Avantia

October 13, 2021

Quarterly Market Review

In this Issue:

Summary of Review:

Many investors today are wondering if they should sell their liquid portfolios and go to cash. Afterall, the rationale seems valid. There is limited return potential in bonds, public equities are clearly expensive, and cash seems likely to get at least some modest boost in the next year or two as the Fed begins to signal rate hikes. These are the same thoughts many had in 1996 when equities were reaching all-time highs. At that time Fed Chairman, Alan Greenspan, gave his "irrational exuberance" speech. In the subsequent four years to his speech, equity markets returned an incredible 106%! Not only did the investors that sold miss out on the returns of the following four years, but they likely paid taxes on the gains they realized, and if they waited to come back into the market after it returned to its 1996 levels…they would still be in cash. Staying invested and keeping risk at appropriate levels while seeking strong after-tax returns given the prevailing market environment is often the wisest choice to investors.

Market Summary:

We remain overweight international equities but are now neutral on U.S. and emerging market equities. We are remaining overweight value relative to growth and small cap relative to large cap. We strongly believe in active management with small cap, emerging markets, and international value.

The low-rate environment, expected inflation, and likelihood of rising rates in late 2022 encourages us to be underweight duration and overweight credit to reap the benefits of interest rate carry. Within our credit exposure we prefer to allocate to floating rate notes to lower our effective duration.

We have begun to realize our belief that the recent spike in inflation was transitory. As such, we have increased our exposure to asset classes that provide an inflation hedge such as REITs, Equities, Energy, and inflation-protected bonds.

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Markets

Asset Class Views:

The most important characteristic an investor can have is the patience to stay invested as short term and secular trends unfold. To that end, here are our current thoughts on the market.

Equities:

Asset Class		Opportunity Set	Outlook	Conviction
Major Asset Classes		Public Equity	▲	▮▮▮▯
		Real Assets	▬	▮▮▯▯
		Fixed Income	▼	▮▮▮▯
Factors		Value	▲	▮▮▯▯
		Small Cap	▬	▮▮▯▯
		Term	▼	▮▯▯▯
		Credit	▲	▮▮▯▯
Preference by Asset Class	Public Equity	U.S.	▬	▮▮▮▮
		International	▲	▮▮▮▮
		Emerging Markets	▬	▮▮▮▯
	Fixed Income	U.S. Treasuries	▼	▮▮▮▮
		Municipal - High Quality	▼	▮▮▮▯
		Municipal - Credit	▬	▮▮▯▯
		Corporate - High Quality	▬	▮▮▮▮
		Corporate - Credit	▬	▮▮▮▮
		Cash - USD	▬	▮▮▮▯
	Real Assets	Real Estate	▬	▮▯▯▯
		Master Limited Partnerships	▲	▮▮▯▯
		Gold	▲	▮▯▯▯

Equity markets are somewhat expensive when compared to historical price to earnings metrics. However, selling completely out of the equity markets is impossibly difficult to time correctly and almost never the right answer. You may remember retired Chairman of the Federal Reserve, Alan Greenspan's, speech on Irrational Exuberance in 1996. From the deliverance of that speech until the peak of the Dot Com bubble, equity markets returned a whopping 106% in just four years. Even when markets seem somewhat expensive, it may not be an opportune time to sell equities. While also considering the tax burden created by selling and the subsequent "break even" return to pay for the tax, smart investors will instead stay invested, consistently "right-sizing" their potential risks by trimming the overgrown asset classes and in turn investing in assets with growth potential. The chart below, provided by JP Morgan Asset Management, indicates that Small Value stocks have tremendous growth potential. In the lower, far-right chart labeled "Current P/E as % of 20-year avg. P/E", the lower the value, the greater attractiveness as an investment opportunity. Small Value has the lowest percentage at 103.1%. We aslo see support for Small Value stocks in the section titled "Since market low". These securiyies have counter-intuitively been one of the most lucrative asset class to invest in since March 2020. The data from US and international markets indicate this is a global trend and can be greatly beneficial to investors.

10-year annualized

	Value	Blend	Growth
Large	12.1%	15.3%	18.4%
Mid	12.2%	13.7%	15.7%
Small	10.8%	12.3%	13.6%

YTD

	Value	Blend	Growth
Large	18.0%	18.0%	16.7%
Mid	20.2%	17.1%	11.6%
Small	22.2%	13.3%	5.0%

Since market peak (February 2020)

	Value	Blend	Growth
Large	19.8%	32.9%	47.9%
Mid	24.0%	32.1%	41.4%
Small	30.5%	33.8%	34.5%

Since market low (March 2020)

	Value	Blend	Growth
Large	93.8%	100.8%	115.8%
Mid	119.2%	121.2%	120.0%
Small	129.6%	125.5%	118.6%

Current P/E vs. 20-year avg. P/E

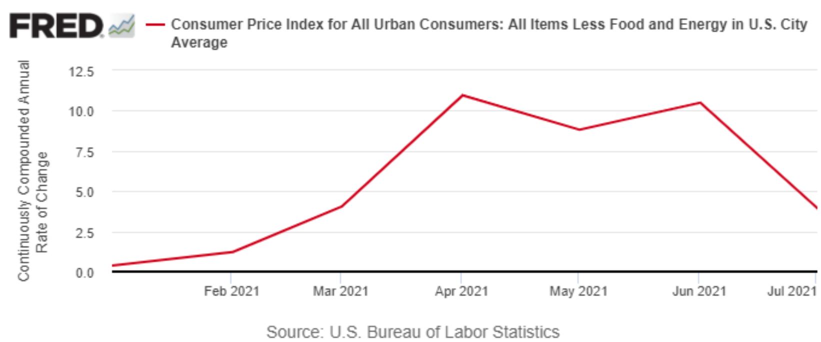
	Value	Blend	Growth
Large	16.5 / 13.7	21.6 / 15.8	30.2 / 18.5
Mid	17.0 / 14.4	21.3 / 16.4	37.4 / 20.3
Small	17.4 / 16.9	26.5 / 21.3	53.0 / 35.3

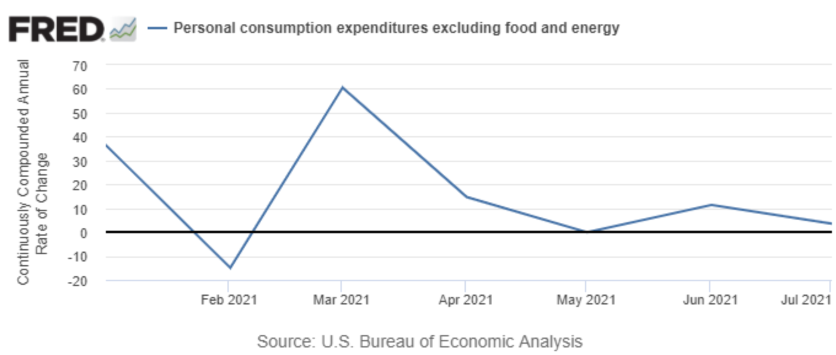
Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	120.4%	136.8%	163.3%
Mid	117.8%	130.0%	183.8%
Small	103.1%	124.5%	150.2%

Inflation: Transitory, Permanent, or does it Matter?

Inflation is a commonly misunderstood concept that holds more power than many investors realize. Equity market return projections are typically calculated by taking an inflation rate and adding the real rate of return which together are referred to as the Risk-Free Rate. We will touch back on the other components of expected rate of return, but the Risk-Free Rate is the basis from which projections start. The question our clients have been asking is whether the high inflation we have seen recently is merely transitory or if it is here to stay. In our mind as investors, this is the wrong question. While the data clearly show (see charts below) that the inflation does appear to be transitory, the more relevant question is how much inflation protection does a given investor need in their unique situation. This is something that an advisor can calculate for their client. We will walk through an example of this in more detail in an upcoming Avantia planning article.





Once the correct amount of inflation protection is understood, certain assets may then be selected based on their effectiveness as an inflation hedge. In other words, certain assets provide more protection against inflation than others while others can be more tax efficient. Examples of inflation protection range from Treasury Inflation Protected Bonds, Real Rstate, Gold, and Inflation-Linked Swaps to Mortgages which provide a unique type of protection. Using Mortgages is particularly helpful when there is at least some modest level of debt in the Real Estate market. As inflation erodes the power of a dollar, it will in turn inflate away the debt. We mention this as it also seems to be the route the Federal Reserve will take as it seeks to address the longer lasting impacts of consistent "quantitative easing". While 2% is a reasonable long-term assumption for inflation, given that it is the Federal Reserve's target, today this number is considerably higher. To the right are two year-to-date charts depicting inflation- CPI and PCE.

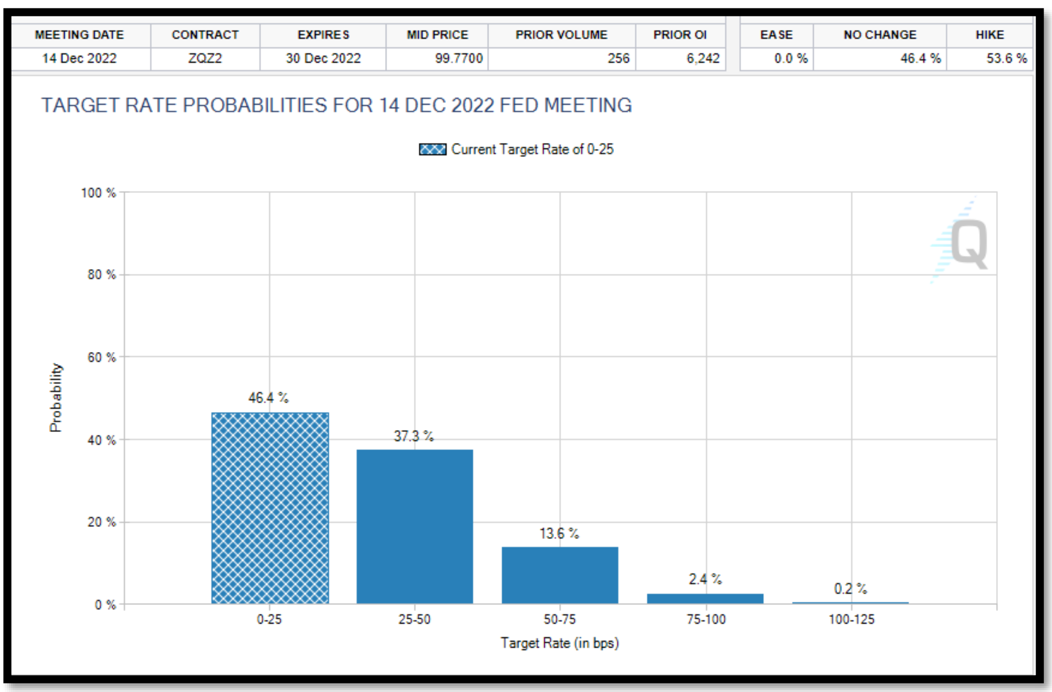
The Federal Reserve has expressed that the steep increase in inflation we are experiencing is transitory, as the FRED Data above supports. While the recent bout of inflation likely was transitory, inflation is regime based in that it does not revert to a long-term average, even if the Federal Reserve has expressed a target percentage goal. The only real

protection against the risk of unexpected inflation is for investors to hedge against that particular risk and as mentioned previously. The amount of hedge is unique to each investor but easily understood.

Beyond our ability to prepare for inflation, we can expect more fiscal spending in the future. When we compare the three charts above, we see an inverse relationship between inflation and the value of the dollar. As inflation rises, the value of the dollar falls. Trading against other countries influences the data as well. The relationship between the dollar and inflation is less clear cut than it may appear.

The Fed will have to raise interest rates, should I sell bonds?

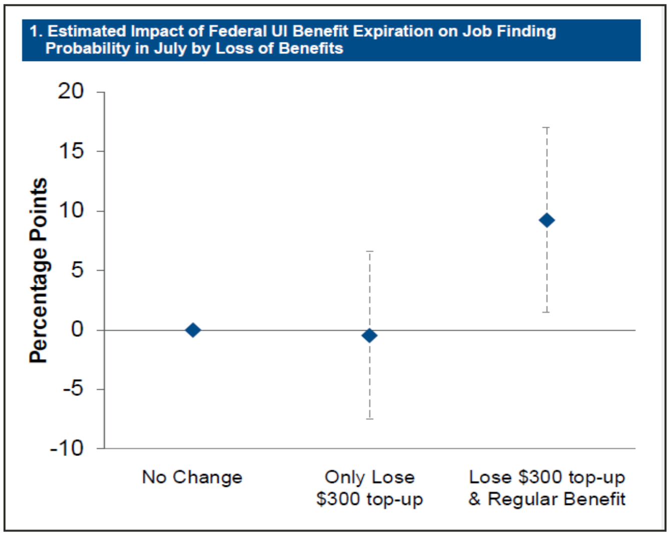
When interest rates rise, bond prices fall. This is a well understood mechanism in the bond market. A bond's price sensitivity to an incremental change in interest rates is called duration. So, it stands to reason that our clients would have questions around whether this is the right time sell bonds given our recent encounter with inflation. First, as we can see in the chart below from the Chicago Mercantile Exchange Group, the market expectations of a rate hike do not go over 50% until December 2022. If this were our only gauge of when to expect rates to rise, then as investors we would have over a year before a change. Of course, markets are anticipatory of changes so one could reasonably expect to see movements in the bond market well ahead of the announcement. More importantly, the role Bonds play in a portfolio is not merely to dampen volatility. For an individual investor or an endowment, bonds are the source of cash to support spending. Moving to cash merely ensures that that the portfolio will underperform inflation which is not suitable

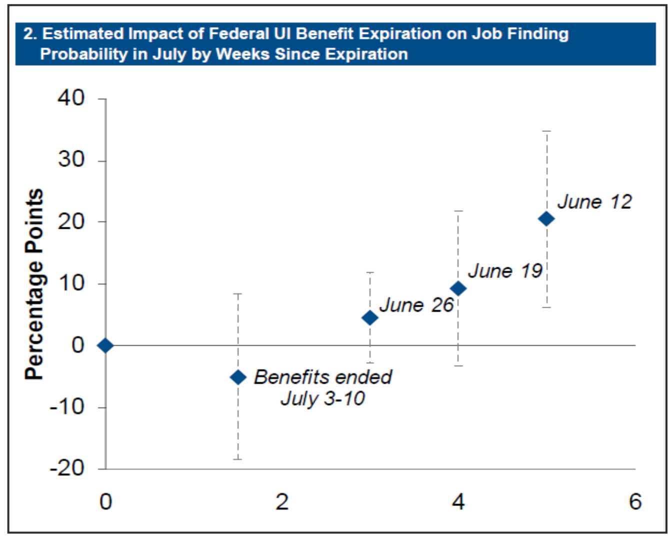


for the investor's purposes. If the investor seeks a dual mandate of protecting their spending while also "beating a benchmark" in the short-term, then a duration constrained approach could be effective so long as the investor realizes they are giving up a robust source of return known as risk premium. A risk premium occurs when an investor provides a loan (owning a bond) for a longer period of time. The further away the cashflows occur, the higher the risk premium we can expect. By the way, a duration constrained approach simply means that the investor would target a duration that is less than ideal for their specific situation. This is common in a low-rate environment as it reduces the volatility an investor will experience. For some investors that watch their accounts regularly and have a lower tolerance for risk, a duration constrained approach will likely help them sleep better at night.

Equity Markets: Are they Overvalued? Should I Sell?

One thing that has surprised many investors has been the lack of American's returning to work after their unemployment checks have ended. As people lose their supplemental unemployment checks, they do not seem more likely to find a job. We saw this in blinding fashion in the August non-Farm Payrolls report. The report was expected to announce 733,000 new jobs and instead only delivered 235,000. This is one of the biggest jobs report misses in recent memory. This signaled, incorrectly, to the market that as supplemental unemployment ended, people would seek jobs.





For weeks since the report, American's felt that the ending of the stimulus payments would not drive a return to work. However, as our friends at Goldman Sachs have pointed out, this conclusion is simply not true. The workforce has been looking for jobs and is finding success doing so. As we see in chart 1 above, people that lost both the $300 top-up and regular unemployment benefit were nearly 10% more likely to find a job.

As we can see in chart 2, the longer a person has gone without unemployment assistance the more likely they are to find work, with those that lost their benefits in early June being more than 20% more likely to find work.

Planning

Grantor Retained Annuity Trust:

As our clients' wealth grows, we look to bring effective planning techniques to their attention. Once such area of planning is around gift taxes. Once a client has achieved a level of wealth that both sufficiently covers their needs and goals for the remainder of their lives and places them in a level of wealth such that their estate will likely be taxable, they may consider techniques designed to transfer wealth to the next generation in a more tax efficient manner. One such technique is a Grantor Retained Annuity Trust (GRAT)

What is a GRAT?

A Grantor Retained Annuity Trust (GRAT) is a planning tool that may be used to transfer substantially appreciating assets to family members and pay little to no gift tax. GRATs are an advanced planning tool that will require the family office to work closely with the client's estate and tax advisors to create, implement, and manage.

Clients who face a large estate tax liability may use a GRAT to lock in the value of all or a portion of an asset that is expected to significantly appreciate. For example, if a client owns an asset worth $1,000,000 as of September 2021 which the client expects to appreciate at 8.0% annually for the next two years, the client can transfer nearly all the appreciation to their children or family members nearly tax free.

How is a GRAT created?

With the guidance of a qualified attorney, the client will establish an irrevocable trust which will exist for a certain period, often two years. The individual establishing the trust, the grantor, pays a tax on the value of the gift when the trust is established. As we will see, this tax is very low given how the value of the gift is calculated for tax purposes. The assets are placed into the trust and the trust pays an annuity to the grantor every year. The present value of the annuity is roughly equal to the value of the assets transferred into the GRAT.

Exhibit 1:

Assumptions:

Starting value of GRAT:	$ 1,000,000.00	Annual Appreciation	8.0%	Excess Annuity:	$ -
§7520 Rate:	1.00%	Term (years)	2		
Annuity Growth	0%	IRS Annuity Factor	1.9704		

	Starting Value +	Appreciation -	Annuity Payment =	Ending Balance
Year 1	$ 1,000,000.00	$ 80,000.00	$ 500,000.00	$ 580,000.00
Year 2	$ 580,000.00	$ 46,400.00	$ 500,000.00	$ 126,400.00
Distribution to Grantor			$ 1,000,000.00	
Distribution to Children				$ 126,400.00

Starting value of GRAT:	$ 1,000,000.00	Reminder to Beneficiary:	$ 126,400.00
PValue of Retained Annuity:	$985,200.00	Tax free transfer:	$ 111,600.00
Value of gift:	$ 14,800.00	Gift Tax due @ 40%	$ 5,920.00

In Exhibit 1 above, we are contributing an asset with a value of $1,000,000 to the GRAT. As of the funding of the GRAT, the §7520 rate is 1.00% and the IRS annuity factor from IRS Publication 1457 Table B is 1.9704. Given these factors, we see that the client contributes the asset and receives an annuity payment each year of $500,000.00 for the two-year term of this GRAT. In this scenario, the client will be deemed to have retained $985,200.00 of the asset they contributed at the start and passed $126,400.00 to the beneficiaries of which $111,600.00 is tax free and $14,800 is subject to gift tax.

In Exhibit 2 below, we see that by allowing the annuity payments to increase overtime at the maximum amount allowed (20%) we can further optimize the amount transferred from $126,400.00 to $130,036.36. This is because more of the asset remains in the trust and is subject to the annual appreciation. The reader should note that the value of the gift is the same in both examples. This is because the gift amount is calculated at the funding of the GRAT, not at the end.

Exhibit: 2

Assumptions:

Starting value of GRAT:	$ 1,000,000.00	Annual Appreciation	8.0%	Excess Annuity:	$ -
§7520 Rate:	1.00%	Term (years)	2		
Annuity Growth	20%	IRS Annuity Factor	1.9704		

	Starting Value +	Appreciation -	Annuity Payment =	Ending Balance
Year 1	$ 1,000,000.00	$ 80,000.00	$ 454,545.45	$ 625,454.55
Year 2	$ 625,454.55	$ 50,036.36	$ 545,454.55	$ 130,036.36
Distribution to Grantor			$ 1,000,000.00	
Distribution to Children				$ 130,036.36

Starting value of GRAT:	$ 1,000,000.00	Reminder to Beneficiary:	$ 130,036.36
PValue of Retained Annuity	$985,200.00	Tax free transfer:	$ 115,236.36
Value of gift:	$ 14,800.00	Gift Tax due @ 40%	$ 5,920.00

However, as we can see in exhibit 3 there is more that we can do on the planning front in this technique. Given that a client would generally want to pay less tax, we can further reduce the tax by increasing the retained annuity. In this example, we add an excess annuity amount of $7,500. This reduces the value of the gift to just $22.00 and the tax to just $8.80! Not bad when one considered that this has allowed a total transfer of $114,436.36 to the next generation.

Exhibit 3:

Assumptions:

Starting value of GRAT:	$ 1,000,000.00	Annual Appreciation	8.0%	Excess Annuity:	$ 7,500
§7520 Rate:	1.00%	Term (years)	2		
Annuity Growth	20%	IRS Annuity Factor	1.9704		

	Starting Value +	Appreciation -	Annuity Payment =	Ending Balance
Year 1	$ 1,000,000.00	$ 80,000.00	$ 462,045.45	$ 617,954.55
Year 2	$ 617,954.55	$ 49,436.36	$ 552,954.55	$ 114,436.36
Distribution to Grantor			$ 1,015,000.00	
Distribution to Children				$ 114,436.36

Starting value of GRAT:	$ 1,000,000.00	Reminder to Beneficiary:	$ 114,436.36
PValue of Retained Annuity	$999,978.00	Tax free transfer:	$ 114,414.36
Value of gift:	$ 22.00	Gift Tax due @ 40%	$ 8.80

In each of the above examples, we chose an asset with an assumed annual appreciation rate of 8%. However, let us consider one final example, exhibit 4 below. If we consider funding a GRAT with an asset that we believe will have very high appreciation, we can see the power of this tool. If a client had contributed a diversified pool of US Small Cap value stocks in March of 2020, at the market low, as of August 2021 those securities would have been up 129.6%. It worth also noting that the §7520 rate in March of 2020 was 1.80% which changes our IRS Annuity Factor to 1.9473 and would cause us to consider a different excess annuity amount, in this case, $13,531. We can see now that the potential transfer to the beneficiaries is an incredible $3,657,805.09!!

Exhibit 4:

Assumptions:

Starting value of GRAT:	$ 1,000,000.00	Annual Appreciation	129.6%	Excess Annuity:	$13,531
§7520 Rate:	1.80%	Term (years)	2		
Annuity Growth	20%	IRS Annuity Factor	1.9473		

	Starting Value +	Appreciation -	Annuity Payment =	Ending Balance
Year 1	$ 1,000,000.00	$ 1,296,000.00	$ 468,076.45	$ 1,827,923.55
Year 2	$ 1,827,923.55	$ 2,368,988.91	$ 558,985.55	$ 3,637,926.91
Distribution to Grantor			$ 1,027,062.00	
Distribution to Children				$ 3,637,926.91

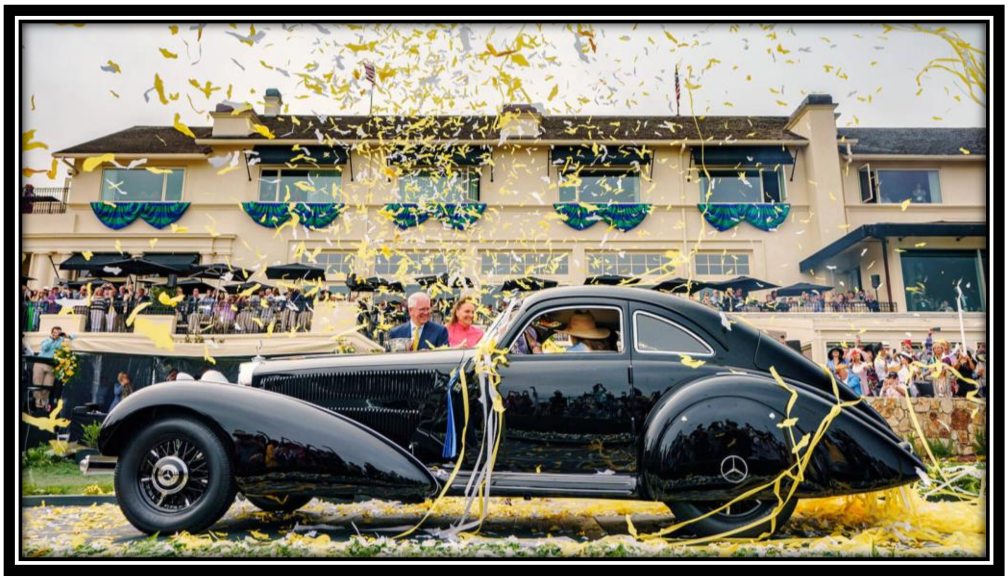
Starting value of GRAT:	$ 1,000,000.00	Reminder to Beneficiary:	$ 3,637,926.91
PValue of Retained Annuity:	$999,998.92	Tax free transfer:	$ 3,637,925.83
Value of gift:	$ 1.08	Gift Tax due @ 40%	$ 0.43

As with any planning technique a grantor retained annuity trust is unique to the specific facts and circumstances of the client. It is important for the family office to work closely with the client's estate and tax advisors to bring relevant techniques to light for the client and to properly construct, implement and manage the overall financial structure for the client.

Avantia Lifestyle

Pebble Beach Car Week

Among car aficionados, the two words “Pebble Beach” do not conjure images of the titans of professional golf. For car people, images of Duesenberg, Alfa Romeo, Allard, and countless other makes and models of cars from a bygone era are mixed with nostalgia and the artistic expression that was so prevalent in the design of fine automobiles prior to World War II. The history and grandeur of the Pebble Beach Concours d ’Elegance is what brings over 15,000 onto the 18th hole of the Pebble Beach Golf Course. However, the entire ecosystem of vendors, auctions, car shows, drives, and the beautiful scenery are what keep people coming back to rocky section of the central California coast year after year. Indeed, one can have an entirely different trip every year for two or three years in a row without revisiting the same event. In this article, we draw from several our client’s experiences at Pebble Beach to help you get the most out of your next (or first) trip to what is increasingly being referred to around the world as “Pebble Beach Car Week” or simply, “Car Week.”



It’s important for anyone new to car week to understand that there is more than enough to do that is not car related that any significant other or family member can enjoy. Carmel, CA (Where we recommended Avantia client’s to reside for the week) is absolutely overflowing with art galleries, fashion boutiques, world class restaurants, stunning strolls right out your front door, and gorgeous hiking just minutes away by car. Carmel is simply one of those special places on earth. There are no addresses, and everyone walks to the post office. The homes are cute, quaint, and expensive. Afterall, not many neighborhoods can claim to have a home designed by Frank Lloyd Wright such as Cabin on the Rocks. If you are a car lover looking for an elegant trip with your significant, there is no better place we would recommend.

This year’s Pebble Beach Car Week marked the 70th anniversary which was highlighted with a special class of cars featuring all past winners of the “best of show” award. The winner of the winners this year was a 1938 Mercedes-Benz 540K Autobahn Kurier owned by The Keller Collection at the Pyramids. This car is a stunning example of what Pebble Beach is all about.

To learn more and view other spectacular photos from the past show, interested readers may follow this link.

Photo courtesy of Mr. K. Heng

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