ROCKBRIDGE
INVESTMENT MANAGEMENT

**FINANCIAL COMMON SENSE** October 2018

**THE ROCKBRIDGE TEAM:**

**Craig Buckhout, CFA**
**Anthony Farella, CFP®**
**Patrick Rohe, CFP®**
**Edward Barno**
**David Carroll, CFP®**
**Claire Kobylanski**
**Kevin Sullivan, CFP®**
**Ethan Gilbert, CFA**
**Mike Antonacci, J.D.**
**Nicholas Stancato**
**Patricia Edwards**
**Julie Murfitt**
**Heather Solazzo**
**Julia Conlan**
**Robert Ryan, Ph.D.**
**Edward Petronio, Ph.D.**
**Richard Schlote**

*Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.*

# New Tax Law Makes Bundling Gifts to Donor-Advised Funds Attractive *by Anthony Farella*

**"Give, but give until it hurts."**
**— Mother Teresa**

I don't think Mother Teresa paid much attention to the tax code, but her quote is unusually prescient for 2018 taxpayers. The changes have made it unlikely to get a tax break on money given to your favorite charities.

When the Tax Cut and Jobs Act was signed into law late last year, the intent was to reduce taxes and simplify the tax code for all Americans. Some of the more significant provisions were the increase of the standard deduction along with the elimination of many itemized deductions.

The standard deduction has nearly doubled to $24,000 for married couples filing jointly ($12,000 for single filers). The non-partisan Tax Policy Center estimates that more than 90% of tax filers will no longer need to itemize their deductions. Therefore, taxpayers who use the standard deduction would not get any tax savings from making charitable donations.

## How the new tax law reduces or eliminates charitable deductions

For example, let's say that a married couple pays at least $10,000 (maximum deductible amount) in state and local property taxes, has mortgage interest of $5,000 and makes $5,000 in charitable contributions. This adds up to $20,000 in deductions, which is lower than the $24,000 standard deduction. The higher standard deduction eliminates the tax deductibility of charitable contributions.

## How bundling restores your charitable deduction

One way to get a tax break on your charitable donations is to bundle them into one year. For example, if you are likely to give $5,000 to charity each year, then making a one-time donation that covers the next 3-5 years to a Donor-Advised fund will allow you to get the tax break back.

## Bundling works like this

Say you make a $15,000 contribution to a Donor-Advised fund in 2018. Using the above example, your total itemized deductions are now $30,000. ($10,000 state tax, $5,000 mortgage interest and $15,000 charity). The additional $6,000 in itemized deductions over the $24,000 standard deduction would be worth 24%-37% of the difference depending on your own marginal tax rate.

Additionally, you can use the Donor-Advised fund to make contributions to your favorite charities anytime (ie. spread equally over 3, 4 or 5 years or in any other timeframe you choose).

There are many Donor-Advised funds to choose from including ones offered by Charles Schwab and TD Ameritrade. For step-by-step instructions for executing this strategy, please visit our blog at https://rockbridgeinvest.com/financial-common-sense. Or just give us a call. ◆



Rockbridge Investment Management, LLC
220 South Warren Street, 9th Floor, Syracuse, NY 13202

Phone: 315-671-0588 | 888-689-2351
Fax: 315-671-0589 | www.rockbridgeinvest.com

# Understanding Bond Returns *by Ethan Gilbert*

We had several clients this year reach out to ask how bonds were performing in their portfolios. These are great questions, so we created a few items to address what you see in your statements. Some people notice they have held bonds for several years but seem to have a loss with their holding. This may come from their monthly statement from the custodian. Below is an example of how that looks:

**EXCHANGE TRADED FUNDS (ETFs)**

| Investment Description | Symbol/ CUSIP | Purchase Date | Quantity | Closing Price | Market Value | Cost Basis | Unrealized Gain/(Loss) |
|---|---|---|---|---|---|---|---|
| VANGUARD INTERMED TERM ETF | BIV | 1/25/16 | 670 | $80.82 | $54,149.40 | $56,313.50 | $(2,164.10) |
| VANGUARD TOTAL BND MRKT ETF | BND | 1/25/16 | 2,621 | 78.98 | 207,006.58 | 213,758.49 | (6,751.91) |

From looking at this statement, it seems this investor has lost almost $9,000 from their bond holdings in the last 2.5 years (1/25/16 to 7/31/18). However, if you look at the returns from the bond funds over that period you see they were positive.

| | | |
|---|---|---|
| Bonds | $261,155.98 | 1.35% |
| Vanguard Total Bond Market (BND) | $207,006.58 | 1.37% |
| Vanguard Intermediate Term Bond (BIV) | $54,149.40 | 1.23% |

This is possible because the bond funds pay interest every month. That interest goes into the account as a monthly cash deposit and is used when we rebalance the portfolio. Interest paid in cash does not increase the market value column. Despite showing an unrealized loss, the investor did make money through these holdings.

All that said, bonds can lose money. When interest rates rise, the value of existing bonds goes down, and returns can be negative even when accounting for interest payments.

### Real life application of interest rates:

a. How it's playing out this year (numbers from 1/1/2018 to 9/26/2018):

| Aggregate Bond Fund | |
|---|---|
| Bond Duration | 6yr |
| Start of Year Bond Yield | 2.57% |
| 9/26/2018 Bond Yield | 3.22% |
| Difference | 0.65% |
| Average Yield | 2.90% |
| Change in Principal | -3.90% |
| Yield through 9/26/2018 | 2.13% |
| **Net Return** | **-1.77%** |

An aggregate bond fund holds thousands of bonds. In their entirety, they have an average weighted life (duration) of 6 years. This number tells us how sensitive they are to interest rate changes.

At the start of the year, an aggregate bond fund was yielding 2.57%. It is now yielding 3.22%. That means it had an interest rate increase of 0.65%. If you multiply that increase by the bond duration, you get the change in value of the underlying bonds. In this case, 6 x 0.65% = 3.90%, so the bonds' market value dropped by 3.90% from January through September 2018.

However, the bonds are paying interest. If you average the yield at the start of the year and currently, you get 2.90%. For roughly 9 months in the year, 2.90% x 9 / 12 = 2.13% of earned interest. This nets out to a loss of 1.77% so far this year.

b. **This isn't a bad thing!** Rising interest rates generally aren't a problem for the following reasons:

i. Your returns going forward will be higher! If bond yields start at 2.57% and never change, you'll earn 2.57% for the rest of your life. If they start at 2.57%, jump to 3.22% and then never change you'll eventually have more money because of it. Remember, the 3.90% drop in principal came because yields went up 0.65%. Every year from now on you'll be getting 0.65% more in return. 3.90% / 0.65% = 6. In six years, you'll have made up the lost principal in extra interest. From that point on you'll be getting more in yield, leaving you better off in the longrun!

(Continued on page 3)



Rockbridge Investment Management, LLC
220 South Warren Street, 9th Floor, Syracuse, NY 13202
Phone: 315-671-0588 | 888-689-2351
Fax: 315-671-0589 | www.rockbridgeinvest.com

# Understanding Bond Returns *Continued*

ii. Usually, bonds and stocks have an inverse relationship. Historically, the price of stocks and bonds move inversely with each other. This means when stocks are falling, interest rates go down and the value of existing bonds goes up. The opposite is true as well; if the economy is doing well and stocks are rising, interest rates are also going up and the value of existing bonds goes down. Quantitative easing by the Federal Reserve has skewed this some, but overtime we expect this to continue. For a balanced investor who holds both stocks and bonds – when bonds are losing value for an extended period, the stock portion of the portfolio is likely going up. Remember, a few months, quarters or even years is a relatively short time when it comes to investing. And for most of our clients, our time horizon is decades not years.

In summary, we feel bonds add value to most individuals' portfolios. Over the longrun they provide a positive return and have much less volatility than stocks. Additionally, they usually move in the opposite direction of stocks which limits large fluctuations in portfolio value and amplifies the benefit of rebalancing. ◆

# Is Your Cash Earning Interest? *by Craig Buckhout*

Interest rates are rising, and yet you may not be earning much on your cash. As financial markets finally begin to reflect a recovery from the crisis of 2008-09, the brokerage industry is changing the way they handle customers' cash, and investors need to pay attention.

Over the past ten years we have become accustomed to earning nothing on our cash. The Federal Reserve kept rates at essentially zero for so long that investors came to expect no return on uninvested funds. It has been a difficult time for savers. Bank CD rates are generally very close to U.S. Treasury rates, and until mid-2016 a 3-month treasury security yielded less than 0.25%. In fact, the Fed dropped rates effectively to zero in December 2008 and finally began to raise them again in December 2015. The 3-month treasury yield has steadily risen along with the Fed Funds rate, from 0.25% in 2016 to over 2% today. By historical standards interest rates are still low, but the increase from zero to 2% is significant for savers and investors of short-term cash.

### So why am I still not earning anything on cash?

The short answer is that the brokerage industry is keeping most of the interest earned in sweep accounts for themselves and forcing investors to deliberately invest cash to earn a competitive rate.

Borrowers who <u>compete</u> for funds are compelled by market forces to pay similar rates – otherwise they don't get the funding they need. So banks selling CDs in the open market have seen rates rise along with treasury yields.

Not all borrowers are forced to compete. Bank deposits and cash balances in brokerage accounts represent something of a captive audience. Years ago, when interest rates were high, and the market was competitive, banks and brokers began offering <u>sweep accounts</u>, where excess cash was automatically swept into an interest-bearing account each night. This arrangement was an important source of profit for banks and brokers as they were able to invest the cash and earn a positive spread, or margin, above what they paid the customer.

When the Fed dropped short-term rates to zero in 2008, the profit margin disappeared from sweep accounts, along with the return to savers and investors.

Fast forward to 2018 and we see that short-term rates have crept back to 2%. At the same time brokers and investment firms have continued to experience competition in other areas of their business; $19.95 was once thought to be an incredible bargain for a brokerage trade. Many brokers now offer trading on an electronic platform with rates below $10, and certain transactions are free. Likewise, the internal management fees or expense ratios for mutual funds and ETFs have been driven downward to the point that Fidelity recently announced some index ETFs with an expense ratio of zero.

In their search for profits, brokerage firms have seized on the sweep accounts as a way for them to make money. Most have transitioned to where excess cash is swept to a bank deposit fund that earns something, but very little. Profits flow back to the brokerage firm because they either own the bank or have some affiliation that returns profit to the brokerage firm. This arrangement has at least one advantage for investors because the bank sweep funds are FDIC insured, but returns are substantially below what we would historically expect from money market funds.



Rockbridge Investment Management, LLC
220 South Warren Street, 9th Floor, Syracuse, NY 13202
Phone: 315-671-0588 | 888-689-2351
Fax: 315-671-0589 | www.rockbridgeinvest.com

# Is Your Cash Earning Interest? *Continued*

### So, what am I supposed to do?

Well the good news is that investors have alternatives. The first strategy is to reduce cash balances where practical. Schwab for example explains that their sweep account is only intended for the minimal cash balances required for near-term transactions. Cash held for a longer period, where the investor wants a return without taking investment risk in stocks or bonds, can be invested in a purchased money market mutual fund. Money invested in these funds is available next-day, rather than same-day in a sweep account.

For Rockbridge clients we are implementing a tighter cash management protocol to reduce balances held in sweep accounts and using money market mutual funds or ultra-short bond funds to generate some return on funds that are not allocated to long-term investment risk.

It is also important to keep this issue in perspective. Our target is to keep cash balances at 1% (now less than 1%), so a $1 million account would have a cash balance of $10,000 or less. If left in the sweep account rather than a fund with 2% returns, the lost income would amount to less than $200 per year.

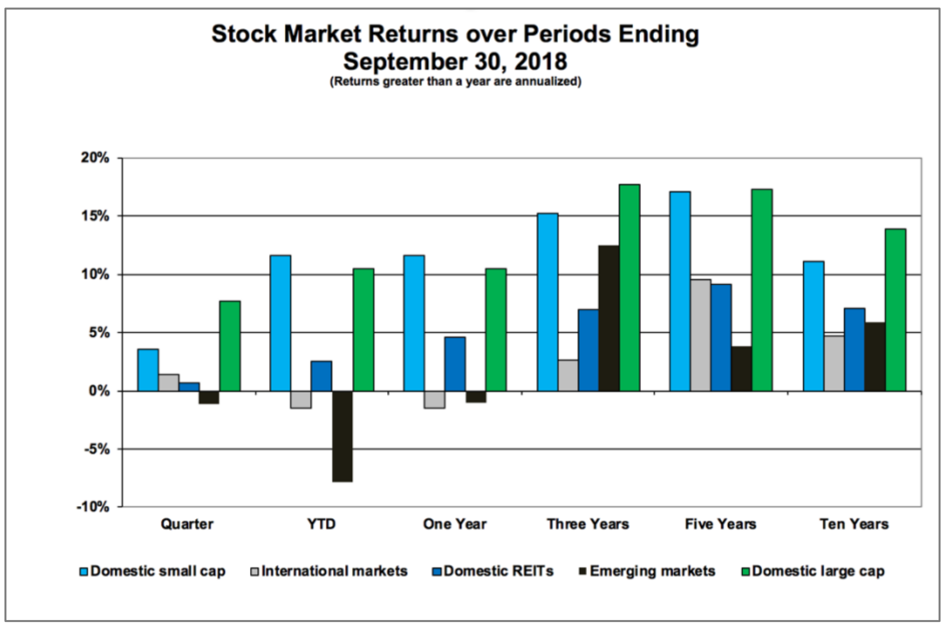
The terminology and nuances of sweep accounts and purchased money funds can be confusing, so if you have any questions, please give us a call to discuss. ◆

# Market Commentary *by Bob Ryan*

## Stock Markets

For the last quarter, stocks are up except for Emerging Markets, which were close to flat. Domestic stocks are seemingly shrugging off the uncertainties of increasing interest rates, trade wars and tariffs.

Year to date, an Emerging Market stock portfolio would be down almost 9%. It is not surprising that today's uncertainties are having a greater impact on developing economies as they tend to have larger debt levels denominated in dollars and exports are a bigger part of their economies. Consequently, the value of the dollar is increasing, interest rates are rising, and tariffs will have a greater impact.



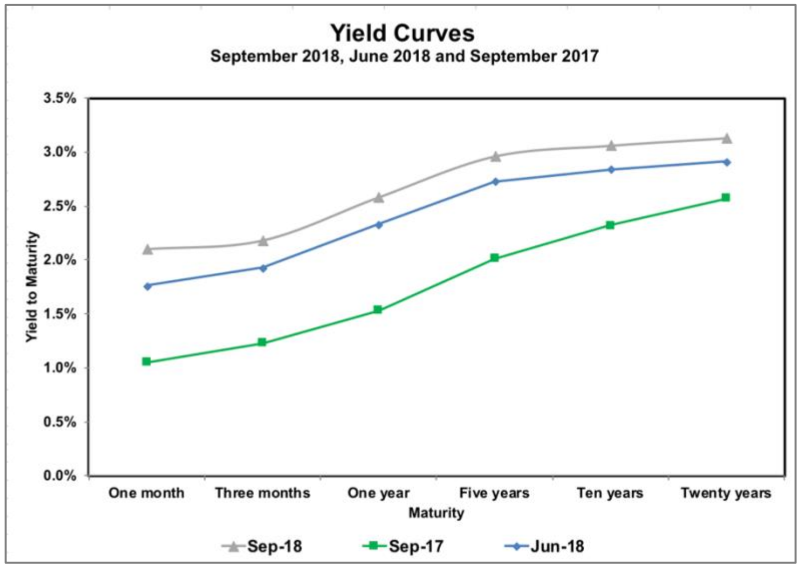

Non-U.S. markets have not kept pace with U.S. markets over the periods presented. Subsequently, stock returns from a globally diversified portfolio over these periods would be below those of the popular domestic indices (e.g. S&P 500). This environment makes maintaining commitments across all markets especially hard. The benefits of diversification are clear, but it often means enduring periods of below average results in various markets for extended periods of time. For example, since 1971 the annualized ten-year return for the S&P 500 has varied between 5% and 17%. It is reasonable to think markets will eventually earn their expected returns (in the "long-term"), but this variability gets in the way of considering ten years the "long-term", as we would expect a much tighter range in these results if it were indeed the long-term. So, when we see non-U.S. stocks underperform in every period reported in the chart above, we do not conclude they will always underperform, but instead that more patience is required to reach the "long-term" and achieve expected returns.



Rockbridge Investment Management, LLC
220 South Warren Street, 9th Floor, Syracuse, NY 13202
Phone: 315-671-0588 | 888-689-2351
Fax: 315-671-0589 | www.rockbridgeinvest.com

# Market Commentary *Continued*

## Bond Markets




The Yield Curves to the right shows that bond yields ticked up for all maturities over the past year and quarter. The Fed recently affirmed its commitment to increase interest rates and the change in yields is consistent with that objective.

How much room is left for bond yields to move? The yield on the 10-year Treasury is currently about 3.1%. Theoretically, a bond's yield should include a premium for (1) the time value of money, (2) risk and (3) expected inflation. For example, let's pick 2% as a premium for investing instead of spending money. Note the difference in yield between one-year and ten-year bonds is 0.5%. This leaves 0.6% as expected inflation over the next ten years. If this expected inflation number is reasonable, then today's yields might be about right – if this number for expected inflation over the next ten years feels low, then yields might have some ways to go. While these observations are not a prediction, they are intended to provide some context for what we see in today's bond markets.

As we think about the recent bull market in U.S. stocks, below-average results in non-U.S. markets, and historical low interest rates, keep in mind that markets have no memory. Remember that prices are based on expectations not the past. ◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending September 30, 2018:

| Market/Asset Class | Quarter | YTD | 1 Year | 3 Years | 5 Years | 10 Years | 20 Years |
|---|---|---|---|---|---|---|---|
| Money Market | 0.48% | 1.30% | 1.58% | 0.84% | 0.52% | 0.34% | 1.93% |
| Bond Market | 0.02% | -1.60% | -1.22% | 1.31% | 2.16% | 3.77% | 4.48% |
| Large-Cap Stock Market | 7.71% | 10.56% | 17.91% | 17.30% | 13.95% | 11.97% | 7.42% |
| Small-Cap Stock Market | 3.58% | 11.51% | 15.24% | 17.12% | 11.07% | 11.11% | 9.45% |
| International Equity Market | 1.42% | -0.98% | 3.25% | 9.77% | 4.90% | 5.87% | 5.64% |
| Emerging Markets | -0.95% | -7.39% | -0.44% | 12.77% | 3.99% | 5.76% | 10.17% |
| Real Estate | 0.72% | 2.56% | 4.59% | 6.87% | 9.11% | 7.15% | 10.00% |
| U.S. Consumer Price Index | 0.06% | 2.28% | 2.16% | 1.95% | 1.49% | 1.43% | 2.19% |

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays US Aggregate Bond Index; the domestic large-cap market by the S&P 500; the domestic small-cap market by the Russell 2000 Index; the emerging markets by MSCI Emerging Markets Index; the real estate market by Dow Jones US Select REIT Index; and the international equity market by the MSCI EAFE Index. Benchmark Portfolio returns now include Real Estate and Emerging Markets allocations beginning in July 2011. Benchmark Portfolio returns do not include allocations to these asset classes prior to June 30, 2011. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.



Rockbridge Investment Management, LLC
220 South Warren Street, 9th Floor, Syracuse, NY 13202
Phone: 315-671-0588 | 888-689-2351
Fax: 315-671-0589 | www.rockbridgeinvest.com