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MARSHALL & SULLIVAN

Marshall & Sullivan, Inc. / Registered Investment Advisor

Winter 2018 newsletter

Steady As We Go

In our winter 2017 newsletter titled "Emotional Quarter", Donald Trump had just been elected and emotions were running high. At the time, we counseled clients to look past the noise and focus on the economy. This advice paid off as the S&P 500, Dow Jones, NASDAQ and most international indices hit all-time highs with most finishing up the year close to their high water marks.

Unlike the news media, stock markets were not particularly emotional in 2017. Indeed, the Dow Jones Industrial Index only had 10 days where it moved more than 1% in either direction. The steady stock market was further aided by falling unemployment rates, expanding domestic and global economies, growing earnings, low interest rates, and proposed tax law changes.

With the proposed tax amendments now law, questions have been coming in to us fast and furious on how best to take advantage of the changes. Since we aren't tax accountants, personal tax matters are generally referred to each client's individual tax professional for assistance. That said, most clients tend to the delay taxes so we manage portfolios in a tax efficient manner whenever possible by accelerating the sale of loss positions and delaying the realization of gains when prudent.

As portfolio advisors, we are greatly interested in whether or not certain portfolio changes should be considered due to the reduced corporate tax rates.

Generally speaking, the recent tax cuts will likely make many businesses worth more as a whole. Investors purchase companies based on earnings. All else being equal, net income tends to increase as taxes go down. As with individuals, each company will be affected differently. For example, some large technology companies paying taxes in the 14 -16% range could end up paying more in taxes on their profits in 2018. On the other hand, multinational businesses that have amassed considerable cash outside the United States may benefit from lower tax rates allowing those currencies to be repatriated back into US dollars.

Banks are in a very different position. A number are still carrying tax loss carry-forwards on their books from the 2008 financial crisis. This has been beneficial to earnings over the past few years because they have been able to use these losses to pay lower taxes as earnings turned positive. Banks carry this as an asset on their books; but, with lower tax rates these assets are now worth less. In 2018, they will likely need to write down the value of these assets lowering earnings and valuations.

There are many examples of how the new tax laws will affect individual companies and industries differently. The key for Marshall & Sullivan is that most of these are one-time items. When we review a company, we always normalize earnings projections by removing one-time items in order to get a better picture of the actual value for the business.

For instance, a bank will see earnings shrink because of the one-time write down of their tax loss; but, the following year, earnings will rebound. For the company that pays less in taxes due to tax law changes, a one-time jump in earnings will occur; the next year, earnings growth will return to normal. The key for us is to concentrate on sustainable earnings growth at a fair price.

For the stock markets to maintain their upward climb, we will need to see the primary trends of 2017 continue. We think this will happen, although perhaps not as robustly. We also expect to see a bit more volatility and the inevitable pullbacks along the way. We believe that the market will end the year higher than it started. The key for Marshall & Sullivan will be sticking to our strict buy and sell disciplines and asset allocation models.

Greg Robinson, President
greg@msinvest.com

Davis Miracle, Vice President
davis@msinvest.com