Wealth Management

Economic uncertainty and tax law changes require changes in investment strategies and estate planning

TABLE of EXPERTS

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As Senior Vice President, Director of Equity Strategies and Portfolio Manager, Jason develops and builds customized portfolio strategies for individual, institutional and non-profit clients. This includes investment policy review and development, portfolio construction, manager and security selection and performance reporting. With over 20 years of experience in financial services, Jason is a Chartered Financial Analyst (CFA®) and holds an MBA in Finance from the University of Wisconsin – Whitewater.

BRADLEY J. KALSCHEUR
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Brad Kalscheur is a partner in the Wealth Planning practice at Michael Best. Brad's practice includes all areas of estate and business succession planning. He serves as a trusted advisor to individuals, families, and companies seeking to cost-effectively structure or transfer businesses. Clients value Brad's responsiveness, particularly his ability to help them understand complex property and tax law concepts.

DAVE SPANO
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Dave is Founder and CEO of Annex Wealth Management, a Registered Investment Advisor firm with over $2 billion in assets under management. A CFP® with over 30 years of experience in wealth management, Dave has significant ties to numerous non-profit and civic organizations, and hosts several financial radio programs.

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Volatility and tax reform have changed the economic landscape, prompting people to rethink their approaches to investing and charitable donations. For business owners, there's new considerations concerning the type of business structures they should utilize as well as whether now is the time to consider selling or transferring ownership of their businesses. Because of these changes, The Milwaukee Business Journal recently assembled a panel of experts to explore the challenges and opportunities.

MODERATOR: WHAT POLITICAL OR ECONOMIC TRENDS ARE YOU PAYING THE CLOSEST ATTENTION TO AND WHY?

DAVE SPANO: Now that we're past the midterm elections, we are watching trade, tariffs and what the Federal Reserve is doing. Concerns about what could happen with China is moving the market, while the Federal Reserve's actions on interest rates has an effect on everything from fixed-income investments to equities.

JASON HERRIED: After two years of strong economic growth in the United States and pretty much across the globe, things are slowing back to trend. Whenever you have that kind of change, especially with the uncertainties involving the Federal Reserve and U.S./China trade policy, there can be a lot of nervousness about all of the bad things that could happen. We will learn a lot more in January, when the next earnings season begins. And between now and then we are awaiting updates on trade when Presidents Trump and Xi Jinping meet at the G-20 summit at the end of November and on monetary policy from the Federal Reserve in mid-December. Investors are hoping for a ceasefire on trade and a Federal Reserve that acknowledges that growth is slowing.

BRAD KALSCHEUR: We're watching the impact of tax law changes and what else might be coming down the pike, although with the change in Congress, you're probably not going to see any big changes over the next two years. We're also keeping our eye on tariffs. It's a very important issue for our business clients. They're concerned about both the short-term pain and long-term impact.

SPANO: I saw a recent survey that showed 75 percent of CEOs list tariffs at the top of their list of concerns.

KALSCHEUR: And they impact a lot of Wisconsin businesses.

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MODERATOR: HOW ARE THOSE CHANGES IMPACTING YOUR RECOMMENDATIONS?

HERRIED: The market has had an expectation that the Federal Reserve is going to raise rates one more time in December and then three times in 2019. Because of some softer economic data, however, that market expectation has been reduced to a December hike and one rate increase next year. However, in their latest official statements, the Federal Reserve is still indicating three rate hikes next year. We think market expectations are closer to where the economy is actually going. So what are we doing in our bond portfolios? For the past year we have positioned our bonds to be less impacted from rising interest rates. However, lately we have been increasing our duration positioning because of lower risk that interest rates move significantly higher in the next year.

SPANO: For fixed income, we think the market knows the Fed won't be that aggressive, so we are pricing that into our recommendations. On the equity side, we're looking at how interest-sensitive stocks react.

MODERATOR: LET'S TALK ABOUT TAX REFORM? HOW HAS FEDERAL TAX REFORM LEGISLATION IMPACTED YOUR RECOMMENDATIONS AND ADVICE FOR CLIENTS?

HERRIED: We're seeing more clients switch out of tax-exempt bonds because the tax-exemption doesn't matter as much now. It all depends on what their marginal tax rates are.

KALSCHEUR: One of the biggest changes with tax reform is the Section 199A deduction, which is prompting business owners to rethink whether they are going to convert from C corporations to S corporations, LLCs or other pass-through organizations. Another significant change is the increase in the estate tax and gift tax exclusions amount. It is $11.18 million per taxpayer in 2018 (increasing to $11.4 million in 2019), which means the estate tax is no longer a concern for 99 percent of people. That's significant because the specter of estate taxes impacts how family farms and family-owned businesses are transferred from one generation to the next. You are also going to see people doing their charitable giving a little differently because of the tax law changes, especially due to the increased standard deduction coupled with the $10,000 deduction limitation on state and local taxes (SALT). Many people will bunch their donations, which means you make two years of contributions in one year so you can get past the threshold to itemize your deductions. The next year you take the standard deduction.

SPANO: We're having a lot of conversations around structured charitable giving. People are doing everything from bunching their donations to forming foundations or contributing to donor-advised funds, which allow people to get an immediate tax deduction and then recommend disbursements from the fund to their favorite charities over time. The new tax law presents other opportunities as well. Lower taxes make Roth IRA conversions more attractive, and they have expanded the use of 529 Qualified Tuition Plans so they can be used to pay tuition expenses for K-4 through high school.

KALSCHEUR: There are a couple of options for charitable donations given the increase in the standard deduction. You don't have to give cash to charities if you are concerned about avoiding taxes. You can give them some of your appreciated securities. The charity gets benefit of the full value of the appreciated asset and the donor avoids having to pay capital gains. Another option is the qualified charitable distribution, which is a good option for people who have reached age 70.5 and have a traditional IRA. They're required to take an annual minimum distribution from their IRAs, but can give up to $100,000 of that distribution directly to a qualifying charity (not the taxpayer's foundation or donor advised fund). They don't get a deduction for the distribution to charity, but the distribution counts as part of their minimum required distribution for the year and is excluded from their adjusted gross income and a lot of other things on an individual's Form 1040 are triggered off what your adjusted gross income level.

MODERATOR: HOW WELL DO YOU THINK PEOPLE UNDERSTAND THE RAMIFICATIONS OF THE TAX REFORM CHANGES ON THEIR WEALTH PRESERVATION AND ESTATE PLANNING STRATEGIES?

HERRIED: It's a process and people are at different points on the journey. Financial advisers are as valuable as they have ever been this year because there has been so much change.

KALSCHEUR: The people who pay estimated taxes are more aware of the changes. Others are really going to realize them come filing season when people actually start putting pencil to paper. One of the biggest misconceptions out there right now is that people will be paying more in taxes because of the $10,000 deduction limit on state and local taxes. Even with the limitation, the reality is that 95 percent of people will pay less taxes, mainly due to the increased amount of income taxed at lower rates and the virtual elimination of the alternative minimum tax (AMT) for the vast majority of taxpayers.

SPANO: Because of the changes, we're having conversations with all our wealth management clients to make sure they have reviewed their estate plans. A lot of people have not done a review or haven't done a review with an expert like Brad. It's very important that people do a review and that they engage a qualified estate planning lawyer and certified public accountant.

KALSCHEUR: The plan may have worked well when it was written, but it may not work as intended with the changed tax laws. For example, in second-marriage situations, estate plans may often have formula clauses that stipulate how assets flow through the estate for tax purposes. Those formulas are impacted by the increase in the estate tax exemption.

SPANO: That's right. Because of the changes, the formulas can end up inadvertently excluding or disinheriting someone like the surviving spouse.

MODERATOR: MANY BABY BOOMERS ARE NEARING RETIREMENT AND MAY BE LOOKING TO SELL OR TRANSFER OWNERSHIP OF THEIR BUSINESSES. HOW DO YOU SEE TAX REFORM AND CURRENT ECONOMIC TRENDS IMPACTING THOSE PLANS?

SPANO: People are wondering whether they should accelerate these conversations for a number of reasons. The tax reform legislation sunsets in 2025, which means there is a limited window to realize the benefits. Second, we have a strong economy with peak earnings growth, which increases the valuation of companies being sold. Rising interest rates are also a concern because they mean higher debt costs for borrower, which has to be factored into the sales price.

KALSCHEUR: The amount of the estate-tax exclusion is a very important consideration for owners of a family-owned business. A family-owned business is not a liquid asset that can be easily converted to cash to pay the estate tax when the owners die. That issue is greatly minimized for most people with the $22.36 million (in 2018) combined estate tax exclusions for married business

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owners. Similar to 2012, they may have an incentive to act before December 31, 2025 when the current law sunsets.

HERRIED: We are definitely seeing more activity around business sales. There's a lot of private equity capital out there, and if you want to sell there is a buyer. One of the concerns people have about selling their businesses is how they will replace the income stream they're currently getting from the business. Higher interest rates make it a little easier for an owner who wants a lower-risk income stream from their investments.

MODERATOR: HOW CONCERNED SHOULD PEOPLE BE ABOUT THE VOLATILITY IN THE MARKET?

HERRIED: Volatility tells you that a change in expectations is occurring. It does not mean a bear market, necessarily; it just means there is change. The change we're seeing is that economic growth is slowing after two really good years. Add on to that the trade tensions and concerns that Federal Reserve actions could restrict growth. What should people be doing when there is volatility? There should be a big emphasis on planning and rebalancing your portfolio. After a big stock year like 2017 and the first half of this year, your portfolio may be over weighted in stocks. And if you don't do something about it, the stock market may rebalance it for you.

SPANO: Even though volatility has increased in 2018, you have to look at where we are in the economic cycle. We are in year 10 of a bull market, which is a very long time. Volatility typically rises in the latter part of the cycle. What's important for people to understand is that volatility is acceptable if you have gone through the exercise of understanding where the risks are in your portfolio and determining how much risk you're willing to accept for the returns you want.

KALSCHEUR: The largest portion of wealth for many owners of family businesses is the business, which is not going to be as volatile as the stock market. They need to keep that in mind and look holistically at all of their assets.

MODERATOR: FROM AN INVESTMENT AND WEALTH PRESERVATION STANDPOINT, WHERE DO YOU SEE THE GREATEST OPPORTUNITIES TODAY? WHERE ARE THE RISKS AND CHALLENGES?

SPANO: There is certainly the opportunity to make sure you are taking advantage of the tax law changes. Everybody should know what their estate plan looks like – from powers of attorney to who the beneficiaries are on their 401k plans.

KALSCHEUR: The greatest opportunity is the increased estate, gift and generation-skipping transfer tax exclusions, which presents greater ability to transfer wealth to the next generation at lower cost through December 2025 when the law sunsets.

HERRIED: From an investment perspective, the best opportunity right now is diversification. In general, assets are richly valued, although bonds are better than they were. Now is the time to look at your portfolio to protect it from the bad things that could happen and to benefit from things that could be impacted by current and emerging economic and political trends. A diversified portfolio has stability, maybe in U.S. treasuries. An opportunity may be in international. That may be in international or emerging stocks, which have significantly underperformed U.S. stocks and have the most to gain if concerns on trade and an overly aggressive Fed subside.

MODERATOR: WHAT ABOUT CHANGES IN THE FINANCIAL SERVICES INDUSTRY?

SPANO: The biggest opportunity for clients is that they are seeing an expansion of financial services combined with a reduction in costs. That also presents an opportunity for wealth managers to talk to their clients about bringing together all of the key people – the tax planner, the estate planner and the investment manager – to make sure they are all talking to each other. Because that truly is what wealth management is all about.

HERRIED: I think we are going to end up with many more a la carte services. There will still be the large providers that provide everything, but I think there are going to be more boutique-type approaches. People will be able to pick the fee structure and service model they want.

MODERATOR: WHAT ARE YOUR ONE-YEAR AND FIVE-YEAR OUTLOOKS FOR THE ECONOMY, INVESTMENT TRENDS, AND TAX AND ESTATE LAWS?

SPANO: It becomes much more of a guess when you start looking out five years, but in the near-term I think we are going to see more moderate growth. This year, we saw significant increases in year-over-year earnings, but we don't expect that next year because the baseline will have changed. We will be comparing year-over-year earnings to this year, which was a very good year. The odds of a recession in 2020 or 2021 are increasing, but the overall trend for the market will likely continue to increase. When I started in the financial services business, the S&P was 200. Today, we are right around 2,700. Yes, there are ups and downs in the market, but the general trajectory is up.

HERRIED: We think the economy is going to slow a bit. The probability that we will have a recession next year appears low at this point, but one is more likely within the next five years. This means returns for stocks are likely to fall below long-term averages.

KALSCHEUR: There is no such thing as permanent tax law. On the individual tax side, we know provisions are set to expire December 31, 2025, but we will have two presidential elections and multiple congressional elections between now and then. Changes will occur, and we will deal with them. The important thing is that you never want to have the tax tail wagging the dog. Tax issues are important, but they should not be the driving force behind most deals or decisions.

HERRIED: The same is true for investments.