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Modera Perspectives – Third Quarter 2018

Investment Commentary:

Short-termism: For investors, this expression refers to an excessive focus on short-term investment performance, often at the expense of long-term objectives.

The third quarter of 2018 (and indeed much of 2018) has been notable for this mindset, where 24-hour news cycles seem to get compressed to 24 seconds. Investors appear content to buy or sell based on what is already working, which has led to concentrated pockets of performance globally and extremely low volatility. The good news is that this investor mindset may be finally shifting (more on early October's market volatility in a moment).

Focusing first on third quarter, it was the best quarter for the S&P 500 since 2013, up 7.7% and now up 10.6% for 2018 for the year through September 30, 2018. U.S. small cap stocks, as measured by the Russell 2000 Index, performed almost half as well during the quarter but are still outperforming the S&P 500 for the year by nearly 1%.

Data ending 9/30/2018 (not annualized if less than 1 year)

Indices	Q3 2018	YTD	1 year	3 years	5 years	10 years
Equities						
MSCI ACWI (All Country World)	4.4%	4.3%	10.4%	14.0%	9.3%	8.8%
S&P 500 (U.S. Large Cap)	7.7%	10.6%	17.9%	17.3%	14.0%	12.0%
Russell 2000 (U.S. Small Cap)	3.6%	11.5%	15.2%	17.1%	11.1%	11.1%
MSCI EAFE (International Developed)	1.4%	-1.0%	3.3%	9.8%	4.9%	5.9%
MSCI EM Emerging Markets (International Emerging)	-1.0%	-7.4%	-0.4%	12.8%	4.0%	5.8%
Fixed Income						
Citigroup World Government Bond Hedged (Global Bonds)	-0.6%	0.2%	1.0%	2.1%	3.1%	3.6%
Barclays U.S. Aggregate (U.S. Investment Grade Bonds)	0.0%	-1.6%	-1.2%	1.3%	2.2%	3.8%
Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds)	-0.2%	0.1%	-0.6%	1.2%	1.9%	3.4%
Barclays U.S. Corporate High Yield (U.S. High Yield)	2.4%	2.6%	3.1%	8.1%	5.5%	9.5%
Other Indices						
S&P Developed REIT (Global Real Estate)	2.4%	2.6%	3.1%	8.1%	5.5%	9.5%
HFRI FOF: Conservative Index (Diversifiers)	0.4%	2.1%	3.3%	2.7%	2.9%	2.9%

Fixed-income markets hovered around the flat line for this past quarter in an environment of steadily rising interest rates. The performance of U.S. investment-grade bonds was exactly flat during the quarter, while the global government bond index (hedged for currency) was slightly down in 3Q. U.S. corporate high yield bonds, recovered 2.4% in the third quarter and are now positive for the year. High-yield bonds may outperform other fixed income categories when the economy is strong and the risk of corporate debt defaults is lower.

International equities were a mixed bag. Developed foreign equity markets, as measured by the MSCI EAFE Index, managed to regain 1.4% of ground during the last quarter. However, emerging market equities (as measured by the MSCI EM Emerging Markets Index) were down 1% in 3Q and were down 7.4% through September 30, 2018.

Taking a Step Back from Short-termism

While short-term disparities in index performance can raise questions about appropriate portfolio exposures, let us take a step back and understand some important historical facts and how Modera

Wealth Management has worked to add value to our clients' investment performance over time and lower downside risk in the process.

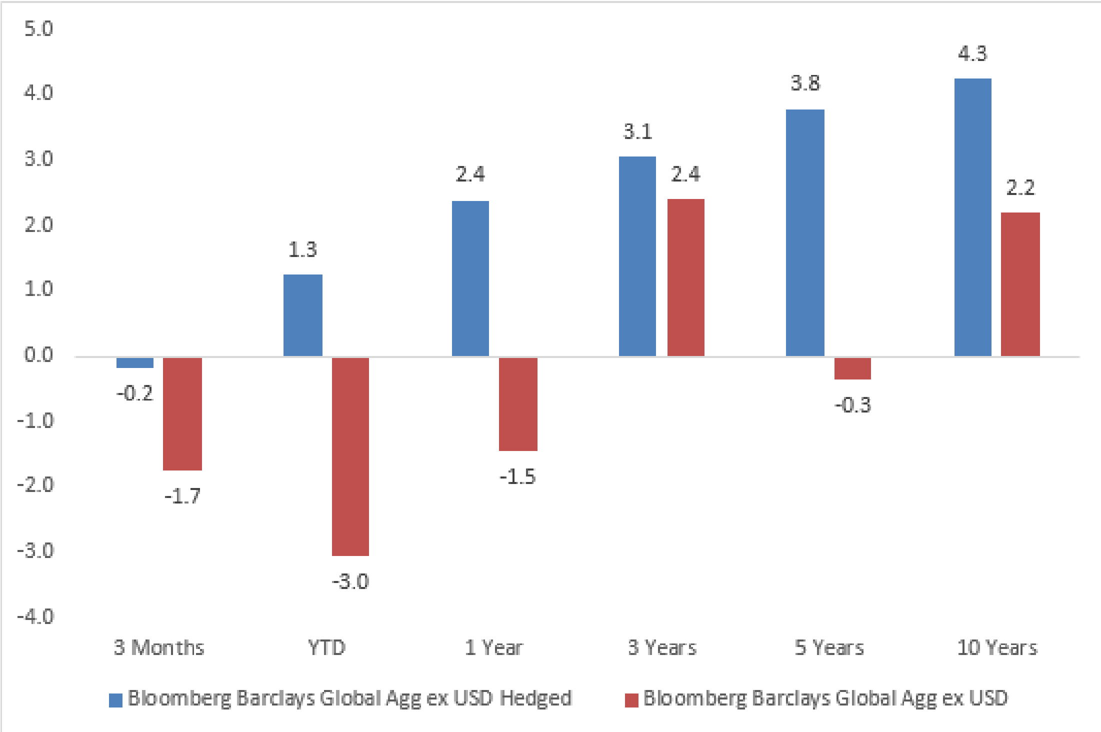
First, it is important to remember that over a 20-year period ending September 30, 2018, U.S. small cap equities, as represented by the Russell 2000 small cap index gained 9.5% versus U.S. large cap equities, as represented by the Russell 1000 large cap index which gained 7.7%. In addition, U.S. value stocks represented by the Russell 3000 Value Index gained 7.8% versus U.S. growth stocks represented by the Russell 3000 Growth Index gained 7.3%. This has been a one-way market for a long time, and we expect some mean-reversion is well overdue (and appears to be happening as we enter the fourth quarter).

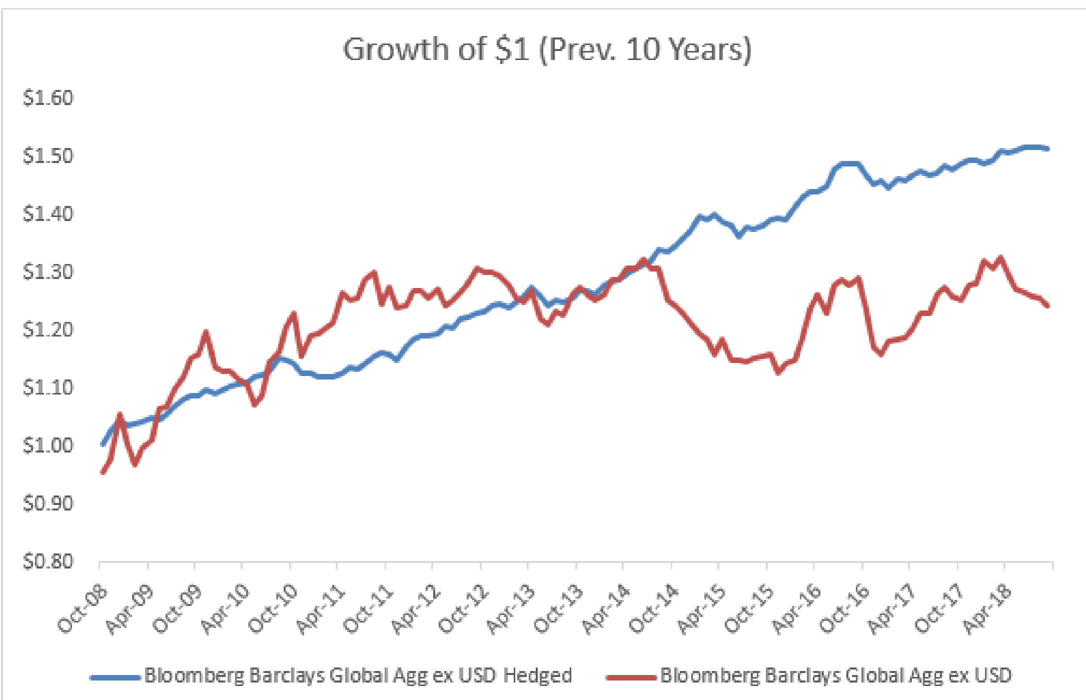
It was only 10 years ago that the financial world was seemingly coming to an end, with some market prognosticators forecasting that marginal returns on investment were the best that investors could hope for in years to come. Instead, global equity and bond markets have mustered solid annualized returns over the past 10 years. In hindsight, it is easy to see how short term-focused the market had become during the financial crisis, thus presenting a compelling investment opportunity. But in the heat of moment, it is easy to make bad investment decisions if you do not have a well-conceived and customized investment strategy in place.

Another example: Over the past year, there has been much written about the decline of bond markets in a rising rate environment. But that is not the whole story, as there are areas of the bond market that were up through the end of this quarter, including corporate high yield and municipal bonds. Modera manages risk in its fixed income portfolios, striving to maintain high credit quality, diversify globally, and keep maturities and "duration" low in its clients' fixed-income portfolios (duration refers to the weighted average time to receive payments from bond holdings). With lower duration, interest-rate changes are intended to have a smaller impact on our fixed income exposures, all else equal. Modera's overall fixed income strategies and actions should provide additional stability and support to portfolios in the face of rising interest rates.

When we look abroad, yes, international markets have been negatively affected in recent months by a stronger U.S. dollar and threats of a trade war caused by U.S tariffs. The relative underperformance of emerging markets also has been further impacted by currency issues and concerns about Turkey and Argentina (despite the fact that these countries are small parts of the index). But remember that emerging market stocks had a stellar calendar year in 2017 (up 37%), outperforming U.S. equities by about 15 percentage points. The three-year annualized performance in emerging markets, including 2018, is up nearly 13%. At Modera, we took advantage of weakness in emerging market stocks back in 2015 by rebalancing for our clients. When emerging market stocks rallied significantly in 2017, we remained disciplined and pared back our emerging markets exposure, which has turned out to be a wise decision in light of performance in 2018 year-to-date.

For global fixed-income investments, Modera uses funds that hedge away currency risk to help reduce the impact of this short-term volatility. The benefits of this strategy are demonstrated in the following charts:





We can see from the charts above that relative performance was both improved and less volatile over time (as exhibited by the blue bars and blue line). This is an example of how Modera strives to improve long-term investment returns while reducing overall portfolio risk for our clients.

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Seeing the Forest Through the Trees (Literally)

It sometimes helps to step back from short-termism and (literally) see the forest through the trees.

Consider this: The sequoias in Yosemite are majestic, huge, beautiful, and old. Some are as old as 3,000 years and their circumferences are 10, 20, or even 30 feet around. When you look at them, it is hard to imagine how they began to grow and what they have weathered over the years. The seed cone of a 300-foot, thousand-year-old sequoia is the size of a fingernail. When you look at the sequoias, you will see many are scarred with burns from wildfires or lightning strikes. Yet, they have not only survived but are still growing because they have learned to adapt and thrive despite it all. Sequoias survive for many reasons, chief among them are their broad stable root systems and thick protective layers of bark.

Like sequoias, investors need to be strongly rooted with a comprehensive long-term investment strategy and have a thick skin to weather many storms over time. These storms can take many forms, in both up and down markets.

As we enter the fourth quarter, we have already seen volatility enter the market again. This increased volatility is a welcome change and may benefit our strategy of tilting to value vs. growth, and our diversification in international and fixed income markets – all of which have held up during this early October correction. It's worth noting that much of the October selling pressure thus far appears focused in the exact areas that did well in the third quarter of 2018. Should it continue, we would welcome this change in investor sentiment, as some reversion to the mean should hopefully continue to work in favor of our investment process.

Short-termism can lead to bad investment decisions, and that is why we take a longer-term approach to investing. Storms do occur and, in the short term, value can underperform growth, large cap can outperform small, or international equities can lag behind the U.S. What we don't know is when these storms will begin or end. At Modera, we build diversified portfolios with the objective of providing a strong-rooted base of stability and strength for our investors for many years to come.

Financial Planning Perspectives

A Roth IRA Conversion: What Is It, and When Can It Be a Good Idea?
by Michael Rose CFP®

If you have accumulated retirement savings in a traditional IRA (individual retirement account), it may be wise to consider moving some portion of the money in your account to a Roth IRA, through an action known as a "conversion." This article aims to help you understand the potential benefits of a Roth IRA conversion and how to decide if it is advantageous to do so.

What is a Roth IRA Conversion?

A Roth IRA conversion moves assets from one particular type of account (a traditional IRA) to a new or existing Roth IRA in the same owner's name. While the conversion usually triggers a taxable event, depending on your situation, there may be good reasons to incur the additional income taxes sooner rather than later.

The Potential Benefits of a Roth IRA Conversion:

- **Pay a potentially lower tax rate on your IRA distributions.** Although as a general rule it is typically better to defer paying taxes into the future, paying taxes sooner rather than later makes sense if your marginal income tax rate will be higher in the future than it is now.

- **A Roth IRA provides you and your heirs with tax-free distributions**. In contrast, when you take a distribution from a traditional IRA, you will have to pay income taxes on some or all of the amount withdrawn, depending upon your marginal ordinary income tax rate at that time and other potential factors.
- **A Roth IRA does not require any withdrawals during your lifetime.** A traditional IRA, on the other hand, imposes a required minimum distribution (RMD), whereby you must withdraw a minimum amount from your IRA each year, starting when you reach age 70 ½. Converting to a Roth IRA prior to age 70 ½ could give your savings a longer time to grow in value on a tax-free basis.

When Should I Consider a Roth IRA Conversion?

A favorable time to consider a Roth IRA conversion is in a year when your income is unusually low that allows you to recognize the taxable income from the conversion at a potentially lower marginal income tax rate.

Certain life events can lessen your income, making a Roth IRA conversion a good option:

- If you have retired from work – say around age 65 – and your annual income is temporarily lower before you begin receiving taxable distributions from your retirement plans;
- If you are temporarily out of work or switch to a lower-paying job.

One way to determine the relative benefit of doing a Roth IRA conversion in a particular year is to consider your marginal income tax rate in the calendar year that you are considering the conversion, versus your expected marginal tax rate when you expect to make withdrawals from your traditional IRA (either to fund your retirement or to satisfy required minimum distributions). The table below provides the breakdown of the latest income tax rates you will pay at each tier of income indicated (depending on whether you file your tax return as single, married, or head of household):

Table 1. Tax Brackets and Rates, 2018

Rate	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
10%	$0	$0	$0
12%	$9,525	$19,050	$13,600
22%	$38,700	$77,400	$51,800
24%	$82,500	$165,000	$82,500
32%	$157,500	$315,000	$157,500
35%	$200,000	$400,000	$200,000
37%	$500,000	$600,000	$500,000

Source: The Tax Foundation: https://taxfoundation.org/2018-tax-brackets/

Because you have the option to convert as much, or as little of your Traditional IRA account as you like in any given year, it may be more advantageous to spread conversions across multiple years. For example, you might consider a partial conversion if you anticipate more than one year of lower-than-expected income enabling you to perform multiple smaller conversions across a period of years, or to limit the conversion amount in a particular year to keep you from entering a higher marginal tax bracket than desired. You should consult with your Modera Wealth Manager who can collaborate with your tax advisor to evaluate changes to your income status and potential tax strategies.

Other Factors to Consider

When considering a Roth IRA conversion, it is important to factor in your “basis” in the traditional IRA, as well as your means to pay for the related income tax due.

Basis refers to traditional IRA contributions that have already been taxed and therefore are not taxable upon distribution or conversion to a Roth IRA. For example, nondeductible contributions to a traditional IRA count toward the account’s basis, since these are made post-tax rather than pre-tax (i.e., tax-deductible) contributions. You can divide the IRA basis by the balance in your traditional IRA account to find the percentage of the balance that is your IRA basis and is not taxable upon conversion to a Roth.

You also should avoid withdrawing additional funds from your IRA to pay for any conversion-related income taxes, as this would be considered a distribution to you from your IRA, and may also be considered an early withdrawal and subject to IRS penalties. Therefore, you and your accountant may want to set up an estimated tax payment schedule for any income taxes incurred from the conversion, using money outside of your retirement accounts. Your accountant should also submit a special form showing that a Roth IRA conversion has taken place.

Consider Converting to a Roth IRA

A Roth IRA conversion may provide a great opportunity to avoid paying more income taxes in the future. It also may delay required distributions from your retirement savings, which may give your account more time to grow. Please consult with your Modera Wealth Manager if you have questions about the pros and cons of a Roth IRA conversion. As always, we are here to guide you and welcome your questions.

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Thank you for your continued confidence and trust in our services.

Modera Wealth Management, LLC

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