BRAVE
Family Advisors

Quarterly Review

February 2021

Dear Clients and Friends,

Last year was a difficult year in many respects but turned out to be an above-average year for most financial markets and for BRAVE Family Advisors (BFA). In this letter we share some thoughts on those two developments and on how upcoming potential tax policy changes may impact your finances, the current expensive state of U.S. equity and fixed income markets, and how we are managing our client portfolios in reaction to that situation.

BRAVE Family Advisors Continues to Grow

Our recent rebrand has definitely helped us better communicate the broader mission that we seek to fulfill as evidenced by our record growth in 2020 in the number of clients that we serve and their assets that we manage! We are now more than double where we were four years ago by both of those measures.

Helping a client secure their financial future so that they can live life with confidence typically encompasses so much more than just managing their portfolio. Putting in place a financial plan to ensure they are on the right path to achieving their financial goals or helping ensure that the appropriate trust and estate plan is in place to protect a client's assets for future generations or making sure that there is sufficient life insurance so that a family's financial needs will be covered in the event of the untimely death of a spouse/parent or stepping in to help a family pick up the financial pieces after the loss of a loved one can all make a bigger difference in a client's and their family's life than just buying the right stocks.

To assist us in continuing to find more families who we can help, Peter Van Alstyne recently began working with BFA with a focus on business development. Pete has enjoyed a successful career in sales and marketing. He also holds several technology patents. He lives in Brooklyn, NY, with his wife and two daughters (when they are not at college). You can reach Pete at pvanalstyne@bravefamilyadvisors.com or (917) 208-8894. Welcome Pete!

Market Thoughts

U.S. stock markets are at an interesting juncture. There a number of positives: the major uncertainties of the last year, political- and COVID-related, have largely been eliminated; additional fiscal and monetary stimulus will be provided; and corporate earnings news should remain favorable. However, valuations by most measures remain stretched suggesting that much of the positive news may have already been discounted. We strongly expect that equities will continue to provide the best long-term returns, but would also suggest that the present is a good time to pare back risk profiles at the margin.

Most financial markets have gotten even more expensive in recent months and signs of growing speculation have become common place. By many long-term measures, the U.S. equity market is as highly valued as it was at the peak of the dot-com bubble in 2000 and the high in 1929; by some measures it has even exceeded those historical peaks. The primary valuation support remains stocks' attractiveness relative to bonds, although that gap has begun to shrink. Developments such as the recent gyrations in stocks like GameStop (GME), the tidal wave of initial public offerings in SPACs (Special Purpose Acquisition Companies), and the unprecedented speculative activity in options suggest that animal spirits are once again reaching a frenzied level.

There are several measures that illustrate the current largely unprecedented valuation levels for U.S. stocks. The S&P 500 is currently trading at 22.1 times forward earnings which is well above average in absolute terms. The U.S. total market capitalization as a % of GDP is at a new modern high **(Chart 1)**. The current CAPE ratio (Cyclically Adjusted Price to Earnings ratio) of 34 indicates that stocks are at among their most expensive levels in the last 100 years only exceeded just before and just after the 2000 peak **(Chart 2)**. U.S. stocks also remain expensive relative to those in other regions trading more than four standard deviations above their 50-year valuation mean relative to European stocks **(Chart 3)**. Within the U.S. market, growth stocks have seen some underperformance relative to value stocks in recent months but remain at levels above those seen at the peak of the dot com bubble twenty years ago **(Chart 4)**.

Chart 1: Wilshire 5000 Total Market Capitalization to US Annual GDP

Chart 2: Long-term Historical Cyclically Adjusted PE Ratio with Recessions

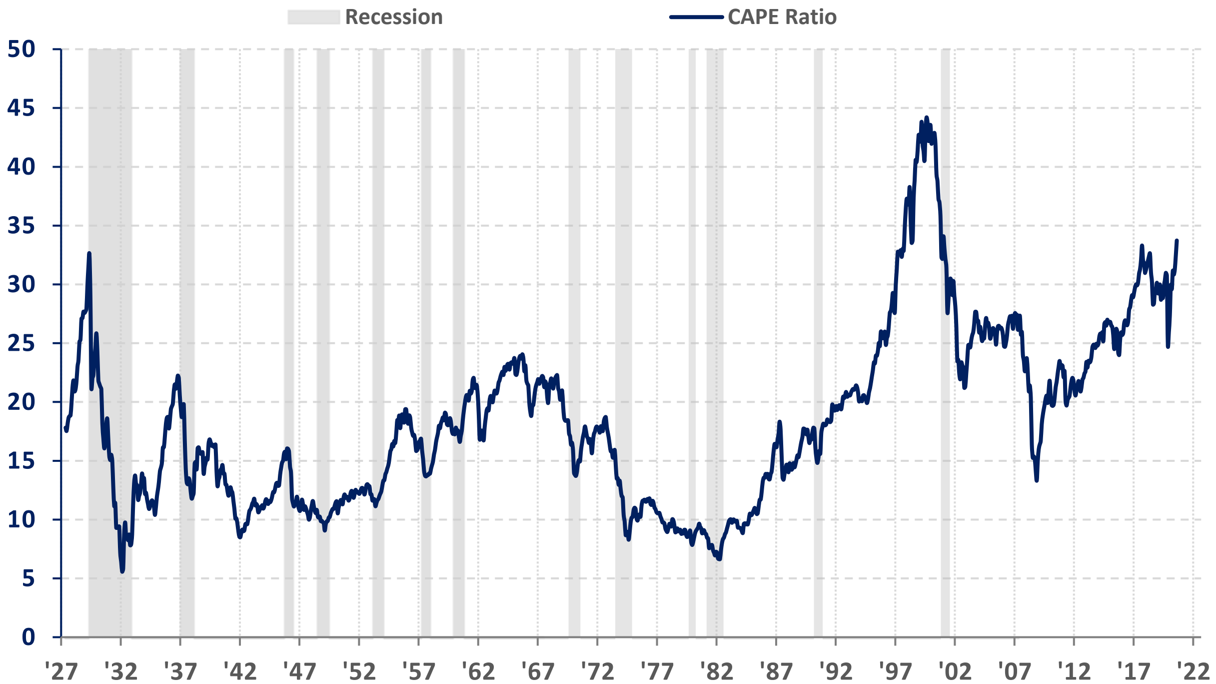

Chart 3: MSCI United States Index vs. MSCI Europe Index

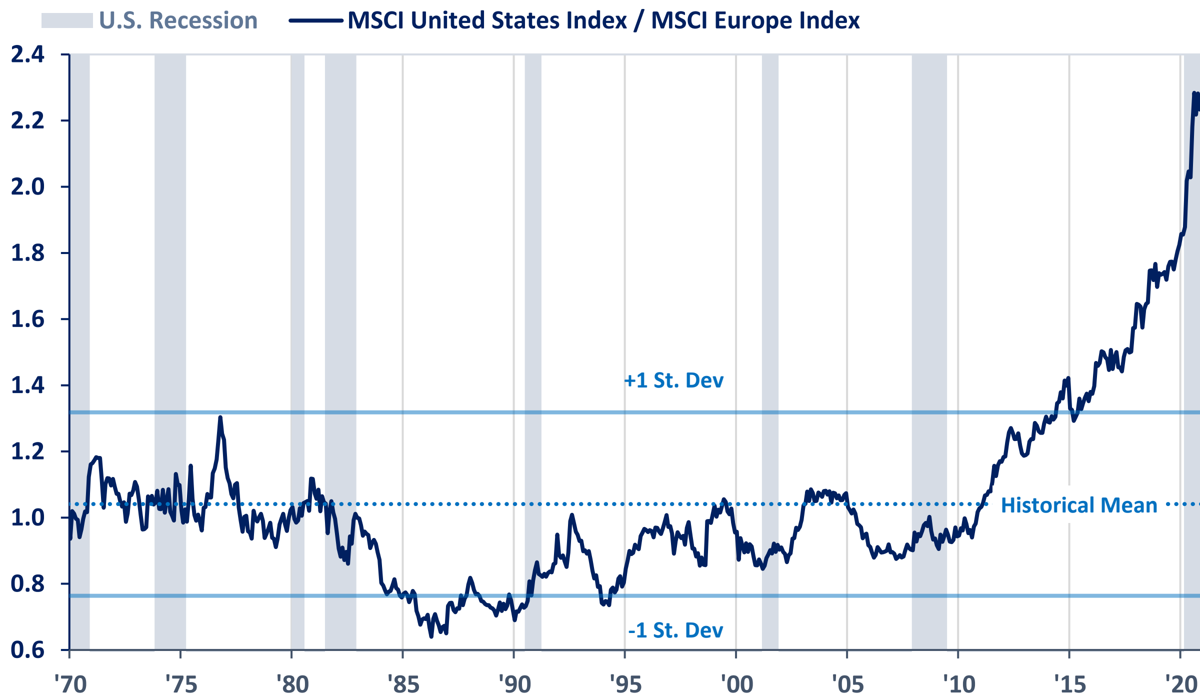

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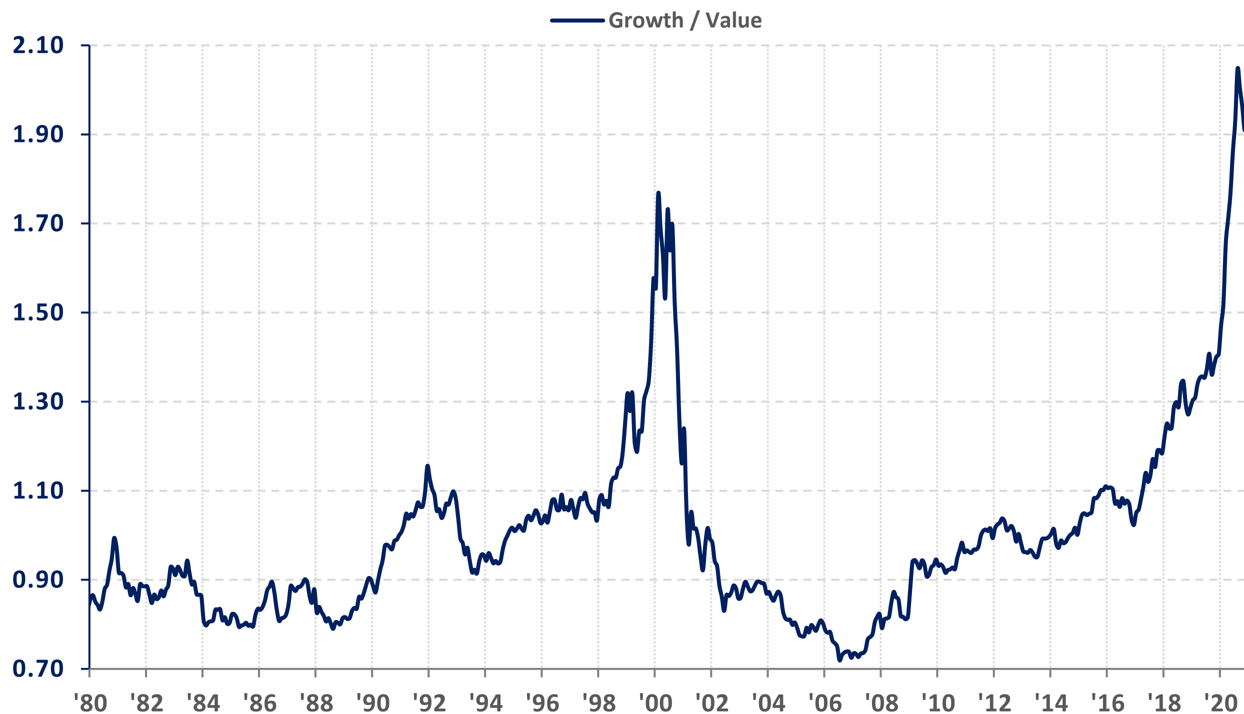
Chart 4: Russell 2000 Growth Index vs. Russell 2000 Value Index



The biggest valuation support for the current U.S. stock market is "TINA" (There Is No Alternative). The dividend and earnings yields for the S&P 500 are still attractive relative to interest rate levels available in the U.S. fixed income market and even more so relative to the trillions of dollars of negative yielding debt around the world **(Charts 5 and 6).** This support has begun to diminish in recent months as the yield on the U.S. 10-year note has more than doubled from the pandemic lows of last year to the current level of 1.14%. Furthermore, the yields on the S&P 500 have declined as the index has continued to rally. We expect interest rates will maintain their gradual move higher this year due to the likely potent combination of further massive fiscal and monetary stimulus and the further reopening of the economy as vaccinations and herd immunity reduce the virus' impact.

We continue to believe that the high valuation of U.S. stocks doesn't necessarily mean that disaster lies ahead; however, it does suggest that future equity returns are likely to be well below historical averages. There is a strong correlation between current valuation levels and future returns. Typically, the cheaper stocks are, the higher future returns will be and vice versa. This relationship can be seen in **Chart 7** which illustrates the relationship between the beginning CAPE ratio and stock market returns over the next 10 years. A beginning CAPE ratio in the 33-35 range (currently at 34) has yielded 10-year future annual average returns in a range of -1% to +6% over the last 94 years. This suggests that investors may need to adjust their expectations to something less than the historical average equity return of close to 10% per year.

Chart 5: S&P 500 Dividend Yield and 10 Year Treasury Yield

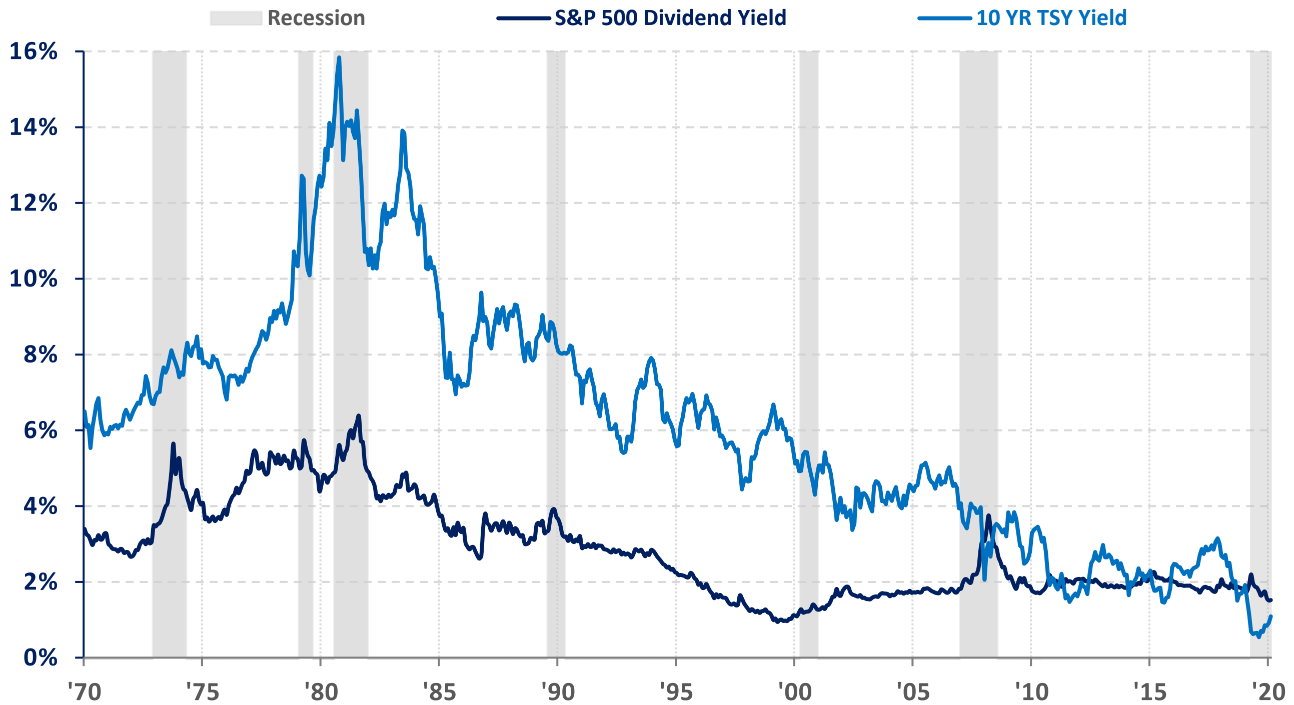


Chart 6: S&P 500 Earnings Yield and 10 Year Treasury Yield

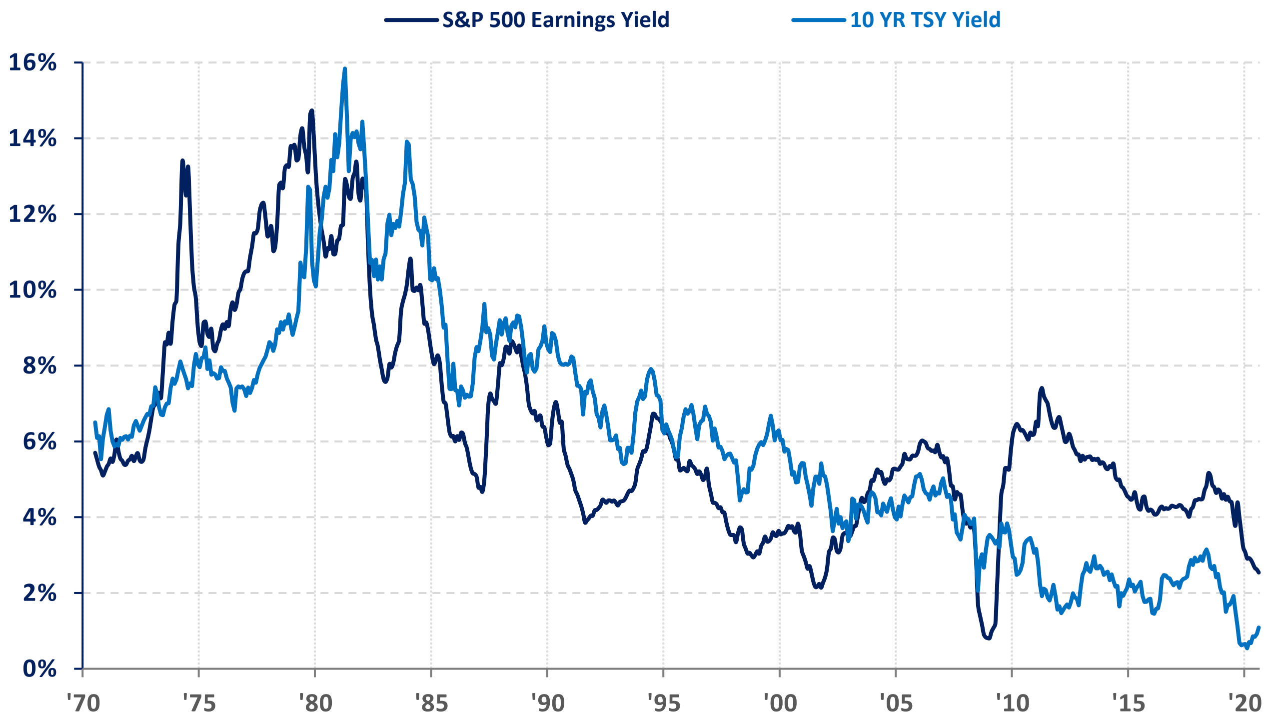
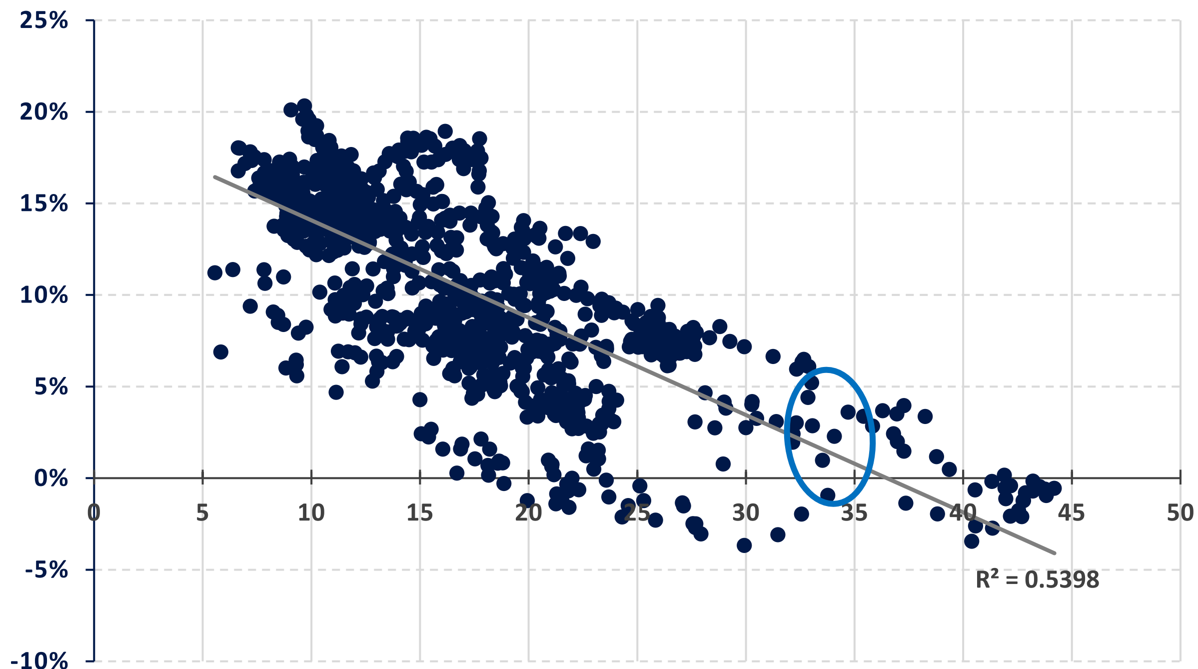


Chart 7: Next 10 Year Annualized Returns of S&P 500 Index (Vertical Axis) vs. Beginning CAPE Ratio (Horizontal Axis)



Portfolio Management

We have client portfolios relatively defensively positioned again as the result of the current rich valuation levels. Typical equity allocations are 8-12% below target levels. We continue to favor value and international stocks for the valuation reasons mentioned above. The iShares S&P 500 Value ETF (ticker: IVE) has a current P/E ratio of 15.4 compared to the 22.1 for the entire S&P 500 index and a dividend yield of 2.35% versus the 1.55% yield on the entire index.

We had owned a sizeable position in gold since October 2018 when it was trading around $1,200 but sold it around the election at about $1,900 and redeployed the proceeds into international and value stocks. Although easy money policies should remain supportive, we felt that greater political certainty, coming improvement in the virus situation, and the fact that everyone including Warren Buffet had become a fan of gold suggested that there was better opportunities at the time in under-loved segments of the equity markets.

In our fixed income portfolios, we have been shortening duration since early spring of last year as we believe a potential generational low in interest rates has been seen. We had a fair amount of 30-year and 10-year Treasuries going into the February/March panic last year. We rolled the 30-year bonds into 10-year notes in March and then rolled the 10-years into 3-year T-notes in the fall. We have also hedged most of our exposures beyond the 3-years with shares of the ProShares UltraShort 20+ Year Treasury ETF (ticker: TBT). This security moves in the same direction as interest rates at the long end of the Treasury yield curve.

In some accounts, we have also bought shares in the Greyscale Bitcoin Trust (ticker: GBTC) which, as its name implies, is a publicly traded trust that owns Bitcoin. We are not going to argue that there is no enthusiasm evident in the world of cryptocurrencies, but we are impressed by two things about Bitcoin that make us think it still has a potentially long road of further appreciation ahead of it. First is its rapidly growing institutional acceptance. Recent examples include being able to buy it at Coinstar machines and to buy, sell, and hold it through PayPal and MetLife's $5 million investment in a Bitcoin provider and its $100 million investment in Bitcoins. Second, there is a finite supply of Bitcoins. There are only 21 million coins that can be mined with only about 2 million left to be generated. Quite a contrast to the situation with U.S. dollars and debt…

Impact on Your Finances of Potential Tax Policy Changes

With the recent change in control of the White House and Senate, we could see changes in the federal tax code that would have significant impacts on your finances.

Candidate Biden proposed several tax changes that would target a redistribution of taxes towards the higher end of the income and wealth spectrum:

1.) Raising the top marginal ordinary income rate back to the Obama-era 39.6% from the current 37.0%.

2.) Increasing the tax rate on long-term capital gains and dividends to 39.6% from the current 20.0% for taxpayers with annual income in excess of $1 million.

3.) Cutting the lifetime Federal estate tax exemption to $3.5 million per person or $7.0 million per couple. The current exemptions are $11.7 million per person and $23.4 million per couple. He also proposed increasing the estate tax rate to 45% from the current rate of 40%.

4.) Eliminating the "step-up in basis" of appreciated assets. The current policy of stepping-up basis resets the cost basis of an asset to the value at the time of the owner's death thus eliminating the potential capital gains tax on the asset for the heir(s). Under Biden's proposal the cost basis on an inherited asset would remain at the deceased's cost basis.

5.) Replacing tax deductions for IRA and 401(k) plan contributions with a tax credit. As envisioned, a tax credit would mean that taxpayers in lower marginal tax brackets would see a greater tax benefit than those in higher marginal brackets relative to the current system.

We do not know at this time whether any or all of these proposals or alternative policies will make their way through the narrowly divided houses of Congress and get signed into law. If changes are made that are retroactive to January 1, 2021, then there will be little that can be done to mitigate the potential impact of them. However, if the changes take affect prospectively, then we will communicate strategies to try to "get ahead" of their becoming effective.

These could include:

A.) Realizing long-term capital gains: Since your capital gains tax rate may nearly double if you make more than $1 million per year, locking in a gain at the current rate could represent a significant tax savings.

B.) Gifting assets: You can take advantage of the current $11.7/$23.4 million exemption to move up to that amount of value out of your taxable estate to heirs or irrevocable trusts before the exemption is possibly cut in half.

C.) Considering a ROTH conversion of an IRA: Converting part or all of an IRA to a ROTH IRA would allow you to pay taxes on it at current ordinary income tax rates rather than being taxed at a higher rate when you or your heirs take future required distributions.

D.) Making charitable contributions from your IRA: The IRS allows direct charitable contributions from IRAs of up to $100,000 per year. Using IRA funds to make charitable donations this year that you would otherwise make from other sources could provide a benefit if the top marginal ordinary tax rate is increased. The tax write-off at current tax rates could very well be less than the tax you will pay on the future IRA distributions that you and your heirs will be required to take at future higher tax rates.

E.) Converting 401(k) contributions to after-tax from pre-tax: Unlike with IRAs, there is no income limit on making ROTH contributions in a 401(k) plan. If their tax benefit of making a tax-deferred contribution is reduced, then high earners may get a greater benefit of making an after-tax contribution at current tax rates and having the money grow tax free for the rest of their lifetimes.

Please do not hesitate to contact us with any questions and look for further communications from us as tax policy changes become clearer.

Administrative Items

A reminder that you have until April 15 to make 2020 contributions to an IRA. The limits for a standard or ROTH IRA are $6,000 or, if you are 50 years old or older, $7,000.

Pershing will be distributing 1099s for 2020 over the next month or so. The release of the forms are phased and occur January 31, February 15, and March 15. The most efficient way for you and/or your tax advisor to access your 1099(s) is through our client portal as the forms get automatically uploaded to your vault in the portal. Please contact us if you or your tax preparer has not enabled a log-in for the portal.

As always, we welcome your comments and questions. Please don't hesitate to call, visit, or email at any time.

Your team at the BRAVE

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