OPPORTUNITIES IN A DOWNTURN

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We obviously can't predict a market downturn in advance, but we can certainly prepare for one. With the markets in a bit of a doldrums the past month, that preparation may come in handy in the fairly near future.

Whenever stocks go down, it opens up a surprising number of (usually temporary) planning opportunities for the alert investor. Perhaps the most obvious is harvesting losses; that is, selling positions that have gone down, booking a loss for tax purposes, and then buying a similar (but not identical) investment that is probably also on sale due to the bearish conditions. The investor retains an essentially equivalent market exposure, but now has a loss to offset gains or income (up to $3,000 of income) on next year's tax return.

Another opportunity is a Roth conversion. That means paying taxes on the value of the shares or cash moving from the IRA into a Roth today, so that you won't have to ever pay taxes on that money again. You've probably read that if you expect to be in the same or lower tax bracket in the future than you are today, then a Roth doesn't make tax sense. But if you can make the conversion at lower valuations, then the tax bill is lower today than it would be if the money was taken out after the market recovers. And some of us believe that tax rates have nowhere to go but up.

People who are making annual gifts to their children or heirs can get a little leverage in a market downturn. Each of us can transfer $17,000 this year to others without paying a gift tax. If you were to transfer investments that are temporarily undervalued, then that $17,000 in depressed ETFs could be a more valuable gift when the market recovers.

And finally, when something goes on sale, it's often a buying opportunity. For some reason, this is how people think when retail or online stores offer discounted prices, but when stocks go on sale, most investors think sell rather than buy. But buying at depressed prices is always a good strategy, long-term, for savvy investors.

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HEADS, I WAS GOOD TAILS, MY LUCK WAS BAD

Mutual fund managers are paid to deliver value through their research and good judgment about the markets—never mind the fact that study after study has shown that most active managers tend to underperform over time. A new research report published in September found that fund managers, in their shareholder communications, were more likely to attribute any performance above their benchmark to skill, and any performance that lagged their benchmark, according to them, was the result of external factors beyond their control (bad luck).

The study had an artificial intelligence program read through 15,434 shareholder reports associated with 1,969 unique funds. The AI reported on the times when the fund manager attributed success or failure to 'internal factors' (that is, decisions made by the fund manager and team) or 'external factors' (like market downturns or an adverse economic environment).

The result: taken altogether, the researchers found that the fund managers were 59% likely to attribute good performance to internal factors, and 83% of the time they blamed underperformance on external factors. In other words, when their performance was good, they tended to attribute it to skill, but when their performance lagged the benchmark, they were overwhelmingly blaming it on their lousy luck.

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THE LOOMING REVERT

Nobody is talking about the fact that the tax provisions in the Tax Cuts & Jobs Act of 2017 are due to revert back, after December 31, 2025, to what they had been in 2017—just 26 months from now. But if and when that threshold is crossed, it could be a rude awakening for a number of taxpayers.

For example? One of the most dramatic shifts would be the estate tax rates. The federal estate tax exemption in 2017 was $5.49 million; that is, the first $5.49 million that a taxpayer passed on to heirs would pass estate-tax free. Today, that exemption is a whopping $12.92 million; for married couples, the combined exemption is $25.84 million. The 'revert' would bring exemption down to something like $6.5 million—a third as high as currently.

The Tax Cuts & Jobs Act also doubled the standard deduction, which led to fewer people going through the hassle of itemizing deductions. The standard deductions for the 2017 tax year were $6,350 for single filers; $12,700 for people married filing jointly. Today, the standard deduction is $13,850 for single filers; $27,700 for those filing jointly.

The tax table revert would generally put people in higher brackets; most Americans would pay 1-4 percent more in personal taxes under the old reverted-to tax tables than they are currently.

Yes, we still have two years (and two months) to prepare for this. But anyone whose net worth is above the old estate tax threshold should start making plans now for how to get money out of the estate, and everybody should brace themselves for once again having to go through the chore of itemizing deductions—unless Congress comes up with a new tax bill. At that point, anything is possible.

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2023 THIRD QUARTER INVESTMENT REPORT

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The Congressional leadership returned to some semblance of sanity and finally passed a bill to keep the U.S. government funded for another few weeks, and the markets breathed a sigh of relief. But the third quarter was filled with drama, moderate losses and a lot of day-to-day volatility. We are experiencing the part of the investment roller-coaster that tests the stomachs of investors and tempts people to jump off at the wrong time.

The market losses in the first three months of year were spread fairly evenly across all sectors, but due to gains early in the quarter, these were relatively modest, and most sectors are still up by healthy margins so far into the year. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—lost 0.17% in the third quarter, and is holding onto a 12.32% return for the year. The comparable Russell 3000 index is up 12.39% so far this year.

Looking at large cap stocks, the Wilshire 2500 index lost 0.14% last quarter, and is still up 12.60% for the year. the Russell 1000 large-cap index has gained 13.01% so far this year, while the widely-quoted S&P 500 index of large company stocks has gained 11.69% since January 1.

Meanwhile, the Russell Midcap Index is down 5.80% for the year.

As measured by the Russell 2000 Small-Cap Index, investors are clinging to a 2.54% gain over the past three quarters. The technology-heavy Nasdaq Composite Index lost 4.12% in the third quarter, but is up 26.30% so far this year.

Foreign markets moved in lockstep with the U.S. lacked the early-year gains and thus are not as generous when looked at on a year-to-date basis. The broad-based EAFE index of companies in developed foreign economies was down 4.57% in the third quarter, but still shows a 2.70% gain for 2023. Emerging market stocks of less developed countries, as represented by the EAFE EM index, lost 1.29% in dollar terms in the third quarter, and are down 0.51% so far this year.

Other diversifying asset classes are down this year. The Wilshire U.S. REIT index posted a 1.84% loss in the third quarter of 2023, and its return so far this year stands at -2.01%. The S&P GSCI index, which measures commodities returns, has lost 1.32% of its value in the most recent nine months. Utility stocks are down 20.47% so far this year.

Bond rates continue their upward trend. 30-year U.S. government bonds are yielding 4.87%; 10-year bonds are yielding 4.74% while, interestingly, 2-year Treasuries are more generous at 5.12%, one-year government bonds are yielding 5.50% and 6-month securities are now yielding 5.58%. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it is called a yield curve inversion. Rarely will you see one as dramatic or long-lasting as this.

Municipal bonds look a bit more orderly at the moment but there is still inversion going on; 30-year and 10-year munis, on average, are yielding 4.47% and 3.49% respectively, but the inversion can be seen in 2-year (3.69 and 1-year (3.77%).

Whenever the markets start to show anything other than steady gains, the financial press rushes in to try to explain it--and they usually start with logic and statistics when the obvious dynamic is mass psychology. Many quick-twitch traders think that we are plunging toward a recession--which may happen, but the numbers suggest that they're pulling the trigger too soon. This is actually normal; markets tend to experience downturns before a recession, and recover during it.

The traders can point to the yield curve inversion as evidence for an economic decline, but of course we have had that signal flashing for more than a year and every quarter we see roughly average GDP gains. The inflation rate is higher than the Fed ec0onomists would prefer, and some predict that the Fed will decree another rate increase. But inflation is clearly moderating as the manufacturing sector finally works

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through the last of the supply mismatches triggered by the Covid pandemic. Unemployment remains low; more people are working, and their wages are trending up. Those are not signals of a weak or faltering economy.

There are undoubted signs of weakness in the commercial real estate sector, where many companies have embraced remote work, and are questioning whether they really need to rent or lease office space that is largely no longer occupied. But those leases are being gradually unwinding, and nobody expects to see significant unwinding until sometime in the middle of next year.

A recent poll of economists, who are the most sober readers of economic statistics found that 55% of them expect a mild recession next year--and that's the lowest reading in a year. For the moment, the quick-twitch traders seem to have the upper hand in dictating stock prices and returns, but their method of playing the market seldom wins in the end.

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