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SIA

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THE SIA REPORT

TURNING MARKET LEMONS INTO TAX LEMONADE

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After the close of the first quarter, we reflected on *The Three Black Swans* (i.e., the Omicron variant, a war in Ukraine, and 40-year high inflation) along with their negative impact on global capital markets and investment portfolios.

At the time, most major stock and bond indexes were down more than 5%—providing little comfort for diversified investors. The selloff continued to accelerate through most of April and May, as the S&P 500® briefly flirted with bear market territory and losses mounted for bond investors in the face of rising interest rates. Currently (as of early June), the 2022 returns for a 60/40 portfolio are on track to be the sixth-worst over the last 100 years.[1]

After recent years of strongly positive stock market performance, 2022 has provided a stark reminder of the risks involved with investing—particularly around the more speculative corners of the market. We expect ongoing choppiness in the market as the Fed seeks to navigate the strongest inflationary pressures in more than a generation.

During these challenging times, it's more important than ever to 'stick to your plan.' But that doesn't necessarily mean sitting on your hands. While market returns have thus far been negative for most asset classes this year, savvy investors can potentially turn that into a positive from a tax perspective. You may want to explore one or more of the following strategies:

Tax loss harvesting

Volatile markets may offer an opportunity to use portfolio losses to create a tax asset. If securities in your taxable investment account have dropped below their original purchase price, you might want to consider selling them to harvest the tax loss. These losses can be used to offset gains and reduce your overall tax bill. If realized losses exceed your realized gains, they can also be used to offset up to $3,000 of ordinary income. And any unused losses beyond that can be carried forward to offset gains in future tax years.

For the first time in many years, 2022 could see significant losses in bonds and bond funds—presenting an even greater tax loss harvesting opportunity than normal. After a position is sold, it can be replaced with a similar security to maintain your asset allocation. But it's important to consult with your advisor before making any replacement purchases to avoid running afoul of IRS wash sale rules.

Roth IRA Conversions

The decline in markets presents an opportunity to enact a Roth IRA conversion at a discount. A Roth IRA allows you to contribute after-tax dollars to a retirement account and enjoy tax-free appreciation and withdrawals throughout your lifetime—without any required minimum distributions (RMDs) like traditional IRAs.

A Roth conversion involves transferring pre-tax retirement funds from your traditional IRA into a Roth IRA (after-tax dollars). Therefore, you will need to pay tax on any funds you choose to convert. But remember, any future withdrawals from the Roth will be tax-free. To the extent IRA account balances have declined this year, the associated tax bill involved with converting assets to a Roth will also be reduced. Assets that you convert may then be able to participate in any future market recovery, resulting in a larger Roth account balance with less taxes paid in the process.

Gifting

Currently, the annual gift-tax exclusion allowed by the IRS is $16,000 per person. In other words, you can gift $16,000 ($32,000 for married couples) to any individuals you wish without any tax implications. For example, you and your spouse could gift $32,000 to each of three adult children ($96,000 in total). But during a market correction, this annual gift can be further amplified. Gifting shares of stocks that

1 60% S&P 500, 40% 10-year Treasuries

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> I believe successful wealth management is the result of an ongoing collaboration between investor and advisor, built upon trust and maintained according to the highest standards of integrity and expertise.

Brian D. Holmes, MS, CFP®, CMFC, AIF®, *President & CEO*

ABOUT SIA

Signature Investment Advisors® (SIA) is a Registered Investment Advisor firm offering investment management solutions that are tailored to meet the unique needs of affluent individuals and organizations. In partnership with your wealth manager, we bring our combined experience, expertise and high level of service to provide a dynamic process that can meet your investment objectives and goals.

Marginal Rates

For tax year 2022, the top tax rate remains 37% for individual single taxpayers with incomes greater than $539,900 ($647,850 for married couples filing jointly).

The other rates are:

35% for incomes over $215,950 ($431,900 for married couples filing jointly)

32% for incomes over $170,050 ($340,100 for married couples filing jointly)

24% for incomes over $89,075 ($178,150 for married couples filing jointly)

22% for incomes over $41,775 ($83,550 for married couples filing jointly)

12% for incomes over $10,275 ($20,550 for married couples filing jointly)

The lowest rate is 10% for incomes of single individuals with incomes of $10,275 or less ($20,550 for married couples filing jointly)

Source: Internal Revenue Service

POSITIONING YOUR BOND PORTFOLIO FOR WHAT MAY LIE AHEAD

BY **Gene Balas**
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When positioning portfolios for what may be a period of rising interest rates, the obvious solution may seem to be putting the funds in short-term instruments, or perhaps to instruments with floating rates that can increase in tandem with any rise in interest rates. Certainly, there may be a strong case to be made for allocating at least *some* of your assets to floating rate notes. But why not earmark all of your fixed income holdings to floating rate instruments if bond prices continue to get crushed in this environment?

There are more than just a few things to unpack in this seemingly simple solution. First of all, it's hardly a secret that the Fed is intent on hiking interest rates. Investors are well aware of what's coming—so much so that, arguably, some of these rate hikes may have already been priced into bond yields, having sent bond prices lower, as painful as that adjustment may have been.

But how high will the Fed ultimately hike rates? Even members of the Federal Reserve's rate-setting Federal Open Market Committee (FOMC), haven't shown widespread consensus. Consider the graph on the adjacent page (see figure 2, page 3), known as the 'dot plot,' which depicts where each member of the FOMC views rates during 2022, 2023, 2024, and over the longer run. Each individual member's view on the level of rates is represented by a dot on the chart (members are not identified by name).

You'll note there's quite a wide range of viewpoints! In 2023 alone, one Fed member sees the Fed funds rate between 2.75% and 3.0%, while one member sees it between 4.25% and 4.50%, with the rest of the Fed members view rates in 2023 in the middle of that range (though skewed toward higher rates). One key reason for such a wide range of expectations is the extreme amount of uncertainty for the future. We simply don't know:

- How long high inflation would persist on its own (absent any Fed intervention),
- How well inflation might respond to the recent and expected future rate hikes, or
- How geopolitics (such as the Russia-Ukraine war) could affect the economy and bond yields.

We also need to consider that high inflation itself can be the master of its own demise. There's no question that the surge in prices we have seen is due in large part to supply that is constrained, combined with strong consumer demand, such as from a collective pent-up desire to return to 'normal' life.

High prices, however, can help to stifle demand. This is especially the case when real average weekly earnings for all employees, as reported by the Bureau of Labor Statistics, fell by -3.9% in the twelve months through May 2022. In other words, consumers' incomes, on average, are shrinking after adjusting for inflation. It's hardly an environment that's conducive to consumers continuing to shop with abandon. And if they cut back on spending, that can slow down the economy and reduce the need for as many rate hikes.

Plus, tighter financial conditions aren't solely determined by how high interest rates go. They also tighten when financial asset prices (like those of stocks) fall. The recent stock market correction—especially if it's sustained—can do some of the Fed's work for it, by making money less readily available.

Looking ahead

We've touched on just a few of the moving pieces involved in inflation and interest rate dynamics. The bond market attempts to consider all of these factors when setting prices and determining yields across the spectrum of maturities, credit qualities, and fixed income sectors. Of course, the base case view is that interest rates are likely to rise, but there remains considerable uncertainty over just how high, how soon, and how long higher rates might last.

If inflation slows quickly because supply comes back online (e.g., people re-enter the labor force, markets overseas including China rebound from Covid concerns, supply chains are restored, etc.), or if inflation slows instead because demand drops considerably, the Fed may not need to hike rates as much. And if the economy slows, or geopolitical concerns mount, then bond yields might not go as high as some may fear. Keep in mind that any significant geopolitical developments can send investors globally into the safe haven of Treasuries, pushing yields down. This may especially be the case considering how much longer-term bond yields have already risen.

Long story short, we believe bond investors would be prudent to diversify across sectors and styles rather than allocating 100% of your fixed income portfolio to a single strategy like floating rate debt or short-duration instruments. A distinction can be made, however, between top-down views applied at the portfolio level and security selection decisions made by the managers we utilize.

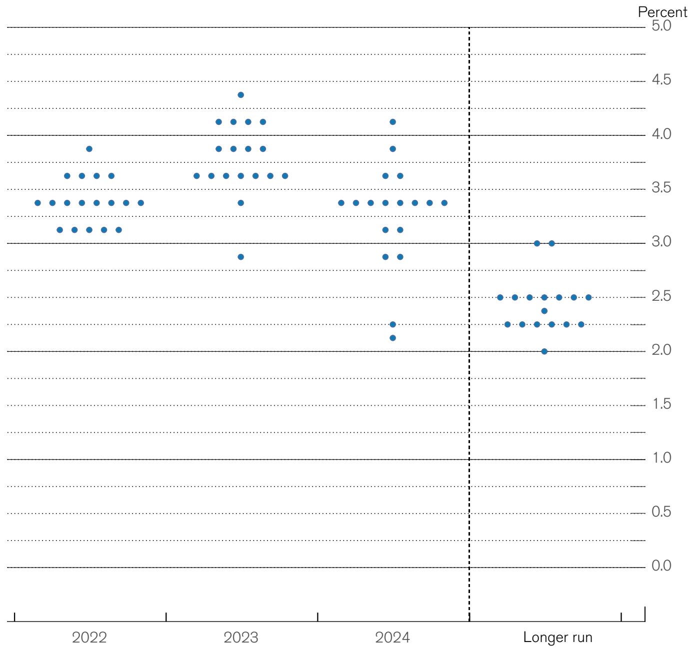
For the top-down views in our discretionary portfolios, we remain underweight duration while tilting towards 'unfixed' income that has the potential to perform relatively better in a rising rate environment. Within the components of each of the 'sleeves' of a fixed income allocation, we continue to advocate for active management, believing that skilled managers can more effectively navigate ongoing uncertainty. These managers are well-attuned to what is happening in the economy, geopolitics, inflation, and the markets, so that they can adapt and adjust the portfolios they manage. It's impossible, however, to avoid market forces entirely.

But remember that there is a reason for diversification: nobody can be absolutely certain any given outcome will occur at some point in the future. Therefore, it may be best to have several active managers who can be flexible enough to accommodate the nature of the flux and uncertainty that now dominate the market, within the confines of the mutual funds they manage.

And while we can make changes in the asset allocations within the fixed income components to reflect current conditions (such as moving assets into floating rate notes), it's arguably even better to combine that approach with not just one, but several, active fixed income mutual fund managers.

Don't forget the chart below (see figure 2) showing the diversity of opinion among Fed officials as to where the rates (ones that they themselves control) will be over coming years. Even for Fed officials, it's hard to have an accurate crystal ball in this environment. For our fixed income strategies, having several different approaches, from several different managers, is an encapsulation of the uncertainty we all currently face. Although it has certainly been a challenging year for bond investors, we believe owning a diversified fixed income strategy may provide you a higher likelihood of success going forward.

FIGURE 2 | FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



TURNING MARKET LEMONS INTO TAX LEMONADE *continued from cover...*

have declined in value can enable the transfer of a greater number of shares while staying below the annual gift limits. In turn, these gifts potentially have a higher expected return today, simply due to lower share prices. And by accelerating stock gifting at lower valuations, you can remove the future growth of these assets from your estate (which in the long run may also help ease estate taxes).

As we approach the mid-point of 2022, both equities and fixed income investment have declined sharply, marking the most challenging start for diversified portfolios in decades. While it's always good advice to 'stick to your plan,' you may want to consider taking advantage of market volatility to optimize your future tax situation.

Please reach out and talk with your advisor about these (or any other) tax and risk mitigation strategies as we prepare to navigate the road ahead.

RESUMING TRAVEL IN A POST-COVID WORLD

For many of us, travel is essential to our personal sense of fulfillment and happiness. It broadens our understanding of other peoples and cultures when we're younger, and provides experiences when we're older that help reignite and rejuvenate our sense of wonder. To quote Oliver Wendell Holmes, *"a mind that is stretched by new experiences can never go back to its old dimensions."*

After what's essentially been a two-year moratorium on vacation travel, recent surveys are indicating that there's finally a light at the end of the tunnel. More than a quarter (28%) of regular travelers say they plan to spend significantly more this summer compared to their pre-COVID travel budgets for major vacations.[1] We're all desperate to get back out into the world and explore it.

Perhaps a small part of this resurgence in travel spending is due to higher costs associated with spiking inflation, but most is the result of two years' worth of accumulated savings that went unspent as most Americans were forced to dramatically curtail leisure travel. And while overseas destinations still remain markedly below 2019 levels, travel to European markets is also beginning to surge—down just 34% from 2019 levels.[2]

Obstacles are being lifted

Airport and airline masking (while still encouraged) is no longer mandated for domestic travel as well as a majority of international destinations. Nevertheless, if you're planning to travel overseas this summer, mask requirements at major tourist venues will likely continue to vary from country to country and place to place. For instance, in Rome you can currently visit the Villa Borghese Museum without any mask requirements at all, while just a few miles away the Vatican Museum requires all visitors to wear a KN95 or N95 mask (no surgical masks are allowed). So, make sure you check masking requirements for all of the individual venues you plan to visit.

Perhaps the single biggest impediment to overseas travel was also removed just a couple of weeks ago—with the U.S. lifting its requirement that all returning travelers be tested for COVID within 24 hours of their return flight. Not only did this requirement create major logistical headaches for travelers, it also raised the very real concern that you could test positive in a foreign country and be forced to quarantine there (at your own cost) for an additional 10-day period prior to being allowed to return home.

Some potential headwinds remain

Unfortunately, the urge to make up for lost vacations and holidays is creating a travel demand that's occasionally outpacing capacity. We've seen it across Europe and most recently here in the U.S., when nearly 3,000 flights had to be canceled over the Memorial Day holiday weekend due to lack of equipment and crews. And the ongoing war in Ukraine is also acting as a modest drag on the travel sector—impacting a number of Eastern European destinations.

According to a recent survey conducted by Deloitte, however, health concerns have dramatically dropped as an impediment to travel this summer—overtaken by mounting financial concerns associated with the combination of shrinking portfolio values and higher inflation. Yet as Americans plan a return to vacation travel in greater numbers despite these challenges, there's one major positive for your travel budget: airfares still haven't fully recovered. The average cost of airfares recorded earlier this year was still 19% lower than the previous 10-year average.[3]

While things may not yet be back to 'normal,' and we may still have not yet arrived at the ideal time for vacation travel, we also realize the critical role travel can play in maintaining positive mental health and happiness. So, carpe diem! Get out there and enjoy your summer holidays.

1 "Monthly Travel Data Report," U.S. Travel Association, June 2022
2 "Getting Back to Getaways: 2022 Summer Travel Survey," Deloitte, May 2022
3 U.S. Bureau of Labor Statistics, June 2022

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