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Investors should be ready for higher taxes and inflation

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MICHAEL J. FRANCIS

The pandemic-induced public policy decisions that injected well over $5 trillion into the U.S. economy in the past 15 months have significant short- and long-term investment implications.

In the short-term, the unprecedented amount of monetary and fiscal stimulus has helped push financial assets to all-time record highs. In the longer-term, it's likely to cause inflation and ultimately, when the bill comes due, higher taxes.

U.S. inflation history

It's been over 40 years since this country experienced an extended period of high inflation. Historically, a sharp rise in inflation has not been friendly to the performance of financial assets.

In January 1966, the U.S. stock market hit an all-time high. Shortly thereafter, inflationary pressures caused by war and an oil price shock caused stock prices to drop sharply. The stock market did not recover meaningfully above the level achieved in 1966 until December 1982. During this same 16-year period, interest rates rose sharply making this also a lousy time to own long-term bonds.

Take action

While inflation-sensitive investments should always be a part of your portfolio, now is an ideal time to investigate whether you have enough exposure to them.

Your stock market holdings are a good place to start. Owning shares of companies whose earnings benefit from rapidly rising inflation or interest rates is a good place to start. Companies in the natural resources and banking industries match this description along with emerging market equity funds.

The most inflation-sensitive investments tend to be those related to commodities. The world's commodity markets are very nuanced and extremely volatile. You can gain diversified exposure to these markets through a commodity exchange-traded fund (ETF) or an index fund. I suggest leaving the trading of individual commodities to the experts.

Another investment sector that does well during inflationary periods is real estate. If you own a home, congratulations, you're already participating in this market. We're often asked if real estate investment trusts (REITs) are a good proxy for real estate. While REITs typically pay an attractive dividend, we recommend caution because historically they have not performed well during periods of rising interest rates.

For the risk averse, Treasury Inflation-Protected Securities (TIPS) offer the safest way to maintain your purchasing power during periods of high inflation. These government-backed bonds make semi-annual interest payments that are adjusted upward every six months based on the current rate of inflation as measured by the Consumer Price Index.

Protect your gains from taxation

It's widely expected that taxes on either your income, capital gains and/or estate will be increasing to pay for all this stimulus. For this reason, now is an excellent time to investigate opportunities to move long-term assets into a Roth account. Roth accounts shelter all future income and capital gains from taxation when withdrawn after age 59½.

Roth accounts are available to everyone, regardless of income, through a company-sponsored 401(k) or 403(b) plan. They currently have an annual per person contribution limit of $19,500, or $26,000 once you turn 50. If you have earned income, but don't have access to an employer's plan, a Roth IRA allows a maximum annual contribution of $6,000, or $7,000 once you turn 50. Be aware that Roth IRAs do have limits on who can use them based on your income.

A "Roth conversion" is a powerful tool that allows you to convert pre-tax retirement savings into a Roth account. There are no dollar limits to the amount of pre-tax 401(k) or IRA assets you can convert to Roth, but any amount you convert is taxable as ordinary income in the year it is converted. This strategy allows you to pay the taxes on your retirement savings at current rates and potentially avoid a higher tax rate in the future. More importantly, it sets you up to enjoy income and capital gains that are tax free from this point forward.

Working with a tax adviser, make sure such a conversion doesn't push you into a higher tax bracket, and that you have enough savings outside the 401(k) or IRA to pay the taxes due next April. The younger you are, the more powerful this strategy is likely to be.

A final idea for those with excess capital; gift money to your child's or grandchild's Roth IRA. Annually, you can contribute up to the amount of their earned income or $6,000, whichever is less. Currently, you may gift up to $15,000 per year per child/grandchild without affecting your lifetime gift exclusion.

We live in unprecedented times. Investment and tax strategies that may have served you well for many years could now be suboptimal for the future. Rethink your strategy and be prepared.

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