ANCORA® FAMILY WEALTH ASSET MANAGEMENT RETIREMENT PLANS

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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 experienced portfolio managers, proprietary investment strategies and an entrepreneurial spirit, Ancora delivers tailored solutions so you can achieve more ... on your terms.

It's the Liquidity!

John Micklitsch, CFA, CAIA
Chief Investment Officer

With markets near all-time highs, we regularly get asked what on earth might be driving this. James Carville, the political strategist, famously declared, "it's the economy!" during the 1992 presidential election campaign. So, in the case of the current stock market, we'll say "it's the liquidity!"

To put the current liquidity backdrop into perspective, if the $1.0 trillion physical infrastructure bill is passed, the U.S. will have spent approximately $6.0 trillion fixing an estimated $2.0 trillion hit to the economy caused by the coronavirus pandemic. That's four trillion dollars of excess liquidity that is coursing through the economy currently. This doesn't even contemplate the additional $1-3 trillion potential spend on social infrastructure that could add additional trillions to that already high liquidity figure. For reference, the size of Japan's entire GDP is $4.9 trillion. Germany's GDP is $3.7 trillion, India's is $2.7 trillion, and the UK's is $2.6 trillion. In other words, when all is said and done, we may have spent the equivalent of two India-sized GDPs in economic stimulus terms.

However, that is not the only government policy response providing liquidity to the economy. The Federal Reserve has expanded the size of its balance sheet from roughly $4 trillion to approximately $8 trillion since the beginning of the pandemic. While this is not a direct injection of cash into consumers' hands, the expansion creates the conditions for very low interest rates, which reduces borrowing costs for consumers and companies and primes the banking system with copious amounts of liquidity, if needed. We've seen the impact of low interest rates on housing prices and the same pricing impact affects other assets such as stocks, commodities and, for that matter, bonds too, whose prices remain elevated, measured by their currently low yields. There is a saying that "every dollar must find a home somewhere," and with real returns on conservative investments mainly in negative territory, clearly many of the additional dollars are finding their way into capital appreciation-oriented assets.

To be clear, earnings are recovering, the consumer is in good shape, companies have access to capital and innovation is alive and

well, so what is the long-term cost of all this excess liquidity? The most likely outcome is that we are borrowing returns and economic growth from the future to ease the situation today. Today's resulting high starting valuations, increased inflation and higher taxes will be the "friction" for lower expected returns in the future. Investors can adapt by looking at traditional asset allocation approaches differently. Security selection will be key. Event-driven investing opportunities with unique risk/return profiles will become more valuable to a portfolio. Quality should never be far from mind, in our opinion, regardless of the environment. Levering returns with borrowed funds and exposing yourself to the risk of permanent loss, however, is not the answer, in our view.

Liquidity has created a bullish backdrop for equities that could extend further than any of us can anticipate. But unless something has changed, there are still no free lunches on Wall Street. Periodic volatility should still be expected, but with liquidity like this, the buffet and free mimosas could stay open for quite some time and who wants to miss out on that? ◊

Stagflation - Now You Know

Kevin Gale
Managing Director, Head of Fixed Income

Many of us are old enough to remember the 1970s and the early and mid-1980s when interest rates spiked significantly. The 2-year U.S. treasury yield rose to 16.9% and the 10-year topped out at 15.8% in September of 1981. The cause of this was "stagflation," or persistent high inflation combined with stagnant GDP growth.

With the recent spike in the Consumer Price Index (CPI), a widely-used measure of inflation, investors are beginning to wonder if we could be headed for another period of stagflation. The CPI rose 5.4% year-over-year in July, its highest reading since July 2008 when it was 5.6%. This, combined with expectations of lower growth due to reduced stimulus and supply chain constraints, has investors talking more about stagflation. Since 1970, year-over-year CPI has averaged 3.9%, but since 1990 it has averaged just 2.4%.

In 2020, the Federal Reserve changed its stance on managing inflation. They had previously maintained a 2% inflation target whereby they would raise or lower short term interest rates to try to keep inflation steady. Now, the Fed has elected to adopt a "flexible form of average inflation targeting" that aims for the inflation target to average 2% over time. This change will allow the Fed to let inflation run hot, or above 2%, for a period without having to raise interest rates quickly to try to bring inflation back down. The risk to this new strategy is if inflation runs hot for too long, it would potentially be even more difficult to get back under control.

CPI vs. Yields

Source: Bloomberg

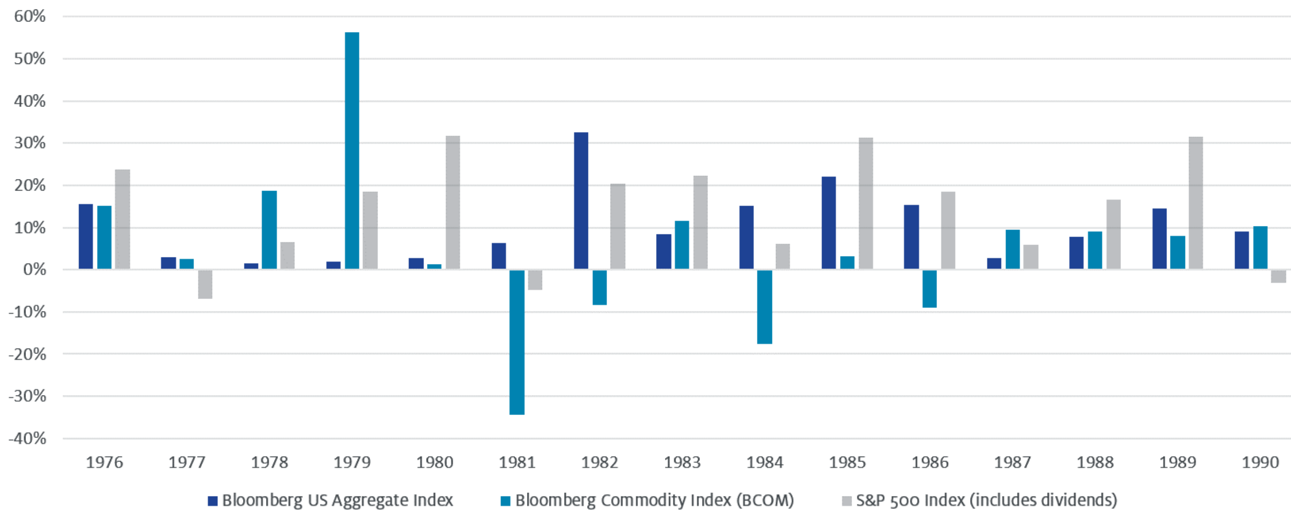
Stagflation puts the Federal Reserve in a difficult situation. On one hand, high inflation should lead the Fed to raise interest rates to subdue the uptick in prices. On the other hand, with slower growth the Fed would want to lower interest rates to promote growth. Not only is the Fed in a difficult situation, but investors are too.

Investing during periods of stagflation can be difficult. With rising interest rates, bond returns will likely be muted, especially when starting from the extremely low rates we have today. Comparing the bond market of today versus the bond market of the 1970s and 1980s can be difficult. Interest rates were significantly higher during the 1970s, which means coupons (interest payments) were

multiple times higher than they are today. Secondly, the average duration (a measure of the sensitivity of the price of a bond to a change in interest rates) of outstanding bonds was significantly lower than it is today. That means that during the 1970s and 1980s, rising long-term interest rates had less of an impact on the total bond market than they are likely to have today.

During periods of rising inflation, equities and commodities may provide higher returns. Rising interest rates generally mean the economy is expanding. However, in stagflation the economy is stagnant or seeing low growth. More defensive sectors such as health care, agricultural goods (food) and commodity-related industries tend to perform well during periods of stagflation.

Historical Market Returns



Source: Bloomberg

Ancora's Fixed Income team continues to monitor economic conditions and we believe that the Federal Reserve will do everything it can to prevent stagflation from creeping into the economy. However, we acknowledge that as inflation continues to run hot, it becomes more and more difficult for the Fed to retain control of it. We are keeping a close eye on wage inflation as well, as we believe this could be the catalyst that leads to even higher inflation than we are already seeing. Maintaining a well-diversified portfolio with exposure to multiple asset classes, potentially including commodities and dividend-paying equities that consistently grow their dividends, could allow investors to better weather times of increased inflation. ◊

Rethinking the 60/40 Asset Allocation Mix

Richard Renner
President, Family Wealth

In 1986, the S&P 500 Index price was at roughly 240 and the 10-year treasury yield was at roughly 7.5%. In the decades that followed, as the 10-year continued to decline to today's historically low levels, we saw a win/win environment for both stock and bond markets, making a ripe playing field to generate attractive real returns in a traditional portfolio, which would most typically resemble a 60/40 (stocks/bonds) asset allocation mix.

During this time frame, bonds helped to level off the volatility of an overall portfolio and did well during economic downturns, acting as a hedge. They also added significant income, given prevailing interest rates at the time. Stocks have also been a great option historically, and started this era with the dividend yield on the S&P 500 averaging over 3.4%, while today it sits closer to 1.3%. It's worth noting that there were very few other avenues for individuals to invest at the time. Only the largest institutional investors had access to what we now refer to as alternative investments.

Today, the traditional 60/40 mix faces new challenges. The stock market has experienced great returns and, as a result, starting valuations are above average. Bonds, the traditional income play, now yield just 0.2% (2-year treasuries) at the short end and 1.3% (10-year treasuries) on the intermediate side and, if rates rise, investors may lose principal if bonds are not held to maturity. Bonds are typically considered ‘safe,’ but also hold more risk due to the potential of rising interest rates.

Finding the Right Mix

Investors should hope to stay ahead of inflation and earn a long-term return on their investments to at least preserve purchasing power. Thus, equities remain an important part of the asset mix, but be sure to consider high-quality stocks. In many instances, quality can be evidenced by consistent cash flows, unique growth attributes, strong balance sheets or an attractive and growing dividend.

Given the current environment, investors might consider a lower-than-normal allocation to fixed income. Besides short- to intermediate-duration high quality bonds, ‘strategic’ income such as preferred stocks or alternative credit can be complementary and help with current yield, over time possibly even giving a better return.

With a smaller allocation going to fixed income, you might wonder where the remaining capital should go. We would suggest looking at alternative investments that are not as correlated to stocks and bonds. These alternatives can be strategies that ‘hedge’ market risk as well as real assets such as commodities, gold and real estate.

Regardless of where your exact asset allocation mix shakes out, and understanding that every investor has unique circumstances, the idea is to maintain long-term stock market exposure for appreciation potential, keep volatility in line with fixed income acting as a ballast and add alternatives that can contribute real returns to the portfolio, but in a way that is not highly correlated to the possible volatility of stocks or the interest rate sensitivity of bonds. In investing, you play the hand you’re dealt as effectively as possible with your ability, willingness and need to take risk always front of mind. ◊

Tax Policy Update: September 2021 Tax Proposals

Howard Essner, JD
General Counsel, Family Wealth Advisor

The House Ways and Means Committee recently released draft legislation containing the proposed tax increases that will help fund up to $3.5 trillion in anticipated social policy programs. The proposed changes impact corporate, individual income, gift, estate and retirement account taxes. Many of these proposals are very different than the tax proposals introduced by the President earlier this year, and are likely to be very different than the proposals coming out of the Senate Finance Committee, details of which are just starting to emerge.

These proposals are just the opening salvo in what will surely be a long and bruising battle in Congress. In the face of unanimous Republican opposition, the Democrats can afford to lose only 3 votes in the House, and no votes in the Senate, to pass any legislation. Senator Joe Manchin (D-W.VA) recently called for a “strategic pause” in the Democrats’ push on the $3.5 trillion bill, so passage in the Senate is far from a foregone conclusion. Assuming both houses do finally approve legislation, a reconciliation process will start to produce final legislation to go the President’s desk for approval. So, it appears we will be in for an “interesting” few months, and this uncertainty will make tax planning over the next few months a very dicey proposition.

With these caveats in mind, we are providing a summary of the key provisions of the House Ways and Means Committee proposal that affect individual taxpayers. The changes described below would, in theory, go into effect for the 2022 tax year, unless otherwise noted. But, as we indicated, there is much ground to cover on Capitol Hill before any aspect becomes final.

Individual Income Changes

The House proposal:

- Increases the top income tax rate to 39.6% on taxable income above $400,000 for individuals and $450,000 for joint filers. Note that these income levels apply to many of the changes discussed below, so for simplicity's sake, we will just call these taxpayers the "High Income Taxpayers." These income thresholds are lower than the President's proposal and much lower than the current thresholds for the top rate.

- Imposes a 3% income surtax on taxable income exceeding $5 million, a provision also not included in the President's proposal.

- Limits the qualified pass-through business income deduction of Section 199a to $400,000 for individual filers and $500,000 for joint filers.

- Expands the 3.8% Net Investment Income Tax (NIIT) to cover net investment income derived from a trade or business for High Income Taxpayers. Essentially, this change will subject all income for High Income Taxpayers from pass-through entities, whether passive or active, to either the 3.8% Medicare self-employment tax or the NIIT.

- Increases the highest long-term capital gain tax rate to 25%. This is lower than the top ordinary income rate proposed by the President for taxpayers with taxable income exceeding $1 million. The effective date for this change was September 13, 2021, with transition rules for binding contracts signed before that date but closing after.

Estate and Gift Tax Changes

The House proposal:

- Accelerates the sunset of the increase in the estate and gift lifetime exclusion that was increased in 2017. This means that the lifetime exemption per individual will revert to $5 million (the prior 2017 figure, but adjusted for inflation will probably be closer to $5.85 million) from the current $11.7 million level. This change was not in the President's proposal, who instead focused on changing the rules regarding the step-up in basis at death. Those changes are not included in the Committee's proposals.

- Makes technical changes that will cause grantor trusts to be included in the grantor's taxable estate and treat sales between the grantor and a grantor trust as a sale to a third party. These changes will effectively end the use of specialized grantor trust strategies in estate and gift planning, such as grantor retained annuity trusts and sales to intentionally defective grantor trusts. The changes will not apply to existing trusts.

Retirement Account Tax Changes

The House proposal:

- Eliminates any new contributions to a retirement plan or IRA if High Income Taxpayer's total retirement accounts (traditional IRAs, Roth IRAs, and employer qualified plans) exceed $10 million.

- Requires High Income Taxpayers with $10 million or more in retirement account balances to take a minimum distribution each year. The minimum distribution will be 50% of the value of the retirement accounts above $10 million. Additional distributions are required if the account values are more than $20 million.

- Prohibits IRAs from investing in any investment vehicle that requires "accredited investor" status, such as private partnerships and hedge funds. This change, under the initial proposal, would be effective in 2022 for new investments, with existing investments required to be liquidated over 2 years starting in 2022. These changes, none of which were part of the President's proposal, are clearly a reaction to the recent news about tech entrepreneur Peter Theil's $4 billion Roth IRA.

> Eliminates the "back-door" Roth IRA strategy by eliminating all Roth conversions for High Income Taxpayers. This change is effective as of December 31, 2031, although some commentators have questioned whether this is a typographical error with the intended effective date to be next year. The elimination of Roth conversions is ironic because liberalization of the Roth conversion rules several years ago was considered a revenue-raising item to offset other tax cuts.

> Eliminates the "Mega Roth" strategy by disallowing all after-tax contributions to a retirement plan regardless of income level.

As we said, tax planning with this uncertainty is very difficult. Many times, we have seen individuals take irrevocable actions based on some assumed future tax law change, only to regret it later when Congress acted in an unexpected way or simply did not act. However, here are a few planning ideas to prepare if Congress does act:

> Prepare for ways to accelerate ordinary income into 2021 and defer deductions into 2022.

> If allowed, prepare to take extra distributions from retirement accounts to pay tax in 2021 and avoid the higher rates in 2022 and the more onerous distribution requirements.

> Make sure that trust documents are prepared and in place to accept funding to use up lifetime exemptions if the law changes.

As always, we stand by to answer your questions and address your concerns. ◊

Firm News

Ancora recently announced a definitive merger agreement with Focus Financial Partners, LLC (Nasdaq: FOCS) a leading partnership of over seventy independent Registered Investment Advisory firms. We are excited about this milestone agreement and the growth potential it brings to all those involved with Ancora, especially for our trusted clients. You can read more about the agreement on our website. If you have any questions, please do not hesitate to reach out to any member of your Ancora team.

Visit ancora.net/insights for more information. ◊

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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