Demming Financial Services Corp.

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3rd Quarter

In accordance with the CDC and Ohio government officials, we will be checking temperatures upon entry and requiring that all visitors wear a mask until further notice.

Please be sure to send us a copy of your 2019 tax returns to info@demmingfinancial.com as they're completed!

Please note, the main inbox for prompt email correspondence is info@demmingfinancial.com!

As a friendly reminder, for your protection, it is our ongoing policy that any requests for funds sent to us via email will also be confirmed by phone.

Please be sure to let us know if there are any changes to your contact information (address, phone number, email, etc.)

Also, please be sure to check out our website at www.demmingfinancial.com!

When the Index is Not the Market

One of the most perplexing aspects of our investment world is how the market summaries you generally see in the newspapers and websites can badly mislead us about the health of the stock market. Today is an extreme case in point. Chances are, you've seen headlines telling us that the Nasdaq Composite index is up about 17% for the year, testing new highs every other day or so. The S&P 500 index is down just about 1% so far this year, but is not far from its late February high. The markets are moving ahead smoothly or even robustly, right?

As it turns out, most of the gains are concentrated in a very narrow band of companies in the tech sector, particularly the larger tech companies like Amazon (up 63% so far this year), Apple (up 32% this year), Facebook (+17%), Netflix (+60%) and

Alphabet (formerly Google; +13%). Those companies are so large that an index like Nasdaq or the S&P 500 is highly influenced by their performance. These five stocks alone now make up about 15% of the market capitalization of the S&P 500 index. If you just look at the performance of the index, you might not realize how much of an impact mass unemployment and historic economic slowdown is having everywhere else in our pandemic-infested economy.

Other sectors of the marketplace, which are typically not reported in the press, paint a more realistic picture of what's actually going on in our corporate landscape. Consider small cap stocks, as measured by the Wilshire U.S. Small Cap Index. These stocks typically outperform large caps over time, but they've lost roughly 14.5% of their value so far this year. Real estate, as measured by the Wilshire U.S. REIT Index, has lost 18.61% of its value year to date. Look abroad, and the EAFE index of large cap companies based outside the U.S. have lost just over 10% of their value so far this year. Clearly, our markets are not quite as healthy as the most popular indices would have you believe.

The point here is not to focus your attention on gloom and doom, but to suggest that what you hear about as "the market" may not be giving you the whole picture. Rarely have we seen such a disparity between the performance of the popular indices and the thousands of stocks that fly under the radar. We see the robust health of a few companies reflected in the most widely-reported numbers, but that doesn't mean our economy, at the moment, is robustly healthy overall.

Roth Conversions Reconsidered

The SECURE Act significantly reduced the benefits of an inherited traditional or Roth IRA, by requiring the non-qualified heir (typically anyone other than the spouse) to take the full amount out of the account within ten years of receipt. Interestingly, that provision makes it somewhat more beneficial for some people to make Roth conversions today.

Chances are you know the difference between a traditional IRA and a Roth; the gist of it is that contributions to a traditional IRA are tax-exempt, but when the money is taken out of a traditional IRA in retirement, it is taxed at the retiree's current tax rate. In contrast, contributions to a Roth are not tax-exempt, but the money comes out tax-free. If you convert from traditional to Roth, then you have to pay ordinary income taxes on the money that is shifted over at ordinary income rates, as the price for getting tax-free distributions in the future.

In general, you don't want to convert assets from a traditional IRA to a Roth IRA unless you can pay those taxes with outside funds; otherwise you're reducing the money that can accrue tax-free until the money is needed. The traditional calculation is that the conversion only makes sense if the person's tax rate today is lower than the future tax rate—and if you have a crystal ball which tells you what future tax rates will be, we would like to have a conversation about it. But some bets are better than others. The years between when a person leaves work and age 72 (when that person has to take required minimum distributions out of the traditional IRA) can be ideal for a conversion. The tax rate during those years when no employment income is earned can be low, and partial conversions up to certain tax brackets can be very attractive. This reduces the required minimum distributions (RMDs)

So what's the additional argument for a Roth conversion post-SECURE Act? Some people don't need their IRA assets to pay for retirement. So they take the lowest amount possible—the RMD—out each year, maintaining a balance, which they will leave to their heirs. The additional benefits accrue to the heirs, particularly if the heirs would inherit the account during their peak earning years.

Under SECURE, if the Roth IRA account is inherited, it still has to be liquidated within ten years of receipt—just like the traditional IRA. But the Roth beneficiaries face a simpler set of choices regarding the payment of taxes. If they inherit a traditional IRA, they have to decide whether to take the money out all at once at the end of 10 years, and risk having a huge tax bill because the distribution puts them in the highest tax bracket, or take the money out gradually and forego years of tax-free compounding. If the new owners of the account is in their prime earning years, then they may already be in a high tax bracket and be pushed higher no matter what they do. A big part of the bequest would be lost to taxes.

The Roth IRA beneficiary, meanwhile, has the luxury of allowing the full 10 years of compounding to proceed without any tax consequences to worry about. He or she is never pushed into a higher bracket during peak earning years. A Roth conversion by the parents is thus a way to transfer more assets to the heirs.

Everybody considering a Roth conversion should talk with a professional to get a full analysis of the potential benefits and drawbacks—understanding, of course, that this analysis requires modeling the unknown future tax code and income levels of potential heirs. Paying taxes now for benefits in the future could be a great strategy under a variety of circumstances which are, alas, still essentially unknowable.

2020 Second Quarter Investment Market Report

This year, investors have been treated to a rare real-world lesson in the mathematics of investing—namely, the fact that after a market decline, it takes a greater market recovery to get back to even. The first quarter saw a frightening downturn that delivered 20% losses across the U.S. and developed foreign markets. Then we experienced a breathtaking 20% gain in the second quarter, the fourth-best quarterly rise since 1950. Work out the mathematics, and virtually all indices are still showing a loss for the year.

You can see this dynamic everywhere you look. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—fell 20.70% in the first three months of the year, then gained 22.69% in the ensuing quarter. By the mathematics of the market, investors in the index are still down 2.88% so far this year. The comparable Russell 3000 index is down 3.48% in the first half of 2020.

Looking at large cap stocks, the Wilshire U.S. Large Cap index lost 19.88% in the first quarter, gained 21.64% in the second, and is still down 2.29% for the first half of the year. The Russell 1000 large-cap index now stands at a 2.81% loss, while the widely-quoted S&P 500 index of large company stocks gained 19.95% in the second quarter after a 20% drop in the first quarter--and is now down 4.04% for calendar 2020.

Meanwhile, the Russell Midcap Index is down 11.21% in the first half of 2020.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies were hit with a very significant 31.40% decline in the first quarter, and then recovered 25.63% in the second. The index is down 13.82% for the year. The comparable Russell 2000 Small-Cap Index is down 12.98% so far this year. The technology-heavy Nasdaq Composite Index recovered from its -13.10% first quarter return to post a 31.61% gain in the second quarter. The index is one of the few unadulterated bright spots for the first half of 2020, up 10.05% for the year.

International investors experienced the same lurching investment ride as U.S. stock holders, but with a shallower recovery. The broad-based EAFE index of companies in developed foreign economies lost 23.43% in the first quarter, then gained back 14.17% in the second quarter. Add it up, and the index is returning negative 12.59% so far this year. In aggregate, European stocks gained 14.33% in the second quarter, but because they were down 24.81% in the first part of the year, they're still sitting on a 14.03% loss for the first half of the year. EAFE's Far East Index meanwhile, gained 10.82% in the second quarter, but for the year it's in losing territory, down 9.29%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 17.27% in the most recent quarter, making up some of the 23.87% losses in the first three months of the year. The index is down 10.73% for the year.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a 25.63% decline during the year's first quarter, and then saw a nice 10.56% rebound in the second. Real estate investors are still down 17.77% for the year. The S&P GSCI index, which measures commodities returns, gained 27.37% in the second quarter, recovering some of the 42.34% 1st quarter loss. The index now posts a 25.39% loss for the year.

In the bond markets, rates continue to drag on at historic lows. Coupon rates on 10-year Treasury bonds stand at an astonishing 0.68%, while 3-month, 6-month and 12-month bonds are still sporting coupon rates of 0%. Five-year municipal bonds are yielding, on average, 0.46% a year, while 30-year munis are yielding 1.70% on average.

The market declined precipitously in March when people realized how much potential economic damage the COVID-19 virus, social distancing and the closing of many businesses could inflict on the U.S. economy. Then the market experienced one of the best quarters on record amid widespread optimism that some are calling euphoria.

Does that mean that the recent market gains represent a bubble? The evidence suggests that it does; the real question is how out-of-line stock prices are from reasonable norms. When you read about hairdressers day trading on Reddit, you know that at least some stocks are being bid up without too much concern about underlying valuations. But when you look at the accompanying chart showing Price/Earnings ratios going back to 1880, you see that the market today is still priced below previous peaks.

Does any of this mean that a severe market downturn is coming, or that stocks still have room to appreciate? That is a far more difficult question, for several reasons.

First, does anybody know how well companies are managing to keep up their operations when their workers are doing their tasks at their kitchen tables? In other words, do we really know how much productivity and economic value is being lost during the pandemic? This is uncharted territory for businesses and companies alike, but you could make the case that public companies (we're not talking about bars and restaurants) are just marginally less valuable now than they were at the start of the year, that the damage will be minimal and life will go on in the corporate world when everybody finally gets back in the office.. It's also possible that they've suffered huge damage to their bottom lines and viability and current prices are unsustainable. You can have your opinions, but nobody really knows.

The other factor is the Federal Reserve Board, which appears to view itself as a fiscal backstop not only for the economy, but also for the markets. Try to imagine a hypothetical investor who has unlimited money in the bank, who decides that stocks are not going to go down and companies will have money in the bank even if they don't earn it through operations. Would that investor ultimately have her way with stock prices? You have just imagined the reality that is the Fed. What we don't know is how long and hard the Fed will fight to prevent a severe market downturn before, say, the November elections.

What are the facts on the ground? June hiring data showed a sharp reversal from May's 2.7 million job losses. The ADP National Employment Report showed that more than 3.3 million workers were hired in the private sector in June. In addition, the most recent manufacturing indices were stronger than expected. But a total of 17 U.S. states have now paused their phased reopening programs due to the coronavirus, as the number of new daily cases rose 12.5%. Some hospitals in Texas, Florida, Arizona and California are reportedly reaching capacity. Then again, some news outlets report optimism that Pfizer--a component of the Dow Jones Industrial Averages and the S&P 500--had reported encouraging trial results of an experimental coronavirus vaccine, even though it's unlikely that a vaccine will be available this year.

The conclusion of these analyses is always and forever the same: we honestly don't know where the markets are going next, and we know with some certainty that trying to predict the market has, in the past, been a fool's errand. The most prudent strategy seems to be to play defense without abandoning the potential upside of equities until we know how the pandemic and its economic consequences play out. That strategy would have underperformed in the past three months, and would have outperformed in the previous three.

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Check out the expansion progress!

We wish you a happy and healthy summer!

From all of us at Demming Financial Services Corp.

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