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AUTO LEASE OPTION TO PURCHASE AS AN INFLATION HEDGE

Written By: Aaron M. Puttroff

One of the many places excessive inflation is showing up is in the markets for both new and used cars. Fortune recently reported that the cost of a new car rose 12.6% from May 2021 to May 2022. Here's a practical strategy for those with auto leases to avoid paying the current higher price for a new auto.

When you lease, the price of the vehicle is established at the time the lease agreement is entered into. In addition, you will have an option to purchase the vehicle at the end of the lease term. Many people who lease vehicles oftentimes return their current vehicle at the end of the lease and lease a new one. However, with prices higher and interest rates trending up, this may not be the most attractive option. The beauty of exercising your option to purchase at the end of the lease is this price, known as the residual value, was also agreed upon at the onset. Meaning, this price was set before inflation began running rampant, and thus, should represent a "good deal" in today's marketplace.

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MARKET DECLINES AND ROTH CONVERSION OPPORTUNITY

Written By: Aaron M. Puttroff

The recent market decline may present a strategic planning opportunity. Roth IRAs differ from traditional IRAs in that any growth and distributions are received tax free. The ability to receive a lifetime of investment growth tax free is a tremendous benefit. So much so, that government rules limit who can directly contribute based upon one's income. The 2022 limit for married filing jointly is $204,000 of modified adjusted gross income. For single, head of household or married filing separately the limit is $129,000.

However, the rules presently allow for anyone to convert a traditional IRA balance to a Roth IRA. The income limits don't apply to conversions, only to contributions. You can also do a conversion within your 401(k) or other company-sponsored retirement plan so long as the plan permits. The ability to convert may change in the future as the original draft of the Build Back Better bill proposed to limit Roth conversions based upon various factors such as income or accumulated wealth. Therefore, the future of Roth conversions is uncertain, but for the time being, they are still permitted.

The way it works is that you file the appropriate paperwork with the administrator or recordkeeper of your account to convert pre-tax sourced money (or even after-tax contributions to a retirement account/plan) to Roth. There aren't any penalties to make a conversion. However, you will owe income taxes on the amount that's converted in the year of conversion. Also, it's not necessary to convert all your traditional balance at one time. You're free to do it in chunks.

So why does the current market decline present an opportunity? Because all the gain that occurs when the markets eventually bounce back will be inside the Roth account. Thus, you're taking advantage of the current market conditions to get a higher percentage of your money to a tax-free state. This has the potential to significantly reduce your lifetime taxes. That said, this won't be a good immediate move for everyone and should be evaluated on a case-by-case basis. Be sure to consult with your financial planner and also your tax professional to understand any tax or planning implications prior to taking any action.

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LOCKING IN 'REAL' LOSSES

You probably know that the 'real' return of an investment is the gains and income you receive minus inflation and taxes. Most of us invest with the idea that, over time, we will experience positive real returns.

One would imagine that the cadres of bond investors have that same expectation, but the current situation is somewhat befuddling. Today, twelve-month Treasury bonds are yielding 3.10%. If you factor in the roughly 9% current inflation rate, that suggests that short-term bond holders are willing to experience 'real' returns of negative six percentage points over the coming year. Twelve-month Treasuries are actually generating a lower yield—currently 2.92%. Even if inflation comes down from its current rate over the next decade, it is not hard to project a negative 'real' return from that investment.

An investor in 1-year municipal bonds would currently receive, on average, a yield of 1.47%, which projects to an even greater negative yield.

What gives? There are a variety of factors at work here, including the fact that bonds tend to act as the portfolio's ballast during market downturns, which makes them valuable in unstable times. They provide a steady income and rarely fall to the same degree as more volatile assets do during bear markets. If you hold a bond to maturity, you receive a predictable yield and, with high-quality bonds, you get your money back at the end. You won't get that kind of guarantee from stocks.

In addition, an allocation to bond or bond funds offers a pool of assets that could be used to buy stocks if/when prices become attractive—in the meantime collecting interest that can be used for the same purpose.

And for a person in or nearing retirement, having one to three years in a stable investment means that you will be able to meet your cost of living needs without having to sell stocks in the portfolio during a market downturn—which is one way of avoiding the danger of locking in losses and compromising the ability to sustain a retirement lifestyle going forward.

Institutions buy bonds for a different reason. Insurance companies have to ensure that they will have the assets to pay out projected death benefits, which means they tend to buy low-risk investments. The same is true of pension funds; buying bonds can allow them to match their future income with future payouts to beneficiaries.

So, yes, locking in a 'real' loss seems counterintuitive. Nobody would recommend that somebody do this with their entire retirement portfolio. But bonds will always, in every scenario, have a place in peoples' portfolios. And if history is any indication, eventually, one hopes sooner rather than later, bond yields will once again outpace inflation, and we can all get back to earning a 'real' return on that part of our investments.

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SOCIAL SECURITY BENEFITS GOING UP

We never know for sure until the announcement by the Social Security Administration each October, but it sure looks like people receiving benefits will get a big raise in 2023. Experts are predicting a 10.5% cost of living (COLA) adjustment, based on recent changes in the Consumer Price Index.

Taxwise, this could be a mixed blessing. More benefits will expose more Social Security income to federal income taxes; any joint return whose combined income (including Social Security income) exceeds $32,000 will trigger taxation of benefits, and higher income could also result in higher income-adjusted Medicare premiums. Those premiums are already becoming costlier; this year, Medicare Part B premiums rose 15.5%—higher than the Social Security cost of living adjustment. That means that Social Security recipients who had Medicare premiums automatically deducted benefits actually saw their monthly checks go down, despite the reported upward adjustment in benefits. Another big increase this year will eat into the higher benefits—or potentially eliminate them completely.

The last time Social Security benefits rose by double digits was 1981, when recipients received an 11.2% raise. Back then, the standard Medicare premium was $89 a month.

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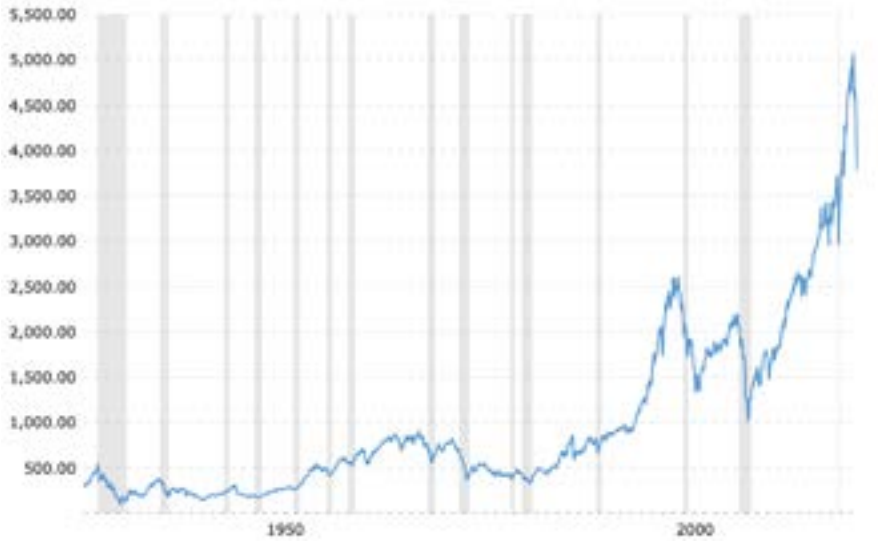
THE INVERTED CASINO

Sometimes it's helpful to take a step back and look at the big picture, and that is probably more true about investing than any other aspect of our lives. The 'little' picture is what happened yesterday, or last week, or the first or second quarters of the year. The big picture is something quite remarkable: the long-term trajectory of stock values, which are the result of millions of people coming to work every day to add value, incrementally, day by day, to their companies.

The chart shown here not only gives you the big picture of returns since the 1920s—the result of all that labor—but also shows, in the gray vertical bars, how few downturns we have experienced compared with times when the markets were rising. Investing in the U.S. stock market is like putting money down in a casino where the odds of winning, over time, greatly exceed the potential for losses.

U.S. Stock Market Returns Since 1926



Focusing on the 'little' picture is natural and normal—and also tends to lead to making decisions that are not ideal in the long run. If you walk into a casino where the odds are in your favor, a short run of bad luck shouldn't discourage you from continuing to play.

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NOT-TRANSITORY INFLATION

For much of last year, the economists at the U.S. Federal Reserve Board confidently told the public that the rampant inflation we were experiencing in the U.S. was 'transitory.'

They were wrong, and increasingly so as time goes on. This won't surprise anybody who has been shopping lately, but economists were shocked to discover that the inflation rate rose 9.1% annualized in the month of June. You would have to go back to 1981 to find a higher rate. And the usual culprits of the war in Ukraine—food and energy prices—were not the only reason for the cost of living increase. If you took out those two parts of the inflation calculation, the rate was still 5.9% overall. The Federal Reserve's 'target' is 2%.

So far, the U.S. Consumer Price Index measure of inflation is running around 8.6%—that is, it costs roughly 8.6% more to fund a normal lifestyle today than it did at this time last year. This is part of an international trend; the UK is looking at 11% overall price increases, and the Eurozone is experiencing an 8.6% inflation rate. South Korea's 6% annual inflation rate is the highest in 24 years, and even Japan, which has flirted with deflation for the past 30 years, is seeing prices rise 2.5%.

How long will this last? Nobody knows. The Fed seems committed to driving U.S. inflation down with a series of aggressive interest rate hikes, but with prices rising everywhere else, one wonders how effective this will be. But perhaps we can take comfort that our cost of living increases are markedly lower than what people are experiencing in Turkey (78% year-over-year), Argentina (60.7%) and Sri Lanka (54.6%).

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