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LATEST ARTICLES

Honey, I Think We Shrunk the Supply of Stocks

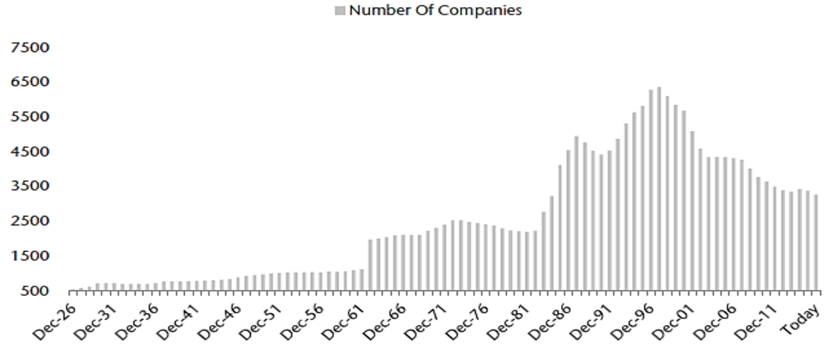
John Micklitsch, CFA, CAIA

Chief Investment Officer

In the past**,** we have written about the concept of competition for capital as a fundamental driver of asset class returns. Absolute valuation, relative valuation, growth outlooks and specific catalysts all play a role in how attractive one asset class is versus another. Over the past several years, low interest rates have created conditions whereby the yields on traditionally conservative investments such as cash equivalents and fixed income have forced investors into riskier asset classes, such as stocks, in search of required returns. Steadily improving economic conditions off the financial crisis bottom have also contributed to investor's confidence in equities and helped grease the market's wheels.

However, there is another phenomenon at play that could be propelling equities and it is as old as economics itself, the law of supply and demand. According to a 2016 research report by Steven DeSanctis of Jefferies and Company, the number of stocks in the commonly cited University of Chicago Center for Research (CRSP) database has steadily shrunk from a high of roughly 6,500 back in 1996 to less than 3,500 by the end of 2016.

Chart 1: Number of stocks in CRSP data lowest since 1984.



Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies.

Stock buybacks and merger activity (both fueled by low borrowing costs) have reduced inventory. In addition, increased public company scrutiny and higher regulatory burdens have resulted in a lack of initial public offerings (IPOs). In fact, according to a report by Michael Mauboussin of Credit Suisse, “The propensity to list is now roughly one-half of what it was 20 years ago”. Not surprisingly, according to CB Insights, the number of venture capital backed private companies in the world valued at over $1 billion (called unicorns) has risen to 216, with a cumulative valuation of $754 billion. How many interviews of these companies have you watched where the founder asked the interviewer, “Why would I want to go public?”. All of this has occurred at a time when demand from investors for equities is high. The result has been a steady underpinning of strong demand and limited supply which at least partially explains the lack of volatility and the quick buying of the market’s dips.

The point in all of this is that investors are flooded with complicated, minute by minute theories about why markets are doing this or that. On a day to day basis if you pay too much attention to all of the noise, you can miss the forest through the trees. It is helpful, therefore, when reviewing your investments to revisit the basics from time to time and there is nothing more basic in economics and asset price movement than supply and demand.

John Micklitsch, CFA, CAIA, Chief Investment Officer.

Meet the New (FED) Boss, Same as the Old Boss?

Jim Bernard, CFA

Managing Director, Fixed Income

Recently FED governor Jerome Powell was nominated to replace Janet Yellen as Chairman of the FED, effective in February 2018. The choice of Governor Powell from a short list of six or more candidates was not considered surprising or controversial. Mr. Powell has been a FED governor since 2012 and has a voting record very similar to Chairperson Yellen throughout the last five years and his statements and remarks were almost always in line with the majority opinion.

The one difference in this nomination is the background of the candidate. Almost all previous FED chairmen have had PHD's in economics and came either from a long career as a central banker or from academia. Mr. Powell’s background is in private equity and as an investment banker. The only previous FED chairman to come out of the business community was G. William Miller, who became Chairperson of the FED under Jimmy Carter in the late 1970's. His chairmanship, which lasted just over one year, is considered a disaster as he believed in promoting economic growth with little regard for inflation concerns. His disregard for the second rail of the FED’s dual mandate lead to runaway inflationary pressures in the late 70’s and he was ultimately replaced by New York FED chair Paul Volker, who ultimately is considered by many the most effective and aggressive FED leader in history.

Many believe with Governor Powell's business and Wall Street background that FED policy may have a greater appreciation of the role capital markets play in shaping future FED policy. Whether this occurs or not in general most FED observers believe the differences in FED policy going forward will be minimal compared to the current FED leadership. A final point on this subject is the fact that in addition to Governor Powell’s Chairperson nomination, there are likely to be up to three new governor appointments over the next twelve months that could further influence policy. So stay tuned for future developments with these pending changes.

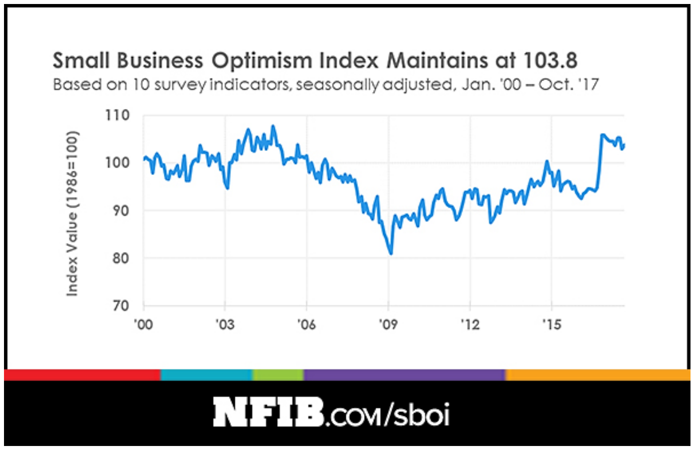
Jim Bernard, CFA, Managing Director, Fixed Income

Small Business Equals Big (Stock Market) Impact

David Sowerby, CFA

Managing Director, Portfolio Manager

One of the best gauges of the improvement in business conditions in the last twelve months has been the sharp rise in small business owner’s optimism. Specifically, the National Federation of Independent Business (NFIB) small business optimism index surged post the November 2016 election and has stayed strong in 2017, up 9% from year ago levels. The index has a history back to 1973 and the gains of the last year are among the strongest since the mid-1980s.



For our Ancora clients who are business owners, our anecdotal evidence is confirming the NFIB measures. Business conditions are generally quite healthy and more companies are reporting that they are positive on economic prospects; that it is a better time to expand; and while they are looking to hire, it is more difficult to find qualified applicants. They are also citing that regulation is less of a problem than year ago levels.

We cite the small business optimism index because we can see a correlating gain in small-cap and micro-cap stock portfolios, which we manage. Since the November 2016 election, some of the best gains in the stock market have come from the small-cap and micro-cap stock indexes. In the twelve-month period immediately following the 2016 election, the Russell 2000 and Russell Micro-Cap stock indexes were up 25% and 27% respectively. The S&P 500 was up 23%. This is in part due to the improvement in business conditions, which can have a more pronounced impact on more economically sensitive smaller publicly traded companies. The gains have also reflected improved expectations of regulatory relief and potential tax reform.

Indeed, it is especially interesting to watch the price return patterns of micro-cap stocks and the corresponding rise in animal spirits among business owners. When the expectations for regulatory relief or tax reform have improved, it has been accompanied by larger outsized gains in micro-cap stocks vis-a-vis the larger company stock indexes. Encouragingly, the internal Ancora strategies have outperformed since the November 2016 election.

There are multiple factors which contribute to favorable returns for small and micro-cap stocks over the long term, including faster sales and profit growth, and an earlier stage in a company's life cycle. This has prompted total portfolio solutions to have an allocation to these asset classes. In the more recent period, the gains in small business optimism, and improved animal spirits, have been matched directionally by the gains for these small and micro-cap stocks, with the market proving its reliability as a long-term voting machine.

David Sowerby, CFA, Managing Director, Portfolio Manager.

Making Lemonade from Lemons

Using Business Losses to Offset a Roth IRA Conversion

Howard Essner, JD

General Counsel, Managing Director, Family Wealth Advisor

From time to time, we come across a client who has incurred business losses as a sole proprietor or through pass-through entities, such as an LLC or S-Corp. If the client is actively involved in the business, such losses can be used to offset other taxable income, such as wages, investment income, pension distributions, etc. Occasionally, the losses are large enough to wipe out the client's entire taxable income with excess losses carried over to the next year (or carried back). While such losses are unfortunate, they can create an opportunity to do a "tax-free" Roth IRA conversion.

What is a Roth conversion? A Roth conversion is simply the transfer of assets from a Traditional IRA to a new or existing Roth IRA. The amount transferred (i.e., converted) is treated as a taxable distribution from the Traditional IRA and therefore subject to tax as ordinary income. In the situation described above, the operating business losses exceeding the client's other taxable income can be used to offset the taxable income created by the Roth conversion, resulting in a potentially "tax-free" conversion. In the right circumstances, this tactic can create significant future tax savings for the client.

Why consider a Roth conversion? A Roth IRA allows tax-free withdrawals on contributions *plus* gains, as long as certain age and holding period requirements are met. (Contributions to the Roth can always be withdrawn tax-free at any time). When a client holds both Traditional and Roth IRAs, distributions from the two sources can be managed to optimize the client's marginal tax rate. Moreover, Roth IRAs are not subject to the Required Minimum Distribution (RMD) rules applicable to Traditional IRAs. If the client does not need the Roth IRA assets to support living expenses, then he or she can leave the Roth IRA intact, providing a wonderful tax-free legacy to his or her family. (As a side note, clients who are subject to the federal estate tax might consider a Roth conversion even without offsetting business losses.)

Clients are also allowed a "second bite at the apple" when converting to a Roth IRA if they change their mind. A Roth conversion can be undone at any time up to the due date of the tax return associated with the year in which the conversion took place (October 15, if an extension is filed.) Thus, if the client's tax situation in the following year has changed, the Roth conversion can be undone, and the excess business operating losses applied to the next year's income.

It is important to note that the business losses discussed in this article must be from a business in which the client actively participates. Passive activity losses (losses from business in which the client does not actively participate) can only be used to offset passive activity income or gains and cannot offset other income, such as from the Roth conversion. Likewise, capital losses (losses from the sale of an asset such as stock, real estate, equipment or a business) must first be used to offset capital gains. While $3,000 of capital losses can be used to offset other income, this provides little opportunity for a Roth conversion.

Please contact your Ancora advisor for more information.

Additional Note: A Year-End Charitable Giving Strategy

If you are considering year-end charitable gifts, have a Traditional IRA, are over age 70 ½, and have not yet taken this year's RMD, you should consider using your IRA to make these contributions. Doing so can provide significant tax savings in the right circumstances. Please contact your Ancora advisor for more information.

Howard Essner, JD, General Counsel, Managing Director, Family Wealth Advisor

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