The Great Wall of Fear

Amateur investors could be excused for believing that, given that obscure (if not arcane) indicators such as a Chinese manufacturing index and the value of the Chinese yuan are inducing drops in the U.S. stock market. They might think that the surprise halts in the recent Chinese trading sessions would throw U.S. and European markets into a tailspin reminiscent of 2008.

Even inside China, it is the locally traded A-shares that are causing the evocative drama. A-shares are stocks that are purchased and traded on the Shanghai and Shenzhen stock exchanges and are not generally available for ownership by non-Chinese nationals.

This is in contrast to Renminbi B-shares, which are owned by foreigners who largely cannot purchase A-shares due to Chinese government restrictions. It is the A-shares that are causing all the pseudo-hysteria of late, and those are not even owned in major global indexes and have historically been dislocated in price from the exact same company trading in B-shares.

Outside China, of course, the U.S. and non-U.S. developed equity markets are composed of companies that do some business in China but still earn the vast majority of their revenue elsewhere. And excepting the much-maligned Chinese economy, economic fundamentals are looking far better than the start to this year's trading would suggest.

The U.S. economy will likely grow around 2.4% or so this year, which is not exactly shooting the lights out, but it is a maintainable pace that seems nowhere near overheating. Consider the other positively indicating commentary about the U.S. economy:

- Employers have been creating an average of 220,000 new jobs per month for the last year. That robust pace seems likely to continue.
- Layoffs are at very low levels, according to outplacement firm Challenger, Gray & Christmas. Most workers have good job security, which boosts confidence.
- Car sales are hit record levels in 2015. Purchasing a car is a big financial commitment, one U.S. consumers are obviously comfortable making.
- In most major markets, American homeowners have recovered nearly all the equity lost during the housing bust. Overall net worth, which also includes financial assets, is close to record levels.
- The once-distressed housing market is stable again, with modest price increases, low mortgage rates, loosening credit standards and more inventory coming on the market.

Meanwhile, economic factors improved in Europe as well, though more slowly than here at home. Euro-area unemployment has inched down, confidence is improving and a string of back-to-back recessions appears to be over. Greece, the biggest source of financial turmoil in Europe, is licking its proverbial wounds, with an unpleasant but workable bailout underway.

To be clear, the U.S. and European economies are not flying along in high gear, as skeptics point to weakening corporate profits in some sectors,

tighter monetary policy by the Federal Reserve and a shrinking share of adult Americans who are even in the workforce. All of these are valid reasons for measured caution, but certainly not for precipitously tumbling markets.

> It takes an expert understanding of the nature of global markets to reach the cognizance that it would be irresponsible *not* to rebalance into equities at lower prices.

While no one – including the professionals at Rockwood Wealth Management or even real macroeconomists – can predict whether recent events are a short-lived blip or the beginning of a protracted bear market, it certainly feels like this temporary dip is dislocated from the realities of the global economy.

While equity markets do not always reflect real economic performance, over longer time periods they are unmistakably correlated with economic cycles. In our opinion, this downturn is exacerbated by fear and uncertainty, which creates buying and rebalancing opportunities for disciplined and well-advised investors.

Recently we overheard one of our contemporaries say, “It takes an iron stomach to buy stocks when markets are falling.” Truthfully, we couldn’t disagree more. It doesn’t take an iron stomach to purchase at lower prices the very investments that we will collectively depend on for decades to come. Given that markets always recover, our view is that it takes an expert understanding of the nature of global markets to reach the cognizance that it would be irresponsible not to rebalance into equities at lower prices.

Quoteworthy

As recent market volatility can bring about anxiety for even the most seasoned investor, it is helpful to remind ourselves that long-term financial security is purchased with the currency of tolerance for short-term fluctuation. Furthermore, well-advised investors understand that temporary down markets are an expected and necessary component of wealth building. You know that downturns are cyclical and that we will experience many more throughout the duration of your investment horizon.

It is a veritable certainty that no person can consistently predict the magnitude or duration of any market fluctuation. We know that in the course of your life, you will cross paths with those who think that financial advice means timing the market and picking stocks. Particularly during market downturns, it takes willpower to ignore these prognosticators – just like you ignore the financial media. You already know that neither has your best interests in mind.

We’ve consistently maintained that your advisory firm should have a Nobel-level understanding of capital markets and behavioral finance. In that pursuit, we thought we might offer the following quotes for your enjoyment:

“The market is full of people who think they can beat it and full of other people who believe them. This is one of the great mysteries of finance. Why do people believe they can do the impossible? And why do other people believe them?” – Daniel Kahneman, Nobel Laureate in Economic Sciences

“There are two kinds of investors: those who don’t know where the market is headed, and those who don’t know that they don’t know.” – William Bernstein, Author of *The Intelligent Asset Allocator*

"I'd compare stock pickers to astrologers, but I don't want to bash astrologers." – Eugene Fama, Nobel Laureate in Economic Sciences

"Those who have knowledge, don't predict. Those who predict, don't have knowledge." – Lao Tzu, Chinese Philosopher and Poet

"The greatest enemies of the investor are expenses and emotions." – John Bogle, Founder of the Vanguard Group

"Most investors, both institutional and individual, will find that the best way to own stocks is through an index fund that charges minimal fees." – Warren Buffett, Chairman and CEO of Berkshire Hathaway

"Investing should be dull." – Paul Samuelson, Nobel Laureate in Economic Sciences

"Panicking is not a good strategy … neither is watching CNBC." – Rockwood Wealth Management

Lowering Taxes While Avoiding Portfolio Distortion

One of the tried-and-true practices of thoughtful wealth management during periods of market volatility is to proactively seek out opportunities to tax loss harvest. We thought we would elaborate on both the benefits of this process and higher-level considerations during implementation for Rockwood Wealth Management clients.

What is tax loss harvesting?

Essentially, tax loss harvesting is selling a security that has experienced a loss – and then buying a similar asset (i.e., one that provides correlated market exposure) to replace it. The strategy has two benefits: It allows our clients to "harvest" the intrinsic value of the loss, and it keeps the portfolio balanced with the required allocation.

Capital losses can lower your tax bill by offsetting gains, but the only way to realize a loss is to sell the depreciated asset (albeit temporarily). However, we must consider that in a well-allocated portfolio, each asset plays an essential role in providing a piece of total market exposure. For that reason, we need to ensure that our clients do not give up the expected returns associated with each asset class just to realize a loss for tax purposes.

How does it lower your tax bill?

Capital losses can be used to offset capital gains one has realized in other transactions over the course of a year – gains on which you would otherwise owe tax. Then, if there are losses left over (or if there were no gains to offset), you can offset up to $3,000 of ordinary income for the year. If any losses still remain, they can be carried forward indefinitely for future use.

Please Do Not Feed Taxman

Tax loss harvesting is primarily a tax deferral strategy, and its benefit depends entirely on unique personal circumstances. Over the long run, it can add value via a combination of these distinct benefits:

- Tax deferral: Losses harvested can be used to offset unavoidable gains in the portfolio or capital gains elsewhere (e.g., from selling a business or real estate), deferring the tax owed.

> We manage your portfolio with a strategy that is based on opportunity created by tax law, not by market speculation.

- Pushing capital gains into a lower tax rate: If you've realized short-term capital gains (STCG) this year, they'll generally be taxed at your highest rate. However, if you've harvested losses to offset them, the corresponding gain on which you owe in the future could be long-term capital gain (LTCG). You've effectively turned a gain that would have been taxed federally at a rate of up to 39.6% today into a gain that will be taxed more lightly in the future (as low as 15% per current tax code).
- Converting ordinary income into long-term capital gains is a variation on the above: Offsetting up to $3,000 from your ordinary income shields that amount from your top marginal rate.
- Permanent tax avoidance: Tax loss harvesting provides benefits now in exchange for increasing built-in gains, subject to tax later. However, in certain situations (charitable donation, bequest to heirs), these gains can avoid taxation entirely.

The best practices in tax loss harvesting include:

- No exposure to short-term capital gains in an attempt to harvest losses. Through our management of essentially similar parallel investment vehicles, a dual-security asset class approach enforces preference for one security without needlessly triggering capital gains in an attempt to harvest losses.
- Tax loss preservation logic extended to protect against significant wash sales. Tax losses are valuable to you, and we need to protect them from the wash sale rule. In short, client cash withdrawals always dictate the sale of any losses first.
- Overlap with other accounts within the household must not disallow any losses. We use a process to eliminate the likelihood of wash sales and permanently disallowed losses triggered by subsequent activity within households with multiple accounts.
- Tax loss harvests also present an opportunity to rebalance across all asset classes, rather than reinvest solely within the same asset class. This further reduces the need to rebalance during volatile stretches, which means fewer realized gains, reduced transaction costs and higher tax alpha.

In summary, tax loss harvesting is a method by which we manage your portfolio with a strategy that is based on opportunity created by tax law, not by market speculation. In some cases, after-tax returns could be greatly enhanced, putting our clients well on the road to having more assets to participate in that next market upturn when it inevitably arrives.

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