

## DECEMBER 2020 INSIGHTS

### INVESTMENT OVERVIEW

#### ERRATIC & EXTREME

Erratic movement between sectors and extreme dispersion create a precarious game board for market participants following the election. Through the end of the third quarter (“3Q20”), the S&P 500® Index had returned **+5.57%** year-to-date (“YTD”), with the S&P 500® Growth Index returning **+20.61%** vs. a sharp decline of **-11.47%** for the S&P 500® Value Index, indicative of extreme disparities in *growth vs. value exposures* in the final weeks leading up to the 2020 U.S. presidential election.

In the midst of the escalating coronavirus pandemic and given the scarcity of long-term, secular growth stories capable of withstanding a pandemic-induced recession, equity investors moved aggressively into a select handful of individual Information Technology and Consumer Discretionary stocks, several of which benefitted from a concurrent, albeit unexpected, increase in demand for and accelerated adoption of their technological services, systems, and/or product offerings across consumer and business end markets. As a result, the market capitalization of the Information Technology sector as a percentage of the total market capitalization of the S&P 500® Index climbed as high as **±29.03%**, approaching the **mid-30.0%** levels last seen during the dot-com bubble years of 2000-2001.

Despite the obviously superior positioning of the Information Technology sector, market participants failed to appreciate how momentum had driven the sector to relative extremes at the expense of the rest of the market. At such extremes, investors/portfolios were positioned as if the *only* assets offering attractive long-term

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### WEALTH ADVISORY OVERVIEW

#### POST-ELECTION TAX UPDATE

Following the 2020 Election, we have some clarity regarding the likelihood of major tax changes for U.S. businesses and individuals. As we discussed in our September Tax Update, President-elect Biden’s informal tax policy would largely have impacted taxpayers earning more than \$400,000 a year in taxable income.

With Biden winning the Presidency and the House remaining in Democratic control, attention now turns to the Senate. It appears most likely that Republicans will retain a slim majority in the Senate, preventing both Houses of Congress from moving to Democratic control. Even if the Senate flips to a 51-50 Democratic control (with Harris being the tiebreaker), the loss of any one Democratic Senator would prevent the ability to count on Senate support for the Democrats initiatives. Therefore, major tax reform over the next two years is very unlikely.

#### Legislative Overview for a Tax Bill

As a recap, Tax Bills generally require significant alignment between the controlling party. Here is an overview of the process.

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#### POINTS OF INTEREST

- [Monthly Index Review](#)
- [Stock & Strategy Spotlight](#)
- [Around McShane Partners](#)

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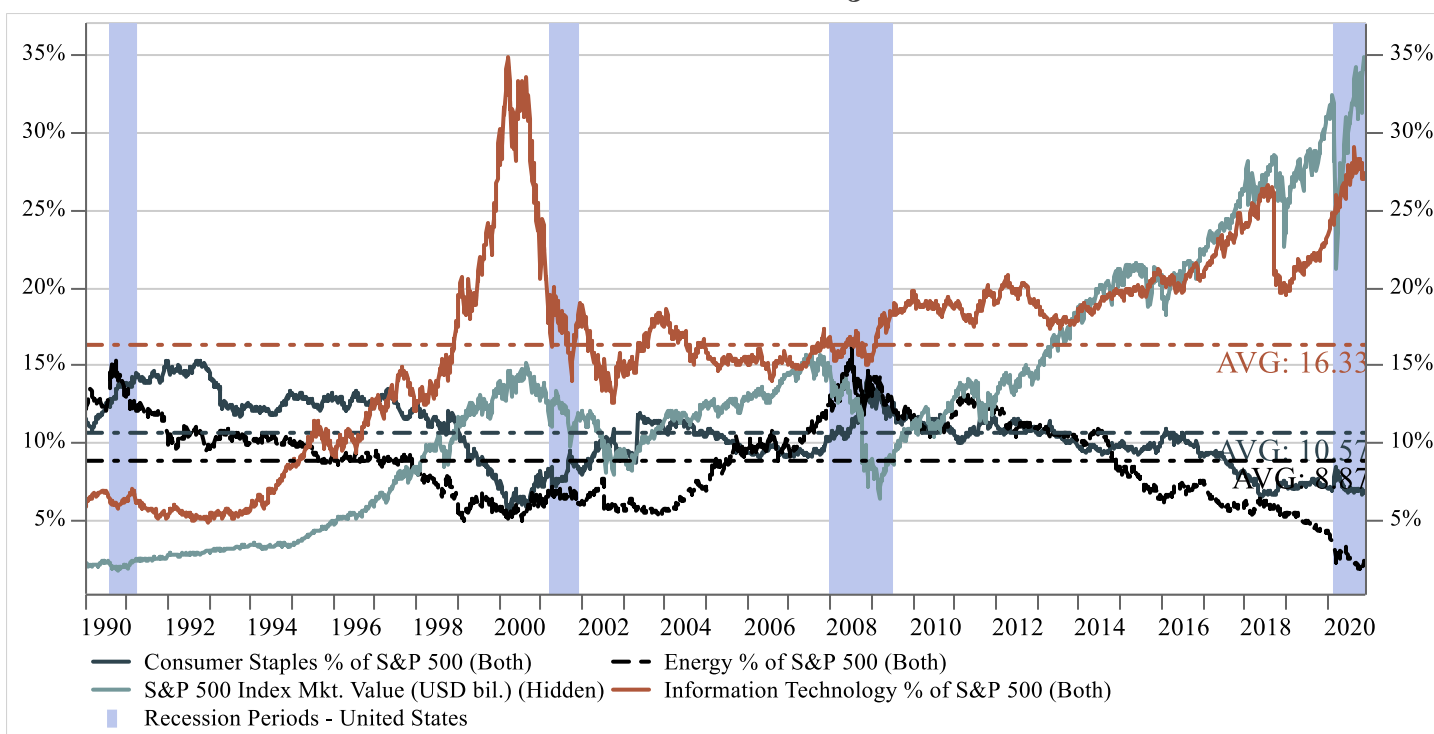
### ERRATIC & EXTREME

returns were Information Technology stocks, regardless of their respective contribution to economic growth relative to other major sectors or industries. It is important to remember, however, that even the most flawlessly positioned or well-capitalized company can become *overpriced* at some point, and the *return to parity* can be particularly painful for a portfolio with unilateral positioning in or concentrated exposures to a singular theme, sector, or stock.

Since Election Day (i.e., Tuesday, November 3<sup>rd</sup>), the S&P 500® Value Index has outperformed the S&P 500® Growth Index by **±1.61%**, with *valuation-sensitive cyclical sectors* (e.g., Energy, Financials, Industrials) outperforming those secular growth and momentum sectors responsible for the majority of the gains YTD in 2020, such as Information Technology and Consumer Discretionary.

Chart I, below, illustrates the growing significance of the Information Technology sector on an absolute and relative basis, with the **burnt orange line** representing its market capitalization as a percentage of that of the S&P 500® Index, which recently started testing prior *bubble-level thresholds* of the dot-com years of 2000-2001. Meanwhile, the utter collapse of the Energy sector over the past **±10 years** is something not seen in over three decades, [Continued on next page](#)

**CHART I: GICS® SECTOR MARKET CAPITALIZATION AS % OF S&P 500® INDEX**



Source: McShane Partners - FactSet Research Systems, Inc.

### MONTHLY INDEX REVIEW USD TOTAL RETURN

DATA AS OF NOVEMBER 30 <sup>TH</sup> 2020	NOVEMBER 2020	2020 YTD	2019	2018
S&P 500® Index	+10.95%	<b>+14.02%</b>	<b>+31.49%</b>	<b>-4.38%</b>
Dow Jones Industrial Average	+12.14%	+6.11%	+25.34%	<b>-3.48%</b>
NASDAQ Composite	+11.91%	<b>+37.09%</b>	<b>+36.69%</b>	<b>-2.84%</b>
Russell 2000	<b>+18.43%</b>	+10.41%	+25.52%	<b>-11.01%</b>
MSCI Emerging Markets	+9.25%	+10.51%	+18.88%	<b>-14.24%</b>
MSCI EAFE	<b>+15.51%</b>	+3.45%	+22.66%	<b>-13.36%</b>
Bloomberg Barclays U.S. Aggregate Bond Index	+0.98%	+7.36%	+8.72%	<b>+0.01%</b>

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### ERRATIC & EXTREME

with its respective weighting in the S&P 500® Index falling from a secular peak of  $\pm 16.25\%$  in July 2008 to an all-time historic low of  $\pm 1.89\%$  on November 6<sup>th</sup> 2020.

*"I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."*

- Warren Buffet

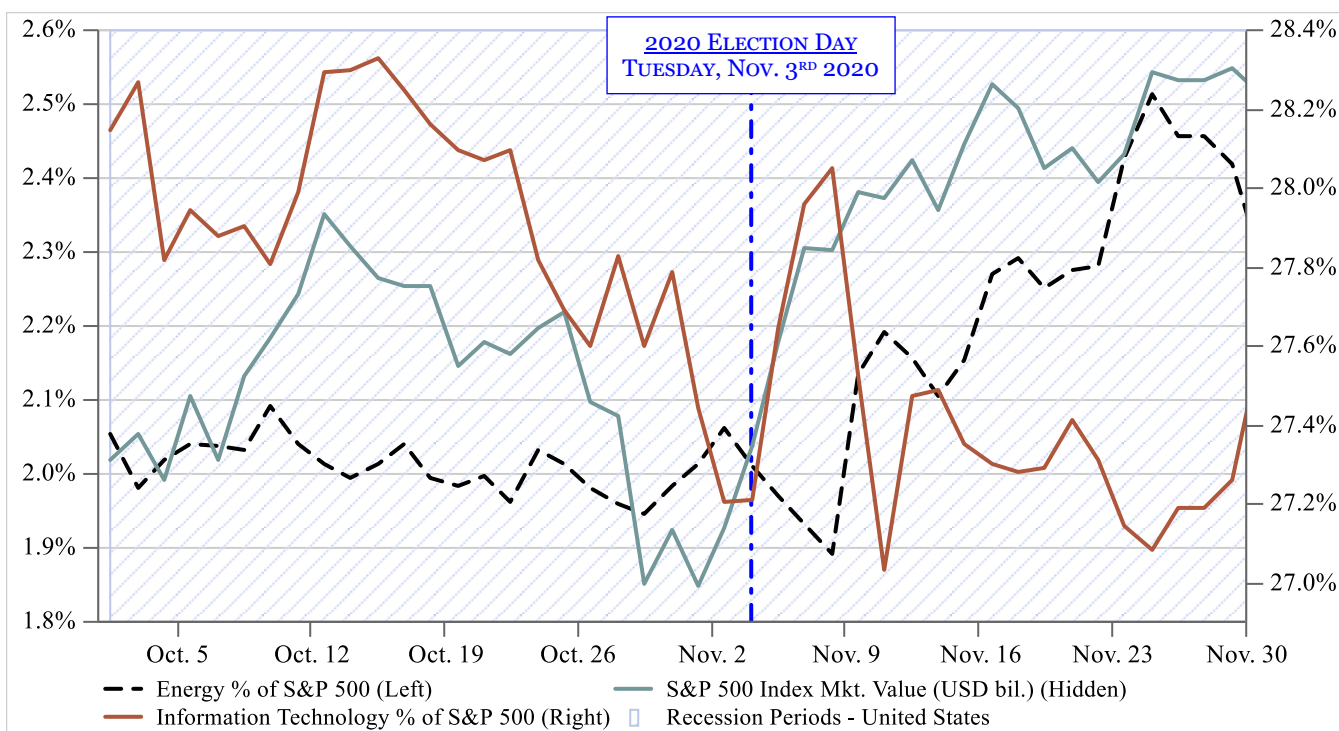
### SHIFTING SENSITIVITIES STIR SECTOR SWINGS

The identification of emerging trends or potential pivots in the sector-level components or indexes across equity markets can have a critical impact on the absolute and relative performance of equity portfolios, as an *overweight allocation* to Energy - and/or corresponding *underweight allocation* to Information Technology - would have resulted in severe relative underperformance vs. the respective index over the past  $\pm 10$  years, as evidenced by the sizable discrepancy in sector-level representations shown in Chart I.

Chart II, below, provides a snapshot of recent developments in the respective market capitalization ("market cap") weightings of the Information Technology and Energy sectors relative to that of the S&P 500® Index quarter-to-date ("QTD"), including the periods immediately before and after the 2020 U.S. presidential election, which is marked by the **vertical blue dotted line** in Chart II. Since Election Day through month-end, the Energy sector has increased  $+23.01\%$  vs. a comparable gain of  $+8.92\%$  for the Information Technology sector, contributing to a noticeable short-term reversion, as the Energy sector quickly moved off of the aforementioned lows of  $\pm 1.89\%$  to as high as  $\pm 2.51\%$  of the S&P 500® Index, benefitting from a concurrent decline in the relative weighting of the Information Technology sector from  $\pm 28.05\%$  to  $\pm 27.09\%$  of the S&P 500® Index.

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**CHART II: INFORMATION TECHNOLOGY VS. ENERGY SECTORS AS % OF S&P 500® INDEX**



Source: McShane Partners - FactSet Research Systems, Inc.

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#### FACTOR FOCUS: VALUE VS. GROWTH

The S&P 500® Value Index (“Value”) has underperformed the S&P 500® Growth Index (“Growth”) for **8 of the past 10 calendar year periods from 2010-2019**, during which time Value has failed to record consecutive periods of back-to-back years of relative outperformance vs. Growth. Over the last ten years, betting on a sustained reversal of the Growth trade after an isolated instance/episode of relative outperformance by Value has consistently proven to be an extremely unwise decision. Is this time different?

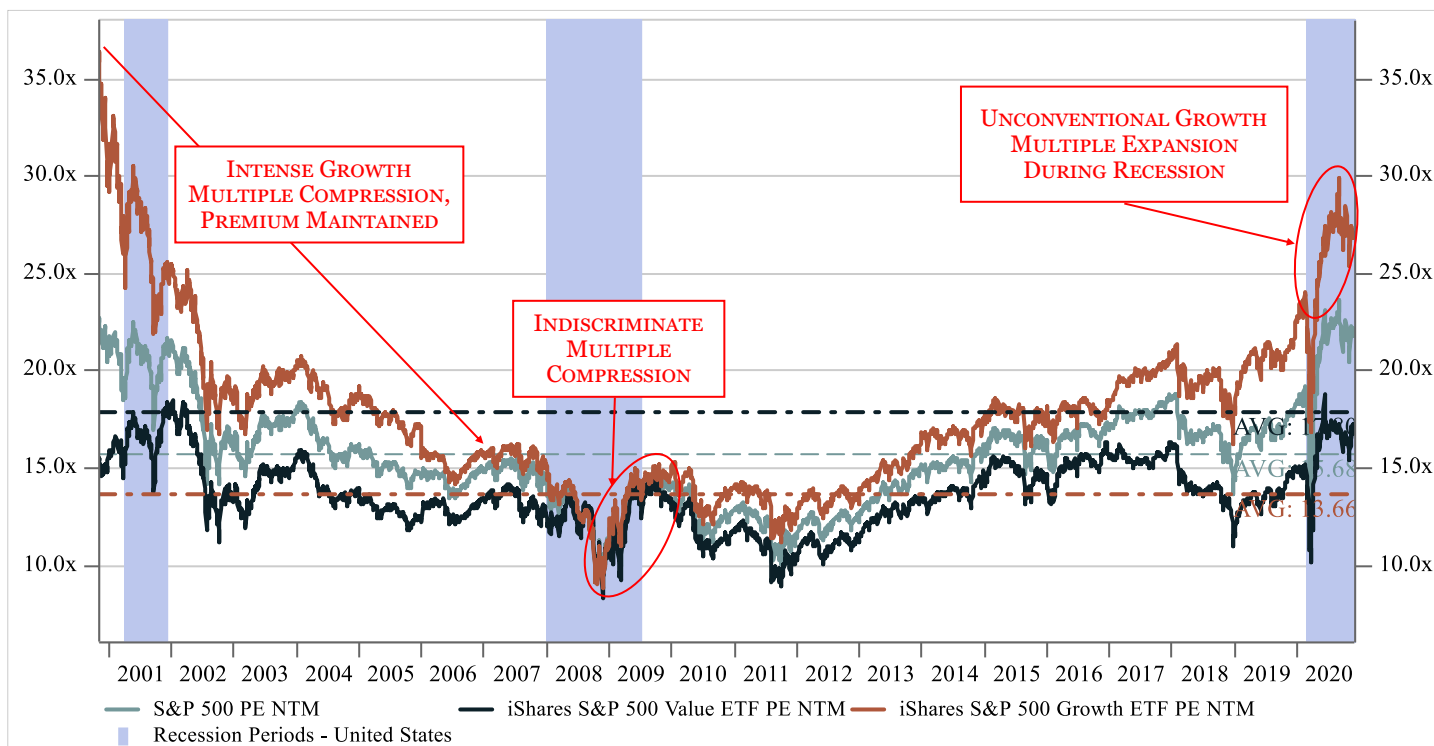
This gravitation toward Growth stocks, particularly large-cap Information Technology stocks, has resulted in a massive momentum trade across global equity markets, wherein the equities of a handful of popular, well-known companies have become *over-valued* and *over-owned*, while shares of lesser-known, attractively valued smaller-capitalization companies have become neglected and under-represented in investors’ portfolios.

Chart III on the next page provides a long-term illustration of the forward-looking price-to-earnings (“PE NTM”) ratios for the iSHARES S&P 500® VALUE ETF (“IVE”) and the iSHARES S&P 500® GROWTH ETF (“IVW”), as well as that for the broader S&P 500® Index. Over the past ±20 years, IVE (i.e., Value) has historically traded at an *average relative discount* of **-23.2%** vs. IVW (i.e., Growth); this valuation discount, however, has expanded dramatically over the past four years, with Value currently trading at a relative PE NTM of **±0.63x** vs. Growth (i.e., a relative discount of **-37.9%**). Growth stocks typically trade at relative premiums, so the question is *not* whether the premium multiple is *warranted*, but, rather, whether or not the *order of magnitude* of the relative premium is justified. In other words, has the premium paid reached a level where sustainable *mean reversion* is likely to return closer to parity?

Growth’s relative premium vs. Value peaked at **±143.8%** during the dot-com bubble, after which Growth’s relative multiple vs. Value suffered an eight-year compression period, hitting a secular trough relative multiple of **±0.94x** (i.e., a relative discount of **-6.4%**) vs. Value during the subsequent recession (i.e., the Global Financial Crisis) only to expand to the current relative premium PE NTM multiple of **±1.59x**. During equity market corrections,

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**CHART III: S&P 500® INDEX LONG-TERM VALUATION ANALYSIS - VALUE VS. GROWTH**



Source: McShane Partners - FactSet Research Systems, Inc.



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Growth multiples tend to compress more than Value multiples, as balance sheets and valuations become more fashionable when times are tough; however, with the recent pandemic-driven recession, the premium multiples on Information Technology stocks actually *expanded* as investors assigned incremental value for accelerating trends in technology consumption and increased demand driven by a secular shift toward *stay-at-home* and *work-from-home* (“WFH”) utilization amongst key end markets.

The Monday and Tuesday after Election Day saw two of the largest days of relative price gains/moves in the value vs. growth trade since October 2008, with Value outperforming the Growth by **+4.56%** and **+2.40%** on November 9<sup>th</sup> and 10<sup>th</sup>, respectively (*Source: FactSet Research Systems, Inc.*). Identifying the move is easy, but determining the sustainability and intimation in this underlying move in market positioning is difficult. The contrarian investment philosophy employed at McShane Partners necessitated the addition of some stock-specific exposure to the Energy and Financial sectors during the correction/sell-off during the first quarter of 2020 (“1Q20”), as multiple compression in these sectors signaled oversold, bottoming sentiment. At this point, the easy bounce has occurred and chasing Value indiscriminately after a decade of false starts does not seem prudent, but slowly adding to undervalued franchises like JP Morgan Chase & Co. (“JPM”) and Exxon Mobil Corp. (“XOM”) may be ways to systematically, methodically balance our sector weights without overreacting.

### STOCK & STRATEGY SPOTLIGHT

NAME	TICKER	NOVEMBER 2020	2020 YTD
Pfizer, Inc.	PFE	+15.11%	+7.31%

#### DESCRIPTION & INVESTMENT THESIS

In the August 2020 edition of [INSIGHTS](#), the Investment Team mentioned/highlighted shares of Pfizer, Inc. (“PFE”) after the company announced regarding positive preliminary data and initial results from its joint vaccine program with BioNTech SE (“BNTX”) against *severe acute respiratory syndrome coronavirus 2* (“SARS-CoV-2”): the current virus strain causing the *2019 novel coronavirus disease* (“COVID-19”). At the time, we hoped that we would be able to feature shares of PFE again in another installment of our monthly **STOCK & STRATEGY SPOTLIGHT**, and we are particularly pleased to be able to do so after an announcement made by PFE and BNTX on Monday, November 9<sup>th</sup> reporting that the results of their joint vaccine program showed an *efficacy rate above 90%*.

PFE shareholders may also have noticed the receipt of shares in Viatris, Inc. (“VTRS”) as part of a spin-off following the successful completion of a merger agreement between PFE and Mylan NV (“MYL”). The Investment Team is working through reviewing individual positions across client investment portfolios to ensure any subsequent recommendations coincide with any/all necessary year-end tax planning needs or requirements.

## WEALTH ADVISORY OVERVIEW

### POST-ELECTION TAX UPDATE

#### 1) House of Representatives

- i. Tax Bills must originate in the House of Representatives and begin in the House Ways and Means Committee. The party in control of the House elects the Chairman of this Committee.
- ii. Full House of Representatives must pass a version of the Proposed Tax Bill.

#### 2) Senate

- i. Once a House Bill is passed, the Senate Finance Committee begins hearings and “Markups” on the House Bill.
- ii. The full Senate gets a version of a marked up Bill for consideration from the Senate Finance Committee and may approve an unamended version of the House Bill, they may approve an amended version of the House Bill, or they may fail to pass any Bill.

#### 3) House of Representatives

- i. The Senate version of the approved Bill goes to the House of Representatives for adoption as amended. If the House fails to adopt it, a Conference Committee gets appointed to work out the differences in the two Bills.

#### 4) Conference Committee

- i. The Conference Committee is made up of members from both Chambers, with the party in control of each Chamber appointing an equal number of members on the Committee.
- ii. The Conference Committee reports its version back to both the House and the Senate, which both vote on the Committee’s compromise version.
- iii. A Compromise Bill passed by both the House and the Senate goes to the President for signature.

#### 5) President

- i. The President can sign the Bill into law or veto the Bill.
- ii. A vetoed Bill goes back to the House for an attempt to override the veto or a revision of the Bill.

As you can see, there is a long road required for Tax Legislation, which is why the prospect of substantive tax reform is very unlikely with a divided Congress. In the upcoming administration, any Tax Bill will be the result of substantial negotiation and compromise at best or will be simply impossible at worst.

As discussed in our previous update, many of the provisions enacted in our last Tax Bill expire in 2025, with certain provisions changing as early as 2022. In addition to the long road to approval, a Tax Bill is subject to complicated spending restrictions and requirements. One way tax legislation has complied with these restrictions in recent years is to make tax laws “temporary”, with some provisions having to be re-adopted every year and some sunset after several years.

With the 2017 Tax Act, the bulk of the tax reductions occurred in the earliest years, with reductions getting less generous, and punitive measures getting more stringent in the years after enactment. The provisions affecting business will begin to tighten with reductions in deductible interest and a deferred deduction for certain R&D expenses after 2021. In 2025 individual tax rates will revert to previous levels, causing an increase in the top tax rate from 37% to 39.6% for income over somewhere close to \$550,000 (the rates are indexed for inflation)

Legislation for the next two years will likely make smaller improvements to the tax code and will include areas of bipartisan agreement, such as the recently proposed legislation intended to encourage retirement savings by simplifying and expanding retirement options.

## ESTATE PLANNING: WHAT HAPPENS TO THE GIFT AND ESTATE TAX EXEMPTION AFTER 12/31/2025?



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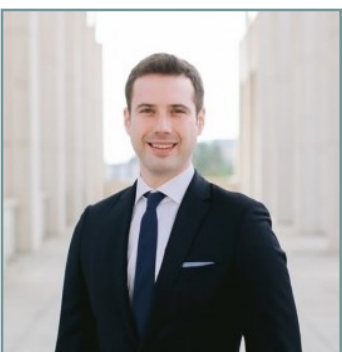
In 2017, the Tax Cuts and Jobs Act (TCJA) raised the estate tax exemption from \$5 million to \$10 million per person indexed annually for inflation. In 2020, the exemption is \$11.58 million (\$23.16 for a married couple). The estate and gift tax exemptions are integrated. Therefore, the estate exemption is reduced for lifetime gifts that exceed \$15,000 per person. Gifts or estates that exceed the exemption amount are taxed at a 40% rate.

The increased gift and estate exemptions are temporary and are scheduled to sunset back to the \$5 million level (adjusted for inflation) as of January 1, 2026. Given this sunset provision, questions have been raised as to how gifts greater than the \$5 million threshold made between 2018 and 2025 would be handled if the donor died after January 1, 2026.

To answer this question, on November 26, 2019, the Treasury Department and the Internal Revenue Service issued final regulations confirming that individuals who take advantage of the increased gift tax exclusion amount in effect from 2018 to 2025 will not be adversely impacted when TCJA sunsets on January 1, 2026. The final regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the basic exclusion amount applied to gifts made prior to January 1, 2026, or the basic exclusion amount applicable on the date of death.

As a result, individuals planning to make large gifts between 2018 and 2025 can do so without concern that they will lose the tax benefit of the higher exclusion level once it decreases after 2025. The same applies to spouses who have the benefit of “ported” exclusions made in this period. However, the regulations set out a “use it or lose it” provision. If an individual dies after 2025 and did not make gifts between 2018 and 2025 greater than the pre-sunset exclusion amount in effect at his/her death, the excess exclusion is lost.

## NEXTGEN: SAVING FOR RETIREMENT



Ryan Vaudrin, CFP®  
Wealth Advisor

As we discussed in last month’s article, saving early is very important but can be a daunting task. One of the easiest ways to begin saving can be through an employer sponsored retirement plan such as a 401(k). A 401(k) plan is a defined contribution plan that is offered to employees by their employer. After meeting eligibility requirements, employees have the option to begin participating to help them save for retirement.

A 401(k) plan is a great option for saving because contributions are automatically deducted from employee’s paychecks and deposited into the 401(k) account. As an additional incentive to contribute, some employers will offer a matching program. For example, if your employer offers a 4% match, the employee will be required to contribute 4% of their salary to receive the employers’ portion. This is a great way to boost your savings and it is recommended that everyone make the minimum contribution to fully utilize the company match.

There will be a few decisions that need to be made upon entering a 401(k) plan. The first decision involves deciding what type of contribution should be made: A Traditional 401(k), a Roth 401(k), or a combination of both. Both a Traditional 401(k) and a Roth 401(k) operate the same way, the difference is how they are taxed. With a traditional 401(k), contributions are excluded from taxable income now and the distributions are taxed in the future when they are withdrawn from the account. With a Roth 401(k), the contributions are contributed post-tax, therefore the contributions and earnings could be distributed tax-free during retirement. To help determine what option may be best, you should consider whether your tax bracket will be higher or lower in the future.

After determining that you want to save and which contribution type should be used, it is time to select an asset allocation, as well as your underlying investment options. Next month, we will review the options for these two important considerations.

## TAX UPDATE: THE HOME OFFICE DEDUCTION



Becky Hoover  
CFP®, CPA, CDFA®  
Director of Tax | Wealth Advisor

The home office deduction allows qualifying taxpayers to deduct certain home expenses on their tax return. With more individuals working from home than ever before, we have had a lot of questions lately regarding whether a home office deduction can be taken. Here are some things to help you understand the home office deduction and whether you can claim it:

- Employees are not eligible to claim the home office deduction. If you are self-employed you are not an employee, you are an owner.
- It is available to both homeowners and renters and includes expenses for mortgage interest, insurance, utilities, repairs, maintenance, depreciation, and rent.
- The term "home" includes a house, apartment, condominium, mobile home, boat, or similar property. It also includes structures on the property such as an unattached garage, studio, barn, or greenhouse.
- There are two basic requirements for the taxpayer's home to qualify:
  1. There must be exclusive use of a portion of the home for conducting business on a regular basis.
  2. The home must be the taxpayer's **principal place** of business. A taxpayer can also meet this requirement if administrative or management activities are conducted at the home and there is no other location to perform these duties. Therefore, someone who conducts business outside of their home but also uses their home to conduct business may still qualify for a home office deduction.
- Taxpayers who qualify may choose one of two methods to calculate their home office expense deduction:
  1. The simplified option has a rate of \$5 a square foot for business use of the home. The maximum size for this option is 300 square feet. The maximum deduction under this method is \$1,500.
  2. The regular method deductions are based on the percentage of the home devoted to business use. Taxpayers who use a whole room or part of a room for conducting their business need to figure out the percentage of the home used for business activities to deduct indirect expenses. Direct expenses are deducted in full.

## SENIOR PLANNING: ANNUAL GIFTING



Lorri Tomlin, FPQP™  
Wealth Advisor

'Tis the season for gifting and for some seniors this means giving the annual tax-free amount allowed by the IRS to children and/or grandchildren. For 2020, the gift tax free amount is \$15,000 per individual (\$30,000 for a married couple). Any gifts over \$15,000 will require a gift tax return to be filed, however, generally there will be no tax due. Gifts greater than \$15,000 will reduce your lifetime gift exclusion, as well as your federal estate tax exemption at death.

The lifetime gift tax and federal estate tax exemptions are integrated. Both are currently \$11.58 million for 2020 (\$23.16 million for a married couple). The lifetime gift tax exemption specifies the amount you may gift within your lifetime. The federal estate tax exemption allows for the tax-free transfer of property at death. The estate tax exemption is transferable to a surviving spouse if it was not fully utilized at the first spouses passing. For example, if a married couple gave a child \$60,000 in 2020, they would exceed the gift

exclusion limit by \$30,000 which would reduce their lifetime gift exclusion, as well as their federal estate tax exemption by \$30,000. Given the current high exclusion level, this is typically not a concern for most people.

Included Gifts	Non-Included Gifts
Money or assets such as stock options	Educational expenses paid directly to the educational institution
Interest free loans to family or friends	Medical expenses paid directly to the medical facility
Selling property to a friend or relative at below fair market value	Gifts given to certain tax-exempt charitable organizations



## AROUND McSHANE PARTNERS

### HOLIDAY CELEBRATIONS



The McShane Partners team would like to wish you and your loved ones a safe holiday season as we look forward to a wonderful new year.

The McShane Partners team will host our annual offsite meeting on Thursday December 10th. We will review 2020 and look forward to what we can accomplish in 2021 with additional initiatives and goals.

The team will also celebrate 2020 at this year's annual Christmas party which will be held on December 15th at the Duke Mansion.

### VERSE & VINO

2020 was our sixth year sponsoring this premier event, which supports the Charlotte Mecklenburg Library Foundation. Much like everything else in 2020, this year's edition had its own challenges as it had to be streamed online. The event was a great success featuring multiple New York Times best-selling authors. Thank you to everyone involved!



### McSHANE PARTNERS

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

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