

GERSTEIN TAX SERVICE

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Earning The Equity Risk Premium Return Of 5.75%

During the Covid pandemic, one day drops in stocks of between -3% and -5% have not been uncommon. And then there was March 12, 2020, a one-day plunge of -12%!

Times of painful stock market losses are when investors earn the equity risk premium. The equity risk premium is financial jargon for “the vig,” the extra return investors were paid for taking a risk. Successful investing requires an understanding of the risk premium on stocks. So here’s a look at the vig in recent months on the Standard & Poor’s 500 index, a period that includes the outbreak of the Covid pandemic in the U.S.

To quantify the post-Covid equity

When subtracting the 1.88% from the 7.63%, the resulting +5.75% represents the premium stock investors have been paid annually over the boom and bust cycles since 1998. Put another way, owning stocks through the tech bubble in 2000, financial crisis in 2008-2009, and COVID outbreak bear-market rewarded investors with a premium of 575-basis points over what they would have earned by investing in risk-free 90-day Treasury bills.

The chart on the last page does a better job of illustrating the scary parts of the equity risk premium. The red data series shows the daily changes in the stock market, as represented by the price of a share of the S&P 500. Enduring a

To Our Clients And Friends:

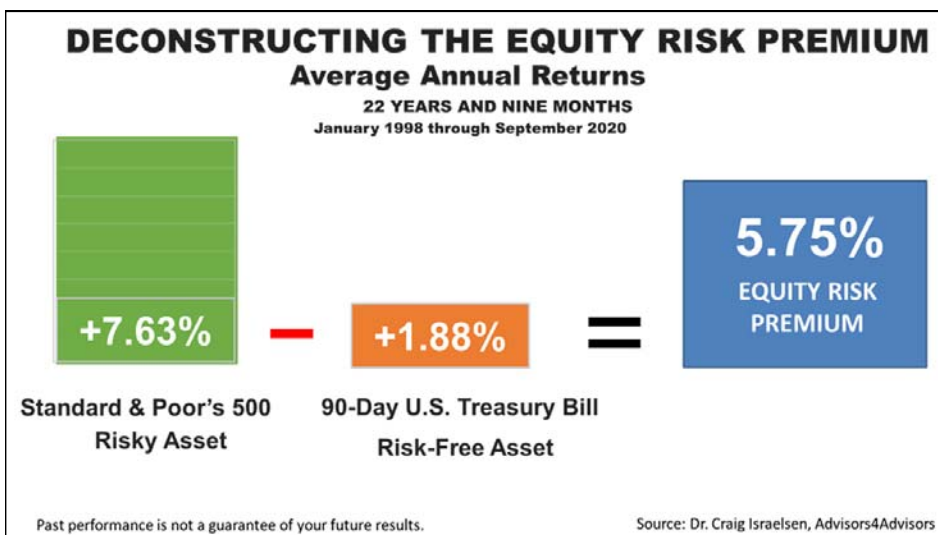
Year-end is a time for reflection. We find ourselves thinking that it’s easy to succeed as a financial advisor when the economy is humming and all is right with the world. As we’re painfully aware, though, that’s not the current situation. But it’s at times like these that the value of good advice shines.

We have excelled at providing customized tax advice to our (very savvy) clients for more than 40 years. Many of you have been with us for much of that time, which heartens and humbles us. We hope our clients, old and new, will keep faith with basic financial principles, regardless of the headwinds along the way. Staying grounded pays off long-term.

This is also a time to thank you again for your trust—and for the referrals you’ve brought to us. We are energized by referrals, and we’re always open to more of them. We’d remind you that if you wish, we’ll donate \$25 to a charity of your choice for each referral.

Now, more than ever, it’s important to do things the right way. For us, that means redoubling our efforts to ensure that all our clients meet their goals and objectives.

With best wishes,
The Gerstein Tax Service Client Team



risk premium, look at the equation in the graphic: Over the 22 years and nine months ended on September 30, 2020, the risk-free 90-day U.S. Treasury bill averaged an annual return of +1.88%, compared to a +7.63% annualized return on the S&P 500 stock index.

loss of one-third of your portfolio’s value, for some investors, was a stomach-wrenching experience. Sometimes, earning the equity risk premium is hard.

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Starting A Business? Plan To Succeed

In America's capitalist system, an economic cycle entails destruction of businesses and their replacement with better businesses. It's survival-of-the-fittest, a process in which the ranks of businesses are periodically thinned by recessions.

The Covid recession, early evidence suggests, is leading to a boom in entrepreneurialism. "The pandemic has had all sorts of unexpected consequences, from a boom in sourdough-bread baking to more people listening to nostalgic music on Spotify," according to The Economist on October 10, 2020. "Less noticed is a once-in-a-generation surge in startups."

So here's an important strategic tax tip for anyone who just started a business or who's about to do so: Plan now to transfer your ownership to your family.

To be clear, your new business may succeed! Capitalism is dynamic, which keeps the American dream

alive. Businesses that failed in the Covid crisis are going to spawn the launch of new businesses that will succeed and ride the wave of growth in the next economic cycle. If you plan to succeed, and, if your business does indeed boom in the new expansion cycle, it is wise to plan now to transfer assets to your children, charities, and what's important to you. You can set up your company tax-efficiently right now to minimize taxes many years from now for your heirs.

Under President Biden, the amount exempt from estate tax is expected to change from \$11.58 million to \$5.75 million, or lower. By

forming the company and managing the selection of shareholders with this in mind from the time of initial formation of your company, you will have more control over the tax-efficient transfer of your business.

The U.S. debt has skyrocketed due to the Covid crisis and estate taxes are expected to head higher in the years ahead. Planning now for the success of a new business by minimizing taxes on its transfer to the next generation could result in considerable tax savings, under a Biden Administration.

In the excitement of starting a new venture, it is rare to plan an exit

strategy. However, the entrepreneurial eruption currently under way, in combination with the expected expansion of the estate tax to millions of more families, may make a little planning today an extremely shrewd tax saving tactic years from now. ●



The Economist
United States
Oct 10th 2020 edition >

The number of new businesses in America is booming

No other rich-world country is experiencing the same rise in entrepreneurship

Private Wealth's Perfect Storm

Amid the Covid pandemic, changes in tax, financial, and economic arenas have created a deluge of added complexity for advisors managing private wealth. Here's an overview of the abrupt change in conditions now battering private wealth, which, when taken together, amounts to a "perfect storm."

Tax Policy. Budget shortfalls across the states as well as at the federal level are expected to result in steep hikes to state and federal income and transfer taxes.

Taxable Estates. For individuals with taxable estates, the current exemption of \$11.58 million from estate and gift tax will be cut in half

January 1, 2026. However, under President elect Joe Biden, the amount of the exemption is expected to change from \$11.58m to \$5.75m, or lower.

Changes in tax policy increase the downside risks of failing to plan. Preparing now to maximize annual gift-tax exclusions, charitable donations, and appropriately tailored trusts to accomplish your goals can ensure a lasting legacy.

Lowest Rates In Decades.

Every month the IRS releases the minimum interest rates you are permitted to charge on loans

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Four Retirement Income Withdrawal Methods

How much should you withdraw from your tax-deferred 401(k) or IRA, and in what form? Here's a brief summary of four retirement income withdrawal methods to help you optimize the decumulation of your retirement income portfolio prudently.

Goals, Obstacles, And Taxes

Your strategy must annually balance withdrawing enough to live comfortably against making your assets last a lifetime. Taxes are a material consideration, since traditional IRA, 401(k) and 403(b) accounts are taxed as ordinary income.

Withdrawals before age 59½ are subject to a 10% early withdrawal penalty. In addition, you must start withdrawing from federally qualified retirement accounts when you reach age 70½. However, under provisions of the SECURE Act, which became law at the end of 2019, the required minimum withdrawal age was pushed back to 72 starting 1/1/2020. An extra 18 months of tax-deferred growth at your age is a nice unexpected bonus.

To minimize taxes on withdrawals, consider paying tax on these assets now and placing them in Roth IRAs, where you pay taxes up front instead of when you're retired. The four methods are:

Bucket Approach

You divide your retirement assets into three separate accounts. The three buckets allow you to set aside a segment of your investments to grow, while having the assurance of a steady income stream.

Your first bucket is in cash, meaning

short-term instruments. Replenishing the cash bucket with earnings generated by the other two buckets enables a quantitative discipline like dollar-cost-averaging.

It's currently not uncommon for these short-term accounts to pay 1.8% to 2.4% annually. A minimum deposit of \$5,000 or so is commonly required. Expect to fractionally beat inflation annually, and do not expect capital appreciation. We always encourage you to read the prospectus and to consult your financial and/or tax advisor.

In all, you allocate three to five years' worth of living expenses, around 20% of your investments in cash, to the first bucket. The second bucket contains fixed-income assets, most often bonds or bond mutual funds and yield interest income.

The third bucket is for stocks. This remains the growth component of your portfolio, as stocks tend to grow the most over the long-term. They get socked the worst during recessions, too, which is why they aren't subject to the near-term withdrawal with the bucket strategy, which would sap your financial security over time.

4% Method

The 4% annual withdrawal method aims to preserve your wealth yet throw off enough to live on. You simply withdraw 4% of your investments annually to start, and, thereafter, annually adjust it for inflation. The 4% method over 30-years is a prudent way to manage the risk of outliving your money. With this withdrawal scheme, and a \$1 million retirement account, you would withdraw \$40,000 the first year, \$40,800 in year No. 2, and

\$41,616 in year three, assuming a 2% inflation rate.

The virtue of the 4% solution is simplicity. The downside is that, in the event of a bear market loss, you must be prepared to withdraw less and perhaps live more modestly. In The Great Recession of 2008, stocks dropped and lost nearly half their value, for example. If stocks made up 60% of your portfolio, even this prudent method put a big dent in your retirement income portfolio and took years to recover from.

Fixed Dollar Withdrawal

With this approach, you withdraw a fixed amount each year, perhaps a flat \$40,000. After two or three years, you would reassess the annual amounts you are withdrawing to ensure you are comfortable with the way it is going. A fixed dollar method is a simple approach, and you can instruct your IRA custodian to withhold an amount to pay for taxes on the income withdrawn each year.

The trouble is, this strategy will not insulate you from inflation and fixed dollar withdrawals are not mindful of year-to-year depletion of your nest egg due to market downturns in stocks, bonds and other risk assets.

The inflation rate has been below 2% for years and is expected to remain low, but that could change and a decline in stock or bond prices in combination with your fixed withdrawals could precipitously shrink the size of your portfolio.

Systematic Method

Another strategy that's easy to administer is to withdraw only the interest and dividends your portfolio accrues. This allows your principal to grow over time and better ensures a retirement income portfolio. The disadvantages are that you won't take out the same amount each year, and conservative income investors must accept the risk of owning stocks as well as bonds or be prepared for the risk that their fixed-income portfolio will result on less real retirement income.

These methods are tools for making a retirement income portfolio custom built to your personal specifications. No single method is best. While the 4% strategy is the method favored for long-term investors, the fixed dollar withdrawal may make sense depending on your health, Medicaid planning, and other personal details. Please call our office with any questions. ●

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to family members, trusts and other related entities. With this "applicable federal rate" currently at less than 1%, loaning assets may be a savvy way to transfer wealth to the next generation for buying a home, starting a business, or making charitable bequests. The loans are sometimes part of a plan to transfer a family business, or support children with special needs. With the pandemic potentially lowering the value of real estate and business assets, and causing frequent stock market volatility, optimizing low interest rates to make intrafamily loans is suddenly a more viable solution to reducing taxes and enhancing legacy planning.

Liability Explosion. With tenants

more often unable to pay rent, and small businesses facing financial difficulty, landlords and business owners are suddenly facing an explosion in their liability exposure. Asset protection strategies to mitigate personal liability exposure in the event of a setback requires preparation before a problem arises or facing a legal challenge.

The Covid pandemic abruptly changed tax and financial conditions affecting estate tax and asset protection drastically, and this perfect storm requires proactive engagement of family members as well as advice from tax, legal and financial professionals. Please contact us with questions about your personal situation. ●

Confronting Mortality's Details

The Covid pandemic is causing families unimaginable suffering, worry, and grief. It is forcing many individuals to confront mortality, to consider, in very real terms, perhaps for the first time, what will happen when their life comes to an end. Here, in less than 300 words, are key facts about documents that govern what happens to you at the end of your life.

A health care proxy and living will name someone to make medical decisions if you're unable to express your wishes and contain instructions about end-of-life care. This is understandably top-of-mind for a lot of people now.

A durable power of attorney (POA) permits someone else to manage financial and other matters while you're alive. The POA empowers someone you appoint to pay bills, write checks, or sell and purchase assets on your behalf should you become incapacitated.

Your last will and testament

provides the details which take effect at your death for distributing your property. It should be reviewed annually so that the trustee, executor, and guardians of minor children you have appointed still conform to your current wishes. It's best to speak with whomever you're appointing about your wishes so that they're aware of your intentions.



A revocable trust can also provide for the disposition of your property after you die while avoiding the probate court process. Because courts across the country were shuttered for a time, they must now deal with a surge

in filings due to the pandemic. In times like these, it's advantageous to have a revocable trust to avoid probate court delays. Setting up a revocable trust requires changing the titling of bank and brokerage accounts, real estate, and other assets, and may require signing documents with a witness or notary present, which is now complicated due to social distancing.

Fortunately, remote signings can be properly executed via online meeting such as Zoom.

Finally, and most importantly, you will want to be certain that the beneficiary designations on both your retirement plans and your life insurance policies are up to date, as circumstances change over time. As a tax advisor, creating legal documents is

beyond the scope of our work, but we can refer you to experienced professionals who can create these documents so they can be properly integrated into a comprehensive financial planning strategy. ●

The Equity Risk Premium

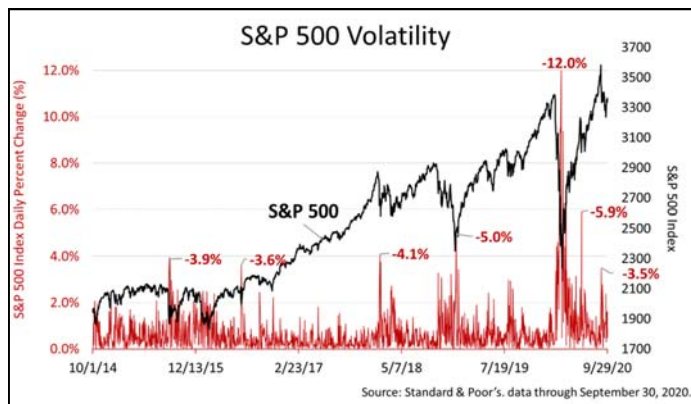
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Armed with these kinds of statistics, however, knowing that big daily down days reliably do come, it is easier to withstand the uncertainty.

With the COVID outbreak tragically surpassing 2,000-deaths in a day and the changes in all three branches of the U.S. Government, the risk of a stock market plunge looms larger. However, permanent investors who plan to own stocks for the rest of their lives would be wise to view

volatility as a friend.

That may be counterintuitive, but it absolutely is valid. Choosing to expose a portion of your portfolio to price volatility, also known as risk, justifies a better return. You wouldn't earn the six percentage-point equity risk premium on stocks, if you weren't exposed to lots of



volatility. It just goes with the territory. It's part of owning a risk asset. ●

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