Gerstein's
BROOKLYN TAX SERVICE

June 2023 www.gersteintaxservice.com (718) 499-8352

Understanding Investment Risk, AI, And Human Nature

An investment's risk is usually defined as its standard deviation in the financial press and advertising. Reducing the concept of risk to a single statistic makes it easy to understand. So the media and marketers cannot be faulted for defining risk in this way. However, standard deviation expresses only one aspect of investment risk. It totally misses the central element of investment risk: how you behave in reaction to seeing your wealth disintegrate in a crisis or other unexpected change, like the 2008 global financial meltdown, when the S&P 500 stock index lost -48% in six months. Human behavior is what really matters in managing investment risk.

Standard deviation measures the risk of price fluctuations in stocks, bonds, cash, and other assets, which is helpful but your reaction is more important. Investors obviously love the upside of standard deviation.
No one complains when investment values surge. Negative volatility, however, when risk assets are subject to 50% drops, is intolerable to some individuals.

Watching the destruction of your wealth in a matter of days or months is the psychological equivalent to waterboarding for some people. For others, it's a matter of waiting out the storm. One investor's acceptable unrealized loss is another's worst financial nightmare.

Statistics like standard deviation are a window into visualizing an unrealized investment loss but do not capture a full picture. Psychological fallout can trigger an investor to turn an unrealized loss into a real one. This is why financial planning works. It prevents an investor from selling at, or near, a price-bottom. resulting in missing the rebound and return to normalcy that historically followed past financial economic crises.

Risk and return data provided in online tools from financial services companies and financial media make it is easy to overlook their bias toward simplifying investing. A respected institution speaking in an authoritative voice can make it sound easy to allocate and rebalance a portfolio annually. Always

(Continued on page 4)

Whew! Tax Season Is Over (Or Is It?)

Well, another tax season has come to a close, and what a year it was in the capital markets. The overall stock market experienced some of the highest volatility we've seen in years. However, amidst the turmoil, we were able to identify tax opportunities for our clients and turn lemons into lemonade. We thank all of our clients for their trust in us during this challenging time.

Although tax season has ended for many, it is important to remember that premier tax management requires year-round vigilance. Tax-law changes and tax-related events do not magically cease after April. If you have experienced or anticipate a lifestyle or business change this year that has tax consequences, such as retiring, selling a business, giving a substantial gift to family or charity, or being awarded a concentrated position in a single-company stock, please let us know about it as soon as possible.

If you have applied for an extension on your 2022 tax returns, remember that the returns are due by October 16th. We encourage you to send us your documents early.

No matter your situation, we are here for you and remain committed to providing you with the best tax management possible, year-round.

Warm regards,
The Gerstein's Brooklyn Tax Service Team

Long-Term Care Insurance Alert

Forty percent of Americans over the age of 65 suffer from a physical or cognitive disability, and the number of those requiring long-term care is growing sharply. However, buying insurance that will pay for a long-term stay in a nursing home places consumers in a hard-to-navigate area of personal finance, where professional guidance is very important.

For many years, long-term care insurance (LTCI) policyowners have been forced to accept lower benefits or pay more to keep their policy's current benefits. Although state regulators are required to approve price hikes and benefit reductions, rarely do regulators refuse to grant insurers' requests.

Rising health care costs and technology have made LTCI policies difficult for insurers to price.

To be clear, companies that write and sell insurance policies start with one set of policy benefits and prices, but they are often subject to change over the years. Pricing the cost of a nursing home, home-care, and other policy benefits is complicated.

How complicated? Compared to the calculation involved with figuring out an individual's risk of dying, LTCI policies are much more complicated products. Life insurance involves one risk: mortality. Calculating an individual's risk of dying is the single risk insurers need to price in to sell a life insurance policy. In contrast, long-term care insurance involves two risks – bad health as well as mortality.

Calculating an individual's risk of bad health as well as their life expectancy requires more actuarial calculations than a life insurance policy. Keep in mind, insurers customarily require your health records to determine your personal risk of heart disease, dementia, cancer, and other chronic diseases before writing you an LTCI policy. The insurers routinely require access to your health history before pricing your personal policy proposal.

For consumers, shopping for a long-term care insurance policy demands that you have access to the same kind of tools used by insurers to offer you an LTCI policy.

Using specialized software tools, we can help you determine whether an LTCI insurer is offering you a correctly priced policy based on your personal health history. Advising on LTCI requires specialized software tools and analysis by a qualified professional based on your individual health and mortality risk. If you are interested in accessing an algorithm that factors in your health, age, and other risk variables to help you price LTCI, please contact us. ●

As The Recent Volatility in the Stock Market Stretches, Remember

Stock bear markets in the post-War era lasted an average of about 11 months.

The current bear market began on June 13, 2022. That was when large-cap stocks, as measured by the Standard & Poor's 500 index, declined by more than 20% from their all-time high price of January 3, 2022.

The bear market will not end unless and until stock prices recover and surpass their early-2022 high price. That's a real risk, and it helps explain why the U.S. stock market became the premier risk asset for long-term investors across the world.

U.S. stocks are unique among the world's investments because they not only possess a history of 10% annualized returns, but they are also liquid. They can be sold anytime. Diamonds, private investments, and other equity assets are generally not as liquid. Nor do they generally possess the documented history of appreciation of the S&P 500.

As the bear market in stocks stretches on, we want to remind you of a paradox of long-term investing: Putting up with periodic losses in the world's leading equity market has been a good investment. Yes, the nation's 500 largest publicly investable companies are a risky investment. However, they have been the key driver of growth for retirement portfolios and family wealth.

The equity risk premium, which is illustrated on the right, shows the rewards received annually for tolerating stock risk versus a risk-free investment.

In the 20 years ended December 31, 2022, stocks averaged a 9.8% annual return, more than seven times the 1.2% of riskless 90-day U.S. Treasury bills.

Subtracting the average annual return on T-bills from the return on stocks, the resulting 8.6% is the premium stock investors over the past 20 years annually earned for taking the risk of owning U.S. stocks. T-bills are considered risk-free because they're backed by the full faith and credit of the United States.

A Brighter Outlook, After Three Years Of Crisis

For three years, it's been one crisis after another. Surprisingly, despite the confluence of crises, the outlook for the U.S. is very bright. Glimmers of optimism are on the horizon. Here's perspective for investors on the tectonic economic shifts under way, as the crises recede and we emerge from the tumultuous post-pandemic era.

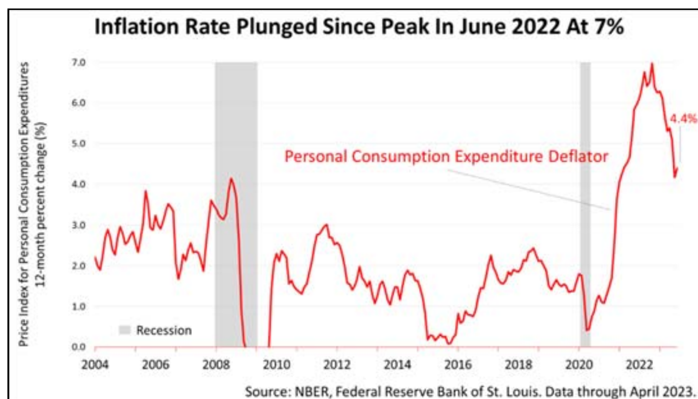
Crises. In February 2020, the Covid crisis began. After partially shutting down the economy, the U.S. government authorized trillions in cash payments to consumers and businesses in 2020 and 2021. In early 2022, as Covid-19 subsided, an inflation crisis erupted. It's well on its way to ending.

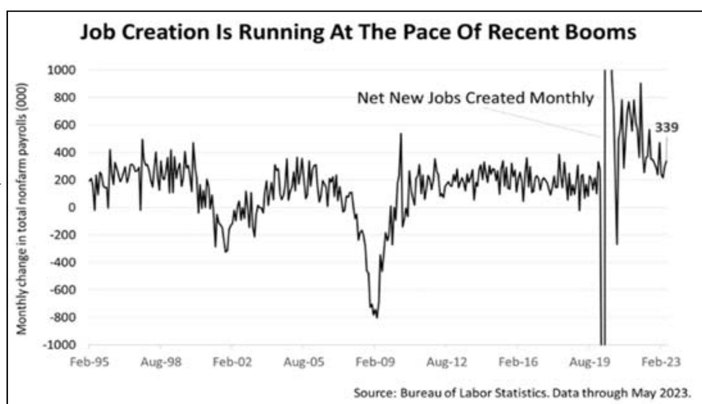
In 2023, however, yet another crisis threatened to wreck the economy: a default by the U.S., on its debts clouded the outlook until June, when the debt ceiling crisis was resolved with a temporary fix, delaying a permanent solution until after the national election in November 2024.

Inflation. The inflation crisis peaked when the Federal Reserve's benchmark index of inflation hit an annual rate of 7% in the 12 months ended June 30, 2022. The worst inflation in four decades was initially sparked by government stimulus payments in 2020 and 2021, along with pandemic-related supply chain disruptions. Inflation worsened after Russia invaded Ukraine in February 2022 and the U.S. imposed sanctions on imports of Russian oil, which led to a spike in energy prices.

In March 2022, U.S. central bankers abandoned their contention that inflation was transitory and acted to halt inflation from further infiltrating the American financial psyche by raising lending rates 10 times in 13 months.

The effects of Fed rate hikes are delayed by several months, which complicates the Fed's delicate task of allowing growth to continue while simultaneously hiking rates to snuff out inflation. Fed monetary policy mistakes caused every recession in post-War U.S. history except for the Covid-19 recession. However, evidence is strong that the Fed is winning its battle to reduce inflation without causing a recessionary cycle.





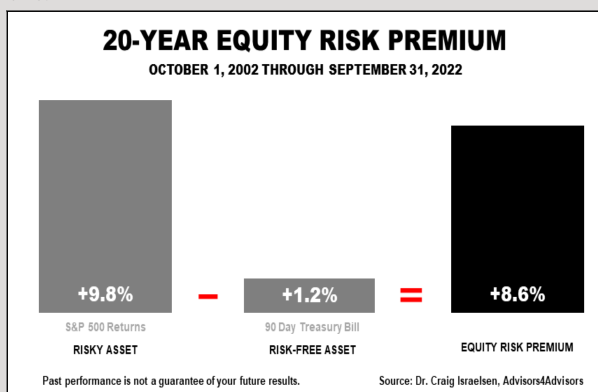
Recession Unlikely. According to the U.S. Bureau of Labor Statistics, 339,000 new jobs were added to the economy in May, nearly twice what was expected. Moreover, the pace of job creation is on par with the dot-com boom and comeback after the 2008 financial crisis, as is shown in the dotted line in the chart. This indicates the Fed's effort to eliminate inflation without causing a recession is working.

The Outlook. Amid a bear market that began in June 2022, investors should be prepared for the next bull market. The confluence of crises in the last three years makes it hard to remember that Covid-19 in February 2020 ended the longest bull market in American history. The record-long 128 month bull market began in March 2009, following the 2008 global financial crisis. The U.S. led the world out of that calamity and, with the widespread adoption of artificial intelligence (AI) already boosting the U.S. economy, the country is poised to lead the world once again from the back-to-back crises of the post pandemic era. ●

the Paradox of Long-Term Investing

In contrast, stock investments are not guaranteed. Stock prices fluctuate unpredictably, depending on investor sentiment and economic conditions. Theoretically, all 500 companies in the S&P 500 index could go bust, and an investment mimicking the index could be totally lost. In addition, there is no guarantee the strong returns earned on stocks will be repeated in the future.

That is precisely why stocks have paid a significant premium over a riskless investment. It's the great paradox of investing and important to remember under current conditions. ●



IRA Strategies for 60- to 73 Year-Olds

Investments in IRAs are the main source of funding retirement income for a number of Americans. Your IRA is probably crucially important to your retirement success and may also play a role in your estate plan. The trouble is, the rules on IRAs have changed, and so has the investment environment. As a result, taking a strategic approach is not so easy. Here is a very simplified explanation of strategic planning opportunities triggered by current estate and income tax rules.

Starting at age 73, it's required by law to take an annual minimum distribution from your IRA accounts. The required minimum distribution (RMD) is determined by an actuarial table based on life expectancy and the value of your IRA. Your investment manager will provide you with the specific number each year.

RMDs get taxed at ordinary income rates. A key aspect of IRA strategic tax planning is minimizing withdrawals on IRA accounts to keep as much of your IRA as possible growing without being subject to income tax.

If you die at age 73 before beginning RMDs from a traditional IRA, your family will not be required to take anything out of that inherited IRA for 10 years. To be clear, assuming your heirs don't need all or any of the IRA assets you left them, they can escape any taxation of the growth on the IRA for 10 years. That's great! The trouble is, you're dead. This is not a strategy you want to plan on happening.

If you have a traditional IRA and you die after the required beginning date for taking RMDs, then you r heirs will be required to take RMDs annually for 10 years to deplete the IRA. That's not a good result because the IRA will get reduced bythe required distribution annually, and less principal will beleft to grow at a compound rate.

The key strategy for maximizing IRA assets in 2022 is converting traditional IRA assets to a Roth IRA. A Roth IRA is as though you died before starting your required minimum distributions at age 73. It's almost like you died and went to tax heaven! There are no RMDs on a Roth IRA, and contributions can be taken out at any time. To take out earnings on a Roth without penalties or taxes, though, you'll need to have owned it for at least five years. And so a Roth IRA can be a great way of preserving your assets for your 80s and 90s and it offers a powerful estate tax planning benefit. It's a great way of preserving your assets for your 80s and 90s and it offers a powerful estate tax planning benefit.

If you die, your heirs inherit a Roth IRA that generally must be depleted all at once in 10 years. To be clear, your heirs – assuming they do not need the assets you left for them – can generally let the account grow tax-free for 10 years and pay no income tax on their withdrawals.

Roth IRA conversion is not a strategy you want to begin to start thinking about in your 80s. If you are in your 60s and own an IRA asset that might outlive you and benefit your spouse and children after you're gone, converting to a Roth should probably be evaluated. Conversion requires paying income tax on all assets contributed to a Roth, which is a calculation you must make with a qualified professional. We are here to help as always. ●

Developing Portfolio Exptectations

(Continued from page 1)

remember, it is in their financial interest to convince you investment management is simple.

Over the past two decades, a new generation of improved investment advice apps made securities trading cheap, easy, and ubiquitous. Now, artificial intelligence (AI) is expected to supercharge knowledge transfer.

A quarter of the tasks performed by American workers before the generative AI breakthrough by ChatGPT in 2023, are expected to be automated by AI in the years just ahead. Labor productivity is likely to surge through 2030, transforming the U.S. labor force. AI already is touted in advertising as yet another new generation of powerful online financial advice tools.

However, AI is still no substitute for a relationship with a professional, who knows you and can assess your investment personality characteristics to test how large a loss you can take before abandoning a strategic plan. Put simply, AI cannot be trusted to replace human judgment on crucial decisions affecting your health and financial well-being.

On May 1, 2023, the "Godfather of AI," joined a growing list of AI experts worried about the release of AI applications. Geoffrey Hinton, a computer science professor, whose company was acquired by Google for $44 million in 2013, announced he was leaving Google, so he could speak freely about AI's dangers without concern for how his comments might impact Google. Google had launched an AI-powered search engine chat feature in March 2023, disclosing it was not always accurate. Meanwhile, Google's rival, Microsoft, launched an AI-powered search engine chatbot that reportedly is prone to hallucinations and fell in love with a tech reporter.

AI is expected to increase knowledge transfer exponentially, but nothing compares to getting advice from a trained professional, who knows you. Investment risk is not a single statistic and it still takes a human who understands you. ●

Gerstein Tax Service, LLC | 375 1st Street, Brooklyn, NY 11215 | Phone: (718) 499-8352 | clientservice@gersteintaxservice.com

Please remember that there can be no assurance that any portion of the content, made reference to directly or indirectly in this newsletter will be suitable for your individual situation, or prove successful. Due to various factors, including changing applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized advice from Gerstein Tax Service, LLC ("Gerstein"). Please remember to contact Gerstein, in writing, if there are any changes in your personal/financial situation for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Gerstein is neither a law firm, nor an investment advisory firm, and no portion of the newsletter content should be construed as legal or investment advice.
©2023 API