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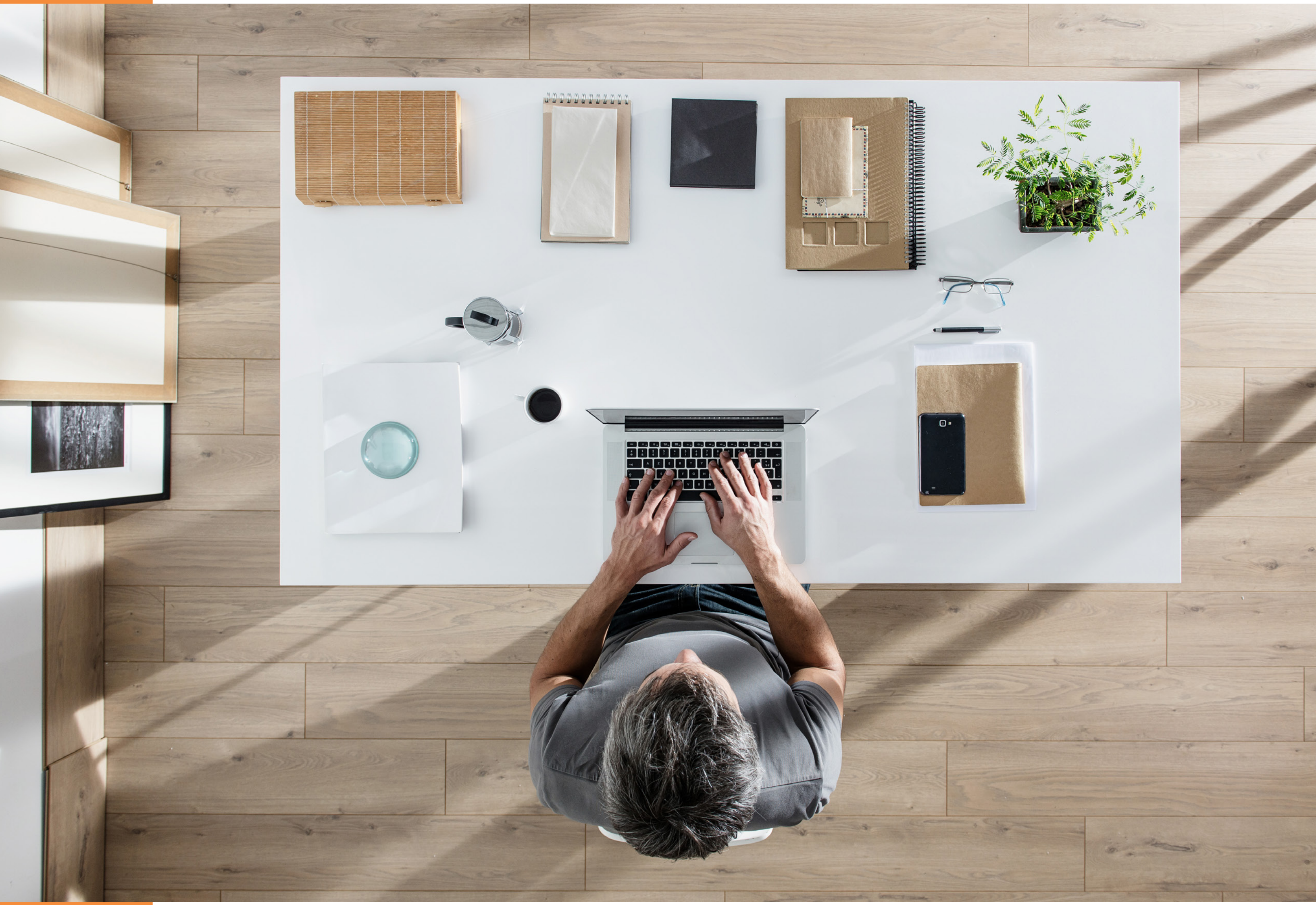
Wealth Management



Three Powerful Optimization Strategies in the Time of COVID-19

The COVID-19 pandemic has many of us thinking about, and prioritizing, our health and wellness.

The volatility in the stock market and skyrocketing unemployment rate have also affected the status of our wealth and income. And while this is an unsettling period financially, it does present opportunities to optimize various areas of our broader financial plans.

As you can imagine, we've had many conversations with our clients, family, and friends during the pandemic. Based on these conversations I've outlined three impactful investment, tax and employment compensation strategies, with the goal of putting our clients in a better overall financial position.

Strategy #1: Refine equity portfolio investments, as we recover from the COVID-19 pandemic and the econoour undergoes significant changes (e.g. work from home).

During times like these, it is wise to review portfolio allocations and holdings as most portfolios were designed during the bull market prior to the coronavirus pandemic. Exposure to certain asset classes, stocks and industries, which may have been prudent investments at the beginning of the year, may no longer be optimal investments.

- For instance, from January 1, 2020 through March 26, 2020, consumer staple stocks (-19%) performed relatively well compared to other industries.

However, after considering secular changes (for example, the need to work from home) along with historical trends, we see that the stocks that perform relatively well during a bear market often under-perform during a recovery. In fact, the stocks that perform the worst during a bear market, often perform the best during a recovery.

3-month returns following trough of S&P 500 20% drawdowns

Market trough	S&P 500	Sector excess return vs. S&P 500 (percentage points)									
		Info Tech	Materials	Industr	Cons Discret	Financials	Comm Services	Health Care	Energy	Utilities	Cons Staples
Aug-82	39%	5	2	8	15	20	(6)	(6)	(12)	(20)	(3)
Dec-87	20	(3)	3	2	8	(1)	(6)	2	1	(11)	(2)
Oct-90	8	7	1	2	2	10	(6)	0	(10)	(2)	4
Aug-98	22	13	(6)	(4)	(4)	0	3	0	(6)	(16)	(1)
Oct-02	20	22	4	(1)	(6)	7	13	(12)	(11)	16	(18)
Mar-09	40	5	12	17	12	60	(5)	(23)	(10)	(19)	(17)
Oct-11	17	(4)	5	6	0	2	3	(2)	9	(8)	(5)
Dec-18	20	7	(4)	3	4	(5)	1	(7)	4	(5)	(4)
Average	23%	7	2	4	4	12	0	(6)	(5)	(8)	(6)
Median	20	6	2	2	3	5	(2)	(4)	(8)	(10)	(4)
Hit rate		75%	75%	75%	75%	63%	50%	38%	38%	13%	13%

Source: Bloomberg, Goldman Sachs. Data as of 05/05/2020

With this in mind, the chart below outlines themes and subsectors suggested to own at the three different phases of the COVID-19-induced bear market. It reinforces the importance of reviewing and potentially refining your portfolio on the path to economic recovery.

Phase 1: Disease Path Uncertainty & Recession Fears	Phase 2: Infection Rate Peaks; Sharp Rebound Off the Bottom	Phase 3: The New (Old?) Normal Secular Stagnation
Themes to Own:	**Themes to Own:**	**Themes to Own:**
Defense	"Junk Trade"	Secular Growth
Non-Cyclicals	The Most Beaten Down	Momentum
Cash	Fading Bankruptcy Risk	High Valuations
Subsectors to Own:	**Subsectors to Own:**	**Subsectors to Own:**
Staples Retailers	"Quick Turn on" Consumer	Cloud Infrastructure
Food Companies	Hotels, Restaurants, Leisure	Data Processors
Household Products	Autos & Components	Internet Retailers
Electric Utilities	Banks	Interactive Media/Gaming
Big Pharma	Energy Companies	Retail Consolidation Plays

Source: Bloomberg, Wolfe. Data as of 05/18/2020

Strategy #2: Take advantage of market volatility and historically low marginal tax rates to convert a Traditional IRA to a tax-free Roth IRA.

There are numerous benefits to a Roth IRA and the obvious benefit is tax-free growth and distributions for the owner.

Given tax law changes with the SECURE Act passed at the end of 2019, Roth IRAs are even more attractive for our clients who look to pass along their IRAs to their children (by helping them avoid higher taxes down the road).

There are two very compelling reasons to evaluate converting your Traditional IRA assets (where income is taxed when taken out) to a Roth IRA:

1. **Historically low income tax rates.** A conversion does mean you need to pay taxes today. However, when tax rates are historically low as they are now, it is often advantageous to pay taxes now, and benefit from tax-free growth and withdrawals in the future when tax rates may be much higher.
2. **IRA values are likely lower now than they were a few months ago.** By opting to pay the tax bill now on a smaller IRA value, the future price recovery and growth will go untaxed.

We guide clients to optimize a number of variables to develop our Roth conversion strategies – which can take multiple years.

For example, a critical aspect of this strategy is keeping clients in an optimal tax bracket. It is rare for clients to convert their entire Traditional IRA to a Roth IRA in the same year. The reason is the amount converted is considered to be current year income, and can increase marginal tax brackets.

Therefore, we recommend "filling the income bracket." To convert (to a Roth IRA) the difference between a client's pre-conversion Adjusted Gross Income ("AGI") and the maximum income amount for their current tax bracket. We repeat the process (fill the bracket) again next year, and so on.

This graph illustrates this process for a couple, claiming Married Filing Jointly status, and with an Adjustable Gross Income (prior to conversion) of $175,000.

Key Points:

- If your combined income is forecast to be $175,000, you will most likey fall into the 24% tax bracket.
- Therefore, it is optimal to convert up to $140,000 to stay in the optimal 24% tax bracket
  - $175k income + $140k conversion = $315k income (max for 24% tax bracket).
  - We call this "filling the bracket"
- Repeat "filling the bracket" over multiple tax years, until our optimal Roth to Traditional IRA balance is achieved.

Rate	Individuals	Married Filing Jointly
10%	Up to $9,525	Up to $19,050
12%	$9,526 to $38,700	$19,051 to $77,400
22%	$38,701 to $82,500	$77,401 to $165,000
24%	$82,501 to $157,500	$165,001 to $315,000
32%	$157,501 to $200,000	$315,001 to $400,000
35%	$200,001 to $500,000	$400,001 to $600,000
37%	Over $500,000	Over $600,000

Source: taxfoundation.org. For illustrative purposes only.

Strategy #3: "Lock in your lifestyle" with your concentrated stock positions.

We meet with a lot of successful individuals who have accumulated a significant amount of their wealth in a single stock position. This wealth in a single stock could be built a number of different ways:

1. An executive at a successful technology company who is compensated with a large number of restricted share units ("RSUs").
2. An investor who was passionate about a company's product, bought the stock and held onto it for years.

But regardless of how this wealth was accumulated, one of the most common and important recommendations we share with people we meet who have a material amount of their wealth in a single stock, is to "lock in your lifestyle."

This strategy is especially important during periods of elevated risk in the stock market. Many people I have spoken with, saw the value of their single stock drop 30 - 50% from the period of January 1, 2020 – March 26, 2020.

The concept of locking in your lifestyle is simple, yet critically important – especially now. The goals are two-fold:

- Significantly reduce the risk in holding a single stock.
- Diversify into a much lower risk portfolio, with enough growth and income, to support your lifestyle (your annual budget) for the duration of your life.

To tactically achieve this goal, we've been guiding clients to diversify enough (not all) of a single, concentrated position, to a much lower-risk, balanced portfolio (including stocks and bonds, U.S. and international stocks) over a defined yet flexible time period.

The key to this process is optimizing a number of variables as we implement the strategy.

- For instance, we always try and execute in a "tax-aware" fashion (being mindful of capital gains taxes, net investment income taxes and other potential tax implications.)
- Additionally, we look to diversify more of a single stock, when the data tells us the price is relatively high. And conversely, less when the evidence tells us the stock is undervalued.

For more on the process and optimization strategies, here's a white paper we wrote on the subject: 4 Critical Factors in Managing Concentrated Stock

If you found these strategies helpful, would like to learn more, or if you have questions about your own personal situation, please contact us to discuss further.

Helping you embrace life's transitions.

Since 2004, BakerAvenue has guided clients through personal and professional life transitions. Our firm provides comprehensive wealth management and investment expertise for high-net-worth individuals, families, trusts, and foundations. Driven by our purpose, we strive to make a positive impact on society alongside financial return. We're headquartered in San Francisco with offices in New York and Dallas.

For more information, please contact us at 415.986.1110 or visit us at bakerave.com.

Disclosures