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# O.F.O. Partners



## Spring

It's springtime. People across the country are reopening their lives. Business is in bloom, too. We have a new administration with ambitious economic plans. Financial markets forecast bumper crops far into the future.

But the change of seasons can be unpredictable. In the economy and the weather, there will be days of disappointment on the road to summer. The economy in front of us is greener and warmer than the one we endured in 2020. But market conditions have transformed since last year – a fact that is easy to overlook when reflecting on the steady gains behind us (see Figure 1).

Investors are subject to two main challenges. The first are changing U.S. **fiscal and tax policies**. The second are risks tied to **low interest rates**. We address both here.



figure 1: The S&P 500 from May 2020 to May 2021

## Part One: The Biden Investment Plan

The Biden Administration put forth its priorities in taxation and spending in April. Proposed investments include \$1.9 trillion for education and \$1.6 trillion for infrastructure over ten years. Most of the offsetting revenue would come from tax increases on wealthy Americans.

Press reports missed the mark when they described the details. Higher **income** tax brackets received lots of headlines. Meanwhile, the rules affecting **balance sheet** items would impose bigger changes to family wealth and private businesses. The ability to transfer money across generations may be at risk.

- 1) **Step-up in Basis at Death.** Current law allows inheritors to adjust the cost basis of their property to prevailing values. This avoids double taxation upon inheritance.

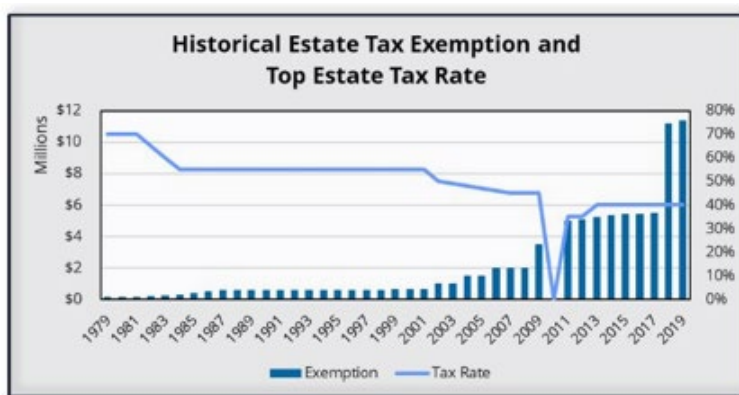
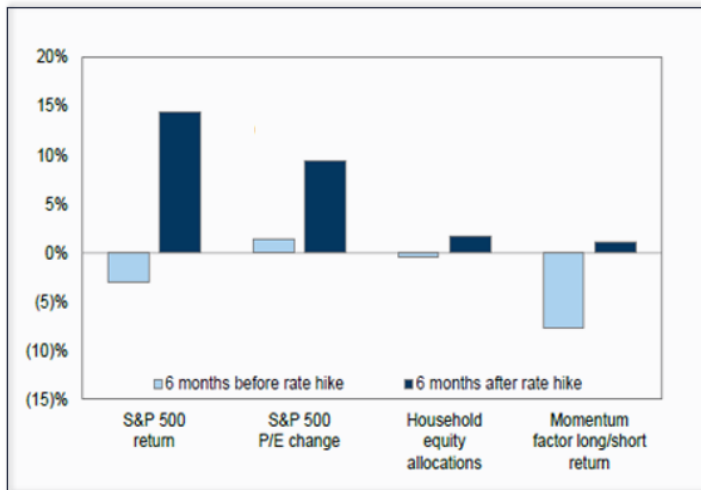


figure 2: The costs of passing wealth to family over time. Source: Value Scope 2019.

Under the proposed law, heirs would pay a 40 percent capital gain tax on assets above \$1 million. The Administration has further proposed bringing lifetime gift exemption levels down to \$3.5 million per individual, catching families in a double-tax bind. This would reverse a 20-year trend in the law that allowed the preservation of entrepreneurial wealth across generations (see Figure 2).

- 2) **Capital Gain Rates.** For those that earn more than \$1 million in income, the federal long-term capital gain tax rate would effectively double to 43 percent. This would lower the return potential of securities portfolios, business assets, real estate, and the net amount of wealth passing to family.
- 3) **IRS Enforcement.** The administration will increase funding to the Internal Revenue Service by \$80 billion over ten years to enforce tax compliance among wealthy taxpayers. Financial institutions would also share customer accounts with the IRS much like traditional wages are reported today.
- 4) **Other Capital Treatment.** The ability of real estate investors to defer tax when they exchange property would be capped at gains of \$500,000. Also, the distribution of carried interest among partnership profits would be taxed at income rates, rather than capital gain rates.

Last year [we wrote](#) that your family's financial strategy ought not rely on predictions to ensure success. The House of Representatives will not move a bill to the Senate before July or August. Then, there are the 2022 midterm elections. Control of Congress is in play. Big talk of tax increases may lead to smaller talk of "deficit spending" for a smaller package of programs.



*figure 3: Equity market trends around U.S. capital gains tax rate hikes (1987, 1988, 2013)*

Real tax hikes have not wrecked the stock market in the past. Prior increases in 1986 (20 to 28 percent) and in 2013 (15 to 25 percent) led to small declines before the laws had taken effect. The dips were transitory. Figure 3 shows how the stock market rebounded in subsequent quarters.

What is the net effect of the new proposals? Clients should talk with trusted advisors as spring turns to summer. You will lower the chance of investment missteps, paying too much in income and transfer taxes, or suffering last-minute planning that occurs on the eve of big policy changes.

## Part Two: Interest Rates

Last quarter, we visited our friend Nick, who sold his manufacturing company about a decade ago. He made several hundred million dollars, and he's been splitting his investments. On the one hand are young private companies and growth stocks. On the other hand are reliable income streams like bonds, real estate, and private lending.

This combination has served Nick well since the end of the financial crisis in 2009. But his investment strategy is riskier now. Interest rates have fallen far enough to threaten the returns on both types of investment. We spelled out the stakes in our December note, [“Snapping Turtles”](#).

Those snapping turtles came alive in the first part this year. Investors shifted their positions as though the end of cheap money were coming. The 10-year Treasury bond yield nearly doubled. At the same time, stocks of profitless companies performed poorly. The net effect was a destabilization of traditionally safe portfolios like Nick's.

How can investors sidestep such a destabilization? Let's look at a few stand-in candidates for traditional bonds at a time of low interest rates.

**Cash:** You can't live with it. You can't live without it.

Keeping cash nearby is an age-old tradition. Money under the mattress is, in effect, a zero-duration bond. It matures daily. Cash can provide a short duration advantage when other assets have stretched out their interest rate sensitivity. The downside is that investors earn no income in holding cash nowadays. At O.F.O., we find acceptable yields on cash balances for clients that keep a sizable amount no matter the season.

### Traditional Bonds: Keep some turtles in the pond

Bonds have elevated risk these days, but the asset class is not without value. Their ability to protect capital in many types of shocks is diluted by low rates, but the benefit has not gone away entirely.

The credit worthiness of bond issuers may well improve during the economic expansion. The Federal Reserve is committed to the smooth functioning of the bond market. These factors provide further support to bondholders, even those who buy riskier securities.

Finally, despite the talk of looming inflation, there is a possibility that demographic trends, supply chain disruptions, or an uneven recovery could forestall a permanent rise in interest rates. In many cases, bonds should remain a welcome, if diminished, part of a portfolio.

*“The bull market for bonds remains intact.*

*We can get to a two percent yield for the ten-year treasury in 2021, but it won’t be sustainable.”*

- Dimitrios Delis, Piper Sandler & Co.

### Stocks with yields: Buy low, buy small

Families with long investment horizons sometimes skip bonds altogether and look elsewhere for income. High-dividend equities, real estate investment trusts, utilities, preferred stock, and business development companies all fit into this category.

This approach whistles past potential dangers right now. First, yields have already been tapped downward in these categories. There is less on offer now than at other times in the business cycle. Second, adding more equity to a portfolio leaves you further exposed to stock market downturns. We advise choosing among this group based on deeper fundamental characteristics beyond the current yield.

### Diversifiers: Looking for ruby slippers

Investors look for diversifiers when they worry about the reliability of stock market gains. Bitcoin, gold, and commodities are flashy right now because fiscal spending seems worryingly high. But are these diversifiers ruby slippers, or cement shoes?

Fans of Bitcoin and other cryptocurrencies point to the algorithms that evade the reach (and policy mistakes) of central banks. But cryptocurrencies have proven to be volatile during shocks. They have a terrible record of hedging stock market downturns, and they provide no income. Tax treatment is cumbersome, and enforcement is a high priority for the IRS. The cryptocurrency promise will not be fulfilled in time to solve today’s yield puzzle.

Gold and commodities are hard assets with longer histories. They can play positive roles in diversification from other risk assets, but they are not income replacements.

### Private Real Estate: Holding your own

Private real estate, in some ways, is like a proxy for a fixed income. Property offers smoothed returns and diversification benefits to traditional security portfolios. Real estate can hedge against inflation as rent growth rises with price levels. We also believe that the long ownership horizon of real estate fits well with the time scale of many private family investors.

Private real estate, either direct or through a sponsoring manager, does come at a cost. Real estate is illiquid. Expenses and profit-sharing fees can be significant. Private investors spend years identifying assets and developing management expertise. For the right type of investor, commercial real estate can be a part of the solution to bond market excesses.

### Part Three: Wizards versus Wisdom

Recently, global stock markets convulsed after Bill Hwang, the manager of something called “Archegos”, made some very bad investments. The losses will total about \$10 billion. High leverage and concentrated investments caused the fall. As far as financial implosions go, this one was not very inventive.

The curious part is how everyone seems to want to call Hwang’s firm, Archegos, a “family office”.

At O.F.O., we take exception to that characterization. A credible family office is a private company that builds wealth, saves time, and personalizes service for its owners. Building sustainable governance, risk, and investment policies ensures longevity, sometimes for generations. Prudence and care should be self-reinforcing since the family invests its own capital.

By all accounts, Mr. Hwang and Archegos failed at this kind of stewardship. As a former hedge fund manager, he seems to have been a Wall Street follower, not an independent outsider. For us, it defies belief to see a family office lead the list of greatest trading losses in history (see Figure 4).

The depiction of Archegos as a “family office” has had noticeable effects. Insurance underwriters have adjusted rates upward to cover these business entities. Congress has threatened to investigate, and further to regulate, family

Who	What	When	Where	Losses
Bill Hwang/Archegos	Equity Derivatives	2021	United States	\$10 billion
Howie Hubler/Morgan Stanley	Credit Default Swaps	2007	United States	\$9 billion
Jerome Kerviel/Societe Generale	Equity Derivatives	2008	France	\$7.2 billion
Brian Hunter/Amaranth	Natural Gas Futures	2006	United States	\$6.6 billion
John Merriweather/Long-Term Capital	Interest Rate Derivatives	1998	United States	\$4.6 billion
Yasuo Hamanaka/Sumitomo	Copper Futures	1996	Japan	\$2.6 billion
Isac Zagury/Aracruz	Foreign Currency Options	2008	Brazil	\$2.5 billion
Bruno Iksil/JPMorgan	Credit Default Swaps	2012	U.K.	\$2 billion
Robert Citron/Orange County, CA	Leveraged Bonds	1994	United States	\$1.7 billion
Heinz Schimmelbusch/Metallgesellschaft	Oil Futures	1993	Germany	\$1.3 billion

figure 4: Large trading losses across three decades

offices. As the number of private family offices grows past 10,000 globally, a parade of investment bankers and media pundits will almost certainly follow.

If your business and career have brought you significant net worth, someone in your inner circle may eventually suggest forming a family office. We understand. After 25 years of helping successful families, this is the reason we formed O.F.O. Partners. We *are* a family business. We've seen how good planning, independence, and experience come together to deliver great outcomes for families undergoing change.

If you are interested in some of the ideas that we have discussed in this letter, let us know. It's springtime, and the days are getting longer. Summer – and better weather – are right around the corner.

Best wishes,

Doug and your friends at O.F.O. Partners

### Questions for you and your family in 2021

1. Should I accelerate large capital gains?
2. How do I secure gifts to future generations?
3. Would a Roth conversion of my IRA make sense?
4. How do I find other tax-deferral strategies?
5. How can I safely generate portfolio income these days?
6. Can I manage my taxable income to remain below new thresholds?
7. Will active and passive investment strategies change my tax burden?
8. What about the taxes I pay related to private and direct investments?
9. Can I benefit from ongoing tax loss harvesting in my portfolio?
10. How exposed are my investments to changes in interest rates or inflation?
11. Who can help me to assess the net affect of these changes on me?
12. Finally, how much will I know before the end of the year?

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