HILLIARD LYONS TRUST COMPANY

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Risk Appetite is on the Rise • Tax Act Offers Estate Planning Opportunities

Risk Appetite is on the Rise

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The financial collapse and recession that occurred a decade ago left significant carnage in its wake. Long lasting collateral damage included the effect it had on investor attitudes toward risk. The 2007-2009 collapse was the second time in less than ten years that markets declined by more than 50%, inflicting devastating losses just as investors were recovering from the 2000-2002 decline. As a result, in the years immediately following that last painful downturn, many investors went out of their way to avoid any risk. In fact, investor risk aversion was the strongest I have seen in my 36 years in the industry.

Fast forward to today, and the pendulum has swung the other way in investor attitudes concerning risk. It has taken nine long years to journey from maximum risk aversion to the embrace of risk-taking that we see today. This increasing appetite for risk is not necessarily a bad development, unless it becomes insatiable in the years ahead. As for today, many valid reasons support investors' rising optimism and explain their willingness to add more risk to their investment portfolios.

Coordinated worldwide growth

One of the most positive developments in 2017 was the blossoming of a synchronized global economic recovery for the first time in decades. The United States, Europe, Asia, and emerging market economies have all been growing in tandem. As a result, corporate earnings are growing at a healthy rate. Coinciding with this pickup in growth is a continuation of the benign inflation environment that has existed throughout the recovery. Interest rates across the globe remain astoundingly low. This combination of factors is a salutary environment for global stock markets, fueling a robust 21.8% return for the S&P 500® in 2017. Returns in many international markets were even higher.

In the United States, economic momentum seems to be building, with GDP growth accelerating from a sub-2% average over the past several years to over 3% in the last nine months of 2017. In addition, the lower U.S. corporate tax rate recently passed into law will boost 2018 corporate earnings. The official unemployment rate is near all-time lows at 4.1%, and consumer and business confidence measures are soaring. These are just a few of the reasons for the pervasive sense of optimism in the investment markets.

Paradoxes and conundrums

At times of rising optimism, investors should keep in mind one of the great conundrums that they face. Simply stated, when investors are cautious and risk averse (2009), valuations tend to be lower because of modest expectations for future returns. When prices are low due to investor pessimism, there is a greater margin of safety built in and the likelihood for strong future returns is high.

Conversely, when investors willingly embrace risk and valuations are higher (as they are now), the margin of safety is smaller and future returns are likely to be lower. Stated another way, if prices of investments reflect particularly rosy expectations and disappointment follows, prices have further to decline. This is the paradox of the stock market: Risk tends to be higher when investors are their most bullish and lower when investors are most fearful. Warren Buffett has alerted investors of this phenomenon by stating that investors are wise to be "fearful when others are greedy and greedy when others are fearful."

Are we seeing irrational exuberance?

This is a time of rising optimism, and investment valuations are on the higher end of the historical range. Does that mean we are in a risky investment environment? Not necessarily. As stated in our last newsletter, we think the pricing structure of the stock market today is rational. Valuations appropriately reflect growing corporate profits combined with very low interest rates. But the margin of safety has narrowed. And if the optimism about today's economic picture turns out to be unjustified, prices could suffer a decline.

So should you invest in Bitcoin?

While we do believe that overall investment market valuations are justifiable, we also see pockets of speculation that prudent investors should avoid. One obvious example is the trading activity occurring in Bitcoin and other cryptocurrencies.

Bitcoin is a new type of digital "currency" with no government or central bank backing it. We think the mania surrounding cryptocurrencies has all the hallmarks of an investment bubble. As was the case with some prior bubbles, there is an exciting development that underlies the speculative trading. The blockchain technology that makes cryptocurrencies possible is real and may have significant applications in the future. That said, we don't know exactly how those uses of this new technology will unfold.

The problem with Bitcoin as an investment is it has no intrinsic value. An investment's intrinsic value can be estimated based on its expected cash flows and earnings. Bitcoin has neither. Since Bitcoin has no intrinsic value underlying its price, the trading of it is nothing more than speculation in its purest form. It has turned into a speculative trading chip. Because our approach to investing is founded on the concept of intrinsic value, we believe any investing disconnected from underlying value is nothing more than speculation. Warren Buffett has opined many times that for any investment, "Price is what you pay; value is what you get." Investors should be very careful paying anything for something that doesn't have a reasonable estimate of underlying value.

If you can keep your head when all about you are losing theirs ...

As we enter the New Year, optimism in the investment markets is on the rise. Economic growth appears to be accelerating, and while valuations are on the high side, they are justifiable. It is an exciting time, with consumer and business confidence reaching their highest levels in many years. It is also a world with many challenges and risks that investors must face. Our approach in this environment can be summed up in a quote from Charlie Munger, Vice Chairman of Berkshire Hathaway at last year's annual meeting: "A lot of other people are trying to be brilliant. We are just trying to remain rational. Trying to be brilliant can be dangerous."

Remaining rational will help us avoid getting caught up in the excitement of the day. Our focus will always be on investing your assets in a highly disciplined, responsible manner. We try to reduce risk in our clients' portfolios by investing primarily in high-quality stocks and bonds at prices we deem reasonable in relation to our estimate of intrinsic value. With risk appetite on the rise in markets today, we are keeping a tight lid on the risk levels in your portfolios.

Thank you for choosing Hilliard Lyons Trust Company. We sincerely appreciate the confidence that you place in us. We are fully committed to providing you with excellent wealth management services delivered with a high level of professionalism and service. We look forward to building on the long-term relationships that we have with you.

Past performance is not a predictor of future success. All investing involves the risk of loss.

Tax Act Offers Estate Planning Opportunities

By **Chris Staples,** Senior Vice President, Trust and Estate Planner | **Seth Todd,** Estate Planning Intern

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When President Trump signed the sweeping tax overhaul bill into law on December 22, the corporate tax cut and the changes to individual income tax deductions grabbed most of the headlines. While these and other income tax provisions will indeed have a marked impact on paychecks and corporate earnings, the changes to the estate and gift tax got much less attention – except for the fact that the tax wasn't repealed.

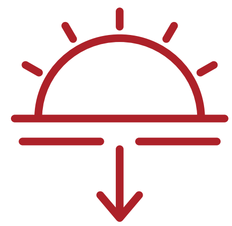
The bottom line? While death and taxes are still inevitable, taxes on estates of significant size became less so. Under the new law:

- The federal **estate, gift, and generation-skipping tax exemption doubles** and will continue to be adjusted annually for inflation. Until the IRS issues the official inflationary adjustments, we won't know the exact amount of the exemption. But most analysts believe it will be approximately $11.2 million per person, which means couples can transfer up to $22.4 million free of estate tax.
- The federal estate and **gift tax rate for amounts above the exemption remains at 40%**.
- **Assets owned at death still receive a step-up in cost basis** to their date-of-death value. That is, an asset purchased for $10 but valued at $100 at the time of the testator's death will have a cost basis of $100 – so future taxable gains in value will be measured off of that higher base, reducing taxes.

The lack of attention the estate tax provisions received is perhaps understandable considering that only about one of every 500 people who die were subject to the tax under the old law. Logically, then, the changes in the new tax law should mean even fewer individuals will need to worry about the tax when evaluating their estate plan. If that were only true; read on.

Sunset causing heartburn

Unfortunately, uncertainty remains due to a sunset provision in the law, inserted in the law to create a tax-neutral tax bill under Senate budgetary rules. Under it, all individual changes in the tax overhaul, including the estate tax provisions, will revert to the pre-2018 law on January 1, 2026 – eight years from now. And hardly anyone reading this can know for sure whether they will die on or before December 31, 2026.



Presumably, after "sunset," the estate tax exemption will revert to approximately $6.2 million. Of course, we will have two presidential elections between now and then – and we've seen that elections have consequences. A new administration, along with a willing Congress, could reduce the exemption amount before the sunset.

This uncertainty alone is reason enough for you to continue to review and update your estate plan regularly. The reality is that most people craft their estate plans with a significant focus on non-tax issues such as protecting family wealth and ensuring that wealth is transferred to future generations in a responsible manner as they intend. Certainly, the available federal estate tax exemption could affect some elements of your plan, but your goals and wishes are still what inform it. Now is not the time to be lulled into a sense of complacency because estate taxes seem like a distant worry. Non-tax issues will exist regardless of tax law.

New planning opportunities

Of course, the increased exemption amount does create some planning opportunities. Remember, assets at death receive a step-up in cost basis. This can significantly reduce the income tax burden on surviving spouses and other heirs. With exemptions in excess of $11 million, a couple may be able to pass assets of $22 million through proper planning to get a full cost-basis step-up. The income tax savings could be substantial for heirs, which is why income tax planning, as part of estate planning, has become more critical.

The increased exemption amount also gives you an opportunity to engage in additional giving and planning strategies if you have previously used some or all of your lifetime exemption. This is especially attractive if you hold potentially high-growth assets and face the prospect of estate taxes regardless of the size of the exemption. The increased exemption creates a unique opportunity to engage in giving and transfer strategies to shore up or enhance previous planning.

Even without the tax overhaul, the annual gift tax exclusion increased from $14,000 to $15,000 beginning January 1, 2018, adding another tool to help with planning.

Other changes for 2018 and beyond

The tax overhaul may adversely affect charitable giving due to the changes in the standard deduction (increased to $12,000 for singles and $24,000 for married couples filing jointly). With this increase, many households will rely on the standard deduction rather than itemizing. This could result in donors seeing no income tax benefit for some charitable gifts.

Most people give out of a desire to help a particular charity, so this loss of a tax benefit will not stop most donors from giving to their favorite charities. (That said, many charities are very wary of how the new tax law will affect their fundraising efforts.) But this change should encourage you to consider whether you are maximizing the tax benefits of your giving. For instance, advanced charitable trust strategies, making qualified charitable distributions from IRA accounts, and using donor-advised funds or private charitable trusts may offer significant tax advantages for individuals who haven't previously considered these types of charitable strategies.

Some advice never changes much ...

The key today with estate and tax planning, as it has been for the last several years, is ensuring that your plans are current and flexible enough to work in a variety of tax landscapes. If you and your family have significant assets that you want to transition while maximizing tax benefits, you should regularly review your plans with your estate counsel or tax advisor.

Hilliard Lyons Trust Company, LLC does not provide tax or legal advice. Clients should consult with their own attorneys and accountants regarding their own individual situation.

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