Johnson Private Client Group | Johnson Trust Company | Johnson Institutional Management

Third Quarter 2018

The Capital Gains Conundrum

As this historic bull market grinds ever-higher, some commonly-used axioms seem apropos to stock investors. "Patience is a virtue." "Don't miss the forest for the trees." "Good things come to those who wait." But the phrase "hindsight is 20/20" also applies. Few investors were confident about stocks in the frantic days of October 2008, when the financial markets seemed to be collapsing on themselves. But those who remained invested have been rewarded handsomely for their fortitude, as stocks recovered all those losses and have gone on to reach new heights.

This is fantastic news for those nearing or already in retirement. As is often the case, the devil is in the details when it comes to how this affects retirement cash flow strategies. The bull market has generated substantial capital gains in taxable accounts. For most people, these gains become taxable when the stocks are sold. These tax implications must be considered in order to confidently assess the portfolio's ability to generate cash flow.

Ignoring this potential tax liability could provide a false sense of security. The need to sell stocks to fund living expenses often leads to larger tax bills. Writing these checks in retirement can be uncomfortable for retirees adjusting to life without a steady paycheck.

So it stands to reason that we need to review these devilish details. A solid approach combines a mindset, math, and methods, which together help manage what would otherwise be an unpleasant tax-time surprise.

Mindset: Shift Perspective on Capital Gains Tax

In the normal course of portfolio management, capital gains will be generated. Similar to pruning a tree, an effective investment strategy requires trimming and selling existing holdings, and the infusion of new holdings. This can generate capital gains, and given the market's massive rally over the past decade, most investors can expect realized gains to increase as a result.

Having to incur capital gains tax should come as no surprise. The IRS has its fair share of obscure and bizarre regulations, but it has always made crystal clear that capital gains taxes will be owed when taxpayers sell an asset for a gain in a taxable (non-retirement) account.

But this tax is often seen as something that can be altogether avoided rather than what it truly is: a deferred tax liability. Investors should view unrealized capital gains as a very real tax liability, whether incurred in the current year or down the road. Either way, Uncle Sam will almost always get his cut.

Math: Debunking the "Lost Growth" Theory

Some investors argue that realizing capital gains is inefficient. In their view, selling appreciated stock and incurring a tax bill of, for example, $10,000, prevents them from benefitting from the growth of that $10,000. In reality, the investor is only "losing growth" of the tax liability itself because the tax liability is already incurred – it's just deferred. Assuming an expected growth rate of 7%, the investor is only losing out on the growth of $700

Featuring

TOTAL RETURNS

	3Q2018	2018
S&P 500	7.7%	10.6%
Dow Jones Industrial Average	9.6%	8.8%
NASDAQ	7.4%	17.5%
Russell 2000	3.6%	11.5%
MSCI EAFE (International)	1.4%	-1.0%
Barclays Aggregate Bond Index	0.0%	-1.6%

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($10,000 capital gains tax bill x 7% expected growth rate = $700).

Taking this one step further, we know all too well markets don't always go up! If a couple is about to retire, what is the cost of not rebalancing a $2,000,000 taxable account that is 80% stock when a 25% bear market hits swiftly and severely? Most of the time the capital gains tax would be dwarfed by the $400,000 loss of value.

Method: Optimizing the Capital Gains Tax Liability

It's often difficult to completely avoid capital gains taxes, but there are several methods to employ to minimize the impact. We are sensitive to capital gains and coordinate with clients and their accountants to ensure there aren't surprises when tax time comes each year. But it's also important not to allow tax optimization to completely drive our investment decisions. In other words, don't let the tax tail wag the dog.

Manage the Tax Brackets: Understanding the various break-points in the capital gains tax brackets (which differ from the standard tax brackets) helps manage capital gains taxes. Most notably, if a couple is recently retired, there could be several years of minimal income (prior to taking Social Security) which, if managed properly, could result in 0% capital gains liability! This reinforces the wisdom of being proactive about tax planning with your advisors.

Harvest Losses: Probably the most well-known capital gains tax strategy is known as loss harvesting. Securities sold for a loss offset realized capital gains dollar-for-dollar, reducing the capital gains total. If there are more losses than gains, investors can deduct a maximum of $3,000 per year from income. Any unused losses can be carried over to subsequent years. Special attention must be given to wash-sale rules if and when a security is repurchased.

Leverage Generosity #1: For the charitably-inclined, donating appreciated stock delivers tax advantages relative to writing checks. The taxpayer can deduct the value of the shares, and furthermore will not incur any capital gains tax on the increased value. A Donor-Advised Fund (DAF) can be used to enhance this strategy. Taxpayers can donate to a DAF to optimize their charitable deduction amounts from year-to-year, but make grants to the charities themselves in different amounts and on a different timetable as necessary.

Leverage Generosity #2: In addition, a taxpayer can make gifts of cash or securities valued up to $15,000 per year to any person for any reason. While such gifts can't be deducted, the recipient "inherits" the cost basis and, assuming a lower tax bracket for the recipient, could sell appreciated securities and incur less capital gains tax than the donor would have owed.

Meet your Maker: Later in life, it's wise to pause before realizing capital gains, as the cost basis is "stepped up" to fair market value on the date of an account owner's death. This allows heirs to inherit the assets with little-to-no capital gain embedded. Then, if necessary heirs can sell the securities for little-to-no capital gains tax.

Properly managing capital gains taxes is essential for effective retirement planning. Just as in the working years, taxes are an inevitable and meaningful expense in retirement. Employing the proper mindset, analyzing the math, and using the right methods to manage capital gains can reduce their impact on retirement cash flow.

Johnson Investment Counsel does not provide tax, legal or accounting advice. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

Market Update

Stocks Surge in Third Quarter despite Several Headwinds

U.S. stocks overcame several headwinds and negative headlines in the third quarter, delivering the largest quarterly gain since 2013. Stock markets in the U.S. are very close to all-time record highs heading into the fourth quarter. The third quarter rally extended the 2018 gains and the broader bull market that began nearly a decade ago.

Much of the credit for this year's gains has gone to the Tax Cuts and Jobs Act passed in late 2017, which lowered tax rates on corporations and individuals. The rally is also being supported by strong corporate earnings and a healthy global economy, particularly in the U.S. Disputes over trade and turmoil in emerging markets failed to upset the market, and developed international stock markets also made gains.

Global Economic Picture is Mostly Bright, Except for Emerging Markets

Stocks have continued to rise thanks in large part to the ongoing economic expansion in most of the world. Emerging markets are the exception to this expansion (more on that below). While some measures of economic growth have slowed, many key indicators continue to point to a bright outlook for most of the world. The U.S. economy expanded by 4.2% during the second quarter, the fastest pace since 2014. U.S. GDP growth is expected to continue at a pace somewhere between 2.5% and 3.0%, and the probability of recession remains at lower levels by most measures. This is supported by fiscal stimulus from tax cuts and increases in government spending, along with rising wages.

Despite recent strength, it's possible economic growth is peaking. As the impact from easier fiscal policy begins to fade, economic growth could moderate as well. Economic headwinds are beginning to accumulate. The yield curve has flattened considerably, and global growth is beginning to decouple. This is especially true as it relates to select emerging markets that are experiencing dramatic weakness.

Fed Hikes Once Again; Bond Returns Slightly Negative in 2018

The Fed has responded to the economic developments as expected by raising its benchmark rate once again at its September meeting. Interest rates in general have risen significantly in 2018 to the highest levels in several years. This creates short-term weakness in bonds, but almost always sets them up for better returns moving forward. Rates are higher across the board this year, but short-term interest rates have risen faster than long-term rates. This dynamic, known as a flattening yield curve, has been a fairly reliable indicator of a peaking economic cycle, more so when it actually inverts (short-term yields higher than long-term yields). However, flat or inverted yield curves can persist for some time before an actual recession takes place, so it's not always an accurate predictor of the timing of recession. In a year like 2018 when bond returns are weak, it's important to keep in mind that a "bad" year for bonds is hardly noticeable relative to the periodic downturns in stocks.

Will Emerging Market Issues Spill Over to the Rest of the World?

While the U.S. economy is healthy, countries like Turkey, Argentina, Venezuela and South Africa are suffering from too much debt, high deficits, and low foreign-currency reserves. As currency rates have fallen rapidly, inflation is climbing to nosebleed levels, putting pressure on consumers and businesses alike. Unfortunately, the easiest remedy is sky-high interest rates, often exacerbating economic weakness at precisely the wrong time, ultimately leading to deep economic recessions.

This doesn't automatically infer a global recession or crisis like that of the late 1990s. Ultimately, handicapping the odds of a financial crisis can be difficult. For now, these pockets of extreme volatility will likely continue to weigh on sentiment and returns in those markets. Looking ahead, policy makers will need to take the necessary, and often difficult, steps to avoid a full-blown crisis.

Key Issues: Trade War, Fed Policy, Mid-Term Elections, Among Others

As we head into the final quarter of 2018, investors will continue to track the progress (or lack thereof) of the Trump Administration's trade policy negotiations with other nations. Late in September, the Trump Administration agreed to deals with Canada and Japan. But the big question is what plays out with negotiations with China, which have slowed in recent days. The Trump Administration has made clear it is willing to fight hard for what it wants. The Chinese have also dug in. These talks are extremely important to its economy and larger society, which is heavily dependent on international trade, especially with the U.S.

The Fed will remain on watch, with one more rate hike expected this year. At the moment, the market is penciling in three more hikes next year, and possibly one more in 2020. But the Fed will react to the economic developments along the way.

It's election season again, with the U.S. mid-terms just around the corner. While political developments almost always receive too much credit or blame for market behavior, this election outcome will impact the effectiveness of the Trump Administration's agenda in the next two years leading up to the 2020 presidential election. It's impossible to predict what this will mean for the stock market. Returns in the fourth quarter and beyond will be more about economic realities than political back-and-forth in Washington.

Barron's Ranks JIC #20 in the Nation

We are excited to share that Barron's, the country's leading financial industry magazine, has ranked Johnson Investment Counsel 20th among all independent advisory firms in the U.S. We believe this ranking reflects the trust our clients have placed in us for over 50 years.

The ranking is based on stringent criteria including assets under management, client retention, and various factors that reflect the firms' ability to provide broad and consistent services to clients.

Barron's ranking is based on a variety of qualitative and quantitative factors, including the assets overseen by the firm, its regulatory record, and the size and scope of its operations, including the number of clients, advisors and offices. Barron's generally sets a $2 billion assets under management minimum for participation. The ranking may not be representative of any one's client's experience as it reflects a sample of client experiences. The award is also not indicative of future performance and there is no guarantee of future investment success.

New Designations

Johnson Investment Counsel is committed to continuing education to provide personal development for our employees and better service to our clients. We are proud to announce that Irene Tsai, Justin Rowden, and Chris Tscheider, recently earned new professional designations.

Tsai

Irene Tsai recently passed the Level III exam of the Chartered Financial Analyst (CFA) Program and is now a charter holder. Irene is a Senior Business Development and Relationship Manager for Johnson Institutional Management. The CFA designation is globally recognized and attests to success in a rigorous and comprehensive study and testing program in the field of investment management and research analysis.

Rowden

Tscheider

Justin Rowden and Chris Tscheider recently received the Certified Financial Planner® certification. Justin is based in our Dayton office and is an Associate Portfolio Manager. Chris Tscheider is a Porfolio Manager in our Cincinnati - West Fork location. The Certified Financial Planner® certification process involves a rigorous curriculum consisting of six prerequisite courses covering a wide range of financial planning topics. This program culminates in a six-hour examination.

Johnson Investment Counsel currently has a total of 33 CFA Charterholders and 19 CFP® Certificants on staff.

2018 Patrick Chong Memorial Scholarships

We established the Patrick Chong Memorial Scholarship in remembrance of Patrick Chong, a Portfolio Manager Assistant at JIC, who died of colon cancer in 2002 at the age of 31. JIC annually awards two $2,500 academic scholarships to children of our employees. This year, we are pleased to honor two outstanding students: Ben Gerding and Alex Wertz. Ben is the son of Institutional Account Administrator, Margaret Palmer. He is a Freshman at the University of Colorado majoring in Business Management. Alex is the son of Director of Wealth Advisory Services, Jay Wertz. Alex is a Junior at Indiana University with a major in Finance.

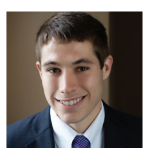
Pictured on the right:
Top: Margaret, Ben, and Jason Jackman, President
Bottom: Jason, Jay, Alex, and Kathy

Chamber Leadership Programs

We would like to congratulate Tony Miliano and Sandy Appel for being selected in 2018 for two different leadership programs managed by the Cincinnati USA Regional Chamber. Sandy is an Associate Portfolio Manager and was selected to participate in the WE Lead program. Tony, a Portfolio Manager Assistant, has been involved with Cincy Next.

These programs focus on leadership development and give participants the opportunity to connect with other professionals at similar places in their careers. Cincy Next focuses on professionals early in their career, and WE Lead prepares, positions, and empowers women to move into higher leadership roles.

Appel



Miliano

Locations

Cincinnati | Cincinnati-Kenwood | Cleveland-Akron | Columbus | Dayton

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

About Us

Johnson Investment Counsel, Inc. is Ohio's largest independent wealth management firm, managing over $10 billion in assets. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-based, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs and more. Johnson Investment Counsel has built strong, long-term relationships with individuals and families, charitable organizations, foundations and corporations through three divisions: Johnson Private Client Group, Johnson Trust Company, and Johnson Institutional Management.

Divisions

- Johnson Private Client Group
- Johnson Trust Company
- Johnson Institutional Management

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- Bond Portfolios
- Balanced Portfolios
- Integrated Wealth Management
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- Pension & Profit Sharing Plans
- Individual Retirement Accounts
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- Foundations
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