increase and marriage on the horizon, however, Chris might consider shifting to another income driven plan known simply as "Pay as you Earn ("PAYE"). The REPAYE plan he is currently on places no cap on the required monthly payment amount, and where salaries increase can result in monthly amounts even higher than the standard (non-income driven) repayment plan. PAYE, on the other hand, caps the monthly payment at the standard repayment amount. In addition, REPAYE, when calculating the payment amount, requires inclusion of the spouse's income, regardless of tax filing status. Under PAYE, Chris and Katy can file separately if they choose, and exclude Katy's income from the repayment calculation. Running the numbers in their case, it appears they could save almost $400 per month in student loan payments by switching from REPAYE to PAYE, and the additional cash flow might be added to their 401k accounts, building their nest egg and reducing their current year taxable income.



Parental Discretion

Brian and Mary, a marketing director and dental hygienist respectively, are proud of their son Will, a recent grad who has begun a promising career in the Information Technology field. For Will's final year of school, Brian and Mary took a Federal PLUS loan for parents at an interest rate of 6.84%. They are concerned about how this debt could impede their retirement plans. There are several options they might consider.

One would be to refinance the PLUS loan through a private lender, in hopes of obtaining a lower interest rate. In doing so, they could take the additional step of establishing the new loan in their son's name, rather than their own. This would involve many considerations regarding Will's income and circumstances, and clear communication and agreement between parents and child.

A home equity loan or line of credit could be another means of rate shopping. In comparing, Brian and Mary would want to be aware that PLUS loans are eligible for the student loan interest deduction, while payments of interest on a home equity loan, taken for this purpose, would not be deductible.

Finally, 401k accounts can be another loan source, often with friendly rates. If resorting to this, Brian and Mary should be sure that their cash flow will allow

them to pay the balance off within five years and should be aware that any unpaid balance will become taxable income upon departure from that employer.

The scenarios above show that each situation is unique and provide an idea of the many factors to be considered when addressing student loan debt in the context of one's financial goals. Often, prioritizing between immediate needs and long-term goals is key in formulating the right plan. If you or a family member are seeking strategies to manage such debt while building wealth, please consult your Wealth Manager.

(Disclaimer: The scenarios included above are intended to be informational in nature, and do not represent financial planning advice to specific individuals. Numerical outcomes contained therein are intended as estimates based upon recent and current interest and tax rates, and are intended to reflect probable, but not guaranteed, results.Individual cases will, of course, vary.)

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MARKET OUTLOOK

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The fourth quarter of 2018 did not usher in the typical year-end rally that investors have come to expect in recent years. Global equity markets got off to a weak start, failed to recover, and ultimately plummeted, as weak business indicators collided with perceived governmental policy risks with respect to the Federal Reserve. Commodity markets also felt the pain of lower oil prices, and fears that a global economic slowdown was beginning to spread to the United States from abroad. By the end of the quarter, equity markets were caught in the grips of a cyclical bear market, and the only asset classes that yielded positive results were the traditional safe havens of bonds, cash, and gold. The quarter was brutal in the short-term due to volatility, and the full-year result was extremely unusual in that very few if any major asset classes offered any gains. But in the final days of the year, the market reversed course and began rallying.

As investors look forward to a new year, they're faced with deciding whether it is wise to keep playing defense, or if it's time to position for a new cyclical bull market that may have already begun.

Navigating A Cyclical Bear Market

We believe that stocks are currently caught in a shallow cyclical bear market, which will ultimately run its course this year, and set up investors for a great chance to purchase new investments at better values than have been afforded in quite some time. There's no way to pinpoint exactly what tips the scales and ignites a sell-off, but the following are a few of the factors that contributed to markets reacting so violently during the recent fourth quarter.

Global Slowdown & Earnings Deceleration

Emotions can drive markets in the short-term, but major turns in the market often indicate the approach of a deterioration in the fundamental economic outlook. During the fourth quarter, evidence of a slowdown in the U.S. economy emerged as a wide swath of economic data began to reduce expectations. Earlier signs of slowing in housing and automobile sales finally leaked into manufacturing data, as well as other leading indicators of growth. To compound the weaker data, a sudden negative shift in bond valuation, higher volatility, and general weakness in business growth all contributed to a tightening in financial conditions. It is very likely that some of the market's recent volatility was due to the global slowdown that appears to be spreading from the rest of the world to the U.S., along with evidence that corporate growth-rates had peaked. As companies reported their third quarter results, many of them had strong top line revenue and earnings growth, but were still punished in their stock price due to cautious growth forecasts. Corporations are citing global growth weakness, higher interest rates, and trade imbalances that continue to put negative pressure on growth, materials costs, and worldwide supply chains.

Federal Reserve Hiking into the Slowdown

The Federal Reserve has now hiked interest rates nine times in the latest market cycle (since 2008), and even though rates are still historically low, in the fourth quarter markets appeared to view continuing those rate hikes as a drag on growth. While the Fed has used a more gradual approach in raising rates this time, the fact that they have been tightening policy going into a global slowdown, and an ongoing trade war, appeared to tip the balance and turn a methodical tightening cycle into a choke point for markets. It's also important to note that the central bank has also been reducing its balance sheet, and some analysts believe that this tightening effect was also a big factor in driving volatility during the fourth quarter. Lastly, due to rising short-term interest rates, the yield on short-term bonds had finally begun to beat some long-term stock returns, which may have encouraged some investors to start shifting out of stocks and into bonds during the quarter.

Trade War Biting

We wrote about the escalating trade war several quarters ago, and highlighted that the risk to growth might have more impact than most estimates suggested. The benign view is that the growth will only slow by an insignificant amount, given the current amount of goods involved, and the current tariff rates on those goods. We argued that the effect on world growth may be worse than expected, because of the importance of supply chains in a globalized world. During the fourth quarter there was a noticeable increase in the number of companies citing the trade war as a drag on earnings, and the market finally recognized that the trade

dispute does matter for corporate America. Trade negotiations with China are ongoing, and it remains to be seen if a deal can be reached, or if tariffs will increase again following the temporary truce.

Complacent Sentiment & Narrowing U.S. Market

The markets trade in cycles of fear and greed, and there were some signs last year that U.S. markets were getting a little greedy. Big name companies in the Technology and Consumer Discretionary sectors had enjoyed a very profitable run since 2016, and by last year a very large portion of U.S. market returns were being driven by just a handful of these stocks, the so-called FANG equities. This subset of the market got over-invested, overvalued, and over-represented in many of the U.S. stock indices. This set the market up for a problem when they finally turned negative in late 2018.

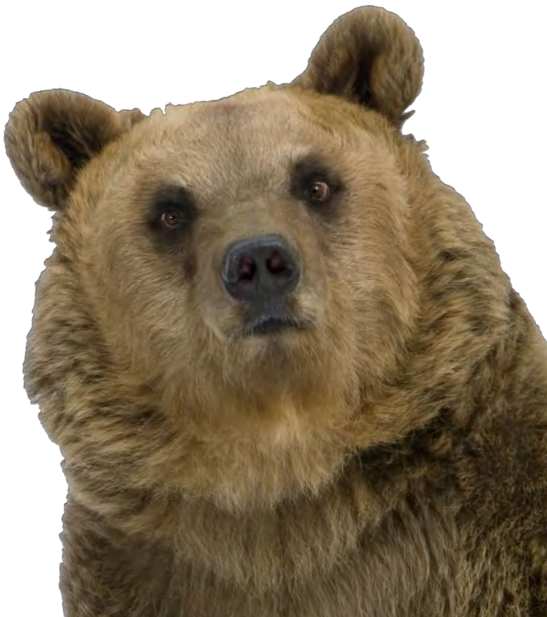
Positives Building

Wall Street endured the worst December since the 1930s, and the low point of the current market slide brought most U.S. markets into bear territory on Christmas Eve. Ever since hitting a low point that day, stocks have enjoyed a robust rally, which has some analysts believing that the cyclical bear market has already run its course, and a new bull market has arrived. On the plus side, the price damage done in late 2018 was substantial, and has already cleared much of the price optimism that had built for several years late in the bull run. There have also been some positive developments occurring during the latest rally. The Federal Reserve has changed its tone and eased the rate hike schedule in response to the recent volatility. The U.S. and China have made some progress in trade conversations, and coming out of the G-20 meeting, China conceded on some level by agreeing to buy more agricultural products, pull back retaliatory tariffs, and tone down some of their "Made in China 2025" rhetoric. Additionally, a solid U.S. employment report for December has stunted some of the fears of recession that were spreading prior to its release.

Risks Still Swirling

We won't deny that the highlighted positives have been enough to ignite an impressive rally in the stock market, but it is important to realize that the primary trend is currently still down, and there are still many risks that could ignite a fresh round of selling that would drive down prices further:

- The Fed has only implied they will pause rate hikes, and their own projections still imply two more rate hikes by the end of the year. Globally, the Brexit situation in the EU is very uncertain, and will soon come to a head.
- China is still broadcasting worrisome economic signals, along with a variety of Asian economies that recently reported very weak manufacturing data.
- On the trade front, the market seems hopeful that the president may soon relent on trade policy, given his nervousness about market volatility. But while the trade rhetoric has eased, there is still risk that the U.S. imposes a higher rate on tariffs that have been deferred until March.
- Earnings season is about to heat up, and recently several retail companies have lowered their forecasts, which may imply that the mighty consumer is starting to falter. Given that the consumer sector has been one of the healthier parts of the economy, this could be a warning that the U.S. economy is deteriorating more than is widely believed.
- Lastly, there is growing risk that the contentious political backdrop in Washington, along with the ongoing government shutdown, is just creating more uncertainty at an already fragile time.



Hunting for A Bottoming Process

There is a chance that the December market lows may represent the bottom for this cycle, but we don't think it's safe to buy just yet. After markets experience sharp selloffs, they normally go through a bottoming process before turning the corner and starting a new bull market. The process usually entails some time and some price choppiness, and typically culminates with the markets revisiting the most recent price bottom. Therefore, there is a decent probability the market will return towards the December low and set up for a critical reset. If that does happen, upon the anticipated relapse it will be critical to evaluate the internal health of the market, to confirm that the worst is over. Then it's time for a new bull market to take over.

Budding Opportunities

The best thing that can be said about bear markets is that they create great longer-term buying opportunities. From that perspective, investors should be embracing occasional cyclical corrections. The current episode should be no different when a solid price bottom eventually forms. Since March 2009, U.S. stocks have been the place to be, and the S&P 500 Index has returned approximately 360% versus the MSCI All Country World Index ex-U.S. that has returned roughly 150%. Using the same time period and indices (the S&P 500, The MCSI, since 2009), the U.S. stock run for the last decade has been astounding, contributing to annualized returns of almost 17% per year, versus the international composites that have averaged just under 10%. This differential in performance has left U.S. stocks looking overvalued, or in the reverse, international markets now appear to be cheap.

But good value alone often isn't enough, and markets usually need a catalyst to help turn the tide and unlock an asset's potential. In this case, one of those catalysts could very well be an easier Federal Reserve policy, and an eventual lift to global growth. If the Fed is forced to reverse policy due to decelerating growth rates, and risks to future earnings growth, then it is plausible that the dollar will begin to fall. The dollar could also fall if global growth begins to pick back up. China has been enacting a slew of stimulus measures

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to combat weaker growth, and it's conceivable that if this continues, China could lift global growth out of its slump. No matter how it happens, should a weaker dollar materialize, it would help the total return of undervalued foreign stocks for U.S. investors. As markets search for a sustainable bottom, our hunch is that it will soon be time to boost our international stock inventory, as a new cycle may favor cheaper global stocks. For now, it still seems to be premature to be buying in front of a possible revisit of the recent lows, but it is not too early to begin thinking about what to buy when the turn does come.

Conclusion

The fourth quarter of 2018 was a rough one for markets, as a combination of weaker business fundamentals and policy missteps contributed to an unusual price drop in what is usually a great time of year for global bourses. The speed and depth of the recent drop was reflective of the convergence of many different factors, but ultimately highly-valued markets clashed with weakening data, and a new primary downtrend was born.

We still believe the trend is down, and can't be sure at this point if markets have hit the low point for the cycle, or if fresh new lows are on the horizon. Our convictions lie with the idea that the markets will likely soon revisit the lows and give us valuable clues as to

whether a solid bottom is being formed. We'll continue to monitor the evidence closely in coming months, as we hunt for a bottom. Should the U.S. business cycle take a turn for the worse, we may have to increase our defensive posture given that equity downturns during recessions take time to run their course and produce the most damage. But if our current non-recessionary view holds, and market data solidifies as the market drops, then it will likely be time to start taking advantage of some of the budding bargains that have developed during the cyclical bear market.

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