# The Ancora Advisory

An Investment Publication for Clients and Friends

*Ancora Holdings Inc. consists of three business units; Family Wealth, Asset Management and Retirement Plans. With top-tier portfolio managers, unique investment strategies and an entrepreneurial spirit, Ancora delivers tailored solutions so you can achieve more ... on your terms.*

## Focus on the Long Term - But Why?

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We've all heard the investment saying, "focus on the long-term," and in uncertain times like these with COVID-19, the upcoming election, trade conflicts etc., you tend to hear it a lot. But have you ever stopped to truly dissect why this has been a winning formula for investors for so long? In our opinion, it comes down to the long-term economic growth trend built on the two pillars of innovation and incentives. These two building-blocks provide a long-term, upward economic lift that financial market participants benefit from over time. Markets may periodically get ahead or behind themselves based on short-term factors, but over the long term, these are two very important drivers of economic growth, and therefore investment returns, so are worth taking a closer look.

### Virtuous Growth Cycle Pillar #1: Innovation

The first pillar of the virtuous growth cycle is innovation. We currently live in a golden era for technology, or so it seems. But innovation, in one shape or form has been around for a long time. The invention of the wheel, which now seems amusingly simple, was an enormous technological leap at the time. The same could be said for roads, ships, navigation, the steam engine, the cotton gin, the automobile, flight, the printing press, penicillin, air conditioning, the semi-conductor, global positioning satellites (GPS), cellular communications, software, the Internet and now cloud based computing to name (a bit more than) a few! Each of these breakthroughs acted like a gust of wind on the economic flywheel that led to a new cycle of economic growth and a higher plateau than before.

The flywheel starts spinning because innovation leads to an increase in productivity which in turn reduces unit costs, lower unit costs increase demand, increased demand creates jobs, more employment increase incomes. Increased incomes lead to population growth due to household formation. Household formation leads to buying "stuff" and when you acquire some "stuff" you want more "stuff" (acknowledgement to the great comedian, George Carlin, on the concept of "stuff"). The desire for more "stuff" brings us back to the beginning of the growth cycle as we seek new ways in our industries, jobs and careers to earn additional compensation through

solving problems and delivering new solutions. This virtuous cycle of activity, driven by innovation, is a major reason why economies grow over time. Financial markets then ride that upward economic wave, albeit with some fits and starts and winners and losers along the way.

**Virtuous Growth Cycle Pillar #2: Incentives**

The second pillar of the virtuous growth cycle is incentives. Capitalism, in its simplest form, is a system that is designed to reward people proportionately for their contributions to innovation and the value it creates. Rewards can take many forms, but for many, reward for innovating is associated with wealth. That certainly seems to be the case when you look at the great fortunes amassed by innovators such as Henry Ford, Bill Gates, Jeff Bezos and now Elon Musk. Companies and individuals that innovate are rewarded with financial gains and society benefits from the innovation. It's a very symbiotic, but delicate, relationship. However, innovation requires taking risk and therefore needs an incentive system designed to make taking risks worth it. There is a fine balance in maintaining both sides of the incentive debate, how much is enough, but we tend to know it when a line has been crossed and incentives are out of line in either direction.

In closing, the beauty of having a vibrant economy built on innovation and proper incentives is that, as investors, we can prosper from identifying innovative individuals, companies and economies. We don't have to be the ones doing the innovating in order to benefit, but we do have to be able to spot innovation, evaluate it, value it and ultimately allocate our capital to it. It should be noted that innovation does not just refer to companies and opportunities in the information technology sector. Every investable industry has leaders who command attention as a result of the innovation and solutions they deliver to their customers.

So, the next time we say, or you read, something that encourages you to focus on the long-term, think about the economic snowball built on innovation and incentives. Recognizing that, as a result of these two pillars, the economy is not finite, can help you remain focused on the long-term and steer your portfolio towards greater odds of long-term success. ◊

## Federal Reserve Policy: Let it Run Hot

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To maintain heightened liquidity in the financial system and aid in the economic recovery, the Federal Reserve recently announced that it will modify its long-standing 2% target inflation policy. Every so often a philosophical shift in policy has enduring ramifications and we believe this is one such occasion.

In the past, the Federal Reserve has targeted maintaining an inflation rate of 2%, raising and lowering interest rates as needed to keep the inflation rate as close to that target as possible. As inflation began to approach 2%, the Federal Reserve would begin to raise interest rates to try to prevent inflation from running above 2%. As inflation fell below 2%, rates would be cut to try to bring inflation back up towards 2%. In the new framework, the Federal Reserve announced it will now allow inflation to "run hot", or run above 2% for an extended period of time provided the average remains close to 2% before beginning to raise rates. The new policy specifically states that it:

> *"seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." -Federal Reserve Statement on Longer-Run Goals and Monetary Policy Strategy amended effective August 27, 2020*

This shift in policy now means that the Federal Reserve will allow inflation to be +/- 2%, for an average of 2% overtime. Why is this change important? With this change, the Federal Reserve has essentially committed to keeping short-term interest rates as low as possible for as long as possible, possibly for several years at the current projected inflation rates. The Federal Reserve's preferred inflation measure, the Personal Consumption Expenditure (PCE), has rarely been above 2% over the past 10 years, averaging just 1.60% over that time period. Even going back 20 years, the PCE was only above 2.20% for periods of time from 2006 to 2008, and

averaged 1.72% over the full period. Based on the new framework of an average of 2% over time, the Federal Reserve may not have raised rates at all from late 2016 through late 2018, despite the low unemployment rates the economy was experiencing.

In closing, with the Federal Reserve expected to keep rates lower for longer under this new policy, investors in risk assets could continue to see valuation support from low interest rates over an extended period of time. Strategic income investments, such as preferred stocks, along with dividend paying equities could also be attractive options for investors seeking income replacement in this environment, albeit with more potential volatility exposure than from traditional fixed income securities alone. For those seeking additional protection from inflation, a carefully constructed investment in commodities could also be considered. ◊

## Making a Difference with Planned Giving

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Philanthropy and giving back in terms of time, talent and treasure to organizations we are passionate about is an integral part of many of our lives. This support, no matter the size, helps these organizations continue to successfully serve their mission in the world. Generally, lifetime gifts allow for income tax deductions and the ability to gift appreciated assets with no associated tax. While lifetime giving is prevalent, it does need to be balanced with recognizing these tax benefits and tracking your own income needs or those of dependents during life.

In light of these considerations, another option is setting up philanthropic gifts through estate planning. Planned gifts allow for your charitable gifts to be celebrated and counted on during your life, however, the actual gift likely will not fully transfer until after your lifetime. This is an attractive strategy because there will be little or no change to your liquidity, many of these gifts are non-binding and oftentimes allow for larger gifts than those made during life. Planned giving allows donors to create a lasting legacy while still capturing great tax advantages.

There are various options when it comes to making a planned gift. Some of the most common vehicles are:

**Bequests**

The majority of planned gifts are made as bequests through the donor's will. A will could leave the charitable organization a set dollar amount, a percentage of the estate or even the entire remainder of the estate.

**Trusts**

The charitable organization can be the beneficiary of a simple revocable or irrevocable trust. Additionally, there are other trust strategies such as Charitable Lead Trusts and Charitable Remainder Trusts that can benefit you, your family and the organization. Both of those vehicles remove assets from your taxable estate and create income streams for set time periods prior to the account transferring completely.

**Beneficiary Designations**

For qualified retirement plans and life insurance policies you are able to name a charitable organization as a beneficiary to the account. If married, in some cases, you will need written consent from your spouse if not naming them as the beneficiary. That said, the gift of these assets at death would pass directly to the organization and allow for an estate tax deduction. Even better, the organization receives the assets tax-free. During your lifetime, you can also take advantage of Qualified Charitable IRA Distributions, which allow you to gift up to $100,000 annually to charity. The gift is income tax free and can count toward your required minimum distribution.

**Charitable Gift Annuities**

This is a contract between a donor and charitable organization where the donor makes a gift and in exchange the organization agrees to provide the donor a fixed monthly income for life. This is considered a "split gift" where some will go to immediate work

and the rest will sit in reserve to provide income until after death when the remainder then goes outright to the organization. The gift allows for an immediate partial tax deduction and provides lifetime income for up to two beneficiaries. Monthly income paid back to beneficiaries will be treated as either a return of capital or be subject to federal and state income tax.

There are many options when choosing how to make a planned gift. It is important to consider the types of assets you have, which of those you wish to gift and the financial goals for you and your family. The end result should be a charitable plan that meets the needs of your family and still provides maximum impact to the organizations you love. Ancora's financial planning team is here to help with any of your philanthropic planning needs. ◊

## Is There a GRAT in Your Future?

Howard Essner, JD
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In recent months, the number of conversations that we are having with clients about federal gift and estate taxes has increased dramatically. These discussions had largely disappeared after 2017 for most clients when the federal estate exemption was increased to more than $11 million per person from more than $5 million per person. Now that the sunset of this increase (at the end of 2025) is on the horizon, and with questions about the tax consequences of the upcoming election on people's minds, estate taxes and how to reduce them are now a more frequent topic of conversation. We talk about several different strategies with clients (most of which have 4-letter acronyms, by the way), but this article will cover one of our favorites, the Grantor Retained Annuity Trust, or GRAT, for short.

A GRAT is a simple concept with some very favorable gift tax consequences, especially in today's low interest rate environment. Here are the basics:

- A person (the Grantor) makes an irrevocable gift of assets to a trust that includes a provision that requires the trust to make an annual (or more frequent) payment of a specified amount back to the Grantor during the term of the trust. This is the "Retained Annuity" part of the trust.
- The GRAT will last a term of years, and at the end of the term, any assets remaining in the GRAT will be paid to the GRAT's beneficiaries, which are usually the Grantor's heirs or another trust for the benefit of those heirs.
- For gift tax purposes, the Grantor has made a gift equal to the value of the assets transferred to the GRAT, less the "present value" of the annual payments retained by the Grantor under the terms of the trust.
- This present value of the annuity stream is the lump sum amount, invested at an assumed interest rate, that would produce enough money over time to make the required annual payments with a zero balance at the end.

The annual payments can be set at any amount, but typically, the Grantor sets the annual payments so that the present value of these payments roughly equals the value of the assets transferred. In that case, the gift to the GRAT will have a near-zero value for gift tax purposes and as a result will use little or none of the Grantor's lifetime gift and estate exemption. We call this a "zeroed-out GRAT."

You may ask why anyone would make a gift that has no value. The answer is in the way the present value of the annuity payments is calculated. The assumed interest rate is set by the IRS monthly based on current rates. For August and September 2020, that rate is an astonishingly low 0.40%. If the assets in the GRAT earn a total return of more than 0.40% over the term of the trust, that excess return will pass to the heirs free and clear of any estate or gift tax.

Here's an example. The Grantor transfers $1,000,000 worth of stocks to a GRAT with a 5-year term. To "zero-out" the value of the gift, the annuity paid the Grantor is set at $202,405 per year. If the trust assets earn 6% a year, the GRAT will still hold $197,252 after the last payment is made. So, in this example, the Grantor has transferred nearly $200,000 to their heirs without using any lifetime exemption.

What can go wrong? Two things. First, if the Grantor does not survive until the end of the term, any assets in GRAT will be included in the Grantor's taxable estate. Second, if the GRAT assets do not perform, the annual payments might exhaust the GRAT before the end of the term. In both cases, the result is the same as if the Grantor did nothing (other than pay a lawyer to draft the documents).

A few other nuances to this strategy:

> A GRAT is not an income tax strategy. The GRAT is an ignored entity for income tax purposes and the taxable income of the GRAT will flow through to the Grantor's personal tax return. This is a good result because it increases the estate tax savings potential.
> It is possible, within limits, to backload the annuity payments to allow the assets more time to grow.
> A GRAT strategy can be highly effective when the Grantor funds the GRAT with closely held business assets with positive cash flows. In this case, additional leverage can be obtained through valuation discounts for gifts of minority and non-controlling interests.
> Often, Grantors will set up a series of GRATs with different terms, increasing the chances that one or more of the GRATs will have successful investment outcomes and increasing the chances that the Grantor will survive the term of one or more of the GRATs.
> We have also seen Grantors set up a series of GRATs each with its own specific investment strategy. For example, rather than holding a diversified basket of stocks in a single GRAT, each GRAT in the series holds stocks in a single sector. If one sector underperforms, that GRAT might implode, but the other GRATs would not be affected by the loss.

There is much more to discuss on this topic and we are happy to start a conversation about this or any other planning concept. ◊

As always, don't hesitate to contact your Ancora advisor or relationship team if you have any questions or would like to learn more about these topics. Visit our website at www.ancora.net to read past newsletters and find other news and insights from the investment professionals at Ancora.

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