

## A letter from Bahl & Gaynor's Chairman



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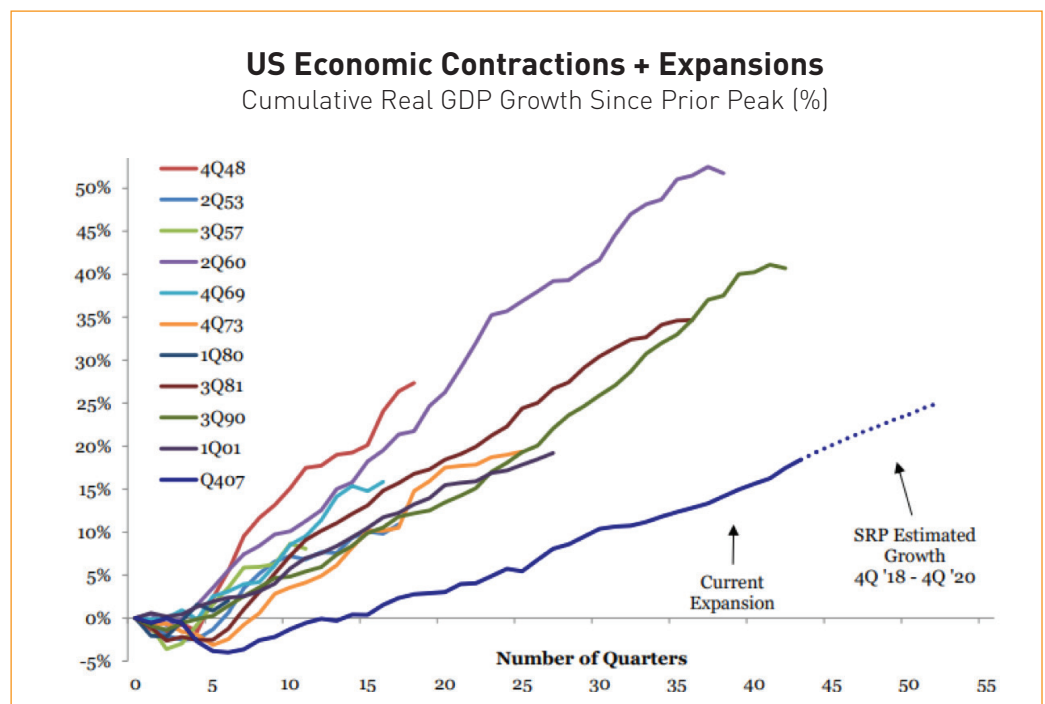
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## Happy Anniversary

This quarter housed an ominous anniversary – the passage of 10 years from the lows registered by the Dow Jones Industrial Average, the NASDAQ, and the S&P 500, all on the same day. On March 9, 2009, the Dow closed at 6,547, the NASDAQ at 1,268 and the S&P 500 at 676. Each of these indices were down -56.8%, -54.9% and -54.1%, respectively from their prior highs established before the onset of the Global Financial Crisis in October 2007. Through March 29, 2019, the Dow has advanced +411.97%, the S&P 500 +417.29%, and the NASDAQ an impressive +582.34%, all return figures expressed as total return.

Despite these enormous capital market gains, the graph below illustrates that the actual *economic* recovery has been more muted in comparison. Much of this is likely attributable to the causes of the recession being financial in nature rather than the more typical inventory recession. In short, financial crises are much more disruptive to economic growth and academic research suggests these events take the better part of a decade to heal before pre-crisis economic health is restored.

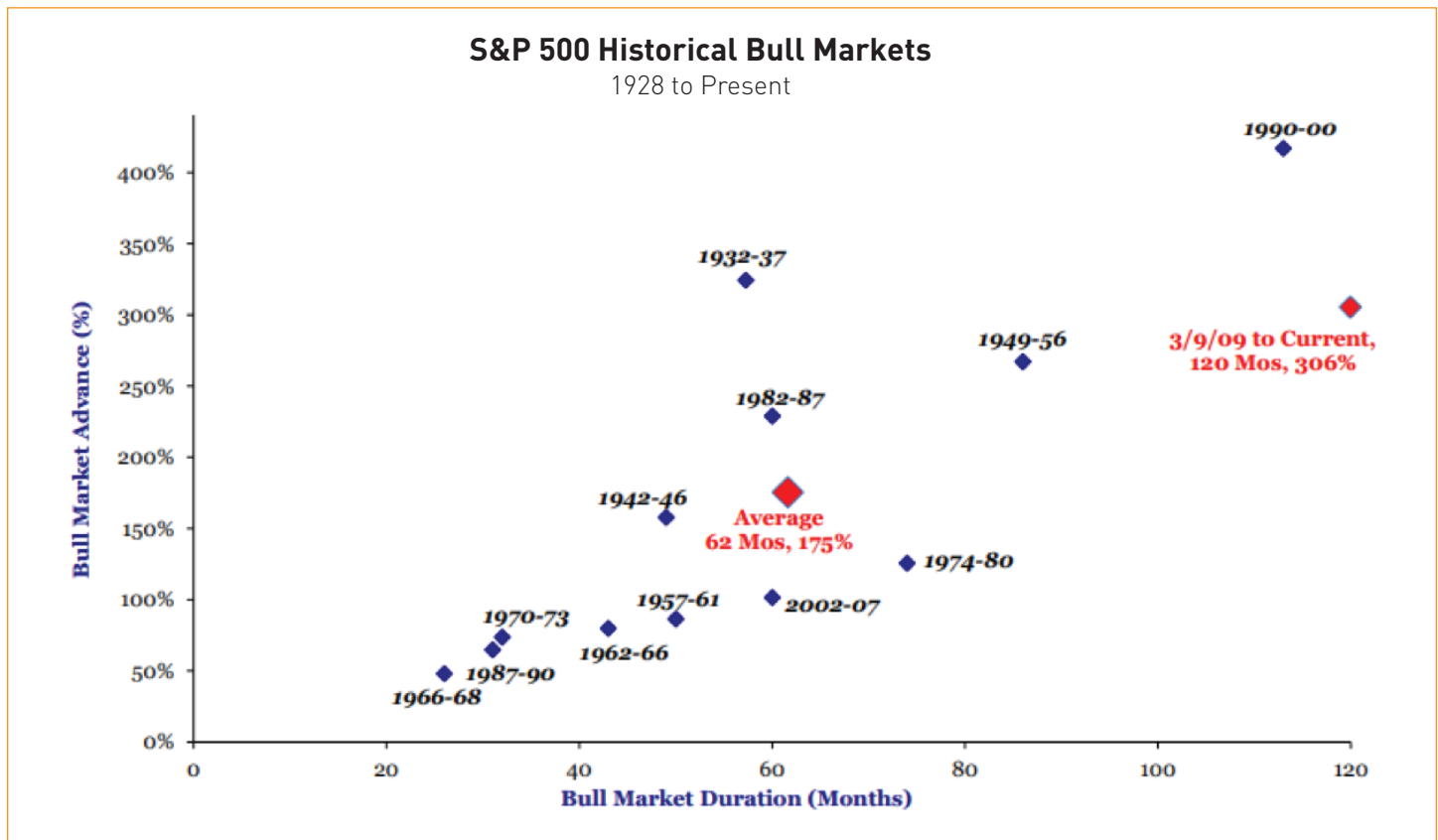


Source: Strategas, 2019.

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# Happy Anniversary *Continued*

This graph above should leave the viewer of the chart below more comfortable with its implications. Although the bull market in stocks currently underway is long in *duration* relative to history and the average, it still has a long *vertical distance* to travel in terms of altitude. This of course does not mean that progress in altitude will be a smooth ride. Quite to the contrary, market advances in the context of a secular bull market contain cyclical gyrations that can be quite harrowing to investors.



Source: Strategas, 2019.

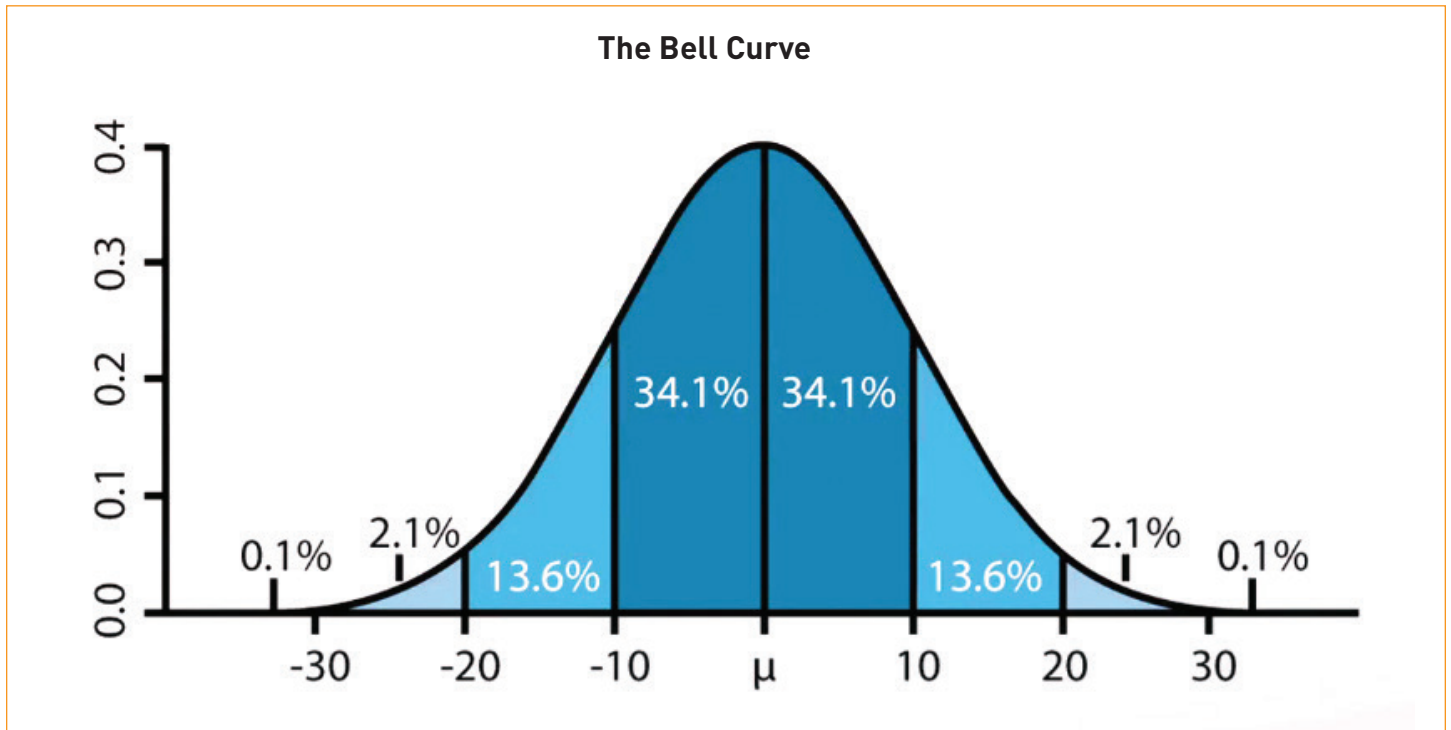
Bahl & Gaynor provides this context to frame a review of the roaring bounce experienced in 1Q2019 on the heels of a return to volatility in 4Q2018. As we have often stated, it is time *in* the market, not *timing* the market that builds wealth. The long-term benefits of stock ownership are evident in the figures presented above. It is the “forest” upon which investors should focus their attention, not so much the “trees” about to be described below.

## Sudden (Standard) Deviation

Thinking back to high school mathematics, the concept of standard deviation may have been introduced. This concept is nothing more than variability around an average measured in increments, or standard deviations, as a function of distance from the average and probability under the bell curve.

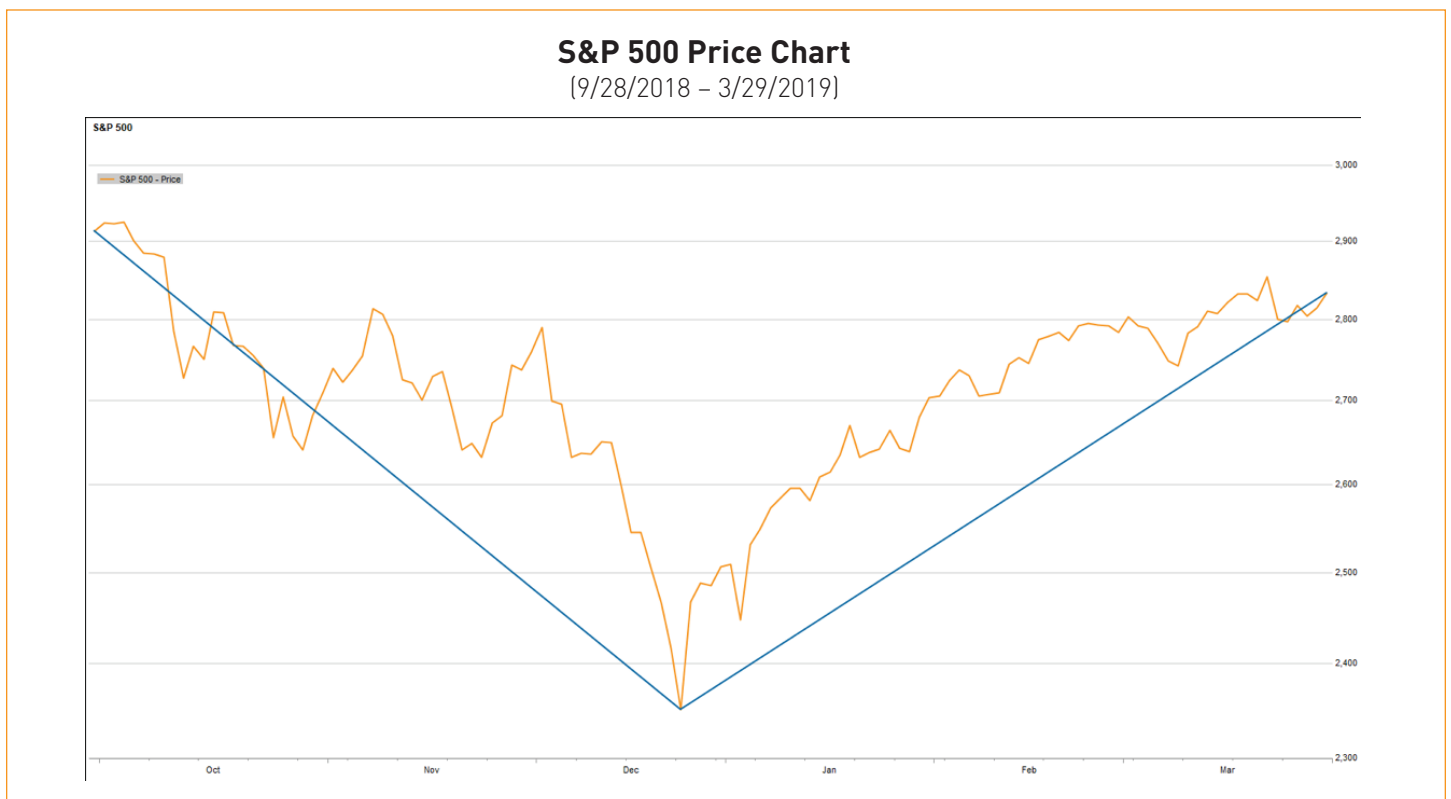
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## Sudden (Standard) Deviation *Continued*



Source: Study.com, 2019.

The orderly world of mathematics suggests that a normal bell curve is *symmetric*. The real world is not orderly, nor is it often symmetric. However, the market experience for investors since the downside events that transpired during 4Q2018 has provided some comforting symmetry on the upside during 1Q2019 as illustrated in the graph below.



Source: Factset, 2019.

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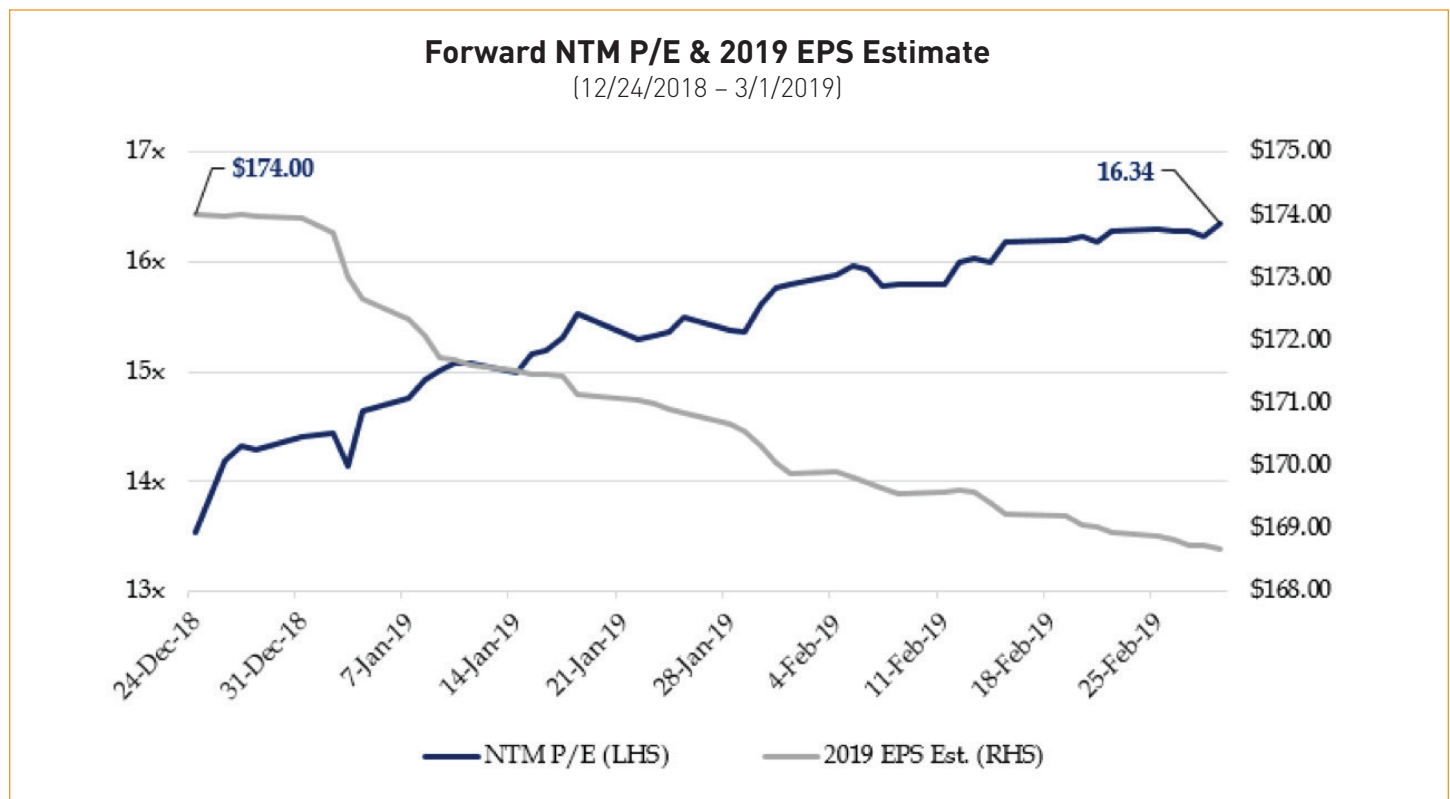
## Sudden (Standard) Deviation *Continued*

Much of the downside action experienced in 4Q2018 was precipitated by the deterioration of several credible domestic and global economic growth factors that had been supportive of equity prices in the prior three quarters. The resulting pace of FY2019 earnings estimate reductions reflected a perfect storm of aggressive Fed policy communications, a US federal government shutdown and combative Beijing-Washington rhetoric regarding trade disputes. Suddenly, “caution ahead, recession imminent” became the consensus view with a capital market downdraft validating this assertion.

## Drivers of the Bounce

Many of the concerns listed above have either passed (partial US federal government shutdown), moderated (recession fears), are in the process of being resolved (China/US trade deal) or are more clearly interpreted (likely 2019 Fed policy action), resulting in a strong capital market rebound during 1Q2019. Indeed, January produced the strongest first-month equity market advance in 20 years. US growth expectations have now seemingly settled into an investor-friendly Goldilocks run rate at lower valuation levels with a degree of FY2019 earnings estimate stability.

Arguably, it was the Fed Chair Powell’s statements in late 2018 and again in early 2019 outlining expectations of a subdued US growth/inflation profile and sympathetically subdued policy that provided an important investor sentiment lift. This has driven forward P/E multiples higher while lowering volatility compared to the 2018 experience (see graph below). The slowdown in FY2019 earnings growth to the +5-7% range is now understood as not representing a setback but, but rather a return to normalcy following the one-time earnings uplift provided by tax reform enacted in late FY2017.



Source: FactSet Market Aggregates, 2019.

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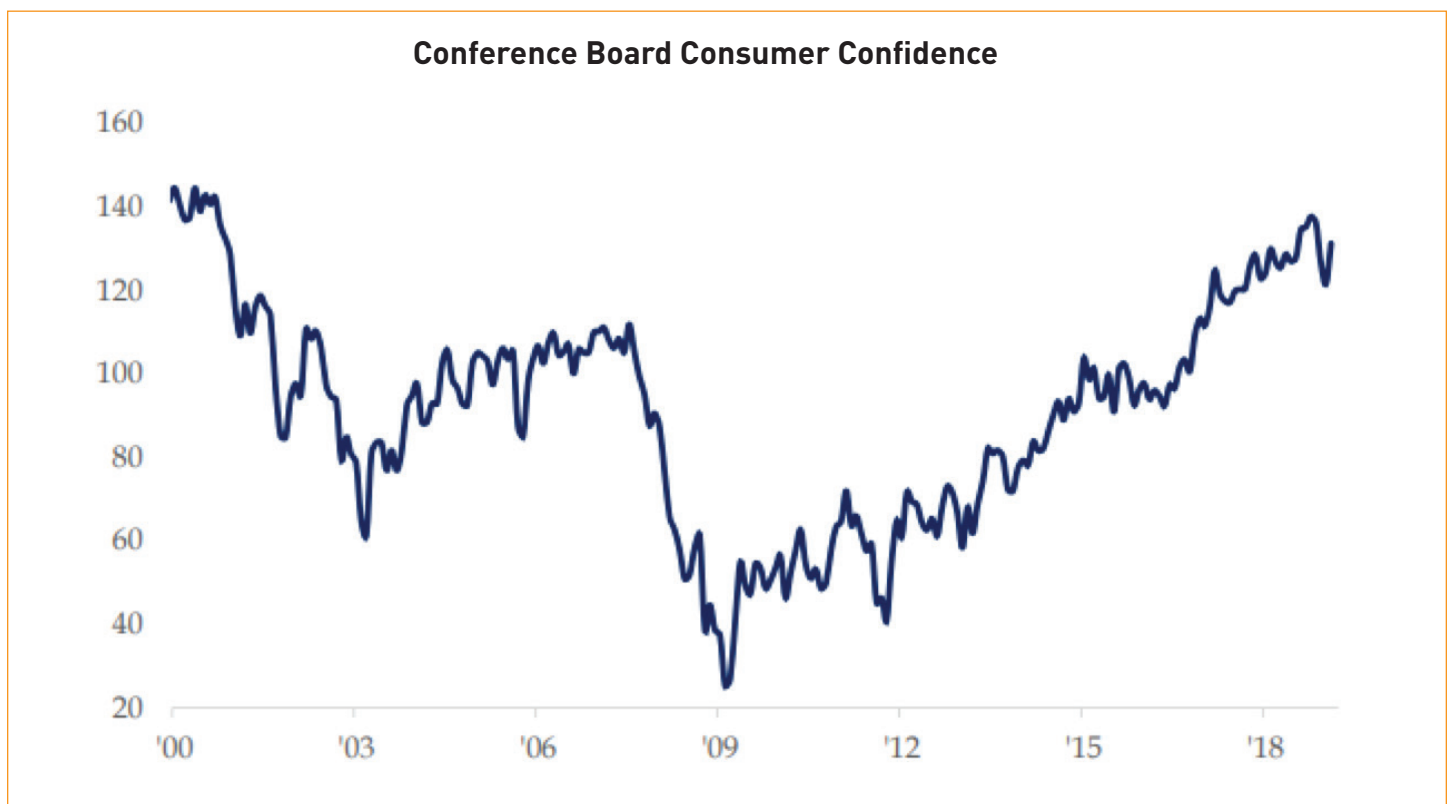
# Peering Over the Horizon

To be clear, no shortage of concerns exists for global capital markets to debate. Each day, month and year brings its unique set of storylines and challenges. This combination of “known unknowns” and “unknown unknowns” is endemic to capital markets.

In Bahl & Gaynor’s view, the following topics are likely to influence the 2019 capital market environment:

- The duration and degree of slower growth in Europe, China and the US;
- The response from both political leadership and global central bank authorities to slower growth;
- As mentioned in our 4Q2018 note, leverage concerns among corporate borrowers and the market’s assessment and focus on quality, and;
- Recently witnessed levels of volatility remaining present as the market digests the above concerns.

Economic bright spots include the moderating, but still leading, US growth profile supported by a still-confident consumer (graph below). Approximately 70% of US GDP is comprised of domestic consumption, so a willing and able US consumer is part and parcel to continued economic buoyancy. Despite the negative wealth effects capital market volatility can impart on a portion of consumers, wage growth remains strong in the US and labor’s growing share of GDP is likely more meaningful to consumer confidence and resultant spending. Further, slowing but still positive growth is a very different thing than negative growth, or contraction. Much of the volatility experienced in 4Q2018 could be viewed as the market digesting the reality we have moved beyond “peak growth.” And the upswing witnessed in 1Q2019 could be viewed as the reminder that still-positive growth in the US is better than no growth at all, or worse, outright contraction!



Source: Strategas, 2019.

Areas of worry include recently arrested small business optimism (graph below). A major objective of tax reform was unlocking capital for businesses of all sizes to be earmarked for reinvestment in support of higher future economic growth. Small business represents the vast majority of employment and economic production in the US. Therefore, a worried small business community can compound to influence broader economic growth dynamics.

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## Peering Over the Horizon *Continued*

### NFIB Small Business Optimism



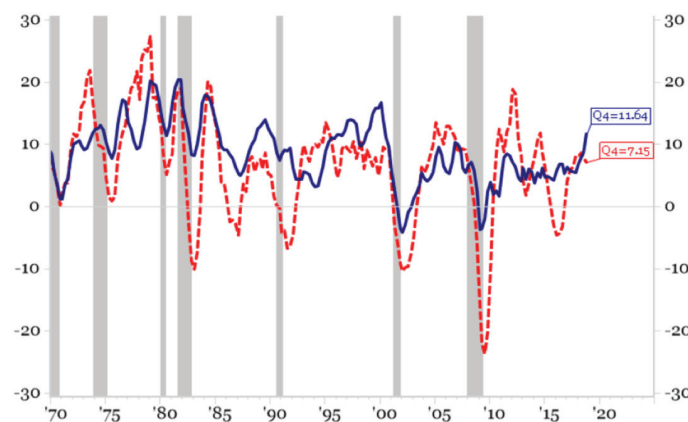
Source: NFIB, Strategas, 2019.

The graph below illustrates capex growth divided into “hard” investment (plant, property & equipment) and “soft” investment (intellectual property products). Businesses are typically more willing to make “hard” investments when capacity is constrained or there is great confidence about the payoff associated with the investment. “Soft” investments on the other hand often move forward under pressured or less optimistic conditions. The graph clearly shows a surge in “hard” capex (dotted red line) following the enactment of tax reform in late 2017 and a soon-thereafter surge in “soft” capex (solid blue line) as geopolitical issues and slowing growth concerns began to dominate mindshare. At the same time geopolitical issues and slowing growth shifted preferences in favor of soft capex, the hard capex trend hooked down from a recent peak.

### Hard vs. Soft CapEx Trends

Private Nonresidential Investment:  
Intellectual Property Products  
% Change - Year to Year SAAR Bil\$

Private Nonresidential Investment:  
Structures + Equipment  
SAAR Bil\$



Source: Bureau of Economic Analysis, Strategas, 2019.

Fortunately, both forms of investment are solidly positive. The ultimate benefit brought by capex in all forms is support of labor productivity growth, or more output produced by a given worker's unit of time. Productivity growth offsets wage inflation, which can extend the length of an economic cycle.

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## Financial Planning Update:

# Capital Gain Tax Management



Source: Dan Reynolds

As noted in the body of this quarterly letter, March 9 of this year marked the 10th anniversary of the bear market lows precipitated by the Great Financial Crisis. For most investors, the decade-long bull market operative since the crisis has created substantial portfolio capital gains. While it is welcome news that remaining steadfastly invested in capital markets has paid off, these gains can often create a hesitancy among investors when the normal course of rebalancing a taxable portfolio creates a tax liability. The strong desire to avoid taxes may cause investors to maintain positions that are no longer appropriate for achieving their goals. Benjamin Franklin once wrote, "in this world, nothing can be said to be certain, except death and taxes." The reality is that if an investor ever plans to use the wealth they have grown through investment, capital gain taxes can be deferred but never entirely avoided. **In other words, the tax obligation is ever-present, it is only a question of when it will have to be paid.**

Some reading this article may be quick to point out that by deferring capital gain taxes they allow the amount they would have paid in taxes to remain invested and grow. While this is true, the actual benefit is not worth much

compared to the overall investment. To illustrate this point, consider an original investment of \$50,000 that is now worth \$100,000, implying a \$7,500 tax liability based on a 15% capital gain tax rate. Maintaining the investment and not paying the \$7,500 tax does not actually *avoid* the tax, it merely *defers* it. The only benefit an investor receives through this strategy is the incremental growth on the \$7,500. Assuming a 6% return, this equates to just \$450 in a given year on an overall investment of \$100,000 – less than half of one percent! Now assume the same scenario with a *negative* 6% return. In this case, the investor loses \$6,000 in gains and *still* owes \$6,600 in taxes. The added risk of not selling an investment for tax purposes easily surpasses the growth potential of deferring the tax.

While investors are unlikely to entirely avoid capital gain taxes, there are some strategies that can be employed to help mitigate their impact:

**Capital Gain Budgeting** This involves doing exactly what the text implies, setting a budget every year for an amount of capital gains to realize and thus owe in taxes. This amount can be based simply on the maximum dollar amount one is willing to pay in taxes or can be driven by tax brackets (utilize the entire balance of one's current current bracket without advancing into the higher adjacent bracket).

**Loss Harvesting** Attempting to offset any realized capital gains with commensurate capital losses in a given tax year can reduce the net tax liability. This can be difficult when there are few assets held at a loss, but it can become a more viable strategy in periods of heightened capital market volatility where losses may be more probable. Further, a net capital loss in a given tax year can be used offset up to \$3,000 of ordinary income with any capital loss exceeding that amount reserved to be carried forward and utilized in future tax years.

**Donating or Gifting** For those willing and able to part with a portion of their highly appreciated assets, donating negates and gifting often reduces any capital gain taxes due. A donated asset will create a tax deduction equal to the market value of the security at the time of donation for the donor. A gifted asset will retain its cost basis with the giftee (in most cases), but that individual may be able to sell the security and realize a lesser capital gain tax liability via a lower tax bracket.

**Leaving a Legacy** Earmarking specific assets to hold until death, such that any heirs will receive a step-up in basis, thus allowing them to sell with little or no tax consequence. Isn't it ironic that the certainty of death is one of the only ways to avoid the certainty of taxes?

A sound strategy to managing capital gains will likely involve some or all these techniques in any given year. While capital gain taxes should never be completely ignored, investors should not let them dominate their investment decisions. Do not allow the tax tail to wag the investment dog! If you have any questions, or would like to implement a capital gain tax management strategy, please reach out to your Bahl & Gaynor portfolio manager.

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# Concluding Thoughts

As in our prior quarter's letter, we end this correspondence on a positive note. Although the current expansion has reached a milestone of sorts, this milestone has little influence on future duration. Rather, it is the underlying economic fundamentals that will drive growth and in turn, capital market performance. No doubt there are elements of concern that in Bahl & Gaynor's estimation, warrant caution on the part of investors. But the roller-coaster ride of the last six months is continued evidence that an investor would be hard-pressed to profitably time market gyrations.

It is our conviction that a balance between benefit today (income) and opportunity tomorrow (income growth), quality (downside protection) and strategic asset allocation (consistent and appropriate exposure to the equity asset class) will remain the most sensible formula for investors.

*Sincerely,*

**William F. Bahl, CFA, CIC | Co-Founder & Chairman**

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