Q2 2021 Update: Diversification, Housing, and Taxes

Mike Mills
Managing Partner
CFP, CLU, CFS

In the update below, you will find the following links that will direct you to the topics and resources we have assembled for your benefit. I hope you find it informative and useful. If you have an extra second, read **Section III: Around the MWA Office** for some great updates. You'll notice that **Section II** has been updated and we plan to have multiple advisors write so you get info from all of us. We are always trying to make this Quarterly Newsletter more informative and less wasteful, so give us feedback if you have any.

Best Wishes. – Mike

Section I: 2nd Quarter Market Update

In MWA's 2nd Quarter 2021 Quarterly Market Review (link) **slide deck:** You'll notice that Global Real Estate had quite a nice quarter, bonds bounced back a little and equity markets continued to rise.

Section II: Mike's Update – Taking the Long Approach

I hope you are having an amazing summer and are getting out of the COVID lockdowns and are enjoying yourself. The US economy has been hitting on all cylinders fueled by pent-up demand, housing, unprecedented government stimulus, and loose lending markets (probably too loose). As a result, stock markets around the world have continued to climb, led by small-undervalued companies that have shot up in value after 10 years of lagging behind bigger company indexes like the DOW/S&P 500, etc. I wish I could tell you that this is unusual, but it is not. When premiums show up it is typically from a violent move up/down depending on the reason. If you looked 6 months ago, the valuation gap between valuation and growth was the widest on record. This spread was not sustainable and the government stimulus, combined with vaccines, and lending to less credit-worthy businesses was the catalyst to send small-cap value stocks shooting up 100% in less than 6 months.

When the COVID market decline occurred, we continued to add money to small, undervalued companies from our defensive reserves despite this asset class' dismal 10 years prior performance record because if there is one lesson, I would ask you remember, is that reversion to the mean is one of the strongest forces in finance. I think this valuation gap may continue to narrow, but we have begun to take some profit (which may mean paying some tax) and reducing our overweight to this area, not because we don't want to own it, but because owning it comes with more risk and given market valuations, we think we would

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prefer to continue to lower the portfolio's overall risk profile (obviously this differs by model and objective).

In several areas of the market, where long-term risk premiums have persisted for hundreds of years, (Value over Growth / High-Profit over Low-Profit / and Small over Large) it is important to remember that these premiums come and go over time. They typically show up about 70-80% of the time in long-term data, but they can go a long time without showing up, potentially up to 15 years. We keep a designed overweight to these premiums in most models because we believe it would be foolish to think, "*It is different this time*". With diversified market indexes permanent capital loss is eliminated, so holding and buying more when an investment is not going your way, while difficult to do, is a crucial step in generating attractive tax-efficient long-term returns. After all, the research is pretty clear that if you save the right amount, buy a diversified portfolio implemented in a low-cost manner, purchased at low to reasonable valuations the only additional ingredient needed to eventually experience investment success is time. Now, how much time is often unclear, as "the problem with the future is, well...it's in the future". We try to remind investors to always remember the 5-year rule (never invest in equities if you must have the money within 5 years), but with most investment strategies 5 years is not long-term, it is just a speck in time. So, to be a great investor we believe you need to continually extend your definition of long-term to decades, not years.

Take look at this chart and see if you see the wisdom that comes from diversification. Notice that in up markets, the diversified portfolio lags, but in down markets, it shines. It may not feel like a diversified portfolio is working (in the short run) but over time it will shine because oftentimes you can win by not losing as much.

Diversification can feel disappointing

BlackRock

A well-diversified portfolio is designed to help you achieve your long-term goals as well as limit your portfolio's downs (and ups). But it doesn't always feel good. You may get upset when you inevitably lose money during certain periods (though your loss is likely less than that of the S&P 500 Index). You may also be disappointed during up markets when you see how well the S&P 500 Index performed, and you didn't do as well. The good news: A diversified portfolio may produce a better outcome for you in the long-term.

A perfect market for "S&P Envy" during the last 20 years

Years	S&P 500 Index	Diversified portfolio	
2000*-2002	-40.1%	-17.3%	"I lost money"
2003-2007	+82.9%	+80.0%	"I didn't make as much"
2008	-37.0%	-24.5%	"I lost money"
2009-2019	+351.0%	+195.3%	"I didn't make as much"
Q1 2020'	-30.4%	-20.7%	"I lost money"
Q2-Q4 2020'	+70.2%	+42.6%	"I didn't make as much"
Total return	**+268.7%**	**+275.3%**	"Diversification can work even when it feels like it's losing"
Growth of $100,000	**$368,745**	**$375,302**	

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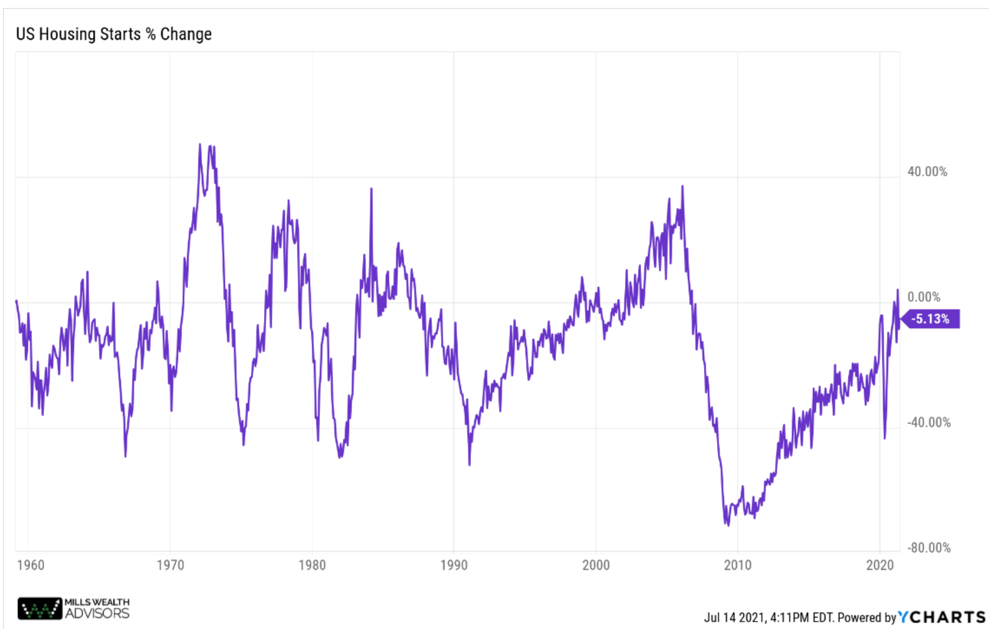
I will leave you with one of my favorite quotes, "in the short run, markets are a voting machine but in the long run, they are a weighing machine." I think markets are fully priced and continuing to build up defense may cause us to trigger a few taxes or miss out on some short-term upside returns, but I am willing to risk that today if you are.

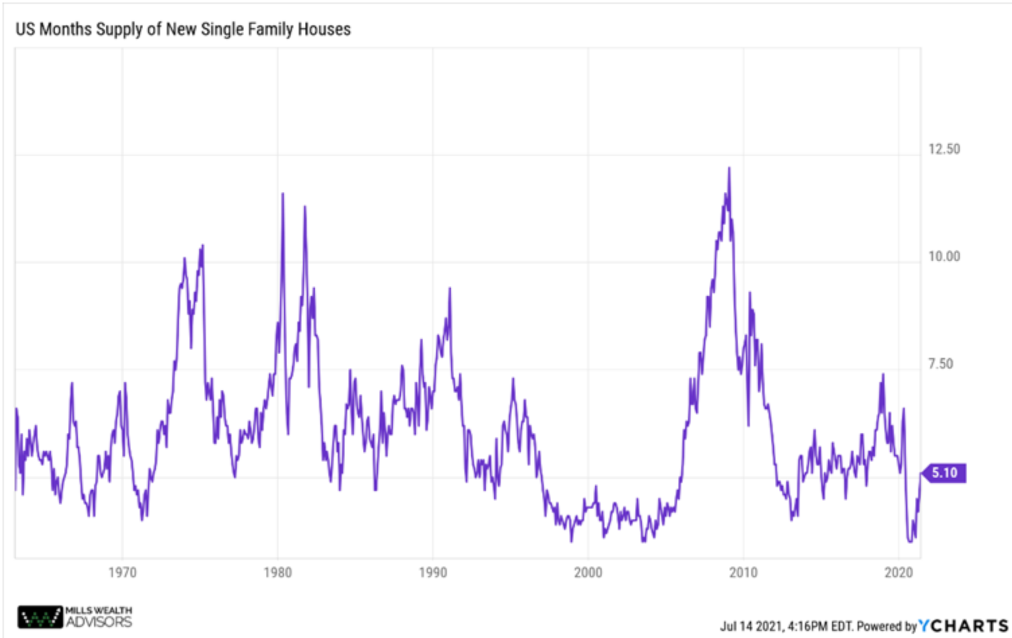
Section II-A: Matt's Update – Housing Market

If you have been looking for a home, or have paid attention to the real estate market, you know that prices across the country are soaring. The market is great for sellers. To remain competitive, many buyers are forced to waive inspections and appraisals, offer all cash, and come in above listing. It feels like a time where everyone is anxious; as a seller, should you sell or should you wait, and if you do sell, how easy will you be able to find a new home?

Home prices were increasing nationwide before the onset of COVID-19, but the recent increase in prices has been likely caused by the stimulus that stemmed from the pandemic. New housing starts (new builds) experienced a steep decline in early 2020 but has since rebounded sharply from its March/April 2020 lows.

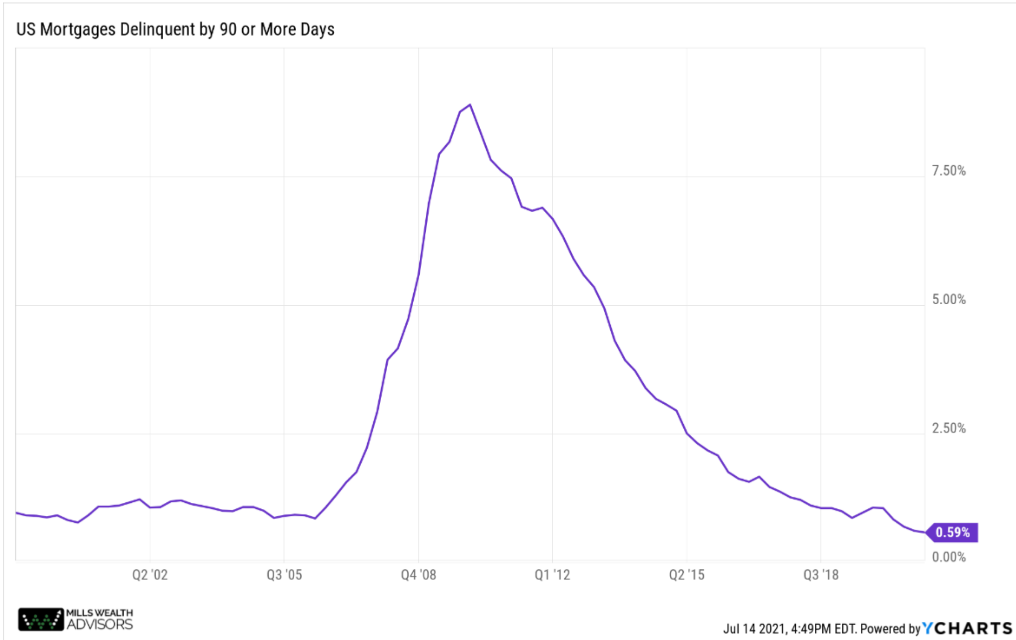


Nevertheless, this increase in construction has yet to materialize in the number of homes available. The supply of homes is near an all-time low, due to low interest rates, continued demand, lumber shortages, as well as other factors, which is why we are seeing prices at all-time highs. This surge in prices really began to gain momentum in the summer of 2020 as "working from home" started to become the new normal for most Americans. As homeowners started to reassess their new situations and lifestyles, there was not a large enough supply to meet the appetite.



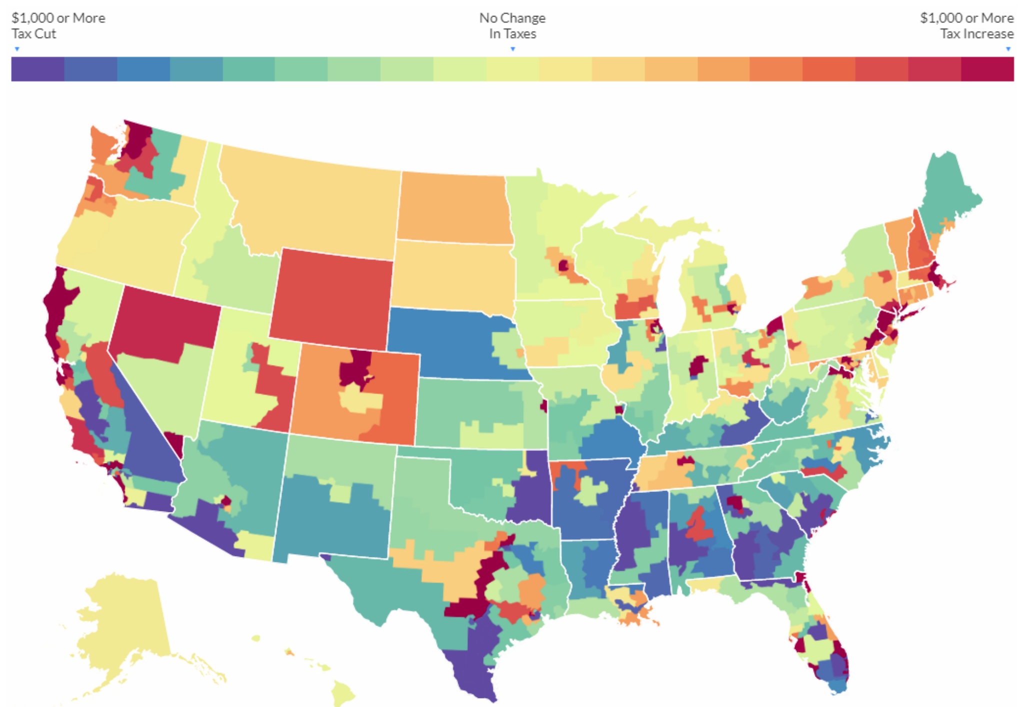
With prices continuing to move upwards and buyers attempting anything to gain an advantage, is what we are seeing today sustainable? Due to inflationary pressure of goods and services, the population changes impacting supply and demand of specific markets, we do not know if the rapid rise will bring about a rapid fall in prices. New housing starts in the U.S. are already higher than pre-pandemic levels and could likely increase as the supply of homes remains low. There is a lot of incentive out there to continue building new homes.

What might be different today than in 2007-2008? Home buyers remain very qualified, based on credit score; leading up to the housing crisis of the 2000s, roughly half of all home buyers had a credit score under 720. Now, less than 20% of home buyers have a credit score under 720. Delinquency on outstanding debt has dropped, meaning that Americans, for the most part, are not having trouble making their monthly mortgage payment. Home prices may be high right now, and they very well could slow down, especially if interest rates go up, but there are some notable differences from what we experienced a few short years ago.



All in all, trying to time the real estate market is very tough game to win, it often revolves more on personal need: shelter for you and your family.

Section II-B: Stephen's Update – Is Biden's Tax Plan Really THAT Bad??



You may have recently heard or read that President Biden has proposed to change the capital gains rate to 48.6%, which would be the highest in developed countries in the world, the US currently sits at 9th in the world. However, the caveat to this is that the top rate will impact fewer people in the future than it does now. For instance, someone could be in the highest capital gain bracket today that would not be in the highest in the proposed plan. So, it is not 100% an apples-to-apples comparison. For instance, today the top capital gains rate begins at $501,601, and Biden's top starts at $1 Million.

> *Biden's proposal would raise the top federal rate on long-term capital gains and qualified dividends to 39.6%, from 20%, for taxpayers with annual income over $1 million.*
>
> *(Under current law, a 3.8% net investment income tax also applies to taxpayers with more than $200,000 of income and married couples with more than $250,000. Most states also impose a separate tax on capital gains and dividends — the average top state rate is 5.2%, according to the Tax Foundation.)*
>
> *Combined, that yields a top rate of 48.6%.*

As I have been researching on the impact of Biden's tax changes, one of the most interesting things I found was a graphic showing how the proposed tax changes would impact each state, then even more detailed each district (Figure5). If you want to interact with the graphic, you can here. This tool allows you to select or unselect the different tax provisions like limiting 1031 exchanges to a $500,000 gain or expanding the American Rescue Plan etc.

From the research we have done it seems that there are two things I ultimately want to share. First, the headlines you are reading make the proposed taxes seem worse than they truly are. This is because some of the tax brackets will be shifting from where they are now to a higher income amount, e.g. the top capital gains tax. Second, there are rumblings that the Biden Administration has used higher numbers in their proposals as a negotiation tactic. They originally proposed a 48.6% tax in hopes that when they get to a 33.2% tax bracket it seems like a win to the opposition because they got them down nearly 15%.

My conclusion is that the tax plan is not as bad as some of the media are making it sound, but I still do not like it.

Section III: Around the MWA Office

Where do I begin? First of all, thank you guys for the great references! In our last quarterly update, I mentioned that we were going to be hiring a new employee and multiple people reached out with great references. We ended up hiring Christi Barnes. Christi spent 15+ years at Fidelity and brings a ton of knowledge to the firm and will help us in our client service as a Client Service Specialist.

Next, due to his hard work and feedback from clients, we have promoted Matt from a Senior Associate Advisor to a Financial Advisor. We are excited about his work and loyalty; cannot believe he has been here for 4 years now!

Matt's promotion creates a hole in our associate advisor department. So, if you know anyone who is going to school to be a financial advisor or who is young in the career and working toward their CFP, let us know. We hope to hire two new associate advisors this year.

Amid all of this shuffle, Jim was offered an opportunity that he felt could not turn down in Fort Worth. He is a great man and advisor and will be missed by clients and the office alike. In the short run, his duties will be shared between Mike, Matt and Stephen. However, in the long run this will bring more balance to our office structure and will catapult us forward as we continue to grow. As always, you, our clients, are our biggest focus and we are committed to providing great service and customized advice. We feel the changes we are making are going to help us better accomplish that mission.

Thank you for all you have done to help us grow!

Section IV: Videos, Podcast, & Recommended Reading

- Interactive Tax Graphic: https://taxfoundation.org/biden-tax-plan-impact-state/
- Estimates on Taxes: https://www.taxpolicycenter.org/model-estimates/tax-provisions-administrations-fy2022-budget-proposal-june-2021/t21-0061-tax

Sources:
1. https://taxfoundation.org/biden-tax-plan-impact-state/
2. https://taxfoundation.org/biden-budget-proposals/
3. https://www.cnbc.com/2021/06/09/biden-tax-plan-would-raise-taxes-by-213000-next-year-on-wealthiest-americans-says-analysis.html
4. https://www.taxpolicycenter.org/model-estimates/tax-provisions-administrations-fy2022-budget-proposal-june-2021/t21-0061-tax
5. https://www.cnbc.com/2021/06/21/biden-tax-plan-raises-top-capital-gains-dividend-tax-rate-to-among-highest-in-world.html

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