SNOWBALL™
WEALTH MANAGEMENT

303.666.6292 www.snowballwm.com Fourth Quarter 2018

A New Risk To Converting To A Roth IRA

Converting to a Roth IRA is appealing if you think Federal taxes will go up, but now carries a new risk. Roth conversion is still a good idea but it's important to understand how the rules changed and could come into play.

Phantom Income. The new risk to converting stems from a change in tax rules and it's probably not going to make you decide against converting a traditional IRA to a Roth, but it is a material new factor in the equation, a risk of being taxed on "phantom income."

Roth v. Traditional IRA. Roth conversions are likely to grow more popular because a Roth is taxed differently from a traditional IRA. You contribute pre-tax dollars to a traditional IRA, which lowers your taxable income each year you contribute. In retirement, you pay taxes on withdrawals to live on. In contrast, a Roth IRA allows you to contribute after-tax dollars and grows tax-free. Withdrawals in retirement are also tax-free. That's why converting to a Roth now looks smart if you think tax rates will be higher in your retirement years.

Tax Rates. The national debt and associated interest expenses are expected by the government to rise sharply due to years of Federal deficit spending, along with rising costs of funding Social Security and Medicare benefits. As a result, tax rates could rise in the decade ahead, which would make withdrawing money from your traditional IRA cost you more in taxes annually in your retirement years.

New v. Old Rules. Until now you could convert to a Roth IRA and then push the "undo" button and reverse the conversion in case of a sharp decline in your account value. The undo tactic has been around for years and it is important to understand what elimination of this technique means. Before 2018, you could reverse the Roth conversion that same year and suffer no ill effects, by using a tactic called a "re-characterization." The Tax Cuts and Jobs Act (TCJA) eliminated using this maneuver.

Re-characterizing Example. Before tax reform, say you converted $300,000 from a traditional IRA to a Roth in June. If you were in the 24% Federal tax bracket, you would have owed $72,000 in April of the next year. In November, if the stock market had

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Keeping The Faith

Many of you may not enjoy reading your 2018 Q4 portfolio report. To use a technical financial term, December sucked. It was the worst December on record for the equity markets since the Great Depression. The S&P 500 lost nearly 10% in December alone thanks to big declines in in tech titans like Amazon and Apple. Daily declines of 2-3% were the norm in December. Now that I've got you severely depressed, allow me to cheer you up.

Corrections are normal. Corrections are healthy. Corrections are welcome at Snowball Wealth Management because they allow us to buy on sale. Long term investing is about more than asset allocation, it's about buying at the right price. December's correction allowed SWM to pick up some great companies at discounted prices.

After struggling with the painful declines throughout the month, my faith was restored on a cold night in December when my wife and I snuck out for a date night to see Free Solo in an IMAX theater. Not only was the cinematography breathtaking—vertigo sufferers beware—but the tale of Alex Honnold's pursuit of exceptionalism in the face of certain death restored my faith in humanity. Combine an understanding of how the U.S. equity markets work in the long run with a faith that our capitalistic economy breeds opportunities for exceptionalism and you get positive change. We invest in that change.

So, the next time the financial markets or political turmoil gets you down, think of Alex free climbing El Capitan and have a little faith. Our system works. In the immortal words of Winston Churchill, "Democracy is the worst form of government except all those other forms that have been tried from time to time."

Is Amazon Keeping The Inflation Rate Low?

Amazon's 2017 annual 10(K) federal financial filing reported $4.1 billion in net operating income. But the profit was entirely attributable to Amazon's tech infrastructure line of business, Amazon Web Services (AWS). Amazon's retail sales business reported a loss.

Unless you're a professional securities analyst or MBA, it may not be easy to discern that Amazon lost money on its main business from the company's required 10(K) annual public disclosure filing with the U.S. Securities and Exchange Commission. But it's disclosed in this table on page 69 of Amazon's 10(K) for 2017. AWS earned a $4.3 billion profit on $17.5 in net sales revenue, while total profits were $4.1 billion on well over $100 billion of sales.

Amazon could afford to take a loss on its retail business. It's a long-term investment in gaining market share. Losses taken on dominating internet retailing were offset by AWS, Amazon's business of building the infrastructure of the web, which has been very profitable.

With its strategy to expand retail market share based on razor-thin profit margins, Amazon transformed retail sales and consumer behavior over the last decade. Before buying at a traditional retail store, consumers now routinely check their phones for a lower price online. The increased efficiency of internet sales enables consumers to buy goods at insanely low prices. While Amazon became the Crazy Eddie of the internet era, it has caused disinflation.

Inflation has always been a somewhat mysterious factor in the economy. It's hard to understand its causes, and harder to control. Officials at the U.S. Federal Reserve Board have conceded in recent years their surprise at the persistently low inflation rate. Amazon is likely a factor in why prices are not rising fast in the economic boom.

This is not a recommendation to buy or sell Amazon securities but an observation about the internet retailer's impact on the U.S. rate of inflation and its implications for economic growth. In the second quarter of 2018, the government reported a 2.9% surge in productivity because real wages *after* inflation declined, lowering the cost of an employee to companies by nearly 1%, according to the Bureau of Labor Statistics quarterly report through June 2018.

Declining unit labor costs amid real wages is a positive for economic growth, and internet retailing is an influence in the economy to keep an eye on. Among the swirl of forces that affect inflation, ranging from international oil politics to the Federal Reserve, your Amazon shopping cart is playing a role. ●

Amazon's 2017 Financials; A Cause Of Disinflation

Information on reportable segments and reconciliation to consolidated net income (loss) is as follows (in millions):

	Year Ended December 31,		
	2015	2016	2017
North America			
Net sales	$ 63,708	$ 79,785	$ 106,110
Operating expenses	62,283	77,424	103,273
Operating income	$ 1,425	$ 2,361	$ 2,837
International			
Net sales	$ 35,418	$ 43,983	$ 54,297
Operating expenses	36,117	45,266	57,359
Operating income (loss)	$ (699)	$ (1,283)	$ (3,062)
AWS			
Net sales	$ 7,880	$ 12,219	$ 17,459
Operating expenses	6,373	9,111	13,128
Operating income	$ 1,507	$ 3,108	$ 4,331
Consolidated			
Net sales	$ 107,006	$ 135,987	$ 177,866
Operating expenses	104,773	131,801	173,760
Operating income	2,233	4,186	4,106
Total non-operating income (expense)	(665)	(294)	(300)
Provision for income taxes	(950)	(1,425)	(769)
Equity-method investment activity, net of tax	(22)	(96)	(4)
Net income	$ 596	$ 2,371	$ 3,033

Net sales by groups of similar products and services is as follows (in millions):

Source: Amazon's 2017 10-K report, page 69.

10 Years After The Great Recession

Ten years ago, the economy was bleak. The U.S. was in a recession. The subprime mortgage crisis was undermining Bear Stearns, Lehman Brothers, Countrywide Financial, AIG, and other major financial institutions; General Motors looked like it might go out of business. Then, in a story for the ages, the nation bounced back and led the world out from The Great Recession.

Over the last 10 years, a dollar in America's 500 largest public companies grew to $2.48. From the stock market's low point on March 9, 2009, a dollar appreciated in value 4.75 times, to $4.72 – a 372% return!

For the past decade, what makes America exceptional was in plain sight but difficult to see in the moment. It's never easy to see why U.S. stocks would gain in value. The current period is no different.

Share prices plunged 10.2% in early February, on inflation jitters, and again in March, on fears of a trade war. In April, *The Wall Street Journal* warned of a long period of weakness

Past performance does not guarantee your future results.

Finding The Balance For Retirement Draw-Downs

Victor and Jane Muratti, a computer analyst and schoolteacher married for more than 30 years, are nearing retirement. Over the years, they have accumulated a mosaic of investments, including stocks, corporate and municipal bonds, mutual funds, exchange-traded funds (ETFs), annuities, real estate, and master limited partnerships (MLPs). Some of these investments are in taxable accounts while others are in tax-deferred retirement plans and traditional and Roth IRAs.

Once they retire, the Murattis will begin drawing income from these various accounts, and after they reach age 70½, they'll have to start taking required minimum distributions (RMDs) from their retirement plans and IRAs. But they don't have a clue about the best way to create their retirement "paychecks."

It's a common situation and the circumstances will vary for every person or couple. However, one typical objective is to minimize federal income tax from investment transactions, while preserving as much wealth as you can for a lengthy retirement.

One way to do that is by paying attention to tax brackets. Income taxes are based on a graduated seven-bracket system, with different tax rates for each bracket. The more of your income that falls into lower brackets—and so is taxed at lower rates—the better. And to the extent that you can control how much income you receive, you could try to take just enough to fill up your current bracket without moving into the next, higher one. You can use this tax bracket management strategy throughout retirement.

But to benefit, you'll need to learn the basics for three different types of accounts you're likely to tap during retirement.

1. Taxable accounts: This category includes all of the investments you hold outside of retirement plans. You may have stocks, bonds, mutual funds and ETFs, as well as interest-bearing savings accounts and certificates of deposit (CDs). If you sell any of these at a gain, your profit will generally be taxed at the favorable rate for long-term capital gains—that is, gains on investments you've held for a year or more. The tax rate for long-term gains is 15%, or 20% if your income puts you in the top tax bracket for ordinary income. Most dividend income from stocks is also taxed at 15% or 20%. But interest from bonds and other investments is likely to be taxed at the higher rates for ordinary income.

2. Tax-deferred accounts: Within tax-deferred accounts such as 401(k) plans and traditional IRAs, capital gains and income from dividends and interest all can accumulate without being taxed. But once you start taking money out of these accounts during retirement, all or most of your withdrawals will be taxed as ordinary income. And when RMDs come along, some of the money *must* come out every year.

One kind of tax-deferred investment—annuities—may help you minimize taxes by postponing payouts until your income is lower during retirement. Deferred compensation from your company could offer similar tax benefits.

3. Tax-free accounts: Of course, no taxes are better than low taxes, and a Roth IRA may give you retirement income that isn't taxed at all. With a Roth IRA that you've had for at least five years, withdrawals after age 59½ are completely tax-free. Meanwhile, although interest income from most bonds is taxed at ordinary income rates, income from municipal bonds or municipal bond funds can be tax-exempt. These bonds could be a valuable part of your retirement portfolio.

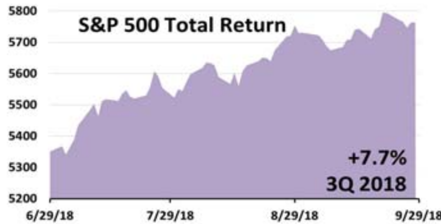
When considering which account to draw from and in what order, a common strategy is to take RMDs first—because you must make those withdrawals—then tap your taxable accounts next, leaving assets in tax-deferred accounts to grow without being eroded by taxes for as long as possible. Finally, make tax-free withdrawals from your Roth IRA, which offers the additional advantage of not requiring distributions during your lifetime.

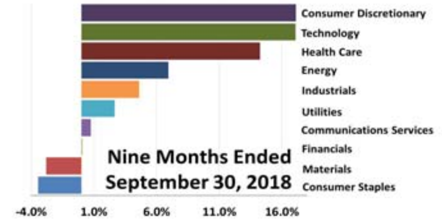
In addition, to the extent you can, you might practice tax bracket management, capping your taxable income at a level that will let you avoid moving into a higher bracket. So that even if you can't avoid taxes entirely during retirement, you may be able to keep them under control. ●

and cracks in global growth. Things looked bleak.

We're here to remind you that U.S. leading economic indicators released in April continued a long surge far beyond the highest point of the last expansion. This key forward-looking composite of 10 indicators points to solid growth for the rest of 2018. Despite the headlines, increased market volatility, and a weak first quarter return on stocks, very strong economic fundamentals remain in place. We're here to help you manage your portfolio for the long run. ●

Market Data Bank: 3rd Quarter 2018 Ψ





S&P 500 GAINED SHARPLY IN 3Q18

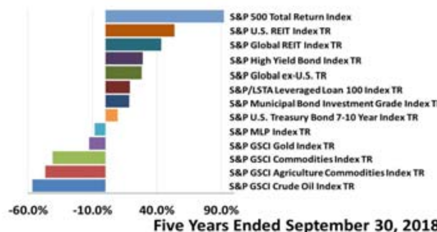
Stocks shot up in 3Q2018, returning 7.7% in price appreciation and dividends. Historically, stocks averaged about a 10% return annually for the last eight decades. So, a quarterly return of 7.7% is excellent. The S&P 500 returned a strong 10.8% in the first three quarters of 2018, but it was with more volatility than in recent years.

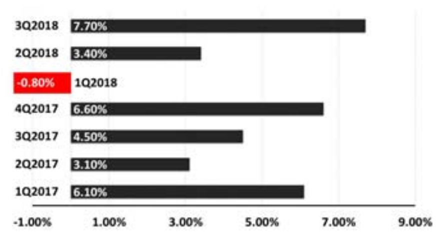
STOCKS NEARLY DOUBLED IN FIVE YEARS

The bull market turned 112 months old in September. The likelihood of a bear market — a correction of at least 20% — increases as the bull market grows older. But usual precursors to a bear market — restrictive Fed policy, the likelihood of slowing economic growth, and irrational exuberance — were not evident.

SECTORS SHOW GROWING APPETITE FOR RISK

With growth expectations rising in each of the first three quarters of the year, American consumers went on a shopping spree, lifting consumer discretionary and technology stocks to a total return of 17.1%. Raw materials and consumer staples stocks were laggards.





INDEXES TRACKING 13 ASSET CLASSES

Atop this wide variety of 13 asset classes was the S&P 500 return of 92.1% — more than three times the S&P Global ex-U.S. 28%. It's testament to U.S. economic resiliency. The surge in U.S. oil supply from the shale-fracking revolution broke oil prices and ample supply of depressed prices for gold and commodities.

S&P 500 AND POST-WAR EXPANSIONS

At 112-months old, this expansion is just months shy of the 120-month boom of the 1990s, the longest in post-War history. With fundamentals strong, this expansion could become the longest boom in modern history. Recessions can lead to bear markets, but not every bear market was spurred by recession.

S&P 500 LAST QUARTER VS. PREVIOUS SIX

Comparing last quarter's 7.7% return on the S&P 500 with performance in the previous six quarters is a snapshot of a bull market. Markets don't go straight up and a double-digit correction could occur at any time. Recessionary conditions that often triggered past bear markets were not present at the end of 3Q2018.

Past results may not indicate future performance. Indices and ETFs representing asset classes are unmanaged and not recommendations. Foreign Investing involves currency and political risk and foreign-country instability. Bonds offer a fixed rate of return while stocks fluctuate. Investing in emerging markets involves greater risk than investing in more established markets, such as risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates and adverse political developments.

A New Risk To Converting

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plunged by 37%, as it did in 2008, your Roth IRA is now worth $189,000. Making matters worse, you'd still have owed $72,000 to Uncle Sam on the withdrawal of the full amount converted from your traditional IRA. You'd have to pay tax on income that was lost in the market decline. The tax reform eliminated the option of undoing the conversion to avoid paying tax on phantom income.

The New Risk In Converting. Since the new tax law eliminated this option, you now have little choice but to pay Uncle Sam the phantom income-tax and — should your account value plunge after converting — you must be prepared to stick with your long-term strategy in the hope that the stock market will rebound. Past performance is no guarantee of your

future results, but a recovery is exactly what happened after the 2008 bear market. The climb back may take years and it's possible — though unlikely — that it might never rebound. From its October 9, 2007 record high of 1565.15, the S&P 500 dropped to a low of 676.53 on March 9, 2009 in the near-collapse of the world financial system. It was not until March 28, 2013 that the S&P 500 surpassed its previous record closing high set in 2007 — a seven-year span.

Bottom line. The new risk of converting and getting hit by phantom income tax is now part of the equation in the math of retirement planning. However, if your Roth IRA will be compounded tax-free for the next decade and you can tap it for income without paying Uncle Sam a dime, then the math may indeed work better for you — especially if you believe tax rates are on the rise. ●

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