Second Quarter Newsletter

WATERFORD ADVISORS LLC
Relationships Beyond Investing

July 2021

Quarterly Investment COMMENTARY

Our midyear Investment Commentary is divided into two parts. First is a brief recap of our shared investment philosophy; second is our perspective on the current situation. As always, we welcome your questions/comments.

GENERAL PRINCIPLES

- You and our team are long-term, goal-focused, plan-driven equity investors. We've found that the best course for us is to formulate a financial plan and to build portfolios based not on a view of the economy or the markets, but on our most important lifetime financial goals.
- Since 1960, the Standard & Poor's 500-Stock Index has appreciated approximately 70 times; the cash dividend of the Index has gone up about 30 times. Over the same period, the Consumer Price Index has increased by a factor of nine. At least historically, then, mainstream equities have functioned as an extremely efficient hedge against long-term inflation and a generator of real wealth over time.

Gregory L. Kozerski
CPA, CFP®, AIFA®
President

- We believe that acting continuously on a rational plan as distinctly opposed to reacting to current events offers us the best chance for long-term investment success. Simply stated: unless our goals change, we see little reason to alter our financial plan. And if our portfolio is well-suited to that plan, we don't often make significant changes to that, either.
- We do not believe the economy can be consistently forecast, nor the markets consistently timed. We're therefore convinced that the most reliable way to capture the long-term return of equities is to ride out their frequent but ultimately temporary declines.
- The only benchmark we care about is the one that indicates whether you are on track to achieve your financial goals.

CURRENT OBSERVATIONS

- The American economy continued its dramatic recovery in the first half of 2021, spurred by (a) the proliferation of effective vaccines against COVID-19 and the retreat of the pandemic, (b) massive monetary and fiscal accommodation, and (c) its own deep fundamental resilience, which ought never to be underestimated.
- The S&P 500 ended the first half at 4,297 an increase of 15.25% from its close at the end of 2020. Coming into the year, the consensus earnings estimate for the Index in 2021 was around $165; as I write, the consensus for the next 12 months has reached $200 and is still being raised.
- The economy continues to struggle with supply chain imbalances, as well as with a historic mismatch between the number of job openings available and continued high (though rapidly declining) unemployment.

(continued on page 2)

The Waterford Difference *We believe wealth is not measured in dollars but in the absence of financial worry. Love of family and desire for self-determination and dignity is what matters to our clients and to us. That is where the Waterford difference begins.*

The chattering class of pundits and financial journalists continues to speculate on when these blockages will clear; to long-term investors like us, the key is our belief that they will, in the fullness of time.

- We are still in the midst of an unprecedented experiment in both fiscal and monetary policy; the outcome remains impossible to forecast. The possibility that we've overstimulated the economy was highlighted this spring by a significant resurgence in inflation. But as the first half ended, statements by Fed Chair Powell and Governor Bullard indicated a keen awareness of this risk, and a readiness to act against it. The markets evidently took these gentlemen at their word, as inflation hedges like gold and oil sold off, the equity market pulled back modestly, and the yield on the bellwether 10-year U.S. Treasury note retreated to the area of 1.5%. One does not want to read too much into short-term phenomena like these; suffice to say that the Fed appears acutely cognizant that its credibility is almost existentially on the line here.
- There is also the issue of the Biden administration's tax proposals with respect to capital gains and estates taxes. The best that can be said on this subject is that, as the first half ended, the momentum behind these initiatives seemed to be ebbing. But the political climate remains as inimical to capital (and capitalists) as it's been in quite a while.
- Nonetheless, for investors like us, we think the most important economic report of this whole six-month period came just a few days ago. It was that household net worth in this country spiked 3.8% in the first quarter of 2021 to $136.9 trillion propelled by broad gains in the equity market and in-home prices. Even more important, perhaps, is the fact that the ratio of household debt to assets continued to fall and is now back down to about where it was 50 years ago.
- The consumer powers this economy, and the consumer has rarely carried more manageable debt levels relative to disposable income and has simply never been holding more cash than he/she does today. In June, the National Retail Foundation raised its outlook yet again; it now expects retail sales to grow 10.5% to 13.5% (that is, $4.44 trillion to $4.56 trillion) year over year. Just this past month, the retail giant Target raised its dividend by a whopping 32%.

Thank you for your continued confidence and trust in our team. A true compliment is to entrust us in assisting your loved ones to achieve their financial goals as well.

On February 19, 2020 the market's peak just before the pandemic took hold the S&P 500 closed at 3,386. It then proceeded to decline 34% in 33 days, amid the worst global health crisis in a century. But if you bought the Index at that epic top and were still holding it on June 30 of this year, your total return with reinvested dividends has been close to 28%. I've never seen and don't expect to ever see again a more vivid demonstration of Peter Lynch's dictum that ***"The real key to making money in stocks is not to get scared out of them."***

Thank you for being our clients.
It is a privilege to serve you.

TAX CORNER

Changes to Monetary and Fiscal Policy Help Explain Price Inflation

Over the past six months or so, many people have started to notice prices rising across the economy. Whether it be the housing market, cost of lumber, gas prices, or the cost of groceries, a dollar doesn't go as far as it did a year ago. While current inflation can seem drastic when comparing it to recent history, it is important to understand that inflation is normal, and a rate of 2% per year is targeted by the Federal Reserve, the nation's central bank. Much of the increases we notice in prices can also be explained by current events, including expansionary monetary and fiscal policy enacted in recent years.

Macroeconomics: Aggregate Supply and Aggregate Demand and Their Effect on GDP

Macroeconomics focuses on understanding large-scale economic factors like national productivity. One of the most widely used measures of productivity is GDP (Gross Domestic Product); the total value of goods produced, and services provided. GDP can be visualized by the point at which the aggregate supply and aggregate demand curves meet.

The aggregate demand curve (AD) shows total demand for goods and services within the economy. The downward slope highlights the negative relationship between price level and the quantity purchased in the economy—as the price of goods and services increase, the quantity demanded decreases.

The aggregate supply curve (AS) shows the total supply of goods and services available in the economy from producers. The upward slope shows the positive relationship between price level and real GDP in the short run; as price level for output increases, the opportunity for additional profits encourages more production, increasing GDP.

Impact of Recent Expansionary Monetary Policy on GDP

In the United States, the Federal Reserve has been delegated the responsibility for

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controlling monetary policy. The Federal Reserve controls the monetary base with the ability to alter the money supply and credit conditions for investment.

- **Historically Low Interest Rates:** In the past 10 years we have seen the lowest interest rates in modern U.S. history. Low interest rates make it easy for individuals and businesses to borrow money to increase investment and expansion. This expansion can be seen with purchases of homes or financing the construction of new factories and equipment to increase output. The increased demand for investment (building materials and labor) shifts the aggregate demand (AD) curve to the right, increasing GDP and price level.

Impact of Recent Expansionary Fiscal Policy on GDP

Fiscal policy impacts aggregate demand and supply through changes in government spending and taxation. Both government spending and taxation directly affect household income, which impacts consumer spending and saving (investing).

- **Tax Cuts**: The Tax Cuts and Jobs Act (TCJA) was the largest overhaul of the U.S. tax code since 1986. Enacted in December 2017 following a 9-year bull market when the S&P 500 index traded at approximately 2,700 (up from the market bottom of ~735 in December 2008), the Act focused on widespread tax cuts for individuals and corporations. From an economic perspective, lowering taxes raises disposable income, allowing consumers to spend additional sums. This positive demand shock shifts the AD curve to the right, increasing both GDP and price level.
- **Tariffs and Sanctions**: The past few administrations have seen several adjustments to trade deals, tariffs, and sanctions imposed (or planned to be imposed) on foreign countries. This is a reversal from the policies of the 1980s to early 2000s which focused on lowest-cost, just-in-time global supply chains. These are widely enacted in the form of taxes imposed on imported goods, paid by the U.S. consumer, to make the cost of these imported goods higher than or comparable to domestically produced products. The result of this is a leftward shift in the supply curve, increasing price but slightly decreasing GDP.

(continued on page 5)

WORKING WHILE COLLECTING
Social Security Benefits

Yes, you can collect Social Security benefits while working. However, depending on your age, there are some important caveats to keep in mind.

Your earned income could reduce the amount of your Social Security benefits if you are younger than your full retirement age (FRA); the age at which you qualify to collect 100% of your Social Security benefits. Before your FRA, the Social Security Administration does not consider you to be "fully retired" if you make more than a certain amount from working. They will reduce a portion of your Social Security benefits if your earnings exceed the annual limit. Once you reach your FRA, however, there is no adjustment to your Social Security benefits based on your earned income.

The current earnings limits are as follows:

- In 2021, you lose $1 in Social Security benefits for every $2 of earned income over $18,960. For example, if you have a part-time job that pays $20,000 per year, your earned income is $1,040 over the limit; therefore, Social Security will deduct $520 in benefits for that year.
- In the year you reach your full retirement age, you lose $1 in Social Security benefits for every $3 of earned income over $50,250. This applies until you reach your FRA; after that, the earnings limit doesn't apply.

It's important to keep in mind that the earnings limit also applies to those receiving spousal benefits, children's

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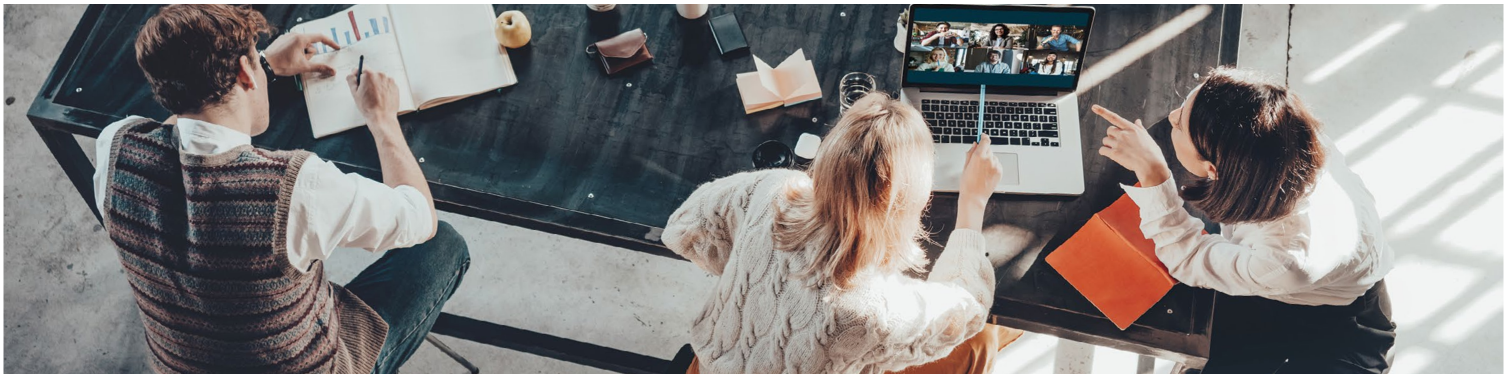
benefits, and survivor benefits. Anyone receiving benefits based on your work record, such as a spouse or a child, could also be affected by these adjustments if your payments are reduced due to the limits. If your spouse has started collecting Social Security benefits early and you're collecting spousal benefits based on their work record, then both of your benefits could be reduced due to their earnings level if it exceeds the limits. However, your spouse's income is not counted towards the earnings limit related to your own benefits, even if you file jointly on your income tax return. Social Security does not count both spouse's incomes against one spouse's earnings limit—they only count what you make from working while receiving benefits.

It's not all bad news though—benefits that you lose while working before your FRA will be recouped later. When you reach your FRA, Social Security will increase your monthly benefit to account for what was previously withheld. See the following example for clarification on how this works:

- Suppose you turn 62 in 2021 and claim Social Security. Your monthly benefit is $1,200 and you earn $25,000 annually through a part-time job. For the year, Social Security withholds $3,020 from your payments (half of the $6,040 by which you exceeded the earnings limit). That works out to 2.5 months of benefits lost, which Social Security rounds up to 3 months.
- Now suppose you continue to lose 3 months of benefits per year until you reach your FRA—that's 66 years and 10 months for people like you who were born in 1959. That works out to an estimated 15 months of withheld benefits. When you hit your FRA, Social Security will reset your benefit as if you'd filed only 43 months early rather than 58 months early. (The difference is that you get 70.8% of your "full" benefit at 58 months early vs. 77.1% at 43 months early.)

The additional years worked could also increase your benefit payments if the earnings for these years are among your 35 years of highest earnings. This would increase your lifetime average for monthly income and would raise your overall benefit amount.

Social Security only considers income earned from work for the earnings test. If you're self-employed, they would count your net income only. They do not count income from interest, capital gains, retirement account distributions, pensions, or annuities.



Social Security will automatically make the necessary adjustments based on the earnings information it receives from your W-2s and income tax returns. However, you can report your estimated income to Social Security as soon as you're aware of your estimated income levels. Here's how it works:

- At the beginning of the year, you notify Social Security what you expect to earn that year, by phone at 800-772-1213, or in person at your local Social Security office. (Note that some offices may be closed due to COVID-19.) You can update the estimate at any time if your work situation changes.
- Based on this information, Social Security stops your monthly benefit until they recover the necessary amount based on how much your income exceeds the limit.
- At the end of the year, you notify Social Security what you've earned, and they revise the calculation. If it turns out they withheld too much, you'll get a refund. If they didn't withhold enough, you'll have to pay the difference.

Self-reporting your estimated income early has the advantages of timeliness and relative certainty. If you wait for the Administration to receive your tax documents, Social Security receives data on your income after you've earned it and may not implement the benefit withholding until many months later. Waiting can often result in receiving a fairly large "bill" from the Social Security administration looking to recoup the amount of temporarily overpaid benefits. This can come as quite a shock if it's not anticipated and there's a chance you may not have the cash readily available to pay the bill.

Waterford Advisors, LLC's financial planners are always available to answer any specific questions that you may have regarding your unique situation and benefits. Please feel free to contact our office at any time.

As always, we welcome your comments or questions and invite you to share our newsletter with family and friends.

TAX CORNER

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- **Government Spending**: At the time this article was written, the Government has spent over $6 trillion on stimulus packages since the start of the pandemic. (This includes the CARES Act with $2.2 trillion in April 2020, the Omnibus Spending Bill with $2.3 trillion in December 2020, and the American Rescue Plan with $1.9 trillion in March 2021.) This is the largest Government stimulus in recent history, significantly higher than the approximate ~$900 billion stimulus during the 2007-2009 financial crisis. As would be expected, the Government stimulus paid to businesses and individuals during this time would raise disposable income. This creates a positive demand shock, and shifts the AD curve to the right, increasing both GDP (to offset reduced productivity) and prices.

Impact of COVID-19 Shutdowns

While Government-enacted expansionary monetary and fiscal policy has played a role in recent price inflation, it is important to note that the business environment as a result of shutdowns resulting from the COVID crisis have also played a significant role in price inflation. During the past year many businesses and producers were required to shut down or scale down their output. Reduced output leads the aggregate supply curve to shift left, decreasing GDP but increasing price.

In Conclusion

These current events and recent policy have influenced the increase to price inflation that we as a country, and the world, have noticed in the past year. While the media has talked about concerns of hyperinflation, a period where both price and GDP increase, it is important to note that all of the aggregate supply changes that increase price actually decrease GDP, moving the economy towards stagflation and a more balanced GDP.

The events of the global economy over past two years highlight that no one can truly predict the future or how the market will react to global events. This leads to the question—how should these recent changes that have impacted prices change my investment portfolio? The simple and obvious answer is, **they shouldn't**. Inflation: the long, slow decline of purchasing power is the reason we are equity investors. Inflation isn't a signal to flee equities, it is the reason we invest in them. Over full market cycles, mainstream equities have been the most efficient protection of wealth from inflation ever created.

As always, if you have concerns or questions about your financial goals or investment portfolio, please do not hesitate to reach out to our team for assistance.

Using Annuities to Increase Predictable Income IN RETIREMENT

The management of a distribution portfolio is unique and should be designed differently from the management of an accumulation portfolio. However, complex distribution planning is still a developing area within the arena of Financial Planning. After focusing much of your investment lifetime on maximizing wealth accumulation through contributions and rates of return, your attention must shift entirely towards generating a sustainable income level for an indefinite period—the remainder of your life. Keeping this in mind, let's look at some of the ways that income annuities can be used to complement fixed income (bond funds) as a portion of the product allocation of your retirement portfolio.

The Role of an Income Annuity in a Retirement Cash Flow Plan

There are two key principles that we believe should guide the use of income annuities in place of bonds and bond funds in a retiree's portfolio. First, you should try to cover as much of your essential expenses (utilities, food, healthcare, etc.) as possible with guaranteed income sources such as Social Security, pension benefits, and income annuities. The greater the portion of your desired spending level that is covered through "secured income sources," the greater your ability to use systematic withdrawals from your investment portfolio (fluctuating income) to help cover discretionary spending (hobbies, vacations, etc.).

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CFP®, EA
Principal

The second important principle is creating your retirement income stream through a combination of varied sources (product diversification), similar to the way that you have propagated your investments (asset diversification) during your wealth accumulation years. Using an income annuity as one of multiple sources for generating retirement income can help mitigate the following:

Market Risk/Interest Rate Risk

As previously mentioned, the primary focus of a retirement portfolio is to generate an indefinite, sustainable income stream. The greater the substitution of income annuities for the bond allocation of a portfolio, the more interest rate risk is reduced while simultaneously securing a percentage of the desired income level. Rising interest rates will lead to falling bond prices and may force a retiree to lock in capital losses, as assets will need to be sold to satisfy their cash flow objectives. A rising interest rate environment, which we will inevitably experience, would pose no risk to the income annuity allocation of a retiree's portfolio.

Longevity Risk

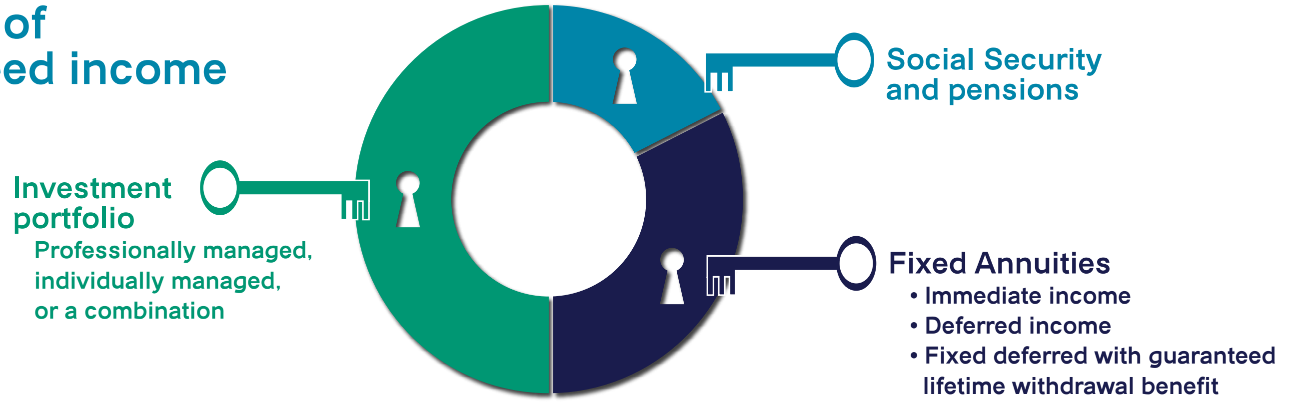
Income annuities provide longevity protection, which is unattainable with fixed income investing through traditional bonds or bond funds. Income annuities can provide income for an indefinite period (single or joint lifetimes) but trying to meet spending objectives solely using bonds or bond funds will certainly result in portfolio depletion.

With income annuities, the issuing insurance company invests the capital primarily in a fixed income portfolio of funds and can therefore be considered a reasonable substitute for the retiree's bond allocation. However, the insurance companies that issue income annuities can use a risk-pooling feature that can provide the retiree with something traditional bonds or bond funds cannot —mortality credits. Individuals that end up experiencing short retirements will subsidize the income stream of those that will experience extended retirements. This concept is known as "longevity protection".

Why Annuitize a Portion of Retirement Capital?

Guaranteed income products, such as deferred or immediate income annuities, serve a specific purpose for retirees. They transfer risks that are unique to a retirement portfolio's interest rate/market risk and longevity risk from the retiree to

Sources of guaranteed income



the issuing insurance company. These products are designed for individuals seeking to trade growth potential for a guaranteed lifetime income stream; this should be the paradigm shift of a new retiree's thought process. Like any investment product, they are not right for everyone, and part of the tradeoff is giving up some flexibility (liquidity), which is why it is better to substitute a portion of your bond allocation rather than all of it. Also, note that annuity payments are based upon the financial strength rating and claims paying ability of the insurer. However, life offers few guarantees, particularly when it comes to personal finances. The peace of mind that comes with knowing that you will have sufficient income that you will not outlive and can rely on may be well worth the tradeoff.

At Waterford Advisors, LLC we are developing expertise that involves incorporating income annuities into our clients' Retirement Cash Flow plans. The financial metrics we are hoping to improve through utilization of this strategy include a reduction of the average withdrawal rate on the retiree's portfolio as well as an increase to the retiree's funded ratio (present value of cumulative assets as a portion of total liabilities). As a result, this should also increase the retiree's retirement sustainability quotient (the probability that they do not run out of funds before they run out of time). If you would like to inquire about this, please feel free to contact our office.

Waterford

HAPPENINGS

Here's the latest from your friends at Waterford Advisors…

Marybeth Rose
Planning Associate

Congrats Dan!

We would like to wish a very special "Congratulations" to Dan and Jill Byles-Smith on the safe arrival of a new addition to their family! Emily was born June 16, 2021 weighing 6 lbs. 5 oz. and measuring 20 inches long. Both Jill and baby Emily are doing very well. Dan and Jill are happy to share in the excitement with big brothers Thomas (5) and Jonathan (2).

Samantha Thomas

Welcoming Sam to the Waterford Team

Please join us in welcoming Samantha Thomas to our firm as a full-time Junior Planner! Sam graduated in May from the University at Buffalo with her Bachelor of Science in Business Administration with a concentration in Financial Analysis. She will be assisting our Financial Planning and Tax Departments with meeting preparation and follow up, data entry for retirement cash flow plans, account paperwork, trading and portfolio rebalancing, and tax return preparation.

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HEART For Animals

This summer, Waterford is helping HEART Animal Rescue curb kitten overpopulation by donating to cover spaying and neutering fees for cats in their care. Millions of healthy, adoptable animals are euthanized simply because there are not enough homes for them. Spaying or neutering your pets is the most effective way to reduce the vast number of animals who are born only to die prematurely without a family to love them. The pet overpopulation issue can be solved if everyone takes one small step, starting with preventing our pets from breeding. Please visit **heartforanimals.org** to learn more.

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Inside this issue…

Tax Corner
Page 3

Increasing Predictable Income with Annuities
Page 6

Working While Collecting Social Security Benefits
Page 4

Happenings
Page 7