HILLIARD LYONS TRUST COMPANY

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Investing in a Low-Return World • Don't Get Scrooged by the Government this Giving Season

Investing in a Low-Return World

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Although the world is filled with investment "experts" happy to make predictions, we believe the investment markets' gyrations are largely unpredictable. Warren Buffett noted drily that "The only value of stock forecasters is to make fortune tellers look good." Although bold prognostications have little value, it is essential to make honest, informed judgments about potential returns available in investment markets at different points in time. Our current stance is that future investment market returns will be lower than normal. In this environment, it is important that we not assume unnecessary risk while seeking higher returns.

Future Fixed Income Returns

It is an easy exercise today to assess expected returns from fixed income markets. Because of the unprecedented actions taken by central banks across the globe, we have been in a period of amazingly low interest rates for several years. With the Federal Reserve beginning to unwind their low-interest-rate policies and other central banks around the world expected to follow suit in future years, interest rates are likely to rise slowly for the rest of this decade. But with extremely low rates today as a starting point, it is sensible to expect lower-than-normal returns from the fixed income markets in the foreseeable future.

Risk Aversion Dissipated

In order to understand potential returns in the stock market, it is necessary to assess how investors feel about risk. When investors in general are afraid of taking on investment risk, prices in the stock market are low, and potential returns are high (think 2009/2010). As those fears subside and investors are more willing to embrace risk, prices in the stock market rise. As prices rise and investor fear turns to greed, the return potential in the stock market declines. There is a strong negative correlation between price levels and future returns – a cycle repeated throughout the history of investing.

In our Q1 2009 investment commentary (at the end of the last significant market decline), we wrote "There are more attractive investment opportunities in the stock market today than at any time in recent history.... It is at times like these that the most attractive business franchises in the world are on sale." Over the past eight years, we have seen risk aversion in the investment community dissipate and prices in the stock market move consistently higher. With higher prices today as a starting point, it is reasonable to expect that future stock market returns will be below the long-term average.

The Temptation To Chase Returns

Although the valuation structure of the stock market today is on the high side of normal, it is not irrational. The backdrop of a growing economy, rising corporate profits, low inflation, and low interest rates, is ideal for financial assets. Investment securities should be at higher values in such an environment. That being said, there are signs of speculation rising in pockets of the investment markets. In fixed income, the yields on junk bonds are very low as investors seem to be ignoring risk in their search for yield. In the stock market, speculation is rising as some companies' stocks are soaring despite their poor business fundamentals. Trading in "cryptocurrencies" like Bitcoin has been compared to the tulip bulb mania in the 17th century. We don't think the markets overall have become irrational. But we do think some investors are pursuing higher returns without considering the amount of risk they are assuming. This is called, simply, "chasing returns."

We don't predict anything dire happening in investment markets in the future. In fact, we still believe that portfolios of high-quality, reasonably priced securities will continue to deliver acceptable rates of return. But as we see other investors ignoring the risks they are taking in a search for higher returns, we will be doing just the opposite in your portfolios. The time to embrace risk is when others are fearful, and the time to be wary of risk is when others are welcoming it with open arms.

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Now What?

How do we ensure portfolios' risks are appropriate? We will monitor their asset allocations and make sure they align with their stated investment policies. As for fixed income securities, we will keep our maturities short-and intermediate-term, and we will invest only in high-quality bonds. In equities, we will be scrutinizing our holdings' prices and ensuring they are reasonable – in addition to investing only in companies with durable business models and talented managers.

Staying The Course

Investment markets are constantly changing. Our investment strategy is designed to help you achieve your investment objectives through all kinds of market climates over very long periods. Our focus is on very high-quality securities, and our portfolio decisions are based on disciplined, unemotional, rational analysis. And in the low-return environment of today, it is important to limit risk-taking in portfolios when other investors are embracing more risk.

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

Don't Get Scrooged by the Government this Giving Season

Ella Neely

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The IRS seems to have intensified its scrutiny of income tax returns claiming charitable deductions. In some instances, this scrutiny has led to a charitable deduction being disallowed in full where the taxpayer failed to meet charitable donation "substantiation" requirements. In the Government's defense, taxpayers are in the best position to "substantiate the charitable deduction" – which is legalese for "proving that they are entitled to the deduction by retaining and maintaining the appropriate paperwork." However, verifying a gift is not always as simple as keeping a receipt.

The Hierarchy of Documentation You Need

The substantiation rules are complex, especially with non-cash gifts, and they increase in complexity as the value of the donation increases:

- **Generally:** You need a receipt showing the charity's name, the contribution date, and the contribution amount. For non-cash items, also include a description of the property and keep records that establish its fair market value when contributed and how that value was determined.
- **Contributions over $250:** You need a Contemporaneous Written Acknowledgement (CWA). Let's break that down:

  Contemporaneous: You must get the CWA from the charity on or before ***the earlier*** of: (a) the day you actually file your return; or (b) the due date for filing your return.

  Written Acknowledgement: The CWA must include: (a) the amount of cash contributed or a description of non-cash property contributed; (b) a statement verifying whether the charity provided goods or services in exchange for any cash or property transferred; (c) if goods and services are provided, a description and good faith estimate of their value; and (d) a statement of whether the charity provides any intangible religious benefits.

- **Contributions over $500:** You need a CWA, plus you may also need to get an appraisal, state how the property was acquired (purchase, gift, inheritance, etc.), or set out the cost basis on your tax return.
- **Contributions over $5,000:** All the above plus a ***qualified appraisal*** of the property, a summary of which must be attached to your tax return.

Traps for the Unwary

- **Ask for it:** It's up to ***you*** as the donor to get an acknowledgement. Some charities do not automatically provide one, so you may need to request it. This can be especially important to remember when donating to churches.
- **Offset:** You must offset the amount you contribute with the value of any goods or services you receive in return (dinner served at a fundraising event, raffle tickets, a plaque with your name, etc.).
- **Watch for aggregating:** Be careful when donating similar items which are aggregated before determining value. This can easily push your gift into a higher dollar threshold, invoking additional requirements (such as an appraisal or cost-basis documentation).
- **Stock:** Publicly traded stock you donate shouldn't require an appraisal, but other securities might require a ***qualified appraisal***.
- **Payroll deductions:** When making gifts through payroll deductions, retain a paystub or some other document from your employer showing the amount withheld for the charity ***and*** a pledge card or other document from the charity showing the charity's name.

"Close" counts in horseshoes, but ...

Do not assume that you can take your charitable deduction if you substantially comply (that is, you followed ***most but not all*** of the rules). That argument hasn't impressed the IRS or Tax Court lately. For example, in one recent case, a business partnership was disallowed a $33,019,000 charitable deduction for not stating on the tax return the partnership's cost basis in the property donated, despite apparently meeting all other requirements. Ouch!

In an older case, a couple was disallowed a charitable deduction of $121,000 for a donation of non-publicly traded stock because they did not get a required "**qualified** appraisal." This happened despite the IRS conceding that the reported values represented the stock's fair market value.

Finally, even donations to Goodwill are scrutinized. This summer, a couple was disallowed $169,000 over two years for not appropriately documenting their donations. To comply with the rules, some receipts required specific itemization, and some of the donations (after aggregation) required cost basis, valuation method, acquisition information, and a qualified appraisal.

While these cases may be extreme, the lesson is the same for everyone: Be very careful to follow the rules set forth by the Government scrupulously so that you don't lose your charitable deduction. Because of the complexity of the rules and because of the increased scrutiny the IRS is paying to these deductions, **you should talk to your tax professional to ensure that you comply fully when making charitable contributions**.

Other Opportunities for Planned Giving Before the Year-End

Since the Giving Season is quickly approaching, here are a few reminders for making the most out of your gift:

- **Low basis is good:** Donating items with low cost basis is usually preferred because you will get a deduction for the current fair market value without paying tax on the underlying gains.
- **AGI limits:** Adjusted Gross Income limits may apply to certain charitable deductions.
- **Your IRA may help if you're old enough:** If you're at least 70 ½, you can give up to $100,000 of your RMD (required minimum distribution) from your IRA. This lets you satisfy your RMD, and the donated amount is excluded from your income for that year.

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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