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A Ten-Year Lesson

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Ten years ago—on March 9, 2009 to be precise—the U.S. stock market hit its bottom in the fallout of the Financial Crisis of 2008. The S&P 500 closed at 676.53 that day, down nearly 57% from its all-time high established exactly 17 months prior.

Though it may seem like a distant memory today, the crisis and subsequent recession destroyed nearly nine million jobs in the U.S. and over $34 trillion of global net worth, calling into question the long-term sustainability of capitalism itself. [1]

Albert Einstein once said, "Failure is success in progress". Recognizing the ten-year anniversary of the crisis offers an opportunity to reflect and learn from our behaviors in tough situations. Ignoring this opportunity to reflect on the past is to eliminate the best method of learning. History suggests markets recover 100% of the time. Unfortunately, many investors do not.

The constant drumbeat of sensationalized news during times of market volatility is easy to get caught up in and allow to fuel emotions. Do you remember how you felt as an investor during this time and how it affected your thinking?

Through just the first ten weeks of 2009, the market was down over 25% and down 45% over the previous six months. The so-called smart money went to cash in late 2008 and early 2009, and for a few weeks—perhaps even months—they were right. However, at year-end 2009 the market was up 65% from the March 9 low and up 24% for the full year. Moreover, in the ten years since that low point, the market has quadrupled, producing an average annual return of nearly 18% during what has come to be the longest bull market in U.S. history. Those that took a longer-term view during the crisis would turn out to be the ones with the smart money after all.

So how did you feel as investor in late 2008 and early 2009? Did you make emotional decisions in times of stress? Did you add to your investments when market multiples hit record lows, did you panic and sell, or did you sit still? While nobody can consistently predict short-term markets, everyone should be able to better understand their behavioral tendencies in times of stress.

Having a clear financial plan while maintaining a journal that documents your emotional state when investing is one way investors can avoid short-sighted mistakes. Write down your feelings and reasoning as you make investment changes. Doing so allows

IN THIS EDITION

Paying for College? Two Ways to Lower Your Taxes

Which is better, the American Opportunity Tax Credit or the Lifetime Learning Credit? They are both on the same IRS form. However, you cannot take both of them for the same dependent student in the same tax year, so you will need to choose.

If you are eligible for the American Opportunity Tax Credit, take that one. It offers the greatest benefit, but it's only available for four years of undergraduate tuition for each eligible student (subject to income thresholds).

Here are the salient points of each credit.

American Opportunity Tax Credit

Type: Partially refundable credit
Used for: First four years of qualified education expenses for an undergraduate degree or other recognized education credential

You can get a maximum annual credit of $2,500 per eligible student. It works like this: Carve out $4,000 of tuition and textbook expenses each year that will be paid for with cash or loans (money withdrawn from tax-advantaged college savings accounts is not eligible). The AOTC yields a dollar-for-dollar tax credit based on the first $2,000 of tuition and textbook expenses, then $0.25 on the dollar for the next $2,000.

If the credit brings the amount of tax you owe to zero, you can receive 40% of any remaining amount of the credit (up to $1,000) as a refund.

The credit isn't available to everyone: Qualified taxpayers with modified adjusted gross incomes of $80,000 or less (or $160,000 or less for joint filers) qualify for the full credit. Taxpayers earning more than this may qualify for a partial credit, but a taxpayer whose modified adjusted gross income is greater than $90,000 ($180,000 for joint filers) cannot claim the credit.

The American Opportunity Tax Credit includes expenses for course-related books, supplies, and equipment, but room and board is not a qualified expense. Payments made in 2018 for academic periods beginning in 2018 or during the first three months of 2019 are eligible.

Each eligible student can claim this tax credit only four times (for each of the four years of postsecondary education). It cannot be taken by the same student in the same year that the Lifetime Learning Credit is taken.

Lifetime Learning Credit

Type: Nonrefundable Credit
Used for: Qualified education expenses of undergraduates who do not qualify for the American Opportunity Tax Credit; graduate programs; courses taken to maintain or improve job skills

If you are enrolled in school at least part time, you may be able to claim a Lifetime Learning Credit of up to $2,000 for qualified education expenses paid. It works like this: the maximum amount of covered expenses is 20% of up to $10,000 of qualified education expenses (no matter how many eligible students are in your household). As with the American Opportunity Tax Credit, expenses paid from a 529 account withdrawal are not eligible, as you can't use the same qualified higher-education expenses to justify two education tax benefits. Your modified adjusted gross income must be lower than $130,000 if married filling jointly; $65,000 for other taxpayers.

Qualified expenses are tuition and fees required for enrollment or attendance (including amounts required to be paid to the institution for course-related books, supplies, and equipment). Payments made in 2018 for academic periods beginning in 2018 or during the first three months of 2019 are eligible.

This credit is available for a unlimited number of tax years, but it cannot be taken by the same student in the same year that the American Opportunity Credit is taken. ■

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you to reflect on your judgement over time and evaluate your decisions. Having that insight further allows you to ensure your risk profile is appropriate and holds up through rising and falling markets.

Investors can also learn through experiences and avoid emotional decisions by relying on a coach or advisor. Removing emotions often requires an educated, objective professional that can address questions and prioritize what is most important for personal decision making.

Among his many noteworthy quotes on investing, is Warren Buffet's comment that "The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd." Bear this in mind as you reflect on what occurred a decade ago and how you responded. It just might improve your investment success in the future. ■

1. Roosevelt Institute, The Crisis of Wealth Destruction, April 7, 2010; Center on Budget and Policy Priorities: Chart Book: The Legacy of the Great Recession.

Like-Kind Exchanges: What's Old is New Again

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When President Trump signed The Tax Cuts and Jobs Act into law on December 22, 2017, the real estate community breathed a collective sigh of relief—Internal Revenue Code Section 1031 was preserved for exchanges of real estate.

Long before the introduction of Paul Ryan's "A Better Way" on Tax Reform in June of 2016, IRC Section 1031 was in the crosshairs of Congressional lawmakers intent on enacting comprehensive tax reform that was simpler, fairer, and more efficient. With a lot of hard work (and a little bit of luck) a broad coalition of stakeholders successfully conveyed the message, on the Hill and elsewhere, that Section 1031 is a powerful capital formation tool and an incredible economic stimulator.

IRC Section 1031 allows an owner of real estate that is held primarily for investment, or for use in a trade or business, to exchange that property, in a tax-deferred manner, provided the owner meets specific regulatory and statutory requirements.

First, the properties must not be personal use property or property held primarily for sale. In some instances, property that has some personal use—like a vacation home—may be eligible for tax-deferred treatment if the personal use is minimal (see Rev. Proc. 2008-16). Second, the properties must be like-kind to each other. In the real estate universe, all real property is like-kind to all other real property. Industrial property can be exchanged for multi-family property; office buildings can be exchanged for strip centers or even vacant land. Third, the transaction must be structured as an exchange of one property for another, as distinguished from a sale followed by a re-investment. If you close on the sale of your manufacturing facility, retail shopping center or multi-family property and simply walk away with the proceeds, you will have a taxable sale and not a like-kind exchange, despite your best intentions.

Engaging the services of a Qualified Intermediary (QI) is crucial to ensuring your transaction is structured correctly. The QI will provide documentation and guidance throughout the process to ensure you meet the safe harbor requirements for a tax-deferred transaction. Specifically, replacement property must be formally identified within 45 days from the date the old property is sold. Additionally, replacement property must be acquired within 180 days from the date the old property is sold. There are no extensions or exceptions to these statutory rules.

IRC Section 1031 allows an owner of real estate that is held primarily for investment, or for use in a trade or business, to exchange that property, in a tax-deferred manner, provided the owner meets specific regulatory and statutory requirements.

Section 1031 is indeed a powerful wealth preservation tool. Many families build their fortunes on investment real estate. As an asset class, real estate is also great for risk diversification as well as for providing current income. Doing a tax-deferred exchange enables investors to continuously trade up in value and grow their portfolio of assets. For older investors looking to get out of active real estate management, there are plenty of passive real estate investment opportunities in the form of Delaware Statutory Trust interests or syndicated tenancy in common interests, that qualify as like-kind property for purposes of Section 1031.

Investors can continue to exchange properties, rolling the gain from one piece of investment property into the next, and deferring the gain recognition until property is finally sold in a taxable transaction. Finally, no matter what an investor's tax basis is in the property at the time of death, heirs who inherit property receive a stepped-up basis, resulting in elimination of taxable gains. ■

Spring 2019 Economic Outlook

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Written February 27, 2019

The ferocity with which global equity markets declined in the fourth quarter, and in particular in December, is only explained clearly with hindsight. It should come as no surprise that very few equity investors foresaw such a quick and violent downturn. After all, economic conditions, at least in the U.S., appear to be rather benign.

To better understand, an examination of market fundamentalists is in order. Interest rates remain historically low, and the U.S. economy is in rather healthy shape. GDP grew at more than 3% in the first nine months of the year, and is expected to have grown somewhere between 2.5% and 3% in the fourth quarter. Inflation appears to be well under control, though some manufacturers report modest inflationary pressures in input prices. Lastly, employment is also quite healthy, with joblessness below 4%, wages finally growing a bit better than the 2%-2.5% rate of the last several years, and many companies finding it difficult to fill certain skilled positions. In fact, on January 4th, the Labor Department reported a very strong nonfarm payroll number for December; perhaps more important, average hourly earnings rose 3.2% over last year.

However, trouble has brewing for the last several months, and a deeper dive exposes storm clouds that have gathered on the horizon. Global economies showed signs of weakening throughout much of 2018, most notably in China. Despite the strong December payroll report, a widely-followed report earlier this week from the Institute for Supply Management (ISM) suggested manufacturing orders fell precipitously in December, with the index showing its largest one-month decline in the last ten years. Further analysis suggests recent strength in GDP may have been a product of businesses building inventories in front of expected tariff increases—a one-time impact that does not portend future growth. In addition, the "sugar high" the U.S. economy enjoyed as a result of the tax cut has about run its course, having had only a minor effect on capital investment. The looming threat of a "trade war" with China and potentially other U.S. trading partners has caused their economies to slow over the last several months. Increasingly, both fixed income and equity investors are concerned with the impact of the U.S. Treasury coming to market in 2019 to fund government deficits that will approach or exceed $1 trillion. The tax cut provided a fiscal boost to an economy but was done at cross-purposes with the Federal Reserve's efforts to tighten monetary policy.

Despite these storm clouds, we continue to have a lot of confidence in the U.S. economy, and its ability to quickly adapt to changing circumstances, be they in monetary policy, trade policy, or global economic weakness. ■

ESTIMATED ECONOMIC VARIABLES AND INTEREST RATES

	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Real GDP	1.90%	2.00	2.50	1.90	1.90
Consumer Price Index	2.20%	1.80	1.90	2.20	2.30
3-month Treasury Bill	2.81%	2.72	2.81	2.95	2.99
10-year Treasury Note	2.69%	2.82	2.91	3.03	3.08
Unemployment	3.80%	3.80	3.70	3.60	3.60

Source: Bloomberg

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