MP McShane Partners

# January 2020 Insights

## Investment Overview

### 2020: Change in Leadership

Predicting the future has proven difficult for even the most brilliant and prescient of investment minds; however, one feature of financial markets that remains constant is change. As we head into an emotionally charged election year, predictions, like superfluous cash allocations, are following the momentum higher and pricing in another perfect year for the global financial markets. Once again, consensus estimates for 2020 reflect pundit pusillanimity insofar as they represent a mere extrapolation of prevailing trends; historically, such an environment can prove ripe for surprises to market expectations - both positive and negative. Consensus estimates amongst market strategies call for **+4.1%** and **+1.9%** increases in the S&P 500® Index and the U.S. economy in 2020, respectively. It is nearly impossible to know anything with exact certainty in the market, and, while the Investment Team does not make yearly numeric market predictions, we feel comfortable saying that, whatever equity markets do end up returning over the next twelve months, it will *not* be **+4.1%**.

Acknowledging that I will sound archaic and "old" (my current mother moniker), I have been playing the market game for over ±20 years now, and the one thing that stays the same is change, and that, time after time, pundits and consensus-oriented investors fail to anticipate the exact nature or timing of coming changes in financial market conditions. For this reason, the Investment Team does

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## Wealth Advisory Overview

### The SECURE Act Becomes Law

On Thursday, December 19th 2019, the Setting Every Community Up for Retirement Enhancement ("SECURE") Act passed both the House and Senate and was signed into law by the President. While the changes are not nearly as broad or substantial as the Tax Cuts & Jobs Act ("TCJA") that was passed two years ago, the new law is mainly intended to expand opportunities for individuals to increase their retirement savings.

While not every section of the legislation can be covered in this article, we have attempted to provide a high-level summary of the more applicable provisions:

**New IRA Rules**

- Elimination of the lifetime "stretch" provision for non-spouse beneficiaries of inherited IRAs and other retirement accounts, replaced by a 10-year distribution requirement
- RMDs required to start beginning at age 72 (instead of 70 ½)
- Removal of 70 ½ contribution age limit for Traditional IRA

One of the most significant changes made by the SECURE Act is the elimination of the 'Stretch' provisions for most non-spouse beneficiaries of defined contribution plans and IRA accounts. Under current law, designated beneficiaries are eligible to stretch distributions over their life expectancy (or in the case of a

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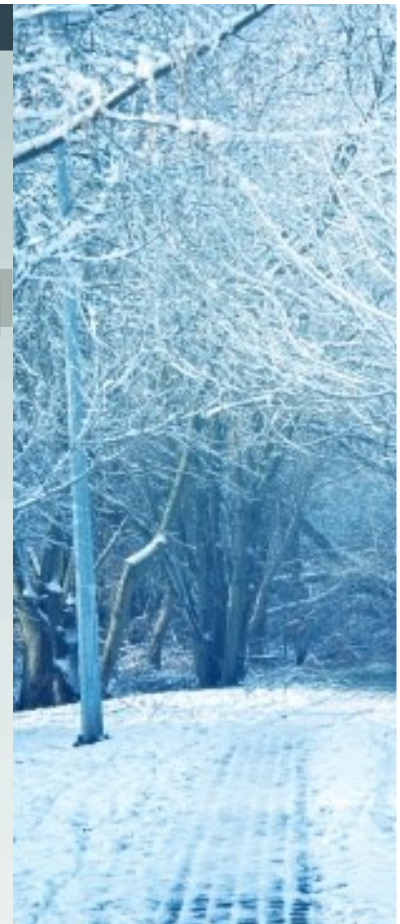

### Investment Team

Daniele Donahoe, CFA
*Chief Investment Officer*
Elliott Van Ness, CFA
*Director of Research | Portfolio Manager*
Thomas Mack
*Research Analyst*

### Wealth Advisory Team

Sandy Carlson, CFP®, CPA, CDFA™
*President | Wealth Advisor*
Rebecca Hoover, CPA, CDFA™
*Director of Tax | Wealth Advisor*
Lorri Tomlin, FPQP™
*Wealth Advisor*
Ryan Vaudrin, CFP®
*Wealth Advisor*
Daniel Hudspeth
*Wealth Associate*
Corey Meyer
*Wealth Associate*
Lesley Burke
*Client Service Associate*

### Points of Interest

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not repeatedly engage in the flawed exercise of predicting market performance each and every year. The key to change is *not predicting a singular event* but *anticipating all potential outcomes* and assembling a diversified portfolio equipped to deal with the inevitability and unpredictability of change, regardless of the final future verdict.

As we enter 2020, the spectrum of change is as broad as it is deep, so a portfolio unilaterally positioned could experience enormous repercussions and volatility. There are two primary leadership changes to consider entering 2020: the 2020 U.S. presidential election and the potential for a massive rotation across global equity markets. The political platforms going into the election are unprecedentedly disparate, so the ultimate outcome will have decidedly different implications for financial markets. Obviously, the current pro-business regime has been effectively priced into U.S. equity markets, and an unexpected upset by a progressive Democratic candidate could have a correspondingly *negative* impact on markets given certain proposals and agendas emphasizing policies regarding deficit reduction and wealth redistribution via higher taxes.

Although premature, the rotation in leadership across equity markets over the past several months could have significant implications for 2020. As can be seen below in Table I, during a particularly strong fourth quarter of 2019 ("4Q19"), large-cap *value* stocks outperformed large-cap *growth* stocks by **+1.61%** after having lagged by **-1.05%** through the first three quarters of 2019 (i.e., "1Q19 - 3Q19"). Furthermore, throughout the month of December, underlying sector-level performance signaled a sharp rotation into Health Care (**+3.59%**) and Energy (**+6.03%**), despite both sectors having lagged the broader market during the first three quarters of the year, returning **+5.6%** and **+6.0%**, respectively, vs. a comparable return of **+20.6%** for the S&P 500® Index. Table II on the next page provides a

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**Table I: 2019 U.S. Equity Market Performance**
**USD Total Return**

| Size & Style/Factor Index Performance | 4Q19 | 1Q19 - 3Q19 | 2019 |
|---|---|---|---|
| S&P 500® | +9.07% | **+20.55%** | **+31.49%** |
| S&P 500® Value | **+9.93%** | +20.01% | **+31.93%** |
| S&P 500® Growth | +8.32% | **+21.06%** | **+31.13%** |
| S&P 500® Equal-Weighted | +7.61% | **+20.10%** | +29.24% |
| S&P Mid-Cap 400® | +7.06% | +17.87% | +26.20% |
| S&P Mid-Cap 400® Value | +7.41% | +17.39% | +26.08% |
| S&P Mid-Cap 400® Growth | +6.73% | +18.32% | +26.29% |
| Russell 2000 | **+9.94%** | +14.18% | +25.52% |
| Russell 2000 Value | +8.49% | +12.82% | +22.39% |
| Russell 2000 Growth | **+11.39%** | +15.34% | +28.48% |

*Source: McShane Partners - FactSet Research Systems, Inc.*

**Monthly Index Review**
**USD Total Return**

| Data as of December 31st 2019 | December 2019 | 2019 | 2018 | 2017 |
|---|---|---|---|---|
| S&P 500® | +3.02% | **+31.49%** | -4.38% | +21.83% |
| Dow Jones Industrial Average | +1.87% | +25.34% | -3.48% | +28.11% |
| NASDAQ Composite | **+3.63%** | **+36.69%** | -2.84% | **+29.64%** |
| Russell 2000 | +2.88% | +25.52% | -11.01% | +14.65% |
| MSCI Emerging Markets | **+7.53%** | +18.88% | **-14.24%** | **+37.75%** |
| MSCI EAFE | +3.27% | +22.66% | -13.36% | +25.62% |
| Bloomberg Barclays U.S. Aggregate Bond Index | -0.07% | +8.72% | **+0.01%** | +3.54% |

# Investment Overview

## 2020: Change in Leadership

**Table II: 2019 U.S. Equity Market Performance**
**USD Total Return**

| Sector Index Performance | 4Q19 | 1Q19 - 3Q19 | 2019 |
|---|---|---|---|
| **S&P 500®** | **+9.07%** | **+20.55%** | **+31.49%** |
| Information Technology | **+14.40%** | **+31.37%** | **+50.29%** |
| Health Care | **+14.37%** | +5.64% | +20.82% |
| Financials | **+10.47%** | +19.60% | **+32.13%** |
| Communication Services | +9.00% | +21.74% | **+32.69%** |
| Materials | +6.38% | +17.11% | +24.58% |
| Industrials | +5.53% | +22.58% | +29.37% |
| Energy | +5.49% | +6.00% | +11.81% |
| Consumer Discretionary | +4.47% | +22.46% | +27.94% |
| Consumer Staples | +3.51% | +23.28% | +27.61% |
| Utilities | +0.75% | **+25.40%** | +26.35% |
| Real Estate | **-0.54%** | **+29.71%** | +29.01% |

*Source: McShane Partners - FactSet Research Systems, Inc.*

breakdown of S&P 500® Index sector-level performance sorted/ranked from highest to lowest based on 4Q19 performance, while also highlighting the differentiated performance in 4Q19 vs. sector-level performance through the first three quarters of 2019. What is particularly interesting is that, with the exception of the Information Technology sector, which continued to outperform in 4Q19, two of the three top-performing sectors through the first three quarters of 2019 were the worst performing sectors in 4Q19.

Obviously, the passive, market-cap-weighted index-tracking mentality had most investors poorly positioned for this short-term rotation. With the exception of Information Technology, the top performing sectors the first three quarters of 2019 were the bottom three in the fourth quarter. Should this trend continue, the Investment Team believes individual investor portfolios and exchange-traded fund ("ETF") strategies would be severely *underexposed* to the emerging sector leadership seen in the last quarter of the 2019. This could precipitate a massive reallocation toward previously depressed styles and sectors in 2020 and, in our opinion, represents the biggest wild card for equity investors in 2020.

With our eyes constantly turned towards extreme overreactions and complacencies across financial markets, the Investment Team first identified this attractive opportunity in small-cap equities in last month's newsletter (McShane Partners December 2019 INSIGHTS), within which we highlighted how small-cap equities - in particular, small-cap value stocks - were not only out-of-favor amongst investors but also extremely inexpensive.

Small-cap U.S. equity value stocks appear to be trading at extreme discounts to growth stocks based on relative PE NTM multiples. Even after the mild outperformance then end of 2019 the iShares Russell 2000 Value ETF ("IWN") is trading at a roughly **-66.5%** discount to the iShares Russell 2000 Growth ETF ("IWO"), despite historically trading at an average relative discount of **-38.0%** over the past **±19 years**. If the emerging rotation plays out to fruition, there could be relative upside potential of **±75.1%** for U.S. small-cap value stocks simply by returning this mispricing to parity: not a heroic assumption. For this reason, we have assembled a panel of small cap portfolio managers for McShane Partners sixth Annual Portfolio Manager Panel.

### McShane Partners' 2020 Portfolio Manager Panel Event: Opportunities in Small Cap

This year, McShane Partners will be hosting its sixth Annual Portfolio Manager Panel at Carmel Country Club on Tuesday, February 25th - we look forward to sending out additional information and details regarding the event over the coming weeks, and we would encourage anyone/everyone who is

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interested in attending the event to RSVP at your earliest convenience by contacting Lesley Burke.

### Watching the Podium & the Pendulum in 2020

Given the Investment Team's strong fundamental belief that financial markets are *mean-reverting mechanisms*, the excessive discount in small-cap value stocks and certain out-of-favor sectors could create controversy in the market that rivals the election. Normally, when the *pendulum* (i.e., relative valuation multiple) swings this far to the *negative* (i.e., relative discount), only a subtle shift in sentiment from *negative* to *less-negative* is required to create outsized upside in undervalued assets. Marginal multiple expansion with mitigated downside risks can cause a significant upward movement in assets that are priced to fail. As the pendulum swings back to *parity,* rotation could catch passive investors by surprise. As the majority of the population pines over the election, McShane Partners will continue to monitor subtle shifts in the market to insure portfolios are positioned for the evolving late-cycle macroeconomic and market environment.

*"Profits tend to be substantially lower and life pretty much more stressful when buying and selling stocks for short-term profits."*

*- Philip Fisher*

### Stock & Strategy Spotlight

| Name | Ticker | 2019 |
|---|---|---|
| Frontier MFG Core Infrastructure Fund - Institutional Class | FMGIX | **+27.78%** |
| Frontier MFG Core Infrastructure Fund - Service Class | FCIVX | **+27.62%** |

### Description & Investment Thesis

The Investment Team is adding the Frontier MFG Core Infrastructure Fund ("the Fund") to our firm-wide mutual fund and exchange-traded fund ("ETF") buy lists. After several in-person meetings and conference calls with members of the Fund's investment and portfolio management teams at MFG Asset Management ("MFG"), we believe that the Fund's underlying investment strategy is complementary to our existing Hybrids' portfolio and is attractive for long-term investors at this stage in the market cycle. In particular, following the considerable outperformance of Utilities and Real Estate Investment Trusts ("REITs") over the past **±12-24 months**, the Investment Team believes that incorporating a high-quality, actively managed investment strategy, such as the Fund, into our strategic Hybrids' allocations will help to mitigate incremental *equity market risk* (i.e., beta) given portfolio-level exposures to and positions in index-tracking, passively managed investment strategies across our Utilities' and REITs' allocations. Given the aforementioned outperformance of these passive Utilities and REITs investment strategies, the Investment Team believes that the Fund can provide *complementary*, *lower-beta* exposure to infrastructure as an asset class within our Hybrids' allocations, which should allow us to capture recent outperformance by rotating out of pure-play beta strategies, where necessary, and trimming or reducing portfolio-level positioning in certain individual stock holdings/ positions that have appreciated beyond our fundamental price targets, without reducing overall sector-/industry-level exposures. The Fund's has two primary investment objectives that we believe are particularly attractive at this stage in the market cycle: protect capital in adverse market conditions; and generate a minimum gross return of consumer price inflation ("CPI") plus ±5.0% per annum over a full business cycle. Furthermore, the two key principles of the Fund's investment strategy highlight the relative appeal of incorporating infrastructure into a long-term, diversified investment portfolio: infrastructure assets have a structural advantage in generating reliable investment returns; and minimizing downside risk is key to generating attractive long-term returns. The Investment Team will be initiating positions in FMGIX | FCIVX across client investment portfolios, where suitable and/or appropriate relative to existing holdings and positions, over the coming weeks and months of the new calendar year.

# Wealth Advisory Overview

## The SECURE Act Becomes Law

qualifying trust, over the oldest applicable trust beneficiary's life expectancy). However, for most designated beneficiaries who inherit in 2020 and beyond, the new standard under the SECURE Act will be the "10-Year Rule." Under this 10-Year Rule, the entire inherited retirement account must be zeroed out by the end of the 10$^{th}$ year following the year of inheritance.

Another change from the SECURE Act involves pushing back the beginning of Required Minimum Distributions ("RMDs") from age 70 ½ to age 72. Individuals will still be able to delay their first RMD until April 1$^{st}$ of the year following the year for which they must take their first RMD.

Beginning in 2020, individuals of any age will be allowed to contribute to a Traditional IRA, including those who are 70 ½ or older. However, the requirement that such individuals have "compensation", which is generally earned income from either wages or self-employment to make such a contribution, remains. Therefore, only those individuals who are 70 ½ or older and who are still working, or who have a spouse that is still working, will be able to take advantage of this change.

The SECURE Act makes no changes to the date at which individuals may begin to use their IRAs, and inherited IRAs, to make Qualified Charitable Distributions ("QCDs"). This means that even though an individual turning 70 ½ in 2020 will not have to take an RMD for 2020, they may still use their IRA to make a QCD of up to $100,000 for the year. This allows for charitable contributions to be made on a pre-tax basis for non-itemizers. Beginning in the year an individual is required to take an RMD, any amounts given to charity via a QCD will also reduce their RMD .

### New 401(k) Provisions

- Maximum contribution for 401(k) automatic enrollment increased to 15%
- Part-time employees who work at least 500 hours in at least three consecutive years will be eligible to participate in their employer's 401(k) plan

Beginning in 2020, the SECURE Act will allow 401(k) plans to increase the default deferral percentage for employees from 10% to as high as 15%. In addition, employees who work *at least* 500 hours in *at least* three consecutive years will be eligible to participate in their employer's 401(k) plan. Under current law, employers can generally exclude employees from participating in a 401(k) if they have not worked at least 1,000 in a single plan year. This leaves many part-time workers, even those who have worked for the employer for several years, unable to participate.

### Other Provisions

- Kiddie tax reverts back to parent's marginal tax rate
- AGI "hurdle rate" for deducting qualified medical expenses to remain at 7.5%

Two years ago, the TCJA changed the nature of the so-called Kiddie Tax, a tax on the unearned income of certain children. Prior to TCJA, any income subject to the Kiddie Tax was taxable at the child's parents' marginal tax rate. The passage of TCJA made that income subject to the compressed trust tax brackets, which typically led to a higher tax bill. The SECURE Act reverses TCJA and makes any income subject to the Kiddie Tax again taxable at the child's parents' marginal tax rate. The change is effective for 2020, however taxpayers can elect to apply the SECURE Act rules to the 2019 tax year, as well as to 2018. For 2018, the cost of filing an amended return should be carefully evaluated against any potential tax savings that may be achieved.

Congress has also retroactively reinstated and made effective through 2020 the 7.5% AGI 'hurdle rate' that must be exceeded to deduct qualified medical expenses.

As always, your Wealth Advisory Team is here to help you navigate the changing legislative landscape, so please contact your Wealth Advisor with any/all questions regarding the impact these new rules and regulations may have on you and your financial planning assumptions.

## Around McShane Partners

### 2020 Portfolio Manager Panel: Opportunities in Small-Cap Equity Investing

You are invited to attend McShane Partners' exclusive portfolio manager panel featuring four tenured portfolio managers sharing unique insights on investing in the small-cap equities. You should walk away from this experience with a better understanding of how to navigate rising market volatility, changing economic growth, and elevated risk of recession. The panel will be moderated by our Managing Partner and Chief Investment Officer, Daniele Donahoe.

**Event Details**:

Tuesday, February 25th 2019
5:30 PM - 7:30 PM
Carmel Country Club

Please contact Lesley Burke at lburke@mcshanepartners.com and RSVP at your earliest convenience if you are able to attend.

### Charitable Giving in Review

This year, McShane Partners donated 10% of our profits to nonprofit organizations with a focus on the Arts, Education and Women. We believe corporate philanthropy is an essential business endeavor that helps support and improve the quality of life for the communities of Charlotte. Notably, a few of our largest donor recipients in the community include the following; the Charlotte Mecklenburg Library, Mint Museum Auxiliary, and Queens University Learning Society. To learn more about our community involvement and the non-profits we support please visit our website. Additionally, we are always open to learn about and support the causes that are dear to our clients.

### Holiday Party Fun & Festivities

The entire McShane Partners gathered together for a fun-filled evening of delicious food and plenty of holiday cheer at Peppervine in SouthPark.

### Good Friends Charlotte

Every year, McShane Partners is proud to sponsor a table for the Good Friends 33rd Annual Holiday Luncheon. Good Friends Charlotte is a women's organization supporting individuals and families with financial resources to improve lives and inspire hope. It is truly amazing how successful the Good Friends Luncheon has become! More than half a million dollars was raised at the luncheon on Thursday, December 12th.

### McShane Partners

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

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