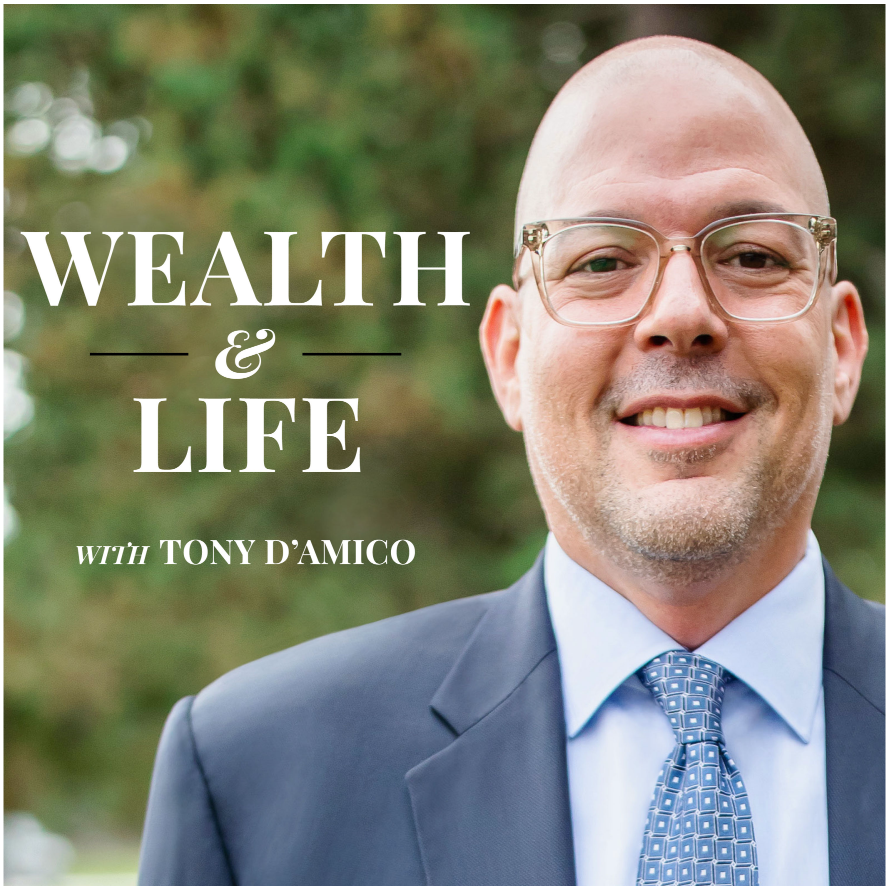
Ep #13: Market Returns, Inflation and Taxes - Where Do We Go From Here?



Full Episode Transcript

With Your Host

Tony D'Amico

***Wealth and Life* with Tony D'Amico**

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Welcome to *Wealth and Life*, where you'll learn with financial planner, consultant, speaker, and business owner, Tony D'Amico. You'll hear stories from successful business owners and individuals about how they navigated the inevitable challenges that arose as they achieved each new level of success, and you'll get insights and strategies from leading wealth planning professionals on how to achieve your next level of success. Now here's your host, Tony D'Amico.

Amy D'Amico: Hi, my name is Amy D'Amico and thanks for joining us for this episode of Wealth and Life Podcast. Today, we have Tony D'Amico, who is the founder and managing partner at Fidato Wealth. We're going to talk about something important today, and we're going to talk about the current planning challenges in today's environment and how to navigate those challenges. So, Tony, what are some current topics that you have had on your mind when you've been managing the portfolios that we utilize for our clients and the wealth planning we provide for our clients?

Tony D'Amico: That's a really good question. I really think the landscape has changed and there are different things that are front of mind, and financial planning, investment management is always about opportunities and risks. But in today's landscape, as I step back, look at where we're at and think about where we're at, there are several factors that come to mind. So I think of taxes, inflation and market returns. So with a client's financial plan, those all play a big, important role in the plan, as well as their life assumptions too, their life expectancy, how much they want to spend, all those sorts of things, but the economic assumptions, taxes, inflation and market returns, those are all assumptions too in the plan. And when I think about those three areas, taxes right now are low historically, inflation is low historically, and market returns have been very good. So it's the perfect trifecta for a client's financial plan, and obviously financial plans will give a probability of success of being able to fund the goals and the wishes for the client.

Tony D'Amico: And those three factors do contribute and affect that probability of success. So that's not that I've been thinking about a lot lately, and in my role I do a lot of, I would say, research and reading, and I always focus on economic policies. So the economics of things, never the political side of things. So let's throw that out there right now. This is strictly going to be a discussion of just economic policies and just looking at, I do continuing education, I do continuing education for my certification as a certified financial planner, and one of them that I attended actually late last year had the new administration's tax proposals and looking at that. And their proposals, it takes an act of Congress for something to become law and also just keeping abreast of that as it's been unfolding. So reading data-based articles, not political based at all, but just about what's being proposed and how that could affect clients' financial plans in the future.

Tony D'Amico: So there are clearly some tax increases that are desired so we have to look at how that could impact a client's financial plan and based upon what their goals are, what adjustments we should make.

Amy D'Amico: Mm-hmm (affirmative). That all makes a lot of sense. And I can just also add, as your wife, because I see Tony morning, noon, and evening, he does listen to economic information constantly, listening to podcasts all morning, always walking around with an earbud in his ear, and really keeping on top of everything that's going on out there. He spends an awful lot of time gathering data, gathering information. Also, I wanted to know, Tony, what are some scenarios or examples that you can think of in regard to the current economic conditions that have impacted a client's planning meeting?

Tony D'Amico: Yeah. Let's just stick with taxes. For the most part, not all clients, everyone's different, but most of our clients want to be tax efficient and they want to do tax planning and they want to take advantage of the clear black and white, vanilla tax strategies that are in the Internal Revenue Code, and the Internal Revenue Code does encourage Americans take advantage of all of the tax strategies available to them. That's the majority of our clients and our goal is to know what's important to our clients. So I've never had somebody yet tell me that they wanted to pay more taxes, but I'm actually prepared for that, because you can actually write a check to the Treasury Department if you would like to give money. But I guess to give an example of that, tax planning has always been something that we've been focused on. I'll give an example there.

Tony D'Amico: So I would say common strategy that we utilize, especially for our clients that had a professional job, contributed to a 401K, and they've done a great job saving, and it's all pre-tax, so they've done such a good job but they do have a growing tax problem, when we look at their financial plan and eventually they have to take a required minimum distribution from that IRA in the future, and if we just look at average rates of returns and just have reasonable assumptions, and I think that's important too, to utilize historical inflation, have the current tax code in the financial planning software, but when we look at what their required distribution will be from their IRA in the future when they turned 72, for some clients, it will push them into the 28% tax bracket or the 33% tax bracket sometimes even higher tax brackets. So they do have a growing tax problem because they were really diligent about saving for their future. But that IRA grows tax deferred, and then you have to take the money out of that.

Tony D'Amico: So a lot of times, a good bit of times, there's opportunities. Not for all clients though, but for some, where they're in a lower tax bracket in their earlier retirement years. So perhaps they're not starting social security right away to take advantage of that guaranteed growth and that guaranteed annuity, basically, that has that cost of living adjustment. And sometimes there's that opportunity where their tax rates are lower, their tax bracket is lower for a period of time. So sometimes that's two years, sometimes that's seven years. What we've always focused on is, perhaps if a client has room within their 22% tax bracket, because you can make up to a certain amount of income and be in the 22% tax bracket, but it's not just earned income, it's also distributions from your IRA. Or in this case, what we would do is a Roth conversion. So to convert the traditional to a Roth, you have to pay tax on the money at that point in time. But there, we're helping the client make a strategic decision and say, "Hey, it's better to pay 22% now than let's say 28% or 33% or 39% in the future.

Tony D'Amico: And this is all based upon current tax codes, what the tax code is today. The tax code will sunset, which the current tax code that's in place was not passed by a super majority so it was not permanent law, so it was only law for 10 years, and that expires December 31st, 2025. So come January 1, 2026, tax rates will change unless Congress takes action between now and then. But to get back to the strategy, if somebody is going to pay 22% now, convert a certain defined amount with the help of a CPA over the course of several years, what that does is it slowly transitions monies from the traditional IRA to the Roth IRA, and with the Roth, then it grows tax-free and you can take income from it tax-free as well. So you do have to have that Roth IRA open for five years. There's a couple of other nuances which are manageable, but then you have that tax-free growth and you can take income from it tax-free and there's no required distributions that are needed or required from the Roth.

Tony D'Amico: So what that does is it lowers the required distribution in the future from the traditional IRA, because that required distribution, that amount, is a function of your age and the amount of the traditional IRA, how much you have in it. So what we're doing is slowly and very tactfully converting. We've done an analysis to compute what is the lifetime tax savings? So I can think of one scenario just the other day, the client was saving $535,000 in income taxes over the life of their financial plan. Again, with what we know about tax rates, tax rates could change, returns could be higher or lower, and all that will effect that. But with looking at averages, they're going to save that amount in income taxes. So that is substantial about getting to the change that we have had. Because of the potential for higher taxes, we've had some clients say, "What about filling up the 24% tax bracket and maybe doing more Roth conversions?"

Tony D'Amico: So to answer your question, the first thing I would say that comes to mind is sticking with our approach to tax planning as part of a comprehensive wealth management plan, and then just re-evaluating if it makes sense to alter it just in light of where things are. So there's always pros and cons and if we just had that crystal ball of, what will taxes be, what will inflation be? How long will somebody live? All those things we can tell them exactly right. What to do, but with taxes, I gave you a bunch there, but that's where we're at. And also, too, I would say just always being the voice of reason for a client. Some clients are more concerned about taxes and maybe they want to do some drastic things. Those can have consequences. Sometimes, too, if people maybe just aren't aware of what their lifetime tax bill will be, our job is to obviously educate them, know what's important to them, know what their goals, values are, what they want to accomplish with their money, and then just have educational and being fiduciary.

Tony D'Amico: Our clients want to be us to be proactive with them and give advice and write that, help them determine what scenario is best given their circumstances. So yeah, it's continued focus on that, because it makes a huge impact on a client's plan. And it's not just too, I'm talking more than I thought I would, but it's not just Roth conversions. We want to take advantage of, I mean, there's a decent amount of room in the 22% tax bracket so for most clients that's a no brainer. So there's different ways to take advantage of the 22% tax bracket. It's not just Roth conversions. It's also, well, I'm in the 22% tax bracket, maybe instead of contributing into the pre-tax portion of my 401K, let me forego that tax deduction, let me contribute into the Roth 401K that I have access to at my employer. And those are the things that we highlight and bring up as potential strategies for the clients that we work with.

Tony D'Amico: So sometimes it's where you save your money heading up to retirement. It's those conversions. Sometimes too, if you're in a lower tax bracket, even while you're working, so conversions don't just happen when someone retires. And then if somebody has an investment account that is not an IRA, not a Roth, it's just an individually owned account or a jointly owned account, then there's gains in those accounts. Well, capital gains tax is also very low historically and capital gains is also tiered so you can have a certain amount of income and there's no capital gains. And then the next bracket is 15%. Then the next bracket is 20%. So whenever we can harvest gains, because it's up and obviously not pay any capital gains tax, then we want to do that. But, again, that capital gain, it's not taxed as income, but it starts to fill up that tax bracket. So sometimes 15% is a client will say, "Hey, this thing is up a lot, perhaps let's harvest some of the gains and pay the tax obligation now."

Tony D'Amico: One of the things that is on the docket that they've been talking about extensively is changing and increasing capital gains tax. And so, again, how do we take advantage of the lower tax brackets for our clients? And then to do that often affects their financial plan, so then if they do that, I was meeting with a client the other day where we've been working with them for over 10 plus years, so we've planted a lot of these trees a long time ago. You know the saying, "The best time to plant a tree was 20 years ago. The second best time is today," well, do you do these strategies? This is a longterm perspective, and that's really also important to know. Then it's like, "Well, what do you do with the money?" That's another piece of it, too. Sometimes it's increased financial security, maybe helping grandchildren out more, could be charitable contributions. Wealth management is a never ending event. So that's with taxes.

Amy D'Amico: I was just thinking, a lot of the planning that you do around taxes is meant so that when a client comes in and they tell us what their goals are and what they'd like to achieve in retirement and beyond, we want them to achieve those goals, so working on any way that that's possible to save on taxes like the Roth conversions and such. That money that's saved on taxes is then there for them to use to meet their goals such as finance longterm care or other such goals, correct?

Tony D'Amico: Mm-hmm (affirmative).

Amy D'Amico: But that's in the future. So do you ever find that trying to balance between a person wanting to live now, but also knowing that they need to prepare for the future too?

Tony D'Amico: Yeah. I mean, that's the yin and yang of this, is you need to have a quality of life today and you need to have a quality of life tomorrow, so striking that right balance and then just constantly educating the client on where they're at today and how this all works and using some good visuals as well to illustrate things. But I mentioned the other thing that's been on my mind is inflation. It might seem odd because everything is going great, but really, when it comes to inflation here is why it's my radar. So number one, it's been historically low. Number two, the Fed has a written statement on what their desire for inflation is. The Fed wants inflation to be higher, flat out, and that's fine, and again, I'm just telling you what the economic policy is. But specifically, the Fed has said too in writing that they want personal consumption expenditures, that they want that inflation to be higher.

Tony D'Amico: So that's a specific basket of goods that also more so relates to what a client would spend their money on. Core inflation is made up of a certain basket of goods, but healthcare has inflation. Food is more sporadic. Food prices have more challenging inflation than some other things do. So the Fed has come out in a statement and saying that they want employment to be very low, which is great. They're not as concerned with inflation, and that's a different stance than previous statements from the Fed. So historically the challenge has always been or when there has been a lot of inflation, hyperinflation. That has happened when our economy has overheated. So they want very low unemployment. Hopefully, I'm using the right words. They want very low unemployment. They're setting interest rates accordingly to accomplish that goal. So the number one goal is lower unemployment. They'll take higher inflation to get to that goal. And again, I have no judgment on whether that's right or wrong, but they are leaving room for inflation to go up.

Tony D'Amico: And there's different things the Fed can do, the Federal Reserve can do, through its monetary policy to control inflation, interest rates, and these things. So, if we do have higher inflation, that will change financial plans. So financial plans have done better the last 10 years because inflation has been low. Now, we use 3% for inflation in our financial plans. Historically, longterm, it's been about 2.9. So we use 3%. We use the historical average as well for healthcare, because that is not 3%. That's in the 5% range. And also, college expenses don't inflate at 3%. So we use a longterm historical average. So plans, if they're done the right way, they assume that the expenses are increasing by that inflation factor each year and making sure that your plan can withstand that. I think it's just really important. When I think of the economy, there are certain publications that are economic based and I read those. It's data driven.

Tony D'Amico: But then I also have my own eyes and I see. I have business owner clients. We also have clients that are business owners and in different businesses, all sorts of different businesses, home builders, dental practice owners, manufacturers, manufacturers of different types of products, real estate investors, and I also have peers and friends that are located in different parts of the country. And I've spent some time in other states and you see how strong the economy is, how strong the demand is for certain goods and services. There are certain areas where, for example, the demand for that good or service is so strong that the materials that they need have gone up in price substantially. Being in financial services for over 20 years now, I've seen these. I've been part of these cycles before, and you just don't know, and are we going to do anything and make some rash decision or drastically change the investments?

Tony D'Amico: Could there be adjustments? Yes. Are there adjustments to a financial plan? Yes. But it's always with that longterm in mind. It's always looking at the evidence and never trying to guess. But why I'm saying this is the economy is strong, I see it on paper. I see it with my eyes. I'm like, "Okay, well, if it continues to go this way, and actually just this month, there are certain costs that have gone up. Home building, for example. The cost of lumber is through the rood, so if someone's looking to build a house now, the materials are so much higher than they ever have been. So the demand, and not just home building, but different areas of the market, have really, really heated up. So just keeping your eye on inflation and maybe if you're listening to this or watching us, how does that change your plan or how would that adjust things?

Tony D'Amico: So, number one is, I'm looking at it. I want to make sure that a client doesn't have too much inflation risk, meaning that they don't have too much money in cash. We like our clients to have three to six months of living expenses as an emergency account that should be in cash. That's really important. If you start to have a lot more than that, well then you're going to have that inflation drag because banks are paying half a percent, let's say. If inflation is 2.5%, then you're losing 2% buying power. So, how do you manage inflation and making sure you don't have too much inflation risk? You can't be too aggressive either, so pairing strategies that have different pros and cons is really important. With inflation too, it's, again, the fundamentals. It's being focused on the plan, helping our clients make sure that they're taking social security at the right time.

Tony D'Amico: There's many strategies with social security, which I actually just recently did a separate podcast on that, but social security is a really unique asset. It grows phenomenally well. If you defer it, it'll grow 6% from 62 to full retirement age, and it grows 8% from full retirement age to age 70. So if you defer from 62 to 70, it's about a 76% increase in the benefit. Now, it's not right for everyone to do, but we're talking about inflation, social security is basically a guaranteed annuity. The guarantee is based upon the government making good on that commitment to pay those funds, but it also has a cost of living adjustment as well. So if there's higher inflation, your social security payment will go up. And portfolios tend to not do as well, your investments not do as well when there's higher inflation.

Tony D'Amico: So, again, it's looking at really somebody's total financial picture, their total balance sheet, if you will, and making sure that they're optimizing things to best handle inflation. And also, too, it's important that with inflation, stocks, having access to stocks or equities, is important, because that has offered a hedge against inflation over history. So making sure that the fundamentals are there, sticking to those longterm fundamentals. I know I've probably said that quite a bit, but just looking at things. I think it's important, what I'm trying to say is, always looking at things with a fresh mind is really important. So with inflation, those are some of the things that we're looking at.

Amy D'Amico: Yeah, it's a lot. It's really like a chess game trying to get all the pieces to be in the correct spots to work properly. So it's a lot of work, yeah. And you might've answered this a little bit, but how is it best to proceed in light of current economic conditions?

Tony D'Amico: If I had the crystal ball.

Amy D'Amico: Yeah.

Tony D'Amico: I guess the other factor too that I mentioned was market returns. Market returns have been really good. We had that dip with COVID onset, a substantial dip. We rebalanced seven times during that period of time to take advantage of that volatility for our clients. So market returns have been really good. And so what do we do there? How do we move forward? I would say, it's relentless discipline is number one. So continuing to rebalance when things grow out of band. So if the target allocation is here, let's say the target allocation for a certain investment is 15%, but it's grown to 20% because that particular asset class has done really well, so to rebalance that, sell it off so you're back down to your 15% is really important. We call this threshold based rebalancing. So it's not calendar based driven. It's based upon the investments growing out of band or dropping below, out of hand.

Tony D'Amico: I think ongoing rebalancing is really important. And I would say discipline too is also really very important, staying disciplined to stick with the plan. And the reason why I say that is because sometimes when the market goes up, people get a little bit, what's the word, and I don't blame people, it's how our brains are wired, we tend to get overconfident when market returns are higher. And I think that's probably one of the biggest things that somebody that's listening can take away is, yes, returns are good. It doesn't mean that we should take more risk. It doesn't mean that we should go in and buy Bitcoin if that wasn't the strategy before. It's not getting overconfident. And overconfidence has actually been studied extensively and it's part of a field of study called behavioral finance, where these psychologists have studied people's decisions and if that decision resulted in a financial gain or loss. And as you can imagine, that overconfidence, "Hey, things are going well, let's take more risk," often that story does not end well.

Amy D'Amico: Let's take more risk. Things are going well, so that means they'll always go well.

Tony D'Amico: Exactly. Yeah. I mean, it's 2021, but your strategy has to work for the longterm. It has to work in '08 and '09.

Amy D'Amico: Mm-hmm (affirmative).

Tony D'Amico: So having the right investment strategy that maximizes gains without taking any additional risk is really important and that longterm-ness. I love a Warren Buffett quote. He said that, "The stock market is a device for transferring money from the inpatient to the patient."

Amy D'Amico: Yeah.

Tony D'Amico: One of my very favorite quotes, and I think that actually applies to investing, but I also think it applies to wealth management and financial planning. Because these strategies are not, "Hey, you're going to get a quick result." It's all about the longterm and letting the results surface and come to you. But with market returns, that's been the focus there, is helping our clients understand their risk profile score. And it's okay, we want clients to ask questions. We want them to say, "Hey, what do you think about this investment?" And I'm happy to do that and we want that open communication. And, again, no judgment there. Obviously, we'll spend time to show them how their portfolio, how much it's gone up over the past year. How their investments support their financial plan as well is really important. So with market returns, that's the focus with planning moving forward.

Tony D'Amico: But I think to answer your question, I would say focusing what should they do moving forward in light of current conditions, really keep your eye on the ball. Don't get overconfident. Control what you can control. Enjoy the good times too. Don't get me wrong, you want to enjoy when things are going well, and we've done that too. We've encouraged clients to make an additional purchase because their returns have been great much greater than expected. But it's also to keep an eye on the longterm and what those potential risks might be, and to make a good decision carefully weighing out the pros and cons. I think the other thing that comes to mind is, we do regular meetings with our clients, so there's no way to do all of this. So if somebody works with an advisor to have those regular ongoing meetings and really assessing where you're at in light of what's important to you and what's identifying what strategies apply, because the available strategies are different based upon a person's goals and their financial situation.

Tony D'Amico: There are certain things that one person can control. There's some other things that somebody else might be able to control. So that ongoing relationship with that advisor, make sure that, I think too, it's really important to keep abreast of economic changes, tax law changes, and then how does that affect the plan? So it's a never ending process, which again, it's important to enjoy the fact. Our clients, our financial planning clients, have plans that are adequate to meet their lifestyles, their successful plan. So we didn't tell any clients to reduce their spending, the clients that reached out to us in March and April of 2020.

If they were retired, we said, "Hey, your portfolio is built for not just sunny days, but also rainy days. That's why you do all of this stuff."

Amy D'Amico: Right.

Tony D'Amico: But I guess in a nutshell, control what you can control. Keep that active, open communication with your advisor. Make sure that there are multiple people too involved. Not just your financial planner, but having an integrated wealth management experience between the financial planner, your CPA, your estate planning attorney, those types of things, and just watch out for overconfidence.

Amy D'Amico: Sounds great. Those are really good takeaways for our podcast listeners and clients today. Thanks, Tony, for sharing all of your insights. We really appreciate it and look forward to scheduling another one of these podcasts where we can hear you speak and pick your brain a little bit, and you can help us understand what's going on out there in the world and how it reflects in financial planning.

Tony D'Amico: Well, this was our first podcast together to our listeners, so I was a little bit worried that Amy was going to be tough on me. Nah, I'm just joking. If you guys have listened this long, you will know that I married up in many different ways. Amy's also a managing partner at Fidato Wealth. I've enjoyed the professional conversation and I'm sure we'll talk about this at dinner tonight. Thanks, Amy, for being a good host today.

Amy D'Amico: All right. Thanks for talking with us, Tony.

Wealth and Life is created and hosted by Tony D'Amico, CEO of Fidato

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