Modera Perspectives – First Quarter 2018

Investment Commentary:

Sooner or later, everything old is new again - Stephen King, The Colorado Kid

Security market performance in early 2018 continued the upward trajectory from 2017. However, strong performance in January was followed by a sudden correction in February and very choppy performance in March. Most asset classes we use in client portfolios, represented in the table below by their corresponding indices, ended the first quarter with returns that were either flat or slightly negative.

In the U.S. stock performance was slightly negative, with small caps holding up better than larger companies. Although international developed companies ended the quarter down 1.4%, emerging market stocks followed their strong performance in 2017 with a 1.5% quarterly gain.

Negative equity market performance in February and March has been attributed to rising interest rates and tariff fears. Comments from the Federal Reserve Bank's January meeting stoked fear that interest rates may rise faster than had previously been anticipated. A second factor impacting renewed equity volatility has been worry around global trade. Concerns that protectionism and tariffs may lead to a trade war are starting to be factored into stock prices.

Fixed income also declined during the quarter. U.S. Investment Grade, High Yield, and Municipal Bonds indices were all down for the quarter. Municipal Bonds held up the best, followed by High Yield, and U.S. Investment Grade bonds performed the worst of the three. The negative fixed income performance is a direct response to rising market interest rates.

Real estate stocks declined for the quarter. Many investors view real estate as an income generator in portfolios. So as interest rates rise, the prices of real estate securities typically fall, because yield and price are inversely related. Diversifiers had a positive quarter, with their performance helping to partially offset declines in the equity and fixed income markets.

Data ending 3/31/2018 (not annualized if less than 1 year)

Indices	Q1 2018	1 year	3 years	5 years	10 years
Equities					
MSCI ACWI (All Country World)	-0.8%	15.4%	8.7%	9.8%	6.2%
S&P 500 (U.S. Large Cap)	-0.8%	14.0%	10.8%	13.3%	9.5%
Russell 2000 (U.S. Small Cap)	-0.1%	11.8%	8.4%	11.5%	9.8%
MSCI EAFE (International Developed)	-1.4%	15.3%	6.1%	7.0%	3.2%
MSCI EM Emerging Markets (International Emerging)	1.5%	25.4%	9.2%	5.4%	3.4%
Fixed Income					
Citigroup World Government Bond (Global Bonds)	2.5%	8.5%	3.5%	1.2%	2.0%
Barclays U.S. Aggregate (U.S. Investment Grade Bonds)	-1.5%	1.2%	1.2%	1.8%	3.6%
Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds)	-0.6%	0.7%	1.3%	1.5%	3.3%
Barclays U.S. Corporate High Yield (U.S. High Yield)	-0.9%	3.8%	5.2%	5.0%	8.3%
Other Indices					
S&P Developed REIT (Global Real Estate)	-5.6%	0.7%	2.1%	5.4%	5.0%
HFRI FOF: Conservative Index (Diversifiers)	0.8%	3.6%	1.7%	3.0%	1.3%

The returns above are of benchmark indices for certain selected asset classes.

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During the first quarter of 2018, we witnessed a stock market that was more volatile than it had been in fifteen months. This occurred amid various talks of tariffs, trade wars, interest rate increases and other economic issues in the news. Despite these headwinds, we believe there are solid fundamentals to support equity valuations, including strong economic growth and high confidence in both the consumer and business sectors. Further, inflation remains low, and expected benefits from the 2017 tax cuts have not been fully absorbed into the economy.

Given recent interest rate increases by the Fed, along with its signals that rates will go up a few more times in 2018 and 2019, there is concern that short-term rates may rise above long-term rates. When we have seen an "inverted yield curve" in the past, economic recessions have often followed within the subsequent 12-18 months. While inverted yield curves are strong indicators for economic slowdowns, they are more akin to a calendar than an alarm clock. That is, we may look for it to happen, but we just don't know when or for how long.

There is similar uncertainty in the equity markets. A pullback has been anticipated for quite some time. We just never know when or for how long. 2017 was an abnormally quiet year, as the U.S. equity market did not experience a drop of more than 3%. By contrast, since the end of World War II there have been 56 corrections in U.S. stocks (defined as a drop of at least 10%), or about one every sixteen months. When in a correction, the median decline has been about 16%. The declines we have experienced in the last three months are shallower than in the past, but are also the first real declines since early in 2016.

These may help put the current market volatility (assuming it is not over) into perspective. We recognize that instability can be nerve-wracking. Nevertheless, we urge you to take the longer view. The ten-year returns in the table above, which encompass the lows reached on March 9, 2009, still show more than 9% annualized index returns for U.S. stocks and more than 6% for stocks globally. Investors are best served with an asset allocation that is aligned with their needs, is flexible enough to absorb short-term gyrations and is designed to meet long-term horizons and goals.

Financial Planning Perspectives

Charitable Gifting Strategies and the New Tax Law
by Laurie Kane Burkhardt CFP®, Financial Planning Committee

The Tax Cuts and Jobs Act that became law in December creates a new paradigm for taxpayers who claim itemized deductions. First, the standard deduction increased significantly -- from $6,500 in 2017 to $12,000 in 2018 for single filers and from $13,000 in 2017 to $24,000 in 2018 for married filers. This means that your deductions must exceed a much higher threshold before itemizing will make sense for you. "*No big deal,*" you may think. "*I already deduct much more than that, so I should be unaffected.*" However, another significant element of the tax law imposes a cap of $10,000 on total state and local taxes, including income, property and real estate taxes. This means that you will only be able to include a total of $10,000 in state income tax and property tax to determine if you exceed the new higher standard deduction. Now you may be thinking, "*Uh oh, this will apply to me, so what can I do to continue to obtain a tax benefit from my charitable gifting?*"

One strategy to consider is to bunch several years of charitable donations into one tax year to exceed the standard deduction in that year and then switch between itemizing deductions and using the standard deduction every few years. A Donor Advised Fund (DAF) is an easy and tax-effective tool to optimize such a strategy because it allows you to pre-fund future charitable contributions and take the full deduction in the year of the donation. You would invest the funds (typically with the DAF offered by your custodian like Schwab or Fidelity) and then make recommendations to the DAF for the charities to which you would like to grant the funds over several years.

DAFs can be funded through gifts of cash or appreciated securities. Gifts of appreciated securities have the added benefit of avoiding capital gains tax on the growth, in addition to permitting an immediate tax deduction for the full market value of the donated securities. Contributions to a DAF can be made at any time during the calendar year and must be completed by December 31 to take the deduction for that tax year.

DAF accounts can be opened with initial donations of at least $5,000 in cash or securities and subsequent contribution minimums are typically $500. Donors are able to receive a current year tax deduction for gifts of cash up to 60% of adjusted gross income, and for gifts of appreciated securities up to 30% of adjusted gross income. The custodian typically will charge an administrative fee of 0.6% to manage the account, and you can select how to invest the funds from several pre-established investment portfolios. When you are ready to begin granting funds to charities, custodians typically have a user-friendly online mechanism to request grants of $50 or more.

Another strategy to consider applies to taxpayers over age 70½ who are taking Required Minimum Distributions (RMD) from their IRAs. You can satisfy your RMD for any given year by donating part or all of the RMD (up to $100,000) to a qualified charity. This provision of the tax law is known as a Qualified Charitable Distribution (QCD). It was first introduced in 2006, and it was made a permanent provision of the tax code at the end of 2015. The maximum total amount of an RMD that can be gifted as a QCD is $100,000 per year, and the amount gifted via a QCD is excluded from your taxable income. Of course, you cannot also claim a deduction for the gift as that would be double counting the gifted amount.

QCDs must be made by your RMD deadline (generally December 31), and non-deductible contributions and distributions from company retirement plans are excluded. QCDs cannot be made to DAFs or private foundations.

A strategy utilizing QCDs to fulfill charitable intent is likely to gain popularity in 2018 because many taxpayers who previously itemized charitable donations will no longer be able to do so. The strategy excludes the distribution from taxable income, and it may have the added benefit of reducing the cost or tax impact of other income-related items, such as Medicare premiums, Medicare surtax and Social Security. A hefty surcharge is applied to Medicare premiums for modified adjusted gross income above $85,000 for singles and $170,000 for married couples. A Medicare Part B premium of $134 per month in 2018 could climb as high as $428.60 per month at higher income levels. The Medicare surtax of 3.8% applies to income levels above $200,000 for single and $250,000 for married taxpayers. For Social Security taxation, up to 85% of benefits may be taxed for singles with adjusted gross income above $34,000 and couples above $44,000. Using a QCD can keep the donated amount out of your income and potentially save taxes in these areas.

As a final note, if you are charitably inclined and you choose not to implement either of these strategies (DAF or QCD), consider donating appreciated securities to a qualified charity rather than gifting cash. Whether or not you can take an itemized deduction for the charitable gift, you will still avoid the capital gains tax on the appreciation.

If you have questions about any of these strategies, please contact your Modera Wealth Manager.

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Thank you for your continued confidence and trust in our services. We welcome your questions and comments.

Modera Wealth Management, LLC

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