POLARIS ADVISORS, LLC.

THE Retirement Report

Retirement Transition Planning

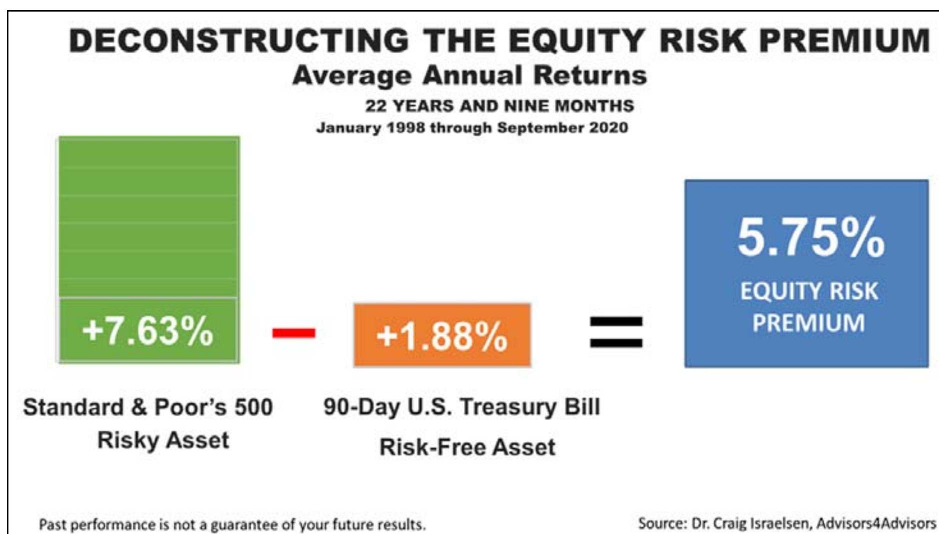
508.481.2299 www.polarisadv.com Fourth Quarter 2020

Earning The Equity Risk Premium Return Of 5.75%

During the Covid pandemic, one day drops in stocks of between -3% and -5% have not been uncommon. And then there was March 12, 2020, a one-day plunge of -12%!

Times of painful stock market losses are when investors earn the equity risk premium. The equity risk premium is financial jargon for "the vig," the extra return investors were paid for taking a risk. Successful investing requires an understanding of the risk premium on stocks. So here's a look at the vig in recent months on the Standard & Poor's 500 index, a period that includes the outbreak of the Covid pandemic in the U.S.

To quantify the post-Covid equity risk premium, look at the equation in the graphic: Over the 22 years and nine months ended on September 30, 2020, the risk-free 90-day U.S. Treasury bill averaged an annual return of +1.88%, compared to a +7.63% annualized return on the S&P 500 stock index.



Subtracting the 1.88% from the 7.63%, resulting +5.75% represents the premium stock investors have been paid annually over the boom and bust cycles since 1998. Put another way, owning stocks through the tech bubble in 2000, financial crisis in 2008-2009, and COVID outbreak bear-market rewarded investors with a premium of 575-basis points over what they would have earned by investing in risk-free 90-day Treasury bills.

The chart on the last page does a better job of illustrating the scary parts of the equity risk premium. The red data series shows the daily changes in the stock market, as represented by the price of a share of the S&P 500. Enduring a loss of one-third of your portfolio's value, for some investors, was a stomach-wrenching experience. Sometimes, earning the equity risk premium is hard.

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From March To November, Who Could Have Known?!

Earlier this quarter, we received thanks from a number of clients for orchestrating such great returns to our portfolios. What we really did was to ensure that all our clients were invested when such great returns occurred. A recent article in the WSJ claims the S&P 500 gained almost 66% since the bottom of the COVID crash! What a shame for any long-term investor to miss that because they jumped out of the markets at the March bottom.

Our newsletter cover article this quarter talks about the "equity risk premium." We hate terms like that. Whatever does that mean? It's investor-speak for the income owners of U.S. stocks earned over the income owners of safe 90-day U.S. Treasury bills earned. It's what we get for taking on periodic stock price plunges, such as happened in March and also in 2008. Conversely, the price of 90-day U.S. bonds changes very little—stable, but low-paying.

The study covers 22 years, a time period included in most individuals' retirement. It discovered long-term returns of 7.63% for stocks and 1.88% for bonds. Our job is to determine how much of each is held in our clients' accounts, so they earn meaningful income without unbearable stress when markets go the wrong way. We can't earn any "equity risk premium" if we're not invested in equities. Since predicting COVID-19 and the market's reaction to it would have been impossible, we need portfolios we can stay with through thick and thin.

Stay safe and well,

Ric and Trang

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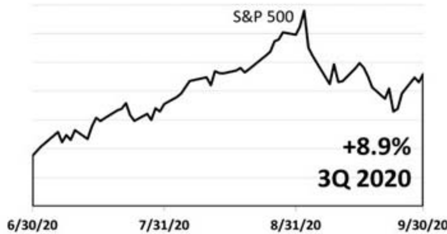
Market Data Bank: 3rd Quarter 2020Ψ

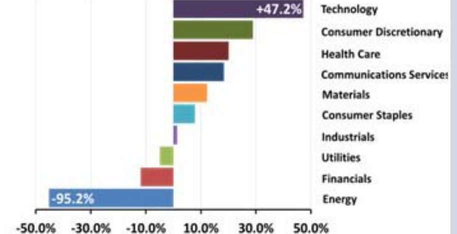


S&P 500 RECOVERS STRONGLY AGAIN

Not only did stocks recover fully from the -33.9% COVID bear market, but the S&P 500 broke its the all-time high set before the pandemic. It was the second consecutive quarter of great returns. Facebook, Apple, Amazon, Netflix, Google, and Microsoft accounted for the S&P 500 gains, leading a fearful slog back to normalcy.

U.S. VERSUS FOREIGN STOCKS

In the five years ended Sept. 30, the S&P 500 delivered more than three times the total return of European stocks, and twice as much as Asia Pacific stocks. U.S. outperformance drove a bull market from April 2009 to February 2020, and was followed by the Covid bear market, which bottomed March 23, 2020.



ENERGY WAS WORST SECTOR AGAIN

Energy stocks lost 45% of their value in the year ended Sept. 30, 2020. Pandenomics caused a worldwide recession, worsening the global oil glut. Meanwhile, technology stocks, propelled by FAANGM, blasted 47% higher. Consumer discretionary and tech stocks have outperformed for years.

INDEXES TRACKING 13 ASSET CLASSES

U.S. stock returns crushed a diverse group of assets in the five years ended Sept. 30, 2020. Despite the Covid bear market, U.S. stocks nearly doubled in this period. Notably, the global stock index, excluding U.S. stocks, returned less than half the S&P 500. Gold stocks surged as investors sought stock alternatives.

EQUITY RISK PREMIUM

Over the 22 years and nine months ended Sept. 30, 2020, a risk-free 90-day U.S. Treasury bill averaged +1.88% annually, compared to +7.63% on stocks. That is equal to a +5.75% annual premium for taking the risk of owning stocks through the tech crash of 2000, the 2008 global crisis, and Covid bear market.

WHAT TO EXPECT

One-day stock plunges are not uncommon in recent years. Earlier this year, stocks plunged -12% in a single day! With COVID still causing uncertainty, stock plunges should be expected. But investors who plan to own stocks for the rest of their lives would be wise to view volatility as a way to earn the equity risk premium.

Past performance is never a guarantee of your future results. Indices and ETFs representing asset classes are unmanaged and not recommendations. Foreign investing involves currency and political risk and political instability. Bonds offer a fixed rate of return while stocks fluctuate. Investing in emerging markets involves greater risk than investing in more liquid markets with a longer history. Indices are unmanaged and not available for direct investment. Investments with higher return potential carry greater risk of loss. Actual annual sector performance data from Standard and Poor's; equity risk premium data ©2020, 7Twelve™ Portfolio, Craig Israelsen.

Three Easy Ways To Increase Your Chance Of Financial Success

Changing your financial behavior can be an important step in determining your long-term financial success. Here are three simple activities that can help.

Automate. Infrequent interventions, such as budgeting once a year, are less likely to bring success than more automatic actions that occur quarterly or monthly. Enrolling in a salary reduction plan which takes money from each paycheck and goes into your qualified retirement plan illustrates the difference between decisions that require your recurring action versus those that are automated. What else might you automate to increase your savings or make sure you pay your bills? Examples include signing up for a newsletter, webinar series, or class about tax and investment planning. The easier you make it to become educated about a topic you might not otherwise research regularly on your own, the more likely you are to seek out the knowledge you need to be more fully engaged in learning and find answers to the important questions.

Write it up. Whenever

Financial Planning For The Long Run Amid The COVID-19 Epidemic

By August 4, 2020, the Institute of Health Metrics and Evaluation (IHME), an independent public health research center at the University of Washington, expected 68,841 deaths from COVID-19 in the U.S. IHME's April 13 statistical model, if accurate, would exceed the 58,209 Americans killed in the 14-year Vietnam War and the 54,246 American lives lost in the three-year Korean War. The human toll in sickness, suffering, and grief is unimaginable.

Almost overnight, the crisis has changed the financial and economic outlook. Change like this is frightening and brings new risks, but it also brings new opportunities. Here's a short list of what to do now.

Do Not Despair. As grim as things are, the models forecast an end to the epidemic. It's not a permanent condition. It will end. IHME, which is funded by the Bill and Melinda Gates' foundation, may turn out to be imprecise about the exact date of the end of COVID-19 deaths, and a second wave of the virus is a risk. Life may not be quite the same, for at least a couple of years and possibly longer, but life goes on. A survivor of the 1918 Spanish flu epidemic, according to The Wall Street Journal, said it took a couple of years before social, and, in turn, economic conditions returned to normalcy.

Stocks. The Standard & Poor's 500 lost about a one-third of its value from an all-time closing high on February 19 through the ultimate low on March 23 and it then has subsequently rebounded 25% off its low. Lower stock valuations may present a unique tax and financial planning opportunity. For example, if you own securities with large losses in a taxable portion of your portfolio, you might consider selling those assets at a loss. This concept is known as tax-loss harvesting. Losses on assets held for more than one year can be used to offset capital gains realized on other assets. So long as you do not buy securities that are identical or substantially the same, you can buy a similar asset to match your portfolio's risk level. The replacement asset will then have a lower cost-basis and more of your investment will ultimately be subject to favorable long-term capital tax treatment.

Roth IRA Conversions. Lower stock values may present an opportunity to convert some portion, or all, of a traditional IRA to a Roth IRA. Traditional IRAs are taxed as ordinary income upon withdrawal, while Roth IRAs are always tax free upon withdrawal. However, when you convert any portion of a traditional IRA to a tax-free Roth account, you must pay tax on the withdrawn amount at your current income tax rate. With asset values having been lowered by the bear market, the taxes owed on assets you wish to convert are commensurately lower, making the cost of converting to a tax-free Roth account less costly and lowering your tax bracket in the years ahead on withdrawals from the Roth IRA.

Paycheck Protection Program (PPP). On Friday, March 27, 2020, the Coronavirus Aid Relief Economic Security Act, a history-making $2.2 trillion stimulus law, allocating $349 billion in loans to business owners in need, and the loans are to be forgiven if you spend the money within the proscribed eight- week time frame to retain your employees. PPP is the primary relief program sponsored by the U.S. Government to aid business owners. PPP is expected to distribute its $349 billion by late April. Additional funding from Congress is widely expected, but it should be noted that the forgivable loans are distributed on a first-come, first-served basis. With 30 million small businesses, this is the one thing business owners want to get right. Contact us if you have questions about how to proceed.

Wealth Transfers. For individuals with taxable estates, unprecedented low interest rates make it smart to consider the use of specially-designed trusts, such as a:

- Grantor Retained Annuity Trust (GRAT)
- Intentionally Defective Grantor Trust (IDGT)
- Generation Skipping Trust (GST)

Estates Currently In Administration. If you are a beneficiary of an estate in the administrative process of distributing assets, the change in asset values may have created a tax-loss harvesting opportunity. In addition, the lower asset values make it prudent for spousal beneficiaries of a qualified retirement account under administration to evaluate a partial or complete disclaimer of inherited assets.

Stay In Touch. The strategic opportunities for individuals described above do not necessarily contemplate your unique personal situation. If you have a specific question about any of this, or how it may apply to you, please contact us. ●

you make a major financial decision, write yourself a note about your decision. By jotting down your analysis at the time you make a decision, you'll create an introspective record that, over the years, will help reveal successes and failures.

Increase self-awareness. Your financial personality can help or hinder your financial success and you may be entirely unaware of it. Increasing self-awareness can help you avoid sabotaging yourself. The burgeoning social science of behavioral finance can help you learn about your financial personality traits. For example, would you rather receive $160 today or $246 in 12 months? How about $160 today or $180 in 12 months? Your answer to a series of questions like this can reveal your predisposition toward deferring rewards now in favor of reaping financial benefits from a long-term plan. Similar questions can guide you in determining how likely you are to tolerate losses in bear markets, whether you are overconfident about your financial decision-making abilities, and offer hints of the types of investments that might work best in a long-term portfolio designed to help you accomplish your financial goals.

If you would like to talk about other steps you can take to ensure healthy financial behavior, please do not hesitate to contact us. ●

Private Wealth's Perfect Storm

Amid the Covid pandemic, changes in tax, financial, and economic arenas have created a deluge of added complexity for advisors managing private wealth. Here's an overview of the abrupt change in conditions now battering private wealth, which, when taken together, amounts to a "perfect storm:"

Tax Policy. Budget shortfalls across the states as well as at the federal level are expected to result in steep hikes to state and federal income and transfer taxes.

Taxable Estates. For individuals with taxable estates, the current exemption of $11.58 million from estate and gift tax will be cut in half January 1, 2026. However, the exemption amount could be cut much sooner, depending on the outcome of the November 3 election. Changes in tax policy increase the downside risks of failing to plan. While 2026 may sound a long way off, preparing now to maximize annual gift-tax exclusions, charitable donations, and appropriately tailored trusts to accomplish your goals can ensure a lasting legacy.

Lowest Rates In Decades. Every month the IRS releases the minimum interest rates you are permitted to charge on loans to family members, trusts and other related entities. With this "applicable federal rate" currently at less than 1%, loaning assets may be a savvy way to transfer wealth to the next generation for buying a home, starting a business, or making charitable bequests. The loans are sometimes part of a plan to transfer a family business, or support children with special needs. With the pandemic potentially lowering the value of real estate and business assets, and causing frequent stock market volatility, optimizing low interest rates to make intrafamily loans is suddenly a more viable solution to reducing taxes and enhancing legacy planning.

Liability Explosion. With tenants more often unable to pay rent, and small businesses facing financial difficulty, landlords and business owners are suddenly facing an explosion in their liability exposure. Asset protection strategies to mitigate personal liability exposure in the event of a setback requires preparation before a problem arises or facing a legal challenge.

The Covid pandemic abruptly changed tax and financial conditions affecting estate tax and asset protection drastically, and this perfect storm requires proactive engagement of family members as well as advice from tax, legal and financial professionals. Please contact us with questions about your personal situation. ●

The Equity Risk Premium

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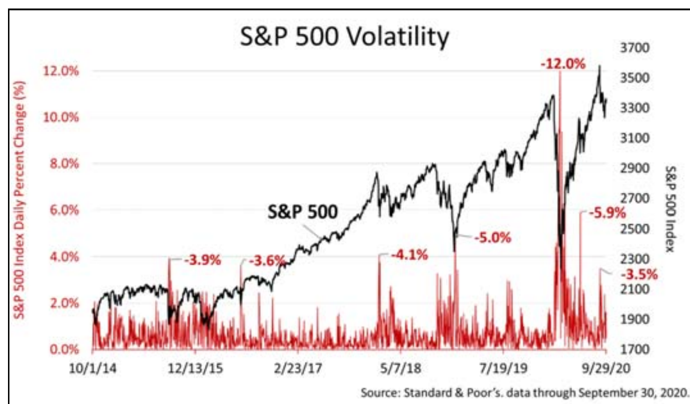
Armed with these kinds of statistics, however, knowing that big daily down days reliably do come, it is easier to withstand the uncertainty.

With the COVID outbreak tragically surpassing 1,000-deaths in a day and the changes in all three branches of the U.S. Government, the risk of a stock market plunge looms larger. However, permanent investors who plan to own stocks for the rest of their lives would be wise to view volatility as a friend.



That may be counterintuitive, but it absolutely is valid. Choosing to expose a portion of your portfolio to price volatility, also known as risk, justifies a better return. You wouldn't earn the six percentage-point equity risk premium on stocks, if you weren't exposed to lots of volatility. It just goes with the territory. It's part of owning a risk asset. ●

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