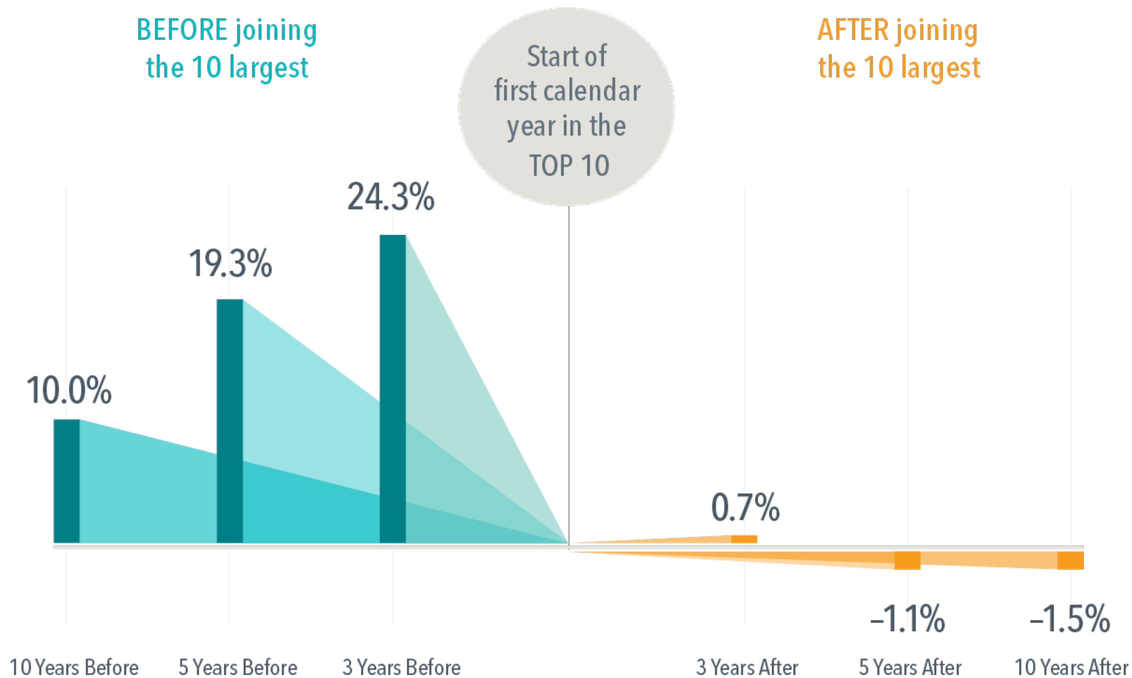
FAANGs Gone Value

One of the more vocal arguments against value investing stems from a belief that we're in a "new normal" environment where innovative or high-tech companies have a leg up on "old guard" industries, such as energy or financials. FAANG stocks have typically been the poster children for this position; these behemoth technology companies have contributed meaningfully to the market's overall return and, by virtue of being growth stocks, the negative value premiums in recent years. Well, guess who showed up as value this summer?! That's right, Russell reclassified Meta (formerly Facebook, the "F" in FAANG) and Netflix (the "N") from growth to value during the index provider's annual reconstitution event. Although signs have been pointing to the waning dominance of FAANG stocks since the start of 2022, it is somewhat ironic that 40% of the pillars supporting an aversion to value investing have now become value stocks themselves.

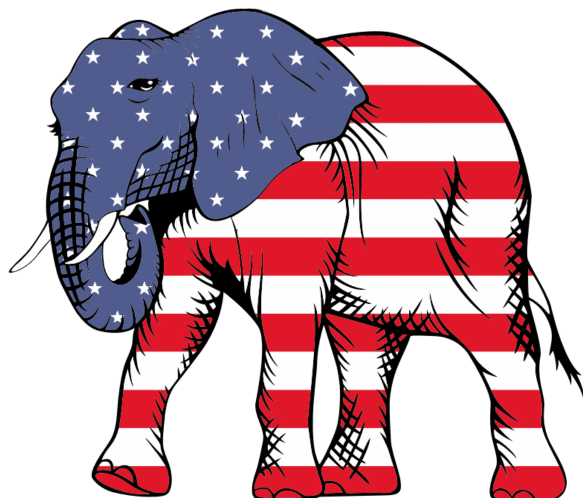
This also serves to highlight a possible misconception about the spirit of value investing. A value premium is a discount-rate effect: If expected future cash flows are not identically discounted for all stocks, then the ones with low prices relative to their expected future cash flows have higher expected returns. Investors advocating for the superiority of growth firms, such as the FAANGs, are inadvertently making the case for their expected future cash flows to be discounted at a lower level—all else equal, greater certainty around future success should be associated with a lower expected return. In fact, this is generally what we see for stocks of companies once they grow to become among the largest in the market. In other words, investors should be careful about equating expected company success with expected stock returns.



Average annualized outperformance of companies before and after the first year they became one of the 10 largest in the US

(Compared to Fama/French Total US Market Research Index, 1927–2021)

Federal Gifting & Estate Taxes: The Elephant in the Distance



We all know the expression that there are only two certainties in life: death and taxes. We just don't always think about the collision of these two forces at the worst possible time if we neglect strategic lifetime tax planning. The good news is that here at Rockwood, we are already thinking about and planning for this component of your financial plan. What is this elephant in the distance and why should you care? We'll come back to the elephant in a minute but first let's unpack a few estate tax concepts and what it all potentially means for you and your loved ones.

When you decide to give a financial asset to somebody you love, the government may tax that gift. Generally speaking, it's better to give away assets while you're alive rather than after you pass away but there are many aspects to consider including the health of your personal balance sheet, the type and titling of your assets, the size of your portfolio, and even the personality and needs of your heirs. Fortunately, a large portion of your gifts and estate can be excluded from taxation by understanding the annual gift tax exclusion and the lifetime gift and estate tax exemption (aka unified tax credit).

What is the annual gift tax exclusion?

Individuals can gift up to $16,000 (for 2022) per recipient per calendar year without reducing their lifetime exemption, mandating the reporting of the gift to the IRS, or paying federal gift tax. If you are married and meet certain requirements, you and your spouse can give $32,000 per recipient per calendar year.

Now back to that elephant….

The elephant represents the potential reduction of the lifetime exemption amount under the unified tax credit.

What is the unified tax credit and how does it work?

The unified tax combines gift and estate taxes into one tax system and provides a set dollar amount that individuals can gift during their lifetime before gift or estate taxes apply. The $12.06 million federal exemption applies to gifts and estate taxes combined – any portion of the exemption you use for gifting purposes will reduce the amount you can use for the estate tax at the time of your passing. Each donor has a separate lifetime exemption, and each married couple can combine their exemptions to get a total exemption of $24.12 million. Therefore, the current exemption, assuming a married couple, sets the exemption amount so high that very few people should be concerned about crossing above that threshold. But there's one caveat with current law so let's look at the history and the potential future of the unified tax credit.

Year	Estate Tax Exemption	Top Estate Tax Rate
1997	$600,000	55%
1998	$625,000	55%
1999	$650,000	55%
2000	$675,000	55%
2001	$675,000	55%
2002	$1,000,000	50%
2003	$1,000,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	$5,000,000 or $0	35% or 0%
2011	$5,000,000	35%
2012	$5,120,000	35%
2013	$5,250,000	40%
2014	$5,340,000	40%
2015	$5,430,000	40%
2016	$5,450,000	40%
2017	$5,490,000	40%
2018	$11,180,000	40%
2019	$11,400,000	40%
2020	$11,580,000	40%
2021	$11,700,000	40%
2022	$12,060,000	40%

The table above shows the history of the estate tax exemption per person from 1997 through today along with the federal estate tax rate. You can see that the amount has varied significantly over time. Note the larger jump between 2017 and 2018.

With the passage of the Tax Cuts and Jobs Act (TCJA), the exemption increased significantly but there's a catch. The TCJA is not permanent and is set to expire after 2025. Unless Congress acts to renew the legislation or address some of its provisions, the exemption will revert to the $5.49 million exemption (per person) plus an adjustment for inflation. Since the future actions of Congress are unknowable, how do you take advantage of the current exemption if you find yourself flirting with the $5.49 million threshold?

If you have acquired enough wealth to surpass the gift and estate tax exemption, there are several strategies that could lock in the current $12.06 million exemption, including outright gifting, trust vehicles, and strategic use of life insurance, to name a few. The most straightforward approach is to gift your assets to your loved ones now, rather than waiting until you pass away. If you are financially secure enough, giving the assets now has two advantages. First, you get to directly experience your loved ones benefiting from your generosity and to potentially make a positive impact earlier in their lives when they truly need the support. (Think of the difference in gifting to loved ones in their 30s versus gifting to them in their 70s) Second, assuming the gift is invested and grows over time, gifting now could substantially decrease your taxable estate.

For example, if you were able to give the entire $12.06 million to your child today, that money could grow over time. At a hypothetical investment growth rate of 5% per year for 10 years, that $12.06 million gift could end up being worth over $19.64 million, and your loved ones will have received the entire amount free from gift or estate taxes.

On the other hand, if you held those assets in your name and then left them for your children at your passing in 10 years, a large portion of the $19.64 million would be taxed at 40% under

today's rules. Additionally, in 10 years the gift and estate tax exemption could revert to the lower $5.49 million amount (per person). That could result in your estate having to pay over $4.9 million in federal taxes, leaving your heirs with about $14.74 million in after-tax assets rather than $19.64 million if you made the gift sooner. Of course, Congress could also raise the exemption after 2025 to a level that does not impact your planning.

Careful consideration of your unique situation and your family dynamics must be considered. One concern many Rockwood clients have when it comes to early giving is that sometimes recipients may not be ready to handle the responsibility of managing the new money or, even worse, the new money may negatively impact their motivation and relationships. If you and/or your recipient aren't ready for this transition, you could consider using a trust as a vehicle for providing a gift with rules related to the investing and distribution of those assets. There are numerous options with structuring a trust and each state has its own rules, so your strategy should be reviewed by a qualified attorney before implementation.

In conclusion, the rules and strategies related to gifting and taxation are complex, vast, and ever changing. There are many nuances to a well-crafted strategy, and this overview has barely scratched the surface. Your advisory team constantly explores and evaluates the changing landscape and the potential impact for your specific goals. Please reach out with any questions or concerns.

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