INVESTMENT PERSPECTIVES

>> FIRST QUARTER 2019

Qualified charitable distributions give investors a two-for-one tax benefit

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With the holiday season in the rear-view mirror and 2019 tax planning underway, many investors are beginning to appreciate the tax benefits of a qualified charitable distribution (QCD) from their IRA accounts. A QCD requires that the individual have attained age 70½ or older and be taking required minimum distributions (RMDs). This charitable giving technique allows eligible taxpayers to distribute up to $100,000 annually from their IRAs directly to qualified public charities, without including the distributions in their gross income.

The QCD satisfies the RMD requirement for the year as long as it doesn't exceed the annual cap of $100,000 per person. (Charitable donations from an IRA in excess of this cap will be considered taxable distributions and will be included in gross income.) For married couples, each spouse can make a QCD up to the annual cap from their individual IRAs. To obtain the tax break, the check must be made payable from the IRA account directly to the chosen charitable entity. The QCD would apply to the taxable amounts of a traditional IRA and the taxable earnings on a Roth IRA if held less than five years.

Beneficiaries of inherited IRAs can also be eligible to donate via a QCD, so long as they are age 70½ or over at the time of the distribution and satisfy the same requirements as IRA owners.

The 2017 Tax Cut and Jobs Act nearly doubled the standard deduction and limited or eliminated several popular itemized deductions, which makes the QCD especially attractive to taxpayers with charitable inclinations. Eligible taxpayers can use the standard deduction and still receive a charitable contribution tax break by using a QCD; that's what makes it a two-for-one special: To the extent that a taxpayer would have otherwise made the same charitable donation from a different non-IRA account, she pockets the tax savings while still contributing to a favored organization.

There are some limitations and exclusions to the QCD; for example, one cannot be made from an active retirement plan, where a contribution has been made for the year. To learn more about the QCD, please reach out to your Relationship Manager or your tax advisor.

>> PERSPECTIVES ON THE ECONOMY

U.S. economy continues to grow but at a slower rate

By Allen Laine, CFA
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As investors scan metrics measuring growth, unemployment, inflation, and confidence, the U.S. economy appears to be in an enviable position. There are no obvious signs of an imminent recession. Consumer and business confidence remain high, albeit slightly below peak levels. But investors are still worried; their concern is related to the second derivative: The rate of growth is decelerating.

Yet the gaudy numbers of 2018 were not sustainable for a mature economy with our demographics. Expectations for 2019 are more reasonable and could provide a more sustained, moderate growth period for the U.S. economy. For example, GDP growth should slow from approximately 3% last year to 2.3% in 2019.

Key pillars to real economic growth like employment and inflation are also well positioned. The unemployment rate recently rose slightly to 3.9%, but it was driven by a jump in labor force participation. There are still almost one million more jobs available than unemployed workers. This has resulted in modest 3% wage inflation, which is not overly worrisome. Broader inflation measures are quite tame, with CPI recently registering at 2.2%. Consequently, the value of the U.S. dollar remains strong on global markets.

High employment, a strong dollar, and modest inflation make an attractive mixture for economic growth, and give the Federal Reserve little reason to hike interest rates. Barring significant deterioration in trade negotiations with China or Fed policy missteps, the U.S. economy looks to be on sound footing for now, and could remain so for some time.

U.S. REAL GROSS DOMESTIC PRODUCT

U.S. economic growth is slowing to more sustainable levels.

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>> FOCUS ON EQUITIES

The grand illusion of zero-fee funds

By Michael A. Tyler, CFA
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It had to happen: After years of price competition, fees for some passively managed exchange-traded funds (ETFs) have finally hit zero. Fidelity Investments was the first firm to offer "free" index funds, but it won't be the last. Since the launch of its two zero-fee funds last August, Fidelity has raised more than $1 billion in assets.

Fidelity wants investors to come sail away on an open course for the virgin sea of zero-fee funds, but investors should remember that what seems to be "too good to be true" usually just isn't true. That's the case with zero-fee funds; those virgin seas may have dangers lurking beneath the surface, and unprepared investors may face unexpected squalls.

Even though sponsors of zero-fee funds don't earn fee revenue from the funds' investors, they still make money — plenty of it. Most ETFs and mutual funds lend securities to short-sellers and earn interest on those loans, to the tune of $8 billion in 2016. This is not a bad thing; the funds' investors usually receive some benefit from these large-scale loans, typically in the form of higher dividends.

A second advantage of securities lending is that the practice acts as a hedge against bad performance. Short-sellers borrow securities that they think will go down in price, so they can sell the borrowed shares today and then buy them back at a cheaper price in the future. Since an ETF owns every security in the index it tracks, the short-sellers are effectively providing a form of insurance specifically for the securities that are more likely to lose value.

The problem with zero-fee funds is that the revenues from securities lending no longer go to the funds' investors as dividends, but instead are used to cover the funds' operating expenses. This means that the hedging value disappears: Fund sponsors still get paid to operate the funds, but investors likely suffer modestly worse performance.

Money is fungible, of course; Fidelity and other fund sponsors will cover their costs and earn a profit whether they charge an expense ratio or not; but their investors should stop fooling themselves into crossing the river Styx to the realm of zero-fee funds.

>> FOCUS ON FIXED INCOME

Bond investors take wing, seeking safety

By Tom Bussone
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While equity markets got more attention, the sudden fourth-quarter reversal in fixed income markets was just as stunning. After rising 83 basis points to 3.23% by the beginning of October (to a level not seen since 2011), the yield on the 10-year yield Treasury note plunged in the fourth quarter, ending the year at 2.69%.

U.S Treasury yields collapsed as investors sold equities searching for safe haven in government bonds, driving up prices. Investors focused on a potential trade war with China, the impending departure of the United Kingdom from the European Union, and Italy's defiant confrontation with the European Central Bank over its fiscal budget deficit. Creating more angst was the Federal Reserve's insistence that the U.S. economy was strong enough to withstand two more rate increases in 2019.

As investors shunned risk, the difference in yield between U.S. Treasuries and corporate debt widened, meaning that Treasury debt performed better than investment grade corporate debt – and much better than lower-quality high-yield paper. Wider credit spreads are normal during times of uncertainty, as investors lose confidence in corporate balance sheets. We expect that this trend will continue during 2019 as global growth is expected to slow.

As a result, we have upgraded the quality of our bond holdings. We sold our high-yield debt positions and increased our holdings in U.S. Treasuries along with A-rated corporate paper. This will help minimize the volatility of our portfolios and protect against possible downside risks.

U.S. TREASURY YIELDS

The 10-year Treasury note has been on a roller-coaster ride.