JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

FROM THE DESK OF CIO CHARLES RINEHART, CFA, CAIA

2024 SECOND QUARTER

Most people have experienced déjà vu at one time or another. The term is taken from the French for "already seen" and refers to the eerie feeling that one has lived an experience before despite knowing it is happening for the first time. I recently learned that the experience has a lesser-known mirror image: jamais vu. It won't surprise you that this one is also French, meaning "never seen," and refers to the experience of feeling as though an event or experience is brand new despite experiencing it numerous times in the past. This concept of jamais vu resonates with investor psychology, particularly regarding the most dangerous four words in finance: "this time is different."

The market's reaction to the current economic data resembles jamais vu. Economic data continued to show signs of slowing this quarter. We've been experiencing negative leading indicators and an inverted yield curve for some time now. More recent data suggest the labor market is also starting to slow, and unemployment has steadily inched up to 4.1%.

In isolation, 4.1% unemployment is not alarming. To provide context, unemployment troughed at 4.4% in March of 2007 before the Great Financial Crisis. However, the current level is up 0.7% from its 2023 low. Unemployment is a mean-reverting series; it doesn't tend to move sideways for very long, making this upward trend significant. A 0.7% increase in unemployment, along with negative leading indicators and yield curve inversion, are trivia facts you can mentally file in case you ever see the Jeopardy category "Things That Happen Before Recessions."

Despite this cautionary economic backdrop, the S&P 500 reached new all-time highs in the second quarter. The S&P 500's year-to-date return of 15.3% marks its third-best start to a calendar year this millennium. However, the S&P's headline return may not fully reflect the market's health. Most stocks had a tough quarter that better reflected the underlying economic activity. While the S&P 500 index advanced 4.3% in the second quarter, the average stock in the index fell by almost 3%. Small (Russell 2000) and mid-sized (Russell Mid Cap) companies also declined roughly 3% during this period, and the Barclays Aggregate Bond Index was flat, up just 0.1%.

The market's reaction to slower growth and economic concerns has been to continue to invest heavily in the largest and most cash-rich growth stocks. Although this approach seems logical, the extent of this investment is causing concern due to rich valuations and market concentration rarely seen.

The largest 10% of stocks are now over 76% of the total value of the market. This degree of winner-take-all concentration of returns is seldom seen. In fact, we're currently in the 97th percentile of concentration by this measure going back to 1970. These periods have historically presaged significant market events. The "Nifty Fifty" collapse of the 1970s and the tech bubble of the late 1990s are the only periods that come close. Over that 50+ year history, there's never been a ten-year

FEATURING

TOTAL RETURNS

	2Q 2024	2024
S&P 500	4.3%	15.3%
Dow Jones Industrial Average	-1.3%	4.8%
NASDAQ	8.5%	18.6%
Russell 2000	-3.3%	1.7%
MSCI EAFE (International)	-0.4%	5.3%
Bloomberg U.S. Aggregate Bond Index	0.1%	-0.7%

period following a concentration level of more than 70% when the cap-weighted index (concentrated) has beaten the equal-weighted index (diversified). Above 75% (remember, we're at 76% right now), the average cumulative out performance of the equal-weighted index over the subsequent ten years has been 61%. Interestingly, periods of extreme concentration have also signaled good times ahead for active management, with the S&P 500 cap-weighted index producing below average returns versus active managers over those same ten-year periods.

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While the driver of the market, AI optimism, is new, the current market dynamics and economic backdrop are jamais vu all over again. Past periods like this remind us of Warren Buffett's advice to "be fearful when others are greedy, and greedy when others are fearful." Patience and temperament are often more important for investors than a high IQ (artificial or otherwise). It is always wise to stay diversified, but history suggests this is a time when it is more important than usual.

The good news for those with the right discipline and long-term focus is that excellent opportunities continue to exist in stocks and bonds. We can participate in the most exciting industries in the market responsibly with diversified portfolio construction and a reminder that trees seldom grow to the sky.

Thank you as always for your trust and confidence. Our team continues to work diligently to stay on top of the changes in the market as they develop. Please reach out to your portfolio manager if you have questions for anyone on our team.

Chief Investment Officer, Charles Rinehart, CFA, CAIA, leads our dedicated team of research analysts and portfolio managers as they manage our investment strategies to deliver financial peace of mind to our clients.

ROTH 401(K) OR TRADITIONAL 401(K)?

THE RETIREMENT SAVER'S CONUNDRUM: ROTH 401(K) OR TRADITIONAL 401(K)?

Socking away as much money as possible for retirement is, by no means, a "hidden secret" nor complex, nuanced retirement strategy. With or without formal advice from a wealth planner, most people intuitively know saving money is the foundational "blocking and tackling" building block required for a stable retirement. But after the table-stakes of retirement planning is established, complexity and analysis come into play, most notably the amount to save when factoring in lifestyle needs, retirement time frame, education planning, taxes, and estate planning goals. This is where experienced and well-informed advice can add value and peace of mind.

But recently, with the increasing availability of Roth 401(k) options in many employer plans, the decision on tax deferred vs. after tax contributions has added another layer of complexity to the retirement savings calculus. In short, investors and savers are now faced with the question of if they should elect a Roth option and how much of their hard-earned retirement savings dollars should be put into a traditional tax deferred savings plan (i.e. tax deferred 401(k), 403(b), etc.) versus a Roth (after-tax) plan?

Much like our friends in the legal, medical, and tax advice-giving business, we too must default to the stock answer frustrating the inquirer: "It depends."

THE TAX RATE TRADEOFF DECISION

To analyze this issue, we must first establish the basic issue at hand. In many defined contribution employer retirement plans, (i.e. 401(k)) employers may offer employees the choice to contribute all or some mixture of their contributions to a Roth or Traditional version of the plan. The primary difference between the two plan options is: traditional plan contributions are pre-tax, effectively lowering an employee's taxable income and lowering annual federal (and other) tax liabilities. Put another way, a $1,000 contribution with a 30% personal tax rate subjects $700 taxes instead of the full $1,000. The tradeoff for this attractive tax break is, of course, when these retirement dollars are disbursed out (either pre-RMD age or at the required beginning age of 73), tax is owed on the amount of the withdrawal. In addition, heirs to these funds will owe tax on withdrawals and for non-spouse heirs, the disbursement schedule is accelerated. A Roth plan works the opposite way. Employees do NOT enjoy lower tax liability with contributions but, in exchange, withdrawals from these accounts are not taxed and importantly, heirs to these funds also avoid tax liability. To use our previous example, the full $1,000 contribution is still counted as fully taxable income.

MAKING THE EDUCATED GUESS

Making this decision would be pretty straightforward if we knew future market growth rates, future tax rates, and the exact day a person will die. Obviously, those are unknowable with certainty. But we can make some educated guesses and increase our odds of making the right call by knowing personal circumstances.

The simple way to consider this decision is to first determine the current federal, state, and local tax rate. If the taxpayer is in higher brackets (30% or more all-in), it can make sense to take the deferral now (by contributing to the traditional tax deferred plan) with the educated guess that, in retirement, the retiree will be in a lower tax bracket. This allows the taxpayer to benefit from the relatively high rate for the tax deduction while working, with the expectation of a lower tax rate in retirement. One downside to this strategy is, under the SECURE ACT, non-spouse heirs to tax deferred accounts must empty these accounts within 10 years, and distributions to the heirs are included as ordinary and taxable income in what could be their peak earning years.

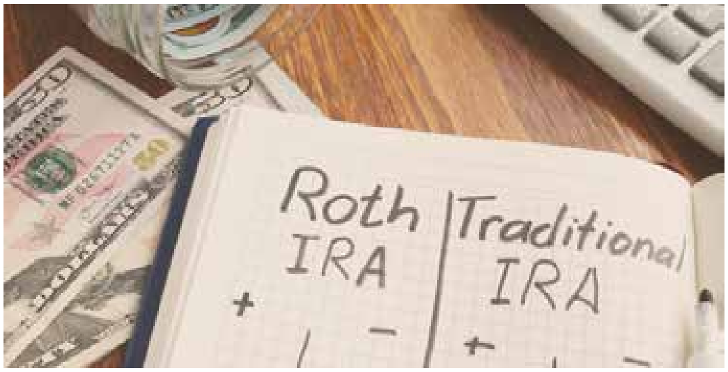
Conversely, taxpayers in lower tax brackets may decide to forgo the tax deferral and contribute to the Roth plan knowing that, in retirement, future withdrawals will be tax free and heirs will enjoy tax-free distributions as well.

Of course, tax brackets move throughout decades of a career so "set it and forget it" is not wise. Savers need to adapt to changing tax laws, income tax brackets, growth rates, and health expectations. In addition, the pre-existing mix of pre-tax vs. After tax retirement savings also plays a factor in where to direct future contributions. So, clearly, this isn't a simple decision.

THE BEST OF BOTH WORLDS

In working with a broad array of clients, we've found a sweet spot or ideal set of circumstances that help maximize tax efficiency with a multi-decade approach requiring diligence and sticking to the plan. This is the heart of customized wealth management: tailoring a plan specific to the family and not relying on "rules of thumb" or general advice.

People or couples that are high earners and good savers, with a realistic chance of retiring "early" (usually before 65), can really leverage the tax code to work in their favor with a tax strategy that goes well beyond a one-year calculation. In these situations, we find people in high tax brackets can benefit from choosing the tax deferral at their current high rates, which can save 30% or more in taxes with each contribution. But what about the high tax rates on these dollars upon withdrawal?



That's where we execute strategic Roth conversions in the first years of retirement before claiming Social Security and before RMDs kick in (currently age 73). For someone retiring at age 60 with substantial savings in tax deferred accounts, executing a well-defined Roth conversion strategy for those 10+ years of "low income" can save on taxes in working years while paying lower tax rates that we can control with the proper calculation of annual Roth conversions at an attractive rate. So instead of paying little to no taxes in the first year of retirement (due to minimal taxable income) and "wasting" the low brackets, well-constructed Roth conversion amounts can voluntarily pay tax in say the low-teens rates instead of paying much higher rates when the full brunt of RMDs (combined with Social Security) come due when clients are in their 70's. (Please note: we must also be mindful of other distinct tax brackets including capital gains rates and IRMAA (Medicare) surcharges when adding income). This savings can be in addition to a taxpayer previously benefiting from the high tax savings while working! This is effectively using the Golden Window of Tax Planning as described and depicted in the article from November 2021.

Additionally, heirs will be thrilled to inherit a more attractive mix of tax-free assets that won't incur higher taxable income on required distributions when they could be in higher tax brackets.

BOTTOM LINE

In reality, there is no "perfect" strategy because so many variables shift over the decades. Tax rates, tax brackets, living expenses, market growth rates, and life expectancy all impact the degree a family can benefit from this strategy. But having a multi-decade plan and a tactical yearly execution can, if executed correctly, save retirees on what is their largest cash outflow over retirement years: taxes.

Disclaimer: Information contained herein is current as of 6/30/2024. It is subject to legislative changes and not intended to be legal or tax advice. Please consult your qualified tax advisor regarding your specific circumstances. The material is provided for informational purposes only on an "as is" basis. It's completeness and accuracy are not guaranteed.

NEW ADDITIONS TO THE TEAM

We are pleased to announce that these individuals have joined our team over the last several months:

> **Brandon Davidson**
> Portfolio Manager Assistant

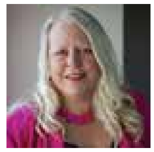
> **Michael Murphy, CFP®**
> Director of Intermediaries & Client Service

> **Christine Smith**
> Front Desk Associate

> **Valerie Spence**
> Client Support Assistant


Davidson


Murphy


Smith


Spence

IN THE NEWS

The expertise of our Johnson team members is often sought after by local and national media sources. Scan the QR code to see recent articles and videos featuring our employees.

Recent highlights include:

> **Brandon Zureick, CFA** in Yahoo! Finance
> **Charles Rinehart, CFA, CAIA** in The Wall Street Journal
> **Charles Rinehart, CFA, CAIA** in CBS News MoneyWatch
> **Tony Kure, CFP®** in Barron's
> **Tony Kure, CFP®** in The New York Times
> **Laura Mattern, CFA, CFP®** on Local12

UPCOMING WEBINARS

Are you a current or former Procter & Gamble employee? This webinar, led by Michael Stanis, CFA, CFP®, MBA, a former P&G employee, is designed to help owners of the P&G Profit Sharing Trust (PST) understand how the proceeds may be distributed and invested, and how taxes are impacted. Johnson Investment Counsel has helped hundreds of P&G employees navigate PST distribution options. We want to share what we know so that you can make the best decisions for your family.

SCAN TO REGISTER

CORPORATE TRANSPARENCY ACT

We want to alert you to a new law that may impact our clients who are owners of various types of business entities. In 2021, the Corporate Transparency Act ("CTA") was enacted. The CTA created new requirements for certain entities to report to the Financial Crimes Enforcement Network ("FinCEN") starting on January 1, 2024. Scan the QR code to learn more.

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ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $19 billion in assets for clients in 50 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-only, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

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