Q2 2019 NEWSLETTER

AICPA Engage Conference

In early June, Ashley flew to Las Vegas to attend the 6-day AICPA conference. It was a conference of superlatives - the best, longest and most expensive conference he's attended. The conference included hundreds of exhibitors, dozens of advanced workshops, and countless networking opportunities with tax professionals around the country. The biggest takeaway by far was the idea of using a specific financial product to hedge against a retirement risk known as Sequence of Returns Risk (SoRR). Ashley's favorite sessions were hearing the IRS commissioner speak and outline their priorities, "Factors Affecting Small Business Valuations", and "Home Lifetime Income Streams Affect Asset Allocation".

Upcoming Travel

San Francisco, CA:
July 15th - 17th
Brisbane, Sydney & Melbourne:
July 25th - August 24th

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Second Quarter Market Commentary

How to make sense out of the recent market behavior? We experienced a painful decline in the last month of 2018 before the markets took a sharp (and unexpected) about-face and delivered the biggest one-quarter gain since the third quarter of 2009. The surprise upward trend has continued through the second quarter, albeit with more modest gains, despite what would normally be considered warning signs in the economy, the global trade markets and corporate earnings.

If we could simply stop the year at this point, the gains would be unusually high for a typical 12-month period; for six months, they are extraordinary. Perhaps we should celebrate cautiously.

Just about every investment asset produced gains in 2019's second quarter. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—rose 3.99% in the most recent three months, and now stands at an 18.66% gain for the year. The comparable Russell 3000 index is up 18.71% so far this year.

Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 4.19% in the second quarter, closing out the first half of the year with a gain of 18.74%. The Russell 1000 large-cap index has gained 18.84 so far this year, while the widely-quoted S&P 500 index of large company stocks was up 3.79% in the second three months of the year, and is up 17.35% in the first half of 2019. Meanwhile, the Russell Midcap Index has delivered a 21.35% return in the first six months of 2019.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies gained 2.03% in the second quarter, and are up 17.85% so far this year. The comparable Russell 2000 Small-Cap Index gained 16.98% the year's first six months. The technology-heavy Nasdaq Composite Index gained 4.40% in the second three months of the year, and is up 20.66% at the year's half-way point.

International investors are also sitting on gains. The broad-based EAFE index of companies in developed foreign economies gained 2.50% in the second quarter, and is up 11.77% so far this year. In aggregate, European stocks are up 13.20% in 2019, while EAFE's Far East Index has gained 7.80%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, lost 0.31% in dollar terms in the second quarter, but the index still up 9.22% for the year.

Kellen Working Towards Enrolled Agent (EA) Status

Kellen has been studying hard these last couple months as he commenced his study for the IRS Enrolled Agent exams. An Enrolled Agent is a federally-authorized tax practitioner who has technical expertise in the field of taxation and who is empowered by the U.S. Department of the Treasury to represent taxpayers before all administrative levels—examination, collection, and appeals—of the Internal Revenue Service. Kellen's EA certification will expand our tax planning capabilities as a firm and help us provide even more value to our clients. Kellen has set a goal to pass all three exams by the end of 2019. Good luck, Kellen!

Wisconsin Energy Fair Presentation - 'Illth' and the Promotion of Financial Health

The Midwest Renewable Energy Association (MREA) hosted it's 30th annual Energy Fair in Custer, Wisconsin June 21st - 23rd. Ashley attended the event with his brother and delivered a presentation called "'Illth' and the Promotion of Financial Health" which explored the value of money and how to use money to enhance our well-being. You must be aware of your goals and values to be able to live your unique, rich life, without this knowledge you may unwittingly be pursuing the accumulation of money for its' own sake.

Kellen Gets Engaged!

While on a Caribbean cruise vacation in May, Kellen proposed to his girlfriend, Jessica, on a remote beach on the coast of Barbados. Jessica graduated from Minnesota State University - Mankato as well, the day before leaving for their cruise! Jessica is excited to begin her career as an elementary school teacher this coming fall.

New Zealand Cycling Trip

In May, Ashley went on a wonderful New Zealand cycling trip with a long time friend. Although the weather wasn't as beautiful as what Kellen was enjoying in the Caribbean, the New Zealand countryside was absolutely breathtaking and a must-see for anyone who enjoys the outdoors.

Fulton Gran Fondo Century

After a few weeks of training, Ashley participated in the 6th annual Fulton Gran Fondo Century, a 100-mile cycling ride departing from Fulton Production Brewery in northeast Minneapolis. He's looking forward to doing a triathlon later this summer as well. All the business travel and an injury haven't helped his preparation.

Working from Australia for the Month of August

In late July, Ashley's family will depart for Brisbane, Australia, where they'll spend a month. Ashley will be working remotely during this time, still meeting with US clients.

Looking over the diversifying investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a 1.63% gain during the year's second quarter, for a 17.92% gain for the first six months of the year. The S&P GSCI index, which measures commodities returns, lost 1.42% in the second quarter, but is still up 13.34% for the year. Energy prices are up 22.80% in 2019, while precious metals have gained 8.86% so far this year.

The bond markets continue the long stretch of low-yield environment, coupled with either a flat or inverted yield curve, depending on where you look. Coupon rates on 10-year Treasury bonds have dropped to 2.01%, while 6-month bonds are now yielding a higher 2.09%. Five-year municipal bonds are yielding, on average, 1.34%, down from 1.89% last quarter, while 30-year muni yields have fallen to 2.40% on average.

What's going on? It's tempting to think that the bull market is running out of steam, in part due to the fact that it's not easy to see how valuations can go much higher. The price-to-earnings ratio of the S&P 500 index--a popular way of valuing stocks--is 21.83 on a trailing basis, compared with a 10-year average of 17.87, and a long-term historical mean of 15.75. At the same time, a popular haven for retreat from the markets--gold--is also above its historical value; the precious metal is not far from its highest level in six years, at $1,413 an ounce.

Bonds are not attractive investments at the 2% range for Treasuries, especially when your yield on six-month issues is higher than if you take the risk of investing over ten years. Moreover, there is growing uneasiness about a global slowdown in economic activity, and trade wars and the threat of trade wars are not likely to boost the global economy, even if the recently-announced detente between the U.S. and China holds. Sluggish profit and economic growth are not normally a recipe for higher stock prices.

You might imagine that a strong first half of the year would normally be followed by an easing back or even a drop in value over the second half, but that hasn't necessarily been the case historically. In years in which the U.S. market rose in the first half of the year, the odds of a positive second half, based on the historical record, are 72%. That certainly doesn't guarantee anything, but it does suggest that market movements tend to be much harder to predict than one might imagine.

All of us were surprised at the roaring start to 2019 considering the downturns at the end of 2018. We can expect to be surprised again, either on the upside or the downside, in the second half of this year.

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Win, Lose or Tie?

The trade war between the U.S. and China seems to be escalating lately—but is there any way of telling who's winning? A recent article on bloomberg.com provides a scorecard of sorts, and the news isn't good for either side.

One way to measure victory is to look at the size of the trade deficit that the U.S. is running against China. China is still maintaining a high surplus, but the article notes that in March, the gap was the narrowest in three years. So if you believe trade deficits are harmful, this can be considered a narrow victory for the American economy.

Another way to keep score is consumer prices. Tariffs drive up prices on both sides of the Pacific; American tariffs cause American consumers to pay more for Chinese products, and Chinese retaliatory tariffs raise prices for Chinese consumers on any American exports they buy. The article says that the price of items on U.S. store shelves in seven tariff-hit categories went up 1.6% since last July. On the Chinese side, higher tariffs on U.S. imports have had little effect on Chinese consumers because many of them are industrial inputs, rather than end-use products—things like soybeans, gold, liquefied natural gas, cotton and liquefied propane. Some of the newly-tariffed Chinese imports are used to manufacture products which are then shipped to the U.S., where they experience further tariffs that are paid by U.S. consumers. This is a clear victory for China.

What about the psychological impact of the trade war on U.S. and Chinese consumers? The article calls this one a draw; Americans aren't very optimistic about the outcome of a trade war, and Chinese consumers are buying less lately in their domestic economy.

What is the impact on each nation's currency? The Chinese yuan has weakened 7.5% against the dollar, which benefits Chinese exporters by making it easier for them to absorb some of the hit by

U.S. tariffs. But if the yuan gets much weaker, it could force the Chinese government to spend some of its reserves. The article calls this one a tie as well.

How are tariffs impacting each country's stock market? Since the start of 2018, Chinese stocks are down almost 14%, while U.S. share prices are up 6%. America has—so far—won this category.

Another measure is economic growth. Both U.S. and China are experiencing signs of GDP weakness in recent weeks, but China's industrial output, retail sales and investment all slowed in April by more than economists forecast. The U.S. is experiencing weaker retail sales, and factory production fell for the third time in four months. The article gives a narrow victory to the U.S.

What about foreign direct investment in the U.S. and Chinese economies? U.S. investment in China has declined only marginally since the start of the tariff war, while Chinese investment in the U.S. has shown a more than 80% drop. As the U.S. misses out on investment, chalk up a victory for China.

The Four Elements of Financial Well-Being According to the CFPB

The CFPB or the Consumer Financial Protection Bureau published a report about 18 months ago, titled "Financial Well-Being in America", that discusses the four elements of financial well-being, and how Americans of different income levels display varying levels of financial wellness. Two of the CFPB's most important conclusions from the study are that "savings and financial cushions provide the greatest differentiation between people with different levels of financial well-being" and that "certain experiences with debt and credit seem to be strongly—and negatively—associated with financial well-being." Credit unions must understand the four elements of financial well-being and how to help improve the borrowing and saving experience for members to help boost their financial wellness.

The CFPB report "Financial Well-Being in America" defines financial well-being as "a state of being wherein a person can fully meet current and ongoing financial obligations, can feel secure in their financial future and is able to make choices that allow them to enjoy life." It further describes the four characteristics as the following:

– Present Security: Control over day-to-day and month- to-month finances
– Present Freedom of Choice: The freedom to make choices to enjoy life
– Future Security: The capacity to absorb financial shock
– Future Freedom of Choice: The state of being on track to meet financial goals

These four elements address present stability in two categories, which directly impact future financial stability. Members must first be able to keep their daily or monthly expenses in line with their income, in

order to save for unexpected expenses in the future and meet financial goals that improve quality of life, such as saving for a home or investing in a more reliable form of transportation.

To help members improve their financial well-being, credit unions can provide members access to tools to control day-to-day and month-to-month finances by borrowing and saving more effectively. Members often need access to the ability to borrow to manage daily and monthly expenses. According to the CFPB, inexpensive, small-dollar loan products can help stabilize members in the short-term. Without these alternative loan options, many members risk falling into a cycle of debt through high-interest payday loans or by accruing large credit card balances with high interest rates. Credit unions are uniquely positioned to offer these small-dollar loan solutions to members because they are invested in the long-term financial stability of members, instead of looking for a quick profit.

In order to improve a member's financial stability enough to start saving, credit unions need to build support for savings. Integrating financial coaching and debt-management counseling services into small-dollar loan products can help members make good decisions throughout the borrowing process. The ability to borrow strategically can directly lead into the ability to save, especially with the guidance of trusted credit union financial coaching professionals. When members turn to a small-dollar loan product offered by a credit union to solve a short-term cash management crisis, the credit union has the opportunity to offer help to build a savings plan once the member's income has stabilized.

The CFPB's report on financial well-being indicates that access to savings and financial cushions is one of the primary indicators of financial wellness and stability. Credit unions should work with their members who struggle with their day-to-day and month-to-month expenses to build a plan to stabilize their income and expenditures. By offering access to small-dollar loan products, paired with financial coaching and savings tools, credit unions can help members improve their financial well-being.

Source:

Morales, Ben. CEO of QCash Financial. December 11, 2017.

New IRS Guidance on State and Local Tax Refunds

The Tax Cuts and Jobs Act of 2017 included a $10,000 ($5,000 if married filing separately) cap on the amount of state and local taxes that can be claimed as an itemized deduction on Schedule A of Form 1040. If you itemize deductions that include a deduction for state and local taxes and then subsequently receive a state or local tax refund, you may have to include part or all of the refund as income in the year you receive it. There were some questions about how the new $10,000 cap would affect the amount of any such refund that would be included in income.

IRS guidance

In general, if you receive a federal tax benefit from deducting state or local taxes in a prior taxable year and then subsequently recover (receive a refund for) some or all of the state or local taxes you had deducted, you have to do a two-part calculation. The first part of the calculation is to go back and determine what your total itemized deduction amount in the prior year would have been if you had paid the correct amount of state and local taxes and subtract that from the amount you originally claimed. The second part of the calculation is the difference between your itemized deductions taken in the prior year and the standard deduction amount (including adjustments for being blind or age 65 or older) for the prior year, provided that you could have claimed the standard deduction that year. The amount of the state or local refund that needs to be included in your income is the smaller of these two amounts.

For the 2019 IRS Form 1040 tax return, it is likely that the instructions for the line "Taxable refunds, credits, or offsets of state and local income taxes" will contain a simple worksheet for implementing this general rule. It will probably also include numerous exceptions that will require the use of a more complicated worksheet in IRS Publication 525. Exceptions might include (among others): you owed alternative minimum tax in 2018; you couldn't use the full amount of credits you were entitled to in 2018; you could be claimed as a dependent by someone else in 2018; or you received a refund on a jointly filed state or local income tax return, but you aren't filing a 2019 joint tax return with the same person.

If you received a federal tax benefit from deducting state and local taxes as an itemized deduction in a prior taxable year and you recover all or a portion of those taxes in the current taxable year, you may need to include a portion of the recovery in gross income.

Example

Assume no exceptions to the general rule apply. You paid local real property taxes of $5,000 and state income taxes of $6,000 in 2018. Your state and local tax deduction was limited to $10,000, so you could not deduct $1,000 of the $11,000 state and local taxes paid. Including other allowable itemized deductions, you claimed a total of $15,000 in itemized deductions on the 2018 federal income tax return. In 2019, you received a $1,500 state income tax refund due to overpayment of state income taxes in 2018.

If you had paid only the proper amount of state income tax in 2018, the state and local tax deduction would have been reduced from $10,000 to $9,500 and, as a result, itemized deductions would have been reduced from $15,000 to $14,500, a difference of $500 (the first calculation).

You filed as a single taxpayer and were entitled to a standard deduction of $12,000 in 2018. The $15,000 of itemized deductions taken in the previous year exceeded the standard deduction by $3,000 (the second calculation).

The smaller of the two calculation amounts is $500. Therefore, you received a $500 tax benefit due to overpayment of state income tax in 2018. Thus, you are required to include $500 of the state income tax refund in gross income for 2019.

Retirement Tweaks

While partisan politics rages everywhere in sight, the U.S. House of Representatives quietly—and nearly unanimously—passed a bill that would reform various aspects of America's retirement laws. The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) was approved by a 417-3 majority of legislators, and the Senate is expected to pass a similar bill by a similar margin in the fairly near future.

The bill contains 29 new provisions, including allowing people who work past age 70 to continue making IRA contributions while they're earning an income, and pushing out the start date to take required minimum distributions from IRAs or 401(k) plans from age 70 1/2 to age 72 (The Senate version would push out the start date to when the IRA owner turns age 75). The bill would also expand employers' ability to create 401(k) plans in conjunction with other (probably small) businesses, allowing them to share and therefore reduce costs.

Also, there would be a $500 tax credit to smaller employers who encourage automatic enrollment in their retirement plan. Studies show that employees save more under automatic enrollment than when they have to affirmatively opt in. The bill increases how much workers can have automatically deducted from their paychecks to go into the retirement account, from the current 10% to a proposed 15%.

Meanwhile, the bill decrees that all defined contribution plans (including 401(k)s) would be required to estimate how much income would be generated by each plan participant's current account value—though how, exactly that calculation would be made is still up in the air. Experts have plenty of questions about how this would even be possible. What return assumption would you make over the next 30 years? Over how many years would the income assumption be made for a 20-year-old staffer vs. somebody who's in her 50s?

Currently, there are a variety of reasons why people can start taking withdrawals from their IRAs before they reach age 59 1/2, and the recently-passed legislation would add another one: a total of $5,000 could be distributed, without penalty, from the IRA or retirement plan if the owner experiences the birth or adoption of a child. (The distribution would need to take place within one year of the birth or adoption; otherwise there would be a tax penalty.)

The bill is not all good news. The SECURE Act would raise revenues by changing the rules regarding distributions from inherited IRAs. As the rules stand today, the amount that would have to be taken out could be spread out over the life expectancy of the heir—which, of course, allows people to stretch out the tax-deferral on inherited IRAs for decades. Under the new bill, most beneficiaries would have to take their money out over a 10-year period. (The Senate version of the bill would require any inherited IRA over $450,000 to be paid out over five years.) But the bill would exempt inheriting spouses and minor children from the provision.

Another part of the bill that may wind up being harmful was heavily lobbied for by the insurance industry: creating a safe harbor for plan sponsors to offer annuities inside their 401(k) plans. Companies that decide to offer annuities would be shielded from liability no matter how awful the annuity product they select (and there are quite a few that are pretty awful). Anybody who has seen the expensive, high-sales-commission products offered to teachers in 403(b) plans knows that there is great potential for harm with this aspect of the new bill.

All in all, the new bill is incremental rather than earth-shaking. Not many workers will be working or want to contribute to an IRA after age 70, but some will. Raising the age when people are required to

take minimum distributions from their IRA by a year and a half is relatively minor, and making retirement plans easier to set up is good, but most companies have already done that work.

That said, it is interesting that bipartisan legislation can still get done amid the hysteria going on between the Democrats and Republicans in the current Congress.

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Should You Buy Long-Term Care Insurance?

When you model the sustainability of a person's retirement asserts, the big unknown is long-term care expenses. The median annual cost of a private room is now over $100,000 a year, according to Genworth's 2018 Cost of Care Survey, and the median annual cost of a home health aide, for those who prefer to stay in their homes during dementia or illness, is over $50,000.

Not everyone will suffer from dementia or a long-term illness that requires skilled care; the Genworth survey noted that two-thirds of retirees may be looking at $0 long-term care costs in retirement, while the other third may be looking at half a million dollars or more.

With most other healthcare issues, Medicare and supplemental insurance will cap the cost at the annual premium amounts, though expensive drugs can raise the out-of-pocket expenses. But the government only covers long-term care costs when a retiree has largely exhausted his or her other resources, at which point Medicaid steps in to pay for (often inferior) facilities that accept government payments.

However, retirees can cover any future long-term care costs with long-term care insurance. The average annual premium for a 55-year-old couple was $3,050 in 2019, according to the American Association for Long-Term Care Insurance. These policies will generally cover a portion of the costs for a defined period, such as three years, greatly reducing a

retirement plan's future uncertainties. There are also life insurance and annuity contracts that provide long-term care benefits.

Some people avoid paying long-term care premiums because the money they're paying for coverage will be lost if they never have to move into a nursing facility or pay for skilled in-home care. But those same people buy home and auto insurance policies that will cover catastrophic losses, and (thankfully) in nearly all years, the money spent on those premiums doesn't result in an insurance payout. Insurance is there for peace of mind. The real question that people should be asking themselves is: does it make sense to protect against the biggest unknown expense in a retirement plan's later years?

Source:

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