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2017 In Review

One would be hard pressed to find anything not to like about the performance of global capital markets in 2017. A portfolio of domestic and international stocks, REITs, investment grade corporate and US government bonds produced excellent returns last year with unusually low volatility. According to data from LPL Research, the biggest drawdown in the S&P 500 last year was just 3% - the smallest intra-year drawdown since 1995. Since 1946, the average intra-year pullback for the S&P 500 has been just under 14%. Every equity index fund that I use in client portfolios had a positive return in 2017. This is a rare gift from on high for which thoughtful men and women must pause and give thanks.

The Vanguard Total Stock Market Index Fund ETF (VTI) rose 21% last year. (All performance numbers are rounded to the nearest whole number because there's nothing to be gained by adding decimal places.) Small company domestic stocks, the performance leaders in 2016, also performed well in 2017. The iShares Russell 2000 Index Fund ETF (IWM) rose 15%. For the first time since 2012, international stocks outperformed domestic stocks. The Vanguard International Stock Index Fund ETF (VEU) rose 27%. Despite rising interest rates, investment grade corporate bonds and US Treasury securities managed to break even or eke out small gains; notwithstanding the numerous forecasts to the contrary.

From 2007 through 2015, emerging market stocks were a disappointment, with a cumulative return of just 6% for those nine years. Just about the time when no one wanted to own emerging market stocks, they began a rebound in 2016 and were last year's standout performers. The iShares Emerging Market Index Fund ETF (EEM) rose 36% and is up 47% over the past two years. Its Vanguard cousin (VWO) crossed the finish line with a gain of 31% and is up 43% over the past two years. The difference in returns can be attributed to the fact that the funds track different emerging market stock indexes. Get ready for exhortations to buy emerging market stock funds from all corners of the financial media in 2018.

I've often mentioned my Lazy Golfer portfolio that I use as a performance benchmark. It contains five Vanguard index funds -- 40% in the Total Stock Market Index Fund (VTSMX), 20% in the Total International Stock Index Fund(VGTSX), 20% in the Inflation Protected Securities Fund (VIPSX), 10% in the Total Bond Market Index Fund (VBMFX) and 10% in the REIT Index Fund (VGSIX). It's 15% gain in 2017 was available to anyone without reading the *Wall Street Journal*, researching Morningstar fund ratings, finding outperforming stocks, playing the market timing game or watching CNBC.

The S&P 500 Index has yielded a positive return for twelve consecutive months in the past but 2017 was the first calendar year in which the index rose every month. The Dow Jones Industrial Average set 21 all-time highs in 2017 and rose each month from April to December; a nine-month winning streak that is the longest since a twelve-month winning streak ended in 1959. Let's set Mr. Peabody's Wayback machine to 1959 to see what else was happening -

- Alaska and Hawaii became the 49th and 50th states in the Union.
- *The Untouchables, Bozo the Clown, Bonanza, Rocky and Bullwinkle, Dennis the Menace* and *The Twilight Zone* made their TV debuts. *Sleeping Beauty* and *Ben-Hur* were released and *The Sound of Music* opened on Broadway.
- The Adolph Coors Co. introduced the aluminum beer can.
- American Airlines began transcontinental jet service with B-707 flights between Los Angeles and New York.
- A plane crash claimed the lives of rock-and-roll stars Buddy Holly, Ritchie Valens and J.P. "The Big Bopper" Richardson.
- The song *Charlie Brown* by The Coasters was banned by the BBC because it contained the phrase "throwing spitballs."
- The Barbie doll was unveiled at the American Toy Fair in New York City.
- NASA announced the selection of America's seven Mercury astronauts.
- Soviet leader Nikita Khrushchev reacted angrily during a visit to Los Angeles upon being told that, for security reasons, he wouldn't be allowed to visit Disneyland.
- Americans bought 100 million Hula Hoops.

Unfortunately, many investors failed to take advantage of last year's exceptional equity gains because they had too much money sitting in cash. They were frightened by headlines about the "sky-high" value of the domestic stock market, the political shenanigans in DC, the deficit, and every other real or imagined crisis that the media fixated on last year. You'll never achieve your retirement goals if you're out of the stock market when gains are double historical averages. The best way to ensure that an appropriate percentage of your portfolio is permanently invested in stocks is to have a financial plan containing an investment strategy and a portfolio allocation that is appropriate for your time horizon, goals and risk tolerance.

If you've fallen for the toxic illusion that the goal of investing is to "beat the market" and tried to time your way into and out of the market in response to the headlines or invested in individual stocks, I have no idea if 2017 was a good or bad year for you. To my way of thinking anyone who passed up double digit gains in global equities, which were available free for the asking, in an attempt to do better, was playing a loser's game.

If you think that the current debt/taxation debate is something new, here's a quote from Alexander Hamilton, the first Secretary of the Treasury, in a report to the House of Representatives in 1795 –

"To extinguish a debt which exists and to avoid contracting more are ideas almost always favored by public feeling and opinion, but to pay taxes for the one or the other purpose, which are the only means of avoiding the evil, is always more or less unpopular"

Indeed, there is nothing new under the sun.

The New Tax Law

The Tax Policy Center estimates that under the new tax law, 80% of Americans will get a tax cut this year. While the new law lowers tax rates for most individuals and corporations, its effect on most of us will be modest due to new limits on deductions and exemptions. Much will depend on each taxpayer's individual circumstances. Here are some highlights.

- The 10% bracket remains unchanged, while the 15% bracket declines to 12%, the 25% to 22%, the 28% to 24%, the 33% to 32%, the 35% tax bracket holds steady, and the 39.6% slips to 37%.
- There's a $10,000 cap on the deductibility of property taxes plus state income taxes (or state sales tax deduction).
- The zero tax rate on long-term capital gains and qualified dividends will apply up to $77,200 of taxable income for married joint filers ($38,600 for singles). The 15% rate then takes effect up to $479,000 for joint filers ($425,800 for singles). The 20% rate applies above that.
- The 3.8% Medicare surtax on net investment income remains. It kicks in at $250,000 of adjusted gross income for married couples and $200,000 for single filers.
- Fortunately, lawmakers didn't enact the first in-first out (FIFO) provision that was part of the Senate version of the tax bill. Taxpayers can continue to sell shares of a fund or stock with the highest cost basis first, thereby minimizing the capital gains tax.
- There is a new tax deduction of 20% of business income for the owners of "pass-through" businesses that flow income directly to an owner's individual tax return, where it is taxed at the owner's marginal rate. The benefit phases out for joint filers with taxable income above $315,000 ($157,500 for singles) who are "service professionals"—such as doctors, lawyers, accountants, financial advisors and consultants.
- The standard deduction is nearly doubling to $12,000 for individuals and $24,000 for married joint filers. It is estimated that this will eliminate the necessity to file a Schedule A of itemized deductions for more than 90% of taxpayers. Congress also decided to keep the "additional standard deduction" for people age 65 and over - $1,300 for each spouse in a married couple and $1,600 for singles. The personal exemption is eliminated.
- Taxpayers over age 70½ can make Qualified Charitable Distributions (QCD) of up to $100,000 from their IRA directly to charities which will count toward their Required Minimum Distribution (RMD). Qualified Charitable Distributions are not included in taxable income which might help avoid the 3.8% surtax on net investment income, higher Medicare premiums or higher taxes on Social Security for some taxpayers.
- 529 account owners can now take tax-free withdrawals of up to $10,000 annually for K–12 expenses at public or private schools. Until this change, 529 plans could be used only for college expenses. While this option has much appeal, the benefit of a 529 plan is that it provides tax-free, *long-term* gains – a benefit that will be minimized if funds are withdrawn after just a few years.
- The new law eliminates miscellaneous itemized deductions including union dues, unreimbursed employee business expenses, moving expenses, uniform expenses, tax preparation fees and investment advisory fees.
- The individual mandate that requires all Americans to have health insurance has been rescinded; effective 2019.
- The federal estate tax exemption will double to $11.2 million per person.

One goal of the tax reform bill was to simplify taxes, but it seems that the only simplification that many taxpayers will see is the elimination of itemized deductions. The bill will increase after-tax earnings for American companies. At the former corporate tax rate of 35%, a dollar of earnings was reduced to 65 cents. At the new 21% rate, it becomes 79 cents – instantly increasing earnings by 21%. Investors should be cautiously optimistic that this will encourage entrepreneurship and economic growth and is one reason why stocks have started 2018 with a bang.

Bitcoin – A Digital Tulip Bulb?

Bitcoin, a digital form of money with no government or central bank behind it, has become the most talked-about asset in the financial world. Most commentators don't know any more about it than you do and are just making things up as they go along. Bitcoin is a virtual currency that is created, owned and traded entirely online in anonymous and unregulated settings – *strike 1*. In theory, there is a limited number of these physically non-existent digital "coins" but no limit to other so-called cryptocurrencies. Anyone can create a new digital coin and there are hundreds of different cryptocurrencies – *strike 2*. Bitcoins started 2017 trading around $1,000, shot up to more than $19,000 and finished the year at around $14,000. This price volatility makes it impossible to put an intelligent estimate on its value – *strike 3*.

We must distinguish between intrinsic value and market value. The intrinsic value of an asset is the sum of the tangible and intangible value it provides. Market value is determined by supply and demand. If there is a sudden interest in an asset, its market value can exceed its intrinsic value. Unlike gold, which is used in jewelry and has industrial uses, bitcoin has no intrinsic value. Some of its proponents claim that neither does a dollar. But the dollar's intrinsic value comes from its acceptance as legal tender; providing a means to transfer value from one person to another in financial transactions. The dollar is universally accepted as a store of value that can be used to pay for goods, services, debts and taxes and can be easily converted to other fiat currencies. Price stability is an essential characteristic of anything that is used as a store of value. At the present time, bitcoin's price volatility eliminates it as a viable currency.

Yet a multitude of people believe that bitcoin will bring them financial gains above and beyond what they expect to receive from more traditional investments. Don't consider "investing" in any cryptocurrency until you understand how it's created and how the creation process produces economic value, are convinced that governments won't restrict its use if it undermines the stability of national currencies (a threat already made by South Korea) and are certain that your cryptocurrency account can't be hacked and the "coins" stolen. You shouldn't expect to receive a positive return from an investment that has no cash-flow, no track record as a medium of exchange, has massive volatility, is popular in social media and will earn you nothing until you can sell it to a greater fool. It's a lottery ticket, not an investment and it's likely that there will be more losers than winners when all is said and done.

The excitement over bitcoin contains many characteristics of a classic financial bubble. Manias and bubbles have a long history in financial markets; starting with the infamous tulip bulb bubble in the Netherlands in the 17th century. Bubbles typically occur during times of economic prosperity when interest rates are low and risk seems minimal. Initially, an event or series of events causes a rapid price increase in an asset. At the outset, fundamentals may drive prices higher but over time investors' greed increases faster than economic value. Reports of outsized gains made by initial investors ignites the FOMO (fear of missing out) emotion in many investors. Soon it seems as if everyone is buying the asset; attempting to profit from its rapidly rising price. This buying frenzy turns into a mania when lenders supply funds to speculators who wish to leverage their bets to maximize short-term gain. At this point, market value is well above intrinsic value and a full-blown bubble is born.

Every financial bubble is unique - the object of speculation, the reason for its initial price appreciation, the amount of credit expansion, the ingenuity of swindlers and the reason that it finally bursts. Warnings citing previous bubbles fall on deaf ears because there are enough subtle differences between then and now to convince true believers that "This time it's different!" ("It's the blockchain, dummy!"). In due course, an external event or events change the expectation of future price increases. Prices plateau or gradually decline. Some speculators, realizing that they've come too late to the party, start selling. As the price continues to decline, selling increases as leveraged investors become sellers. A selling panic follows as sellers, trying to cash out before realizing a loss, outnumber buyers. The progress of time, technology and education have not eliminated this lamentable and predictable transition from mania to bubble to panic.

The *Wall Street Journal* reported that Merrill Lynch has blocked clients and financial advisers who trade on their behalf from buying bitcoin, citing concerns over the cryptocurrency's investment suitability. UBS, JPMorgan Chase, Citigroup, Morgan Stanley and Wells Fargo have initiated similar restrictions. This hesitancy is noteworthy. It's not often that Wall Street passes up an opportunity to fleece sheep that are stampeding to the slaughter.

It's impossible to offer investment advice on something like bitcoin. Call me old-fashioned but I'm suspicious of anything that goes up 1,375% in one year. If the price rise of an asset looks like the left side of the Eiffel Tower, it won't be long before the price decline looks like the right side of the Eiffel Tower. There can be no doubt that the cryptocurrency mania will attract scoundrels and scam artists throughout the world. Bitcoin's fame is due solely to its rapid price appreciation. Only time will tell if it will become infamous.